Professional Ethics
Executive Committee

May 5-6, 2016 Open Meeting Agenda
Durham, NC
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<th>May 5th</th>
<th>Open Meeting Begins</th>
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| 9:00 a.m. – 10:30 a.m. | **Definition of Client**  
Mr. Mintzer and Ms. Ziemba will report on the Task Force’s activities and seek direction from the Committee. |
| 10:30 a.m. – 10:45 a.m. | **AM Break** |
| 10:45 a.m. – Noon | **Information Technology and Cloud Services**  
Ms. VanDyne and Ms. Goria will seek the Committee’s approval to expose the proposed interpretations on hosting and cloud based services as well as feedback on permitted installation and integration services. |
| Noon – 1:00 p.m. | **LUNCH** |
| 1:00 p.m. – 2:30 p.m. | **Leases**  
Mr. Wilson and Mr. Mercer will update the Committee on the Task Force’s activities. |
| 2:30 p.m. – 2:45 p.m. | **Afternoon Break** |
| 2:45 p.m. – 4:45 p.m. | **Entities Included In State and Local Government (SLG) Financial Statements**  
Ms. Miller and Ms. Goria will report on the Task Force’s activities and seek feedback on the Task Force’s direction for SLG affiliates. |
| 4:45 p.m. – 5:00 p.m. | **IESBA Update**  
Ms. Snyder will update the Committee on the March and April meetings of the IESBA. |

**May 6th**

| Open Meeting Reconvenes |
| 9:00 a.m. – 9:45 a.m. | **Compliance with Standards**  
Ms. Snyder will seek the Committee’s feedback on a proposed FAQ addressing the application of the Compliance with Standards rule with regard to services performed using technical standards not promulgated by bodies designated by Council. |

**Informational Purposes Only**

| Minutes of the Professional Ethics Executive Committee Open Meeting  
This item is on the agenda for informational purposes only as the Committee approved the minutes from the February 2016 meeting electronically.  
[External Link: February 2016 PEEC Minutes] |
| Committee Project Agenda  
[External Link - Project Agenda] |

**Open Meeting Concludes**

**Future Meeting Dates**
- July 12-13, 2016 – TBD
- November 3-4, 2016 – Austin, TX
Agenda Item 1

Definition of Client

Task Force Members
Andy Mintzer (Chair), Rick David, Bob Denham, George Dietz, Gregory Guin, Brian Lynch, and Linda McAninch
Staff: Shannon Ziemba and Ellen Goria

Task Force Charge
The Client Task Force (Task Force) is charged with determining what, if any revisions are necessary to the definition of client to conform to the organizational independence requirements in the GAO Yellow Book. Also, determine if criteria “a.” and the phrase “and, if different, the person or entity with respect to which professional services are performed” should remain in the definition.

Reason for Agenda Item
At the January 2015 Professional Ethics Executive Committee (the Committee) meeting, it was recommended to reorganize the Task Force since all but one member of the Task Force was no longer on the Committee. At that January meeting, the Committee had agreed there were unintended consequences to removing the phrase “the person or entity with respect to which professional services are performed” from the definition of client. The “new” Task Force was charged to evaluate whether there was a need to edit the client definition, add interpretations to applicable rules, or possibly change the applicable rules based on those edits to the definition. The Task Force was also asked to re-evaluate if “professional services” is the best term for purposes of the government employee exception.

At the May 2015 Committee Meeting, the “new” Task Force chaired by Andy Mintzer reported that the Task Force reviewed a spreadsheet which identified every instance that the term client appeared in the Code and found some instances where the term client was used but it appeared the term attest client was more appropriate. The Task Force also solicited feedback from the Committee if the Committee believe attest client was a subset of client or not.

At the July 2015 Committee Meeting, the Task Force received tentative approval of the proposed revised definition of client and attest client.

At the October 2015 meeting, the Committee recommended changing attest client to attest entity, moving the government provision from the attest client definition to the Independence section of the Code, and adding a note in the Code telling members that Commission and Referral Fees Rules also applies to attest entities.

At the February 2016 meeting, the Committee discussed at length whether the violation of the Contingent Fee and the Commissions and Referral Fees Rules should be a violation of the Independence Rule. The Committee also discussed whether the engaging entity, if not the target entity of the audit, could also engage that same member to perform nonattest services for a contingent fee on the engaging entity. The Committee was split on this topic.

At this meeting, the Task Force is requesting discussion on certain topics to assist the Task Force decide the best direction for possible edits to the definitions of client and attest entity and revisions and additions to the Code based on the revised definitions in the hopes of bring recommendations for exposure to the July Committee meeting.
Summary of Issues

Definition of Client

The Task Force had previously recommended that the definition of client should only be the person or entity that engages the member and not include the entity the member is performing the professional services on (target entity) if that target entity does not engage the member. In addition, the Task Force recommended that the government provision be moved from the client definition to an interpretation into the Independence section of the Code since the government provision involves independence and attest engagements. As such the Task Force has recommended, and PEEC tentatively agreed, at previous meetings that the definitions of client and Attest Entity (formerly Attest Client) read as:

Client - Any person or entity, other than the member’s employer, that engages a member or a member’s firm to perform professional services.

For guidance on how the “Commissions and Referral Fees Rule” [1.520.001] applies to an attest entity, members should refer to the “Application of the Commission and Referral Fees Rule to Attest Entities” interpretation [1.520.015].

Attest Entity - Any person or entity, whether or not a client, with respect to which a member performs an attest engagement.

In practice, when the attest entity is also the entity that engages the member to perform the attest engagement, the attest entity is often referred to as an attest client.

See the “Client Affiliate” interpretation [1.224.010] for acquisitions and business combinations that involve a financial statement attest entity. In addition, for guidance on how the “Commissions and Referral Fees Rule” [1.520.001] applies to an attest entity, members should refer to the “Application of the Commission and Referral Fees Rule to Attest Entities” interpretation [1.520.015].

The Task Force and PEEC considered if any modifications to interpretations should be made to take into account the revised definition of client being only the engaging entity. Considerable time and thought was spent in developing revisions to eliminate unintended consequences in confidentiality, records retention, referral fees and contingent fees.

Since independence rules are essential in performing attest engagements all the initial drafts of the revised code limited independence interpretations to “attest entities” and did not refer to “clients” After the February meeting, a Committee member voiced concern about removing the engaging entity (if not the target entity) from the Independence Rule and all its interpretations. Below are some examples of scenarios that raised concern to the Task Force (assume all engaging entities are not the target entities):

- Partner in Firm X has a direct financial interest in Company B. Company B engages Firm X to perform an audit of Entity G.

Question for the Committee

1. Does the Committee believe the above scenario should be violation of the Independence Rule?
2. Does the Committee believe the above scenario would be captured in the Conflict of Interest Rule or under the Conceptual Framework so not have to be violation of Independence but a violation of another rule?

- Partner in Firm X has a loan to Company B. Company B is looking to purchase Company F in hopes of expanding Company’s B business. Company B has asked Firm X to do the due diligence audit of Company F.

**Question for the Committee**

3. Does the Committee believe the above scenario should be violation of the Independence Rule?

4. Does the Committee believe the above scenario would be captured in the Conflict of Interest Rule or under the Conceptual Framework so not have to be violation of Independence but a violation of another rule?

- Partner in Firm X has a joint closely held investment with Howard Burns, owner of Company B. The joint closely held investment is material to the Partner. Mr. Burns has asked the Partner to have the Partner’s firm audit Company L.

**Question for the Committee**

5. Does the Committee believe the above scenario should be violation of the Independence Rule?

6. Does the Committee believe the above scenario would be captured in the Conflict of Interest Rule or under the Conceptual Framework so not have to be violation of Independence but a violation of another rule?

- Partner in Firm X’s father is the owner of Company B. Company B is looking to purchase Company F in hopes of expanding Company’s B business. Company B engages Firm X to perform an audit of Entity G.

**Question for the Committee**

7. Does the Committee believe the above scenario should be violation of the Independence Rule?

8. Does the Committee believe the above scenario would be captured in the Conflict of Interest Rule or under the Conceptual Framework so not have to be violation of Independence but a violation of another rule?

- Partner in Firm X is on the board of directors of Company B. Company B engages Firm X to perform an audit of Entity G.

**Question for the Committee**

9. Does the Committee believe the above scenario should be violation of the Independence Rule?

10. Does the Committee believe the above scenario would be captured in the Conflict of Interest Rule or under the Conceptual Framework so not have to be violation of Independence but a violation of another rule?

- Manager Jane Smith in Firm X has applied for a position at Company B. Company B engages Firm X to perform an audit of Entity G. Jane Smith will be the manager on the audit of Entity G.
Question for the Committee

11. Does the Committee believe the above scenario should be violation of the Independence Rule?
12. Does the Committee believe the above scenario would be captured in the Conflict of Interest Rule or under the Conceptual Framework so not have to be violation of Independence?

One of the Task Force member discussed that he was not concerned about a CPA firm doing prohibited non-attest services for an engaging entity, who is not the target entity of an attest service which the CPA firm will also perform. The member was concerned about the interpretations related to financial interests, key positions, family relationships and associations with the engaging entity.

Question for the Committee

1. Does the Committee agree that the Task Force should not be concerned regarding a CPA firm doing prohibited non-attest services for an engaging entity who is not the target entity of an attest service?
2. Does the Committee agree that the Task Force should be address a CPA Firm having financial interests, key positions, family relationships and associations with an engaging entity who is not the target entity of an attest service?
3. Does the Committee believe the above issues should be addressed in the client definition or the attest entity definition?

Contingent Fee Rule

At the February 2016 PEEC meeting, the Committee discussed at length and was split on the following scenario:

- Firm X performs non-attest services for Company B on a contingent fee basis. Company B is now engaging Firm X to perform an audit on Company H.
  - Some members of the Committee believed this was acceptable and is currently done in practice.
  - Other members believed that since the Contingent Fee rule states (in part):
    
    A member in public practice shall not

    a. Perform for a contingent fee any professional services for, or receive such a fee from a client for whom the member or the member’s firm performs,

    i. an audit or review of a financial statement; or

    It does not matter that the audit was performed on Company H, the rule prohibits any contingent fee relationship between Company B and Firm X.

Question for the Committee

1. Does the Committee believe that Contingent Fee relationships should extend to non-attest services performed on a client for whom the firm also performs an audit even if the audit is on another entity?
**Target Entity**

The Task Force would like feedback from the Committee on the scope of responsibility owed to the target entity when it is not the engaging entity. The Task Force voiced in the past that they do not believe the target entity is owed any level of knowledge as to the outcome of the engagement or anything learned from the engagement. As currently interpreted the target entity is included within the “client” definition and arguably is entitled to the engagement findings as such. Accordingly the TF decided and the Committee tentatively agreed to define client as the engaging entity. Notwithstanding that the target is not entitled to communications the engaging entity is entitled to, the TF concluded and the Committee tentatively agreed that members had responsibilities for confidentiality and record retention with respect the non-engaging target and that the commission and contingent fee rules had implications to the independence rules which must be considered. The TF is currently considering and seeking input how the target entity, if different than the engaging entity, affects the impudence rules more generally.

**Question for the Committee**

1. Does the Committee agree with the Task Force that the target entity, if not the engaging entity, is not entitled to engagement findings and results?
2. Does the Committee believe that there are any other duties or professional responsibilities that the member does not have to the target entity, if different than the engaging entity?
IT and Cloud Services Task Force

Task Force Members: Shelly VanDyne (Chair), Cathy Allen, Wendy Davis, Mike Schmitz, Katie Jaeb, Ray Roberts, and Anna Dourkourekas. Staff: Ellen Goria

Task Force Objective
Recommend to PEEC any changes necessary to the nonattest services subtopic in light of current information technology (including cloud) service offerings by members.

Reason For Agenda
To provide feedback on the suggested changes made by Staff to the draft interpretation to address the Committee’s feedback and to begin discussing what other revisions might be necessary to the Information Systems Design, Implementation, or Integration interpretation [1.295.145] and nonattest services FAQ document.

Summary of Issues

Hosting Services
Following is a summary of the main revisions made to the Hosting Services proposal since the February PEEC Meeting.

Location in Code
The Codification Task Force organized the interpretations that address specific nonattest services examples alphabetically in the Nonattest Services subtopic. As such, the Task Force recommends that the Hosting Services interpretation be located between the Forensic Accounting interpretation [1.295.140] and the Information, Systems Design, Implementation, or Integration interpretation [1.295.145] and be numbered 1.295.143.

Custody and/or Control
During the Committee’s February meeting a straw poll was taken where 14 members agreed that if the member was engaged to have either custody or control of data or records that the attest client uses to conduct its operations, the member would be considered to be providing hosting services that impair independence. The idea being that there may be situations where the member does not have custody of a client’s assets but can still control them such as when a bank holds the client’s cash but the member has the authority to authorize disbursements. The proposed Hosting Services interpretation found in Agenda Item 2B was revised to incorporate this conclusion.

Situations Where Member Is Not Hosting Client Data or Records
During the February PEEC meeting the Committee noted that the lead in to paragraph .03 could result in confusion because it seemed to imply that there are hosting services that could be provided that would not impair independence. To avoid such confusion the Task Force changed the lead in to paragraph .03 so that the focus is on the fact that in the situations listed the member would not be considered to be hosting client data or records and not on whether independence would be impaired.

In addition, the Task Force revised item c in paragraph .03 so that it would cover situations where the member might use a portal to communicate with third parties on the client’s behalf, such as when a client asks a member to deliver K1s to the partners of a partnership. Following is the revised language:

Electronically exchanging data or records with or on behalf of a client provided the member has not been engaged to retain custody or control of the data or records on behalf of the attest client. For example, a member and an attest client may use a portal...
to exchange data and records related to professional services the member has been engaged to provide or when the attest client requests the member send its work product to third parties.

Effective Date
The Task Force recommends that since there is no guidance relating to hosting data and information currently in the Code, it may take some time for members to wrap up existing engagements so that their independence is not impaired. As such, the Task Force recommends that the proposed interpretation allow members 6 months to wrap up existing engagements. Following is the effective date that the Task Force recommends be included in the proposal:

**Effective Date**
This interpretation is effective [6 months from the date it is published in the *Journal of Accountancy*]. Hosting service engagements commenced prior to [last day of the month the new interpretation is published in the *Journal of Accountancy*] will not be deemed to impair independence provided such engagements are terminated before [the effective date of this interpretation], and the member complied with all applicable independence interpretations in effect on [the last day of the month the new interpretation is published in the *Journal of Accountancy*].

So for example if the new interpretation was published in the March 2017 *Journal of Accountancy* the interpretation would not be effective until September 30, 2017. Then any hosting engagement that had begun prior to March 31, 2017 would not impair the member’s independence as long as it was terminated before September 30, 2017 and met the requirements of the nonattest services subtopic. Alternatively, that means that if the member enters into a new hosting engagement between April 1, 2017 and September 29, 2017, terminating the engagement by September 30, 2017 won’t cure the independence impairment.

