

May 20, 2015

Ms. Lisa A. Snyder, Director  
AICPA Professional Ethics Division  
1211 Avenue of the Americas, 19<sup>th</sup> Floor  
New York, NY 10036-8775

**Re: December 10, 2014 Professional Ethics Executive Committee (PEEC) Exposure Draft (ED) of a Proposed Interpretation, *Firm Mergers and Acquisitions***

Dear Ms. Snyder:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to speak on behalf of local and regional firms and represent those firms' interests on professional issues in keeping with the public interest, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective.

TIC has reviewed the ED and is providing the following comments for your consideration.

**GENERAL COMMENTS**

TIC appreciates the Committee's efforts in providing guidance on independence issues that may arise during mergers and acquisitions, but believes the nonattest services section of the proposal is unnecessarily complex. TIC favors an interpretation that would provide one set of evaluation criteria, based on a threats and safeguards approach, for all firms that are party to the merger or acquisition. Such criteria would require an evaluation of all prohibited nonattest services that are performed by either party to the acquisition or merger during any financial statement period covered by an attest report issued subsequent to the effective date of the merger and would result in the deletion of paragraph .05 and the revision of paragraphs .06 and .07.

TIC also had concerns with certain specific provisions of the ED. For example, the assertion in paragraph .07b that an evaluation of threats and safeguards should be based on whether the acquiring firm assumes responsibility for the nonattest services performed by the acquired firm could result in unintended consequences that would not be in the public interest. TIC has some additional recommendations to clarify evaluation periods and certain terminology used in the ED.

TIC also believes that a one-year transition period will be necessary.

## **SPECIFIC COMMENTS**

### **Employment or Association with an Attest Client**

TIC agrees with the guidance in this section of the proposed interpretation.

### **Nonattest Services**

#### *Questions for Respondents*

1. *The PEEC is proposing that, in situations where 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, the threats created would be so significant that they could not be reduced to an acceptable level and, therefore, independence would be impaired. Do you agree with this conclusion or would an evaluation of threats and application of safeguards be a more appropriate approach, similar to the guidance for instances where the acquired firm performed prohibited nonattest services to an attest client of the acquiring firm?*

TIC believes the criteria for determining independence in a merger or acquisition should not differ based on which firm performed prohibited nonattest services for the other firm's attest clients. Criteria based on the evaluation of threats and the application of safeguards seem more logical than assuming that no safeguards could apply.

TIC believes that it is possible for relationship changes to occur between the time that the prohibited nonattest services were performed and the start of the attest engagement that could reduce or eliminate the perceived threat to independence such that appropriate safeguards could be applied. For example, assume the acquiring firm performed the prohibited nonattest services for a subsidiary of the company at the beginning of the period covered by the financial statements and the subsidiary was sold a month later. Also assume that the effective date of the acquisition was at the end of the calendar year of the attest client of the acquired firm. In this case, the usual self-review, management participation and advocacy threats may be quite low in some circumstances. The acquiring firm should be given the option to evaluate the threat and consider possible safeguards before assuming that independence has been impaired. TIC believes the automatic presumption of impairment should be avoided wherever possible because of the difficulty inherent in predicting every possible circumstance that could affect independence.

TIC would agree, however, that one of the criteria to be considered in the evaluation of threats and application of safeguards is if the prohibited nonattest service was provided by the acquiring firm.

Please refer to Question 2 below for TIC's recommendation as to the criteria that should be applied when one of the firms involved in a merger or acquisition has performed prohibited nonattest services for attest clients of another firm involved in a merger or acquisition.

2. *Paragraph .07b of the proposal requires an evaluation of the threats to be performed on the basis of the attribution of the results of the nonattest services to the acquiring firm (that is, whether the acquiring firm will assume responsibility for such services) when prohibited nonattest services were provided by the acquired firm to an attest client of the acquiring firm. Is this guidance sufficiently clear?*

No, TIC believes the proposed guidance is difficult to read and overly complex to apply, especially the section that addresses prohibited nonattest services that were performed by the acquired firm for an attest client of the acquiring firm during the period covered by the financial statements. In particular, TIC did not agree with the assertion in paragraph .07b that an evaluation of threats and safeguards should be based on whether the acquiring firm assumes responsibility for the nonattest services performed by the acquired firm.

