

BACKGROUND AND BASIS FOR CONCLUSIONS:

REVISIONS TO INTERPRETATIONS AND RULINGS UNDER RULE 101— INDEPENDENCE

**PHASE I ADOPTED BY THE AICPA PROFESSIONAL ETHICS EXECUTIVE COMMITTEE on
DECEMBER 31, 2003**

**PHASE II ADOPTED BY THE AICPA PROFESSIONAL ETHICS EXECUTIVE COMMITTEE on
April 26, 2007**

- INTERPRETATION 101-3 (REVISION)
- INTERPRETATION 101-13 (DELETION)
- ETHICS RULINGS NO. 104 AND NO. 105 (DELETION)

This document summarizes considerations that were deemed significant by the Professional Ethics Executive Committee (the Committee) in revising in 2003 Interpretation 101-3, *Performance of Other Services* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05) and deleting in 2003 Interpretation 101-13, *Extended Audit Services* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.15), Ethics Ruling No. 104, *Operational Auditing Services* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.208-.209), and Ethics Ruling no. 105, *Frequency of Performance of Extended Audit Procedures* (AICPA, *Professional Standards*, vol. 2, ET section 191.210-11). It includes reasons for accepting certain recommendations for change and rejecting others and is intended to assist users of Interpretation 101-3 in understanding the revisions and the rationale for them. The above revisions are referred to as the "Phase I" revisions.

In January 2005 and April 2007, the Committee added an addendum to this document (see paragraphs 56-59) to provide further clarification on the Phase 1 revisions.

This document also summarizes the considerations that were deemed significant by the Committee in 2006 when it revised the interpretation to include specific guidance on Tax Compliance Services and Forensic Accounting Services. These revisions are referred to as the "Phase II" revisions.

PHASE I

BACKGROUND

1. In the fourth quarter of 2001, the Committee added a project to its three-year agenda to reexamine Interpretation 101-3 and Interpretation 101-13 to ensure their continued effectiveness in promoting independence when a member renders nonattest services to an attest client. Subsequently, the International Federation of Accountants (IFAC), an organization of which the AICPA is a member, adopted revisions to its rules on independence, which included new restrictions for certain nonattest services. One of those services involves appraisal and valuation services. As a result of IFAC's revisions, the AICPA's rules governing appraisal and valuation services for attest clients were different than IFAC's, making the need for the Committee to reexamine the AICPA's rules more apparent. In May 2002, the Committee began a substantive re-examination of the aforementioned interpretations as a first step in reviewing all of its nonattest services rules. Consistent with its primary standard-setting objective, the Committee sought to ensure that the AICPA's nonattest services independence rules would continue to be

relevant and protect the public interest.

2. During the succeeding months, the Committee conducted its reexamination, focusing initially on certain nonattest services. Recognizing that many entities are subject to independence rules of other authoritative bodies, such as the Securities and Exchange Commission (SEC) and the General Accounting Office (GAO), the Committee considered the various proposed and existing rules and regulations of those bodies, as well as the nonattest services independence provisions of the Sarbanes-Oxley Act, which was signed into law in July 2002. The Committee also analyzed the conceptual underpinnings of the current AICPA nonattest services independence rules to determine whether they should continue to serve as the foundation for the rules.
3. Throughout the reexamination process, the Committee was mindful of the widespread application of the AICPA's nonattest services independence rules because independence is a prerequisite for performing any audit or other attestation engagement under the profession's standards. The Committee believed that the AICPA's nonattest services independence rules should not only be universal in breadth, but also capable of being applied by a diverse population of practitioners providing attest services to a diverse population of attest clients—from attest engagements performed for private, family-owned businesses to those performed for companies regulated by other authoritative bodies.
4. The Committee decided to conduct its reexamination of Interpretation 101-3 in phases. During the first phase, the Committee's reexamination focused on the general requirements and conceptual underpinnings of the rule, three of the services that are specifically addressed in Interpretation 101-3, and the services that are specifically addressed in Interpretation 101-13:
 - a. Bookkeeping services
 - b. Appraisal, valuation, and actuarial services
 - c. Financial information systems design, installation, or integration services
 - d. Internal audit assistance services (previously called *extended audit services*)
5. Individuals with relevant and significant technical expertise assisted the Committee in conducting its reexamination. To bring local regulatory perspectives to the reexamination process, individuals who were associated with certain state accountancy boards and the National Association of State Boards of Accountancy (NASBA) actively participated in the process.
6. As a result of completing the first phase of its reexamination, on March 19, 2003 the Committee issued for public comment an Omnibus Ethics Exposure Draft (Exposure Draft) with a 60-day comment period. The Exposure Draft proposed to:
 - a. Incorporate by reference the nonattest services rules of certain authoritative bodies into Interpretation 101-3;
 - b. Strengthen the general requirements for performing nonattest services;
 - c. Require arrangements under which the member will perform a nonattest service for the attest client to be documented prior to the member performing the nonattest service;

- d. Clarify certain nonattest services rules, such as bookkeeping and internal audit assistance;
 - e. Incorporate the internal audit assistance rules into Interpretation 101-3; and
 - f. Add new restrictions for valuation, appraisal, and actuarial services and financial information systems-related services.
7. The Exposure Draft also asked respondents to consider replying to 19 questions relating to various aspects of the proposed rules.
8. The Committee received 30 comment letters on its proposal. On June 2 and 3, 2003, the Committee held a public meeting to discuss the comments and further deliberate the relevant issues. As a result of its deliberations, the Committee made certain modifications to the proposed revisions and adopted the proposal as modified.

REVISIONS ADOPTED BY THE COMMITTEE AND BASIS FOR CONCLUSIONS

9. The Committee proposed rule revisions to Interpretation 101-3 (the Interpretation) as follows:
- Added new guidance under the heading *Engagements Subject to Independence Rules of Certain Regulatory Bodies* ;
 - Clarified and enhanced the guidance under the heading *General Requirements for Performing Nonattest Services* , including establishing a requirement for members to document in writing their understanding with the client regarding key aspects of the engagement ; and
 - Revised certain of the examples and their effects on independence under the heading *Specific Examples of Nonattest Services*. The proposed revisions and the related comments, along with the Committee's consideration and conclusions, are described below.

