



# **Professional Ethics Executive Committee**

**February 9-10, 2017 Open Meeting Agenda  
San Juan, PR**

**AICPA Professional Ethics Executive Committee**  
**Open Meeting Agenda**  
**February 9-10, 2017**  
**San Juan, Puerto Rico**

February 9 <sup>th</sup>	<i>Open Meeting Begins</i>	
9:00 a.m. – 11:15 a.m. (inclusive of a 15-minute break)	<b>Entities Included in State and Local Government (SLG) Financial Statements</b> Ms. Miller and Ms. Gorla will seek the Committee's approval to expose a revised interpretation for comment.	<b>Agenda Item 1A</b> <b>Agenda Item 1B</b> <b>Agenda Item 1C</b> <b>Agenda Item 1D</b> <b>Agenda Item 1E</b>
11:15 a.m. to Noon	<b>NOCLAR Task Force – IESBA Convergence</b> Mr. Denham and Mr. Evans will seek the Committee's approval to expose proposed interpretations for comment.	<b>Agenda Item 2A</b> <b>Agenda Item 2B</b> <b>Agenda Item 2C</b>
Noon – 1:00 p.m.	<b>Lunch</b>	
1:00 p.m. – 2:30 p.m.	<b>Information Technology and Cloud Services</b> Ms. VanDyne and Ms. Gorla will seek the Committee's approval to adopt the proposed Hosting Services interpretation and will update the Committee on its direction for IT services.	<b>Agenda Item 3A</b> <b>Agenda Item 3B</b> <b>Agenda Item 3C</b> <b>Agenda Item 3D</b> <b>Agenda Item 3E</b>
2:30 p.m. - 4:45 p.m. (inclusive of a 15-minute break)	<b>Leases</b> Mr. Wilson and Mr. Mercer will seek the Committee's approval to expose a revised interpretation for comment.	<b>Agenda Item 4A</b> <b>Agenda Item 4B</b> <b>Agenda Item 4C</b> <b>Agenda Item 4D</b> <b>Agenda Item 4E</b>
4:45 p.m. - 4:55 p.m.	<b>IESBA Update</b> Ms. Snyder will update the Committee on the December meeting of the IESBA. ❖ <b>External Link:</b> <a href="#">Structure ED-2</a> ❖ <b>External Link:</b> <a href="#">Safeguards ED-2</a> ❖ <b>External Link:</b> <a href="#">Applicability ED</a>	
4:55 p.m. – 5:00 p.m.	<b>Minutes of the Professional Ethics Executive Committee Open Meeting</b> The Committee is asked to approve the minutes from the November 2016 meeting.	<b>Agenda Item 5</b>
5:00 p.m.	<i>Open Meeting Concludes for the Day</i>	
February 10 <sup>th</sup>	<i>Open Meeting Reconvenes</i>	
8:00 a.m. – 8:45 a.m.	<b>Cyber-Security Services</b> Ms. Tish, Ms. Snyder and Ms. Gorla will seek the Committee's input on the draft FAQs developed.	<b>Agenda Item 6A</b> <b>Agenda Item 6B</b>
8:45 a.m. – 9:00 a.m.	<b>Transfer of Files and Return of Client Records in Sales, Transfer, Discontinuance or Acquisition of Practice</b> Ms. Snyder will seek the Committee's input on a proposed FAQ.	<b>Agenda Item 7A</b> <b>Agenda Item 7B</b>
9:00 a.m. – 9:30 a.m.	<b>Compilation of Pro-Forma Financial Statements and Specified Procedures Engagements</b> Mr. Brand will update the Committee on the Task Force's preliminary discussion.	
9:30 a.m. – 10:00 a.m.	<b>IESBA Convergence – Long Association</b> Mr. Evans will discuss the final IESBA standard on Long Association and request that the Committee appoint a Task Force to consider the non-PIEs related provisions for possible convergence.	<b>Agenda Item 8A</b> <b>Agenda Item 8B</b>

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	<i>Open Meeting Concludes</i>	
Informational Purposes Only	<b>Committee Project Agenda</b> ❖ <i>External Link - <a href="#">Project Agenda</a></i>	
	<b>Future Meeting Dates</b> <ul style="list-style-type: none"><li>• May 16-17, 2017 – Chicago</li><li>• July 25-26, 2017 -- TBD</li></ul>	

### Entities Included In State and Local Government Financial Statements Task Force

#### Task Force Members

Nancy Miller (Chair), James Curry, John Good, Lee Klumpp, George Dietz, Flo Ostrum, Anna Dourdourekas, Jack Dailey, Randy Roberts, E. Gorla (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.

#### Summary of Issues

##### ***Financial Reporting Objectives Differ Between State and Local Government (SLG) Entities and Commercial Sector Entities***

The Task Force believes that the [Client Affiliates](#) interpretation [1.224.010] that is applicable to commercial sector entities does not work in the SLG sector because of the fundamental differences in the financial reporting objectives and financial statement presentation of these two sectors.

*Financial Reporting Objectives.* The financial reporting objectives in the commercial sector relies heavily on the FASB definitions of control and significant influence, which are not used in the GASB's standards. Instead, GASB uses the concept of financial accountability to identify whether an entity is included in a state or local government's financial statements. This concept of accountability is the foundation on which all other GASB financial reporting objectives are built and commercial sector entities do not have relationships with other entities akin to the accountability relationships. Some of the most significant examples of how GASB standards address differences between governmental and commercial financial reporting include:

1. the view that capital assets are primarily used to provide services to citizens rather than to contribute to future cash flows;
2. the measurement and recognition of certain types of revenues (for example, taxes and grants);
3. the use of fund accounting and budgetary reporting to meet public accountability needs;
4. the use of accountability notions rather than equity control to define the financial reporting entity; and
5. the view that governments and their pension plans generally are ongoing entities with the ability to take a career-long view of the employment exchange.

In the SLG sector, the "entities" are usually referred to as "Funds" or "Component Units". A "fund" is a fiscal and accounting entity with a self-balancing set of accounts which are segregated for the purpose of carrying on specific activities or attaining certain objectives. Funds are not legally separate entities.

Component units on the other hand are legally separate entities that governments do not control or have significant influence over the way a commercial sector entity has over its subsidiaries. Component units that are included in a governmental reporting entity can

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operate very autonomously from each other by having separate governing boards, separate accounting systems, separate financial reporting systems, separate operations and even separate strategic directions. The accountability relationship putting them in the reporting entity may be merely the appointment of a majority of the otherwise autonomously operating governing board and a significant financial benefit /burden relationship with the governmental reporting entity being legally obligated to provide significant operating subsidies or financial support to it. Many times governmental component units interact with each other in an adversarial fashion that is probably foreign in a corporate environment. Officials at a component unit do not report up an organizational structure to someone at the governmental reporting entity like they do in a corporate environment. Often times there is no communication, operating much like two different entities. Affiliates guidance does not work in the government because the assumptions of control and significant influence that underpin the ASC accounting guidance in the affiliates definition is not the glue that binds a governmental reporting entity.

*Financial Statement Presentation.* SLG financial statements are not consolidated into a single column like commercial sector entities. Instead, government-wide financial statements and fund financial statements may be presented. Financial information within the government-wide financial statements and fund financial statements is presented in a columnar format. Different fund categories and in certain circumstances, different fund types within the same fund category will not be included on a single set of fund financial statements but will be spread across multiple fund financial statements. For example, refer to pages 38 - 59 of the [City of NY Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2015](#) for a sample of the GASB-based basic financial statements.

Furthermore, auditors may not opine solely on the financial statements as a whole for the entity. Instead, auditors (often multiple auditors) opine on the financial statements as a whole through auditing individual opinion units separately. Opinion units may be over a single entity, such as a discretely presented component unit, or may be over an aggregate of several discretely presented component units or funds. For example, refer to pages 3-4 of the [City of NY Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2015](#) in which the auditor's report explains they did not audit the financial statements of those entities disclosed in Note E.1.

***Funds and Component Units Required To Be Included in the Reporting Entity of the Financial Statement Attest Client***

The extant interpretation does not provide any independence guidance related to funds and component units that are excluded from the reporting entity but required to be included under the applicable framework. Since it is not uncommon for a primary government to exclude a fund or component unit from the reporting entity for a variety of reasons such as unavailability of a component unit's audited financial statements, the Task Force has drafted the proposed revised interpretation to provide members with independence guidance when this occurs.

***Independence of Funds and Component Units Required To Be Included in the Reporting Entity of the Financial Statement Attest Client – Downstream View***

Under the extant interpretation, members do not need to remain independent of funds and component units that are included in the reporting entity of the financial statement attest client when the member explicitly states reliance on another auditors' reports (i.e., makes reference to another auditor's report).

After further consideration, the Task Force has concluded that making reference to another auditor's report may not be an effective safeguard by itself. Specifically, the Task Force believes threats to independence are significant when the fund or component unit is also material to the primary government as a whole and the primary government has more than minimal influence over the accounting or financial reporting process of the fund or component unit. As such, the Task Force recommends that the Committee require members be independent of such funds and component units.

The safeguards available as a result of making reference to another auditor would be sufficient to mitigate threats in the circumstance where members provide an otherwise prohibited nonattest services if such nonattest services will not be subject to financial statement attest procedures. To provide members with an example where a fund or component units financial statements might be subject to the member's attest procedures, the Task Force will develop an FAQ.

Following is the visual aid the Task Force suggests be used to assist with explaining the downstream view of the proposed revised guidance:

Auditor of Primary Government Must Apply The Independence Rules To				
Current & Proposed	Proposed Interpretation			
Funds and component units included in reporting entity where the auditor does not make reference to another auditors report for that fund or component unit.	A Non-Temporary Investment Held By The Primary Government That The Primary Government		Material Funds and Component Units That the Primary Government Has More Than Minimal Influence Over The Accounting and Financial Reporting Process And the Funds and Component Units Are	
	has control over and the investment is not de minimus to the primary government as a whole.	has significant influence over and is material to the primary government as a whole.	included in reporting entity where the auditor makes reference to another auditors report for that fund or component unit	material and excluded from the reporting entity (but required to be included under the applicable framework)

Independence Required
Independence required but can provide prohibited nonattest services to the entity if it is reasonable to conclude that the services do not create self-review threats with respect to the financial statement attest client.

#### Question For The Committee

- Does the Committee agree with the Task Force's recommendations?

#### ***Independence When the Financial Statement Attest Client is Included in Another Reporting Entity As a Fund or Component Unit and the Primary Government Of That Reporting Entity is Not a Financial Statement Attest Client – Upstream View***

Under the extant interpretation when the member does not audit the primary government, members do not need to remain independent of entities that the member doesn't audit (e.g., upstream entity) except the covered member and their immediate family and close relatives may not have a key position within the primary government.

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After further thought, the Task Force believes threats to independence are significant when the primary government has more than minimal influence over the accounting and financial reporting process of the financial statement attest client and (1) the financial statement attest client is required to be included in the reporting entity of a primary government and (2) the financial statement attest client is material to the primary government. In this situation, the Task Force believes that members should be independent of the primary government body that has more than minimal influence over the financial statement attest client.

The Task Force believes that independence should only be required of the entity or body that has more than minimal influence. The Task Force intends to scope out entities that do not have more than minimal influence over the financial statement attest client such as departments or agencies that don't influence the attest client's financial accounting or reporting. The proposed interpretation in paragraph .09 has been drafted to clarify this narrow application. The challenge is that funds are an accounting mechanism and not a governance mechanism. Feedback received from stakeholders indicates that a member may believe that this applies to the legal entity, which would include all the funds but not the component units in the reporting entity. The Task Force plans to add one more FAQs to provide further clarification.

The Task Force can envision situations where threats may not be significant and as such, identified 4 exceptions to this position:

1. A covered member may have a loan with a key official when the member does not know or have reason to believe the individual is in such position at the primary government.
2. The firm can provide prohibited nonattest services to the primary government provided it is reasonable to conclude the results of the nonattest services will not be subject to attest procedures.
3. Former employees can be employed at the primary government in a key position as long as the former employee isn't in a key position with respect to the attest client.
4. Covered members, immediate family members and close relatives can be employed in a key position with the primary government as long as this does not put them in a key position with respect to the attest client.

The Task Force believes it would be helpful to develop FAQs to provide members with guidance regarding circumstances where the member needs to consider independence of the primary government that includes the financial statement attest client in its reporting entity as well as funds and component units included in the financial statement attest client. Following are the visual aids the Task Force suggests be used to assist with explaining the upstream view of the proposed revised guidance:

**Financial Statement Attest Client is a Material Fund of Primary Government and Primary Government Has More Than Minimal Influence Over Fund**

**XYZ County of NJ (County)  
Primary Government**

- Audited by Firm B and Firm B makes reference to Firm A's report on the Transportation Capital Projects Fund
- Firm A does not provide any attest services to primary government

**Transportation Capital Projects Fund  
Firm A's Financial Statement Attest Client**

- Primary Government has more than minimal influence over this Fund's accounting or financial reporting process.
- This fund is material to the primary government

**CONCLUSIONS**

The member needs to apply the independence rules and related interpretations to the County because the fund is material to the County and the County has more than minimal influence over the fund's accounting or financial reporting process. However, Firm A may apply the exception provided for in ET 1.224.020.08a, b, c and d.

**Color Key**

- Firm A's Financial Statement Attest Client
- Firm A - Independence required
- Firm A - Independence not required

**Financial Statement Attest Client is a Material Fund of the Primary Government and Primary Government Does Not Have More Than Minimal Influence Over Fund**

**XYZ County of NJ (County)  
Primary Government**

- Audited by Firm B and Firm B makes reference to Firm A's report on the Transportation Capital Projects Fund
- Firm A does not provide any attest services to primary government

**Transportation Capital Projects Fund  
Firm A's Financial Statement Attest Client**

- Primary Government does not have more than minimal influence over this Fund's accounting or financial reporting process.
- This fund is material to the primary government

**CONCLUSIONS**

- The County is not an affiliate to the Transportation Capital Projects Fund because the County does not have more than minimal influence over the Transportation Capital Fund's accounting or financial reporting process.

**Color Key**

- Firm A's Financial Statement Attest Client
- Firm A - Independence required
- Firm A - Independence not required



**Financial Statement Attest Client is an Immaterial Fund of the Primary Government and Primary Government Has More Than Minimal Influence Over Fund**

**XYZ County of NJ (County)  
Primary Government**

- Audited by Firm B and Firm B makes reference to Firm A's report on the Transportation Capital Projects Fund
- Firm A does not provide any attest services to primary government






**Transportation Capital Projects Fund  
Firm A's Financial Statement Attest Client**

- Primary Government has more than minimal influence over this Fund's accounting or financial reporting process.
- This fund is immaterial to the primary government

**CONCLUSIONS**

- The member does not need to apply the independence rules and related interpretations to the County because the fund is immaterial to the County.

**Color Key**

-  Firm A's Financial Statement Attest Client
-  Firm A - Independence required
-  Firm A - Independence not required

**Financial Statement Attest Client is an Immaterial Fund of the Primary Government and Primary Government Does Not Have More Than Minimal Influence Over Fund**

**XYZ County of NJ (County)  
Primary Government**

- Audited by Firm B and Firm B makes reference to Firm A's report on the Transportation Capital Projects Fund
- Firm A does not provide any attest services to primary government






**Transportation Capital Projects Fund  
Firm A's Financial Statement Attest Client**

- Primary Government does not have more than minimal influence over this Fund's accounting or financial reporting process.
- This fund is immaterial to the primary government

**CONCLUSIONS**

- The member does not need to apply the independence rules and related interpretations to the County because the fund is immaterial to the County and the County does not have more than minimal influence over the Transportation Capital Project Funds accounting and financial reporting process.

**Color Key**

-  Firm A's Financial Statement Attest Client
-  Firm A - Independence required
-  Firm A - Independence not required

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**Question For The Committee**

1. Does the Committee agree with the Task Force's recommendations?

***Minimal Influence***

While the Task Force believes there is a presumption that the primary government has more than minimal influence over its fund's and component unit's accounting or financial reporting process, it also agrees that it is very possible for this presumption to be rebutted depending upon the specific facts and circumstances. For example, a state government financial statement attest client may not have more than minimal influence over the accounting and financial reporting processes of a university component unit that has a separate board, management, accounting systems and accounting personnel. To assist members in assessing their unique facts and circumstances the Task Force proposes to include a list of factors that might help members evaluate the level of influence the primary government has over the fund or component unit. For the previous example, the state government might have more than minimal influence over the university if the state government performs the accounting functions on behalf of the university.

**Question For The Committee**

1. Does the Committee agree with the Task Force's recommendation?

***Current and Post-Employment Benefit Plans***

It is the Task Force's understanding that in early February the GASB will be issuing a new fiduciary activities standard that will be effective calendar year 2019. This fiduciary activities standard will generally result in that when the primary government can appoint the majority of board members of the plan and the plan is a separate legal entity, the plan will be pulled into the reporting entity as a component unit because the primary government will be considered a fiduciary of the plan because the financial benefit burden criteria will have been met. The Task Force believes that when plans are required to be included in the reporting entity, members should apply the Independence Rule and related interpretations as required by paragraphs .05 through .09 (i.e., both the downstream and upstream guidance) since the plan will be a component unit. The Task Force believes that in some cases the plans will be material to the primary government and the primary government will have more than minimal influence over the accounting or financial reporting process of the plan's and so this requirement would likely have a significant impact.

However, when the plan is not required to be included in the reporting entity, the Task Force believes the member should only apply paragraph .10 which would require the member apply the [Conceptual Framework for Independence](#) if the member knows or have reason to believe that a relationship or circumstance exists with the entity that would create threats to independence. The Task Force plans to develop a number of FAQs to help members understand how to apply the guidance when plans are involved.

***Investments Held by the Financial Statement Attest Client***

The Task Force is including a section in the interpretation that addresses how investments held by a state or local entity should be treated. Investments in a state or local government are not considered a fund or component unit and require explicit guidance in evaluating when independence is required.

The Task Force believes that members should apply the independence rules and related interpretations to certain investments of a state and local government entity. The first situation that the Task Force is recommending the independence rules be extended to are investments that are not de minimus to the financial statement attest client as a

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whole, where the financial statement attest client can control the investment. The Task Force is recommending including a de minimus threshold because of the operational problems associated with determining which entities are controlled by a financial statement attest client when those entities are insignificant. Unlike in the commercial sector, state and local governments may not have systems in place to track this information. Nor do they have regulatory requirements that might be applicable to commercial entities to monitor investment relationships.

The other situation where the Task Force is recommending the rules be extended to are when a financial statement attest client has significant influence over a material investment.

The Task Force believes it may not be intuitive to members regarding the types of entities that might typically hold investments and plans to develop a FAQ to highlight some of the typical entities where members may find investments.

**Question For The Committee**

1. Does the Committee agree with the Task Force's recommendations?

**Key Official**

The Task Force noted that some of the interpretations of the Independence Rule restricts relationships a member may have with officers, directors or owners of an attest client (e.g., loans and financial interests). While these terms work in a commercial environment, they could be challenging to apply in the state and local government environment. As such, the Task Force developed the concept it refers to as a "key official" to cover these types of individuals in the government environment and recommends the following definition be included in the proposed revised interpretation:

An individual employed by or associated with a primary government who has governance responsibilities or control over financial reporting.

The Task Force also recommends including clarification that when the terms "director, officer or owner" appear in other independence interpretations, that member should use the key official definition when the terms "director, officer or owner" are not applicable to the member's financial statement attest client. The Task Force also recommends asking a question in the exposure draft to see if there are other terms or phrases that members have difficulty translating to the government environment.

**Question For The Committee**

1. Does the Committee agree with the Task Force's recommendations?

**Conforming Revision**

The Task Force recommends striking the last sentence in the definition of "financial statement attest client" since this term is now being used in the SLG interpretation.

**Financial statement attest client.** An entity whose *financial statements* are audited, reviewed, or compiled when the *member's* compilation report does not disclose a lack of *independence*. ~~This term is used in the "Client Affiliates" interpretation [1.224.010] of the "Independence Rule" [1.200.001] and in the definition of an affiliate [0.400.02].~~

**Question For The Committee**

1. Does the Committee agree with the Task Force's recommendations?
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### **Exposure Draft Questions**

The only question identified so far for inclusion in the exposure draft is:

- Are there any situations where you believe the framework proposed will not reach the appropriate answer for the General Fund? If so, please explain the situation and why you believe the appropriate answer would not be reached.
- Paragraph .03 of the proposed revised interpretation notes that when an interpretation of the "[Independence Rule](#)" [1.200.001] is applied to a state or local government entity and the interpretation restricts relationships with an "officer, director or owner" of the attest client, a member should apply the key official definition in the proposed revised interpretation if the terms "officer, director or owner" are not applicable to the member's financial statement attest client. Are there any other terms or concepts included in the interpretations to the Independence rules that the Committee should consider providing additional application guidance for?

<b>Question For The Committee</b>
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| 1. Does the Committee agree with the Task Force's recommendation? |
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### **Parking Lot Items**

The Task Force believes the remaining 2 parking lot items should be addressed after the revised interpretation is adopted. The first item is whether or not the guidance should be applied to compliance audits. The second parking lot item relates to whether or not this guidance should be applied to the federal government.

