

AICPA Private Company Practice Section Inadvertent Independence Violations Practice Tool

Objective

Members of the AICPA are required by the bylaws to adhere to the rules of the AICPA Code of Professional Conduct (the code). The code requires that if a member's independence is impaired, the member should be prepared to justify his or her departure from Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. 01). The purpose of this tool is to assist members, particularly those practicing in small and medium size firms, to properly assess the impact an inadvertent independence violation may have on the attest engagement team's integrity, objectivity, or professional skepticism, so they can determine if a departure is justified. This tool is not authoritative, and it is not intended to suggest that a technical independence violation of the code can be cured or ignored. This tool presents suggested steps to be taken and related courses of action in dealing with matters that represent technical breaches of AICPA independence requirements. Following the suggested steps and related courses of action in this tool will not prevent an investigation or enforcement action by the AICPA, state board, or other regulator. The following information outlines the advice and guidance a member would likely receive from the AICPA's Ethics Hotline if he or she called to discuss a similar situation.

Handling Inadvertent Independence Violations

For purposes of this tool, an *inadvertent independence violation* is a matter that occurs when a member or a firm unintentionally and unknowingly violates an independence rule, and when the threat to independence is insignificant such that the attest engagement team's integrity, objectivity, and professional skepticism are not compromised. An inadvertent violation is *not* a situation in which a member of the attest engagement team knowingly chooses to violate the rules, is ignorant of the rules, or has not taken steps to understand the rules.

In order for an independence violation to be considered inadvertent, the firm must 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. The policies and procedures should enable the firm to communicate its independence requirements to its personnel and, when applicable, others subject to them; to identify and evaluate circumstances and relationships that create threats to independence; and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards or, if effective safeguards cannot be applied, withdrawing from the engagement. These policies and procedures should be designed to provide the firm with reasonable assurance that it is notified of breaches of independence requirements and to enable it to take appropriate actions to resolve such situations.

If a firm has the preceding established policies and procedures in place, then it is possible that after analyzing the violation using the following methodology, a member could determine that the violation is inadvertent because, based on the specific facts and circumstances of the particular matter, the attest engagement team's integrity, objectivity, and professional skepticism were not compromised in the circumstances. When conducting this analysis, members should consider the appearance of independence.

Tool

Upon discovering an inadvertent independence violation, a member should gain a thorough understanding of the matter so that the member can determine if he or she is able to demonstrate that a departure from

Rule 101 does not affect the integrity, objectivity, and professional skepticism of the engagement team and, therefore, their independence was not compromised. Following are some situations involving independence departures along with some suggested questions that members may find useful when analyzing a violation. Documentation of the member's analysis would be a prudent step, given that multiple parties (such as internal personnel, peer reviewers, and regulators) may request documentation of your analysis.

FINANCIAL INTEREST MATTER

The member or his or her immediate family inadvertently purchases or otherwise obtains a financial interest in an attest client, and the financial interest is a technical violation of independence rules. This does not include unsolicited financial interests that are covered under Interpretation No. 101-15, "Financial relationships," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101, par. .17).

ANALYSIS OF INADVERTENT VIOLATION

1. Does the firm have controls in place designed to prevent such investments? If so, why weren't they effective? If not, would the violation have been prevented by controls? Were any controls put in place to prevent future violations from occurring?
2. Was the violation due to misinterpretation of the rules or lack of knowledge of the rules? If so, what training will be implemented to prevent the violation from occurring again?
3. Should the member have known that he or she was violating the independence requirements, or was it an isolated oversight? If so, what procedures or training will be implemented to prevent the violation from occurring again?
4. What actions were taken upon discovery of the violation (that is, was the violation corrected immediately, reported to appropriate parties within the firm, at the client or at the client's regulator, or was any disciplinary action implemented)?
5. What safeguards can be implemented or actions taken to eliminate or reduce the threat(s) to independence to an acceptable level?

MEMBER'S CONSIDERATIONS

- Consider requirements of AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1).
- Dispose of the financial interest immediately upon discovery.
- Determine whether to discuss the matter with those charged with governance.
- Assess the quality control system and, if necessary, implement controls and procedures to prevent the violation from occurring again.
- Take appropriate training to prevent the violation from occurring again.
- If the member has a prohibited financial interest during the period of the professional engagement, he or she should normally wait to provide attest services again until the client's financial statements for the period covering the impairment are attested to by an independent firm (equivalent or higher level of attest services). Alternatively, a one-year cooling off period might also be appropriate. In either case, if the violation would not affect the financial results being attested to and the violation was caused by an inadvertent oversight, then the member would have to use his or her professional judgment to determine if a cleansing engagement or cooling off period is necessary.
- ***Firms with more than one professional*** should also assess the threat to determine if the attest engagement team's integrity, objectivity, or professional judgment was compromised. If it was compromised (that is, threats are not at an acceptable level), apply necessary safeguards, such as (1) removing the individual from the engagement team and from a position to influence the engagement until the subsequent year's engagement, and (2) having the individual's attest work reperformed or reviewed by an individual or firm that is independent from the client.