### Questions For the Committee
1. Does the Committee approve Agenda Item 2B for exposure?
2. Does the Committee believe the typical 60 day exposure period is adequate or is a longer exposure period necessary?

**Cloud Based Services**
The Task Force believes the phrase “cloud based services” is appropriate because according to the definitive authority on cloud computing the National Institute of Standards and Technology, cloud computing is a model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (e.g., networks, servers, storage, applications, and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction. Said more simply, the cloud, refers to software and services that run on the Internet instead of your computer. Apple iCloud, Dropbox, Netflix, Amazon Cloud Drive, Flickr, Google Drive, Microsoft Office 365, Yahoo Mail -- those are all cloud services. There are many advantages to using the cloud including being able to access information from anywhere.

The Committee asked the Task Force to consider removing the parenthetical explanation of what permitted nonattest services are because it made the paragraph difficult to read. The Task Force believes the paragraph would be easier to read if the phrase “permitted nonattest service” was removed combined with other streamlining edits since the phrase “permitted nonattest service” is not used elsewhere in the Code. The changes from the February meeting appear in highlight.
.09 Activities Provided Through a Cloud Based Solution. Threats to independence would not be considered significant solely because a member provides a permitted nonattest service (that is, a nonattest service that does not impair independence and complies through a cloud-based solution. When providing nonattest services through a cloud-based solution, members are reminded to comply with all the requirements for the Nnonattest Services subtopic) through a cloud-based solution provided the member complies with including the “Hosting Services” interpretation [1.295.xxx143]

Questions For the Committee
1. Does the Committee approve Agenda Item 2C for exposure?
2. Does the Committee believe the typical 60 day exposure period is adequate or is a longer exposure period necessary?

Information Systems Design, Implementation, or Integration Interpretation and Related FAQs

With respect to “item a” in paragraph .02 of the Information Systems Design, Implementation, or Integration interpretation [Agenda Item XD], the Task Force believes it would be helpful to provide guidance on what install or integrate could involve and what an off-the-shelf accounting package is and the amount of customization that could be done to an “off-the-shelf” accounting package without impairing independence.

.02 If the member applies the “General Requirements for Performing Nonattest Services” interpretation [1.295.040] of the “Independence Rule” [1.200.001], threats would be at an acceptable level and independence would not be impaired. For example, a member may

a. install or integrate an attest client's financial information system that the member did not design or develop (for example, an off-the-shelf accounting package).

While the Task Force is thinking the guidance would be in the form of FAQs, it does plan to discuss if the term “off-the-shelf” continues to be the clearest way describe what is meant or if some other description might be better.

Some of the preliminary feedback received is that with respect to customization is that there oftent seems to be a lot of complexity with the configuration of the interfaces with the various systems and that when providing installation or integration services the firms make sure that

- it is not acting as the project manager
- it will not be changing the way the software functions
- it is only providing advise to the client regarding the business process

Questions For the Committee
1. Does the Committee believe the phrase “off-the-shelf” continues to be a well understood term and if not, is there a better way to describe what it meant?
2. What types of installation or integration services is your firm asked to provide in connection with these accounting packages and where do you draw the line in order for independence to be maintained?
3. What level of customization do you believe maybe provided without impairing independence?
**Modifications To Source Code**

The Task Force discussed the following FAQ:

What factors should a *member* consider in determining whether the modifications made to source code underlying an *attest client’s* financial information system are other than insignificant?

If the modifications have more than an insignificant effect on the functionality of the software, they should be considered to be other than insignificant. [Added Prior To June 2005]

The Task Force would like to understand how members of the Committee apply the significance threshold in this FAQ as several Task Force members noted that their firm’s don’t permit making any modifications, significant or insignificant, to source code.

### Questions For the Committee

1. Do you ever use this FAQ to permit coding that is insignificant and if not should we remove the concept?
2. Can you share with us any situations where your firms determined that the coding was insignificant and therefore permitted? What is involved with making modifications to source code? How did your firm determine what is allowed and what is not allowed?
3. Can you share with us any situations where your firms believes coding would result in more than significant?

### Effective Date

TBD

### Communication Plan

TBD

### Materials Presented

- **Agenda Item 2B** Draft New Hosting Services Interpretation
- **Agenda Item 2C** Draft Revised Scope and Applicability of Nonattest Services Interpretation
- **Agenda Item 2D** Information Systems Design, Implementation, or Integration interpretation
- **Agenda Item 2E** Excerpt of the Nonattest Services FAQs
Agenda Item 2B

Items In Highlight Are Changes From the February Meeting

1.295.xxx143 - Hosting Services

01. An attest client’s management is responsible for maintaining custody and control over its assets which includes its data and records. When a member is engaged to provide hosting services that involve the member having custody and control of data or records that the attest client uses to conduct its operations (hosting services) the self-review and management participation threats to the member’s compliance with the “Independence Rule” [1.200.001] would not be at an acceptable level, and cannot be reduced to an acceptable level by the application of safeguards, and independence would be impaired.

02. Examples of hosting services that would impair independence include:
   a. Acting as the attest client’s business continuity or disaster recovery provider.
   b. Housing the production environment of the attest client’s system (financial or non-financial) on the member’s servers. For example, the firm hosts the attest client’s financial system or website on firm’s servers.
   c. Keeping the attest client’s data or records in the member’s office for safekeeping. For example, the attest client’s original lease agreements or other legal documents are stored in the member’s office.

03. Following are examples of situations where a member will not be considered to be providing hosting services that would impair independence since the member would not have custody and control of hosting data or records that the attest client uses to conduct its operations:
   a. Retaining a copy of an attest client’s data or records as documentation to support a service provided, for example, the member retains a copy of the payroll data that supports a payroll tax return the member prepared or a copy of a bank reconciliation that supports attest procedures performed on the cash account.
   b. Retaining a copy of a work product that the member was engaged to prepare, for example, a tax return that the member was engaged to prepare.
   c. Electronically exchanging data or records with or on behalf of a client provided the member has not been engaged to retain custody or control of the data or records on behalf of the attest client. For example, a member and an attest client may use a portal to exchange data and records related to permissible nonattest professional services the member has been engaged to provide or when the attest client requests the member send its work product to third parties.
   d. Attest client licenses from the member the use of a software product where the attest client inputs its data and the software product provides the attest client with an output that the attest client is responsible for maintaining. The software product must perform an activity that if performed by the member, would not impair independence.

Effective Date

04. This interpretation is effective [6 months from the date it is published in the Journal of Accountancy]. Hosting service engagements commenced prior to [last day of the month the new interpretation is published in the Journal of Accountancy] will not be deemed to impair independence provided such engagements are terminated before [the effective date of this interpretation], and the member complied with all applicable independence interpretations in effect on [the last day of the month the new interpretation is published in the Journal of Accountancy].
Agenda Item 2C

Items In Highlight Are Changes From the February Meeting

1.295.010 Scope and Applicability of Nonattest Services

.09 When a member performs nonattest services for an attest client, self-review, management participation, or advocacy threats to the member’s compliance with the “Independence Rule” [1.200.001] may exist. When significant independence threats exist during the period of the professional engagement or the period covered by the financial statements (except as provided for in paragraph .03), independence will be impaired unless the threats are reduced to an acceptable level and any requirements included in the interpretations of the “Nonattest Services” subtopic [1.295] under the “Independence Rule” have been met.

.10 For purposes of the interpretations of the “Nonattest Services” subtopic [1.295] under the “Independence Rule” [1.200.001], the term member includes the member’s firm.

.11 Period of engagement. A member’s independence would not be impaired if the member performed nonattest services that would have otherwise impaired independence during the period covered by the financial statements if all of the following conditions exist:
   a. The nonattest services were provided prior to period of the professional engagement.
   b. The nonattest services related to periods prior to the period covered by the financial statements.
   c. The financial statements for the period to which the nonattest services relate were audited by another firm (or in the case of a review engagement, reviewed or audited by another firm).

Nonauthoritative questions and answers regarding the period of the professional engagement are available at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf.

.12 Activities related to attest services. Performing attest services often involves communications between the member and client management regarding
   a. the client’s selection and application of accounting standards or policies and financial statement disclosure requirements;
   b. the appropriateness of the client’s methods used in determining accounting and financial reporting;
   c. adjusting journal entries that the member has prepared or proposed for client management consideration; and
   d. the form or content of the financial statements.
These communications are considered a normal part of the attest engagement and are not considered nonattest services subject to the “General Requirements for Performing Nonattest Services” [1.295.040] and “Documentation Requirements When Providing Nonattest Services” [1.295.050] interpretations.

.13 However, the member should exercise judgment in determining whether his or her involvement has become so extensive that it would constitute performing a separate service which would be subject to the “General Requirements for Performing Nonattest Services” interpretation [1.295.040].

.14 For example, activities such as financial statement preparation, cash-to-accrual conversions, and reconciliations are considered outside the scope of the attest engagement and, therefore, constitute a nonattest service. Such activities would not impair independence if the requirements of the interpretations of the “Nonattest Services” subtopic [1.295] are met.
Engagements subject to independence rules of certain regulatory or standard-setting bodies. Threats to compliance with the “Independence Rule” [1.200.001] would not be at an acceptable level and could not be reduced to an acceptable level through the application of safeguards if a member is not in compliance with the independence regulations of authoritative regulatory bodies that are more restrictive than the interpretations of the “Nonattest Services” subtopic [1.295] under the “Independence Rule” (examples of such authoritative bodies are the SEC, the Government Accountability Office [GAO], the Department of Labor [DOL], the Public Company Accounting Oversight Board [PCAOB], and state boards of accountancy) when a member performs nonattest services for an attest client and is required to be independent of the attest client under the regulations of the applicable regulatory body. Independence would be impaired under these circumstances. [Prior reference: paragraph .05 of ET section 101]

Activities Provided Through a Cloud Based Solution. Threats to independence would not be considered significant solely because a member provides a permitted nonattest service (that is, a nonattest service that does not impair independence and complies through a cloud-based solution. When providing nonattest services [1.295] through a cloud-based solution, members are reminded to comply with all the requirements for the “Hosting Services” interpretation [1.295.xxx143]

Effective Date

Paragraph .06 of this interpretation is effective for engagements covering periods beginning on or after December 15, 2014. Paragraph .08 of this interpretation is effective [last day of the month the change appears in the Journal of Accountancy].
INFORMATION TECHNOLOGY SERVICES

1. Why does the Information Systems Design, Implementation, or Integration interpretation indicate that independence would be impaired if a member is operating a client’s network?

Operating an attest client’s network is considered to be a management responsibility that would violate the General Requirements for Performing Nonattest Services interpretation.

2. Would outsourcing the client’s entire network operation and independently operating the client’s network impair independence?

Yes.

3. Would performing network maintenance (for example, updating virus protection, applying updates and patches, or configuring user settings, consistent with management’s request) impair independence?

No. Performing network maintenance is not considered to be operating the attest client’s network and, therefore, would not impair independence provided a client employee with the necessary skill, knowledge, and/or experience is making all decisions and approving all activities. [Added Prior To June 2005]

4. Would assisting an attest client with a server project (for example, install, migrate, or update its network operating system; add equipment and users; or copy data to another computer) impair independence?

No. Provided the member does not make other than insignificant modifications to the source code underlying the attest client’s financial information system. [Added Prior To June 2005]

5. Would supervising client personnel in the daily operation of the attest client’s financial information system impair independence?

Yes. In this case, the member would be performing management responsibilities (that is, directing or accepting responsibility for the actions of the attest client’s employees), which would impair independence. [Added Prior To June 2005]

6. Would assisting an attest client with procuring and securing Internet access impair independence?

No, provided an individual designated by the attest client to oversee the service has the necessary skill, knowledge, and/or experience and makes all decisions concerning the Internet provider and services to be provided.

7. What criteria should a member use to determine whether an attest client’s information system is unrelated to its financial statements or accounting records?

Information systems that produce information that is reflected in the amounts and disclosures in the attest client’s financial statements, used in determining such amounts and disclosures, or used in effecting internal control over financial reporting are considered to be related to the financial statements and accounting records. However, information
systems that are used only in connection with controlling the efficiency and effectiveness of operations are considered to be unrelated to the financial statements and accounting records. [Added Prior To June 2005]

8. What factors should a member consider in determining whether the modifications made to source code underlying an attest client’s financial information system are other than insignificant?

If the modifications have more than an insignificant effect on the functionality of the software, they should be considered to be other than insignificant. [Added Prior To June 2005]

TRAINING SERVICES

1. An attest client is implementing changes to its financial reporting system or process (for example, implementing International Financial Reporting Standards [IFRSs] or eXtensible Business Reporting Language [XBRL]). Would a member’s independence be impaired if he or she provided training to the attest client related to such system or process?

A member’s independence would not be impaired if he or she provides attest client personnel with a general understanding of the financial reporting system or process (FRP). If attest client personnel already have a general understanding of the FRP, the member may provide more specific training to attest client personnel on how the system or process applies to the attest client’s specific circumstances. In providing training services, however, the member should ensure that such nonattest services do not involve supervising attest client personnel in either the implementation or daily operation of the FRP, or performing other management responsibilities, such as making FRP operational decisions or implementing the internal controls necessary for the FRP to run effectively [Added February 2010].

PROJECT MANAGEMENT SERVICES

.01 Would a member’s independence be impaired if he or she managed a project for an attest client (such as converting the client’s FRP from US GAAP to IFRSs or implementing XBRL)?

Yes, accepting responsibility for the management of an attest client’s project would be considered a management responsibility and as such would impair a member’s independence. This would be true even if the project did not impact the financial statements.

Independence, however, would not be impaired if management makes all decisions related to the project and the member’s involvement was limited to providing assistance, advice, suggestions and/or recommendations regarding matters that are within their areas of knowledge or experience. Such activities might include (a) providing advice about either the tagging of XBRL-formatted or preparation of IFRSs-based financial statements, (b) providing feedback on management’s plans, including how management will prioritize its activities, and (c) assisting the client with its understanding of the general considerations for the project [Added February 2010.]

.02 Would a member’s independence be impaired if he or she assisted attest client management with its determination of whether or not to proceed with a project (for
example, convert its FRP from US GAAP to IFRSs or is implementing XBRL for its financial statements)?

Provided the member only assists the attest client by providing guidance on the conversion or implementation issues and does not make the decision of whether or not to proceed with the project, the member’s independence would not be impaired. For example, such assistance may include (a) helping gather information that management will use to conduct its analysis or (b) providing advice and making recommendations on the assumptions management plans to use in its analysis [Added February 2010.]
Leases Task Force

Task Force Members
Blake Wilson (Chair), Bill Mann, Alan Gittelson, David East, Nancy Miller, Chris Cahill
Staff: Brandon Mercer; Observers: Lisa Snyder, Ellen Goria

Task Force Charge
Revise the independence guidance based upon the revised accounting standards on leases issued by the Financial Accounting Standards Board (FASB).