<b>Question For The Committee</b>
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| 1. Does the Committee agree with the Task Force's recommendation? |
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### **Staff Suggested Editorial Revision**

During the Task Force's discussion, an editorial revision came to Staff's attention that I would like to run by the Committee. Specifically, item "a." in paragraph .01 (see below) refers to "public employee retirement plan" and Staff believes this term is too limiting. Staff recommends it be replaced with "public employee benefit plan" so that all plans are pulled in.

#### ***Plan Is an Attest Client or Is Sponsored by an Attest Client***

.01 When a *covered member* participates in an employee benefit plan that is an *attest client* or is sponsored by an *attest client*, during the *period of the professional engagement* or during the period covered by the *financial statements*, the self-interest *threat* to compliance with the "[Independence Rule](#)" [1.200.001] would not be at an *acceptable level*. *Independence* with respect to the employee benefit plan and the sponsor would be *impaired* except in the following specific situations:

- a. *Governmental organization*. When a *covered member* is an employee of a governmental organization that sponsors, cosponsors, or participates with other governmental organizations in a public employee **benefit retirement** plan (the plan) and the *covered member* is required by law, rule, or regulation to audit the plan, *threats to independence* would be at an *acceptable level* if all of the following *safeguards* are met:
  - i. The *covered member* is required to participate in the plan as a condition of employment.

- ii. The plan is offered to all employees in comparable employment positions.
  - iii. The *covered member* is not associated with the plan in any capacity prohibited by the “[Simultaneous Employment or Association With an Attest Client](#)” interpretation [1.275.005] of the “Independence Rule.”
  - iv. The *covered member* has no influence or control over the investment strategy, benefits, or other management activities associated with the plan.
  - b. *Former employment or association with the attest client.* The requirements of [paragraph .04](#) of the “Former Employment or Association With an Attest Client” interpretation [1.277.010] must be met. [Prior reference: paragraphs .214–.215 of ET section 191]
- .02 When an *immediate family* member participates as a result of his or her employment, in an employee benefit plan that is an *attest client* or is sponsored by an *attest client*, the requirements of the “[Immediate Family Member Participation in an Employee Benefit Plan That Is an Attest Client or Is Sponsored by an Attest Client \(Other Than Certain Share-Based Arrangements or Nonqualified Deferred Compensation Plans\)](#)” interpretation [1.270.030] of the “Independence Rule” [1.200.001] must be met. [Prior reference: paragraph .17 of ET section 101]

#### **Question For The Committee**

1. Should this interpretation be revised as suggested by Staff?

#### **Effective Date**

The Task Force believes that members who practice in the SLG environment will need significant time to implement the proposed revisions. As such, the Task Force recommends that the interpretation be effective for engagements covering periods beginning on or after June 15, 2019 but allow for early implementation.

#### **Question For The Committee**

1. Does the Committee agree with the Task Force’s recommendation?

#### **Action Needed**

The Committee is asked to expose the proposed revised interpretation.

#### **Communication Plan**

Following is a summary of how the proposal would be publicized

- CPA Letter Daily
- Ethically Speaking
- Direct Emails to
  - State Society Ethics Committee Liaisons/Chairs and where identified related society SLG committees
  - State Board Executive Directors
  - SLG Expert Panel
  - TIC

#### **Materials Presented**

Agenda Item 1B – Draft Interpretation

Agenda Item 1C – Extant Interpretation

Agenda Item 1D - Listing of FAQs the Task Force Has Under Development

Agenda Item 1E - Government Reporting Crosswalk

## Proposed Revised Interpretation

### 1.224.020 Entities Included in State and Local Government Financial Statements

#### Introduction

- .01 This [interpretation](#) provides guidance on which entities [members](#) should be independent of because the entities have some relationship to a [financial statement attest client](#) that is a state or local government entity.
- .02 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 to be included in a primary government's reporting entity under the applicable financial reporting framework. For purposes of this interpretation the applicable financial reporting framework is as defined in the auditing standards (for example, governmental GAAP, regulatory basis, cash basis, modified cash basis).
- .03 When an interpretation of the "[Independence Rule](#)" [1.200.001] is applied to a state or local government entity and the interpretation restricts relationships with an "officer, director or owner" of the attest client, a member should apply the key official definition in this interpretation if the terms "officer, director or owner" are not applicable to the member's financial statement attest client.

#### Terminology

- .04 The following terms are defined here solely for use with this interpretation:
  - a. Primary Government. The primary government includes (1) the [financial statement attest client](#) and all entities that are required to be included in the [financial statement attest client's](#) reporting entity under the applicable financial reporting framework as well as (2) the reporting entity in which the [attest client's financial statements](#) are required to be included under the applicable financial reporting framework.
  - b. State and Local Governmental Entities. State and local governmental entities include general purpose governments such as states, counties, cities, towns, villages and special purpose governments that perform limited activities. Examples of special purpose governments include, but are not limited to, cemetery districts, school districts, universities and colleges, utilities, hospitals or other health care organizations, and public employee retirement systems (PERSs).
  - c. Funds and Component Units. Funds and component units are intended to be broadly defined and can include, but are not limited to, departments, agencies, programs, organizational units administered by elected officials, grant reporting, organizational units within component units, employee benefit plans and other fiduciary and custodial activities. A component unit can also be a primary government in its standalone financial statements.
  - d. Investments. An investment is a security or other asset that (a) the [financial statement attest client](#) holds primarily for the purpose of income or profit and (b) has a present service capacity based solely on its ability to generate cash or to be sold to generate cash. This includes investments and ownership in equity interest in common stock accounted for using the equity method of accounting as provided for in GASB Codification I50. The following interests are not considered investments for purposes of this interpretation: (1) interests obtained by a [financial statement attest client](#) as a result of an action by a third party, such as through a bequest or a grant, and that the entity does not intend to retain; and (2) equity interests in joint ventures partnerships,



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LLCs or other type of entity where the intent of the [financial statement attest client](#) is to directly enhance its ability to provide governmental services, and (3) equity interests in component units where the intent of the [financial statement attest client](#) is to directly enhance its ability to provide governmental services.

- e. Key Official. An individual employed by or associated with a primary government who has governance responsibilities or control over financial reporting.

***Independence of Funds and Component Units Required To Be Included in the Reporting Entity of the Financial Statement Attest Client***

- .05 [Members](#) should apply the “[Independence Rule](#)” [1.200.001] and related [interpretations](#) to all funds and component units included in the [financial statement attest client’s](#) reporting entity where the [covered member](#) does not make reference to another auditor’s report on the fund or component unit.
- .06 [Members](#) should apply the “[Independence Rule](#)” [1.200.001] and related [interpretations](#) to all material funds and component units included in the [financial statement attest client’s](#) reporting entity where the [covered member](#) makes reference to another auditor’s report on the material fund or component unit, and the primary government has more than minimal influence over the accounting or financial reporting process over that fund or component unit.
- .07 [Members](#) should apply the “[Independence Rule](#)” [1.200.001] and related [interpretations](#) to all material funds and component units excluded from the [financial statement attest client’s](#) reporting entity but required to be included under the applicable framework when the primary government has more than minimal influence over the accounting or financial reporting process over those funds or component units.
- .08 In the situations identified in paragraphs .06 and .07 of this interpretation, the [member](#) and [member’s firm](#) may provide nonattest services that [impair independence](#) 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 [financial statement attest client](#) because the results of the nonattest services will not be subject to the [covered member’s 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](#).

***Independence When the Financial Statement Attest Client is Required To Be Included in Another Reporting Entity As a Fund or Component Unit and Primary Government of That Reporting Entity is Not A Financial Statement Attest Client***

- .09 When a material fund or component unit is a [financial statement attest client](#) and is required to be included in another reporting entity, [members](#) should apply the “[Independence Rule](#)” [1.200.001] and related [interpretations](#) to a primary government body that exerts more than minimal influence over the accounting or financial reporting process of the [financial statement attest client](#). [Members](#) do not need to apply the “[Independence Rule](#)” [1.200.001] and related [interpretations](#) to other funds and component units that are included in the reporting entity of that primary government, provided those other funds and component units do not have more than minimal influence over the accounting or financial reporting process of the [financial statement attest client](#). However, the following exceptions may be applied:
  - a. A [covered member](#) may have a [loan](#) to or from an individual who is a key official of the primary government during the [period of the professional](#)

- engagement unless the covered member knows or has reason to believe that the individual is in such a position with the primary government. If the covered member knows or has reason to believe that the individual is a key official of the primary government, the covered member should evaluate the effect that the relationship would have on the covered member's independence by applying the "Conceptual Framework for Independence" [1.210.010].
- b. A member or the member's firm may provide nonattest services that impair independence to the primary government 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 financial statement attest client because the results of the nonattest services will not be subject to the covered member's 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.
  - c. A firm will only have to apply the "Subsequent Employment or Association With an Attest Client" interpretation [1.279.020] of the "Independence Rule" if the former employee is employed by the primary government and is in a key position with respect to the financial statement attest client. Individuals in a position to influence the attest engagement and on the attest engagement team who are considering employment with the primary government will still need to report consideration of employment to an appropriate person in the firm and remove themselves from the financial statement attest engagement, even if the position with the primary government or employer is not a key position.
  - d. A covered member's immediate family members and close relatives may be employed in a key position at the primary government during the period of the professional engagement or during the period covered by the financial statements, provided they are not in a key position with respect to the financial statement attest client.

#### **Other Funds, Component Units or Activities**

- .10 For funds, component units or activities not specified in paragraphs .05 through .09 of this interpretation, members should apply the Conceptual Framework for Independence if the member knows or have reason to believe that a relationship or circumstance exists with the entity that would create threats to independence.

#### **Investments Held by the Financial Statement Attest Client**

- .11 Members should apply the "Independence Rule" [1.200.001] and related interpretations to an entity in which the financial statement attest client
- a. has a controlling investment in that is not de minimus to the financial statement attest client as a whole. De minimus amounts are dollar amounts that in the member's professional judgement are clearly inconsequential to the financial statement attest client as a whole.
  - b. has an investment in that gives the financial statement attest client significant influence over the entity and that is material to the financial statement attest client as a whole.
- .12 Members should use their professional judgement to determine if control or significant influence exists. Members should consider using the definitions for control at ET 0.400.10 and significant influence at ET 0.400.45 along with any applicable GASB guidance.



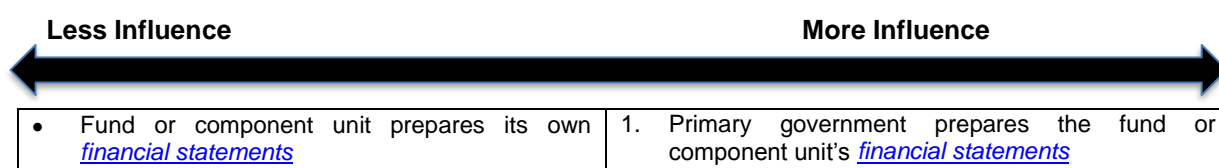
- .13 A [member](#) must expend best efforts to obtain the information necessary to identify these investments. If, after expending best efforts, a [member](#) is unable to obtain the information to determine the investments of the [financial statement attest client](#), [threats](#) would be at an [acceptable level](#) and [independence](#) would not be [impaired](#) if the [member](#) (a) discusses the matter, including the potential impact on [independence](#), with [those charged with governance](#); (b) documents the results of that discussion and the efforts taken to obtain the information; and (c) obtains written assurance from the [financial statement attest client](#) that it is unable to provide the [member](#) with the information necessary to identify the investments of the [financial statement attest client](#).

***Determination of Whether Primary Government Has More Than Minimal Influence Over Funds or Component Units***

- .14 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. To rebut this presumption, [members](#) can consider 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 prepare the [financial statements](#) for the fund or component unit.
- b. Accounting or finance staff of the fund or component unit is not the same staff as the primary government.
- c. Fund or component unit does not have the same accounting systems as the primary government.
- d. Fund or component unit does not have the same internal control over financial reporting systems as the primary government
- e. Primary government does not have a significant level of operational control over the fund or component unit.
- f. Primary government does not direct the behaviors or actions of the governing board of the fund or component unit.
- g. Primary government does not have the ability to add or remove members of the governing board of the fund or component unit.
- h. 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

- .15 The overall facts and circumstances should be considered when using the factors in paragraph .14 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.



<ul style="list-style-type: none"> <li>Accounting staff separate from primary government staff</li> </ul>	2. Accounting staff part of primary government finance staff
<ul style="list-style-type: none"> <li>Separate accounting system</li> </ul>	3. Same accounting system as primary government with no fund or component unit subsystems that feed the primary government system
<ul style="list-style-type: none"> <li>Separate internal control over financial reporting</li> </ul>	4. Same internal control over financial reporting as primary government
<ul style="list-style-type: none"> <li>Primary government has no operational control</li> </ul>	5. Primary government has strong operational control
<ul style="list-style-type: none"> <li>Strong independent governing board</li> </ul>	6. Same governing body as primary government with high level of involvement.
<ul style="list-style-type: none"> <li>No level of financial dependence on primary government</li> </ul>	7. High level of financial dependence (such as, operating loss subsidies, payment for certain costs)
<ul style="list-style-type: none"> <li>Board members are not otherwise associated with the primary government</li> </ul>	8. Board members are associated with the primary government such as ex-officio members that are employed by the primary government
<ul style="list-style-type: none"> <li>Fund or component unit <a href="#">financial statements</a> incorporated into primary government without modification (i.e., either fund-level or government-wide level statements of primary government)</li> </ul>	9. Fund component unit <a href="#">financial statements</a> 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)

### **Effective Date**

.16 This interpretation will be effective for engagements covering periods beginning on or after June 15, 2019. Early implementation is allowed.

### **Other Conforming Revisions**

**Financial statement attest client.** An entity whose [financial statements](#) are audited, reviewed, or compiled when the [member's](#) compilation report does not disclose a lack of [independence](#). This term is used in the "Client Affiliates" interpretation [1.224.010] of the "Independence Rule" [1.200.001] and in the definition of an affiliate [0.400.02].

## Extant Interpretation

### 1.224.020 Entities Included in State and Local Government Financial Statements

- .01 For purposes of this interpretation, a financial reporting entity's basic *financial statements* issued in conformity with generally accepted accounting principles (GAAP) include the following:
- a. The government-wide *financial statements* (consisting of the entity's governmental activities, business-type activities, and discretely presented component units)
  - b. The fund *financial statements* (consisting of major funds, nonmajor governmental and enterprise funds, internal service funds, blended component units, and fiduciary funds)
  - c. Other entities disclosed in the notes to the basic *financial statements*. Examples of other entities that should be disclosed include the following:
    - i. Related organizations
    - ii. Joint ventures
    - iii. Jointly governed organizations
    - iv. Component units of another government with characteristics of a joint venture or jointly governed organization
- .02 Certain terminology used in this interpretation is specifically defined by the Governmental Accounting Standards Board (GASB).
- .03 When a *covered member* audits the basic *financial statements* of a financial reporting entity or the *financial statements* of a major fund, a nonmajor fund, an internal service fund, a fiduciary fund, or a component unit of the financial reporting entity or other entity that should be disclosed in the notes to the basic *financial statements*, the *covered member* must be independent of the entity, fund, or component unit that the *covered member* is auditing, as discussed in this interpretation.

### Auditor of the Financial Reporting Entity

- .04 When a *covered member* audits the basic *financial statements* of the financial reporting entity, the *covered member* must also be independent of any major or nonmajor fund, internal service fund, fiduciary fund, or component unit or other entities disclosed in the basic *financial statements* unless the primary auditor explicitly states reliance on other auditors' reports
- .05 *Independence* is not required with respect to an entity disclosed in the notes to the basic *financial statements* if the financial reporting entity is not financially accountable for the entity and the required disclosure does not include financial information. For example, a disclosure limited to the financial reporting entity's ability to appoint the governing board members would not require the *covered member* to be independent of that entity.
- .06 Regardless of the exceptions in [paragraph .05](#), if a *covered member* or a *covered member's immediate family* holds a *key position* in any of the following entities during the *period of the professional engagement* or during the period covered by the *financial statements*, *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 the *covered member's independence* would be *impaired*:

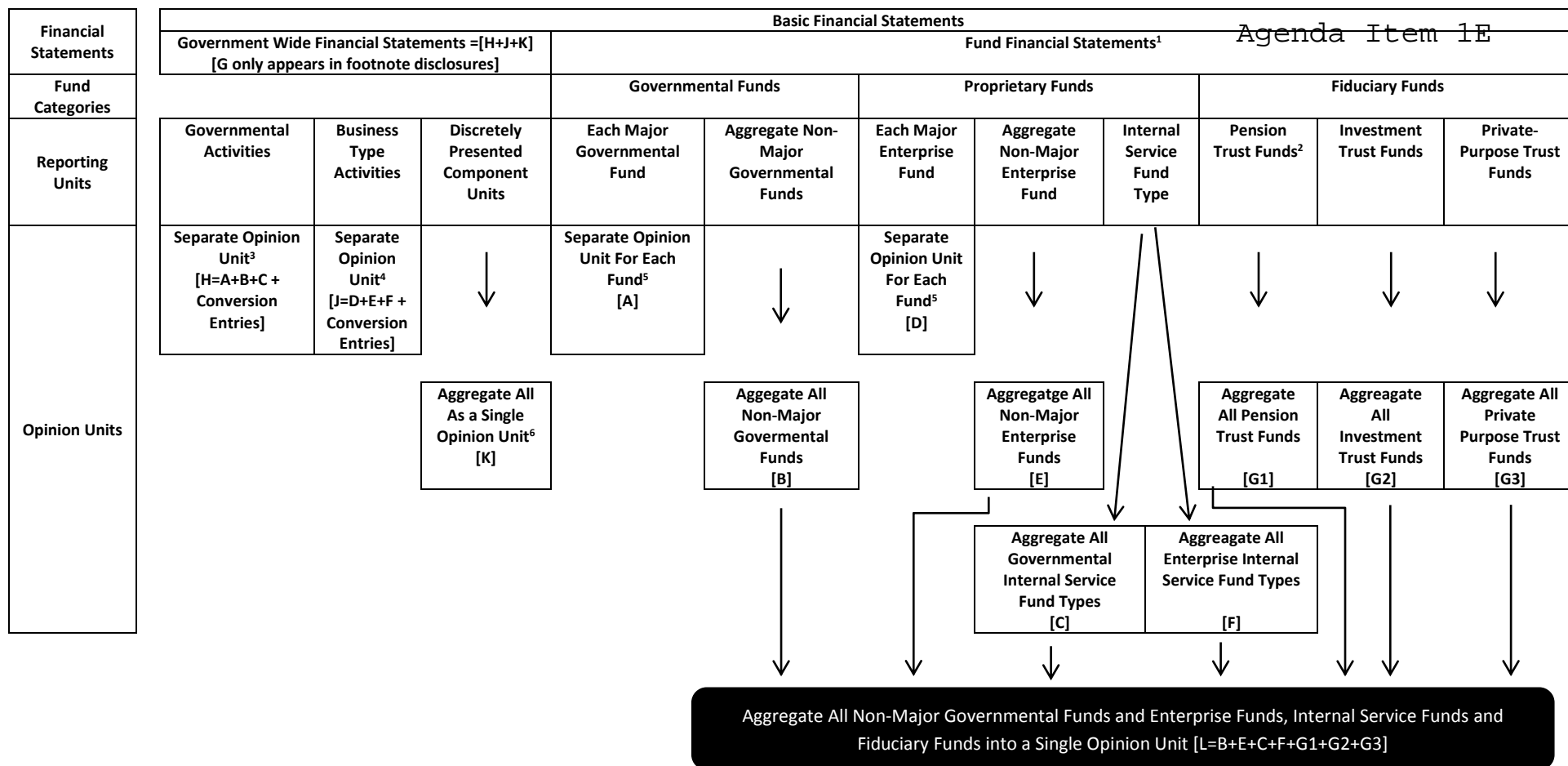
- 
- a. Major fund, nonmajor fund, internal service fund, fiduciary fund, or component unit of the financial reporting entity
  - b. Other entity that should be disclosed in the notes to the basic *financial statements*

***Auditor Does Not Audit the Primary Government***

- .07 When a *covered member* does not audit the primary government but audits the *financial statements* of the following entities, the *covered member* is not required to be independent of entities that the *covered member* does not audit:
- a. A major fund, a nonmajor fund, an internal service fund, a fiduciary fund, or a component unit of the financial reporting entity
  - b. An entity that should be disclosed in the notes to the basic *financial statements* of the financial reporting entity
- .08 However, if a *covered member* or a *covered member's immediate family* holds a *key position* within the primary government during the *period of the professional engagement* or during the period covered by the *financial statements*, *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*. Accordingly, the *covered member's independence* would be *impaired*. For purposes of this interpretation, a *covered member* and the *covered member's immediate family* would not be considered employed by the primary government if the exceptions provided for in [paragraph .07b](#) of the “Client” definition [0.400.07] were met. [Prior reference: paragraph .12 of ET section 101]

PLANNED FAQs – As of January 25, 2017

1. **Special Purpose Government (Paragraph .04b)**
2. **Key Official (Paragraph .04e)**
3. **Materiality Considerations (Paragraphs .06, .07, .09 and .11b)**
4. **Subject to Financial Statement Attest Procedures (Paragraphs .08 and .09b)**
5. **Evaluation of a Reporting Entity that includes a Financial Statement Attest Client (Paragraph .09)**
6. **Examples of Other Entities – (Paragraph .10)**
7. ***Funds or Component Units Included in a Reporting Entity That Includes the Financial Statement Attest Client and the Funds or Component Units Are Not a Financial Statement Attest Client – (Paragraph .10)***
8. **Examples of Entities that Hold Investments – (Paragraph .11)**
9. **Other Post-Employment Benefit Plan (OPEB) Required To Be Included In the Primary Government's Financial Reporting Entity– (Paragraphs .05 - .08)**
10. **Employee Benefit Plan Required To Be Included In the Primary Government's Financial Reporting Entity - (Paragraph .09)**
11. **Primary Government is Financial Statement Attest Client and A Government Employee Benefit Plan Not Required To Be Included In the Primary Government's Financial Reporting Entity - (Paragraph .10)**
12. **Government Employee Benefit Plan is Financial Statement Attest Client And Not Required To Be Included In the Primary Government's Financial Reporting Entity- (Paragraph .10)**
13. **Service Provider to a Government Employee Benefit Plan – (Paragraph .04 - .08)**
14. **Private Purpose Trust Fund is Financial Statement Attest Client - (Paragraph .09)**
15. **Investments Held by a Private Purpose Trust Fund Financial Statement Attest Client – (paragraph .11)**



<sup>1</sup> 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.