Engagements Subject to Independence Rules of Certain Regulatory Bodies

10. The Exposure Draft proposed to incorporate into the Interpretation a requirement for members to comply with the more restrictive nonattest services independence rules of other authoritative bodies (e.g., the SEC or GAO) when providing nonattest services to attest clients for which they are required to comply with the independence rules of those bodies. Accordingly, a member who violates another authoritative body's more restrictive nonattest services independence rules would be considered to be in violation of the AICPA's nonattest services independence rules. To achieve this, the Committee added an explicit statement to the Interpretation, which requires compliance with the Interpretation *in addition to* the independence rules of bodies such as the SEC, GAO, Department of Labor, and state boards of accountancy when those other rules apply to the member's engagement.
11. The Committee believed this was an important addition to the AICPA's nonattest services independence rules. First, it may serve as a reminder that prompts members to consider whether, in addition to the independence rules of the AICPA, the rules of another body also apply to them in connection with a particular engagement. Second, this addition was considered important because with this change a loss of independence under another body's applicable rules would mean an automatic loss of independence under the AICPA's rules. Independence under Rule 101 of the AICPA Code of Professional Conduct is a prerequisite for performing a financial statement audit under Generally

Accepted Auditing Standards¹ and a financial statement review or other attestation services under other authoritative AICPA literature.² Previously, members who were found to have violated another organizations' applicable independence rules or regulations were deemed to have violated AICPA Rule 501, *Acts Discreditable* (AICPA, *Professional Standards*, vol. 2, ET section 501) but could still assert their independence under Rule 101 because Rule 501 is not an independence rule. The new guidance would more appropriately enable the Committee to find members in violation of the AICPA's independence rule (i.e., Rule 101). As part of its sanctioning process, members who have violated Rule 101 are referred by the Committee to the auditing or other relevant literature to determine the appropriate measures to be taken, including withdrawing their audit or other attest report. No such sanction occurs for a violation of Rule 501. The Committee recognized that increasing the potential for a member to have to withdraw his or her attest report or be precluded from issuing it under AICPA independence rules could have potentially significant ramifications. The Committee believed, however, that those ramifications would serve as an inducement to members to ensure their compliance with all of the independence rules that apply to their engagements.

12. The Committee acknowledged that members will make certain judgments in complying with independence rules. When a member is found to be in violation of another body's independence rule, deeming that member to be in violation of Rule 101 when the member made a good faith judgment in applying the other body's independence rule, particularly one that may be complex, ambiguous, or unclear, seemed unfair to one respondent. The Committee considered this but was not persuaded that the AICPA's rule should contain an exception for such a circumstance. If a member finds an independence rule to be complex, ambiguous, or unclear, the Committee expects the member to seek appropriate guidance to address the complexity or ambiguity and gain the necessary clarity to comply with the applicable independence rule prior to performing the nonattest service. Among other things, members could consult persons in their firms responsible for independence, refer to applicable regulations, commentary, releases, and any other explanatory guidance for a rule, or contact the body that issued the rule and seek guidance directly from that body.
13. Most respondents agreed with the Committee's proposed addition. Some suggested that the Committee also refer to the independence rules of banking regulators, such as the Federal Deposit Insurance Corporation or the Office of Thrift Supervision. The Committee considered the suggestion but concluded that the addition was unnecessary, noting that those regulators generally refer to one of the rules and regulations already referenced in the proposed addition. Respondents also generally agreed that while a reference to regulators that may have more restrictive nonattest services independence rules could be helpful, an all-inclusive list was not necessary.

General Requirements for Performing Nonattest Services

14. ***“The member should not perform management functions or make management decisions for the attest client. ...” (Item 1).*** The proposal underscored and sought to enhance within the Interpretation the Committee's longstanding position that a member may not perform management functions or make management decisions on an attest client's behalf. Rather, the client must be solely responsible for performing all management functions—including all significant decision-making on its own behalf—in connection with a nonattest services engagement. This basic prerequisite is the critical conceptual underpinning of the AICPA's nonattest services independence rules.

¹ Statement on Auditing Standards (SAS) No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 220, “Independence”).

² See Statement on Standards for Accounting and Review Services No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR secs. 100.19 and 100.39), and Statement on Standards for Attestation Engagements No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101.35).

Compliance with it effectively mitigates the self-review threat that can arise when a member audits financial statements that reflect the results of significant judgments that he or she made when rendering nonattest services. Accordingly, the member and the attest client must agree to observe certain parameters for the nonattest services engagement regarding their respective roles and responsibilities *before* the engagement begins. This is to ensure that in conducting the engagement the member does not act in a capacity equivalent to that of client management (e.g., make decisions on the client's behalf, such as which adjusting journal entries to record, approving invoices for payment, monitoring business processes, or supervising client employees). With the appropriate division of duties, the member's subsequent audit procedures will be applied solely to transactions and other matters that reflect the client's decisions, not the member's, thus enabling the member to carry out those procedures with objectivity and an appropriate level of professional skepticism.

15. The Committee provided the following example in its March 19, 2003 Omnibus Ethics Exposure Draft: A client asks a member to perform certain bookkeeping services, which includes preparing journal entries and financial statements. Before accepting the engagement, the member and the client must first agree on the responsibilities that each will need to undertake in connection with the engagement to ensure that the member will not undertake responsibilities that are those of client management. Further, in connection with the service the client must designate a competent employee to oversee the engagement and make all management decisions (e.g., determining or approving account classifications, adjusting journal entries, and changes to source documents [See Addendum paragraph 56]). The client must also agree to establish and maintain internal controls, including monitoring ongoing activities related to the subject matter of the services, and to evaluate the adequacy of the services. This is to ensure that the member, through his or her services, does not become part of the client's internal control structure. [See Addendum paragraph 59]. Finally, the client must take responsibility for the books, records, and related financial statements. Under these guidelines the member is prohibited from, among other things, creating source documents upon which evidence of an accounting transaction would be initially recorded, classifying or coding transactions without obtaining client approval, or changing the client's pre-coded source documents (e.g., an invoice) or any information in the source documents without the client's approval. These parameters enable the member to provide the bookkeeping services without assuming responsibility for functions that are the responsibility of client management. Accordingly, because the member would neither make significant judgments on the client's behalf nor exercise discretion in providing the bookkeeping services, the services would not impair his or her independence and should not cause him or her to be unwilling to challenge the amounts recorded in the financial statements because doing so would not call into question his or her own judgments.
16. Because this provision represented a longstanding position of the Committee, the Exposure Draft included only editorial changes, which were generally adopted as proposed.
17. ***“The client must agree to perform the following functions in connection with the engagement to perform nonattest services...” (Item 2).*** The proposal sought to amplify this important prerequisite for performing nonattest services for an attest client. To help ensure that the client employee designated to oversee the nonattest service would in fact be able to do so, the Exposure Draft proposed that the member assess the competency of the client to do that prior to accepting the engagement. Specifically, in order to perform nonattest services for an attest client, the member must be satisfied that, based on a careful assessment of the nature of the assignment and the weight of available evidence, that the designated client employee possesses the level of sophistication, skill, and expertise needed to be able to carry out his or her responsibilities in connection with the engagement. The Exposure Draft also stressed

that the designated client employee must be able to oversee the member's services and be willing to do so.