NONATTEST SERVICE MATTER

The member or his or her firm intentionally provides a nonattest service, but inadvertently provides it to an attest client and impairs independence (for example, member is not aware the client is an affiliate of an attest client), or the member inadvertently fails to comply with any requirements of Interpretation No. 101-3, “Performance of nonattest services,” under Rule 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05) (for example, inadvertently fails to meet general requirements of Interpretation No. 101-3; inadvertently performs a general activity impairing independence as defined by Interpretation No. 101-3; or otherwise inadvertently fails to comply with any specific provision of Interpretation No. 101-3); or, the member inadvertently violates the more restrictive independence provisions of another regulatory body (when the engagement is subject to the regulatory requirements of such body).

ANALYSIS OF INADVERTENT VIOLATION

1. Does the firm have controls in place designed to prevent such violations? If so, why weren’t they effective? If not, would the violation have been prevented by controls? Were any controls put in place to prevent future violations from occurring?
2. Was the violation due to misinterpretation of the rules or lack of knowledge of the rules? If so, what training will be implemented to prevent the violation from occurring again?
3. Should the member have known that he or she was violating the independence requirements, or was it an isolated oversight? If so, what procedures or training will be implemented to prevent the oversight from occurring again?
4. Are the fees from the nonattest service insignificant to the fees of the attest engagement?
5. What actions were taken upon discovery of the violation (that is, was the violation corrected immediately, reported to appropriate parties within the firm, at the client or at the client’s regulator, or was any disciplinary action implemented)?
6. What safeguards can be implemented or actions taken to eliminate or reduce the threat(s) to independence to an acceptable level?

MEMBER’S CONSIDERATIONS

- If impairment occurred during a year that has already had a report issued, consider requirements of AU section 561.
- Cease the service immediately upon discovery.
- If the member provided prohibited nonattest services during a period when another independent firm attested to the financial statements, independence would not be impaired unless a need exists for the member to opine on a restatement.
- Conclusion reached will depend upon the service provided, the significance of the matter, and the number and types of threats that exist. Usually, it is more difficult to justify that the engagement team's integrity, objectivity, and professional skepticism is not compromised when a management participation threat exists (for example, when the member made management decisions or took on management responsibilities through the provision of the service).
- Once a member has provided prohibited nonattest services, he or she should normally wait to provide attest services until the client’s financial statements for the period covering the performance of the prohibited nonattest services are attested to by another independent firm (equivalent or higher level of attest services).
- Prohibited nonattest services performed in a subsequent year but affecting the year subject to audit could impair independence in both years. If the violation would not affect the financial results, was performed for an operation or element of the financial statements that was insignificant to the clients overall operations, and was caused by an inadvertent oversight, the member would have to use professional judgment to determine the steps necessary, if any, to address the violation.
- If independence is impaired due to the performance of certain nonattest services (such as appraisal, valuation, or actuarial services), it may be possible to restore independence if the client

engaged another professional services firm that is independent of the audit firm to (1) reperform the entire service, or (2) reperform the nonattest service to the extent necessary to take responsibility for that service.

- Consider whether to communicate the matter to those charged with governance and ensure that all general requirements of Interpretation No. 101-3 with respect to the services rendered were met during the period covered by the financial statements and the period of professional engagement.
- If the member failed to meet the more restrictive requirements of another regulatory body, the member should follow any relevant guidance under that body's rules. If that body has an inadvertent violations provision, the member must meet the requirements for relief under that body's guidance.

EMPLOYMENT AND ASSOCIATION MATTER

The member or his or her immediate family or close relative inadvertently becomes associated with or employed by an attest client in a manner that impairs independence. Either the association and employment is inadvertent, or the member is not aware that the client is an attest client.