<sup>2</sup> In addition to pension trust funds, this fund includes other employee benefit trust funds.

<sup>3</sup> 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.

<sup>4</sup> 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 predominate customers as well as any necessary conversion entries to create the business-type activities financial statements.

<sup>5</sup> 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.

<sup>6</sup> 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 it should be reported as a blended component unit.

## IFAC Convergence – NOCLAR

### Task Force Members

Bob Denham (Chair), Carlos Barrera, Sam Burke, Greg Guin, Brian Lynch, and Elizabeth Pittlekow. Staff: Jason Evans. Observer: Lisa Snyder

### Task Force Charge

The Task Force is charged with reviewing the International Ethics Standards Board for Accountants' (IESBA) standards entitled, Responding to Non-Compliance with Laws and Regulations (NOCLAR) and recommend to PEEC revisions to the AICPA Code for purposes of convergence.

### Reason for Agenda Item

To approve new interpretations 1.170.010 and 2.170.010, both entitled Responding to Non-Compliance with Laws and Regulations, for exposure.

### Summary of Issues

#### **Background**

The final NOCLAR pronouncement was approved by the IESBA in April 2016 and will become effective July 15, 2017. **Agenda Item 2C** contains the final NOCLAR standards issued by IESBA. At the PEEC's November 2016 meeting, the Committee provided feedback to the NOCLAR Convergence Task Force with regard to its draft interpretations. It was suggested that the guidance should include a statement that a member would be permitted to disclose a NOCLAR to an appropriate authority if done so with the consent of the client. Thus, the Task Force amended the proposed guidance to include a reference to permitted disclosures included in the Confidential Client Information Rule.

The Committee should note that when referring to NOCLAR in this agenda item, the term NOCLAR includes both identified as well as suspected NOCLAR.

#### **Points of Distinction and Differences from the IESBA Standard**

The proposed interpretations do contain some differences from the IESBA standard. A summary of the differences and other key points of the proposed interpretations are noted as follows:

- The IESBA standard would permit a professional accountant to override the confidentiality requirement for clients and employers if certain conditions were met and the accountant believed it was in the public interest to disclose the NOCLAR to an outside authority and/or external auditor. The PEEC agreed that the AICPA guidance should not converge with the IESBA guidance because most state laws would prohibit such disclosure. It should be noted that the IESBA standard precluded disclosure if laws or regulations in the jurisdiction prohibit disclosure.
- The PEEC agreed that due to state confidentiality laws, the AICPA guidance should not converge with the IESBA standard by permitting a professional accountant in public practice (PAPP) to disclose a NOCLAR to the client's successor accountant. The Committee believed the current guidance of requesting the successor to obtain the client's permission and raising a "red flag" continued to be appropriate.
- The Committee agreed with the IESBA position that a professional accountant in business (PAIB) should be permitted to disclose a NOCLAR to the company's auditor if doing so

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was part of the member's obligation to provide all relevant facts when dealing with the auditor.

- Since the proposed interpretation for members in public practice does not include provisions that would permit disclosure of a NOCLAR to an external auditor or outside authority, the guidance for members in public practice was not bifurcated between audit services and non-audit services.
- The IESBA standard provides guidance for disclosure of a NOCLAR within a group audit. The proposed interpretation 1.170.010 provides guidance for communication for all group attest engagements.
- Under the IESBA standard, if a PAPP is performing a service for an audit client of the firm (or a component of an audit client), the PAPP is required to communicate the NOCLAR within the firm so that the audit partner is informed of the NOCLAR. The proposed interpretation 1.170.010 extends this requirement to review clients of the firm as well.
- The IESBA standard requires the auditor to document certain matters. For all other PAPPs, the IESBA standard encourages documentation. With regard to PAIBs, documentation of certain matters is encouraged. Due to the significance of a NOCLAR and the potential impact on the public, all members in public practice are required to document certain matters under the proposed standards. With regard to members in business, the proposed interpretation 2.170.010 encourages documentation concerning certain matters.

#### **Action Needed:**

1. The PEEC is asked to read **Agenda Item 2B** and approve for exposure.
2. The PEEC is asked to consider whether the exposure draft should include a question as to whether documentation should be encouraged, rather than required, for PAPPs who perform only nonattest services.
3. Does the PEEC believe that paragraph .33 of 1.170.010 should contain reasoning for the reference to the Confidential Client Information Rule? The Code normally does not provide such explanations.

#### **Materials Presented**

**Agenda 2A** – This Agenda Item

**Agenda 2B** – Proposed NOCLAR Interpretations

**Agenda 2C** – IESBA NOCLAR Standards



### ***DRAFT NOCLAR INTERPRETATIONS***

#### ***1.170 Responding to Non-Compliance with Laws and Regulations***

##### ***1.170.010 Responding to Non-Compliance with Laws and Regulations***

###### ***Introduction***

- .01 When a member encounters or is made aware of non-compliance or suspected non-compliance with laws and regulations in the course of providing a professional service to a client, threats to compliance with the “Integrity and Objectivity Rule” [1.100.001] may exist. The purpose of this interpretation is to set out the member’s responsibilities when encountering such non-compliance or suspected non-compliance, and guide the member in assessing the implications of the matter and the possible courses of action when responding to it.
- .02 Non-compliance with laws and regulations (“non-compliance”) comprises acts of omission or commission, intentional or unintentional, committed by a client, or by those charged with governance, by management or by other individuals working for or under the direction of a client which are contrary to the prevailing laws or regulations.
- .03 When responding to non-compliance or suspected non-compliance in the course of providing a professional service to a client, the member should consider his or her obligations under the “Confidential Client Information Rule” [1.700.001]. For example, a member should not disclose the non-compliance or suspected non-compliance to a third party without the client’s consent unless expressly permitted under the “Confidential Client Information Rule,” such as, when reporting the non-compliance or suspected non-compliance to a regulatory authority in order to comply with applicable laws and regulations, as discussed in paragraph.04 of this interpretation.
- .04 Some regulators, such as the Securities and Exchange Commission or state boards of accountancy, may have regulatory provisions governing how a member should address non-compliance or suspected non-compliance which may differ from or go beyond this interpretation. In some circumstances, state and federal civil and criminal laws may also impose additional requirements. When encountering non-compliance or suspected non-compliance, a member has a responsibility to obtain an understanding of those legal or regulatory provisions and comply with them, including any requirement to report the matter to an appropriate authority, and any prohibition on alerting the client prior to making any disclosure.
- .05 A distinguishing mark of the accounting profession is its acceptance of the responsibility to act in the public interest. When responding to non-compliance or suspected non-compliance, the objectives of a member are:

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- a. To comply with the “Integrity and Objectivity Rule” [1.100.001];
  - b. By alerting management or, where appropriate, those charged with governance of the client, to enable them to:
    - i. Rectify, remediate or mitigate the consequences of the identified or suspected non-compliance; or
    - ii. Deter the commission of the non-compliance where it has not yet occurred.
  - c. To determine whether withdrawal from the engagement and the professional relationship is necessary, where permitted by law and regulation.

### **Scope**

- .06 This interpretation sets out the approach to be taken by a member who encounters or is made aware of non-compliance or suspected non-compliance with:
  - a. Laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the client’s financial statements; and
  - b. Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the client’s financial statements, but compliance with which may be fundamental to the operating aspects of the client’s business, to its ability to continue its business, or to avoid material penalties.
- .07 Examples of laws and regulations which this interpretation addresses include those that deal with:
  - a. Fraud, corruption and bribery.
  - b. Money laundering.
  - c. Securities markets and trading.
  - d. Banking and other financial products and services.
  - e. Data protection.
  - f. Tax and pension liabilities and payments.
  - g. Environmental protection.
  - h. Public health and safety.
- .08 Non-compliance may result in fines, litigation or other consequences for the client that may have a material effect on its financial statements. Importantly, such non-compliance may have wider public interest implications in terms of potentially substantial harm to investors, creditors, employees or the general public. For the purposes of this interpretation, an act that causes substantial harm is one that results in serious adverse consequences to any of these parties in financial or non-financial terms. Examples include the perpetration of a fraud resulting in significant financial losses to investors, and breaches of environmental laws and regulations endangering the health or safety of employees or the public.
- .09 A member who encounters or is made aware of matters that are clearly inconsequential, judged by their nature and their impact, financial or otherwise, on the client, its stakeholders and the general public, is not required to comply with this interpretation with respect to such matters.
- .10 This interpretation does not address:

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- a. Personal misconduct unrelated to the business activities of the client; and
  - b. Non-compliance other than by the client or those charged with governance, management or other individuals working for or under the direction of the client. This includes, for example, circumstances where a member has been engaged by a client to perform a due diligence assignment on a third party entity and the identified or suspected non-compliance has been committed by that third party.

A member may nevertheless find the guidance in this interpretation helpful in considering how to respond in these situations.

### ***Responsibilities of the Client's Management and Those Charged with Governance***

- .11 It is the responsibility of the client's management, with the oversight of those charged with governance, to ensure that the client's business activities are conducted in accordance with laws and regulations. It is also the responsibility of management and those charged with governance to identify and address any non-compliance by the client, by an individual charged with governance of the entity, by a member of management, or by other individuals working for or under the direction of the client.

### ***Responsibilities of Members in Public Practice***

- .12 Where a member becomes aware of a matter to which this interpretation applies, the steps that the member takes to comply with this interpretation should be taken on a timely basis, having regard to the member's understanding of the nature of the matter and the potential harm to the interests of the entity, investors, creditors, employees or the general public.

### ***Obtaining an Understanding of the Matter***

- .13 If a member engaged to perform professional services becomes aware of information concerning an instance of non-compliance or suspected non-compliance, whether in the course of performing the engagement or through information provided by other parties, the member should obtain an understanding of the matter, including the nature of the act and the circumstances in which it has occurred or may occur.
- .14 A member is expected to apply knowledge, professional judgment and expertise, but is not expected to have a level of knowledge of laws and regulations that is greater than that which is required to undertake the engagement. Whether an act constitutes non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body. Depending on the nature and significance of the matter, the member may consult on a confidential basis with others within the firm, a network firm or a professional body, or with legal counsel.
- .15 If the member identifies or suspects that non-compliance has occurred or may occur, the member should discuss the matter with the appropriate level of management and, if the member has access to them and where appropriate, those charged with governance.

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- .16 Such discussion serves to clarify the member's understanding of the facts and circumstances relevant to the matter and its potential consequences. The discussion also may prompt management or those charged with governance to investigate the matter.
- .17 The appropriate level of management with whom to discuss the matter is a question of professional judgment. Relevant factors to consider include:
- a. The nature and circumstances of the matter.
  - b. The individuals actually or potentially involved.
  - c. The likelihood of collusion.
  - d. The potential consequences of the matter.
  - e. Whether that level of management is able to investigate the matter and take appropriate action.
- .18 The appropriate level of management is generally at least one level above the person or persons involved or potentially involved in the matter. If a member believes that management is involved in the non-compliance or suspected non-compliance, the member should discuss the matter with those charged with governance. The member may also consider discussing the matter with internal auditors, where applicable. In the context of a group attest engagement, the appropriate level may be management at an entity that controls the client.

### ***Addressing the Matter***

- .19 In discussing the non-compliance or suspected non-compliance with management and, where appropriate, those charged with governance, the member should advise them to take appropriate and timely actions, if they have not already done so, to:
- a. Rectify, remediate or mitigate the consequences of the non-compliance;
  - b. Deter the commission of the non-compliance where it has not yet occurred; or
  - c. Disclose the matter to an appropriate authority where required by law or regulation or where considered necessary in the public interest.
- .20 The member should consider whether the client's management and those charged with governance understand their legal or regulatory responsibilities with respect to the non-compliance or suspected non-compliance. If not, the member may suggest appropriate sources of information or recommend that they obtain legal advice.
- .21 The member should comply with applicable:
- a. Laws and regulations, including legal or regulatory provisions governing the reporting of non-compliance or suspected non-compliance to an appropriate authority. In this regard, some laws and regulations may stipulate a period within which reports are to be made; and
  - b. Requirements under auditing or other professional standards, including those relating to:
    - i. Identifying and responding to non-compliance, including fraud.
    - ii. Communicating with those charged with governance.
    - iii. Considering the implications of the non-compliance or suspected non-compliance for the auditor's report.
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### ***Communication with Respect to Group Attest Engagements***

.22 A member may:

- a. For purposes of a group attest engagement, be requested by the group engagement team to perform work on financial or other information related to a component of the group; or
- b. Be engaged to perform an attest engagement of a component for purposes other than the group attest engagement, for example, a statutory audit.

Where the member becomes aware of non-compliance or suspected non-compliance in relation to the component in either situation, the member should, in addition to responding to the matter in accordance with the provisions of this interpretation, communicate it to the group engagement partner unless prohibited from doing so by law or regulation. This is to enable the group engagement partner to be informed about the matter and to determine, in the context of the group attest engagement, whether and, if so, how it should be addressed in accordance with the provisions in this interpretation.

.23 Where the group engagement partner becomes aware of non-compliance or suspected non-compliance in the course of a group attest engagement, including as a result of being informed of such a matter in accordance with paragraph .22, the group engagement partner should, in addition to responding to the matter in the context of the group attest engagement in accordance with the provisions of this interpretation, consider whether the matter may be relevant to one or more components:

- a. Whose financial or other information is subject to procedures performed for purposes of the group attest engagement; or
- b. Whose financial or other information is subject to procedures performed for purposes other than the group attest engagement, for example, a statutory audit.

If so, the group engagement partner should take steps to have the non-compliance or suspected non-compliance communicated to those performing work at components where the matter may be relevant, unless prohibited from doing so by law or regulation. If necessary in relation to subparagraph b., appropriate inquiries should be made (either of management or from publicly available information) as to whether the relevant component(s) is subject to attest procedures and, if so, to ascertain, to the extent practicable, the identity of the accountant. The communication is to enable those responsible for work at such components to be informed about the matter and to determine whether and, if so, how it should be addressed in accordance with the provisions in this interpretation.

### ***Determining Whether Withdrawal from the Engagement Is Necessary***

.24 The member should assess the appropriateness of the response of management and, where applicable, those charged with governance.

.25 Relevant factors to consider in assessing the appropriateness of the response of management and, where applicable, those charged with governance include whether:

- a. The response is timely.
- b. The non-compliance or suspected non-compliance has been adequately investigated.

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- c. Action has been, or is being, taken to rectify, remediate or mitigate the consequences of any non-compliance.
  - d. Action has been, or is being, taken to deter the commission of any non-compliance where it has not yet occurred.
  - e. Appropriate steps have been, or are being, taken to reduce the risk of re-occurrence, for example, additional controls or training.
  - f. The non-compliance or suspected non-compliance has been disclosed to an appropriate authority where appropriate and, if so, whether the disclosure appears adequate.
- .26 In light of the response of management and, where applicable, those charged with governance, the member should determine if withdrawing from the engagement and the professional relationship is necessary, where permitted by law and regulation.
- .27 The determination of whether withdrawing from the engagement and the professional relationship is necessary, will depend on various factors, including:
- a. The legal and regulatory framework.
  - b. The urgency of the matter.
  - c. The pervasiveness of the matter throughout the client.
  - d. Whether the member continues to have confidence in the integrity of management and, where applicable, those charged with governance.
  - e. Whether the non-compliance or suspected non-compliance is likely to recur.
  - f. Whether there is credible evidence of actual or potential substantial harm to the interests of the entity, investors, creditors, employees or the general public.
- .28 Examples of circumstances that may cause a member no longer to have confidence in the integrity of management and, where applicable, those charged with governance include situations where:
- a. The member suspects or has evidence of their involvement or intended involvement in any non-compliance.
  - b. The member is aware that they have knowledge of such non-compliance and, contrary to legal or regulatory requirements, have not reported, or authorized the reporting of, the matter to an appropriate authority within a reasonable period.
- .29 In determining the need to withdraw from the engagement and the professional relationship, a member should exercise professional judgment and take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances available to the member at the time, would be likely to conclude that the member has acted appropriately and in the public interest.
- .30 As consideration of the matter may involve complex analysis and judgments, a member may consider consulting internally, obtaining legal advice to understand the member's options and
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the professional or legal implications of taking any particular course of action, or consulting on a confidential basis with a regulator or professional body.

### ***Communicating the Matter to the Client's Auditor***

- .31 If the member is performing a service for a financial statement audit or review client of the firm, or a component of a financial statement audit or review client of the firm, the member should communicate the non-compliance or suspected non-compliance within the firm. The communication should be made in accordance with the firm's protocols or procedures or, in the absence of such protocols and procedures, directly to the audit or review engagement partner.
- .32 If the member is performing a service for a financial statement audit or review client of a network firm, or a component of a financial statement audit or review client of a network firm, the member should consider whether to communicate the non-compliance or suspected non-compliance to the network firm. Where the communication is made, it should be made in accordance with the network's protocols or procedures or, in the absence of such protocols and procedures, directly to the audit or review engagement partner.
- .33 If the member is performing a service for a client that is not a financial statement audit or review client of the firm, except as required by law or regulation, the member is not permitted to communicate the non-compliance or suspected non-compliance to the firm that is the client's external auditor, if any. See the "[Confidential Client Information Rule](#)" [1.700.001]
- .34 In all cases, the communication is to enable the audit or review engagement partner to be informed about the non-compliance or suspected non-compliance and to determine whether and, if so, how it should be addressed in accordance with the provisions of this interpretation.

### ***Documentation***

- .35 In relation to an identified or suspected act of non-compliance that falls within the scope of this interpretation, the member should, in addition to complying with the documentation requirements under applicable professional standards, document:
  - a. The matter.
  - b. The results of discussion with management and, where applicable, those charged with governance and other parties.
  - c. How management and, where applicable, those charged with governance have responded to the matter.
  - d. The courses of action the member considered, the judgments made and the decisions that were taken, having regard to the reasonable and informed third party perspective.



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## **2.170 Responding to Non-Compliance with Laws and Regulations**

### **2.170.010 Responding to Non-Compliance with Laws and Regulations**

#### **Introduction**

*Applicable to all Members in Business*

- .01 When a member in business encounters or is made aware of non-compliance or suspected non-compliance with laws and regulations in the course of carrying out professional services, threats to compliance with the “Integrity and Objectivity Rule” [2.100.010] may exist. The purpose of this interpretation is to set out the member’s responsibilities when encountering such non-compliance or suspected non-compliance, and guide the member in assessing the implications of the matter and the possible courses of action when responding to it. This interpretation applies regardless of the nature of the employing organization.
- .02 Non-compliance with laws and regulations (“non-compliance”) comprises acts of omission or commission, intentional or unintentional, committed by the member’s employing organization or by those charged with governance, by management, or by other individuals working for or under the direction of the employing organization which are contrary to the prevailing laws or regulations.
- .03 When responding to non-compliance or suspected non-compliance in the course of carrying out professional services, the member should consider his or her obligations under the “Confidential Information Obtained from Employment or Volunteer Activities” interpretation [2.400.070]. For example, a member should not disclose the non-compliance or suspected non-compliance to a third party without the employer’s consent unless expressly permitted under the “Confidential Information Obtained from Employment or Volunteer Activities” interpretation, such as, when reporting the non-compliance or suspected non-compliance to a regulatory authority in order to comply with applicable laws and regulations, as discussed in paragraph .04.
- .04 Some regulators, for example, the Securities and Exchange Commission or state boards of accountancy, may have provisions governing how members should address non-compliance or suspected non-compliance which may differ from or go beyond this interpretation, and state and federal civil and criminal laws, in some circumstances, may impose additional requirements. When encountering such non-compliance or suspected non-compliance, the member has a responsibility to obtain an understanding of those provisions and comply with them, including any requirement to report the matter to an appropriate authority and any prohibition on alerting the relevant party prior to making any disclosure, for example, pursuant to anti-money laundering legislation.
- .05 A distinguishing mark of the accounting profession is its acceptance of the responsibility to act in the public interest. When responding to non-compliance or suspected non-compliance, the objectives of the member are:



- a. To comply with the “Integrity and Objectivity Rule” [2.100.010];
- b. By alerting management or, where appropriate, those charged with governance of the employing organization, to enable them to:
  - i. Rectify, remediate or mitigate the consequences of the identified or suspected non-compliance; or
  - ii. Deter the commission of the non-compliance where it has not yet occurred; and
- c. To take such further action as appropriate in the public interest.

### **Scope**

- .06 This interpretation sets out the approach to be taken by a member who encounters or is made aware of non-compliance or suspected non-compliance with:
  - a. Laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the employing organization’s financial statements; and
  - b. Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the employing organization’s financial statements, but compliance with which may be fundamental to the operating aspects of the employing organization’s business, to its ability to continue its business, or to avoid material penalties.
- .07 Examples of laws and regulations which this interpretation addresses include those that deal with:
  - a. Fraud, corruption and bribery.
  - b. Money laundering.
  - c. Securities markets and trading.
  - d. Banking and other financial products and services.
  - e. Data protection.
  - f. Tax and pension liabilities and payments.
  - g. Environmental protection.
  - h. Public health and safety.
- .08 Non-compliance may result in fines, litigation or other consequences for the employing organization that may have a material effect on its financial statements. Importantly, such non-compliance may have wider public interest implications in terms of potentially substantial harm to investors, creditors, employees or the general public. For the purposes of this section, an act that causes substantial harm is one that results in serious adverse consequences to any of these parties in financial or non-financial terms. Examples include the perpetration of a fraud resulting in significant financial losses to investors, and breaches of environmental laws and regulations endangering the health or safety of employees or the public.
- .09 A member who encounters or is made aware of matters that are clearly inconsequential, judged by their nature and their impact, financial or otherwise, on the employing organization, its stakeholders and the general public, is not required to comply with this interpretation with respect to such matters.

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.10 This interpretation does not address:

- a. Personal misconduct unrelated to the business activities of the employing organization; and
- b. Non-compliance other than by the employing organization or those charged with governance, management, or other individuals working for or under the direction of the employing organization.

The member may nevertheless find the guidance in this section helpful in considering how to respond in these situations.

### ***Responsibilities of the Employing Organization's Management and Those Charged with Governance***

.11 It is the responsibility of the employing organization's management, with the oversight of those charged with governance, to ensure that the employing organization's business activities are conducted in accordance with laws and regulations. It is also the responsibility of management and those charged with governance to identify and address any non-compliance by the employing organization or by an individual charged with governance of the entity, by a member of management, or by other individuals working for or under the direction of the employing organization.

### ***Responsibilities of Members in Business***

.12 Many employing organizations have established protocols and procedures (for example, an ethics policy or internal whistle-blowing mechanism) regarding how non-compliance or suspected non-compliance by the employing organization should be raised internally. Such protocols and procedures may allow for matters to be reported anonymously through designated channels. If these protocols and procedures exist within the member's employing organization, the member should consider them in determining how to respond to such non-compliance.

.13 Where a member becomes aware of a matter to which this interpretation applies, the steps that the member takes to comply with this section shall be taken on a timely basis, having regard to the member's understanding of the nature of the matter and the potential harm to the interests of the employing organization, investors, creditors, employees or the general public.

### ***Responsibilities of Members who are Senior Professional Accountants in Business***

.14 Members who are senior professional accountants in business are directors, officers or senior employees able to exert significant influence over, and make decisions regarding, the acquisition, deployment and control of the employing organization's human, financial, technological, physical and intangible resources. Because of their roles, positions and spheres of influence within the employing organization, there is a greater expectation for them to take whatever action is appropriate in the public interest to respond to non-compliance or suspected non-compliance than other professional accountants within the employing organization.

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### ***Obtaining an Understanding of the Matter***

- .15 If, in the course of carrying out professional services, a member who is a senior professional accountant becomes aware of information concerning an instance of non-compliance or suspected non-compliance, the member should obtain an understanding of the matter, including:
  - a. The nature of the act and the circumstances in which it has occurred or may occur;
  - b. The application of the relevant laws and regulations to the circumstances; and
  - c. The potential consequences to the employing organization, investors, creditors, employees or the wider public.
- .16 A member who is a senior professional accountant is expected to apply knowledge, professional judgment and expertise, but is not expected to have a level of understanding of laws and regulations beyond that which is required for the member's role within the employing organization. Whether an act constitutes non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body.
- .17 Depending on the nature and significance of the matter, the member may cause, or take appropriate steps to cause, the matter to be investigated internally. The member may also consult on a confidential basis with others within the employing organization or a professional body, or with legal counsel.

### ***Addressing the Matter***

- .18 If the member who is a senior professional accountant identifies or suspects that non-compliance has occurred or may occur, the member should, subject to paragraph .12, discuss the matter with the member's immediate superior, if any, to enable a determination to be made as to how the matter should be addressed. If the member's immediate superior appears to be involved in the matter, the member should discuss the matter with the next higher level of authority within the employing organization.
- .19 The member who is a senior professional accountant should also take appropriate steps to:
  - a. Have the matter communicated to those charged with governance to obtain their concurrence regarding appropriate actions to take to respond to the matter and to enable them to fulfill their responsibilities;
  - b. Comply with applicable laws and regulations, including legal or regulatory provisions governing the reporting of non-compliance or suspected non-compliance to an appropriate authority;
  - c. Have the consequences of the non-compliance or suspected non-compliance rectified, remediated or mitigated;
  - d. Reduce the risk of re-occurrence; and
  - e. Seek to deter the commission of the non-compliance if it has not yet occurred.
- .20 In addition to responding to the matter in accordance with the provisions of this interpretation, the member who is a senior professional accountant should determine whether disclosure of the matter to the employing organization's external auditor, if any, is necessary pursuant to the member's duty or legal obligation to provide all information necessary to enable the auditor to perform the audit. See the *Obligation of a Member to His or Her Employer's External Accountant* interpretation for additional guidance [2.130.030].

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### ***Determining Whether Further Action Is Necessary***

- .21 The member who is a senior professional accountant should assess the appropriateness of the response of the member's superiors, if any, and those charged with governance.
- .22 Relevant factors to consider in assessing the appropriateness of the response of the member's superiors, if any, and those charged with governance include whether:
  - a. The response is timely.
  - b. They have taken or authorized appropriate action to seek to rectify, remediate or mitigate the consequences of the non-compliance, or to avert the non-compliance if it has not yet occurred.
  - c. The matter has been disclosed to an appropriate authority where appropriate and, if so, whether the disclosure appears adequate.
- .23 In light of the response of the member's superiors, if any, and those charged with governance, the member should determine if further action is necessary in the public interest. The determination of whether further action is necessary, and the nature and extent of it, will depend on various factors, including:
  - a. The legal and regulatory framework.
  - b. The urgency of the matter.
  - c. The pervasiveness of the matter throughout the employing organization.
  - d. Whether the member who is a senior professional accountant continues to have confidence in the integrity of the member's superiors and those charged with governance.
  - e. Whether the non-compliance or suspected non-compliance is likely to recur.
  - f. Whether there is credible evidence of actual or potential substantial harm to the interests of the employing organization, investors, creditors, employees or the general public.
- .24 Examples of circumstances that may cause the member who is a senior professional accountant no longer to have confidence in the integrity of the member's superiors and those charged with governance include situations where:
  - a. The member suspects or has evidence of their involvement or intended involvement in any non-compliance.
  - b. Contrary to legal or regulatory requirements, they have not reported the matter, or authorized the matter to be reported, to an appropriate authority within a reasonable period.
- .25 In determining the need for, and nature and extent of any further action necessary, the member who is a senior professional accountant should exercise professional judgment and take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances available to the member at the time, would be likely to conclude that the member has acted appropriately in the public interest.
- .26 Further action by the member who is a senior professional accountant may include:

- a. Informing the management of the parent entity of the matter if the employing organization is a member of a group.
- b. Resigning from the employing organization.

.27 Where the member who is a senior professional accountant determines that resigning from the employing organization would be appropriate, doing so would not be a substitute for taking other actions that may be necessary to achieve the member's objectives under this section.

.28 As consideration of the matter may involve complex analysis and judgments, the member who is a senior professional accountant may consider consulting internally, obtaining legal advice to understand the member's options and the professional or legal implications of taking any particular course of action, or consulting on a confidential basis with a regulator or professional body.

### ***Documentation***

.29 In relation to an identified or suspected act of non-compliance that falls within the scope of this interpretation, the member who is a senior professional accountant is encouraged to have the following matters documented:

- a. The matter.
- b. The results of discussions with the member's superiors, if any, and those charged with governance and other parties.
- c. How the member's superiors, if any, and those charged with governance have responded to the matter.
- d. The courses of action the member considered, the judgments made and the decisions that were taken.
- e. How the member is satisfied that the member has fulfilled the responsibility set out in paragraph .23.

### ***Responsibilities of Members Other than those who are Senior Professional Accountants in Business***

.30 If, in the course of carrying out professional services, a member becomes aware of information concerning an instance of non-compliance or suspected non-compliance, the member should seek to obtain an understanding of the matter, including the nature of the act and the circumstances in which it has occurred or may occur.

.31 The member is expected to apply knowledge, professional judgment and expertise, but is not expected to have a level of understanding of laws and regulations beyond that which is required for the member's role within the employing organization. Whether an act constitutes non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body. Depending on the nature and significance of the matter, the member may consult on a confidential basis with others within the employing organization or a professional body, or with legal counsel.

.32 If the member identifies or suspects that non-compliance has occurred or may occur, the member should, subject to paragraph .12, inform an immediate superior to enable the superior

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to take appropriate action. If the member's immediate superior appears to be involved in the matter, the member should inform the next higher level of authority within the employing organization.

- .33 In addition to responding to the matter in accordance with the provisions of this interpretation, the member should determine whether disclosure of the matter to the employing organization's external auditor, if any, is necessary pursuant to the member's duty or legal obligation to provide all information necessary to enable the auditor to perform the audit. See the "Obligation of a Member to His or Her Employer's External Accountant" interpretation for additional guidance [2.130.030].

### ***Documentation***

- .34 In relation to an identified or suspected act of non-compliance that falls within the scope of this interpretation, the member is encouraged to have the following matters documented:
- a. The matter.
  - b. The results of discussions with the member's superior, management and, where applicable, those charged with governance and other parties.
  - c. How the member's superior has responded to the matter.
  - d. The courses of action the member considered, the judgments made and the decisions that were taken.

**Final Pronouncement**  
[July 2016]

*International Ethics Standards Board  
for Accountants®*

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## Responding to Non-Compliance with Laws and Regulations



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# RESPONDING TO NON-COMPLIANCE WITH LAWS AND REGULATIONS

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## SECTION 225

### Responding to Non-Compliance with Laws and Regulations

#### Purpose

- 225.1 A professional accountant in public practice may encounter or be made aware of non-compliance or suspected non-compliance with laws and regulations in the course of providing a professional service to a client. The purpose of this section is to set out the professional accountant's responsibilities when encountering such non-compliance or suspected non-compliance, and guide the professional accountant in assessing the implications of the matter and the possible courses of action when responding to it. This section applies regardless of the nature of the client, including whether or not it is a public interest entity.
- 225.2 Non-compliance with laws and regulations ("non-compliance") comprises acts of omission or commission, intentional or unintentional, committed by a client, or by those charged with governance, by management or by other individuals working for or under the direction of a client which are contrary to the prevailing laws or regulations.
- 225.3 In some jurisdictions, there are legal or regulatory provisions governing how professional accountants should address non-compliance or suspected non-compliance which may differ from or go beyond this section. When encountering such non-compliance or suspected non-compliance, the professional accountant has a responsibility to obtain an understanding of those provisions and comply with them, including any requirement to report the matter to an appropriate authority and any prohibition on alerting the client prior to making any disclosure, for example, pursuant to anti-money laundering legislation.
- 225.4 A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. When responding to non-compliance or suspected non-compliance, the objectives of the professional accountant are:
- (a) To comply with the fundamental principles of integrity and professional behavior;
  - (b) By alerting management or, where appropriate, those charged with governance of the client, to seek to:
    - (i) Enable them to rectify, remediate or mitigate the consequences of the identified or suspected non-compliance; or
    - (ii) Deter the commission of the non-compliance where it has not yet occurred; and
  - (c) To take such further action as appropriate in the public interest.

#### Scope

- 225.5 This section sets out the approach to be taken by a professional accountant who encounters or is made aware of non-compliance or suspected non-compliance with:
- (a) Laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the client's financial statements; and
  - (b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the client's financial statements, but compliance with which may

be fundamental to the operating aspects of the client's business, to its ability to continue its business, or to avoid material penalties.

225.6 Examples of laws and regulations which this section addresses include those that deal with:

- Fraud, corruption and bribery.
- Money laundering, terrorist financing and proceeds of crime.
- Securities markets and trading.
- Banking and other financial products and services.
- Data protection.
- Tax and pension liabilities and payments.
- Environmental protection.
- Public health and safety.

225.7 Non-compliance may result in fines, litigation or other consequences for the client that may have a material effect on its financial statements. Importantly, such non-compliance may have wider public interest implications in terms of potentially substantial harm to investors, creditors, employees or the general public. For the purposes of this section, an act that causes substantial harm is one that results in serious adverse consequences to any of these parties in financial or non-financial terms. Examples include the perpetration of a fraud resulting in significant financial losses to investors, and breaches of environmental laws and regulations endangering the health or safety of employees or the public.

225.8 A professional accountant who encounters or is made aware of matters that are clearly inconsequential, judged by their nature and their impact, financial or otherwise, on the client, its stakeholders and the general public, is not required to comply with this section with respect to such matters.

225.9 This section does not address:

- (a) Personal misconduct unrelated to the business activities of the client; and
- (b) Non-compliance other than by the client or those charged with governance, management or other individuals working for or under the direction of the client. This includes, for example, circumstances where a professional accountant has been engaged by a client to perform a due diligence assignment on a third party entity and the identified or suspected non-compliance has been committed by that third party.

The professional accountant may nevertheless find the guidance in this section helpful in considering how to respond in these situations.

## **Responsibilities of the Client's Management and Those Charged with Governance**

225.10 It is the responsibility of the client's management, with the oversight of those charged with governance, to ensure that the client's business activities are conducted in accordance with laws and regulations. It is also the responsibility of management and those charged with governance to identify and address any non-compliance by the client, by an individual charged with governance of the entity, by a member of management, or by other individuals working for or under the direction of the client.

## Responsibilities of Professional Accountants in Public Practice

- 225.11 Where a professional accountant becomes aware of a matter to which this section applies, the steps that the professional accountant takes to comply with this section shall be taken on a timely basis, having regard to the professional accountant's understanding of the nature of the matter and the potential harm to the interests of the entity, investors, creditors, employees or the general public.

### Audits of Financial Statements

#### *Obtaining an Understanding of the Matter*

- 225.12 If a professional accountant engaged to perform an audit of financial statements becomes aware of information concerning an instance of non-compliance or suspected non-compliance, whether in the course of performing the engagement or through information provided by other parties, the professional accountant shall obtain an understanding of the matter, including the nature of the act and the circumstances in which it has occurred or may occur.
- 225.13 The professional accountant is expected to apply knowledge, professional judgment and expertise, but is not expected to have a level of knowledge of laws and regulations that is greater than that which is required to undertake the engagement. Whether an act constitutes non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body. Depending on the nature and significance of the matter, the professional accountant may consult on a confidential basis with others within the firm, a network firm or a professional body, or with legal counsel.
- 225.14 If the professional accountant identifies or suspects that non-compliance has occurred or may occur, the professional accountant shall discuss the matter with the appropriate level of management and, where appropriate, those charged with governance.
- 225.15 Such discussion serves to clarify the professional accountant's understanding of the facts and circumstances relevant to the matter and its potential consequences. The discussion also may prompt management or those charged with governance to investigate the matter.
- 225.16 The appropriate level of management with whom to discuss the matter is a question of professional judgment. Relevant factors to consider include:
- The nature and circumstances of the matter.
  - The individuals actually or potentially involved.
  - The likelihood of collusion.
  - The potential consequences of the matter.
  - Whether that level of management is able to investigate the matter and take appropriate action.
- 225.17 The appropriate level of management is generally at least one level above the person or persons involved or potentially involved in the matter. If the professional accountant believes that management is involved in the non-compliance or suspected non-compliance, the professional accountant shall discuss the matter with those charged with governance. The professional accountant may also consider discussing the matter with internal auditors, where applicable. In

the context of a group, the appropriate level may be management at an entity that controls the client.

### *Addressing the Matter*

- 225.18 In discussing the non-compliance or suspected non-compliance with management and, where appropriate, those charged with governance, the professional accountant shall advise them to take appropriate and timely actions, if they have not already done so, to:
- (a) Rectify, remediate or mitigate the consequences of the non-compliance;
  - (b) Deter the commission of the non-compliance where it has not yet occurred; or
  - (c) Disclose the matter to an appropriate authority where required by law or regulation or where considered necessary in the public interest.
- 225.19 The professional accountant shall consider whether the client's management and those charged with governance understand their legal or regulatory responsibilities with respect to the non-compliance or suspected non-compliance. If not, the professional accountant may suggest appropriate sources of information or recommend that they obtain legal advice.
- 225.20 The professional accountant shall comply with applicable:
- (a) Laws and regulations, including legal or regulatory provisions governing the reporting of non-compliance or suspected non-compliance to an appropriate authority. In this regard, some laws and regulations may stipulate a period within which reports are to be made; and
  - (b) Requirements under auditing standards, including those relating to:
    - Identifying and responding to non-compliance, including fraud.
    - Communicating with those charged with governance.
    - Considering the implications of the non-compliance or suspected non-compliance for the auditor's report.

### *Communication with Respect to Groups*

- 225.21 A professional accountant may:
- (a) For purposes of an audit of group financial statements, be requested by the group engagement team to perform work on financial information related to a component of the group; or
  - (b) Be engaged to perform an audit of a component's financial statements for purposes other than the group audit, for example, a statutory audit.

Where the professional accountant becomes aware of non-compliance or suspected non-compliance in relation to the component in either situation, the professional accountant shall, in addition to responding to the matter in accordance with the provisions of this section, communicate it to the group engagement partner unless prohibited from doing so by law or regulation. This is to enable the group engagement partner to be informed about the matter and to determine, in the context of the group audit, whether and, if so, how it should be addressed in accordance with the provisions in this section.

225.22 Where the group engagement partner becomes aware of non-compliance or suspected non-compliance in the course of an audit of group financial statements, including as a result of being informed of such a matter in accordance with paragraph 225.21, the group engagement partner shall, in addition to responding to the matter in the context of the group audit in accordance with the provisions of this section, consider whether the matter may be relevant to one or more components:

- (a) Whose financial information is subject to work for purposes of the audit of the group financial statements; or
- (b) Whose financial statements are subject to audit for purposes other than the group audit, for example, a statutory audit.

If so, the group engagement partner shall take steps to have the non-compliance or suspected non-compliance communicated to those performing work at components where the matter may be relevant, unless prohibited from doing so by law or regulation. If necessary in relation to subparagraph (b), appropriate inquiries shall be made (either of management or from publicly available information) as to whether the relevant component(s) is subject to audit and, if so, to ascertain to the extent practicable the identity of the auditor. The communication is to enable those responsible for work at such components to be informed about the matter and to determine whether and, if so, how it should be addressed in accordance with the provisions in this section.

*Determining Whether Further Action Is Needed*

225.23 The professional accountant shall assess the appropriateness of the response of management and, where applicable, those charged with governance.

225.24 Relevant factors to consider in assessing the appropriateness of the response of management and, where applicable, those charged with governance include whether:

- The response is timely.
- The non-compliance or suspected non-compliance has been adequately investigated.
- Action has been, or is being, taken to rectify, remediate or mitigate the consequences of any non-compliance.
- Action has been, or is being, taken to deter the commission of any non-compliance where it has not yet occurred.
- Appropriate steps have been, or are being, taken to reduce the risk of re-occurrence, for example, additional controls or training.
- The non-compliance or suspected non-compliance has been disclosed to an appropriate authority where appropriate and, if so, whether the disclosure appears adequate.

225.25 In light of the response of management and, where applicable, those charged with governance, the professional accountant shall determine if further action is needed in the public interest.

225.26 The determination of whether further action is needed, and the nature and extent of it, will depend on various factors, including:

- The legal and regulatory framework.
- The urgency of the matter.

- The pervasiveness of the matter throughout the client.
  - Whether the professional accountant continues to have confidence in the integrity of management and, where applicable, those charged with governance.
  - Whether the non-compliance or suspected non-compliance is likely to recur.
  - Whether there is credible evidence of actual or potential substantial harm to the interests of the entity, investors, creditors, employees or the general public.
- 225.27 Examples of circumstances that may cause the professional accountant no longer to have confidence in the integrity of management and, where applicable, those charged with governance include situations where:
- The professional accountant suspects or has evidence of their involvement or intended involvement in any non-compliance.
  - The professional accountant is aware that they have knowledge of such non-compliance and, contrary to legal or regulatory requirements, have not reported, or authorized the reporting of, the matter to an appropriate authority within a reasonable period.
- 225.28 In determining the need for, and nature and extent of, further action, the professional accountant shall exercise professional judgment and take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at the time, would be likely to conclude that the professional accountant has acted appropriately in the public interest.
- 225.29 Further action by the professional accountant may include:
- Disclosing the matter to an appropriate authority even when there is no legal or regulatory requirement to do so.
  - Withdrawing from the engagement and the professional relationship where permitted by law or regulation.
- 225.30 Where the professional accountant determines that withdrawing from the engagement and the professional relationship would be appropriate, doing so would not be a substitute for taking other actions that may be needed to achieve the professional accountant's objectives under this section. In some jurisdictions, however, there may be limitations as to the further actions available to the professional accountant and withdrawal may be the only available course of action.
- 225.31 Where the professional accountant has withdrawn from the professional relationship pursuant to paragraphs 225.25 and 225.29, the professional accountant shall, on request by the proposed successor accountant, provide all such facts and other information concerning the identified or suspected non-compliance that, in the predecessor accountant's opinion, the proposed successor accountant needs to be aware of before deciding whether to accept the audit appointment. The predecessor accountant shall do so despite paragraph 210.14, unless prohibited by law or regulation. If the proposed successor accountant is unable to communicate with the predecessor accountant, the proposed successor accountant shall take reasonable steps to obtain information about the circumstances of the change of appointment by other



means, such as through inquiries of third parties or background investigations of management or those charged with governance.

- 225.32 As consideration of the matter may involve complex analysis and judgments, the professional accountant may consider consulting internally, obtaining legal advice to understand the professional accountant's options and the professional or legal implications of taking any particular course of action, or consulting on a confidential basis with a regulator or professional body.

#### Determining Whether to Disclose the Matter to an Appropriate Authority

- 225.33 Disclosure of the matter to an appropriate authority would be precluded if doing so would be contrary to law or regulation. Otherwise, the purpose of making disclosure is to enable an appropriate authority to cause the matter to be investigated and action to be taken in the public interest.

- 225.34 The determination of whether to make such a disclosure depends in particular on the nature and extent of the actual or potential harm that is or may be caused by the matter to investors, creditors, employees or the general public. For example, the professional accountant may determine that disclosure of the matter to an appropriate authority is an appropriate course of action if:

- The entity is engaged in bribery (for example, of local or foreign government officials for purposes of securing large contracts).
- The entity is regulated and the matter is of such significance as to threaten its license to operate.
- The entity is listed on a securities exchange and the matter could result in adverse consequences to the fair and orderly market in the entity's securities or pose a systemic risk to the financial markets.
- Products that are harmful to public health or safety would likely be sold by the entity.
- The entity is promoting a scheme to its clients to assist them in evading taxes.

The determination of whether to make such a disclosure will also depend on external factors such as:

- Whether there is an appropriate authority that is able to receive the information, and cause the matter to be investigated and action to be taken. The appropriate authority will depend on the nature of the matter, for example, a securities regulator in the case of fraudulent financial reporting or an environmental protection agency in the case of a breach of environmental laws and regulations.
- Whether there exists robust and credible protection from civil, criminal or professional liability or retaliation afforded by legislation or regulation, such as under whistle-blowing legislation or regulation.
- Whether there are actual or potential threats to the physical safety of the professional accountant or other individuals.

- 225.35 If the professional accountant determines that disclosure of the non-compliance or suspected non-compliance to an appropriate authority is an appropriate course of action in the

circumstances, this will not be considered a breach of the duty of confidentiality under Section 140 of this Code. When making such disclosure, the professional accountant shall act in good faith and exercise caution when making statements and assertions. The professional accountant shall also consider whether it is appropriate to inform the client of the professional accountant's intentions before disclosing the matter.

- 225.36 In exceptional circumstances, the professional accountant may become aware of actual or intended conduct that the professional accountant has reason to believe would constitute an imminent breach of a law or regulation that would cause substantial harm to investors, creditors, employees or the general public. Having considered whether it would be appropriate to discuss the matter with management or those charged with governance of the entity, the professional accountant shall exercise professional judgment and may immediately disclose the matter to an appropriate authority in order to prevent or mitigate the consequences of such imminent breach of law or regulation. Such disclosure will not be considered a breach of the duty of confidentiality under Section 140 of this Code.

### *Documentation*

- 225.37 In relation to an identified or suspected act of non-compliance that falls within the scope of this section, the professional accountant shall, in addition to complying with the documentation requirements under applicable auditing standards, document:
- How management and, where applicable, those charged with governance have responded to the matter.
  - The courses of action the professional accountant considered, the judgments made and the decisions that were taken, having regard to the reasonable and informed third party perspective.
  - How the professional accountant is satisfied that the professional accountant has fulfilled the responsibility set out in paragraph 225.25.
- 225.38 *International Standards on Auditing* (ISAs), for example, require a professional accountant performing an audit of financial statements to:
- Prepare documentation sufficient to enable an understanding of significant matters arising during the audit, the conclusions reached, and significant professional judgments made in reaching those conclusions;
  - Document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place; and
  - Document identified or suspected non-compliance, and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity.

**Professional Services Other than Audits of Financial Statements***Obtaining an Understanding of the Matter and Addressing It with Management and Those Charged with Governance*

- 225.39 If a professional accountant engaged to provide a professional service other than an audit of financial statements becomes aware of information concerning an instance of non-compliance or suspected non-compliance, the professional accountant shall seek to obtain an understanding of the matter, including the nature of the act and the circumstances in which it has occurred or may be about to occur.
- 225.40 The professional accountant is expected to apply knowledge, professional judgment and expertise, but is not expected to have a level of understanding of laws and regulations beyond that which is required for the professional service for which the accountant was engaged. Whether an act constitutes actual non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body. Depending on the nature and significance of the matter, the professional accountant may consult on a confidential basis with others within the firm, a network firm or a professional body, or with legal counsel.
- 225.41 If the professional accountant identifies or suspects that non-compliance has occurred or may occur, the professional accountant shall discuss the matter with the appropriate level of management and, if the professional accountant has access to them and where appropriate, those charged with governance.
- 225.42 Such discussion serves to clarify the professional accountant's understanding of the facts and circumstances relevant to the matter and its potential consequences. The discussion also may prompt management or those charged with governance to investigate the matter.
- 225.43 The appropriate level of management with whom to discuss the matter is a question of professional judgment. Relevant factors to consider include:
- The nature and circumstances of the matter.
  - The individuals actually or potentially involved.
  - The likelihood of collusion.
  - The potential consequences of the matter.
  - Whether that level of management is able to investigate the matter and take appropriate action.

*Communicating the Matter to the Entity's External Auditor*

- 225.44 If the professional accountant is performing a non-audit service for an audit client of the firm, or a component of an audit client of the firm, the professional accountant shall communicate the non-compliance or suspected non-compliance within the firm, unless prohibited from doing so by law or regulation. The communication shall be made in accordance with the firm's protocols or procedures or, in the absence of such protocols and procedures, directly to the audit engagement partner.
- 225.45 If the professional accountant is performing a non-audit service for an audit client of a network firm, or a component of an audit client of a network firm, the professional accountant shall consider whether to communicate the non-compliance or suspected non-compliance to the

network firm. Where the communication is made, it shall be made in accordance with the network's protocols or procedures or, in the absence of such protocols and procedures, directly to the audit engagement partner.

225.46 If the professional accountant is performing a non-audit service for a client that is not:

- (a) An audit client of the firm or a network firm; or
- (b) A component of an audit client of the firm or a network firm,

the professional accountant shall consider whether to communicate the non-compliance or suspected non-compliance to the firm that is the client's external auditor, if any.

225.47 Factors relevant to considering the communication in accordance with paragraphs 225.45 and 225.46 include:

- Whether doing so would be contrary to law or regulation.
- Whether there are restrictions about disclosure imposed by a regulatory agency or prosecutor in an ongoing investigation into the non-compliance or suspected non-compliance.
- Whether the purpose of the engagement is to investigate potential non-compliance within the entity to enable it to take appropriate action.
- Whether management or those charged with governance have already informed the entity's external auditor about the matter.
- The likely materiality of the matter to the audit of the client's financial statements or, where the matter relates to a component of a group, its likely materiality to the audit of the group financial statements.

225.48 In all cases, the communication is to enable the audit engagement partner to be informed about the non-compliance or suspected non-compliance and to determine whether and, if so, how it should be addressed in accordance with the provisions of this section.

*Considering Whether Further Action Is Needed*

225.49 The professional accountant shall also consider whether further action is needed in the public interest.

225.50 Whether further action is needed, and the nature and extent of it, will depend on factors such as:

- The legal and regulatory framework.
- The appropriateness and timeliness of the response of management and, where applicable, those charged with governance.
- The urgency of the matter.
- The involvement of management or those charged with governance in the matter.
- The likelihood of substantial harm to the interests of the client, investors, creditors, employees or the general public.

- 225.51 Further action by the professional accountant may include:
- Disclosing the matter to an appropriate authority even when there is no legal or regulatory requirement to do so.
  - Withdrawing from the engagement and the professional relationship where permitted by law or regulation.
- 225.52 In considering whether to disclose to an appropriate authority, relevant factors to take into account include:
- Whether doing so would be contrary to law or regulation.
  - Whether there are restrictions about disclosure imposed by a regulatory agency or prosecutor in an ongoing investigation into the non-compliance or suspected non-compliance.
  - Whether the purpose of the engagement is to investigate potential non-compliance within the entity to enable it to take appropriate action.
- 225.53 If the professional accountant determines that disclosure of the non-compliance or suspected non-compliance to an appropriate authority is an appropriate course of action in the circumstances, this will not be considered a breach of the duty of confidentiality under Section 140 of this Code. When making such disclosure, the professional accountant shall act in good faith and exercise caution when making statements and assertions. The professional accountant shall also consider whether it is appropriate to inform the client of the professional accountant's intentions before disclosing the matter.
- 225.54 In exceptional circumstances, the professional accountant may become aware of actual or intended conduct that the professional accountant has reason to believe would constitute an imminent breach of a law or regulation that would cause substantial harm to investors, creditors, employees or the general public. Having considered whether it would be appropriate to discuss the matter with management or those charged with governance of the entity, the professional accountant shall exercise professional judgment and may immediately disclose the matter to an appropriate authority in order to prevent or mitigate the consequences of such imminent breach of law or regulation. Such disclosure will not be considered a breach of the duty of confidentiality under Section 140 of this Code.
- 225.55 The professional accountant may consider consulting internally, obtaining legal advice to understand the professional or legal implications of taking any particular course of action, or consulting on a confidential basis with a regulator or professional body.

### *Documentation*

- 225.56 In relation to an identified or suspected act of non-compliance that falls within the scope of this section, the professional accountant is encouraged to document:
- The matter.
  - The results of discussion with management and, where applicable, those charged with governance and other parties.
  - How management and, where applicable, those charged with governance have responded to the matter.

- The courses of action the professional accountant considered, the judgments made and the decisions that were taken.
- How the professional accountant is satisfied that the professional accountant has fulfilled the responsibility set out in paragraph 225.49.

## SECTION 360

### Responding to Non-Compliance with Laws and Regulations

#### Purpose

- 360.1 A professional accountant in business may encounter or be made aware of non-compliance or suspected non-compliance with laws and regulations in the course of carrying out professional activities. The purpose of this section is to set out the professional accountant's responsibilities when encountering such non-compliance or suspected non-compliance, and guide the professional accountant in assessing the implications of the matter and the possible courses of action when responding to it. This section applies regardless of the nature of the employing organization, including whether or not it is a public interest entity.
- 360.2 Non-compliance with laws and regulations ("non-compliance") comprises acts of omission or commission, intentional or unintentional, committed by the professional accountant's employing organization or by those charged with governance, by management, or by other individuals working for or under the direction of the employing organization which are contrary to the prevailing laws or regulations.
- 360.3 In some jurisdictions, there are legal or regulatory provisions governing how professional accountants should address non-compliance or suspected non-compliance which may differ from or go beyond this section. When encountering such non-compliance or suspected non-compliance, the professional accountant has a responsibility to obtain an understanding of those provisions and comply with them, including any requirement to report the matter to an appropriate authority and any prohibition on alerting the relevant party prior to making any disclosure, for example, pursuant to anti-money laundering legislation.
- 360.4 A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. When responding to non-compliance or suspected non-compliance, the objectives of the professional accountant are:
- (a) To comply with the fundamental principles of integrity and professional behavior;
  - (b) By alerting management or, where appropriate, those charged with governance of the employing organization, to seek to:
    - (i) Enable them to rectify, remediate or mitigate the consequences of the identified or suspected non-compliance; or
    - (ii) Deter the commission of the non-compliance where it has not yet occurred; and
  - (c) To take such further action as appropriate in the public interest.

#### Scope

- 360.5 This section sets out the approach to be taken by a professional accountant who encounters or is made aware of non-compliance or suspected non-compliance with:
- (a) Laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the employing organization's financial statements; and
  - (b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the employing organization's financial statements, but



compliance with which may be fundamental to the operating aspects of the employing organization's business, to its ability to continue its business, or to avoid material penalties.

- 360.6 Examples of laws and regulations which this section addresses include those that deal with:
- Fraud, corruption and bribery.
  - Money laundering, terrorist financing and proceeds of crime.
  - Securities markets and trading.
  - Banking and other financial products and services.
  - Data protection.
  - Tax and pension liabilities and payments.
  - Environmental protection.
  - Public health and safety.
- 360.7 Non-compliance may result in fines, litigation or other consequences for the employing organization that may have a material effect on its financial statements. Importantly, such non-compliance may have wider public interest implications in terms of potentially substantial harm to investors, creditors, employees or the general public. For the purposes of this section, an act that causes substantial harm is one that results in serious adverse consequences to any of these parties in financial or non-financial terms. Examples include the perpetration of a fraud resulting in significant financial losses to investors, and breaches of environmental laws and regulations endangering the health or safety of employees or the public.
- 360.8 A professional accountant who encounters or is made aware of matters that are clearly inconsequential, judged by their nature and their impact, financial or otherwise, on the employing organization, its stakeholders and the general public, is not required to comply with this section with respect to such matters.
- 360.9 This section does not address:
- (a) Personal misconduct unrelated to the business activities of the employing organization; and
  - (b) Non-compliance other than by the employing organization or those charged with governance, management, or other individuals working for or under the direction of the employing organization.

The professional accountant may nevertheless find the guidance in this section helpful in considering how to respond in these situations.

## **Responsibilities of the Employing Organization's Management and Those Charged with Governance**

- 360.10 It is the responsibility of the employing organization's management, with the oversight of those charged with governance, to ensure that the employing organization's business activities are conducted in accordance with laws and regulations. It is also the responsibility of management and those charged with governance to identify and address any non-compliance by the employing organization or by an individual charged with governance of the entity, by a member

of management, or by other individuals working for or under the direction of the employing organization.

### **Responsibilities of Professional Accountants in Business**

- 360.11 Many employing organizations have established protocols and procedures (for example, an ethics policy or internal whistle-blowing mechanism) regarding how non-compliance or suspected non-compliance by the employing organization should be raised internally. Such protocols and procedures may allow for matters to be reported anonymously through designated channels. If these protocols and procedures exist within the professional accountant's employing organization, the professional accountant shall consider them in determining how to respond to such non-compliance.
- 360.12 Where a professional accountant becomes aware of a matter to which this section applies, the steps that the professional accountant takes to comply with this section shall be taken on a timely basis, having regard to the professional accountant's understanding of the nature of the matter and the potential harm to the interests of the employing organization, investors, creditors, employees or the general public.

### **Responsibilities of Senior Professional Accountants in Business**

- 360.13 Senior professional accountants in business ("senior professional accountants") are directors, officers or senior employees able to exert significant influence over, and make decisions regarding, the acquisition, deployment and control of the employing organization's human, financial, technological, physical and intangible resources. Because of their roles, positions and spheres of influence within the employing organization, there is a greater expectation for them to take whatever action is appropriate in the public interest to respond to non-compliance or suspected non-compliance than other professional accountants within the employing organization.

#### *Obtaining an Understanding of the Matter*

- 360.14 If, in the course of carrying out professional activities, a senior professional accountant becomes aware of information concerning an instance of non-compliance or suspected non-compliance, the professional accountant shall obtain an understanding of the matter, including:
- (a) The nature of the act and the circumstances in which it has occurred or may occur;
  - (b) The application of the relevant laws and regulations to the circumstances; and
  - (c) The potential consequences to the employing organization, investors, creditors, employees or the wider public.
- 360.15 A senior professional accountant is expected to apply knowledge, professional judgment and expertise, but is not expected to have a level of understanding of laws and regulations beyond that which is required for the professional accountant's role within the employing organization. Whether an act constitutes non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body. Depending on the nature and significance of the matter, the professional accountant may cause, or take appropriate steps to cause, the matter to be investigated internally. The professional accountant may also consult on a confidential basis with others within the employing organization or a professional body, or with legal counsel.

*Addressing the Matter*

- 360.16 If the senior professional accountant identifies or suspects that non-compliance has occurred or may occur, the professional accountant shall, subject to paragraph 360.11, discuss the matter with the professional accountant's immediate superior, if any, to enable a determination to be made as to how the matter should be addressed. If the professional accountant's immediate superior appears to be involved in the matter, the professional accountant shall discuss the matter with the next higher level of authority within the employing organization.
- 360.17 The senior professional accountant shall also take appropriate steps to:
- (a) Have the matter communicated to those charged with governance to obtain their concurrence regarding appropriate actions to take to respond to the matter and to enable them to fulfill their responsibilities;
  - (b) Comply with applicable laws and regulations, including legal or regulatory provisions governing the reporting of non-compliance or suspected non-compliance to an appropriate authority;
  - (c) Have the consequences of the non-compliance or suspected non-compliance rectified, remediated or mitigated;
  - (d) Reduce the risk of re-occurrence; and
  - (e) Seek to deter the commission of the non-compliance if it has not yet occurred.
- 360.18 In addition to responding to the matter in accordance with the provisions of this section, the senior professional accountant shall determine whether disclosure of the matter to the employing organization's external auditor, if any, is needed pursuant to the professional accountant's duty or legal obligation to provide all information necessary to enable the auditor to perform the audit.

*Determining Whether Further Action Is Needed*

- 360.19 The senior professional accountant shall assess the appropriateness of the response of the professional accountant's superiors, if any, and those charged with governance.
- 360.20 Relevant factors to consider in assessing the appropriateness of the response of the senior professional accountant's superiors, if any, and those charged with governance include whether:
- The response is timely.
  - They have taken or authorized appropriate action to seek to rectify, remediate or mitigate the consequences of the non-compliance, or to avert the non-compliance if it has not yet occurred.
  - The matter has been disclosed to an appropriate authority where appropriate and, if so, whether the disclosure appears adequate.
- 360.21 In light of the response of the senior professional accountant's superiors, if any, and those charged with governance, the professional accountant shall determine if further action is needed in the public interest.
- 360.22 The determination of whether further action is needed, and the nature and extent of it, will depend on various factors, including:
- The legal and regulatory framework.

- The urgency of the matter.
  - The pervasiveness of the matter throughout the employing organization.
  - Whether the senior professional accountant continues to have confidence in the integrity of the professional accountant's superiors and those charged with governance.
  - Whether the non-compliance or suspected non-compliance is likely to recur.
  - Whether there is credible evidence of actual or potential substantial harm to the interests of the employing organization, investors, creditors, employees or the general public.
- 360.23 Examples of circumstances that may cause the senior professional accountant no longer to have confidence in the integrity of the professional accountant's superiors and those charged with governance include situations where:
- The professional accountant suspects or has evidence of their involvement or intended involvement in any non-compliance.
  - Contrary to legal or regulatory requirements, they have not reported the matter, or authorized the matter to be reported, to an appropriate authority within a reasonable period.
- 360.24 In determining the need for, and nature and extent of any further action needed, the senior professional accountant shall exercise professional judgment and take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at the time, would be likely to conclude that the professional accountant has acted appropriately in the public interest.
- 360.25 Further action by the professional accountant may include:
- Informing the management of the parent entity of the matter if the employing organization is a member of a group.
  - Disclosing the matter to an appropriate authority even when there is no legal or regulatory requirement to do so.
  - Resigning from the employing organization.
- 360.26 Where the senior professional accountant determines that resigning from the employing organization would be appropriate, doing so would not be a substitute for taking other actions that may be needed to achieve the professional accountant's objectives under this section. In some jurisdictions, however, there may be limitations as to the further actions available to the professional accountant and resignation may be the only available course of action.
- 360.27 As consideration of the matter may involve complex analysis and judgments, the senior professional accountant may consider consulting internally, obtaining legal advice to understand the professional accountant's options and the professional or legal implications of taking any particular course of action, or consulting on a confidential basis with a regulator or professional body.

#### Determining Whether to Disclose the Matter to an Appropriate Authority

- 360.28 Disclosure of the matter to an appropriate authority would be precluded if doing so would be contrary to law or regulation. Otherwise, the purpose of making disclosure is to enable an appropriate authority to cause the matter to be investigated and action to be taken in the public interest.

360.29 The determination of whether to make such a disclosure depends in particular on the nature and extent of the actual or potential harm that is or may be caused by the matter to investors, creditors, employees or the general public. For example, the senior professional accountant may determine that disclosure of the matter to an appropriate authority is an appropriate course of action if:

- The employing organization is engaged in bribery (for example, of local or foreign government officials for purposes of securing large contracts).
- The employing organization is a regulated entity and the matter is of such significance as to threaten its license to operate.
- The employing organization is listed on a securities exchange and the matter could result in adverse consequences to the fair and orderly market in the employing organization's securities or pose a systemic risk to the financial markets.
- Products that are harmful to public health or safety would likely be sold by the employing organization.
- The employing organization is promoting a scheme to its clients to assist them in evading taxes.

The determination of whether to make such a disclosure will also depend on external factors such as:

- Whether there is an appropriate authority that is able to receive the information, and cause the matter to be investigated and action to be taken. The appropriate authority will depend upon the nature of the matter, for example, a securities regulator in the case of fraudulent financial reporting or an environmental protection agency in the case of a breach of environmental laws and regulations.
- Whether there exists robust and credible protection from civil, criminal or professional liability or retaliation afforded by legislation or regulation, such as under whistle-blowing legislation or regulation.
- Whether there are actual or potential threats to the physical safety of the professional accountant or other individuals.

360.30 If the senior professional accountant determines that disclosure of the matter to an appropriate authority is an appropriate course of action in the circumstances, this will not be considered a breach of the duty of confidentiality under Section 140 of this Code. When making such disclosure, the professional accountant shall act in good faith and exercise caution when making statements and assertions.

360.31 In exceptional circumstances, the senior professional accountant may become aware of actual or intended conduct that the professional accountant has reason to believe would constitute an imminent breach of a law or regulation that would cause substantial harm to investors, creditors, employees or the general public. Having considered whether it would be appropriate to discuss the matter with management or those charged with governance of the entity, the professional accountant shall exercise professional judgment and may immediately disclose the matter to an appropriate authority in order to prevent or mitigate the consequences of such imminent breach of law or regulation. Such disclosure will not be considered a breach of the duty of confidentiality under Section 140 of this Code.

*Documentation*

360.32 In relation to an identified or suspected act of non-compliance that falls within the scope of this section, the senior professional accountant is encouraged to have the following matters documented:

- The matter.
- The results of discussions with the professional accountant's superiors, if any, and those charged with governance and other parties.
- How the professional accountant's superiors, if any, and those charged with governance have responded to the matter.
- The courses of action the professional accountant considered, the judgments made and the decisions that were taken.
- How the professional accountant is satisfied that the professional accountant has fulfilled the responsibility set out in paragraph 360.21.

### **Responsibilities of Professional Accountants Other than Senior Professional Accountants in Business**

360.33 If, in the course of carrying out professional activities, a professional accountant becomes aware of information concerning an instance of non-compliance or suspected non-compliance, the professional accountant shall seek to obtain an understanding of the matter, including the nature of the act and the circumstances in which it has occurred or may occur.

360.34 The professional accountant is expected to apply knowledge, professional judgment and expertise, but is not expected to have a level of understanding of laws and regulations beyond that which is required for the professional accountant's role within the employing organization. Whether an act constitutes non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body. Depending on the nature and significance of the matter, the professional accountant may consult on a confidential basis with others within the employing organization or a professional body, or with legal counsel.

360.35 If the professional accountant identifies or suspects that non-compliance has occurred or may occur, the professional accountant shall, subject to paragraph 360.11, inform an immediate superior to enable the superior to take appropriate action. If the professional accountant's immediate superior appears to be involved in the matter, the professional accountant shall inform the next higher level of authority within the employing organization.

360.36 In exceptional circumstances, the professional accountant may decide that disclosure of the matter to an appropriate authority is an appropriate course of action. If the professional accountant does so pursuant to paragraph 360.29, this will not be considered a breach of the duty of confidentiality under Section 140 of this Code. When making such disclosure, the professional accountant shall act in good faith and exercise caution when making statements and assertions.

## Documentation

360.37 In relation to an identified or suspected act of non-compliance that falls within the scope of this section, the professional accountant is encouraged to have the following matters documented:

- The matter.
- The results of discussions with the professional accountant's superior, management and, where applicable, those charged with governance and other parties.
- How the professional accountant's superior has responded to the matter.
- The courses of action the professional accountant considered, the judgments made and the decisions that were taken.



## CONSEQUENTIAL AND CONFORMING CHANGES TO OTHER SECTIONS OF THE CODE (MARK-UP FROM EXTANT CODE)

### SECTION 100

#### Introduction and Fundamental Principles

...

##### *Fundamental Principles*

100.5 A professional accountant shall comply with the following fundamental principles:

...

- (e) Professional Behavior – to comply with relevant laws and regulations and avoid any **action** **conduct** that discredits the profession.

...

##### *Conflicts of Interest*

...

##### *Ethical Conflict Resolution*

...

100.23 If a significant conflict cannot be resolved, a professional accountant may consider obtaining professional advice from the relevant professional body or from legal advisors. The professional accountant generally can obtain guidance on ethical issues without breaching the fundamental principle of confidentiality if the matter is discussed with the relevant professional body on an anonymous basis or with a legal advisor under the protection of legal privilege. **Instances in which the professional accountant may consider obtaining legal advice vary. For example, a professional accountant may have encountered a fraud, the reporting of which could breach the professional accountant's responsibility to respect confidentiality. The professional accountant may consider obtaining legal advice in that instance to determine whether there is a requirement to report.**

100.24 If, after exhausting all relevant possibilities, the ethical conflict remains unresolved, a professional accountant shall, **where possible unless prohibited by law**, refuse to remain associated with the matter creating the conflict. The professional accountant shall determine whether, in the circumstances, it is appropriate to withdraw from the engagement team or specific assignment, or to resign altogether from the engagement, the firm or the employing organization.

##### *Communicating with Those Charged with Governance*

100.25 When communicating with those charged with governance in accordance with the provisions of this Code, the professional accountant or firm shall determine, having regard to the nature and importance of the particular circumstances and matter to be communicated, the appropriate person(s) within the entity's governance structure with whom to communicate. If the professional accountant or firm communicates with a subgroup of those charged with governance, for

example, an audit committee or an individual, the professional accountant or firm shall determine whether communication with all of those charged with governance is also necessary so that they are adequately informed.

100.26 In some cases, all of those charged with governance are involved in managing the entity, for example, a small business where a single owner manages the entity and no one else has a governance role. In these cases, if matters are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role. The professional accountant or firm shall nonetheless be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the professional accountant or firm would otherwise communicate in their governance capacity.

## SECTION 140

### Confidentiality

...

140.7 As a fundamental principle, confidentiality serves the public interest because it facilitates the free flow of information from the professional accountant's client or employing organization to the professional accountant. Nevertheless, the following are circumstances where professional accountants are or may be required to disclose confidential information or when such disclosure may be appropriate:

- (a) Disclosure is permitted by law and is authorized by the client or the employer;
- (b) Disclosure is required by law, for example:
  - (i) Production of documents or other provision of evidence in the course of legal proceedings; or
  - (ii) Disclosure to the appropriate public authorities of infringements of the law that come to light; and
- (c) There is a professional duty or right to disclose, when not prohibited by law:
  - (i) To comply with the quality review of a member body or professional body;
  - (ii) To respond to an inquiry or investigation by a member body or regulatory body;
  - (iii) To protect the professional interests of a professional accountant in legal proceedings; or
  - (iv) To comply with technical and professional standards, ~~and including~~ ethical requirements.

## SECTION 150

### Professional Behavior

- 150.1 The principle of professional behavior imposes an obligation on all professional accountants to comply with relevant laws and regulations and avoid any ~~action-conduct~~ that the professional accountant knows or should know may discredit the profession. This includes ~~actions-conduct~~ that a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at that time, would be likely to conclude adversely affects the good reputation of the profession.

...

## SECTION 210

### Professional Appointment

#### *Client Acceptance and Continuance*

- 210.1 Before accepting a new client relationship, a professional accountant in public practice shall determine whether acceptance would create any threats to compliance with the fundamental principles. Potential threats to integrity or professional behavior may be created from, for example, ~~questionable~~ issues associated with the client (its owners, management or activities)-  
~~210.2 Client issues~~ that, if known, could threaten compliance with the fundamental principles. These include, for example, client involvement in illegal activities (such as money laundering), dishonesty, ~~or~~ questionable financial reporting practices or other unethical behavior.
- 210.~~23~~ A professional accountant in public practice shall evaluate the significance of any threats and apply safeguards when necessary to eliminate them or reduce them to an acceptable level.
- Examples of such safeguards include:
- Obtaining knowledge and understanding of the client, its owners, managers and those responsible for its governance and business activities; or
  - Securing the client's commitment to address the questionable issues, for example, through improving corporate governance practices or internal controls.
- 210.~~34~~ Where it is not possible to reduce the threats to an acceptable level, the professional accountant in public practice shall decline to enter into the client relationship.
- 210.~~45~~ It is recommended that a professional accountant in public practice periodically review acceptance decisions for recurring client engagements. Potential threats to compliance with the fundamental principles may have been created after acceptance that would have caused the professional accountant to decline the engagement had that information been available earlier. A professional accountant in public practice shall, therefore, periodically review whether to continue with a recurring client engagement. For example, a threat to compliance with the fundamental principles may be created by a client's unethical behavior such as improper earnings management or balance sheet valuations. If a professional accountant in public practice identifies a threat to compliance with the fundamental principles, the professional accountant shall evaluate the significance of the threats and apply safeguards when necessary to eliminate the threat or reduce it to an acceptable level. Where it is not possible to reduce the threat to an acceptable

level, the professional accountant in public practice shall consider terminating the client relationship where termination is not prohibited by law or regulation.

### *Engagement Acceptance*

- 210.56 The fundamental principle of professional competence and due care imposes an obligation on a professional accountant in public practice to provide only those services that the professional accountant in public practice is competent to perform. Before accepting a specific client engagement, a professional accountant in public practice shall determine whether acceptance would create any threats to compliance with the fundamental principles. For example, a self-interest threat to professional competence and due care is created if the engagement team does not possess, or cannot acquire, the competencies necessary to properly carry out the engagement.
- 210.67 A professional accountant in public practice shall evaluate the significance of threats and apply safeguards, when necessary, to eliminate them or reduce them to an acceptable level. Examples of such safeguards include:
- Acquiring an appropriate understanding of the nature of the client's business, the complexity of its operations, the specific requirements of the engagement and the purpose, nature and scope of the work to be performed.
  - Acquiring knowledge of relevant industries or subject matters.
  - Possessing or obtaining experience with relevant regulatory or reporting requirements.
  - Assigning sufficient staff with the necessary competencies.
  - Using experts where necessary.
  - Agreeing on a realistic time frame for the performance of the engagement.
  - Complying with quality control policies and procedures designed to provide reasonable assurance that specific engagements are accepted only when they can be performed competently.
- 210.78 When a professional accountant in public practice intends to rely on the advice or work of an expert, the professional accountant in public practice shall determine whether such reliance is warranted. Factors to consider include: reputation, expertise, resources available and applicable professional and ethical standards. Such information may be gained from prior association with the expert or from consulting others.

### *Changes in a Professional Appointment*

- 210.89 A professional accountant in public practice who is asked to replace another professional accountant in public practice, or who is considering tendering for an engagement currently held by another professional accountant in public practice, shall determine whether there are any reasons, professional or otherwise, for not accepting the engagement, such as circumstances that create threats to compliance with the fundamental principles that cannot be eliminated or reduced to an acceptable level by the application of safeguards. For example, there may be a threat to professional competence and due care if a professional accountant in public practice accepts the engagement before knowing all the pertinent facts.

210.940 A professional accountant in public practice shall evaluate the significance of any threats. ~~Depending on the nature of the engagement, this may require direct communication with the existing accountant to establish the facts and circumstances regarding the proposed change so that the professional accountant in public practice can decide whether it would be appropriate to accept the engagement. For example, the apparent reasons for the change in appointment may not fully reflect the facts and may indicate disagreements with the existing accountant that may influence the decision to accept the appointment.~~ 210.11 Safeguards shall be applied when necessary to eliminate any threats or reduce them to an acceptable level. Examples of such safeguards include:

- When replying to requests to submit tenders, stating in the tender that, before accepting the engagement, contact with the existing [or predecessor](#) accountant will be requested so that inquiries may be made as to whether there are any professional or other reasons why the appointment should not be accepted;
- Asking the [existing-predecessor](#) accountant to provide known information on any facts or circumstances that, in the [existing-predecessor](#) accountant's opinion, the proposed [successor](#) accountant needs to be aware of before deciding whether to accept the engagement. ~~For example, the apparent reasons for the change in appointment may not fully reflect the facts and may indicate disagreements with the existing-predecessor accountant that may influence the decision to accept the appointment;~~ or
- Obtaining necessary information from other sources.

210.10 When the threats cannot be eliminated or reduced to an acceptable level through the application of safeguards, a professional accountant in public practice shall, unless there is satisfaction as to necessary facts by other means, decline the engagement.

210.112 A professional accountant in public practice may be asked to undertake work that is complementary or additional to the work of the existing accountant. Such circumstances may create threats to professional competence and due care resulting from, for example, a lack of or incomplete information. The significance of any threats shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. An example of such a safeguard is notifying the existing accountant of the proposed work, which would give the existing accountant the opportunity to provide any relevant information needed for the proper conduct of the work.

210.123 An existing [or predecessor](#) accountant is bound by confidentiality. Whether that professional accountant is permitted or required to discuss the affairs of a client with a proposed accountant will depend on the nature of the engagement and on:

- (a) Whether the client's permission to do so has been obtained; or
- (b) The legal or ethical requirements relating to such communications and disclosure, which may vary by jurisdiction.

Circumstances where the professional accountant is or may be required to disclose confidential information or where such disclosure may otherwise be appropriate are set out in Section 140 of Part A of this Code.

210.134 A professional accountant in public practice will generally need to obtain the client's permission, preferably in writing, to initiate discussion with an existing [or predecessor](#) accountant. Once that permission is obtained, the existing [or predecessor](#) accountant shall comply with relevant [legal](#)

laws and ~~other~~ regulations governing such requests. Where the existing or predecessor accountant provides information, it shall be provided honestly and unambiguously. If the proposed accountant is unable to communicate with the existing or predecessor accountant, the proposed accountant shall take reasonable steps to obtain information about any possible threats by other means, such as through inquiries of third parties or background investigations of senior management or those charged with governance of the client.

210.14 In the case of an audit of financial statements, a professional accountant shall request the predecessor accountant to provide known information regarding any facts or other information that, in the predecessor accountant's opinion, the proposed successor accountant needs to be aware of before deciding whether to accept the engagement. Except for the circumstances involving identified or suspected non-compliance with laws and regulations set out in paragraph 225.31:

- (a) If the client consents to the predecessor accountant disclosing any such facts or other information, the predecessor accountant shall provide the information honestly and unambiguously; and
- (b) If the client fails or refuses to grant the predecessor accountant permission to discuss the client's affairs with the proposed successor accountant, the predecessor accountant shall disclose this fact to the proposed successor accountant, who shall carefully consider such failure or refusal when determining whether or not to accept the appointment.

## SECTION 270

### Custody of Client Assets

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270.3 As part of client and engagement acceptance procedures for services that may involve the holding of client assets, a professional accountant in public practice shall make appropriate inquiries about the source of such assets and consider legal and regulatory obligations. For example, if the assets were derived from illegal activities, such as money laundering, a threat to compliance with the fundamental principles would be created. In such situations, the professional accountant ~~may consider seeking legal advice~~ shall comply with the provisions of section 225.

## **Effective Date**

This pronouncement is effective as of July 15, 2017. Early adoption is permitted.



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## IT and Cloud Services Task Force

**Task Force Members:** Shelly VanDyne (Chair), Cathy Allen, Wendy Davis, Mike Schmitz, Katie Jaeb, Anna Dourkourakas, Dan O'Daly John Ford, Mike Brand. Staff: Ellen Goria

### Task Force Objective

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

### Reason For Agenda

Adopt the hosting services proposal and provide feedback on the information technology services strawman.

### Summary of Issues

#### *Hosting Services*

At the November meeting, the Committee did not have an opportunity to provide the Task Force with feedback on the majority of the questions posed by the Task Force so those questions have been included in this agenda again. However, the Committee did recommend that the Task Force clarify what components of management responsibilities are impacted when providing hosting services to try to develop guidance, authoritative or otherwise, that would explain if preparing schedules (e.g., depreciation schedules) or write up work would be considered hosting services.

In an effort to facilitate the discussion of the comments received on the Hosting Services interpretation, Staff grouped comments into the following discussion topics.

#### *Custody or Control*

One member of the Society of Louisiana CPAs Ethics Committee ([CL 2](#)) does not believe having custody of a client's records should impact independence at all. In speaking with this commenter, he explained that since so much of what he has is in electronic format, if the client lost their version and asked for a copy he could print it and basically make it become the "original". He is concerned that this is a slippery slope.

[CL 3](#) questions whether maintaining a client's depreciation records, and performing write-up services for which the accountant maintains the client's general ledger based on source documents provided and journal entries approved by the client would be considered having control. This commenter goes on to explain that as drafted it would appear to preclude write-up work for an attest client unless the data were stored on an unrelated third party's system and if this is not the intent, recommends clarification be made. This commenter does not believe access to client production systems alone impairs independence because the real issue arises when the licensee takes control of a client's systems. This commenter believes that when the client has no direct control over the disposition of their systems, threats arise to the client's continued financial operations should the ability of the licensee to provide those services be compromised, through third party actions or the licensee's own actions. These same issues exist if the licensee is providing the hosting service through a private cloud leased from a third party or if providing hosting services on their own system. [CL 6](#) has similar concerns and so **strongly disagrees** with the proposal<sup>1</sup>.

CL 4 believes the concepts of custody and control over data or records should be replaced by a responsibility criteria because physical custody of data is an increasingly irrelevant concept as data moves to various third-party cloud servers. This commenter suggest the criteria be more along the lines of having "primary or sole responsibility for data".

<sup>1</sup> Refer to the comment letter for their detailed explanation.

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CL 5 recommends the definition and meaning of “custody or control” as it relates to meaningful use of client data and systems be clarified and distinguish between physical and logical assets as it relates to custody and control.

Task Force Recommendation:

The Task Force was in agreement that it would be clearer if instead of referring to custody or control if the concepts were replaced by a responsibility criteria that better explained what the Task Force envisioned by those terms. After some discussion, it was agreed that what was envisioned was the situation where a member assumed sole or primary responsibility for the custody, storage, security or back-up of the data or records, such that that attest client’s data or records would be incomplete unless they got the information from the member. The Task Force recommends including the description of what hosting services are in the interpretation, so that it doesn’t have broader application. The Task Force also believes doing this will allow for the interpretation to be adopted without re-exposure. The Task Force recommends the definition be added as the first paragraph of the interpretation and read as follows:

***Hosting Services. For purpose of this interpretation, hosting services are nonattest services that involve a member accepting sole or primary responsibility for the custody, storage, security or back-up of an attest client’s data or records whereby those data or records are otherwise only available to the attest client from the member, such that the attest client’s data or records are incomplete***

The Task Force was also concerned that members might not realize that they are providing hosting services when they have the sole or primary responsibility for keeping an attest client’s depreciation schedule or general ledger and so clarified this in item c of paragraph .03. The revised text for item c appears below in the discussion item entitled “*Original Lease Agreements or Other Legal Documents – Example c Paragraph .03*” since additional revisions were also made to this example for other reasons. To address the Committee’s concern related to how a member can avoid providing hosting services when asked to prepare a depreciation schedule for an attest client, the Task Force recommends the following FAQ be issued:

**Question:** Would a member be considered to be providing hosting services if the member prepared an attest client’s depreciation schedule using criteria determined or approved by attest client management?

**Answer:** The member would not be considered to be providing hosting services if the member performed the depreciation calculation and then provided the calculation and detailed information to the attest client so that the attest client can take responsibility for the work and ensure that its books and records are complete. However, the member is reminded to comply with [General Requirements for Performing Nonattest Services](#) interpretation [1.295.040] in the performance of this nonattest service.

The majority of the Task Force members do not believe the clarifications result in a substantive change of position and so does not believe these changes would result in re-exposure.