For example, assume the acquired firm performed prohibited nonattest services for the acquiring firm's attest client prior to the start of merger negotiations but during the period covered by the financial statements. The acquiring firm could assert that it had no responsibility for those services because they preceded the period during which the merger was pending. Under paragraph .07(b)(ii), those nonattest services would not have to be evaluated for impairment of independence. However, under this provision, the partner in the acquired firm that performed (or had oversight over) those nonattest services could theoretically become the partner that would oversee the attest engagement in the combined firm. TIC believes this possible outcome would pose a self-review threat that should be evaluated as a potential impairment to the acquiring firm's independence.

Therefore, TIC recommends that paragraphs .06-.07 be revised to apply to prohibited nonattest services performed by either firm. In addition, paragraph .07 should be simplified to require evaluation of threats and safeguards for all prohibited nonattest services provided by either firm during the periods not previously covered by a predecessor firm's attest report, and the evaluation criteria in paragraph .07b should no longer depend on whether or not the acquiring firm assumes responsibility for the prohibited nonattest services performed by the acquired firm.

### **Additional Recommendations Relating to Paragraph .07**

Even if PEEC decides not to adopt TIC's suggested criteria, TIC recommends some additional clarification of paragraphs .07a and .07b to address certain unclear and inconsistent guidance.

### **Issues Associated with "Period of the Professional Engagement"**

Paragraph .07 refers to the period of the professional engagement or the period covered by the financial statements as the period during which independence could be impaired if the acquired firm performs prohibited nonattest services to an attest client of the acquiring firm during that time. TIC believes the reference to “the period of professional engagement” adds complexity to the proposed interpretation and may create contradictory guidance between paragraphs .06 and .07 of the ED.

The AICPA *Code of Professional Conduct* (ET paragraph 0.400.39) defines the “period of the professional engagement” as:

*The period begins when a member either signs an initial engagement letter or other agreement to perform attest services or begins to perform an attest engagement for a client, whichever is earlier. The period lasts for the entire duration of the professional relationship, which could cover many periods, and ends with the formal or informal notification, either by the member or client, of the termination of the professional relationship or by the issuance of a report, whichever is later. Accordingly, the period does not end with the issuance of a report and recommence with the beginning of the following year’s attest engagement.*

Based on the above definition, the period of the professional engagement could begin prior to the financial statement period covered by the acquiring firm’s next attest report. For example, the acquiring firm may sign an engagement letter with a new attest client in October 2014 for the audit of the calendar year 2015 financial statements. Assume the acquired firm performed prohibited nonattest services for the same client in December 2014. This example creates an inconsistency in that the fact pattern falls under the scope of paragraphs .06 and .07, each of which reaches a different conclusion regarding the impairment of independence.

The language in paragraph .06 implies that independence would not be impaired because the prohibited nonattest services were performed by the acquired firm in December 2014, which is prior to the financial statement period covered by the acquiring firm’s next attest report. However, paragraph .07 also seems to apply because the acquired firm provided the prohibited nonattest services to an attest client of the acquiring firm during the period of the professional engagement (i.e., shortly after the attest engagement letter was signed). If the example falls under the scope of paragraph .07, further evaluation is needed to determine whether independence has been impaired. TIC believes this outcome was not PEEC’s intent.

Upon further examination of the definition of the “period of the professional engagement,” TIC also noted that PEEC’s intent may not be clear regarding the independence evaluations that may be necessary for subsequent financial statement periods. That is, if the prohibited nonattest services were also provided in the period following the firm’s next attest report, it seems it would also be appropriate to evaluate the effect of those services on the firm’s independence.

For example, assume the following fact pattern:

- An attest client of the acquiring firm has a December 31, 2014 year-end.
- Prohibited nonattest services were provided by the acquired firm during 2015 and terminated on February 28, 2015, which is prior to the effective date of the merger.
- The merger occurs on March 15, 2015
- The attest report for December 31, 2014 is issued on April 30, 2015.

According to the criteria in paragraph .07, the acquiring firm would have to conduct an independence evaluation for the calendar year 2014 attest engagement. Since prohibited nonattest services were provided for the first 2 months of 2015 and terminated prior to the merger date, an independence evaluation would also be required for the calendar year 2015 attest engagement.

Therefore, to improve the clarity of the interpretation and eliminate the potential contradictory guidance inherent in the phrase “period of the professional engagement,” TIC recommends simplifying the criteria in paragraph .07 to “periods not previously covered by a predecessor firm’s attest report.” TIC believes this phrase would clarify that the prohibited nonattest services could impact the current year’s financial statement period, as well as the following year, and would eliminate the contradiction noted above in the “period of the professional engagement.”