ANALYSIS OF INADVERTENT VIOLATION

1. Does the firm have controls in place designed to prevent such violations? If so, why weren't they effective? If not, would the violation have been prevented by controls? Were any controls put in place to prevent future violations from occurring?
2. Was the violation due to misinterpretation of the rules or lack of knowledge of the rules? If so, what training will be implemented to prevent the violation from occurring again?
3. Should the member have known that he or she was violating the independence requirements, or was it an isolated oversight? If so, what procedures or training will be implemented to prevent the oversight from occurring again?
4. What actions were taken upon discovery of the violation (that is, was the violation corrected immediately, reported to appropriate parties within the firm, at the client or at the client's regulator, or was any disciplinary action implemented)?
5. What safeguards can be implemented or actions taken to eliminate or reduce the threat(s) to independence to an acceptable level?

MEMBER'S CONSIDERATIONS

- If impairment occurred during a year that has already had a report issued, consider requirements of AU section 561.
- Remove the individual from the engagement team or terminate employment or association with the client and have the individual's attest work re-performed or reviewed by an individual outside or within the firm that is independent. If a sole practitioner, consider terminating the employment relationship or attest engagement immediately.
- Discuss the matter with those charged with governance.

Other Regulators Guidance

When certain safeguards are present, the Securities and Exchange Commission (SEC) allows the provision of certain prohibited nonattest services if the services are not subject to audit procedures during the audit, whereas the International Ethics Standards Board of Accountants and U.S. Government Accountability Office has certain inadvertent violation provisions. The SEC independence rules also provide for "safe harbor" relief with respect to certain inadvertent violations of the SEC rules under which the accounting firm's independence is deemed not to be impaired solely because a covered person in the firm is not independent. Members may wish to consider these standards when conducting their analysis to determine if it is the member that can justify a departure from Rule 101 because he or she believes the engagement team's objectivity is not compromised.

Securities and Exchange Commission

Section 210.2-01(c)(4)_of Title 17, *Commodity and Securities Exchanges*, of *U.S. Code of Federal Regulations* (CFR) provides an exception that allows an accounting firm to provide five of the prohibited nonaudit services (that is, bookkeeping; financial information systems design and implementation; appraisal, valuation, fairness opinions, or contribution-in-kind reports; actuarial; and internal audit outsourcing) to an audit client if it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

Section 210.2-01(d)_of Title 17, *Commodity and Securities Exchanges*, of *U.S. Code of Federal Regulations* (CFR) provides that an accounting firm's independence will not be impaired solely because a covered person in the firm is not independent of an audit client provided

- (1) the covered person did not know of the circumstances giving rise to the lack of independence;
- (2) the covered person's lack of independence was corrected as promptly as possible under the relevant circumstances after the covered person or accounting firm became aware of it; and
- (3) the accounting firm has a quality control system in place that provides reasonable assurance, taking into account the size and nature of the accounting firm's practice, that the accounting firm and its employees do not lack independence, and that covers at least all employees and associated entities of the accounting firm participating in the engagement, including employees and associated entities located outside of the United States.
- (4) For an accounting firm that annually provides audit, review, or attest services to more than 500 companies with a class of securities registered with the Commission under section 12 of the Securities Exchange Act of 1934 (15 U.S.C 78l), a quality control system will not provide such reasonable assurance unless it has at least the following features:
 - (i) Written independence policies and procedures;
 - (ii) With respect to partners and managerial employees, an automated system to identify their investments in securities that might impair the accountant's independence;
 - (iii) With respect to all professionals, a system that provides timely information about entities from which the accountant is required to maintain independence;
 - (iv) An annual or on-going firm-wide training program about auditor independence;
 - (v) An annual internal inspection and testing program to monitor adherence to independence requirements;
 - (vi) Notification to all accounting firm members, officers, directors, and employees of the name and title of the member of senior management responsible for compliance with auditor independence requirements;
 - (vii) Written policies and procedures requiring all partners and covered persons to report promptly to the accounting firm when they are engaged in employment negotiations with an audit client and requiring the firm to remove immediately any such professional from that audit client's engagement and to review promptly all work the professional performed related to that audit client's engagement; and
 - (viii) A disciplinary mechanism to ensure compliance with this section.

International Federation of Accountants' International Ethics Standards Board for Accountants Code of Ethics for Professional Accountants

Paragraph 290.38 of the *International Federation of Accountants' International Ethics Standards Board for Accountants Code of Ethics for Professional Accountants* (Code of Ethics) states,

There may be occasions when there is an inadvertent violation of this section (Independence – Audit and Review Engagements). If such an inadvertent violation occurs, it generally will be deemed not to compromise independence provided the firm has appropriate quality control

policies and procedures in place, equivalent to those required by International Standards on Quality Control, to maintain independence and, once discovered, the violation is corrected promptly and any necessary safeguards are applied to eliminate any threat or reduce it to an acceptable level. The firm shall determine whether to discuss the matter with those charged with governance.