Reason for Agenda Item
The Leases Task Force was last active in 2012, and has been awaiting the issuance of the final leases standard by FASB to evaluate the need for related revisions to the AICPA Code of Professional Conduct (the “Code”) under the Leases Interpretation (1.260.040) of the Independence Rule (1.200). In February 2016, FASB issued Audit Standards Update No. 2016-02 Leases (the “Update”), which made various changes to the accounting model for leases. The FASB project page, which contains the final standard, a summary, and other background documents, can be found at this link:


The Task Force held its initial conference call on April 15, 2016 to discuss the changes made by the Update, review the resulting impact on the AICPA Code and existing concerns of PEEC and the prior Task Force, and establish a preliminary position and/or direction for PEEC feedback. The purpose of this agenda item is to inform PEEC of the Task Force’s preliminary direction and obtain PEEC’s position on several issues as noted below.

Background
The extant AICPA Code addresses leasing arrangements and independence at the Leases Interpretation (1.260.040), which is presented in this agenda and in Agenda Item 3B. As noted in the Leases Interpretation, a primary factor in evaluating independence is whether a lease is categorized as a capital lease (impairs independence) or operating lease (does not impair independence). As explained below, the FASB Update changed the accounting treatment of operating leases by moving them to the statement of financial position; previously operating leases were treated as a current operating expense.

FASB Audit Standards Update No. 2016-02: Leases
The Update made significant changes to the way lessees account for operating leases, while leaving the lessor’s accounting treatment largely unchanged. This and other changes are highlighted for both lessees and lessors below. The Update is effective for fiscal years beginning after December 15, 2018 (public companies) and December 15, 2019 (private companies).

Lessee Accounting Model – Short Term Leases, Operating Leases, Finance Leases
In the Update, FASB defines a lease as:
a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. Control over the use of the identified asset means the customer has both (1) the right to obtain substantially all of the economic benefits from the use of the asset and (2) the right to direct the use of the asset.

Under the FASB Update, lessees will classify leases as short term leases, operating leases, or finance leases.

A “short term lease” is a lease with terms of twelve (12) months or less which does not include an option to purchase that the lessee is reasonably certain to exercise (ASU par. 842-20-15-1). If a lease is classified as a short term lease, the lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term (ASU par. 842-20-25-2). The accounting treatment of short term leases is consistent with the prior GAAP accounting model for operating leases.

“Operating leases” are all other leases that do not meet the criteria for finance leases at ASU Paragraph 842-10-25-2 (see below). If the lease is classified as an operating lease (i.e. lease is not short term or finance lease), a lessee is required to do the following:
1. Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position
2. Recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis
3. Classify all cash payments within operating activities in the statement of cash flows.

A “finance lease” is a lease that meets essentially the same criteria as capital leases under prior GAAP. Most current capital leases will be finance leases under the Update. The lease is classified as a finance lease by the lessee (and a sales-type lease by the lessor) if it meets one of the following criteria: (a) lease transfers ownership by end of lease term; (b) lease contains a purchase option that is reasonably certain to be exercised; (c) lease term is a major part [formerly 75%] of the remaining economic life of the asset; (d) the present value of the sum of lease payments and residual value guaranteed by the lessee equals or exceeds substantially all [formerly 90%] of the fair value of the asset; or (e) the asset has no alternative use to the lessor at the end of the lease term. If the lease meets one of the criteria to be classified as finance lease, a lessee is required to:
1. Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position
2. Recognize interest on the lease liability separately from amortization of the right-of-use asset in the statement of comprehensive income
3. Classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities in the statement of cash flows.

As a transition to the new accounting model, if a lease was previously accounted for as an operating lease, and the short term lease accounting election is not applied, the lessee is required to recognize a right-of-use asset and a lease liability at the later of 1) the beginning of the earliest period presented in the financial statements and 2) the commencement date of the lease (ASU 842-10-65-01).
**Lessor Accounting Model – Operating, Sales-type, and Direct Financing Lease**

The lessor accounting model was largely unchanged by the Update. According to the Update, “the vast majority of operating leases should remain classified as operating leases, and lessors should continue to recognize lease income for those leases on a generally straight-line basis over the lease term.” As noted above, leases classified as finance leases by the lessees would be classified as sales-type leases by the lessor.

Leases not classified as sales-type leases by the lessor are classified as either operating leases or direct financing leases. Direct financing leases are those in which 1) the present value of the sum of the lease payments and residual value guaranteed by the lessee or other third party unrelated to the lessor exceeds substantially all the fair value of the underlying asset, and 2) it is probable the lessor will collect the lease payments plus any residual value guarantee. All other leases are operating leases. Leveraged leases were removed from the guidance with the Update.

The Update has some slight differences from the International Financial Reporting Standards (IFRS) and a recently exposed proposal from the Governmental Accounting Standards Board (GASB) to adopt similar revisions to the Governmental Accounting Standards (GAS).

**IFRS Comparison**

The Update notes that, among other differences, IFRS 16 requires all leases to be accounted for in the same manner as finance leases, but contains exemptions for short term leases and leases of “small assets,” or assets valued less than approximately $5,000 (BC421). The FASB Update and GASB proposal do not contain an exception for small assets.

**GASB January 25, 2016 Exposure Draft – Leases (the “GASB Exposure Draft”)**

On January 25, 2016 GASB exposed revisions to its accounting model for leases; comments are due May 31, 2016. According to the GASB project page, the final pronouncement should be issued in December 2016, with changes effective for reporting periods beginning after December 15, 2018 (early application permitted). A link to the project website which includes the January 25, 2016 Exposure Draft and other background documents is below:

http://www.gasb.org/jsp/GASB/GASBContent_C/ProjectPage&cid=1176158470874

The revised GASB accounting model is similar to that of the FASB Update, with some minor differences. A lessee would recognize a lease liability and asset at the beginning of the lease, unless the lease is a short term lease or transfers ownership of the underlying asset. Leases that transfer ownership are considered a financed purchase of the underlying asset with payments financed over time, and would be addressed by the GASB guidance for acquisitions of capital assets with related long-term liabilities instead of the guidance for leases (B25). Similar to the FASB Update, the GASB proposal provides an exception for short term leases; however, the exception is mandatory rather than an accounting election.

**Existing Independence Standards of AICPA and Other Bodies/Regulators**

**AICPA Code – Leases Interpretation**
Agenda Item 3B presents all instances of the terms “lease,” “leases,” and “leasing” in the AICPA Code. The Leases Interpretation indicates that a lease would not impair independence if it meets the criteria of an operating lease and is under comparable terms and all amounts are paid in accordance with the lease. The Leases Interpretation further indicates that a capital lease would be considered a loan and would impair independence:

1.260.040 Leases

.01 If a covered member enters into a leasing agreement with an attest client during the period of the professional engagement, the self-interest threat would be at an acceptable level and independence would not be impaired if all the following safeguards are met:
   a. The lease meets the criteria of an operating lease (as described in GAAP).
   b. The terms and conditions set forth in the lease agreement are comparable with other leases of a similar nature.
   c. All amounts are paid in accordance with the lease terms or provisions.

This paragraph excludes leases addressed by paragraph .04 of the “Loans and Leases with Lending Institutions” interpretation [1.260.020] of the “Independence Rule” [1.200.001].

.02 Threats to compliance with the “Independence Rule” [1.200.001] would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards, and independence would be impaired, if a covered member has a lease that meets the criteria of a capital lease (as described in GAAP). Accordingly, independence would be impaired because the lease would be considered to be a loan with an attest client. This paragraph excludes a lease that is in compliance with the “Loans and Leases with Lending Institutions” interpretation [1.260.020] of the “Independence Rule.” [Prior reference: paragraphs .182–.183 of ET section 191]

The AICPA Code does not define a lease, but does define a loan (which excludes leases) and financial interests:

Loan. A contractual obligation to pay or right to receive money on demand or on a fixed or determinable date and includes a stated or implied rate of return to the lender. For purposes of this definition, loans include, among other things, a guarantee of a loan, a letter of credit, a line of credit, or a loan commitment. However, for purposes of this definition, a loan would not include debt securities (which are considered a financial interest) or lease arrangements. [Prior reference: paragraph .19 of ET section 92]

Financial interest. An ownership interest in an equity or a debt security issued by an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest. [Prior reference: paragraph .17 of ET section 101]

International Ethics Standards Board for Accountants (IESBA)
The 2015 IESBA Handbook of the Code of Ethics for Professional Accountants (the “IESBA Code”) does not define or directly address leases or leasing arrangements as it relates to independence. The IESBA Code does define a financial interest (see below),
which includes loans and other securities, but does not specifically include or exclude leases. Thus, it appears that practitioners would be expected to use the Conceptual Framework and evaluate the significance of the self-interest threat to independence caused by the leasing arrangement.

Financial interest – An interest in an equity or other security, debenture, loan, or other debt instrument of an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest.

Securities Exchange Commission (SEC)
The SEC addresses leasing relationships between clients and firms in examples 10 and 11 of Section 602.02.e Business Relationships of the SEC 2004 Codification (see Agenda Item 3C). The examples and the introductory language in Section 602.02.e indicate that leasing interests, except for landlord-tenant relationships that are immaterial to the firm and the client, would generally impair independence:

**Direct and material indirect business relationships**, other than as a consumer in the normal course of business, with a client or with persons associated with the client in a decision-making capacity, such as officers, directors or substantial stockholders, will adversely affect the accountant's independence with respect to that client. Such a mutuality or identity of interests with the client would cause the accountant to lose the appearance of objectivity and impartiality in the performance of his audit because the advancement of his interest would, to some extent, be dependent upon the client. In addition to the relationships specifically prohibited by Rule 2-01 leasing interests, (except for immaterial landlord-tenant relationships)...are examples of other connections which are also included within this classification.

In conjunction with this section, several No Action letters interpreting materiality relating to landlord/tenant relationships have been issued by the SEC.

In a No Action letter to *Arthur Andersen* February 22, 1985, the SEC concluded that the firm’s independence would be impaired if an office building where the firm leased approximately 50% of the square footage and was a 22% owner in a limited partnership which currently owned the property, were to be sold to an audit client. The SEC concluded that the high percentage of leased space would preclude an assessment that the space leased was immaterial and therefore, examples in Section 602.02 could not be applied.

In a separate No Action letter to *Arthur Andersen* dated January 9, 1987, the SEC indicated to the firm that their lease for office space from their audit client that was at a fair rental and consisted of less than 20% of the total space in the building would not appear to raise concerns over the firm’s independence.

Finally, in a No Action letter to *Winthrop and Weinstine* dated February 24, 1989, the SEC concluded that the firm’s independence would not be impaired though the firm occupied and leased a portion of a building complex owned by an audit client. The firm argued that the entire two building complex should be viewed as a single unit for determining the materiality of the leased space in the facility, as the two buildings were connected by a private skyway, both buildings housed operations of the client, the complex was recognized by the state regulators as a single facility, and the complex was...
similarly designed and decorated. The SEC concurred with the firm’s assessment and concluded that the rental of the space was not material as the firm was not the only tenant in the facility, the terms of the lease were similar to those of the other tenants, and the percentage of space rented consisted of 15.4% of the total available space in the facility, below the 20% specified by the SEC in prior No Comment Letters. Staff consulted with the SEC, which further pointed out its previous reply to Winthrop and Weinstine dated January 25, 1989, which indicated that the firms should evaluate the appearance of independence as well as the materiality of the relationship:

“Generally, a relationship of this nature must be immaterial and the surrounding conditions must be such that a user of the client’s financial statements would be unlikely to see the relationship as having the potential to color the auditor’s objectivity.”

Governmental Accounting Office (GAO) Independence Standards (the “Yellow Book”)
The Yellow Book does not specifically address leases and leasing arrangements as it relates to independence; therefore practitioners would be expected to use the GAGAS Conceptual Framework Approach to Independence to evaluate the significance of the self-interest threat to independence caused by the leasing arrangement. The GAO has not proposed any revisions to the GAO independence standards pursuant to the GASB Exposure Draft.

Summary of Issues
The Task Force held a conference call in April 2016 and discussed concerns and issues raised by prior task forces and PEEC. A summary of PEEC’s prior positions and concerns and the Task Force’s input on those issues is presented below. The Task Force requests that PEEC discuss these issues and provide feedback.

1992 Exposure Draft – Capital leases are similar to a loan and impair independence.
According to the 1992 Exposure Draft, PEEC’s position was that a capital lease was similar to a loan and impaired independence; the ethics ruling regarding leases (eventually Ethics Ruling No. 91) was added to the Code at that time. This position regarding operating and capital leases remains in the current Code.

The Task Force discussed the position of the extant AICPA Code that indicates a capital lease is a loan and impairs independence, while the extant definition of a loan specifically excludes leases. Task Force members noted that it is not always clear whether an arrangement is a lease or a loan, as these types of arrangements have become more complicated over time. The group further noted that some leases may be more like a business relationship, while other leases may be more like loans. The Task Force agreed that the mere fact that a capital lease in reported on the balance sheet does not by itself make a capital lease a loan and impair independence.

The Task Force noted that the FASB definition of a lease does not include loans, and that the 2013 revision to the AICPA Code definition of a loan was partly based upon the FASB definition. The Task Force agreed that if a definition of a lease is introduced as part of any revisions, the definition should be similar to the FASB definition of a lease.

2003 Exposure Draft – Inmaterial capital leases would no longer impair independence.
In 2003, PEEC issued an Exposure Draft proposing revisions to Ethics Ruling No. 91. According to the Exposure Draft, PEEC’s position was that “regardless of whether a lease is classified as
an operating lease or a capital lease, independence should be considered impaired if a covered member leased personal or business property to or from a client, unless the lease was immaterial to the lessee and lessor, and certain other criteria are met. Accordingly…immaterial capital leases would no longer be deemed to impair independence.” The exposed revision to Ethics Ruling No. 91 appears below, with additions in bold italic and deletions in strikethrough:

**Member Leasing Property to or From a Client**

.182 *Question*—Would independence be considered to be impaired if a covered member leased personal or business property, other than automobiles (which would be covered by Interpretation 101-5 [ET section 101.07]), to or from a client?

.183 *Answer*—Independence would not be considered to be impaired if all of the following criteria are met:

a. The annual lease payments are immaterial to the lessee and lessor.

b. The leased property is leased under the lessor’s normal terms, procedures, and requirements.

c. Payments are kept current at all times, the lease meets the criteria of an operating lease (as described in Generally Accepted Accounting Principles), the terms and conditions set forth in the lease agreement are comparable with other leases of a similar nature, and all amounts are paid in accordance with the terms of the lease.

Independence would be considered to be impaired if a covered member had a lease that meets the criteria of a capital lease (as described in Generally Accepted Accounting Principles) unless the lease is in compliance with interpretations 101-1.A.4 [ET section 101.02] and 101-5 [ET section 101.07], because the lease would be considered to be a loan to or from the client.

**Grandfathered Operating Leases**

*Independence would not be considered to be impaired for operating leases that existed prior to [the effective date of the revision], provided they met the conditions outlined in the guidance in effect at the inception of the lease, the lessee remains current as to all lease terms, and the terms of the lease do not change in any manner not provided for in the original lease agreement.*

According to the June 2003 PEEC minutes, PEEC determined that “the ruling would be inconsistent with the loan rule in that one could have an immaterial lease but not an immaterial loan (with the exception of permitted loans such as credit cards).” Members also raised concerns about how to measure materiality, inconsistency with the accounting rules (which considered capital leases to be loans), and inconsistency with the Security Exchange Commission (SEC) rules.