18. Most respondents supported this provision. Some, however, were concerned that smaller entities would be disproportionately harmed by such a rule because they believed that many smaller entities lack the resources to employ individuals who would be considered competent enough to oversee the services. Some commented that the needs of financial statement users of private versus public companies were inherently different and that it would not be in the public interest if members were precluded from performing nonattest services for those entities, mainly small, privately-held businesses, simply because the client did not have an employee who was competent to oversee the services. In addition, some respondents asked the Committee to define *competence* for purposes of this rule, and some were concerned that the degree of difficulty in accurately assessing a client employee's competence for this purpose may be too great to justify such a requirement. [See Addendum paragraph 56]
19. Although the Committee acknowledged that assessing a client employee's competency can be difficult, it believed that generally members are capable of performing such an assessment. For example, members assess the competency of individuals and client employees when complying with Statement on Auditing Standards (SAS) No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336) and SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322). The assessment of a client employee's competence called for by the revised rules may be similar to an assessment made under those standards, depending on the facts and circumstances. Accordingly, the Committee was not convinced that the degree of difficulty associated with such an assessment was sufficiently high to warrant eliminating the requirement. However, the Committee did not intend that the level of a client employee's competence be equivalent to that of a specialist or internal auditor. For example, although this Interpretation and its requirements apply when a member provides tax services to an attest client, the Committee did not intend that the client possess the level of tax expertise that the member possesses in order to be able to carry out its responsibilities under the Interpretation. Instead, the Committee intended that the client employee have a sufficient level of understanding of the results of the service such that he or she could effectively oversee them, including making any necessary management decisions related to a member's nonattest service. The competence level necessary for a client employee to carry out its responsibilities under the Interpretation will vary depending on the nature of the nonattest services engagement. However, in all cases it should be sufficient to allow the individual to understand the nonattest service to be rendered and enable him or her to make all management decisions and perform all management functions associated with the service, evaluate the adequacy and results of the service, accept responsibility for those results, and establish and maintain internal controls (including monitoring activities) over the subject matter of the service. [See Addendum paragraph 56]
20. The proposal continued to require the client to make all management decisions and perform all management functions, evaluate the adequacy and results of the services performed, accept responsibility for the results of the member's services, and establish and maintain internal controls related to the subject matter of the member's services. [See Addendum paragraph 59] Respondents did not raise any objections to those requirements and the Committee adopted them as proposed. The Committee recognized that the designated competent employee will be the one to carry out the safeguards described in paragraphs 2a., 2c., 2d., and 2e. in the *General Requirements* section of the Interpretation [See Addendum paragraph 56]. The Committee believes this is appropriate and consistent with the employee assuming responsibility for overseeing the nonattest services as prescribed by the safeguard in the paragraph 2b.

21. **“Before performing nonattest services, the member should establish and document in writing his or her understanding with the client...” (Item 3).** The previous rule encouraged but did not require members to establish in writing their understanding with the client concerning the (1) objectives of the nonattest services engagement and any applicable limitations, (2) nature of the services, and (3) member's and the client's respective responsibilities. The Exposure Draft proposed that members be *required* to document such understanding with the client prior to performing the nonattest services engagement. This proposed requirement also presumed that the “*General Requirements for Performing Nonattest Services*” have been met (e.g., the client is willing and able to perform related management functions, accept responsibility for the services, and so on). The proposal did not specify the form of the required documentation; the explanation accompanying the Exposure Draft indicated that it would be left to the member's discretion. Thus, under the proposal the documentation could be included in an engagement letter or in an internal file memorandum.
22. A few respondents believed that documentation was either unnecessary or did not belong in an independence rule. One respondent argued that a documentation requirement should not be part of an independence rule and would go beyond what was necessary and appropriate to ensure auditor independence. However, most respondents supported a requirement to document the understanding between the member and the attest client prior to the member performing nonattest services for the client. Several believed it was important to memorialize the agreement between the member and the client. One respondent indicated that such documentation would provide a clear and definitive record of the objectives of the engagement, the nature of the services, and the respective parties' responsibilities. Another stated that documentation should help to ensure that the member considers the requirements of the interpretation.
23. The proposal also asked respondents to comment on whether the rule should include a requirement for the member to specifically document his or her assessment of the competence of the designated client employee to effectively oversee the member's services. Several respondents recommended that members be required to specifically document this aspect of their assessment. The Committee believed that requiring that additional documentation was unnecessary. Implicit in the requirement in item 3c of the Interpretation (i.e., to document the understanding regarding client responsibilities) is that the member is satisfied that the client employee is competent to carry out his or her responsibilities to oversee the nonattest services engagement and that the member has reached that conclusion based on having made an appropriate assessment of the employee's competence. [See Addendum paragraph 56] Adding a requirement to document that specific assessment would impose an additional compliance cost on members that the Committee concluded would not produce significant benefit. Accordingly, the Committee decided not to require it.
24. The Committee considered whether a member's independence would be considered to be impaired if he or she failed to document his or her understanding with the attest client prior to performing nonattest services. The Committee agreed that the guidance in footnote 5 of the Interpretation sufficiently addresses that matter. That guidance indicates that a member's isolated and inadvertent failure to document his or her understanding with the client prior to performing nonattest services would not result in an impairment of independence provided that the member, among other things, promptly documented the understanding upon discovering that it had not been done. [See Addendum paragraph 57]
25. The Exposure Draft also asked respondents whether the rules should incorporate a “rebuttable presumption” test in which the member would begin his or her assessment presuming that the designated client employee lacks the requisite competence to oversee the service. Replies to this question were mixed with slightly more than half

indicating that the rules should not incorporate the notion of a rebuttable presumption. Of those opposing its use, most believed it simply was not necessary. The Committee concluded that assessing employee competence to overcome a rebuttable presumption should not result in a different conclusion than assessing employee competence without a requirement to overcome such a presumption. Accordingly, the Committee decided against the use of a rebuttable presumption test in this context.

Specific Examples of Nonattest Services

Bookkeeping Services

26. The Committee adopted the revisions to the guidance on bookkeeping services that it proposed in the Exposure Draft. Three revisions were proposed to the guidance in the chart labeled *Impact on Independence of Performance of Nonattest Services*. One revision clarified the client's and the member's responsibilities in connection with a bookkeeping engagement. Specifically, the Exposure Draft clarified that when a member proposes standard, adjusting, or correcting journal entries, client management should review the entries and the member must be satisfied that client management understands the nature of those entries and the impact they will have on the financial statements.
27. The Exposure Draft also proposed deleting a provision that indicated that a member may provide data processing services to an attest client. The Committee believed that the widespread use of computer systems by even the smallest businesses has rendered this specific provision obsolete. The deletion was not, however, intended to mean that such services would impair independence. If the member complies with the general requirements of the Interpretation, the services would not impair independence. In addition, the Exposure Draft proposed deleting the prohibition against "*originat[ing] data*" because the Committee considered the term "originate data" to be synonymous with "*preparing source documents*" and therefore redundant. That deletion was not intended to mean that such a service would not impair independence. That service, as well as the preparation of source documents, would continue to be viewed by the Committee as impairing independence.
28. Most respondents did not specifically comment on the bookkeeping rule revisions. Of those that did, two raised concerns about a client's ability to understand and effectively oversee the preparation of adjusting and closing entries. The Committee believed that such an ability, and the willingness to exercise it, is critical to preserve the member's independence and that such a requirement continues to be appropriate. Another respondent believed that due to the widespread availability of bookkeeping services, it was unnecessary for members to provide bookkeeping services to their attest clients and therefore the service could be banned altogether, especially if the public would have a negative perception of an auditor performing this service for an audit client. The Committee acknowledges that the public's perceptions are important considerations in establishing independence rules. In developing its rules, the Committee is mindful of the need for members to be independent in appearance, as well as in fact, and is guided by how a reasonable and informed third party with knowledge of all relevant information might perceive a particular relationship between the member and the attest client. Applying that test in this case, the Committee concluded that it was unnecessary to preclude members from providing such a service if the safeguards prescribed in the Interpretation (e.g., a competent client employee oversees the nonattest service) are implemented to reduce or eliminate the threat to independence that might arise from the rendering of the service. [See Addendum paragraph 56]