<b>Question For The Committee</b>
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1. Does the Committee agree with the Task Force’s recommendations?
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- |   |
|---|
| <ol style="list-style-type: none"><li>2. Does the Committee believe that the clarifications result in a substantive change of position?</li><li>3. Does the Committee believe the FAQ should be issued?</li></ol> |
|---|

*Threats Not Necessarily Present*

**CL 5** does not support the position taken by the PEEC that providing hosting services, including business continuity and disaster recovery, necessarily involves having custody or control of data or records that the client uses to conduct its operations which creates a “management participation threat” to independence, or that this creates a “self- review” threat to independence that cannot be reduced to an acceptable level through the application of safeguards. They believe that as defined both self-review and management participation threats, a properly provisioned and properly operated hosting environment is, by consequence of design, capable of satisfying independence requirements and does not involve the assumption of custody and control of the data and records. They believe that if self-review threats were created there are acceptable safeguards available and can be implemented in any applicable hosting environment in order to ensure that there is no opportunity for the appearance of an attest client impairment to independence to exist. They believe that only raw data is housed in the data center and is not usable without additional resources to convert it to interpretable information, so the member’s role is to maintain a usable, secure, and reliable platform for the client’s access. Consequently, CL 5 believes self-review threats are presented at levels that can be reduced with the application of safeguards.

CL 5 also points out that it believe business continuity plans entail many aspects and components that are not relative to the backup and recovery of information systems. The information technology component of a business continuity plan is an aspect of consideration that can only be addressed by management. In their experience they don’t believe any management responsibilities are assumed by the member as it relates to the process of backing up and restoring data and is concerned with the unintended implications of a blanket policy as it relates to the ability of the member or member firm to assist an attest client with data recovery. This commenter also believes that creating an absolute rule will undermine the Conceptual Framework for Members in Public Practice and are concerned that the proposed interpretation will have inappropriate and unintended consequences and recommends the proposal be deferred until further analysis can be conducted.

CL 4 believes that the self-review threat may not always be present when providing hosting services, rather maybe associated with delivery of the service that caused the member to take responsibility for the data. This commenter recommends that an introductory paragraph is needed to clarify that the proposed interpretation covers only the threats related to hosting services and refer the member to other sections of the AICPA Code of Professional Conduct, including the conceptual framework for independence, to determine permissibility for related services provided along with potential hosting services.

**Task Force Recommendation:**

The Task Force recommends that the self-review threat be removed since the primary threat that is present when providing hosting services is the management participation threat. For the self-review and other threats, the Task Force believes the underlying nonattest service being provided will determine if there are any other threats that are present. To highlight this, the Task Force recommends that the lead in to the examples of nonattest services that are not hosting services (i.e., paragraph .04) remind members to apply the requirements outlined in the Nonattest Services subtopic that are applicable to the nonattest services being provided. The edits to accomplish this appear below under different discussion topics. The Task Force also recommends the FAQ be added that provide further insight into the fact that the management participation threat is the key threat that exists when providing hosting services:

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**Question:** Why are the safeguards contained in the [General Requirements for Performing Nonattest Services](#) interpretation [1.295.040] not enough to eliminate or reduce the management participation threats to an acceptable level when providing hosting services?

**Answer:** When hosting services are provided, the management participation threat is significant because a member has accepted responsibility for the maintenance, custody, storage, security or back-up of the attest client's data or records. When a member accepts these responsibilities, the member has become part of the attest client's system of internal control over its data or records, which impairs independence.

**Question For The Committee**

1. Does the Committee agree with the Task Force's recommendations?

*Additional Examples of Services that Members May Seek Guidance On*

[CL 3](#) recommends more examples of services that would impair, or not impair, independence be added to proposed paragraphs .02 and .03. CL 3 notes that examples that clarify what constitutes control of client data, and what constitutes "data or records the attest client uses to conduct its operations" would help licensees, their clients and regulators better understand the boundaries of permitted services.

Due to the advancement of information technology services being performed by members, [CL 7](#) recommends more examples of services that would impair, or not impair, independence be added to proposed paragraphs .02 and .03 or to the FAQ document. At a minimum, this commenter recommends an additional example be added to paragraph .03 that addresses assisting attest clients with migration of data to a third-party provider. The situation they provided as an example of what they mean is:

ABC Co., a private attest client, determines it will move its existing on premise operating data system platform to a third-party service provider. The services will not include design, configuration or data room to manage attest client data. ABC Co. has requested assistance to identify recommendations for them to consider related to like-to-like migration of their data and applications to a third-party service provider based on the criteria established by client management, including assistance with the data migration.

CL 4 recommends additional examples of services that do not impair independence be added such as an example of survey tools and data and analytic services:

- *Survey tools*  
An audit client engages the member to conduct a survey that is a permissible nonattest service. The survey data is stored on cloud servers licensed by the member. The client has the ability to obtain dashboard reporting through a visualization tool. The dashboard reporting is the only deliverable to the client and the detailed survey data is not provided to the client at the end of the engagement. We do not believe this constitutes hosting since the data is for internal use by the member in order to provide the summary reports to the client. This would be no different from the firm using paper surveys, summarizing them manually, and then providing a summary hard copy report to the client.
- *Data and analytics*  
Data and analytics engagements involve analyzing very large amounts of structured and unstructured data using sophisticated analysis tools. A client engages a member to perform data and analytics on its customer records to identify purchasing patterns as part

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of a permissible service. The client provides copies of its customer records to the member who then performs the data and analytics analysis and provides the client with summary reports of the data. The analysis is performed once and the engagement is concluded. We do not believe this constitutes hosting of client data and/or records. The data obtained by the member is a copy of the client's data and is used by the member to perform the analysis. The data does not represent data that is necessary to the client's business process as it is a copy of historical data.

Task Force Recommendations:

The Task Force recommends adding an example to address the survey situation. Specifically, the Task Force believes that when a member conducts a survey, the data collected is the members and the work product is the report that summarizes the results of the survey. Following is the example the Task Force recommends be added to the interpretation:

- c. Retaining data collected related to a work product that the member prepared. For example, the member conducts an employee survey and provides the attest client with a report. The member retains the survey data collected to prepare the report.***

If the Committee believes this example is too specific (cannot be broadly applied to other situations) the following FAQ could be used to replace the bullet. It would be helpful if the Committee could discuss the merits of the belief that the data collected from the survey participants would be considered the member's data and not the attest client's data:

**Question:** Would a member be providing hosting services if the member's firm performed an employee satisfaction survey for an attest client because the member retained the data collected from the survey participants?

**Answer:** No the member would not be providing hosting services since the data collected from the survey participants would be considered the member's data.

The Task Force also believes that providing guidance on a data and analytics engagement would be helpful and recommends adding the following FAQ to the nonattest services FAQ document. The Task Force believes a FAQ is more appropriate since it addresses a unique situation and is not broad guidance like the other examples.

**Question:** A member's firm licenses software that resides on firm servers to an attest client. The attest client inputs data from its lease documents into the software, which generates reports that allows the attest client to view its lease data in various ways. Would the member be providing hosting services?

**Answer:** The member would not be considered to be providing hosting services if the client assumes primary responsibility for storing the data entered into the software and the output generated by the software is stored outside of the member's software. In this case, the software is solely being used for data manipulation purposes. Additionally, the member should ensure that the activities the software performs include only those activities that would not impair independence under the Nonattest Services subtopic [1.295] of the Independence Rule.



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**Questions For The Committee**

1. Should the survey situation be addressed as an example in the interpretation or as a FAQ or both?
2. Why should the data collected when performing a survey for an attest client be the member's data and not the client's?
3. Does the Committee agree with the Task Force's recommendation to add a FAQ that addresses data analytics?

**Production Environment – Example b Paragraph .03**

CL 1 is recommends that the term “production environment” be clarified as it may not be widely understood by members. CL 3 also recommends “production environment” be clarified and indicated they assume that what is intended is any environment that contains real-time systems and/or data upon which the client depends for regular operations, financial or otherwise. CL 5 recommends a definition and meaning of “production environment” be included and the proposal discuss the implications of having “access to”, versus “custody and control of”, the data and records. CL 4 also recommends deleting the phrase “production environment” because it focuses inappropriately on the related service as opposed to the member taking responsibility for the client's data and/or records on behalf of the attest client. In addition, this commenter believes members may assume that hosting in a non-production environment may always be permissible hosting services which may not always be the case. The commenter suggests the following replace the example used in proposed 1.295.143.02.b:

*b. Housing the attest client's financial or non-financial system(s) on the member's firm's servers or servers licensed by the member firm. For example, the firm hosts the attest client's financial information system or website on firm servers.*

**Task Force Recommendations:**

The Task Force recommends replacing example b in paragraph .02 with the example suggested by CL 4. Doing this would eliminate the need to use the phrase “production environment”.

**Question For The Committee**

1. Does the Committee agree with the Task Force's recommendations?

**Original Lease Agreements or Other Legal Documents – Example c Paragraph .03**

One member of the Society of Louisiana CPAs Ethics Committee ([CL 2](#)) does not believe physically storing documents would impair independence, assuming all the transactions related to the documents were executed by the attest client without the involvement of the member. However, since most records are stored electronically by members and many can be reproduced and accepted as an “original”, this member disagrees with including this type of example.

CL 4 believes this example seems dated and not reflective of data that is more often maintained electronically and suggests changing the example to the following:

*c. Responsible for keeping the attest client's data or records on behalf of the client. For example, the attest client's lease agreements or other legal documents stored on servers licensed, maintained or provided by the member's firm or hard copy storage maintained by the member's firm.*

**Task Force Recommendations:**

The Task Force agreed that the example should also include electronic data or records and as such revised the example using some of the thoughts suggested by CL 4. As discussed above under “Custody or Control”, the Task Force was concerned that members might not realize that they are providing hosting services when they have



the sole or primary responsibility for keeping an attest client's depreciation schedule or general ledger and so clarified this as well. The Task Force's recommended revisions to item c of paragraph .02 are:

- c. **Responsible for** ~~keeping the attest client's data or records~~ **on the attest client's behalf** ~~in the member's office for safekeeping. For example, the attest client's general ledger, supporting schedules (for example, depreciation or amortization schedules), original lease agreements or other legal documents are stored~~ **on servers licensed, maintained or provided by the member's firm or the member is responsible for storing hard copy versions of the data or records** ~~in the member's office.~~

**Question For The Committee**

1. Does the Committee agree with the Task Force's recommended revisions to item c?

*Work Product – Example b Paragraph .04*

CL 7 recommends the phrase "that the member was engaged to prepare" be removed from example b in proposed paragraph .03 as it is redundant.

- 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.~~

Task Force Recommendation:

The Task Force agreed the phrase was redundant but given the definition of hosting services, it was no longer necessary to emphasize the importance of the member "being engaged". As such, the Task Force recommends item b be revised as follows:

- b. Retaining a copy of a work product that the *member* ~~was engaged to prepare~~, (for example, a tax return) **for the member's records** ~~that the member was engaged to prepare.~~

**Question For The Committee**

1. Does the Committee agree with the Task Force's recommended revisions to item b?

*Portal Example in Paragraph .04*

CL 4 believes that use of portals could be a hosting service in certain circumstances. To safeguard against providing an unintended hosting service, the commenter suggests a firm may provide notification to a client that the portal is not intended to be the client's repository for the work product delivered through the portal. The firm could then purge or return data after a reasonable time frame to ensure that the portal does not become a repository or means of hosting the client's data or records. As such, this commenter suggests modifying the example in proposed paragraph 1.295.143.03 as follows:

Electronically exchanging data or records with or on behalf of an *attest 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 to deliver the *member's* work product to third parties. **However, the member should consider threats that the client may use the portal as its primary or sole repository of data and therefore result in the member providing hosting services. In such cases, the member should apply the Conceptual Framework for Independence [1.210.010].**

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CL 7 recommends guidance be provided on what a reasonable time period would be to keep information on a portal. For example, up to 1 year could be reasonable and not viewed as hosting/being the attest client's repository.

CL 1 recommends that the phrase "exchanging data" in this example be clarified as it may not be widely understood by members.

Task Force Recommendation:

The Task Force recommends these concerns be addressed and revised the example accordingly:

Electronically exchanging data, **or records or the member's work product** with **an attest client** or on behalf of an **attest client at the attest client's request** ~~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:

- a. exchange data and records related to professional services **provided by the member to the attest client** ~~has been engaged to provide, or~~
- b. ~~to~~ deliver the *member's* work product to third parties **at the attest client's request.**

**To avoid providing hosting services, members should terminate the attest client's access to the data or records in the portal within a reasonable period of time after the engagement is terminated.**

**Question For The Committee**

1. Does the Committee agree with the Task Force's recommended revisions to this example?

*Attest Client Inputs Data Example In Paragraph .04*

CL 4 believes the example related to the attest client inputting data into software in proposed paragraph .03 indicates that inputs by a client have an impact on determining whether a service is a hosting service. The commenter believes that if the member is responsible for client data as a result of the client's input, such would constitute hosting and be impermissible. The commenter believes that the determinant should be who has responsibility for the data and not who inputs the data and proposes the following modification to the example:

- d. Licensing to an *attest client* the use of software **where not providing hosting services** ~~into which the attest client inputs its data~~ and the software provides the *attest client* with an output that the *attest client* is responsible for maintaining. The software must perform an activity that if performed by the *member*, would not *impair independence*.

CL 7 suggests providing further clarification with respect to what is meant by the "use of software" in the interpretation or non-authoritative guidance. The example this commenter provided is when a member is evaluating independence in relation to licensing software, how should the member take into consideration the following: software developed by the member vs. a third-party, or a third-party with whom the member has a teaming relationship; software used to analyze data relevant to financial reporting; or software hosted in the client's information technology infrastructure or a third-party infrastructure such as a cloud. This commenter also recommends providing further clarity around the last sentence of this example by adding a sentence with an example of one or more software activities that if performed by a member would not impair independence.

Task Force Recommendation:

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The Task Force recommends that this example be deleted and instead FAQs be issued that addresses whether a member would be providing hosting services in this situation. The FAQ that would replace this example was discussed above in the discussion item entitled “*Additional Examples of Services that Members May Seek Guidance On*”.

1. **Question:** Why would a member be considered to be providing hosting services if the member houses the attest client’s general ledger on the member’s server or servers leased by the member?

**Answer:** The member would be considered to be providing hosting services by assuming responsibility for maintaining the attest client’s data since the member would have become part of the attest client’s internal controls over its financial information.

2. **Question:** The member and the attest client each license the same general ledger software and house the software on their respective servers. The member provides bookkeeping services to the attest client and sends updated financial information to the attest client. Would the member be providing hosting services in addition to bookkeeping services?

**Answer:** No, the member would not also be providing hosting services in this instance. The member is providing a professional service (bookkeeping) and to facilitate the delivery of this service maintains the same general ledger software as the attest client on its servers. The attest client also maintains the general ledger software, along with the data of record, on its servers and thus the member is not hosting the data on behalf of the client. To ensure that the member does not assume any management responsibilities in connection with the bookkeeping services, the member is reminded to comply with any applicable interpretations under the “Nonattest Services” subtopic such as the [General Requirements for Performing Nonattest Services](#) interpretation [1.295.040] and [Bookkeeping, Payroll, and Other Disbursements](#) interpretation [1.295.120].

3. **Question:** An attest client enters into an agreement with a third party service provider to maintain its general ledger in a cloud based solution. If the attest client gives the member edit access to the general ledger so the member can perform monthly bookkeeping services, would the member be providing hosting services in addition to bookkeeping services?

**Answer:** No, the member would not also be providing hosting services because the member is not maintaining the attest client’s general ledger on servers it owns or leases, rather is just remotely accessing the general ledger to facilitate the delivery of the bookkeeping services. In order to ensure that the member does not assume any management responsibilities in connection with the bookkeeping services, the member is reminded to comply with any applicable interpretations under the “Nonattest Services” subtopic such as the [General Requirements for Performing Nonattest Services](#) interpretation [1.295.040] and [Bookkeeping, Payroll, and Other Disbursements](#) interpretation [1.295.120].

<b>Question For The Committee</b>
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| <ol style="list-style-type: none"><li>1. Does the Committee agree with the Task Force’s recommendation to delete this example and replace it with the above FAQs ?</li></ol> |
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#### Clarify Certain Terms or Phrases

**CL 4** believes the concept of “engaged by” to determine independence seems to take a form over substance approach and if a member is substantively providing hosting services, the member has taken on a management responsibility regardless of whether the member was engaged to specifically provide hosting services. The commenter believes hosting services may be provided specifically as an explicit service or be inherent within the delivery of an otherwise permissible service.

CL 4 recommends that the term “asset” be removed from the first paragraph as it could be misunderstood. This commenter also recommends that data and records should be defined within the code or the proposed interpretation in order avoid having to include the phrase “client uses to conduct its operations”. This commenter believes that the data “client uses to conduct its operations” could be interpreted in several ways and may confuse members. To implement these changes, this commenter recommends paragraph .01 be edited as follows and that definitions of “hosting services” and “client data and/or records” be added to the code or to the interpretation:

.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 services that involve the member having custody or control of~~ **assumes responsibility for the client's** data or records that the ~~attest client~~ uses to conduct its operations (hosting services) **on behalf of management**, 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 could not be reduced to an *acceptable level* by the application of *safeguards*, and *independence* would be *impaired*.

*[0.400.xx] Hosting services include services where the member has taken responsibility for the maintenance, custody, storage, security, repository, or back-up of client data and/or records on behalf of the client.*

*[0.400.xx] Client data and/or records are primary, source, or backup data used in the client's business processes. Client data and/or records includes information that the client would have to replicate if lost or otherwise becomes unavailable.*

CL 5 recommends the proposal:

1. Clarify the definition and meaning of “data or records the client uses to conduct its operations”
2. Expand upon the implications of having different platforms in the “hosting” arena.
3. Clarify the implications, if any, when a member establishes an affiliated entity to provide hosting services to the firm's attest clients.
4. Provide the meaning and definition of “member's servers” and clarify the difference with servers located at a third party data center.

#### Task Force Recommendation:

The Task Force agreed that the determining factor of whether hosting services were provided should not depend upon whether or not the member was engaged to provide the service. As such, the Task Force revised the interpretation to eliminate this concept wherever it was mentioned.

The Task Force recommends deleting the reference to the self-review threat for the reasons explained in discussion item entitled “*Threats Not Necessarily Present*” above.

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Finally, the paragraph was streamlined since the Task Force agreed to add a definition for “hosting services” to the interpretation, as explained above in discussion item entitled “*Hosting Services Definition*”:

~~.02 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 or 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 could not be reduced to an acceptable level by the application of safeguards, and independence would be impaired.~~

**Question For The Committee**

1. Does the Committee agree with the Task Force’s revisions to paragraph .02?

*Comments the Task Force Does Not Recommend Be Addressed*

When summarizing the comments for the Task Force’s discussion, Staff organized the comments into topics. The Task Force did not have any recommendations related to the following topics.

*Need for a Holistic Approach to the Issues*

[CL 3](#) believes it would be more helpful to address all the issues the Task Force is charged with working on in a single interpretation rather than piecemeal, to help avoid unintended consequences, inconsistency and confusion in applying guidance so that the final result is cohesive and provides clear guidance on these issues.

*Management Responsibility Interpretation*

[CL 4](#) recommends that hosting services be included as an example of a management responsibility in the Management Responsibility interpretation. PwC recommends that if the Committee believes having control over an attest client’s assets is equally impermissible then it should be added to the example in the Management Responsibilities interpretation that discusses that having custody of a client’s assets is a management responsibility.

*Non-Financial Information*

One member of the Society of Louisiana CPAs Ethics Committee ([CL 2](#)) does not believe having custody of non-financial information should impair independence. In communicating with this commenter, he explained that if for example management is responsible for maintenance of the information and all the auditor does is provide space for it he doesn’t see how or why that should affect independence since it doesn’t impact the financial statements. The Task Force believes the information is still the attest client’s assets and hopes that eliminating the self-review threat will help convey this.

*Business Continuity or Disaster Recovery Provider – Example a Paragraph .02*

One member of the Society of Louisiana CPAs Ethics Committee ([CL 2](#)) does not believe being hired to be a provider for business continuity or disaster recovery plan would automatically impair independence since the vast majority of these plans are never implemented. Rather, this commenter notes that depending on the details in the plan, once the plan was implemented, then the member should evaluate the threats to determine if independence is impaired. CL 7 believes it is unclear whether the intent of this paragraph includes situations where the member is acting in an advisory



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capacity only to assist in developing the business continuity or disaster recovery plan or testing of a plan. If it is not the intent, this commenter recommends parenthetical clarification such as (not including business continuity or disaster recovery planning/advisory services) or clarify in non-authoritative guidance. PwC also believes this example is broadly written and should be clarified with a qualifying statement that better differentiates aspects of this service that are impermissible from those that permissible. What if the member is only advising the attest client on business continuity issues? As an example, while a member should not operate, for instance, as an attest client's "data center," the member would be permitted to provide advice on the attest client's business continuity or disaster recovery measures or plans without impairing his or her independence.

*Title of Interpretation*

[CL 1](#) is concerned that the proposed title might lead members to believe the guidance applies when a member is *only* providing a client with cloud services. Accordingly, CL 1 suggests that the PEEC consider amending the name of the proposed interpretation to something along the lines of, "Maintaining Custody and Control over Client Data and Records."