The Task Force discussed the concerns expressed by PEEC and commenters, and agreed that materiality should not be defined, but that PEEC should consider noting some criteria or factors that can be considered when determining materiality of a leasing arrangement. The Task Force will have further discussions regarding the basis for materiality and factors/criteria to consider after receiving PEEC feedback and direction on this issue. Staff’s view was that if the Task Force did not believe a lease constituted a loan (discussed below), materiality should be a consideration, similar to the manner in which the AICPA Code addresses business relationship
One member noted that leases classified as short term leases may be generally considered immaterial, and that capital/finance leases may be considered material in most instances; thus it may be necessary to only address the materiality of operating leases.

2011/2012 Loans and Leases Task Force – Definition of loan revised to exclude leases.
Task Force agendas and PEEC minutes indicate that the Loans and Leases Task Force believed a bright line distinction allowing covered members to engage in operating leases without regard for materiality was inappropriate. However, no revisions were made to the extant Code as it related to leases due to the pending status of the FASB Leases Project. PEEC agreed that leases should remain separated from the definition of a loan; thus PEEC revised the definition of a loan (deriving parts from the FASB definition) to exclude leases and debt securities and eliminated leasing companies from the definition of a financial institution. The revisions were included in the April 15, 2013 Exposure Draft of the Proposed Revised Code of Professional Conduct, while the leases issue was tabled until issuance of the Update.

Consistent with the 2012 Task Force position, the Task Force agreed that it was not appropriate to have a bright line distinction between operating and capital leases in evaluating independence, and that the accounting treatment of a lease does not change the risk level of the threat to impact on independence. The Task Force further agreed that materiality should be a consideration in evaluating independence and leasing arrangements. This bright line distinction causes the independence evaluation to be based upon the terms of the lease, with no required consideration of the materiality of the lease. The Task Force noted that the SEC guidance regarding business relationships indicates that materiality is a factor in the evaluation; the IESBA Code requires a conceptual approach, which would include an evaluation of the significance of the leasing relationship when determining the risk level of the self-interest threat to independence.

Grandfathering of Pre-existing Operating Leases
As noted above, the 2003 Exposure Draft addressed grandfathering of pre-existing operating leases, provided the leases met the guidance in effect at the inception of the lease, the lease terms did not change, and the lessee remains current with all lease terms. The FASB Update indicates that all existing operating leases must be recorded on the balance sheet at the later of the inception of the lease or the beginning of the earliest period presented in the financial statements.

The Task Force agreed that operating leases that did not impair independence and are in existence at the effective date of any guidance issued should be addressed using the independence requirements in effect at the inception of the lease. The Task Force tabled further discussion of the issue until the Task Force direction is established.

Effective Date
NA

Action Needed
The Task Force requests that PEEC discuss the issues noted above and the Task Force’s preliminary conclusions, and consider the following questions:

1. Does PEEC agree with the position reflected in the extant Leases interpretation, that capital/finance leases are considered loans and impair independence? If the PEEC agrees with the position, what is the basis for the conclusion (i.e. does meeting a criterion for capital/finance leases make those leases become loans)? If capital/finance
leases are considered loans, does PEEC agree this position is inconsistent with the extant AICPA Code definition of a loan in that the definition excludes leasing arrangements?

2. Given that leases are excluded from the extant AICPA Code definitions of loans and financial interests, does PEEC believe it is necessary to define a lease in the AICPA Code? If so, does PEEC agree that the definition should default to the FASB definition?

3. Does PEEC agree that the GAAP treatment of a lease does not impact the risk level of threats to independence that may exist in a leasing relationship? Furthermore, does PEEC agree that it is not appropriate to have a bright line distinction allowing operating leases without regard to materiality?

4. Does PEEC believe that leases should be addressed in a similar manner to loans and business relationships? That is, capital/finance leases would be treated similarly to loans to/from non-lending institutions and would impair independence; while all other leases would be treated similarly to business relationships (members would consider the materiality of the relationship).

5. If PEEC believes the guidance should be centered on materiality, does PEEC agree that materiality it should not be defined, and what are appropriate criteria for materiality of a lease? Does PEEC believe that any types of leases can be considered material or immaterial due to their lease classification? That is, short term leases are immaterial, capital/finance leases are material, and operating leases may be material if they meet certain conditions, which would be provide in the guidance.

6. Does PEEC believe that the Leases interpretation requires revision pursuant to the FASB Update and the issues noted in this agenda item?

Communications Plan
The Task Force will take input from PEEC on the issues noted above and will report progress to PEEC at its July meeting.

Materials Presented
Agenda Item 3B: Instances of “Lease / Leases / Leasing” in the Independence Rule
Agenda Item 3C: SEC 2004 Codification: Business Relationships
Agenda Item 3D: Materiality in the Independence Rule
Leases in AICPA Code

.29 **Loan.** A contractual obligation to pay or right to receive money on demand or on a fixed or determinable date and includes a stated or implied rate of return to the lender. For purposes of this definition, loans include, among other things, a guarantee of a loan, a letter of credit, a line of credit, or a loan commitment. However, for purposes of this definition, a loan would not include debt securities (which are considered a financial interest) or lease arrangements.

1.260.020 **Loans and Leases With Lending Institutions**

.01 The “Loans” interpretation [1.260.010] of the “Independence Rule” [1.200.001] provides that a self-interest threat would not be at an acceptable level and independence would be impaired if a covered member had a loan to or from an attest client, any officer or director of the attest client, or any individual owning 10 percent or more of the attest client’s outstanding equity securities or other ownership interests, except as provided for in this interpretation.

.02 Home mortgages, secured loans, and immaterial unsecured loans. However, threats would be at an acceptable level and independence would not be impaired if a covered member or his or her immediate family has an unsecured loan that is not material to the covered member’s net worth (that is, immaterial unsecured loan), a home mortgage, or a secured loan from a lending institution attest client, if all the following safeguards are met:
   a. The home mortgage, secured loan, or immaterial unsecured loan was obtained under the lending institution’s normal lending procedures, terms, and requirements. In determining when the home mortgage, secured loan, or immaterial unsecured loan was obtained, the date a commitment or line of credit is granted must be used, rather than the date a transaction closes or funds are obtained.
   b. The home mortgage, secured loan, or immaterial unsecured loan was obtained
      i. from the lending institution prior to its becoming an attest client;
      ii. from a lending institution for which independence was not required and was later sold to an attest client;
      iii. after May 31, 2002, from a lending institution attest client by a borrower prior to his or her becoming a covered member with respect to that attest client; or
      iv. prior to May 31, 2002 and the requirements of the loan transition provision in www.aicpa.org/interestareas/professionalethics/community/downloadeddocuments/transistion%20periods.pdf are met.
   c. After becoming a covered member, any home mortgage, secured loan, or immaterial unsecured loan must be kept current regarding all terms at all times, and the terms may not change in any way not provided for in the original agreement. Examples of changed terms are a new or extended maturity date, a new interest rate or formula, revised collateral, and revised or waived covenants.
   d. The estimated fair value of the collateral for a home mortgage or other secured loan must equal or exceed the outstanding balance during the term of the home mortgage or other secured loan. If the estimated fair value of the collateral is less than the outstanding balance of the home mortgage or other secured loan, the portion that exceeds the estimated fair value of the collateral may not be material to the covered member’s net worth.

.03 Loans to partnerships and other similar entities. For purposes of applying the loan provision in paragraph .02 when the covered member is a partner in a partnership, a loan to a limited partnership (or similar type of entity) or general partnership would be ascribed to each
covered member who is a partner in the partnership on the basis of his or her legal liability as a limited or general partner if

a. the covered member’s interest in the limited partnership, either individually or combined with the interest of one or more covered members, exceeds 50 percent of the total limited partnership interest, or

b. the covered member, either individually or together with one or more covered members, can control the general partnership.

Even if no amount of a partnership loan is ascribed to the covered member(s) previously identified, threats to compliance with the “Independence Rule” [1.200.001] would not be at an acceptable level and could not be reduced to an acceptable level through the application of safeguards if the partnership renegotiates a loan or obtains a new loan that is not a permitted loan, as described in paragraph .04 of this interpretation. Accordingly, independence would be impaired.

.04 Other loans and leases. Threats would be at an acceptable level and independence would not be impaired if a covered member obtains one of the following types of loans or leases under the lending institution’s normal lending procedures, terms, and requirements, provided the covered member complies with the terms of the loan or lease agreement at all times (for example, keeping payments current):

a. Automobile loans and leases collateralized by the automobile

b. Loans fully collateralized by the cash surrender value of an insurance policy

c. Loans fully collateralized by cash deposits at the same lending institution (for example, passbook loans)

d. Aggregate outstanding balances from credit cards and overdraft reserve accounts that have a balance of $10,000 or less after payment of the most recent monthly statement made by the due date or within any available grace period

.05 Members should consider that certain state and federal agencies may proscribe more restrictive requirements over lending institutions that are subject to their oversight and that, in turn, impose more restrictive requirements upon members that perform attest engagements for these lending institutions. For example, the Securities and Exchange Commission (SEC) proscribes more restrictive requirements over members providing attest services to lending institutions and broker-dealers within their purview. [Prior reference: paragraph .07 of ET section 101 and paragraphs .150–.151 of ET section 191]

.06 Covered members may be subject to additional restrictions, as described in the “Depository Accounts” interpretation [1.255.010] and the “Member of a Credit Union” interpretation [1.280.040] of the “Independence Rule” [1.200.001].

1.260.040 Leases

.01 If a covered member enters into a leasing agreement with an attest client during the period of the professional engagement, the self-interest threat would be at an acceptable level and independence would not be impaired if all the following safeguards are met:

a. The lease meets the criteria of an operating lease (as described in GAAP).

b. The terms and conditions set forth in the lease agreement are comparable with other leases of a similar nature.

c. All amounts are paid in accordance with the lease terms or provisions.

This paragraph excludes leases addressed by paragraph .04 of the “Loans and Leases With Lending Institutions” interpretation [1.260.020] of the “Independence Rule” [1.200.001].

.02 Threats to compliance with the “Independence Rule” [1.200.001] would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards, and independence would be impaired, if a covered member has a lease that meets the criteria of a capital lease (as described in GAAP). Accordingly, independence would be impaired because the lease would be considered to be a loan with an attest client.
This paragraph excludes a lease that is in compliance with the “Loans and Leases With Lending Institutions” interpretation [1.260.020] of the “Independence Rule.” [Prior reference: paragraphs .182–.183 of ET section 191]

1.260.050 Association With an Entity That Has a Loan To or From an Attest Client

.01 If a covered member is an officer, a director, or a shareholder of an entity and the entity has a loan to or from an attest client during the period of the professional engagement, a self-interest threat to the covered member’s compliance with the “Independence Rule” [1.200.001] may exist. Threats to compliance with the “Independence Rule” would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards if the covered member has control over the entity. Accordingly, independence would be impaired because the lease would be considered to be a loan with an attest client. This paragraph excludes a lending relationship that is permitted under the “Loans and Leases With Lending Institutions” interpretation [1.260.020] of the “Independence Rule.”

.02 If any partner or professional employee of the firm is an officer, a director, or a shareholder of an entity and the entity has a loan to or from an attest client, threats to the partner’s or professional employee’s objectivity may exist. If the partner or professional employee is able to exercise significant influence over the entity but is not a covered member who can control the entity (see paragraph .01), the partner or professional employee should consider the “Conflicts of Interest” interpretation [1.110.010] of the “Integrity and Objectivity Rule” [1.100.001].

.03 When making the decision about whether to perform a professional service and in making disclosure to the appropriate parties, the member should consider the “Confidential Client Information Rule” [1.700.001]. [Prior reference: paragraphs .220–.221 of ET section 191]
Sec. 602.02.e. Business Relationships

Direct and material indirect business relationships, other than as a consumer in the normal course of business, with a client or with persons associated with the client in a decision-making capacity, such as officers, directors or substantial stockholders, will adversely affect the accountant's independence with respect to that client. Such a mutuality or identity of interests with the client would cause the accountant to lose the appearance of objectivity and impartiality in the performance of his audit because the advancement of his interest would, to some extent, be dependent upon the client. In addition to the relationships specifically prohibited by Rule 2-01, joint business ventures, limited partnership agreements, investments in supplier or customer companies, leasing interests, (except for immaterial landlord-tenant relationships) and sales by the accountant of items other than professional services are examples of other connections which are also included within this classification.

The following cases illustrate the types of inquiries received by the staff in this area:

Example 1

Facts: A computer firm was engaged exclusively in computer processing income tax return data for professional tax return preparers, including various local offices of many national accounting firms. When the computer company was contemplating making a public offering of its stock, an inquiry was made regarding whether an accounting firm which utilized this computer service could be deemed independent with respect to the audits of the financial statements of the computer firm required for the purpose of the public offering.

Conclusion: An accounting firm's independence would be adversely affected if billings for this service from the computer firm to the accounting firm or to the local office which would perform the audit were significant to the accounting firm, its local office, or to the computer firm. Since these computer services are a direct part of the professional tax service rendered by the accounting firm, any material amount of such computer services would create a mutuality of interests that would impair the appearance of objectivity of the accounting firm necessary for the performance of the audit.

Example 2

Facts: Five covered persons of an accounting firm owned ten percent of the voting interests in a small business investment company which planned to participate with another small business investment company in a loan to a client of the accounting firm. In conjunction with the loan, the lending companies would receive warrants for five percent of the common stock of the audit client.

Conclusion: Independence of the accounting firm would be adversely affected with respect to the audit of the client's financial statements if the covered persons retained their interests in
the small business investment company, which would have a creditor relationship with the client
and a right to acquire an equity interest as a result of the loan.

**Example 3**

*Facts:* An accounting firm inquired whether its independence would be adversely affected
with respect to a client if the controlling shareholder became a limited partner in a partnership
which is controlled by covered persons of the accounting firm in their capacity as general
partner.

*Conclusion:* The accounting firm's independence would be questioned in these
circumstances in as much as the joint business venture would impair the appearance of
independence of the accounting firm.

**Example 4**

*Facts:* An accounting firm's client, a realtor corporation, was the general partner and ten
percent owner in a limited partnership which owned unimproved land held for appreciation in
value. The accounting firm also owned a five percent interest in this limited partnership and a
covered person in the firm had a two percent interest.

*Conclusion:* The joint investment with the client was viewed as incompatible with the
appearance of independence.

**Example 5**

*Facts:* A covered person in a foreign accounting firm that performed the audit of financial
statements of a client in the foreign country which was a subsidiary of a company registered with
the Commission also owned an industrial equipment company from which the client had ordered
an expensive piece of equipment. A large deposit on the purchase commitment was held by the
partner's company during the audit engagement. Engaging in commercial transactions with a
client does not conflict with the professional standards for independence of accountants in the
foreign country.

*Conclusion:* The accounting firm's independence was adversely affected since the partner's
commercial company was dependent on the client for a profit on the commercial transaction and
was in a debtor position in relation to the client as a result of the large deposit. These factors
created a question regarding the objectivity of the firm in conducting the audit.

**Example 6**

*Facts:* Client of an accounting firm was engaged in the business of selling franchises. Two
covered persons of this firm had invested approximately five percent of their personal fortunes to
buy one-half of the stock of a corporation which held a franchise granted by this client. Except
for the payment of a percentage of sales to the franchisor, the franchisee operated independently.
Conclusion: The firm could not be considered independent because the covered persons had a material investment in the franchisee which had a close identity in fact and in appearance with the client.

Example 7

Facts: Covered persons in accounting firm was also a financial vice president and stockholder of a real estate investment trust. In addition, he was a limited partner in a company which manages the trust. A client of his firm had asked him to help them get a loan from the investment trust.

Conclusion: Independence for future periods would be adversely affected if the company were to obtain the loan from the real estate investment trust. However, no question would be raised as to periods prior to the commencement of negotiations for the loan.

Example 8

Facts: Covered persons in the accounting firm had a common investment with stockholders of a prospective client. These covered persons owned approximately 11 percent of Company A and the other investors who owned approximately 78.5 percent of Company A, also owned 22 percent of the prospective client.

Conclusion: Independence was adversely affected because the common investment which the covered persons of the firm had with the substantial minority shareholders of the prospective client was such a circumstance as could lead a third party to question the firm's objectivity.

Example 9

Facts: An accounting firm planned to construct office buildings in which it would occupy a relatively small portion of the space and would rent the remainder to other tenants, some of whom might be clients of the firm.

Conclusion: The activity of owning and managing real property is more in the nature of a commercial business activity than of a professional service. Rental of a material amount of space to a client would raise a question of independence since the accounting firm would appear to have a material business relationship with the client. Some reasonable tests which would be applied in determining what constitutes a rental of material amount might be the relationship of a single lease to the fees earned in the office located in the building concerned, total lease rentals from all clients to the firm's total fees, and lease rentals from a particular client to the auditing fee paid by that client for the same period.

Example 10

Facts: Several covered persons of an accounting firm formed a general partnership to build two office buildings which would then be leased to third parties. Would leases entered into
between the partnership and present or future clients of the accounting firm impair the firm's independence?

**Conclusion:** The activities conducted by the covered persons through the general partnership would be attributed to the accounting firm for purposes of independence determinations. Therefore, any material business relationship arising between the general partnership and a client of the accounting firm would impair the independence of the accounting firm as auditors for that client and its affiliates.

**Example 11**

**Facts:** An accounting firm had its office in a building which was owned by a client. The accounting firm, which occupied approximately 25 percent of the available office space in the building, was the only tenant other than the client.

**Conclusion:** The fact that the accounting firm was the only other tenant in the client's building and leased a substantial portion of the available office space are circumstances that would lead a reasonable third party to question the firm's objectivity. Therefore, independence was adversely affected.

**Example 12**

**Facts:** Accounting firm planned to rent block time on its computer to a client if the client's computer becomes overburdened.

**Conclusion:** Renting excess computer time to a client, except in emergency or temporary situations, is a business transaction with a client beyond the customary professional relationship and would therefore adversely affect independence.

**Example 13**

**Facts:** A covered person in an accounting firm acquired, and assigned to his minor daughter, a ten percent voting interest in a corporation which owned a retail store franchised from a proposed client that also operated similar stores directly.

**Conclusion:** Independence of the accounting firm would be adversely affected with respect to the audit of the client’s financial statements because the covered person was deemed to have a direct interest in a company over which the client may exercise control through the franchise agreement for operation of the retail store. In addition, the company had a close identity in fact and appearance with the client through the operation of similar retail stores.

**Example 14**

**Facts:** An accountant and five persons who were the sole stockholders of the proposed registrant acquired a parcel of real estate for the purpose of selling or leasing it to the company. The total purchase price was $85,000 of which $26,000 was paid in cash and the balance by a
note secured by a mortgage. In addition to providing his portion of the cash payment, the accountant loaned the others $21,000 on interest bearing notes to cover their share of the down payment. It was also provided that the accountant would receive 25 percent of any profit arising from sale of the property to an outsider.

Conclusion: Independence was impaired.

Example 15

Facts: A covered person, together with certain officers of the registrant, organized a corporation which purchased property from the registrant for $100,000 giving the registrant $25,000 cash and a purchase money mortgage for $75,000.

Conclusion: Independence was impaired.

Example 16

Facts: Certain covered persons of an accounting firm were to become principals in a finance company whose wholly owned insurance agency would place with an insurance company client of the firm all or a substantial part of the insurance on the chattels financed.

Conclusion: If the insurance were so placed, the accounting firm would not be considered independent with respect to its insurance company client.

Example 17

Facts: The wife of a covered person had a 47.5 percent interest in one of the three principal underwriters of a proposed issue by the registrant.

Conclusion: Not independent.

Example 18

Facts: A consultant to an accounting firm was also a director and member of the audit committee of a client served by the accounting firm. The consultant's compensation from each of these two involvements was significant in relation to his total earnings.

Conclusion: The apparent conflict of interest which arose from the dual roles of the consultant caused the appearance of the accounting firm's independence to be affected adversely.

Example 19

Facts: A covered person certifying the financial statements of a registered broker-dealer was a co-signer on the broker's indemnity bond.

Conclusion: Independence impaired.
Example 22

Facts: An accounting firm audited the brokerage operations of a financial concern and planned to perform what it considered to be consultative or advisory work for another branch of the business which marketed an estate planning service. This additional work would consist chiefly of developing individual estate planning packages for customers and making recommendations jointly with management to the customers.

Conclusion: The accounting firm's independence would be adversely affected with respect to the audit of the brokerage operations if it performed the additional services for another branch of the business, because it would be participating with management in the development and the sale of a product to be marketed by the company.
Section 0.400 Definitions

.02 Affiliate. The following entities are affiliates of a financial statement attest client:

a. An entity (for example, subsidiary, partnership, or limited liability company [LLC]) that a financial statement attest client can control.

b. An entity in which a financial statement attest client or an entity controlled by the financial statement attest client has a direct financial interest that gives the financial statement attest client significant influence over such entity and that is material to the financial statement attest client.

c. An entity (for example, parent, partnership, or LLC) that controls a financial statement attest client when the financial statement attest client is material to such entity.

d. An entity with a direct financial interest in the financial statement attest client when that entity has significant influence over the financial statement attest client, and the interest in the financial statement attest client is material to such entity.

e. A sister entity of a financial statement attest client if the financial statement attest client and sister entity are each material to the entity that controls both.

f. A trustee that is deemed to control a trust financial statement attest client that is not an investment company.

g. The sponsor of a single employer employee benefit plan financial statement attest client.

h. Any entity, such as a union, participating employer, or a group association of employers, that has significant influence over a multiemployer employee benefit plan financial statement attest client and the plan is material to such entity.

i. The participating employer that is the plan administrator of a multiple employer employee benefit plan financial statement attest client.

j. A single or multiple employer employee benefit plan sponsored by either a financial statement attest client or an entity controlled by the financial statement attest client. All participating employers of a multiple employer employee benefit plan are considered sponsors of the plan.

k. A multiemployer employee benefit plan when a financial statement attest client or entity controlled by the financial statement attest client has significant influence over the plan and the plan is material to the financial statement attest client.

l. An investment adviser, a general partner, or a trustee of an investment company financial statement attest client (fund) if the fund is material to the investment adviser, general partner, or trustee that is deemed to have either control or significant influence over the fund. When considering materiality, members should consider investments in, and fees received from, the fund.

Nonauthoritative questions and answers related to the application of the independence rules to affiliates of employee benefit plans are available at
.27 **Key position.** A position in which an individual has

- primary responsibility for significant accounting functions that support **material** components of the *financial statements*;

- primary responsibility for the preparation of the *financial statements*; or

- the ability to exercise influence over the contents of the *financial statements*, including when the individual is a member of the board of directors or similar governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

For purposes of *attest engagements* not involving a *client’s financial statements*, a key position is one in which an individual is primarily responsible for, or able to influence, the subject matter of the *attest engagement*, as previously described. [Prior reference: paragraph .18 of ET section 92]

### 1.210.010 Conceptual Framework for Independence (excerpt only)

**Introduction**

.02 The code specifies that in some circumstances no *safeguards* can reduce an *independence threat* to an *acceptable level*. For example, the code specifies that a covered member may not own even an **immaterial** direct financial interest in an *attest client* because there is no *safeguard* to reduce the self-interest *threat* to an *acceptable level*. A member may not use the conceptual framework to overcome this prohibition or any other prohibition or requirement in an *independence interpretation*.

### 1.220.010 Network and Network Firms (excerpt only)

**Characteristics of a Network**

.10 *Sharing profits or costs.* This characteristic exists when entities within the association share profits or costs. Following are examples of profit and cost sharing that would not create a *network*:

- Sharing **immaterial** costs

- Sharing costs related to operating the association

- Sharing costs related to the development of audit methodologies, manuals, and training courses
d. Arrangements between a firm and an otherwise unrelated entity to jointly provide a service or develop a product

1.220.020 Alternative Practice Structures (excerpts only)

.10 In addition, threats to compliance with the “Independence Rule” [1.200.001] would not be at an acceptable level, could not be reduced to an acceptable level by the application of safeguards, and independence would be impaired in the following circumstances:

a. Indirect superiors and other public company entities have a material relationship with an attest client of Newfirm that is prohibited by the “Overview of Financial Interests” interpretation [1.240.010], the “Trustee or Executor” interpretation [1.245.010], the “Loans” interpretation [1.260.010], or the “Joint Closely Held Investments” interpretation [1.265.020] of the “Independence Rule” (for example, investments, loans, and so on). In making the test for materiality for financial relationships of an indirect superior, all the financial relationships with an attest client held by that person should be aggregated and, to determine materiality, assessed in relation to the person’s net worth. In making the materiality test for financial relationships of other public company entities, all the financial relationships with an attest client held by such entities should be aggregated and, to determine materiality, assessed in relation to the consolidated financial statements of PublicCo.

b. Any other public company entity over which an indirect superior has direct responsibility has a financial relationship with an attest client during the period of the professional engagement that is material in relation to the other public company entity’s financial statements.

c. Financial relationships of indirect superiors or other public company entities allow such persons or entities to exercise significant influence over the attest client during the period of the professional engagement. In making the test for significant influence, financial relationships of all indirect superiors and other public company entities should be aggregated.

d. Other public company entities or any of their employees are connected with an attest client of Newfirm as a promoter, an underwriter, a voting trustee, a director, or an officer during the period of the professional engagement or during the period covered by the financial statements.

.13 If an attest client of Newfirm holds an investment in PublicCo that is material to the attest client or that allows the attest client to exercise significant influence over PublicCo during the period of the professional engagement, threats to compliance with the “Independence Rule” [1.200.001] would not be at an acceptable level and could not be reduced to an acceptable level through the application of safeguards. Accordingly, independence would be impaired.

1.228.030 Alternative Dispute Resolution
A covered member may include in an engagement letter a provision to use alternative dispute resolution (ADR) techniques to resolve disputes relating to past services (in lieu of litigation). Threats to compliance with the “Independence Rule” [1.200.001] would be at an acceptable level and independence would not be impaired because the covered member and attest client would not be in positions of material adverse interests due to threatened or actual litigation.

The covered member should exercise professional judgment when rendering current services, regardless of the existence of the provision. [Prior reference: paragraphs .190–.191 of ET section 191]

If ADR techniques are initiated to resolve a dispute with the attest client, threats to compliance with the “Independence Rule” [1.200.001] would be at an acceptable level when the ADR techniques are designed to facilitate negotiation, and the conduct of those negotiations does not place the covered member and the attest client in positions of material adverse interests. Independence would not be impaired under these circumstances. If, however, the ADR proceedings are sufficiently similar to litigation (as in the case of binding arbitration), an adverse interest threat may exist and place the covered member and the attest client in a position of material adverse interests. Under such circumstances, the member should apply the guidance under the “Actual or Threatened Litigation” interpretation [1.290.010] of the “Independence Rule.” [Prior reference: paragraphs .192–.193 of ET section 191]

1.240 Financial Interests

1.240.010 Overview of Financial Interests

If a covered member had or was committed to acquire any direct financial interest in an attest client during the period of the professional engagement, the self-interest threat to the covered member’s compliance with the “Independence Rule” [1.200.001] would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards. Accordingly, independence would be impaired. [Prior reference: paragraphs .02A(1) and .17 of ET section 101]

If a covered member had or was committed to acquire any material indirect financial interest in an attest client during the period of the professional engagement, the self-interest threat to the covered member’s compliance with the “Independence Rule” [1.200.001] would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards. Accordingly, independence would be impaired. [Prior reference: paragraphs .02A(1) and .17 of ET section 101]

If a partner or professional employee of the firm, his or her immediate family, or any group of such persons acting together owned more than 5 percent of an attest client’s outstanding equity securities or other ownership interests during the period of the professional engagement, the self-interest threat to compliance with the “Independence Rule” [1.200.001] would not be at an acceptable level and could not be reduced to an acceptable
level by the application of safeguards. Accordingly, independence would be impaired. [Prior reference: paragraph .02B of ET section 101]

.04 Refer to the “Joint Closely Held Investments” interpretation [1.265.020] for additional guidance.

1.240.020 Unsolicited Financial Interests

.01 When a covered member becomes aware that he or she will receive, or has received, an unsolicited financial interest in an attest client during the period of the professional engagement, such as through a gift or an inheritance, the self-interest threat would be at an acceptable level and independence would not be impaired if both of the following safeguards are met:

a. The covered member disposes of the financial interest as soon as practicable but no later than 30 days after the covered member has knowledge of and obtains the right to dispose of the financial interest.

b. During the period in which the covered member does not have the right to dispose of the financial interest, the covered member does not participate on the attest engagement team, and the direct financial interest or indirect financial interest is not material to the covered member. [Prior reference: paragraph .17 of ET section 101]

1.240.030 Mutual Funds

.01 A covered member who owns shares in a mutual fund has a direct financial interest in the mutual fund. However, whether the underlying investments in the mutual fund are considered to be the covered member’s direct financial interests or indirect financial interests depends on the proportion of the mutual fund’s outstanding shares that the covered member owns and whether the mutual fund is diversified.

.02 If a covered member owns 5 percent or less of the outstanding shares of a diversified mutual fund, the underlying investments would be considered immaterial indirect financial interests. Accordingly, the self-interest threat would be at an acceptable level, and independence would not be impaired. To determine if the mutual fund is diversified, the covered member should consider referring to (a) the mutual fund’s prospectus for disclosure regarding fund management’s determination regarding diversification and (b) Section 5(b)(1) of the Investment Company Act of 1940.