Information Systems—Design, Installation, or Integration

29. The Exposure Draft proposed more restrictive rules for certain financial information systems design, installation, and integration services that are rendered to attest clients. The Committee proposed that designing or developing an attest client's financial information system or making significant modifications to that system or to an existing system would be considered to impair the member's independence. Those services require highly specialized expertise on the part of the individual performing them and the Committee concluded that it was not reasonable to expect an attest client to have an employee on its staff who possesses the required expertise and skills to be able to effectively oversee the member's services in this particular area. Accordingly, the Committee proposed to prohibit such services for an attest client.
30. The Exposure Draft also described certain services that a member could perform without impairing independence. For example, provided that the general prerequisites in the Interpretation are met, the member could design, develop, install, or integrate an information system that is unrelated to the client's financial statements or accounting records, install or integrate a financial information system that was not designed or developed by the member, and assist the client in setting up a chart of accounts.
31. Respondents generally agreed with the proposed changes. A few, however, opposed various elements of the proposal. One respondent argued that independence would not be impaired when a member designs an attest client's financial information system because the respondent believed that the service would not directly affect specific financial statement amounts. Another respondent believed that auditors with the appropriate expertise are ideally suited to provide financial information systems services to their attest clients. Two respondents suggested that the Committee make the rule consistent with the GAO's rule in this area. The GAO's rule goes farther than the proposal by providing that installing any accounting system for an attest client, even pre-packaged software developed by someone else, also would be considered to impair independence.
32. Some respondents noted that members often install pre-packaged accounting software, such as *QuickBooks*, for their clients and as part of such an engagement may set up the chart of accounts and financial statement format defaults. Those respondents questioned whether this service would impair independence. The Committee concluded that this type of service did not constitute "designing" a system, provided that the member did not create or change the source code(s) underlying the pre-packaged software. The Committee revised that portion of the rule to reflect that making significant modifications to source code underlying an attest client's existing financial information system would impair independence. The Committee also revised the proposal to clarify that it is the act of designing or developing a financial information system—not the installation or integration of that system—that causes independence to be impaired.
33. The Exposure Draft also proposed that independence would be impaired if a member operated a client's local area network (LAN), even if the client had designated a competent member of management to be responsible for the LAN [See Addendum paragraph 56]. The Committee concluded that having the responsibility to operate such a system for the client, even with client oversight, is a management function. Respondents generally agreed with this proposal. One respondent disagreed, indicating that operating a client's LAN was a mechanical, rather than a management, function. The Committee acknowledges that the actual operating processes of a LAN could be mechanical in nature, depending on the facts and circumstances. However, it is the responsibility to operate the LAN, regardless of how mechanical its processes may be, that the Committee believed causes the member to undertake a management function. The Committee was not persuaded that the client's oversight and assumption of overall responsibilities for the LAN would be sufficient to overcome the fact that the member is participating in a management function.

34. The Committee adopted the remainder of the proposed rule changes for financial information systems design and implementation services, including the provision acknowledging that independence would not be impaired when a member designs or develops an information system that does not affect the attest client's financial statements or accounting records. The Committee acknowledged that it may be difficult to determine whether an information system designed or developed by the member that is *not* related to the client's financial statements or accounting records might subsequently affect such statements or records due to a change in the overall design of the system. The Committee concluded that judgment by members would be required to make that determination, considering all of the relevant facts and circumstances.

Appraisal, Valuation, and Actuarial Services

35. The Exposure Draft proposed significant new restrictions for appraisal, valuation, and actuarial services by prohibiting the performance of such services if the results of the service would be material to the financial statements *and* the service involved a significant degree of subjectivity. A significant degree of subjectivity would generally be evident, for example, when a member expected that applying a particular methodology would result in a broad range of outcomes because the results of the service are largely affected by judgments required in applying the methodology (i.e., determining the assumptions).
36. The Committee believed that in most cases involving appraisal, valuation, and actuarial services it was not reasonable to expect a client employee to have the requisite competence or technical skills to be able to meet the prerequisites that would allow the member to perform these types of nonattest services. However, even if the individual did have a sufficient level of competence to meet the prerequisites, the Committee concluded that the extent of the member's judgments that would be necessary to perform these services, and the potentially wide variability of results, would make it difficult for the member to be dispassionate with respect to the resulting amounts, thus creating a self-review risk that could not be mitigated by the application of safeguards. Accordingly, even if the client made those judgments and assumptions, the Committee concluded that when significant subjectivity is required to develop the appraisal, valuation, or actuarial amounts and the results would be material to the financial statements, the member could not rely upon a designated client employee to meet the prerequisites of the rule. In those cases, the Committee believed that the self-review risk would be unacceptable and the services should be precluded.
37. Respondents generally agreed with this proposal. As a result of comments received from the business valuation community, the Committee decided to clarify that the Interpretation applies only if the client for which a nonattest service is being rendered is also an attest client of the member. Accordingly, the Committee changed "client" to "attest client" in the first paragraph of the Appraisal, Valuation, and Actuarial Services section of the Interpretation.
38. The Committee also agreed to specifically state that valuations of Employee Stock Ownership Plans (ESOP) impair independence if they are material to the attest client's financial statements because such valuations generally involve significant subjectivity. The Committee included ESOP valuations as an example of the types of valuation services that generally would entail a significant degree of subjectivity and would impair independence if the results are material to the client's financial statements.
39. The proposed rule indicated that one determinant of significant subjectivity was whether a single prescribed methodology is used or whether multiple available methodologies can be used for performing an appraisal, valuation, or actuarial service. During the comment process, the Committee was informed that although certain single prescribed

methodologies do not involve significant subjectivity, and thus can be expected to produce reasonably consistent results regardless of who applies them, it is possible that the use of multiple available methodologies also could produce reasonably consistent results depending on the types of methodologies and other facts and circumstances. The Committee also understands that it is possible that valuation results could vary widely even though performed using a single prescribed methodology, depending on the facts and circumstances. Accordingly, the Committee concluded that it did not have sufficient evidence to support a statement in the Interpretation suggesting that the degree of subjectivity inherent in a valuation methodology is always directly linked to whether that methodology is prescribed. Instead, the Committee focused on whether the methodology and the overall valuation service would involve a significant degree of subjectivity, and decided to delete references to single versus multiple methodologies in the guidance on appraisal, valuation, and actuarial services.

40. The Exposure Draft distinguished actuarial valuations of an attest client's pension or other postemployment benefit liabilities from other valuations on the basis that those actuarial valuations generally do not entail a significant degree of subjectivity. In addition to the client making all of the significant assumptions required in performing the calculation, the types of assumptions that must be made and the calculation itself are prescribed by generally accepted accounting principles. Thus, the valuation methodology is based on a single prescribed set of reasonably objective criteria set out in the applicable accounting standard and can be expected to produce generally the same or a relatively narrow range of amounts no matter who performs the calculation. For that type of actuarial valuation, the Committee believes that the risk of self-review by the member is sufficiently mitigated because the amounts would generally be the same whether the member's actuary or another actuary performed the calculation. The Committee believed that would allow the member to be dispassionate with respect to the results of the valuation and therefore free to challenge the attest client's reported liability amounts. Accordingly, the proposal noted that provided the general requirements of the Interpretation are met, actuarial valuations of an attest client's pension or other postemployment benefit liabilities would not impair independence because such valuations do not require the member to exercise a significant degree of subjectivity.
41. Comments were mixed on the Committee's conclusion regarding actuarial valuations of an attest client's pension or other postemployment benefit liabilities. Some respondents believed that the distinction identified by the Committee was insufficient to justify a result that was different than for other valuations while others believed it was a sufficient distinction and supported it as the basis for the Committee's conclusion that such valuations do not involve significant subjectivity.
42. The Committee decided to adopt the rule as proposed, with the modifications noted earlier, because it continued to believe that the provision of actuarial valuations of pension and other postemployment benefit liabilities would not involve significant subjectivity. In reaching its decision, the Committee relied on an actuarial expert who advised it on the nature of these services and provided the Committee with an understanding of the prescribed valuation methodology used. The Committee was unable to conclude that other appraisal, valuation, or actuarial services, for example, valuations in connections with business combinations or ongoing assessments of related goodwill, would *not* involve a significant degree of subjectivity. The Committee noted that the valuation experts advising the Committee also were unable to conclude that other types of valuations would *not* require the exercise of significant subjectivity or would produce the same or relatively narrow range of results regardless of who performed the valuation.
43. The Exposure Draft proposed that appraisal, valuation, and actuarial services that are performed for tax planning or tax compliance, estate or gift taxation, or divorce proceedings, and other such services performed solely for non-financial reporting

purposes not be subject to the materiality and subjectivity tests because the results of such services do not directly affect the client's financial statements. Respondents generally agreed with this and the Committee adopted this provision as proposed.

44. The Committee noted that the general prerequisites of the Interpretation would continue to apply to the performance for an attest client of actuarial valuations of pension and other postemployment benefit liabilities and valuations for tax purposes, divorce proceedings, and other non-financial reporting purposes. To emphasize that requirement, the Committee added to the provision on appraisal, valuation, and actuarial services a statement that such services may be performed provided that, *"all other requirements of this Interpretation [are] met, including that all significant assumptions and matters of judgment are determined or approved by the client and the client is in a position to have an informed judgment on, and accepts responsibility for, the results of the service."*

Internal Audit Assistance Services

45. The Exposure Draft proposed that the guidance in Interpretation 101-13, *Extended Audit Services*, be moved to the Interpretation and that Ethics ruling no. 103, *Attest Reports on Internal Controls* and Ethics Ruling No. 104, *Operational Auditing Services*, also be incorporated into the Interpretation. Guidance in Ethics Ruling No. 105, *Frequency of Performance of Extended Audit Procedures*, was determined to be unnecessary and proposed for deletion.
46. By incorporating Interpretation 101-13 and related guidance into the Interpretation, the new documentation requirement and the obligation to assess the client's ability and willingness to oversee the engagement would also apply to internal audit assistance services. Further, other authoritative bodies' rules incorporated into the proposed rule by reference, would also apply where appropriate.
47. The Exposure Draft also proposed clarifying the guidance on internal audit assistance services. Interpretation 101-13 has always precluded members from providing such services when the client delegates or "outsources" responsibility and accountability for managing part or its entire internal audit function to the member because this would result in the member acting in a capacity equivalent to that of client management, which is prohibited. To emphasize this, the proposal included the following statement; *"...any outsourcing of the internal audit function to the member whereby the member in effect manages the internal audit activities of the client would impair independence."*
48. To avoid redundancies when incorporating internal audit assistance rules into the Interpretation, the Exposure Draft also proposed deleting references to the prohibited activities in Interpretation 101-13 that were already reflected in the Interpretation.
49. The Exposure Draft also clarified that procedures considered to be extensions of the member's audit scope (i.e., applied in the audit of the client's financial statements) and engagements performed under attestation engagements would not be considered internal audit assistance for purposes of the Interpretation (i.e., they are attest rather than nonattest services and are therefore not subject to this rule).
50. Comments on proposed revisions to the internal audit services rules were mixed. Some respondents believed that the AICPA's rule should be as restrictive as the rules of the SEC and the GAO, both of which largely ban internal audit assistance services altogether. Among the reasons respondents believed that the services should be considered to impair independence is the notion that such services constitute the performance by the member of a management function. The Committee agreed that such services, if not structured appropriately, have the potential to cause the member to undertake management functions. For that reason, the revised guidance is aimed at

preventing members from undertaking management functions. It repeats the general requirements in the Interpretation to ensure that client management, not the member, will perform all tasks and assume all responsibilities that are rightfully those of client management. Another reason cited was the belief that rendering internal audit assistance services causes the member to participate in the client's internal control system. The Committee agreed that independence would be considered to be impaired if the member became part of the client's internal control system. For that reason, the guidance in the Interpretation is aimed at preventing members from becoming a part of the client's internal control system. It provides that members may not perform ongoing monitoring or control activities that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both. Members also may not perform tasks that are equivalent to those of an ongoing compliance or quality control function in connection with the client's operating or production processes, regardless of how routine the tasks may be. The Committee concluded that these safeguards are appropriate in protecting a member's independence when providing internal audit assistance services.

51. The Committee also discussed the requirement in the Interpretation that client management designate a competent employee to be responsible for the internal audit function. The Committee considered whether a basic understanding of internal audit activities would be sufficient to meet this requirement or whether in-depth knowledge and expertise of internal auditing would be required. For example, the Committee considered whether an employee with a public accounting (external audit) background could be considered competent for this purpose or whether the employee should be required to have substantial internal auditing expertise. The Committee agreed that the key is that the employee's understanding of internal audit activities should be sufficient to enable him or her to oversee the services to be performed by the member in accordance with the requirements of the Interpretation. Accordingly, in this example, if the employee's public accounting experience provides him or her with the basis upon which to do that, he or she could be considered to be competent for purposes of overseeing an internal audit assistance services engagement. Whether an in-depth knowledge of internal auditing would be required would depend on the facts and circumstances (e.g., the complexity of the organization). Further, the Committee recognized that the designated competent employee, rather than client management, will likely be the one to carry out the safeguards described in the second, third, and fourth bullets in the Internal Audit Assistance Services section of the Interpretation. The Committee believes this is appropriate and consistent with the employee assuming responsibility for the client's internal audit function as prescribed by the safeguard in the first bullet. [See Addendum paragraph 56]
52. The Committee noted that in considering an attest client's internal audit function under SAS No. 65, the member would be assessing this employee and any of his or her staff. The member would not be assessing the staff of his or her own firm who may be performing internal audit assistance services for the client.
53. Because the guidance in ethics ruling no. 103 (Attest Report on Internal Controls) does not pertain to a nonattest service, the Committee decided not to incorporate it into the Interpretation but to retain it in the form of an ethics ruling. The Committee adopted the remaining internal audit assistance provisions as proposed.

Transition

54. The Exposure Draft did not include a transition provision but asked respondents to comment on whether a transition provision would be appropriate, and, if so, how it should be applied and for how long a period of time.

55. Respondents generally favored a transition provision for the new rules to give members sufficient time to consider them and adjust their firm policies and procedures accordingly. A transition period also would give members time to complete services under existing contracts that the Interpretation would effectively prohibit (e.g., the more restrictive rules on appraisal, valuation, and actuarial services or the rules on financial information systems design and implementation services).

Given the nature of the revisions to the Interpretation, the Committee decided to adopt an effective date of December 31, 2003 to allow members a three-month period (from date of publication in the *Journal of Accountancy*) to transition to the new rules. Earlier application is permitted. In addition, the Committee decided that members who have arrangements in place on December 31, 2003 to provide their attest clients nonattest services that are effectively prohibited under the Interpretation will have until December 31, 2004 to complete those services provided that the member is in compliance with the preexisting requirements of this Interpretation.

Addendum

In late 2004 and early 2005, the Committee revisited a number of the Interpretation's provisions after it became evident, based on feedback from a significant number of members, that further clarification was warranted with respect to (a) general requirement number 2, specifically, the client's designation of a competent employee to oversee the nonattest service(s) provided by the member, (b) general requirement number 3, the documentation requirement, and (c) the applicability of general requirements nos. 2 and 3 to the member's performance of *routine activities* when performed as part of the normal member-client relationship.

The following changes which do not relax the rules or change their meaning were adopted by the Committee during its January 26-27, 2005 meeting:

56. *Competency Requirement*

The Committee agreed to replace the term "competence" with the words "*suitable skill, knowledge, and/or experience*" throughout the Interpretation. In addition, the Committee agreed to replace the term (client) "*employee*" with "*individual*" to clarify that the person designated by the client to oversee the service could be the owner of the company or an individual outside the company such as an outsourced bookkeeper or controller. In making these changes, the Committee sought to clarify its intent with respect to the degree of "competence" the individual designated by the client to oversee the nonattest service is expected to possess. Some members interpreted the competency requirement as calling for the designated client individual to have a very high level of ability and expertise regarding the subject matter of the nonattest service. That was not the Committee's intent. The Committee intended that an individual designated by the client to oversee the nonattest service possess only the *skill, knowledge, and/or experience* that would be suitable in the circumstances to enable him or her to carry out his or her responsibilities in connection with the nonattest services engagement (e.g., understand the nature of the services, make all management decisions, and evaluate the adequacy and results of the service). The Committee believed that replacing the term "competent" with the words *suitable skill, knowledge, and/or experience* would appropriately clarify its intent.

57. *Documentation requirement*

While the Committee remains committed to the belief that the requirement to document the understanding with the client is an important and necessary safeguard to ensure that the member and client both understand their roles and responsibilities in connection with

the nonattest service (see paragraphs 21-23), it has reconsidered the appropriateness of enforcing a failure to prepare the required documentation under Rule 101-Independence (see paragraph 24). The Committee acknowledges that if the member has in fact established an understanding with the client (a long standing provision of the interpretation), then a failure to prepare the required documentation would not in and of itself cause a member's independence to be impaired with respect to the client.

Accordingly, the Interpretation has been revised to emphasize that a failure to prepare the required documentation would not impair independence (Rule 101-Independence) but would be considered a violation of Rule 202 – *Compliance With Standards*. Because this requirement will be considered a violation of Rule 202 and not Rule 101, the Committee agreed that it was no longer necessary to provide for an exception where the failure to document the understanding was *isolated and inadvertent* so this "exception" was deleted.

58. *Routine activities*

In response to a number of questions received from members, the Committee has revised the Interpretation to clarify that routine activities are exempt from both general requirements no.2 which requires the client to designate an individual with suitable skill, knowledge, and/or experience to oversee the nonattest services and no. 3, the documentation requirement. While acknowledging that a member is prohibited from performing management functions when performing routine activities for an attest client (i.e., general requirement no.1), it was never the Committee's intent to subject routine activities to general requirements no. 2 and no. 3 of the Interpretation.

The following editorial changes were adopted by the Committee during its April 26-27, 2007 meeting:

59. *Establish and maintain internal controls*

The Committee agreed to adopt revisions to the interpretation to clarify that establishing or maintaining controls, including performing ongoing monitoring activities for a client, would impair independence if performed by a member. Specifically, the Committee agreed that it would be more appropriate to classify General Requirement 2e (requiring that the client must agree to establish and maintain internal controls) under the interpretation's "General Activities" rather than a "client responsibility." Accordingly, General Requirement 2e was deleted and the following prohibition was added under General Activities: "*Establishing or maintaining internal controls, including performing ongoing monitoring activities for a client.*" Conforming edits were also made to the internal audit assistance services guidance and related footnote.

Phase II

Tax Compliance Services

Background

60. 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. Individuals with relevant and significant technical expertise assisted the Committee in conducting its assessment of these issues.

61. While the Committee initially undertook this project to address the increase in electronic filing and fund transfer programs, after studying the issues it concluded that the threats to independence were the same regardless of whether the tax returns were prepared and submitted in paper or electronic form and therefore, the guidance should apply to both types of tax returns.
62. On September 8, 2006 the Committee issued for public comment an Omnibus Ethics Exposure Draft (2006 Exposure Draft) with a 60-day comment period. The 2006 Exposure Draft proposed guidance on:
- a. Preparation of tax returns.
 - b. Filing a client's tax returns and transmitting related tax payments.
 - c. Signing and filing a tax return.
 - d. Authorized representation of clients before a taxing authority.
63. The Committee received 17 comment letters on the proposal. On November 30, 2006 the Committee held a public meeting to discuss the comments and further deliberate the relevant issues. As a result of its deliberations, the Committee made certain modifications and unanimously adopted the proposal as modified.

REVISIONS ADOPTED BY THE COMMITTEE AND BASIS FOR CONCLUSIONS

64. The Committee believes that when a member files an attest client's tax return and transmits the related payment, the member's independence is threatened because it appears that the member is acting in a management capacity.
65. 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) associated with filing an attest client's tax return, the Committee believed it was necessary to incorporate an additional safeguard over and above the General Requirements. Specifically, the Committee proposed that independence would not be impaired when filing an attest client's tax return provided 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. The Committee believes that when this approval is combined with the safeguards provided for under General Requirements 1 and 2 (e.g. this individual must 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 transmitting of the tax return by the member becomes clerical in nature (that is, not a management function).
66. However, when it comes to transmitting the client's related tax payment, the Committee did not believe there were any safeguards available to eliminate the management participation threat (that is, having custody or control over a client's assets). Accordingly, the proposal stated that a member must not have custody or control over the client's assets when he or she transmits the tax payments (whether in paper or electronic form) to a taxing authority. However, because 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, the Committee concluded that making electronic tax payments under a taxing authority's specified criteria would not be considered having custody or control over a client's funds.
67. Most respondents supported these provisions, however, one firm pointed out that the proposal appeared to conflict with the explanation section of the 2006 Exposure Draft (Explanation Section). Specifically, the proposal only indicated that the individual designated by the client to oversee the tax services must approve the return before it was

filed, whereas the explanation section incorporated the notion that such individual must *review* and approve the return *and related tax payment*. It was the Committee's intent that members have their clients *approve the contents of the return and the related tax payment* and not just provide the member with blanket approval. Accordingly, the Committee revised the guidance to state that the client must *review and approve* the return and related tax payment prior to it being filed by the member.

68. Other respondents suggested that the proposal's definition of "custody and control" should be expanded to exempt other ministerial or clerical tasks such as the transmittal of a client's paper check or use of a client's credit card to make the approved tax payment. The Committee agreed that remitting a paper check made payable to the taxing authority for a specific amount that is signed by the client would not constitute having custody or control over a client's assets. The Committee did not agree, however, that the use of a client credit card to make a client's tax payment would not constitute control over the client's assets and therefore, expanded the exemption to cover only the transmittal of paper checks approved and signed for by the client.
69. In addition, one respondent pointed out that certain returns need not be signed and so the Committee agreed to modify the guidance to clarify that a signature was only necessary if required for filing.
70. With respect to a member signing a tax return on the client's behalf, the Committee proposed that additional safeguards, over and above the General Requirements, should be applied in order to sufficiently mitigate the management participation threat.
71. These additional safeguards include that the member must have the legal authority to sign and file the return on the client's behalf. In many jurisdictions, this legal authority may be obtained by executing a power of attorney.
72. Since many members practice before the IRS, the Committee looked to the procedures the IRS had in place to determine whether such procedures would adequately safeguard the member's independence. The Committee concluded that the procedures set forth in IRS Forms 8879 for signing a tax return on behalf of a client, served as sufficient safeguards and agreed that independence would not be impaired provided the taxing authority had procedures in place that meet, at the minimum, standards for electronic return originators and officers outlined in IRS Form 8879.
73. The Committee also recognized that certain taxing authorities may not have specific procedures in place comparable to those set forth in IRS Form 8879. In those cases where no such procedures exist, the Committee agreed that the following critical safeguards must be in place in order for a member to maintain his or her independence:

An individual in client management who is authorized to sign and file the client's tax return must provide the member with a signed statement that clearly identifies the return being filed and represents that;

- the individual is authorized to sign and file the tax return;
- the individual has reviewed the tax return, including accompanying schedules and statements and that it is complete and accurate to the best of his or her knowledge and belief; and
- the individual authorizes the member to sign and file the tax return on behalf of the client.

74. While most respondents supported this requirement, several noted that the proposal was unclear whether these critical safeguards could be applied if the taxing authority's procedures did not meet the minimum standards outlined by IRS form 8879. The Committee's intent was for the guidance to be flexible and so it made an editorial revision to the guidance to make it clear that these critical safeguards could be implemented when the taxing authority's prescribed procedures do not meet the minimum standards outlined in IRS Form 8879. This editorial revision also incorporated standard federal tax return jurat by replacing the term "accurate" with "true and correct".
75. Other respondents suggested the requirement that the client provide the member with a *signed* statement was overly burdensome. However, the Committee believed that the management participation threat could not be sufficiently mitigated unless such statement was received in writing and chose not to amend the proposed guidance.
76. The final service addressed by the Committee dealt with representing a client in an administrative proceeding before a taxing authority. Often this representation is authorized by executing a power of attorney or similar power from the taxing authority and these documents (or powers) often give the member the authority to commit a client to a specific arrangement.
77. The Committee proposed that independence would not be impaired when representing a client in an administrative proceeding provided the member did not use such power to commit a client to a specific arrangement with the taxing authority without first obtaining client approval. Most respondents supported this requirement.
78. A number of respondents also raised concerns as to whether representation of a client in tax court should be prohibited on the basis of the advocacy threat since such representation of clients in tax court could be viewed as just an extension of the examination process and akin to an administrative court of limited jurisdiction.
79. The Committee discussed these concerns at length during its deliberations. Ultimately, the Committee concluded that the advocacy threat could not be reduced to an acceptable level when a member represents a client in court to resolve a tax dispute because the member is placed in an adversarial position with the taxing authority before a third party. While the proposal would have considered the act of filing of a petition to be considered "representing a client in a court," the Committee acknowledged that in some jurisdictions, it was possible to file a petition and continue to work with an agent or representative of the taxing authority without having to go before a court. Accordingly, the Committee clarified the standard by deleting the phrase, "filing of a petition."
80. The Committee also agreed to add a footnote to the term "court" to clarify that such court would encompass "a tax court, district court, or federal court of claims and equivalent state, local or foreign forums." In addition, it agreed that representation before forums that are equivalent to a court would impair independence.

In determining what other forums may be equivalent to a court, the Committee agreed that the following criteria would be indicative that the forum is equivalent to a court:

- The forum is presided over by a trier of fact who is independent of the taxing authority and is empowered to render a determination that is binding (absent appeal);
- The forum conducts formal proceedings governed by a set of procedural rules dealing with matters such as evidence and testimony;
- The forum is the last opportunity for the parties to present new factual evidence, so that any appeal of the forum's decisions would only involve a review of the forum's records, including its factual or legal findings, and not an evidentiary hearing.