Whatever PEEC decides to use as the criteria in paragraph .07, TIC recommends that the final interpretation include illustrative examples to ensure that the paragraph is interpreted correctly.

*Connector Needed Between Subparagraphs .07a and .07b*

The relationship between subparagraphs .07a and .07b is unclear as stated and could be misinterpreted. Without clarification, TIC believes members may fail to realize that the evaluation in paragraph .07b is also required after the acquired firm terminates the prohibited nonattest services (paragraph .07a). TIC suggests that the lead-in sentence to subparagraphs (a) and (b) be changed to:

*...the acquiring firm’s independence would not be impaired, provided that all of the following are met:*

Alternatively, the lead-in could be left as is and the connector “and” could be added to the end of paragraph .07a.

*Clarification Needed Relating to Assuming Responsibility for Prohibited Nonattest Services Performed and the Related Evaluation Periods*

If finalized as written, determining whether the acquiring firm is “assuming responsibility” for the results of the prohibited nonattest services performed by the

acquired firm could cause implementation issues. The term “assume responsibility” is subject to varying interpretations, which could range from assuming legal liability for the nonattest services (if challenged) to agreeing to assume all risks associated with those services (legal or otherwise). If PEEC prefers not to add the parenthetical phrase “(that is, be held liable or accountable, or both)” from page 7 of the ED, then additional guidance or an example should be provided to clarify the Committee’s intent.

Paragraphs .07(b)(i) and .07(b)(ii) specify different evaluation periods depending on whether or not the nonattest services can be attributed to the acquiring firm. Paragraph .07(b)(i) applies if the prohibited nonattest services performed by the acquired firm can be attributed to the acquiring firm. TIC did not understand why the evaluation period in this case was limited to the financial statement period to be covered by the acquiring firm’s next attest report. TIC suggests that explanatory guidance be included in the final interpretation to clarify PEEC’s rationale.

TIC was also confused by the wording in subparagraph .07(b)(ii). This subparagraph applies if the nonattest services performed by the acquired firm cannot be attributed to the acquiring firm. However, the proposal would require the acquiring firm to evaluate all prohibited nonattest services that the acquired firm performed for the attest client of the acquiring firm during the period in which the merger or acquisition was pending (that is, from the commencement of negotiations through the effective date of the merger or acquisition). In many, if not most, cases, the period during which the merger or acquisition was pending could be considerably longer than the period of professional engagement or the period covered by the financial statements. As discussed above, TIC believes the evaluation period should be the period to be covered by the acquiring firm’s next attest report and recommends that paragraph .07(b)(ii) be clarified accordingly.

Finally, paragraph .07(b)(ii) defines “the period in which the merger or acquisition was pending” as the period “from the commencement of negotiations through the effective date of the merger or acquisition.” However, the date of the commencement of negotiations is subject to interpretation. For example, the commencement of negotiations could be the date that the firms agree in principle to merge or when they start talking about the possibility of a merger or acquisition. TIC believes the only date that would be operational is the date that the firms agree in principle to merge. TIC therefore recommends that PEEC clarify the definition to that effect.

#### *Editorial Comment*

The explanatory memorandum on page 7 and paragraph .02 of the ED erroneously refer to paragraphs 11-18 in FASB ASC 805-10-55 for guidance on identifying the acquirer in a business combination. The applicable paragraphs should be 11-15, not 11-18.

### **Effective Date**

3. *Is the effective date for the proposal appropriate or is a transition period necessary? If a transition period is necessary, please explain why and indicate what time period would be sufficient.*

TIC believes a one-year transition period is necessary to accommodate mergers and acquisitions in process. In larger firms, especially, thousands of personnel and client relationships will need to be evaluated; and until the acquisition or merger is consummated, neither side may know the extent of such relationships. Firms will need a transition period to become aware of independence issues resulting from the merger and, in some cases, to upgrade their processes and systems to identify and resolve these issues.

TIC also recommends that the Professional Ethics Division heavily publicize the final interpretation. Targeted education will be necessary to emphasize that firms need to review their processes and procedures for identifying independence issues resulting from a merger or acquisition to ensure that the combined firm can appropriately identify any potential or actual independence impairments in a timely fashion.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,



Scot Phillips, Chair  
PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees