
EXPOSURE DRAFT

OMNIBUS PROPOSAL OF PROFESSIONAL ETHICS DIVISION INTERPRETATIONS AND RULINGS

PROPOSED INTERPRETATION 101-16 UNDER RULE 101: *Indemnification, Limitation of Liability, and ADR Clauses in Engagement Letters* □ PROPOSED DELETION OF ETHICS RULING NO. 94 UNDER RULE 101: *Indemnification Clause in Engagement Letters* □ PROPOSED DELETION OF ETHICS RULING NO. 95 UNDER RULE 101: *Agreement With Attest Client to Use ADR Techniques* □ PROPOSED REVISION TO INTERPRETATION 101-3 UNDER RULE 101: *Performance of Nonattest Services: Forensic Accounting Services and Tax Compliance Services*

September 8, 2006

Prepared by the AICPA Professional Ethics Executive Committee for comments from persons interested in independence, behavioral, and technical standards matters

Comments should be received by November 8, 2006, and addressed to
Lisa A. Snyder, Director, Professional Ethics Division,
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September 8, 2006

This exposure draft contains important proposals for review and comment by the AICPA's membership and other interested parties regarding pronouncements for possible adoption by the Professional Ethics Executive Committee (the PEEC, or Committee). The text and an explanation of the proposed pronouncements are included in this exposure draft.

After the exposure period is concluded and the Committee has evaluated the comments, the Committee may decide to publish one or more of the proposed pronouncements. Once published, the pronouncements become effective on the last day of the month in which they are published in the *Journal of Accountancy*, except as may otherwise be stated in the pronouncements.

Your comments are an important part of the standard-setting process. Please take this opportunity to comment. Responses must be received at the AICPA by November 8, 2006. All written replies to this exposure draft will become part of the public record of the AICPA and will be available for inspection at the office of the AICPA after December 8, 2006, for a period of one year.

All comments received will be considered by the Committee at an open meeting scheduled to be held on November 30 and December 1, 2006, at the AICPA offices in Durham, N.C.

Please send comments to Lisa A. Snyder, Director, AICPA Professional Ethics Division, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881 or via the Internet to lsnyder@aicpa.org. Comments submitted via electronic mail are encouraged and would be appreciated.

Sincerely,

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Chair
AICPA Professional Ethics
Executive Committee

Lisa A. Snyder
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The Professional Ethics Executive Committee gratefully acknowledges the contributions of Adam Weinreb in the development of this proposal.

PROPOSED INTERPRETATION 101-16, INDEMNIFICATION, LIMITATION OF LIABILITY, AND ADR CLAUSES IN ENGAGEMENT LETTERS, UNDER RULE 101, INDEPENDENCE

[Explanation]

Background

In September 2005, the Professional Ethics Executive Committee (the PEEC, or Committee) issued an exposure draft containing proposed Ethics Interpretation 101-16, *Indemnification, Limitation of Liability, and ADR Clauses in Engagement Letters*. The Committee received 15 comment letters in response to the proposal and as a result of these comments, input from various participants at the public meetings and further deliberations by the Committee, it agreed to reconsider the conceptual underpinnings of the proposed guidance, specifically as it relates to the specific threats to independence resulting from such limitation of liability and indemnification provisions and possible safeguards available to mitigate these threats.

In deliberating these issues, the PEEC debated whether the inclusion of indemnification, limitation of liability, and ADR clauses in engagement letters should be evaluated under Rule 101, *Independence* or under Rule 201, *General Standards*. Historically, the profession has viewed the inclusion of such clauses in attest engagement letters from an independence perspective. For example, according to the Securities and Exchange Commission (SEC), indemnification agreements remove one of the major stimuli to objective and unbiased consideration of problems encountered in an engagement. Existence of such an agreement may result in the use of less extensive procedures or failure to carefully appraise information disclosed during the engagement. The PEEC concluded that the inclusion of such clauses in audit, or other attest, engagement letters may appear to compromise a member's independence. Notwithstanding the fact that a member must exercise due professional care to comply with the general standards, the PEEC concluded to address indemnification, limitation of liability, and ADR provisions included in engagement letters under Rule 101, *Independence*.

The PEEC considered guidance issued by other regulators, including the SEC, as well as the *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters* issued by the Federal Financial Institutions Examination Council (FFIEC). However, the PEEC was mindful that the FFIEC guidance is based on the impact that indemnification and limitation of liability provisions have on the "safety and soundness" of financial institutions, whereas the Committee's guidance is based on the impact such provisions have on a member's independence and therefore was developed using the risk-based approach described in the Conceptual Framework for AICPA Independence Standards (see below). The Committee also acknowledged that there may be differences between public interest entities such as SEC registrants or other regulated entities and nonpublic companies with respect to the nature and extent of the safeguards necessary (e.g., safeguards created by legislation or regulation and those implemented by the attest client) to mitigate the threats to independence. For example, public companies must comply with more stringent requirements for boards of directors; greater corporate governance requirements; additional disclosure of events that affect a

company's finances; and, certification by CFOs and CEOs of the accuracy of financial disclosures. The owners (shareholders) of public companies are generally removed from the day-to-day operations of the company and many have limited sophistication and knowledge of the company's business practices and access to the financial records of the company. Accordingly, more restrictive requirements to help protect the public interest are considered necessary with respect to public companies.

Due to these significant differences between public companies and nonpublic companies, along with the differences in perspectives used by the FFIEC compared to the PEEC in developing guidance (that is, safety and soundness versus independence), the Committee concluded it was appropriate, in certain circumstances, to propose guidance that differed from that of the FFIEC and SEC.

Proposed Guidance

The Conceptual Framework for AICPA Independence Standards describes the risk-based approach the PEEC uses to analyze independence matters when developing independence standards. Under that approach, a member's relationship with a client is analyzed to determine whether it poses an unacceptable risk to the member's independence. As described in the Conceptual Framework, such an analysis involves identifying and assessing the extent to which a threat to the member's independence exists and, if it does, whether it can be effectively mitigated or eliminated through the use of safeguards.

The Committee continues to believe that certain types of indemnification and limitation of liability provisions pose an unacceptable threat to a member's independence because they may result in a member's performance of insufficient attest procedures in reliance on the belief that the member is protected through the indemnification or limitation of liability provision. However, the Committee also believes that this threat could be sufficiently mitigated, provided the limitation of liability or indemnification agreement was contingent on the member's attest services being performed in compliance with professional standards. For example, a member enters into an agreement with an audit client whereby the client would be required to reimburse the member for litigation costs and expenses resulting from the member's defense of claims for damages in connection with the member's performance of the audit. In these circumstances, the threat that the member would perform insufficient audit procedures in reliance on the belief that the member would be protected through such limitation of liability or indemnification provision would be eliminated if the provision only became operative if the audit was performed in accordance with generally accepted auditing standards (GAAS).

Accordingly, the PEEC is proposing ethics guidance that adopts an underlying principle whereby independence would be considered to be impaired if a member entered into an agreement with a client that included an indemnification or limitation of liability provision regarding a member's exposure to actual damages unless such provision was contingent on the member's attest services being performed in compliance with professional standards, in all material respects. Based on this principle, any indemnification or limitation of liability provision that limits or eliminates a member's liability for actual damages arising from the member's failure to perform the attest services in accordance with professional standards, in all material respects, would impair

independence. The PEEC believes that an indemnification or limitation of liability provision should not be deemed inoperative due to an immaterial departure from professional standards and proposes that compliance with professional standards “in all material respects” sets an appropriate threshold.

The PEEC also believes that an indemnification or limitation of liability agreement that limits or eliminates a member’s liability for *punitive* damages would not impair the member’s independence. Specifically, the member still remains exposed to clients, and also to lenders, shareholders and other nonclients, for damages for any *actual* harm caused. The amount of actual damages can be significant; accordingly, the Committee believes that the possibility that actual damages might be awarded against a member in favor of clients and/or nonclients serves as a sufficient safeguard to mitigate the threats to a member’s independence.

The Committee’s original proposal issued in September 2005 would have permitted a limitation of liability agreement in which a member would not be liable to a client for punitive damages but would have considered independence to be impaired if a member entered into an agreement to be indemnified from third-party claims for punitive damages. Some commenters challenged this conclusion and argued there was inconsistency in the Committee’s position of permitting a contractual exclusion of punitive damages to a client without impairing a member’s independence, while treating provisions relating to a member’s exposure to punitive damage claims from third parties as an impairment of independence. The Committee agreed with these commenters and concluded that an indemnification against punitive damage claims from third parties would not impair independence.

Consistent with the original proposal issued in September 2005, the proposed interpretation states that independence would not be impaired if a member and the client agree that the unsuccessful party in a lawsuit or alternative dispute resolution (ADR) proceeding between them will pay the legal fees and expenses of the successful party. The proposed interpretation retains the conclusion that an indemnification or limitation of liability provision related to nonattest services performed for an attest client (that is, where the provision relates only to the nonattest services engagement and not the attest engagement) would not impair a member’s independence with respect to that client.

The Committee also considered certain other provisions, such as a limitation of the time period during which the client would otherwise be legally entitled to file a claim, or a limitation on the client’s legal right to assign or transfer a claim. While the PEEC’s original proposal issued in September 2005 would have considered such provisions to impair independence, commenters argued that the Committee had no real basis for determining that these types of provisions would impair independence. With respect to a provision limiting the time period to file a claim, the Committee reconsidered this issue and concluded that independence would not be considered to be impaired provided that the time period included in the agreement was reasonable so that the client’s ability to assert a claim against the member was not constructively eliminated and, therefore, the member still had an incentive/safeguard to perform the attest service in accordance with professional standards. The Committee further agreed that it should not define what would be considered a “reasonable” time period; rather, the member and client should use their judgment in determining what would be reasonable given the circumstances. The Committee

also reconsidered its basis for determining that independence would be impaired due to the inclusion of a provision that would limit the client's legal right to assign or transfer a claim. The Committee concluded that from an independence perspective, there was no real threat to independence under such circumstances and therefore revised the proposed guidance to state that such a provision would not impair independence.

Finally, the proposed interpretation also provides guidance on arrangements whereby a member and client agree to use arbitration, mediation, or other ADR methods to resolve a dispute between them, or agree to waive a jury trial. The PEEC does not believe independence would be impaired (that is, there are no threats to independence) when a member and his or her client agree to use an ADR procedure to resolve disputes between them. Specifically, ADR clauses merely determine the forum in which a dispute will be heard and decided, and facilitate dispute resolution between the member and the client. However, if an ADR clause incorporates an indemnification or limitation of liability provision that would otherwise impair independence, the ADR clause would also impair independence. In addition, a provision in an arbitration agreement that prohibits discovery, or unreasonably limits the extent or nature of discovery, would impair independence unless the agreement permits the arbitrator to override such provision as they determine necessary for the conduct of a fair and cost effective proceeding. The PEEC believes its position regarding discovery is, in all material respects, consistent with the rules of the principle ADR providers. During arbitration proceedings, discovery occurs under the auspices of the arbitrator and pursuant to the parties' agreement. In this regard, the PEEC understands that the U.S. Circuit Courts and State Courts regularly have found that it is proper and necessary to vest arbitrators with the authority to determine the extent of discovery.

The PEEC also concluded that waiver of a jury trial would not impair independence. Specifically, such a waiver merely specifies one procedural aspect of a how a dispute will be resolved.

The proposed standard provides for a transition period whereby independence would not be considered impaired as a result of the interpretation's more restrictive requirements for engagements contracted for prior to January 1, 2008, and completed prior to January 1, 2009. While the Committee is interested in receiving comments on all aspects of the proposed interpretation, it specifically requests feedback on whether or not this transition period is appropriate.

PROPOSED INTERPRETATION 101-16, INDEMNIFICATION, LIMITATION OF LIABILITY, AND ADR CLAUSES IN ENGAGEMENT LETTERS, UNDER RULE 101, INDEPENDENCE

Terminology

The following specifically identified and defined terms are used solely for purposes of this interpretation:

- A. **Member.** The term *member* includes both a member and his or her firm.
- B. **Indemnification.** An *indemnification* is a client's agreement to compensate a member for some or all loss, damage, or costs sustained or incurred by that member as a result of claims made against the member by a third party (for example, a lender or shareholder). An indemnification does not insulate a member from claims asserted by the client.
- C. **Limitation of liability provisions.** A *limitation of liability provision* is a client's agreement to restrict some or all of the damages the client could recover from a member arising out of the member's performance of professional services. A limitation of liability provision does not insulate a member from claims asserted by third parties.
- D. **ADR.** The term *ADR* refers to alternative dispute resolution.
- E. **Actual damages.** *Actual damages* consist of all damages, other than punitive damages, that a plaintiff may be permitted to recover in a civil action against the member.
- F. **Punitive damages.** *Punitive damages* are damages awarded to a plaintiff in civil litigation that are not intended to compensate for a plaintiff's loss but, rather, are intended to punish or penalize the defendant for wrongful action or inaction.

Because these terms have legal significance and the application may vary by jurisdiction, members may wish to consult with legal counsel when drafting engagement letters or similar arrangements.

Interpretation

This interpretation provides guidance to members concerning the impact that certain indemnification and limitation of liability provisions may have on a member's independence when included in engagement letters or other agreements entered into with a client.¹ Certain

¹ When auditing public company registrants or clients in regulated industries such as insurance companies and federally insured depository institutions, members should also comply with the rules and regulations of the appropriate regulator(s), which may be more restrictive.

types of indemnification and limitation of liability provisions in an attest engagement pose an unacceptable threat to a member's independence because they may result in a member's performance of insufficient attest procedures in reliance on the belief that the member's exposure to damages and litigation expense is reduced through the indemnification or limitation of liability provision.

This interpretation also provides guidance on the effect of arrangements whereby the unsuccessful party will pay the legal fees and expenses of the successful party and limitations on the time period in which a client may file a claim or its right to assign or transfer a claim. Finally, this interpretation provides guidance on arrangements whereby a member and client agree to use arbitration, mediation, or other ADR techniques or proceedings to resolve a dispute between them, or agree to waive a jury trial.

In no circumstance does the inclusion of an indemnification or limitation of liability provision relieve a member from the obligation to comply with all professional standards in the performance of an engagement as required by Rule 201, *General Standards* [ET section 201], and Rule 202, *Compliance With Standards* [ET section 202].

Members should refer to Ethics Interpretation 101-6, "The effect of actual or threatened litigation on independence" [ET section 101.08] and Ethics Ruling no. 96, "Commencement of ADR Proceeding," under Rule 101 [ET section 191.192] for guidance on the impact on independence of threatened or actual litigation or ADR proceedings between the client and the member.

Indemnification and Limitation of Liability Provisions in Attest Services Engagements

An indemnification or limitation of liability provision that limits or eliminates a member's liability for actual damages arising from the member's failure to perform the attest services in accordance with professional standards, in all material respects, would impair independence.

An indemnification or limitation of liability provision that limits or eliminates a member's liability for punitive damages would not impair the member's independence.

An indemnification or limitation of liability provision that requires the client to reimburse the member for litigation costs and expenses, including amounts paid in settlement of actual damage claims, incurred in connection with the member's defense of claims for damages arising from the member's performance of attest services would not impair independence as long as such provision is contingent upon the member having performed such services in accordance with professional standards, in all material respects.

Indemnification and Limitation of Liability Provisions in Nonattest Services Engagements

An indemnification or limitation of liability provision related to nonattest services performed for an attest client would not impair a member's independence with respect to that client.

Unsuccessful Party to Pay Legal Fees and Expenses

Independence would not be impaired if a member and the client agree that the unsuccessful party in a lawsuit or ADR proceeding between them will pay the legal fees and expenses of the successful party.

Limitation on Time Period in Which a Client May File a Claim

A limitation of the time period during which the client would otherwise be legally entitled to file a claim would not impair independence provided the time period set forth is reasonable in the circumstances.

Limitation on a Client's Right to Assign or Transfer a Claim

A limitation on the client's legal right to assign or transfer a claim or potential claim would not impair independence.

Agreement to Use ADR Technique or Proceeding

An agreement between a member and client to use arbitration, mediation, or another ADR technique or proceeding to resolve a dispute between them would not impair the member's independence provided the ADR technique or proceeding does not incorporate a provision, procedure, or rule that would impair independence under the preceding guidance. However, a provision in an arbitration agreement that prohibits discovery, or unreasonably limits the extent or nature of discovery, would impair independence unless the agreement permits the arbitrator(s) to override such provision as they determine necessary for the conduct of a fair and cost-effective proceeding.

Agreement to Waive a Jury Trial²

An agreement between a member and client to waive a jury trial would not impair independence.

Transition

Independence would not be impaired as a result of the more restrictive requirements of this interpretation for engagements contracted for prior to January 1, 2008, and completed prior to January 1, 2009, where the member complied with all applicable independence interpretations and rulings in effect prior to [*effective date dependent on publication date in the Journal of Accountancy*].

² Some jurisdictions may limit or fail to give effect to certain of these arrangements.

PROPOSED DELETION OF ETHICS RULINGS NO. 94 AND NO. 95 UNDER RULE 101- INDEPENDENCE

94. Indemnification Clause in Engagement Letters

~~.188 *Question*—A member or his or her firm proposes to include in engagement letters a clause that provides that the client would release, indemnify, defend, and hold the member (and his or her partners, heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management. Would inclusion of such an indemnification clause in engagement letters impair independence?~~

~~.189 *Answer*—No.~~

~~[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]~~

95. Agreement With Attest Client to Use ADR Techniques

~~.190 *Question*—Alternative dispute resolution (ADR) techniques are used to resolve disputes (in lieu of litigation) relating to past services, but are not used as a substitute for the exercise of professional judgment for current services. Would a predispute agreement to use ADR techniques between a member or his or her firm and a client cause independence to be impaired?~~

~~.191 *Answer*—No. Such an agreement would not cause independence to be impaired since the member (or the firm) and the client would not be in threatened or actual positions of material adverse interests by reason of threatened or actual litigation.~~

~~[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]~~

**PROPOSED REVISIONS TO INTERPRETATION 101-3, *PERFORMANCE OF
NONATTEST SERVICES*, UNDER RULE 101, INDEPENDENCE**

[Explanation]

The Professional Ethics Executive Committee (PEEC or Committee) is proposing revisions to Ethics Interpretation 101-3, *Performance of Nonattest Services*, that would provide guidance on how the provision of Forensic Accounting Services and Tax Compliance Services would affect a member's independence with respect to his or her attest clients. In developing the proposed guidance, the Committee sought input and feedback from a number of experts and practitioners in these fields to ensure the development of meaningful and practical guidance. The Committee is only seeking comment on the proposed revisions to the Interpretation – that is, forensic accounting services and tax compliance services. Accordingly, please limit your comments to those areas even though the Committee has included the Introduction, General Requirements, and General Activities sections of the interpretation for contextual purposes.

Forensic Accounting Services

Background

In September 2005, the Committee issued an exposure draft containing a proposed ethics interpretation, Interpretation 101-17, *Performance of Client Advocacy Services, Fact Witness Testimony and Forensic Accounting Services* (the “September 15, 2005, proposal”). The Committee sought comment on the proposal, especially the underlying premise—that is, independence would be considered to be impaired when an expectation of confidentiality of information between the member and the client/client attorney exists, and the communication of any information uncovered by the member during the course of the forensic engagement is restricted (for example, subject to the attorney-client privilege or attorney-work product doctrine) and therefore cannot be shared with members of the attest engagement team.

The Committee received 15 comment letters in response to the proposal, which it considered at an open meeting held on January 30 and 31, 2006. Many comments received asserted that the underlying premise was flawed—that is, any inability of a member to communicate with the attest engagement team may constitute a scope limitation but should not be the basis for finding that independence is impaired. Moreover, it was noted in the comment letters that such potential scope limitations could arise regardless of whether the expert witness or the consultant was, or was not, from the same firm as that which provided attest services. These commenters pointed out that in many cases the professional standards provide alternative methods for a member to obtain adequate assurance that sufficient competent evidence has been obtained, and thereby enable a member to altogether avoid a possible scope limitation. Among other comments received, some believed that the performance of expert witness services resulted in an appearance that independence is impaired and therefore should be prohibited for an attest client.

Based upon the responses received to the September 15, 2005, proposal, the Committee concluded that it needed to reconsider the conceptual basis of the proposed guidance and the positions taken.

Proposed Guidance

Upon considering the comments received to the September 15, 2005, proposal and receiving further input from members who perform forensic accounting services, the Committee is proposing to incorporate revised guidance on forensic accounting services into Interpretation 101-3, *Performance of Nonattest Services*. Accordingly, those forensic accounting services that would be permitted under the proposal would be subject to the general requirements of the interpretation, including the requirement to have the client designate an individual who possesses suitable skill, knowledge, and/or experience to oversee the services and that the requirement that the member establish and document in writing the understanding reached with the client regarding the services to be performed.

For purposes of the proposed interpretation, forensic accounting services are defined as nonattest services that involve the application of specialized accounting, auditing, finance, and quantitative methods, and skills in various aspects of law, research, and investigative methods to collect, analyze, and evaluate evidential matter, and to interpret and communicate these findings. Under the proposal, forensic accounting services consist of (1) litigation services and (2) investigative services.

Litigation Services

Litigation services are those services provided as part of actual or potential legal or regulatory proceedings before a trier of fact in connection with a resolution of disputes between parties. They consist of expert witness services, litigation consulting services, and other services such as serving as a court-appointed expert, special master, trier of fact, or arbitrator.

Under the September 15, 2005, proposal, independence would have been considered impaired if performance of the expert services resulted in an expectation of confidentiality of information between the client/client attorney and the member, and the communication of any information uncovered by the member during the course of the engagement was restricted (that is, could not be communicated to members of the attest engagement team). Based on comments received on the September 15, 2005, proposal, the Committee concluded that determining whether or not independence is impaired should not rest on the ability to communicate information to the attest engagement team. Furthermore, the Committee agreed that the performance of expert witness services create the *appearance* that a member is advocating or promoting a client's position (that is, an advocacy threat as defined in the Conceptual Framework for AICPA Independence Standards). Accordingly, under the proposed guidance, if a member agreed to perform such services, independence would be considered impaired as there are no sufficient safeguards to mitigate this threat to an acceptable level. The Committee noted that this position was consistent with that of other regulators, such as the Securities and Exchange Commission. Due to concerns that opposing counsel may misconstrue this provision when a member is providing expert witness services for a *nonattest* client, the Committee agreed that it was necessary to add a footnote to clarify that a member must still comply with Rule 102, *Integrity and Objectivity*, which requires that a member maintain objectivity and integrity and not subordinate his or her judgment to others.

Litigation consulting services involve providing advice about the facts, issues, and strategy of a matter without testifying as an expert witness before a trier of fact. Based on the various types of nonattest services currently permitted under Interpretation 101-3, the Committee agreed that performance of litigation consulting services would not be considered to impair independence provided the member complies with the general requirements set forth under the Interpretation. However, if the member subsequently agreed to serve as an expert witness, independence would be considered to be impaired. The Committee noted that the member should therefore make it clear to the client and/or the client's attorney (possibly, through an engagement letter) that he or she could not provide expert witness testimony. In addition, such consulting services would be permitted without regard to whether the communication of any information uncovered by the member during the course of the engagement is restricted, which would have impaired independence under the September 15, 2005, proposal.

Consistent with the September 15, 2005, proposal, the Committee agreed that the performance of *other services* such as, serving as a trier of fact, special master, court-appointed expert, or arbitrator in a matter involving the client, would create the appearance that the member is not independent and, therefore, such services would be considered to impair independence. However, the Committee reconsidered its initial position with respect to serving as a mediator or referee in a matter involving the client, and after further deliberation decided that such services would not necessarily impair independence provided the client approved any final decision regarding the matter. In reaching this conclusion, the Committee noted that Interpretation 101-3 would permit a member to "participate in transaction negotiations in an advisory capacity" with respect to a client. In addition, the Committee did not believe that acting as a mediator or referee would impair the appearance of independence since such processes occur in a private setting.

Investigative Services

Investigative services include all forensic accounting services that do not involve actual or threatened litigation, including the performance of analyses and investigations that may involve the same skills as litigation services. Consistent with the September 15, 2005, proposal, the provision of these services under the current proposal would not impair independence provided the services comply with the general requirements of Interpretation 101-3.

Fact Witness Testimony

The proposed revision to Interpretation 101-3 also provides guidance on the provision of fact witness testimony. The Committee acknowledged that these services are by their very nature substantially different from, and outside the scope of, forensic accounting services. However, the Committee believed it was appropriate for the proposed interpretation to address these services so comprehensive guidance exists in one place for the convenience of the user.

The Committee acknowledged that when providing fact witness testimony (sometimes referred to as a percipient or sensory-witness testimony), the member's role is to provide factual testimony to the trier of fact based on the member's direct knowledge of the facts or events in dispute. Consistent with the September 15, 2005, proposal, the current proposal would not

consider such services to impair independence. The Committee also noted that while testifying as a fact witness, the trier of fact or counsel may request that the member testify as to his or her opinions regarding the matter under consideration if it is within the member's area of expertise. The Committee did not believe a member should be penalized (that is, impair independence) in this situation and therefore independence would not be considered to be impaired provided the member did not previously agree to serve in this expert witness capacity.

Under the September 15, 2005, proposal, the guidance stated that when performing fact witness testimony, "*the member is neither acting in any capacity for the client nor engaged by the client or the client's attorney. Should the member be engaged by either, he or she would be considered to be performing forensic accounting services and subject to those provisions.*" The Committee reconsidered this provision and agreed that a member may be called upon (for example, through a subpoena) by the client and/or client counsel to provide fact witness testimony, for example, in connection with a previous audit performed by the member's firm. The Committee concluded that the fact that the client/client counsel is requesting that the member provide such testimony should not result in the member being considered to be performing forensic accounting services (for example, expert witness services). Accordingly, the Committee agreed to remove this language from the proposed guidance. Finally, the Committee recognized that members may require further guidance in determining whether they would be considered to be providing expert witness testimony as opposed to fact witness testimony. Accordingly, the task force agreed to clarify the definitions in the current proposal and add a footnote reference to the Federal Rules of Evidence where such terms are described.

Due to the fact that the proposal is being incorporated into Interpretation 101-3, guidance on "client advocacy services" that was contained in the September 15, 2005, proposal was deleted as it was deemed no longer necessary since such services are covered (that is, prohibited) under the Interpretation's general requirements and activities.

The Committee is proposing to prohibit the performance of expert witness services for an attest client on the basis that such services create the *appearance* that a member is advocating or promoting a client's position (that is, an advocacy threat as defined in the Conceptual Framework for AICPA Independence Standards). On the other hand, the Committee is proposing to permit the performance of litigation consulting services on the basis that the general requirements set forth under Interpretation 101-3 provide sufficient safeguards to mitigate the threats to independence when performing consulting services for an attest client.

Tax Compliance Services

Due to the increase in electronic filing and electronic fund transfer programs authorized or required by taxing authorities nationwide, at its January 2006 meeting the Committee undertook a project to consider these issues and the impact that electronic tax compliance services may have on a member's independence. However, after studying these issues, the Committee concluded that the enclosed proposal should not make a distinction between tax returns and

payments prepared and submitted in a paper format and those prepared and submitted in an electronic format.

The services included in this proposal are:

- Preparation of a tax return.
- Transmittal of a tax return, and transmittal of the related tax payment to the taxing authority.
- Signing and filing of a tax return.
- Authorized representation of clients before a taxing authority.

Management Participation Threat

The Committee believes that when a member prepares and files a client's tax return and transmits the return and related tax payments to a taxing authority for an attest client, the member's independence is threatened because it could appear that the member is acting in a management capacity. To safeguard against the management participation threat (that is, taking on the role of client management or otherwise performing management functions on behalf of an attest client), the Committee proposes some additional requirements over and above the general requirements included in Interpretation 101-3. Specifically, the Committee proposes that independence would not be impaired when preparing and transmitting a client's tax return only if the individual designated by the client to oversee the tax services approves the contents of the tax return and signs the return *prior to* the member transmitting the return to the taxing authority. Since this individual has the responsibility to understand the company's tax situation, including a general understanding of how the amounts on the tax return were determined, and must make all decisions regarding significant tax positions taken in the tax return, the Committee believes that the transmitting of the tax return by the member is clerical in nature (that is, not a management function).

However, if it is necessary for the member to sign the tax return on behalf of the client, the Committee believes that additional safeguards must be adhered to in order to sufficiently mitigate the management participation threat. These additional safeguards include that the member must be legally permitted to sign the return on behalf of the client and must follow the taxing authority's prescribed procedures for signing on behalf of a client. If the taxing authority does not have any such procedures in place, the member must have the individual in client management who is authorized to sign and file the client's tax return provide the member with a signed statement that clearly identifies the return being filed and represents that such individual is authorized to sign and file the tax return; that such individual has reviewed the tax return, including accompanying schedules and statements; that it is complete and accurate to the best of his or her knowledge and belief; and that such individual authorizes the member to sign and file the tax return on behalf of the client. The Committee believes that with these additional safeguards in place, the management participation threat is sufficiently mitigated and the member would not be considered to be performing a management function.

Advocacy Threat

The proposal also sets out the Committee's position surrounding a member representing a client in either an administrative proceeding before a taxing authority or in a court to resolve a tax dispute.

When representing a client in an administrative proceeding, the Committee acknowledged that such representation is often authorized by executing a power of attorney or similar power from the taxing authority. While these documents (or powers) often give the member the authority to commit a client to a specific arrangement, the Committee proposes that independence would not be impaired when representing a client in an administrative proceeding provided the member does not use such power to commit a client to a specific arrangement with the taxing authority without first obtaining client approval. However, the Committee believes that this safeguard is not sufficient to mitigate the threat to a member's independence when a member files a petition or otherwise represents a client in court to resolve a tax dispute because once a member moves into this capacity, he or she is, or appears to be, promoting the client's interests or position (that is, the advocacy threat).

Custody of Client Assets

The Committee does not believe there are any sufficient safeguards available to protect a member's independence if he or she were to take custody or control of a client's assets. Accordingly, the proposal states that a member must not have custody or control over the client's funds when he or she transmits the tax payments, whether in paper or electronic form, to a taxing authority. The Committee believes that the threat to independence when transmitting such tax payments is sufficiently mitigated provided the individual at the client designated to oversee the tax services reviews and approves the amount and payment of funds *prior* to such funds being transmitted to the taxing authority. The Committee also acknowledged that many taxing authorities have parameters in place to ensure that legal title and physical custody of client assets do not pass to a member when he or she remits client funds to a taxing authority and that such parameters would be considered sufficient to safeguard a member from having custody or control over the client's funds.

Title Revision

Since tax disbursements will be addressed under the new category "Tax Compliance Services" the Committee recommends that the examples discussing taxes be deleted from the "Payroll and Other Disbursement Services" category.

**PROPOSED REVISION TO INTERPRETATION 101-3, PERFORMANCE OF
NONATTEST SERVICES, UNDER RULE 101, INDEPENDENCE**

[Text of Proposed Interpretation]

Note: Certain sections of Interpretation 101-3 have been intentionally omitted below since they are not being proposed for revision. The Introduction, General Requirements and General Activities sections of the interpretation have been included for contextual purposes while the footnotes to these sections have been omitted for convenience. The entire text of the Interpretation can be found at:

[http://www.aicpa.org/about/code/et_101.html#et_101.05].

.....

101-3—Performance of nonattest services. Before a member or his or her firm ("member") performs nonattest services (for example, tax or consulting services) for an attest client, the member should determine that the requirements described in this interpretation have been met. In cases where the requirements have not been met during the period of the professional engagement or the period covered by the financial statements, the member's independence would be impaired.

Engagements Subject to Independence Rules of Certain Regulatory Bodies

This interpretation requires compliance with independence regulations of authoritative regulatory bodies (such as the Securities and Exchange Commission [SEC], the General Accounting Office [GAO], the Department of Labor [DOL], and state boards of accountancy) where a member performs nonattest services for an attest client and is required to be independent of the client under the regulations of the applicable regulatory body. Accordingly, failure to comply with the nonattest services provisions contained in the independence rules of the applicable regulatory body that are more restrictive than the provisions of this interpretation would constitute a violation of this interpretation.

General Requirements for Performing Nonattest Services

1. The member should not perform management functions or make management decisions for the attest client. However, the member may provide advice, research materials, and recommendations to assist the client's management in performing its functions and making decisions.
2. The client must agree to perform the following functions in connection with the engagement to perform nonattest services:
 - a. Make all management decisions and perform all management functions;
 - b. Designate an individual who possesses suitable skill, knowledge, and/or experience, preferably within senior management, to oversee the services;
 - c. Evaluate the adequacy and results of the services performed;
 - d. Accept responsibility for the results of the services; and

- e. Establish and maintain internal controls, including monitoring ongoing activities.

The member should be satisfied that the client will be able to meet all of these criteria and make an informed judgment on the results of the member's nonattest services. In assessing whether the designated individual possesses suitable skill, knowledge, and/or experience, the member should be satisfied that such individual understands the services to be performed sufficiently to oversee them. However, the individual is not required to possess the expertise to perform or re-perform the services.

In cases where the client is unable or unwilling to assume these responsibilities (for example, the client does not have an individual with suitable skill, knowledge, and/or experience to oversee the nonattest services provided, or is unwilling to perform such functions due to lack of time or desire), the member's provision of these services would impair independence.

3. Before performing nonattest services, the member should establish and document in writing his or her understanding with the client (board of directors, audit committee, or management, as appropriate in the circumstances) regarding the following:
 - a. Objectives of the engagement
 - b. Services to be performed
 - c. Client's acceptance of its responsibilities
 - d. Member's responsibilities
 - e. Any limitations of the engagement

The documentation requirement does not apply to:

- a. Nonattest services performed prior to January 1, 2005.
- b. Nonattest services performed prior to the client becoming an attest client

General requirements 2 and 3 above do not apply to certain routine activities performed by the member such as providing advice and responding to the client's questions as part of the normal client-member relationship.

General Activities

The following are some general activities that would impair a member's independence:

- Authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of a client or having the authority to do so
- Preparing source documents, in electronic or other form, evidencing the occurrence of a transaction
- Having custody of client assets
- Supervising client employees in the performance of their normal recurring activities

- Determining which recommendations of the member should be implemented
- Reporting to the board of directors on behalf of management
- Serving as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent

Specific Examples of Nonattest Services

The examples in the following table identify the effect that performance of certain nonattest services for an attest client can have on a member's independence. These examples presume that the general requirements in the previous section "General Requirements for Performing Nonattest Services" have been met and are not intended to be all-inclusive of the types of nonattest services performed by members.

[Note: Only the Payroll and Other Disbursement examples of the table are shown below since this is the only section containing proposed revisions.]

Impact on Independence of Performance of Nonattest Services

<i>Type of Nonattest Service</i>	<i>Independence Would Not Be Impaired</i>	<i>Independence Would Be Impaired</i>
Payroll and other Non tax disbursement	<ul style="list-style-type: none"> • Using payroll time records provided and approved by the client, generate unsigned checks, or process client's payroll. • Transmit client-approved payroll or other disbursement information to a financial institution provided the client has authorized the member to make the transmission and has made arrangements for the financial institution to limit the corresponding individual payments as to amount and payee. In addition, once transmitted, the client must authorize the financial institution to process the information. • Make electronic payroll tax payments in accordance with U.S. Treasury Department or comparable guidelines provided the client has made arrangements for its financial institution to limit such payments to a named payee.⁹ 	<ul style="list-style-type: none"> • Accept responsibility to authorize payment of client funds, electronically or otherwise except as specifically provided for with respect to electronic payroll tax payments. • Accept responsibility to sign or cosign client checks, even if only in emergency situations. • Maintain a client's bank account or otherwise have custody of a client's funds or make credit or banking decisions for the client. • Sign payroll tax return on behalf of client management. • Approve vendor invoices for payment

Forensic Accounting Services

For purposes of this interpretation, forensic accounting services¹⁰ are nonattest services that involve the application of special skills in accounting, auditing, finance, quantitative methods and certain areas of the law, and research, and investigative skills to collect, analyze, and evaluate evidential matter and to interpret and communicate findings and consist of:

- *Litigation services; and*
- *Investigative services.*

Litigation services recognize the role of the member as an expert or consultant and consist of providing assistance for actual or potential legal or regulatory proceedings before a trier of fact in connection with the resolution of disputes between parties. Litigation services consist of the following services:

- Expert witness services¹¹ are those litigation services where a member is engaged to render an opinion before a trier of fact as to the matter(s) in dispute based on the member's expertise, rather than his or her direct knowledge of the disputed facts or events.*

Expert witness services create the appearance that a member is advocating or promoting a client's position.¹² Accordingly, if a member conditionally or unconditionally agrees to provide expert witness testimony for a client, independence would be considered to be impaired.

- Litigation consulting services are those litigation services where a member provides advice about the facts, issues, and strategy of a matter. The consultant does not testify as an expert witness before a trier of fact.*

The performance of litigation consulting services would not impair independence provided the member complies with the general requirements set forth under this interpretation.¹³ However, if the member subsequently agrees to serve as an expert witness, independence would be considered to be impaired.

- Other services are those litigation services where a member serves as a trier of fact, special master, court-appointed expert, or arbitrator (including serving on an arbitration panel), in a matter involving a client. These other services create the appearance that the member is not independent. Accordingly, if a member serves in such a role, independence would be considered to be impaired.*

Investigative services include all forensic services not involving actual or threatened litigation such as performing analyses or investigations that may require the same skills as used in litigation services. Such services would not impair independence provided the member complies with the general requirements set forth under this interpretation.

Fact Witness Testimony

A fact witness¹⁴ is also referred to as a percipient witness or a sensory witness. Fact witness testimony is based on the member's direct knowledge of the facts or events in dispute. A fact witness may have obtained his or her direct knowledge of the facts or events in dispute from the performance of prior professional services for the client. As a fact witness, the member's role is to provide factual testimony to the trier of fact. While testifying as a fact witness, the

trier of fact or counsel may request that the member testify as to his or her opinions pertaining to matters within the member's area of expertise. In such circumstances, independence would not be considered to be impaired.

Transition

Independence would not be impaired as a result of the more restrictive requirements of the forensic accounting services provisions, provided such services are pursuant to engagements commenced for an existing attest client prior to [effective date dependent on publication date in the Journal of Accountancy] and the member complied with all applicable independence interpretations and rulings in existence on [effective date dependent on publication date in the Journal of Accountancy].

Tax Compliance Services

Tax compliance services involve preparation of a tax return,¹⁵ transmittal of a tax return, and transmittal of the related tax payment to the taxing authority, signing and filing a tax return, and authorized representation of clients before a taxing authority.

Preparing a tax return and transmitting the tax return and related tax payment to a taxing authority, in paper or electronic form, would not impair a member's independence provided the member does not have custody or control¹⁶ over the client's funds and the individual designated by the client to oversee the tax services approves and signs the tax return prior to the member transmitting the return to the taxing authority. However, signing and filing a tax return on behalf of client management would impair independence, unless the member has the legal authority to do so and:

- A. The taxing authority has prescribed procedures in place for a client to permit a member to sign and file a tax return on behalf of the client (for example, Form 8879 or 8453), and such procedures meet, at the minimum, standards for electronic return originators and officers outlined in I.R.S. Form 8879; or*
- B. If no such procedures exist, an individual in client management who is authorized to sign and file the client's tax return provides the member with a signed statement that clearly identifies the return being filed and represents that:
 - a. Such individual is authorized to sign and file the tax return;*
 - b. Such individual has reviewed the tax return, including accompanying schedules and statements, and it is complete and accurate to the best of his or her knowledge and belief; and*
 - c. Such individual authorizes the member to sign and file the tax return on behalf of the client.**

Authorized representation of a client in administrative proceedings before a taxing authority would not impair a member's independence provided the member does not commit a client to a specific arrangement with the taxing authority without first obtaining client approval. Filing a

petition or otherwise representing a client in a court to resolve a tax dispute would impair a member's independence.

¹⁰ *The definitions of the specific services identified in this interpretation are solely for purposes of this interpretation and are not intended to be used for any other purpose.*

¹¹ *In determining whether the member's services are considered to be expert witness or fact witness services, members should refer to the Federal Rules of Evidence, Article VII. Opinions and Expert Testimony (Rules 701, 702 and 703) and other applicable laws, regulations, and rules.*

¹² *See advocacy threat as defined in the Conceptual Framework for AICPA Independence Standards (ET section 100.01). However, even though there is an appearance of advocacy, when providing expert witness services, a member must comply with Rule 102, Integrity and Objectivity, which requires that a member maintain objectivity and integrity and not subordinate his or her judgment to others.*

¹³ *For purposes of complying with general requirement no. 2, the client may designate its attorney to oversee the litigation consulting services.*

¹⁴ *See footnotes 10 and 11.*

¹⁵ *For purposes of this interpretation, a tax return includes informational tax forms filed with a taxing authority (for example, estimated tax vouchers, extension forms, and Forms 1099 and W-2) or other federal or state regulatory agencies (for example, Form 5500).*

¹⁶ *Making electronic tax payments under a taxing authority's specified criteria would not be considered having custody or control over a client's funds.*