.03 If a covered member owns more than 5 percent of a diversified mutual fund’s outstanding shares, or if a covered member owns a financial interest in a nondiversified mutual fund, the covered member should evaluate the mutual fund’s underlying investments to determine whether the covered member holds a material indirect financial interest in any of the underlying investments.

.04 The following example illustrates how to determine if the underlying investments are material to a covered member’s net worth. If
- a nondiversified mutual fund owns shares in client company A,
- the mutual fund’s net assets are $10 million,
- the covered member owns 1 percent of the outstanding shares of the mutual fund, having a value of $100,000, and
- the mutual fund has 10 percent of its assets invested in company A,

then the covered member’s indirect financial interest in company A is $10,000 ($100,000 × 10%). The covered member would then compare the $10,000 indirect financial interest with his or her net worth, including the net worth of his or her immediate family, to determine if the indirect financial interest in company A is material. [Prior reference: paragraph .17 of ET section 101]

1.255 Depository, Brokerage, and Other Accounts

1.255.010 Depository Accounts

.01 If a covered member maintains checking, savings, certificates of deposit, money market, or other depository accounts (depository accounts) at a bank or similar depository institution that is an attest client during the period of the professional engagement, a self-interest threat to the covered member’s compliance with the “Independence Rule” [1.200.001] may exist. For specific guidance applicable to any other types of custodial accounts (for example, brokerage accounts), see the “Brokerage and Other Accounts” interpretation [1.255.020] of the “Independence Rule.”

.02 When the covered member is a firm, the threat would be at an acceptable level, and independence would not be impaired if the firm concludes that the likelihood is remote that the bank or similar depository institution will experience financial difficulties.

.03 When the covered member is an individual, the threat would be at an acceptable level, and independence would not be impaired if

a. the balance in the depository account(s) is fully insured by the appropriate state or federal government deposit insurance agencies or by any other insurer, or

b. any uninsured amounts, in the aggregate, were not material to the covered member’s net worth, or

c. if uninsured amounts were considered material, any uninsured amounts, in the aggregate, are reduced to an immaterial amount no later than 30 days from the date that the uninsured amount becomes material to the covered member’s net worth.

.04 Refer to the “Member of a Credit Union” interpretation [1.280.040] of the “Independence Rule” [1.200.001] for additional guidance. [Prior reference: paragraphs .140–.141 of ET section 191]

1.255.020 Brokerage and Other Accounts
.01 If an attest client in the financial services industry, such as an insurance company, an investment adviser, a broker-dealer, a bank, or similar depository institution, has custody of a covered member’s assets other than depository accounts, including retirement plan assets, during the period of the professional engagement, a self-interest threat to the covered member’s compliance with the “Independence Rule” [1.200.001] may exist. For specific guidance applicable to depository accounts held at a bank or similar depository institution, see the “Depository Accounts” interpretation [1.255.010] of the “Independence Rule.”

.02 Threats would not be at an acceptable level and independence would be impaired unless the following safeguards are met:

a. The attest client’s services were rendered under the attest client’s normal terms, procedures, and requirements.

b. Any covered member’s assets subject to the risk of loss are immaterial to the covered member’s net worth.

.03 In determining if there is a risk of loss, the covered member should consider losses arising from the attest client’s insolvency, bankruptcy, or acts of fraud or other illegal acts but should not consider potential losses arising from a market decline in the value of the assets.

.04 When considering the materiality of assets subject to the risk of loss, the covered member should consider the following:

a. Protection that state or federal regulators provide for the assets, such as state insurance funds

b. Private insurance or other forms of protection that the financial services company obtains to protect its customers’ assets, such as coverage by the Securities Investor Protection Corporation

c. Protection from creditors, such as assets held in a pooled separate account or separate escrow accounts [Prior reference: paragraphs .081–.082 of ET section 191]

1.260.020 Loans and Leases With Lending Institutions (excerpt only)

.01 The “Loans” interpretation [1.260.010] of the “Independence Rule” [1.200.001] provides that a self-interest threat would not be at an acceptable level and independence would be impaired if a covered member had a loan to or from an attest client, any officer or director of the attest client, or any individual owning 10 percent or more of the attest client’s outstanding equity securities or other ownership interests, except as provided for in this interpretation.

.02 Home mortgages, secured loans, and immaterial unsecured loans. However, threats would be at an acceptable level and independence would not be impaired if a covered member or his or her immediate family has an unsecured loan that is not material to the covered member’s net worth (that is, immaterial unsecured loan), a home mortgage, or a secured loan from a lending institution attest client, if all the following safeguards are met:
a. The home mortgage, secured loan, or immaterial unsecured loan was obtained under the lending institution’s normal lending procedures, terms, and requirements. In determining when the home mortgage, secured loan, or immaterial unsecured loan was obtained, the date a commitment or line of credit is granted must be used, rather than the date a transaction closes or funds are obtained.

b. The home mortgage, secured loan, or immaterial unsecured loan was obtained
   i. from the lending institution prior to its becoming an attest client;
   ii. from a lending institution for which independence was not required and was later sold to an attest client;
   iii. after May 31, 2002, from a lending institution attest client by a borrower prior to his or her becoming a covered member with respect to that attest client; or
   iv. prior to May 31, 2002 and the requirements of the loan transition provision in www.aicpa.org/interestareas/professionalethics/community/downloadabledocuments/transistion%20periods.pdf are met.

c. After becoming a covered member, any home mortgage, secured loan, or immaterial unsecured loan must be kept current regarding all terms at all times, and the terms may not change in any manner not provided for in the original agreement. Examples of changed terms are a new or extended maturity date, a new interest rate or formula, revised collateral, and revised or waived covenants.

d. The estimated fair value of the collateral for a home mortgage or other secured loan must equal or exceed the outstanding balance during the term of the home mortgage or other secured loan. If the estimated fair value of the collateral is less than the outstanding balance of the home mortgage or other secured loan, the portion that exceeds the estimated fair value of the collateral may not be material to the covered member’s net worth.

1.265  Business Relationships

1.265.010  Cooperative Arrangements With Attest Clients

.01 If a member or his or her firm has a cooperative arrangement with an attest client, self-interest, familiarity, and undue influence threats to the member or his or her firm’s compliance with the “Independence Rule” [1.200.001] may exist. Threats to compliance with the “Independence Rule” would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards if, during the period of the professional engagement, the cooperative arrangement is material to the firm or attest client. Accordingly, independence would be impaired.

.02 A cooperative arrangement exists when a member or the member’s firm and an attest client jointly participate in a business activity. However, a cooperative arrangement would not exist when all of the following safeguards are met:
a. The participation of the firm and attest client are governed by separate agreements, arrangements, or understandings that do not create rights or obligations between the firm and attest client.

b. Neither the firm nor the attest client assumes responsibility for the other’s activities or results.

c. Neither party has the authority to act as the other’s representative or agent.

.03 Examples of cooperative arrangements include the following:

a. Prime and subcontractor arrangements to provide services or products to a third party

b. Joint ventures to develop or market products or services

c. Arrangements to combine one or more of the firm’s services or products with one or more of the attest client’s services or products and market the package with references to both parties

d. Arrangements under which the firm acts as a distributor or marketer of the attest client’s products or services or the attest client acts as the distributor or marketer of the firm’s products or services

.04 Refer to the “Contingent Fees Rule” [1.510.001] and the “Commissions and Referral Fees Rule” [1.520.001] for additional guidance. [Prior reference: paragraph .14 of ET section 101]

1.265.020 Joint Closely Held Investments

.01 If a covered member has a joint closely held investment, a self-interest threat to the covered member’s compliance with the “Independence Rule” [1.200.001] may exist. Threats to compliance with the “Independence Rule” would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards if the covered member holds a material joint closely held investment during the period of the professional engagement. Accordingly, independence would be impaired. [Prior reference: paragraph .02A(3) of ET section 101]

.02 A joint closely held investment includes a joint interest in a vacation home shared by a covered member and an attest client (or one of the client’s officers or directors, or any owner who has the ability to exercise significant influence over the attest client), if the covered member and attest client (or one of the client’s officers or directors or any owner who has the ability to exercise significant influence over the attest client) control the investment and the vacation home is material to the covered member. Such is the case even if the vacation home is solely intended for the personal use of the owners. [Prior reference: paragraphs .184–.185 of ET section 191]

1.270.040 Immediate Family Member Participation in an Employee Benefit Plan With Financial Interests in an Attest Client
.01 If during the period of the professional engagement, an immediate family member of a covered member is employed at a non-client or employed in a non-key position at an attest client, the immediate family member may hold a direct financial interest or material indirect financial interest in an attest client through participation in an employee benefit plan if threats are at an acceptable level. Threats would be at an acceptable level, and independence would not be impaired, if all of the following safeguards were met:

   a. The covered member neither participates on the attest engagement team nor is an individual in a position to influence the attest engagement.

   b. Such investment is an unavoidable consequence of such participation. Unavoidable consequence means that the immediate family member has no other investment options available for selection, including money market or invested cash options, except for selecting an investment option in an attest client.

   c. In the event that a plan provides an option that permits the immediate family member to invest in a nonattest client or a non-client investment option that becomes available, the immediate family member is required to select the investment option in the non-client or nonattest client and dispose of financial interests in the attest client as soon as practicable but no later than 30 days after such option becomes available. When legal or other similar restrictions exist on an immediate family member’s right to dispose of a financial interest at a particular time, the immediate family member need not dispose of the interest until the restrictions have lapsed. For example, an immediate family member is not required to dispose of a financial interest in an attest client if doing so would violate an employer’s policies on insider trading. On the other hand, waiting for more advantageous market conditions to dispose of the interest would not fall within this exception. [Prior reference: paragraph .02 of ET section 101]

This paragraph excludes participation in share-based compensation arrangements and nonqualified deferred compensation arrangements (see paragraph .02).

1.290.010 Actual or Threatened Litigation

1.290.010 Actual or Threatened Litigation

.01 The relationship between an attest client’s management and a covered member must be characterized by complete candor and full disclosure regarding all aspects of the attest client’s business operations. In addition, the covered member must not be biased so that the covered member can exercise professional judgment and objectivity in evaluating management’s financial reporting decisions.

.02 Litigation or the expressed intention to commence litigation between a covered member and an attest client or its management and, in some cases, other parties during the period of the professional engagement may create self-interest or adverse interest threats to the member’s compliance with the “Independence Rule” [1.200.001]. Accordingly, covered members should evaluate all such circumstances in accordance with this interpretation.
Litigation or the expressed intention to commence litigation between a covered member and an attest client or its management and, in some cases, other parties requires the covered member to assess the materiality of the litigation to the covered member, the covered member’s firm, and the attest client. The covered member’s assessment should include an evaluation of the nature of the matter(s) underlying the litigation and all other relevant factors.

**Litigation Between the Attest Client and Member**

.04 When an attest client’s present management commences, or expresses an intention to commence, legal action against a covered member, the covered member and the attest client’s management may be placed in adversarial positions in which self-interest may affect the covered member’s objectivity and management’s willingness to make complete disclosures.

.05 Accordingly, independence may be impaired whenever the covered member and the covered member’s attest client or its management are in threatened or actual positions of material adverse interests due to threatened or actual litigation.

.06 Situations involving threatened or actual litigation are complex and diverse, making it difficult to identify precise points at which threats to the covered member’s compliance with the “Independence Rule” [1.200.001] would be at an acceptable level. There are situations regarding litigation between covered members and attest clients in which threats to the covered member’s compliance with the “Independence Rule” would not be at an acceptable level and could not be reduced to an acceptable level by safeguards and independence would be impaired. Examples of these situations are:

a. An attest client’s present management commences litigation alleging deficiencies in audit work performed for the attest client or expresses its intention to commence such litigation, and the covered member concludes that it is probable that such a claim will be filed.

b. A covered member commences litigation against an attest client’s present management alleging management fraud or deceit.

.07 If threatened or actual litigation is unrelated to the performance of a client’s attest engagement and is for an amount that is not material to the covered member’s firm or the attest client, threats to the covered member’s compliance with the “Independence Rule” [1.200.001] would be at an acceptable level, and independence would not be impaired. Such claims may arise, for example, out of immaterial disputes regarding billings for services, results of tax or management services advice, or similar matters.

**Litigation by Security Holders**

.08 A covered member may also become involved in litigation (primary litigation) in which the covered member and the attest client or its management are defendants. For example, one or more stockholders may bring a stockholders’ derivative action or class-action lawsuit against the attest client or its management, the attest client’s officers, directors, or underwriters, and covered members.
.09 Such primary litigation by itself would not threaten the covered member’s compliance with the “Independence Rule” [1.200.001]. However, if other circumstances exist that may create threats, the covered member should apply the “Conceptual Framework for Independence” interpretation [1.210.010] to evaluate whether the threats are at an acceptable level. For example, threats will exist if cross-claims are filed against the covered member alleging that the covered member is responsible for any deficiencies in work performed for the attest client if the covered member, as a defense, alleges that the attest client’s management engaged in fraud or deceit.

.10 The following are examples of situations in which threats to the covered member’s compliance with the “Independence Rule” [1.200.001] would not be at an acceptable level and could not be reduced to an acceptable level by safeguards, thereby impairing independence:

a. The attest client or its management or directors have filed cross-claims to protect a right to legal redress in the event of a future adverse decision in the primary litigation (or, in lieu of cross-claims, agreements to extend the statute of limitations), and there is a significant risk that the cross-claim will result in a settlement or judgment in an amount that is material to the covered member’s firm or the attest client.

b. The attest client’s underwriter and the attest client or its present management assert cross-claims against the covered member.

.11 If only the underwriter or officers or directors of other clients of the covered member file cross-claims against the covered member, threats to the covered member’s compliance with the “Independence Rule” [1.200.001] would be at an acceptable level unless other circumstances create threats to compliance with the “Independence Rule.”

Other Third-Party Litigation

.12 A lending institution or other creditor, security holder, or insurance company that alleges reliance on the attest client’s financial statements as a basis for having extended credit or insurance coverage to an attest client may commence third-party litigation against the covered member to recover their loss. An example is an insurance company commencing litigation either as a result of receiving an assignment of a claim or under subrogation rights against the covered member in the attest client’s name to recover losses that the insurer reimbursed to the attest client. If the attest client is only the nominal plaintiff, threats to the covered member’s compliance with the “Independence Rule” [1.200.001] would be at an acceptable level unless other circumstances exist, such as when the covered member alleges, as a defense, that present management engaged in fraud or deceit. The attest client is a nominal plaintiff when the insurance company or lender sues in the name of the attest client and the attest client does not have a beneficial interest in the claim.