Paragraph 290.116 of the Code of Ethics states,

If a firm or a partner or employee of the firm, or a member of that individual's immediate family, receives a direct financial interest or a material indirect financial interest in an audit client, for example, by way of inheritance, gift or as a result of a merger and such interest would not be permitted to be held under this section, then:

- (a) If the interest is received by the firm, the financial interest shall be disposed of immediately, or a sufficient amount of an indirect financial interest shall be disposed of so that the remaining interest is no longer material;
- (b) If the interest is received by a member of the audit team, or a member of that individual's immediate family, the individual who received the financial interest shall immediately dispose of the financial interest, or dispose of a sufficient amount of an indirect financial interest so that the remaining interest is no longer material; or
- (c) If the interest is received by an individual who is not a member of the audit team, or by an immediate family member of the individual, the financial interest shall be disposed of as soon as possible, or a sufficient amount of indirect financial interest shall be disposed of so that the remaining interest is no longer material. Pending the disposal of the financial interest, a determination shall be made as to whether any safeguards are necessary.

Paragraph 290.117 of the Code of Ethics states,

When an inadvertent violation of this section as it relates to a financial interest in an audit client occurs, it is deemed not to compromise independence if:

- (a) The firm has established policies and procedures that require prompt notification to the firm of any breaches resulting from the purchase, inheritance or other acquisition of a financial interest in the audit client;
- (b) The actions in paragraph 290.116 (a)–(c) are taken as applicable; and
- (c) The firm applies other safeguards when necessary to reduce any remaining threat to an acceptable level. Examples of such safeguards include:
 - Having a professional accountant review the work of the member of the audit team; or
 - Excluding the individual from any significant decision-making concerning the audit engagement.

The firm shall determine whether to discuss the matter with those charged with governance.

Paragraph 290.133 of the Code of Ethics states,

When an inadvertent violation of this section as it relates to family and personal relationships occurs, it is deemed not to compromise independence if:

- (a) The firm has established policies and procedures that require prompt notification to the firm of any breaches resulting from changes in the employment status of their immediate or close family members or other personal relationships that create threats to independence;

- (b) The inadvertent violation relates to an immediate family member of a member of the audit team becoming a director or officer of the audit client or being in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion, and the relevant professional is removed from the audit team; and
- (c) The firm applies other safeguards when necessary to reduce any remaining threat to an acceptable level. Examples of such safeguards include:
 - (i) Having a professional accountant review the work of the member of the audit team; or
 - (ii) Excluding the relevant professional from any significant decision-making concerning the engagement.

The firm shall determine whether to discuss the matter with those charged with governance.

Paragraph 290.159 of the Code of Ethics states,

Providing certain non-assurance services to an audit client may create a threat to independence so significant that no safeguards could reduce the threat to an acceptable level. However, the inadvertent provision of such a service to a related entity, division or in respect of a discrete financial statement item of such a client will be deemed not to compromise independence if any threats have been reduced to an acceptable level by arrangements for that related entity, division or discrete financial statement item to be audited by another firm or when another firm re-performs the non-assurance service to the extent necessary to enable it to take responsibility for that service.

U.S. Government Accountability Office

According to paragraph 3.09 of *Government Auditing Standards (GAS)*

When the audit organization identifies a personal impairment to independence prior to or during an audit, the audit organization should take action to resolve the impairment in a timely manner. In situations in which the personal impairment is applicable only to an individual auditor or a specialist on a particular audit, the audit organization may be able to eliminate the personal impairment. For example, the audit organization could remove that auditor or specialist from any work on that audit or require the auditor or specialist to eliminate the cause of the personal impairment. If the personal impairment cannot be eliminated, the audit organization should withdraw from the audit. In situations in which auditors employed by government entities cannot withdraw from the audit, they should follow paragraph 3.04.

Paragraph 3.04 of GAS also states

When evaluating whether independence impairments exist, either in fact or appearance, with respect to the entities for which audit organizations perform audits or attestation engagements, auditors and audit organizations must take into account the three general classes of impairments to independence—personal, external, and organizational. If one or more of these impairments affects or can be perceived to affect independence, the audit organization (or auditor) should decline to perform the work—except in those situations in which an audit organization in a government entity, because of a legislative requirement or for other reasons, cannot decline to perform the work, in which case the government audit organization must disclose the impairment(s) and modify the GAGAS compliance statement. (See paragraphs 1.12–1.13.)