Transition

81. During its deliberations, the Committee was asked to consider the need to transition the effective date for this guidance so that members had adequate time to implement the more restrictive requirements into their internal policies and procedures and so that members could complete already existing engagements. Accordingly, the Committee concluded that it would give members until the end of 2007 to complete engagements that were in process by the February 28, 2007 provided all other applicable independence interpretations and rulings were followed. Additionally, the Committee agreed to permit members to complete engagements to represent an attest client in a court to resolve a tax dispute if the engagement commenced before the guidance was published.

Forensic Accounting Services

Background

82. 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 proposal contained an 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.
83. The Committee received 15 comment letters in response to the September 15, 2005 proposal, which it considered at an open meeting held on January 30-31, 2006. Many respondents 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.
84. 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. Upon considering the comments received to the September 15, 2005, proposal and receiving further input from members who perform forensic accounting services, the Committee issued an exposure draft in September 2006 (the "September 8, 2006 proposal") proposing to incorporate revised guidance on the provision of forensic accounting services into Interpretation 101-3, *Performance of Nonattest Services*.
85. The Committee received 19 comment letters in response to the September 8, 2006 proposal. On December 1, 2006, the Committee held a public meeting to discuss the comments and further deliberate the relevant issues. As a result of its deliberations, the Committee made certain modifications and adopted the proposal as modified by affirmative votes of 2/3 of the member's voting.

REVISIONS ADOPTED BY THE COMMITTEE AND BASIS FOR CONCLUSIONS

86. Although the Committee acknowledged that there are other definitions of the term forensic accounting services used in the accounting and legal professions, for purposes of the proposed interpretation, the Committee defined forensic accounting services 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 interpretation, forensic accounting services consist of (1) litigation services and (2) investigative services.
87. *Litigation services* are defined in the interpretation as 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.
88. The Committee agreed that those forensic accounting services addressed by the interpretation are examples of nonattest services and therefore, it would be appropriate to address such guidance under Interpretation 101-3. The Committee further agreed that those forensic accounting services permitted under the interpretation should be subject to the interpretation’s General Requirements.

Expert witness services

89. As reflected in the September 8, 2006 proposal, the Committee concluded 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 the Committee believed there were no sufficient safeguards to mitigate this threat to an acceptable level. 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.
90. A number of respondents recommended that the Committee reconsider its conclusion that the provision of expert witness services would impair independence on the basis that such services must be performed in an objective manner and safeguards are in place to ensure that the expert does not serve as an advocate for the client, such as oversight by the trier of fact and compliance with Rule 102. The Committee devoted a significant amount of time to deliberating this issue and acknowledged that if the expert complied with all standards, he or she should be independent in fact. However, most still believed that from an appearance standpoint, a reasonable and informed third party would likely conclude that the expert was acting as an advocate for the client and therefore, agreed that such services would impair independence due to the *appearance* of advocacy.
91. At least one respondent asked the Committee to consider including an exception for situations where a member provides expert witness services for a large group of plaintiffs or defendants that include one or more attest clients of the firm provided that certain conditions/safeguards are met. The Committee agreed that provided certain conditions were met to ensure that the attest client did not have any ability to influence the member in the performance of the expert services, independence would not be impaired. Specifically, the Committee concluded that provided the following conditions were satisfied at the outset of the engagement, the appearance of advocacy would be sufficiently mitigated (i.e., independence would not be impaired):

- a. The member's attest clients constitute less than 20% of the:
 - Members of the group
 - Voting interests of the group, and
 - Claim;
- b. No attest client within the group is designated as the "lead" plaintiff or defendant of the group; and
- c. No attest client has the sole decision-making power to select or approve the expert witness.

Litigation consulting services

92. The Committee's proposed guidance stated that *litigation consulting services* (defined as those litigation services where a member provides advice about the facts, issues, and strategy of a matter without testifying as an expert witness before a trier of fact) would not 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.
93. A few respondents argued that the member's role when providing litigation consulting services in many respects is no different than when the member is providing expert witness services and should therefore receive similar treatment – i.e., litigation consulting services should impair independence. The Committee considered these arguments but believed there was a difference with respect to the appearance of independence when a member is assisting the client or client's attorney by performing litigation consulting services as compared to testifying on the client's behalf in an adversarial and public setting. In addition, the Committee noted that if it were to prohibit litigation consulting services, it would be inconsistent with the treatment afforded other consulting services under Interpretation 101-3. Accordingly, the Committee agreed to continue to permit litigation consulting services subject to the general requirements of Interpretation 101-3.

Other services

94. Consistent with the September 15, 2005, proposal, the Committee continues to believe 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 proposed guidance 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.
95. A couple of respondents questioned whether it was appropriate to exclude the roles of mediator and referee from the definition of "other services" (i.e., permit a member to serve in such a capacity) since they believed it was impractical that a member would be appointed to such a role and in certain states, the term *referee* may involve prohibited services. Still another respondent recommended that the guidance clearly state that such services were permitted. The Committee considered these comments and concluded that

provided the member was not involved in making any decisions on behalf of the parties, such services would not impair independence.

96. To clarify its position, the Committee agreed to add the following guidance to the standard:

However, independence would not be considered impaired if a member serves as a mediator or any similar role in a matter involving a client provided the member is not making any decisions on behalf of the parties but rather is acting as a facilitator by assisting the parties in reaching their own agreement.

97. The Committee also agreed to add a footnote to remind members that they must also comply with Interpretation 102-2, *Conflicts of Interest*.

Investigative services

98. The Committee defined *investigative services* to 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 Committee proposed that the provision of these services would not impair independence provided the services comply with the general requirements of Interpretation 101-3. Respondents did not take issue with this position and the Committee agreed that the final standard should permit the provision of investigative services.

Fact witness testimony

99. The proposed revision to Interpretation 101-3 included 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 fact witness testimony so comprehensive guidance existed in one place for the convenience of the user.
100. One respondent argued that fact witness testimony should not be considered a “professional service” subject to the General Requirements of the Interpretation due to the nature of fact witness testimony. The Committee agreed that it was not its intent to subject such testimony to the General Requirements and that such testimony should not be considered a nonattest service. The Committee concluded that it was not appropriate to address fact witness testimony under Interpretation 101-3 and therefore, agreed to delete the guidance from the proposal.
101. However, the Committee believed it was still necessary to address the situation where a member who is testifying as a fact witness, is questioned by the trier of fact or counsel as to his or her opinions pertaining to matters within the member’s area of expertise. The Committee agreed to move the guidance on this issue to the “Expert witness services” section. Specifically, the guidance states that answering such questions would not impair the member’s independence since the Committee believes a member should not be penalized (that is, impair independence) in this situation provided the member did not previously agree to serve in an expert witness capacity.

Transition

102. The Committee agreed to provide a transition period whereby 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 prior to February 28, 2007 and the member complied with all applicable independence interpretations and rulings in effect on February 28, 2007