.13 If the real party in interest in the litigation (for example, the insurance company) is also the covered member’s attest client (the plaintiff client), threats to the covered
member's compliance with the “Independence Rule” [1.200.001] may exist if the litigation carries a significant risk of a settlement or judgment in an amount that would be material to the covered member’s firm or the plaintiff client.
Entities Included in State and Local Government Financial Statements Task Force

**Task Force Members**
Nancy Miller (Chair), James Curry, John Good, Lee Klummp, George Dietz, Flo Ostrum, Anna Dourdourekas, Eric Holbrook, Jack Dailey, Randy Roberts, John Ford, E. Goria (Staff), Teresa Bordeaux (Staff), Laura Hyland (Staff), Sue Hicks (Staff)

**Task Force Charge**
Consider incorporating the threats and safeguards approach into the Entities Included in State and Local Government Financial Statements interpretation [1.224.020] and determine if a conceptual framework assessment could be utilized to determine when a member needs to be independent of state and local governmental entities for which he or she is not providing financial statement attest services. The Task Force will also clarify who at the firm and which immediate family members the interpretation should extend to and if the interpretation should contain any exceptions. The Task Force will also determine if the final guidance could be extended to the federal government environment.

**Reason For Agenda**
The Task Force seeks the Committee’s feedback on its direction. The discussion will begin with a refresher on the SLG environment which is outlined in Agenda Item 4G.

**Summary of Issues**
The Task Force will present its overall direction by explaining the numerous agenda materials included. Following supplements that presentation:

The Client Affiliate interpretation [1.224.010] begins with the premise that members should apply the independence rules and interpretations to affiliates of the member’s financial statement attest clients, and then provides for certain limited exceptions. The Task Force believes the revised SLG interpretation [See Agenda Item 4C] should begin with the same premise and has identified some exceptions.

FASB concepts of control and significant influence that are used in consolidation and equity method reporting are not GASB concepts. Rather, GASB uses the concept of financial accountability to determine which entities (that is, funds and component units) are required to be included in the financial reporting entity under the applicable framework. As such, when determining which entities should be considered affiliates in the SLG environment, the Task Force believes it is appropriate to default to including all entities that are required to be included in the reporting entity under the applicable framework that the primary government is reporting on. Other differences between the SLG environment and the general affiliate environment are outlined in Agenda Item 4E.

As noted above the Client Affiliate interpretation includes some exceptions. These exceptions were determined appropriate because it was believed that threats to independence in these unique circumstances were not or may not be significant. The Task Force has identified some situations in the SLG environment where it believes threats are not significant and as such proposes exceptions be provided in those situations. In order to explain the exceptions identified so far, the Task Force developed a visual aid [See Agenda Item 4B] which will be explained to the Committee during the meeting.

One of the concepts developed by the Task Force for purposes of determining when an exception might be appropriate is the concept of whether the primary government has
“only minimal influence over the accounting or financial reporting process of a fund or component unit”. This concept is different from the GASB concept of “financial accountability”. Paragraph .04 of Agenda Item 4D provides some examples of factors that demonstrate the primary government has only minimal influence.

While the Task Force believes that there is a presumption that the primary government has “more than minimal influence over the accounting or financial reporting process of a fund or component unit” the proposed direction allows members to evaluate whether this presumption can be rebutted by the unique facts and circumstances that exist in their client’s environment. Paragraph .05 of Agenda Item 4D provides guidance related to how facts and circumstances might carry differing weight and Agenda Item 4B provides a visual aid of how this presumption is applied. Agenda Item 4F compares the identified factors in the SLG environment to the general affiliate environment. All these materials will be described in further detail during the meeting.

**Action Needed**
The Committee is asked to provide feedback on the Task Force’s direction, especially where it believes the proposal inappropriately differs from the Client Affiliate interpretation.

**Effective Date**
TBD

**Communication Plan**
While an overall communication plan has yet to be developed, the Task Force plans to continue having open discussions with the AICPA SLG Expert Panel (Expert Panel) members. To date, members of the Task Force have met with the Expert Panel twice.

**Materials Presented**
- **Agenda Item 4B** Visual Aid To Demonstrate How To Apply the SLG Affiliate Exceptions
- **Agenda Item 4C** (Return to Blue Skies) Visual Aid to Demonstrate The Rebuttable Presumption that the Primary Government has More Than Minimal Influence
- **Agenda Item 4D** SLG Straw-Man
- **Agenda Item 4E** Snapshot Comparison of Affiliate Interpretations
- **Agenda Item 4F** Basis of Conclusion for Departures from the General Affiliate’s Interpretation for SLG Related to Making Reference
- **Agenda Item 4G** Governmental Crosswalk
## Independence Requirements

### Entities Under Audit Opinion
*(Funds and Component Units Opinioned On By Auditor of Primary Government Where Reference To Another Auditor Not Made)*

<table>
<thead>
<tr>
<th>Entities Audited By Another Auditor</th>
<th>Excluded Entities</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>(Funds and Component Units that Auditor of Primary Government Makes Reference to Other Auditors Reports)</em></td>
<td><em>(Funds and Component Units that the Primary Government Excludes But That Are Required to Be Included Under the Applicable Framework)</em></td>
</tr>
<tr>
<td><strong>Primary Government Has Only Minimal Influence Over the Accounting or Financial Reporting Process of Entity</strong></td>
<td><strong>Excluded Entity is Material to Primary Government</strong> <em>(Will the Exclusion Result in GAAP Departure?)</em></td>
</tr>
<tr>
<td><strong>Entity is Material to Primary Government</strong></td>
<td><strong>Entity is Immaterial to Primary Government</strong></td>
</tr>
<tr>
<td><strong>Entity Will Not Be Subject to Financial Statement Attest Procedures of the Member</strong></td>
<td><strong>Primary Government Has Only Minimal Influence Over the Accounting or Financial Reporting Process of Excluded Entity</strong></td>
</tr>
<tr>
<td><strong>Entity Will Be Subject to Financial Statement Attest Procedures of the Member</strong></td>
<td><strong>Primary Government Has More Than Minimal Influence Over the Accounting or Financial Reporting Process of Excluded Entity</strong></td>
</tr>
</tbody>
</table>

- **Independence Not Required**
- **May Use Conceptual Framework To Evaluate Threats**
- **Reasonable to Conclude Exception Available for Nonattest Services But Must Comply with All Other Independence Rules**
- **Independence Required**
Fiscal Dependency
Primary Government pays for 60% of the School’s operations.

Fiscal Dependency
Primary Government has its own taxing authority and doesn’t get funding from Primary Government.

Interrelationship of Accounting Systems
School Board has its own accounting system and accounting personnel. School Board’s system feeds into the Primary Government’s system.

Interrelationship of Accounting Systems
School Board uses same accounting system and accounting personnel as the Primary Government.

Budgetary Control
Primary Government approves the School Board’s budget at the beginning of the fiscal year. Not involved with School Board’s specific expenditures.

Budgetary Control
School Board’s specific expenditures must be approved by Primary Government.

Governing Board
Primary Government appoints 25% of the School Board’s Members.

Governing Board
Governing Board of the Primary Government and School Board members are the same.

Starting Point Presumption
Primary Government Has More Than Minimal Influence over School Board

Return to Blue Skies

Agenda Item 4C
1.224.020 Entities Included in State and Local Government Financial Statements

01 This interpretation applies to financial statement attest engagements of state and local governmental entities whose basic financial statements include funds and component units that are required under the applicable framework, as defined in AU-C 200.14, (b) and (c), to be included in the reporting entity of a primary government (funds and component units).

02 For purposes of this interpretation, state and local governmental entities include general purpose governments such as states, counties, cities, towns and villages. State and local governmental entities also include special purpose governments, which perform only one activity or only a few activities. Examples of special purpose governments include, but are not limited to, school districts, public universities and community colleges, utilities, hospitals or other health care organizations, public retirement systems, public transportation systems, public authorities, tribes, and special districts.

Auditor of Primary Government

03 When performing a financial statement attest engagement for a primary government, covered members should apply the “Independence Rule” [1.200.001] and related interpretations applicable to the primary government to all funds and component units included or required to be included in the reporting entity under the applicable framework except in the following specific situations.

a. When the member makes reference to another auditor’s report and the primary government has only minimal influence over the accounting or financial reporting process of a fund or component unit:
   i. Members and member’s firms do not need to be independent of a fund or component unit that is immaterial to the primary government.
   ii. Members and member’s firms do not need to be independent of funds or component units that are material to the primary government provided it is reasonable to conclude that the material fund or component unit will not be subject to financial statement attest procedures of the member.
   iii. When a material fund’s or component unit’s financial information will be subject to the member’s financial statement attest procedures, members may use the Conceptual Framework for Independence to evaluate any relationships or circumstances that the member knows or have reason to believe exist that impairs independence under the interpretations of the “Independence Rule” to determine if safeguards can be applied that will eliminate significant threats or reduce them to an acceptable level.

b. When the primary government excludes a fund or component unit that is required to be included under the applicable framework (excluded fund or component unit), members do not need to be independent of the excluded fund or component unit if the excluded fund or component unit is:
   i. Immaterial to the primary government.
   ii. Material to the primary government but the primary government has only minimal influence over the accounting or financial reporting process of the excluded fund or component unit.
c. The member and member’s firm may provide prohibited nonattest services to the following entities during the period of the professional engagement or during the period covered by the financial statements, provided that it is reasonable to conclude that the services do not create a self-review threat with respect to the primary government because the results of the nonattest services will not be subject to financial statement attest procedures. For any other threats that are created by the provision of the nonattest services that are not at an acceptable level (in particular, those relating to management participation), the member should apply safeguards to eliminate or reduce the threats to an acceptable level. The entities that this provision applies to are:

i. Funds and component units that a member makes reference to another auditors report when the primary government has more than minimal influence over the accounting or financial reporting process of that fund or component unit.

ii. Excluded funds or component units that are material to a primary government.

.04 There is a rebuttable presumption that the primary government has more than minimal influence over the accounting or financial reporting process of a fund or component unit. However, the member can rebut that presumption by considering the factors such as the following that, in the member’s professional judgment, demonstrate the primary government has only minimal influence

a. Primary government does not have the ability to direct the behaviors or actions of the governing board of the fund or component unit.

b. Primary government does not have the ability to add or remove members of the governing board of the fund or component unit.

c. Primary government does not exert influence that results from:

i. the primary government’s issuance or full or partial payment of the fund’s or component unit’s debt,

ii. the primary government’s financing of some or all of the fund’s or component unit’s deficits, or

iii. the primary government’s actions to use or take the fund’s or component unit’s financial resources

d. Primary government does not have budgetary control over the fund or component unit.

e. Fund or component unit does not have the same accounting systems as the primary government.

f. Fund or component unit does not have the same internal control over financial reporting systems.

g. Primary government does not prepare the financial statements for the fund or component unit.

h. Accounting or finance staff of the fund or component unit is not the same staff as the primary government.
.05 The overall facts and circumstances should be considered when using the factors in paragraph .04 to evaluate whether a primary government has more than minimal influence over the accounting or financial reporting process of a fund or component unit. While some factors may indicate influence others may indicate little to no influence. Some factors may be weighted differently depending on the circumstances and the subject matter of any potential impairment. Thus, the consideration of these factors runs along a spectrum. The following illustrates one possible spectrum.

<table>
<thead>
<tr>
<th>Less Influence</th>
<th>More Influence</th>
</tr>
</thead>
<tbody>
<tr>
<td>* Strong independent governing board</td>
<td>1. Same governing body as primary government with high level of involvement.</td>
</tr>
<tr>
<td>* No level of financial dependence on primary government</td>
<td>2. High level of financial dependence (such as, operating loss subsidies, payment for certain costs)</td>
</tr>
<tr>
<td>* Primary government has no budgetary control</td>
<td>3. Primary government has strong budgetary control</td>
</tr>
<tr>
<td>* Separate accounting system</td>
<td>4. Same accounting system as primary government with no fund or component unit subsystems that feed the primary government system</td>
</tr>
<tr>
<td>* Separate internal control over financial reporting</td>
<td>5. Same internal control over financial reporting as primary government</td>
</tr>
<tr>
<td>* Fund or component unit prepares its own financial statements</td>
<td>6. Primary government prepares the fund or component unit’s financial statements</td>
</tr>
<tr>
<td>* Accounting staff separate from primary government staff</td>
<td>7. Accounting staff part of primary government finance staff</td>
</tr>
<tr>
<td>* Fund or component unit financial statements incorporated into primary government without modification (i.e., either fund-level or government-wide level statements of primary government)</td>
<td>8. Fund component unit financial statements need adjustments or reclassifications (e.g., significant adjustments made by primary government are necessary to include balances or notes to statements modified for differing accounting methods or reporting alternatives)</td>
</tr>
</tbody>
</table>

.06 Members should consider factors such as the following when evaluating whether a fund or component unit’s financial statements will be subject to the member’s financial statement attest procedures:

a. Are significant modifications made by the primary government to the fund or component unit’s financial statements in order to be included into the primary government’s basic financial statements (e.g., adjustments to add fund or component unit financial information into government-wide statements)?

b. Are there modifications to the fund or component unit’s financial statements made by the primary government to revise the fund or component unit’s financial information for accounting methods or reporting alternatives?
<table>
<thead>
<tr>
<th>Application</th>
<th>General Affiliate Guidance</th>
<th>Extant State and Local Guidance</th>
<th>Proposed State and Local Guidance</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Applies to all financial statement attest entities that meet the definition regardless of whether included in the reporting entity.</td>
<td>Applies to entities included in the reporting entity.</td>
<td>Applies to entities that are <strong>required to be included</strong> in the reporting entity under the applicable framework.</td>
<td>Change in extant guidance brings the SLG affiliates guidance more in line with the general affiliate guidance.</td>
</tr>
<tr>
<td>Control</td>
<td>Control over an entity by the financial statement attest client creates an affiliate relationship.</td>
<td>All entities in the reporting entity are included unless the making reference exception applies.</td>
<td>All entities that are <strong>required to be included</strong> in the reporting entity under the applicable framework are included.</td>
<td>The concept of control is not used under GASB standards except to the extent it influences the concept of financial accountability. Financial accountability determines when an entity is included in the reporting entity under GAAP (GASB).</td>
</tr>
<tr>
<td>Significant influence</td>
<td>When the financial statement attest client has significant influence over an entity that is material to the financial statement attest client, the entity is an affiliate of the financial statement attest client.</td>
<td>All entities in the reporting entity are included unless the making reference exception applies.</td>
<td>All entities that are <strong>required to be included</strong> in the reporting entity under the applicable framework are included.</td>
<td>The concept of significant influence is not used under GASB standards.</td>
</tr>
<tr>
<td>Materiality</td>
<td>Uses the GAAS definition and is a matter of professional judgment</td>
<td>Not applicable.</td>
<td>Uses the GAAS definition and is a matter of professional judgment.</td>
<td>We don't believe this is likely to be necessary for downstream evaluations as the entity already has evaluated to determine the reporting entity.</td>
</tr>
<tr>
<td>Best Efforts</td>
<td>Available but requires that the client provide written assurance.</td>
<td>Silent.</td>
<td>Silent.</td>
<td></td>
</tr>
<tr>
<td>Making reference exception</td>
<td>Not available.</td>
<td>Independence requirements do not extend to entities where the auditor makes reference to another auditor.</td>
<td>Rebuttable presumption that all entities require independence, making reference can be used in some circumstances if other factors exist.</td>
<td>Because of the different reporting for state and local governments (versus consolidated reporting in private companies), multiple financial statements are presented. Additionally, an auditor other than the primary government auditor often does, audit and report on some of these separately presented financial statements. In many cases, there is no interaction, influence, or other threat to the component unit auditor’s performance and reporting for that separate reporting/opinion unit. The transparency of the primary government’s reporting of these separate financial statements and the primary government auditor’s clear language about the evidence and reporting of the audit of those separate statements by the other auditor is obvious and clear.</td>
</tr>
<tr>
<td>Reasonable to conclude exception</td>
<td>Not available.</td>
<td>Not available.</td>
<td>Available when making reference to other auditors if not SMA.</td>
<td>Because of the differences in financial accountability that may include entities where control does not exist and since we are not excluding downstream entities as affiliates when material, we believe that this represents a reasonable approach to threats to independence.</td>
</tr>
<tr>
<td>Documentation requirements</td>
<td>Silent.</td>
<td>Silent.</td>
<td>Silent.</td>
<td></td>
</tr>
</tbody>
</table>

**Notes:**
- **Required to be included** indicates mandatory inclusion under the applicable framework.
- **Materiality** uses the GAAS definition and is a matter of professional judgment.
- **Best Efforts** available but requires written assurance.
- **Making reference exception** not available. Independence requirements do not extend to entities where the auditor makes reference to another auditor.
- **Documentation requirements** silent in all cases.
## Agenda Item 4F

<table>
<thead>
<tr>
<th>SLG Environment</th>
<th>General Affiliates Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Level of influence</strong></td>
<td>Control and significant influence are not GASB concepts; rather GASB uses financial accountability which is not directly analogous to control and significant influence. Financial accountability brings in entities into the financial reporting entity that would not meet control.</td>
</tr>
<tr>
<td>Ownership</td>
<td>Control and significant influence are predicated on FASB definitions related to consolidation or equity method reporting; or, in the case of NPOs, FASB control concepts.</td>
</tr>
<tr>
<td>Ownership</td>
<td>Ownership is the most common factor in evaluating control and significant influence but does not work for every type of relationships, such as EBPs or NPOs.</td>
</tr>
<tr>
<td>Governance</td>
<td>Governance is generally strongly correlated to control; significant influence and ownership.</td>
</tr>
<tr>
<td>Legal requirements</td>
<td>Many entities are included in an SLG reporting entity based on legal requirements over financial accountability that may not be exercised or result in an impact on the other entity.</td>
</tr>
<tr>
<td>Stakeholders</td>
<td>This is not a factor for entities that fall under the general affiliate’s definition.</td>
</tr>
<tr>
<td>Stakeholders</td>
<td>Stakeholders consist of investors and lenders.</td>
</tr>
<tr>
<td>Financial reporting</td>
<td>The presentation of SLG statements under GASB is in a columnar format with individual sets of financial statements comprised within unlike the single column consolidated presentation of FASB entities.</td>
</tr>
<tr>
<td>Financial reporting</td>
<td>Reports are consolidated into one column for reporting.</td>
</tr>
<tr>
<td>Historical precedence</td>
<td>The practice of not extending independence requirements to entities which the auditor of the primary government makes reference to another auditor is a long standing practice that is widely understood by users of the audit report. Thus, the reasonable and informed third party recognizes that independence is limited to those entities that the auditor has audit responsibility for. While “this is how we have always done it” is not a compelling argument by itself, when considered in context with the other factors it does demonstrate that</td>
</tr>
<tr>
<td>Historical precedence</td>
<td>Not applicable.</td>
</tr>
<tr>
<td>Subject matter of audit</td>
<td>The discrete, standalone nature of many entities means that the auditor of the primary government is unlikely to have any self-review threats to independence since the entity will not be subject to the attest procedures of the primary government auditor.</td>
</tr>
<tr>
<td>Subject matter of audit</td>
<td>Generally, subsidiaries are not discrete entities and have reporting into and governance by the upstream entities.</td>
</tr>
</tbody>
</table>
Fund Financial Statements will generally include Funds and Blended Component Units. Funds are not separate legal entities; they are self-balancing sets of accounts that are segregated for the purpose of reporting a specific activity of the government. For example, an activity that receives significant support from user fees and charges such as a water activity may be reported as an Enterprise Fund. It is possible that blended component units will be included in the governmental and/or proprietary fund categories. Blended component units are separate legal entities that are so closely related to the primary government such that they are reported just like a fund of the primary government. Component units that are fiduciary in nature are reported as if they were a fiduciary fund of the primary government.

In addition to pension trust funds, this fund includes other employee benefit trust funds.

The Governmental Activities Opinion Unit is generally comprised of all the data reported in the Governmental Funds category, and the internal service funds category (unless their predominant customers are business-type activities), as well as conversion entries (including those to convert governmental fund data to the accrual basis of accounting). Generally, the entries made to create the financial statements of the governmental activities opinion unit from the underlying governmental funds and any applicable internal service funds are far more significant than those made to create the financial statements of the Business Type Activities Opinion Unit from the underlying enterprise funds and any applicable internal service funds.

The Business Type Opinion Unit is generally comprised of all the data reported in the Major and Non-Major Enterprise Funds categories, internal services funds where business-type activities are the predominant customers as well as any necessary conversion entries to create the business-type activities financial statements.

The opinion units for the major governmental and enterprise funds are comprised of funds and blended component units. The criteria for determining whether a fund or blended component unit is major is defined by GASB. Each major fund is a separate opinion unit and are presented in the applicable fund financial statement in separate columns. Separate opinions for each major fund.

Aggregate discretely presented component units opinion unit is comprised of separate legal entities where the primary government has financial [control] sufficient to require the inclusion of that entity into the Government Wide Financial Statements because the relationship is not so close that is should be reported as a blended component unit.
Compliance With Standards

**Task Force:** Sam Burke, Michael Brand, Tom Campbell Robert Denham, Nancy Miller, James Smolinski

**Staff:** Lisa Snyder

**Reason for Agenda Item**
The Committee is being asked to approve a non-authoritative FAQ addressing the application of the Compliance With Standards rule of the AICPA Code of Professional Conduct as it relates to professional services performed using standards that are not promulgated by bodies designated by AICPA Council as set forth in Appendix A, “Council Resolution Designating Bodies to Promulgate Technical Standards” (“Council Resolution”).

**Background**
At the PEEC’s February 2016 meeting, the Committee was asked to provide input regarding the application of the Compliance With Standards Rule [Agenda Item 5C] as it relates to performance audits performed in accordance with the GAO’s Yellow Book and other services that would not be covered by AICPA professional standards. The Committee generally agreed that the rule was intended to mean that a member is only required to comply with standards promulgated by bodies designated by Council if standards exist that are applicable to the service. In cases where there are no such applicable standards covering the service, the member should not be required to “fit” the service into a particular set of standards. The Committee agree to appoint a task force to further consider the matter and develop a FAQ that would state that if there are applicable standards that are promulgated by bodies designated by Council, members must comply with such standards; if there are no relevant standards applicable to the service performed by the member, the member must comply with the General Standards Rule [Agenda Item 5C].

**Summary of Issues**
The Task Force held a meeting via conference call to discuss a draft FAQ and provide input on a number of issues. The Task Force agreed that a member should be permitted to perform a professional service using standards that have not been established by a body designated by AICPA Council, (“Alternative Standards”). However, the Task Force believes that the member should also be required to apply any applicable technical standards established by a body designated by AICPA Council (“Established Standards”). The Task Force further discussed whether it should be presumed that there would be Established Standards available to the member that covered the particular service and noted that many services could likely be performed under the consulting standards [See Agenda Item 5D for definition of consulting services].

Some task force members believed that the FAQ should indicate that there is a presumption that the professional service could also be covered by Established Standards while others believed the term presumption is confusing and unnecessary and a statement that the must consider whether the professional service can be covered by Established Standards should be sufficient. In either case, the Task Force agreed that a statement should be included that members should use professional judgment in determining whether a particular professional service can also be covered by Established Standards. The Committee should note that there are varying views on whether all professional services performed by CPAs could be covered by Established Standards. For example, it was suggested that services such as Yellow Book performance audits, verification letters for tax clients, and “10% low income carryover reports” would not be covered by Established Standards. The Task Force agreed that irrespective of the professional service performed by the member and whether he or she applies Established
Standards, Alternative Standards, or both, the member must always comply with the General Standards rule.

**Action Needed**
The Committee is asked to:
1. Discuss the proposed FAQ in Agenda Item 5B, particularly the issue of whether there should be included a presumption that Established Standards would also exist and therefore, should be applied.
2. Approve a final FAQ that would be posted to the Division’s non-authoritative FAQs on its website as well as referenced in the AICPA Code as non-authoritative guidance.
3. Determine an effective date for the FAQ.

The Committee’s consideration of this matter is appreciated.

**Effective Date**
To be discussed

**Communications Plan**
CPA Letter Daily
AICPA Website

**Materials Presented**

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DRAFT

Compliance with Standards Promulgated by Bodies Designated by AICPA Council

Question: May a member perform a professional service using standards that have not been established by a body designated by AICPA Council, as set forth in Appendix A, “Council Resolution Designating Bodies to Promulgate Technical Standards” (“Council Resolution”) of the AICPA Code of Professional Conduct (“AICPA Code”) (hereinafter referred to as “Alternative Standards”)?

Answer: Yes, a member is permitted to perform a professional service using Alternative Standards. However, the member must consider whether there is a presumption that the professional service can be covered by technical standards established by a body designated by AICPA Council (hereinafter referred to as “Established Standards”). The member must also comply with any relevant Established Standards when performing the professional service in addition to any Alternative Standards agreed with the client. Members should use professional judgment in determining whether a particular professional service can also be covered by Established Standards. [Note: The Committee will be asked if the highlighted text should be replaced with the bracketed text.]

The Compliance With Standards rule [1.310.001] of the AICPA Code states the following:

“A member who performs auditing, review, compilation, management consulting, tax, or other professional services shall comply with standards promulgated by bodies designated by Council.”

The Council Resolution sets forth those bodies designated by Council to promulgate technical standards and includes AICPA standard-setting bodies, such as the Accounting and Review Services Committee (ARSC), Auditing Standards Board (ASB), and Management Consulting Services Executive Committee. (See all bodies designated by Council at Appendix A of the AICPA Code, Council Resolution Designating Bodies to Promulgate Technical Standards http://pub.aicpa.org/codeofconduct/resourcesseamlesslogin.aspx?prod=ethics&tdoc=et-cod&tptr=et-cod_appA).

When a member is engaged to perform a professional service that can be covered by Established Standards (e.g., the Statements on Auditing Standards (SASs), Statements on Standards for Attestation Engagements (SSAEs), Statements on Standards for Accounting and Review Services (SSARSSs) and Statement on Standards for Consulting Services (SSCS)), the member must perform the service using such Established Standards. The member is permitted to also apply any relevant Alternative Standards.

In circumstances in which a member is engaged to perform a professional service that, based on his or her professional judgment, cannot be covered by Established Standards, the member would not be considered to be in violation of the Compliance With Standards rule if only the Alternative Standards were applied but the member must always comply with the provisions of the General Standards rule (see below).

Irrespective of the professional service performed by the member and whether he or she applies Established Standards, Alternative Standards, or both, the member must always comply with the General Standards rule [2.300.001] of the AICPA Code when performing any professional service. This rule requires that a member comply with the following standards:
a. Professional Competence. Undertake only those professional services that the member or the member’s firm can reasonably expect to be completed with professional competence.

b. Due Professional Care. Exercise due professional care in the performance of professional services.

c. Planning and Supervision. Adequately plan and supervise the performance of professional services.

d. Sufficient Relevant Data. Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

Members should also be aware that laws or regulations, including state boards of accountancy rules and regulations, may require the professional service to be performed under Established Standards.
1.310.001 Compliance With Standards Rule

.01 A member who performs auditing, review, compilation, management consulting, tax, or other professional services shall comply with standards promulgated by bodies designated by Council.

.02 See Appendix A “Council Resolution Designating Bodies to Promulgate Technical Standards.”

2.300.001 General Standards Rule

.01 A member shall comply with the following standards and with any interpretations thereof by bodies designated by Council.

a. Professional Competence. Undertake only those professional services that the member or the member’s firm can reasonably expect to be completed with professional competence.

b. Due Professional Care. Exercise due professional care in the performance of professional services.

c. Planning and Supervision. Adequately plan and supervise the performance of professional services.

d. Sufficient Relevant Data. Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

.02 See appendix A, “Council Resolution Designating Bodies to Promulgate Technical Standards.”
The definition of consulting services is: Professional services that employ the practitioner's technical skills, education, observations, experiences, and knowledge of the consulting process. fn 1

Consulting services may include one or more of the following:

a. Consultations, in which the practitioner's function is to provide counsel in a short time frame, based mostly, if not entirely, on existing personal knowledge about the client, the circumstances, the technical matters involved, client representations, and the mutual intent of the parties. Examples of consultations are reviewing and commenting on a client-prepared business plan and suggesting computer software for further client investigation.

b. Advisory services, in which the practitioner's function is to develop findings, conclusions, and recommendations for client consideration and decision making. Examples of advisory services are an operational review and improvement study, analysis of an accounting system, assistance with strategic planning, and definition of requirements for an information system.

c. Implementation services, in which the practitioner's function is to put an action plan into effect. Client personnel and resources may be pooled with the practitioner's to accomplish the implementation objectives. The practitioner is responsible to the client for the conduct and management of engagement activities. Examples of implementation services are providing computer system installation and support, executing steps to improve productivity, and assisting with the merger of organizations.

d. Transaction services, in which the practitioner's function is to provide services related to a specific client transaction, generally with a third party. Examples of transaction services are insolvency services, valuation services, preparation of information for obtaining financing, analysis of a potential merger or acquisition, and litigation services.

e. Staff and other support services, in which the practitioner's function is to provide appropriate staff and possibly other support to perform tasks specified by the client. The staff provided will be directed by the client as circumstances require. Examples of staff and other support services are data processing facilities management, computer programming, bankruptcy trusteeship, and controllership activities.

f. Product services, in which the practitioner's function is to provide the client with a product and associated professional services in support of the installation, use, or maintenance of the product. Examples of product services are the sale and delivery of packaged training programs, the sale and implementation of computer software, and the sale and installation of systems development methodologies.

fn 1 The definition of consulting services excludes the following:

a. Services subject to other AICPA professional standards such as Statements on Auditing Standards (SASs), Statements on Standards for Attestation Engagements (SSAEs), or Statements on Standards for Accounting and Review Services (SSARSS). (These excluded services may be performed in conjunction with consulting services, but only the consulting services are subject to the Statement on Standards for Consulting Services [SSCS].)

b. Engagements specifically to perform tax return preparation, tax planning or advice, tax representation, personal financial planning or bookkeeping services, or situations involving the preparation of written reports or the provision of oral advice on the application of accounting principles to specified transactions or events, either completed or proposed, and the reporting thereof.

c. Recommendations and comments prepared during the same engagement as a direct result of observations made while performing the excluded services.