<p><i>Question For the Committee</i></p>
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| <p>1. Does the Committee believe that any of these comments should be addressed in the Hosting Services interpretation?</p> |
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*Effective Date*

CL 1 recommends that the proposed interpretation be effective 6 months from the last day of the month that it is published as opposed to from 6 months from the date it is published in the Journal of Accountancy. Staff believes this was just a drafting error and if the Task Force continues to believe 6 months is the appropriate amount of time, then the phrase "from the date it is published" should be changed to "from the last day of the month that it is published".

CL 4 propose an effective date of one year from issuance for existing engagements since they believe that many of these engagements could require significant effort by members and their clients to move data onto other platforms. For new engagements, this commenter recommends members apply the proposed interpretation upon issuance.

Although CL 7 believes the effective date proposed seems reasonable, they are concerned that some firms may not be viewing hosting services as impairing independence and as such, it might be better if the effective date was based upon the engagement period. For example, the effective date could be for engagement periods beginning or after June 30, 2017.

The Task Force is concerned that some members may be providing hosting services and not realize they are doing so (e.g., depreciation schedules). As such, the Task Force believes members will need time to learn about the guidance and then time to get out of existing arrangements and implement policies. If the Committee adopts the interpretation at this meeting it will likely not appear in the Journal of Accountancy until May. The Task Force can envision some members not learning about the change until they attend a CPE class this summer and then need to get out of arrangements. Since hosting services would impair independence during the period covered by the financial statements, the Task Force recommends the interpretation be effective for engagement periods beginning on or after December 15, 2017. This would allow members about 7 months to learn about the requirement and terminate any problematic services while not tainting them for periods that are in 2017.

Staff was asked to research whether a transition provision was necessary. Staff believes that a transition provision is usually adopted when a standard is effective on one date but members

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are allowed additional time to wrap up existing engagements. Given the recommended extended effective date, Staff doesn't believe a transition provision is necessary. If the Committee believes a transition provision is necessary, it should discuss if the effective date should be sooner than December 15, 2017 and would read something like:

Independence would not be impaired as a result of the more restrictive requirements of the Hosting Services interpretation provided such services are pursuant to engagements commenced prior to December 15, 2017, and completed prior to March 1, 2018, and the member complied with all applicable independence interpretations and rulings in effect on December 15, 2017.

*Question For the Committee*

1. Does the Committee agree with the Task Force's recommended effective date?
2. Does the Committee believe a transition provision is necessary?
3. Does the Committee believe that the changes agreed to result in a substantive change of position such that the guidance should be re-exposed?

*Information Systems Services*

The extant interpretation explains that a member's independence will not be impaired if a member installed or integrated a "...financial information system that the member did not design or develop" and could "...design, develop, install, or integrate an *attest client's* information system that is unrelated to the attest client's financial statements or accounting records" without impairing independence. Using this guidance, it seemed that there were two critical questions that needed to be asked when evaluating whether a nonattest service related to information systems would impair independence and they are:

- Did the member design or develop the system?
- Is the system related to or impact the financial statement or accounting records?

So the first thing the Task Force did was to try to define what design and develop would entail since these activities are integral to the guidance. The Task Force recommends that the guidance explain that designing an information system would include determining how a system or transaction will function, process data and produce results (for example, reports, journal vouchers and documents such as sales and purchase orders) to provide a blueprint or schematic for the development of software code (programs) and data structures. Once the design process is complete, the next step would involve development of the system which the Task Force recommends be explained as creating software code, for individual or multiple modules, and testing such code to confirm it is functioning as designed.

The Task Force is thinking that when a Commercial Off-the-Shelf ("COTS") solution is involved, the design and develop definitions are most likely not triggered. To help set COTS software solutions apart, the Task Force developed a definition of this term. The Task Force defined COTS as "A software package developed, distributed, maintained and supported by a third party vendor (vendor), sometimes simply referred to as an "off the shelf" package or solution. COTS solutions have generally referred to traditional on-premises software that runs on a customer's own computers or on a vendor's "cloud" infrastructure. COTS solutions range from software packages requiring only installation on a computer and ready to run or to large scale, complex enterprise applications."

From there, the Task Force analyzed each activity using the design/develop and impact on financial statements or accounting records. The result is the strawman that is found in Agenda Item 3D.

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**Questions For the Committee:**

1. Does the Task Force have any suggested input on the draft strawman?
2. Should examples of specific nonattest services that do not impair independence be added to the strawman or should commenters be asked if they think this would be helpful and if so, to provide examples of services for the Committee's consideration?

**Integrating a Commercial-Off-The-Shelf Software Solution**

The Task Force believes that integrating a new COTS software solution means interfacing the new software solution to one or more legacy or other third party solutions or both. If interfacing involves designing and developing software code that allows data to pass from one system to another, the significance of the threats to independence will depend upon whether or not the interfacing involves an attest client's financial information system. When integration involves a financial information system, the Task Force believes threats will be so significant that independence will be impaired.

The Task Force noted that sometimes an Application Program Interface (API) is used to connect the new COTS software to legacy systems. While sometimes the API can be used without the member having to design or develop any additional code so that the systems will interface properly, often it is necessary to design or develop additional code before the systems can be properly integrated. The Task Force recommends the following FAQ be used to help address this very likely question:

**Question:** If a member uses an Application Program Interface (API) developed by a third party to integrate a COTS software solution to an attest client's financial information system, would independence be impaired?

**Answer:** It depends. If the integration involves the member designing or developing additional software code so that the API will allow the COTS software solution to interface with the attest client's financial information system, the member's independence would be considered impaired. However, if the integration does not require the member to design or develop additional software code to allow the COTS software solution to interface with the attest client's information system, the member's independence would not be impaired provided the member complies with the safeguards outlined in paragraph .02 of the Information Systems Services interpretation.

**Question For the Committee:**

1. Does the Committee agree with the Task Force's proposed conclusions with respect to integration services and the proposed FAQ?

**Data Conversion Services**

The Task Force believes that data conversion services for a new COTS software solution means revising the format of the legacy system's data, as applicable, so that such data is compatible in structure to that of the new COTS software solution. The Task Force believes that if a member designs or develops the code used to convert an attest client's legacy financial information system's data so that the new COTS software solution can effectively function when the data is loaded, the Task Force believes threats would be significant and independence would be impaired. The Task Force would appreciate the Committee's input regarding whether it believes members conversion services can ever be done without having to design or develop code and if so, should a FAQ be developed to clarify this?



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**Questions For the Committee:**

1. Does the Committee agree with the Task Force's proposed conclusions with respect to data conversion services?
2. Does the Committee believe it is possible to perform data conversion services without designing or developing code?

**Communication Plan**

The Task Force is asked to discuss what additional communications should be considered for the Hosting Services interpretation aside from the traditional steps of publication in the Journal of Accountancy and Ethically Speaking.

**Materials Presented**

<b>Agenda Item 3B</b>	Hosting Services interpretation
<b>Agenda Item 3C</b>	Draft Hosting Services FAQs
<b>Agenda Item 3D</b>	Information Systems Services Strawman
<b>Agenda Item 3E</b>	Draft IT Services FAQs

## Additions to the Proposal Appear in Boldface Italic and Deletions are Stricken.

### Text of Proposed Hosting Services Interpretation

#### 1.295.143 - Hosting Services

- .01 ***Hosting Services. For purpose of this interpretation, hosting services are nonattest services that involve a member accepting sole or primary responsibility for the custody, storage, security or back-up of an attest client's data or records whereby those data or records are otherwise only available to the attest client from the member, such that the attest client's data or records are incomplete.***
- .02 ~~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 or 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 could not be reduced to an acceptable level by the application of safeguards, and independence would be impaired.***
- .03 ***The following are*** ~~Examples of hosting~~ ***nonattest*** ~~services that would impair independence include these~~ ***because they are considered to be hosting services:***
  - a. ***Accepting responsibility to be*** ~~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)~~ ***system(s) on the member's firm's servers or servers licensed by the member firm. For example, the firm hosts the attest client's financial system or website on firm servers.***
  - c. ***Responsible for*** ~~Keeping the attest client's data or records~~ ***on the attest client's behalf in the member's office for safekeeping. For example, the attest client's general ledger, supporting schedules (for example, depreciation or amortization schedules), original lease agreements or other legal documents are stored on servers licensed, maintained or provided by the member's firm or the member is responsible for storing hard copy versions of the data or records in the member's office.***
- .04 ~~The following are examples of activities situations in which a member that would not be considered to be hosting services. Members are reminded to apply the requirements outlined in the interpretations of the Nonattest Services subtopic when providing nonattest services. data or records that the attest client uses to conduct its operations and would not impair independence:~~
  - 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:~~
    - i. ~~the payroll data that supports a payroll tax return the member prepared.~~
    - or
    - ii. ~~a copy of a bank reconciliation that supports attest procedures performed on the cash account.~~
    - iii. ***the client's vendor data used to prepare an analysis of vendor activity.***
  - b. ~~Retaining a copy of a work product that the member was engaged to prepared, (for example, a tax return) for the member's records that the member was engaged to prepare.~~

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- c. ***Retaining data collected related to a work product that the member prepared. For example, the member conducts an employee survey and provides the attest client with a report. The member retains the survey data collected to prepare the report.***
  - c. Electronically exchanging data, ***or records or the member's work product with an attest client*** or on behalf of an attest client ***at the attest client's request*** ~~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:
    - a. exchange data and records related to professional services ***provided by the member to the attest client*** ~~has been engaged to provide,~~ or
    - b. ~~to~~ deliver the member's work product to third parties ***at the attest client's request.******To avoid providing hosting services, members should terminate the attest client's access to the data or records in the portal within a reasonable period of time after the engagement is terminated.***
  - d. ~~Licensing to an attest client the use of software into which the attest client inputs its data and the software provides the attest client with an output that the attest client is responsible for maintaining. The software must perform an activity that, if performed by the member, would not impair independence.~~

***Effective Date***

- .05 This interpretation is effective ***for engagement periods beginning on or after December 31, 2017*** ~~[6 months from the date it is published in the *Journal of Accountancy*].~~

## Draft Hosting Services FAQs

1. **Question:** Why are the safeguards contained in the [General Requirements for Performing Nonattest Services](#) interpretation [1.295.040] not enough to eliminate or reduce the management participation threats to an acceptable level when providing hosting services?

**Answer:** When hosting services are provided, the management participation threat is significant because a member has accepted responsibility for the maintenance, custody, storage, security or back-up of the attest client's data or records. When a member accepts these responsibilities, the member has become part of the attest client's system of internal control over its data or records, which impairs independence.

2. **Question:** Would a member be considered to be providing hosting services if the member prepared an attest client's depreciation schedule using criteria determined or approved by attest client management?

**Answer:** The member would not be considered to be providing hosting services if the member performed the depreciation calculation and then provided the calculation and detailed information to the attest client so that the attest client can take responsibility for the work and ensure that its books and records are complete. However, the member is reminded to comply with [General Requirements for Performing Nonattest Services](#) interpretation [1.295.040] in the performance of this nonattest service.

3. **Question:** Why would a member be considered to be providing hosting services if the member houses the attest client's general ledger on the member's server or servers leased by the member?

**Answer:** The member would be considered to be providing hosting services by assuming responsibility for maintaining the attest client's data since the member would have become part of the attest client's internal controls over its financial information.

4. **Question:** The member and the attest client each license the same general ledger software and house the software on their respective servers. The member provides bookkeeping services to the attest client and sends updated financial information to the attest client. Would the member be providing hosting services in addition to bookkeeping services?

**Answer:** No, the member would not also be providing hosting services in this instance. The member is providing a professional service (bookkeeping) and to facilitate the delivery of this service maintains the same general ledger software as the attest client on its servers. The attest client also maintains the general ledger software, along with the data of record, on its servers and thus the member is not hosting the data on behalf of the client. To ensure that the member does not assume any management responsibilities in connection with the bookkeeping services, the member is reminded to comply with any applicable interpretations under the "Nonattest Services" subtopic such as the [General Requirements for Performing Nonattest Services](#) interpretation [1.295.040] and [Bookkeeping, Payroll, and Other Disbursements](#) interpretation [1.295.120].

5. **Question:** An attest client enters into an agreement with a third party service provider to maintain its general ledger in a cloud based solution. If the attest client gives the member edit access to the general ledger so the member can perform monthly bookkeeping

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services, would the member be providing hosting services in addition to bookkeeping services?

**Answer:** No, the member would not also be providing hosting services because the member is not maintaining the attest client's general ledger on servers it owns or leases, rather is just remotely accessing the general ledger to facilitate the delivery of the bookkeeping services. In order to ensure that the member does not assume any management responsibilities in connection with the bookkeeping services, the member is reminded to comply with any applicable interpretations under the "Nonattest Services" subtopic such as the [General Requirements for Performing Nonattest Services](#) interpretation [1.295.040] and [Bookkeeping, Payroll, and Other Disbursements](#) interpretation [1.295.120].

6. **Question:** Would a member be providing hosting services if the member's firm performed an employee satisfaction survey for an attest client because the member retained the data collected from the survey participants?

**Answer:** No the member would not be providing hosting services since the data collected from the survey participants would be considered the member's data.

7. **Question:** A member's firm licenses software that resides on firm servers to an attest client. The attest client inputs data from its lease documents into the software, which generates reports that allows the attest client to view its lease data in various ways. Would the member be providing hosting services?

**Answer:** The member would not be considered to be providing hosting services if the client assumes primary responsibility for storing the data entered into the software and the output generated by the software is stored outside of the member's software. In this case, the software is solely being used for data manipulation purposes. Additionally, the member should ensure that the activities the software performs include only those activities that would not impair independence under the Nonattest Services subtopic [1.295] of the Independence Rule.

## Information Systems Services Strawman

- .01 When a member provides services related to an attest client's information systems, self-review and management participation threats to the covered member's compliance with the "[Independence Rule](#)" [1.200.001] may exist.
- .02 When performing information systems services for an attest client that **are not financial statement related or** are permitted under this interpretation, all requirements of the "[General Requirements for Performing Nonattest Services](#)" interpretation [1.295.040] of the "Independence Rule" [1.200.001] should be met, including that all significant assumptions and matters of judgment are determined or approved by the attest client, and the attest client is in a position to have an informed judgment on, and accepts responsibility for, the results of the service.

### Terminology

- .03 The following terms are defined solely for the purpose of applying this interpretation:
  - a. Commercial Off-the-Shelf: ("COTS") means a software package developed, distributed, maintained and supported by a third party vendor (vendor), sometimes simply referred to as an "off the shelf" package or solution. COTS solutions have generally referred to traditional on-premises software that runs on a customer's own computers or on a vendor's "cloud" infrastructure. COTS solutions range from software packages requiring only installation on a computer and ready to run or to large scale, complex enterprise applications.
  - b. Placing into Production: means that the system is now available for use on a regular basis for its intended purpose.
  - c. Interface: means connecting two or more systems by designing and developing software code that passes data from one system to another. Interfaces may flow in one direction or be bidirectional and may involve the performance of an end-to-end transaction or pass data from one system to another for reporting purposes.

### Design or Development of an Information System

- .04 Designing an information system means determining how a system or transaction will function, process data and produce results (for example, reports, journal vouchers and documents such as sales and purchase orders) to provide a blueprint or schematic for the development of software code (programs) and data structures. Once designed, the information system is developed, which entails creating software code, for individual or multiple modules, and testing such code to confirm it is functioning as designed.
- .05 If a member designs or develops an attest client's financial information system 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.
- .06 If, however, the member designs or develops an information system that is unrelated to the attest client's financial statements or accounting records, threats may be reduced to an acceptable level provided the safeguards outlined in paragraph .02 of this interpretation are applied.
- .07 If the member provides advice or recommendations related to design a COTS software solution and applies the "[Advisory Services](#)" interpretation [1.295.1050] and 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 [Task Force to discuss if adding examples of services would be helpful or if this paragraph should be removed.]

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## **Implementation Services**

- .08 Implementation services can involve any activity after the design and development of an information system that a member is engaged to provide related to an attest client's information systems. For example, implementation can include activities such as configuring, testing and placing into production a system, and also includes supporting activities such as end-user training, change management and organizational communications. It can also involve installing, integrating, customizing and performing data conversions necessary for implementing a COTS software solution. Threats created by certain implementation services can be reduced to an acceptable level by the application of safeguards, while in other situations threats to compliance with the "[Independence Rule](#)" [1.200.001] would be significant and could not be reduced to an acceptable level by the application of safeguards.
- .09 If the member provides advice or recommendations related to the implementation of a COTS software solution and applies the "[Advisory Services](#)" interpretation [1.295.1050] and 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 [Task Force to discuss if adding examples of services would be helpful or if this paragraph should be removed.]

## **Installing a Software Solution**

- .10 Installing a software solution means the initial loading of software on a computer. In the case of a COTS implementation, installation would normally refer to loading the software on a customer's server(s). Software configuration, development, integration and conversion activities may follow installation.
- .11 When a member installs a COTS software solution, even if a financial information system, threats may be reduced to an acceptable level provided the safeguards outlined in paragraph .02 of this interpretation are applied.

## **Configuring a Commercial-Off-The Shelf Software Solution**

- .12 Configuring a COTS software solution means selecting the software features, functionality options, and settings of the COTS software solution, that when selected determine how the software will perform certain transactions and process data. Configuration options may also include selecting the predefined format of certain data attributes and the inclusion or exclusion of such attributes. For purposes of this interpretation, configuring a COTS software solution does not generally involve developing new software code or features to modify or alter the functionality of the COTS software solution in ways not pre-defined by the vendor.
- .13 When a member configures a COTS software solution, even if a financial information system, threats may be reduced to an acceptable level provided the safeguards outlined in paragraph .02 of this interpretation are applied. For example, a member may [Task Force to discuss if an example should be added.]

## **Customization of a Commercial-Off-The Shelf Software Solution**

- .14 Customizing a COTS software solution means altering or adding to the features and functions of the software as provided for by the vendor, which go beyond all options available when configuring the COTS software solution. Customizing can either involve:



- 
- a. Modification which for purposes of this interpretation involves altering the COTS software solution code to change or add to the functionality provided by the vendor, or
  - b. Enhancements which for purposes of this interpretation involves developing new code, external to the COTS software solution, and works in concert with the COTS software solution to provide altered or additional functionality.
- .15 If a member customizes an attest client's financial information system 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.
- .16 If however, the member customizes an information system that is unrelated to the attest client's financial statements or accounting records, threats may be reduced to an acceptable level provided the safeguards outlined in paragraph .02 of this interpretation are applied.
- .17 If the member provides advice or recommendations related to customizing a COTS software solution and applies the "[Advisory Services](#)" interpretation [1.295.1050] and 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 **[Task Force to discuss if an example should be added.]**

### ***Integrating a Commercial-Off-The Shelf Software Solution***

- .18 Integrating a new COTS software solution means interfacing the new software solution to one or more legacy or other third party solutions or both. If interfacing involves designing and developing software code that allows data to pass from one system to another, the significance of the threats to independence will depend upon whether or not the interfacing involves an attest client's financial information system.
- .19 When a member provides integration services that involves an attest client's financial information system, 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.
- .20 If however, the member provides integration services that is unrelated to the attest client's financial statements or accounting records, threats may be reduced to an acceptable level provided the safeguards outlined in paragraph .02 of this interpretation are applied.
- .21 If the member provides advice or recommendations related to integrating a COTS software solution and applies the "[Advisory Services](#)" interpretation [1.295.1050] and 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 **[Task Force to discuss if an example should be added.]**

### ***Data Conversion Services***

- .22 Data conversion services for a new COTS software solution means revising the format of the legacy system's data, as applicable, so that such data is compatible in structure to that of the new COTS software solution.
- .23 If a member designs or develops the code used to convert an attest client's legacy financial information system's data so that the new COTS software solution can effectively function when the data is loaded, 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.



- 
- .24 If, however, the member designs or develops the code used to convert an attest client's legacy system's data that is unrelated to the attest client's financial statements or accounting records, threats may be reduced to an acceptable level provided the safeguards outlined in paragraph .02 of this interpretation are applied.
- .25 If the member provides advisory only services related to a data conversion and applies the "[Advisory Services](#)" interpretation [1.295.1050] and 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 [Task Force to discuss if an example should be added.]

### **Other Information Systems Services**

#### **.26 To Be Developed**

Nonauthoritative questions and answers regarding information systems design, implementation, and integration services are available at <a href="http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf">www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.pdf</a> .
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### Draft Information Technology Services FAQs

1. **Question:** If a member uses an Application Program Interface (API) developed by a third party to integrate a COTS software solution to an attest client's financial information system, would independence be impaired?

**Answer:** It depends. If the integration involves the member designing or developing additional software code so that the API will allow the COTS software solution to interface with the attest client's financial information system, the member's independence would be considered impaired. However, if the integration does not require the member to design or develop additional software code to allow the COTS software solution to interface with the attest client's information system, the member's independence would not be impaired provided the member complies with the safeguards outlined in paragraph .02 of the Information Systems Services interpretation.

DRAFT

## Leases Task Force

### Task Force Members

Blake Wilson (Chair), Bill Mann, Alan Gittelsohn, David East, Nancy Miller, Chris Cahill

Staff: Brandon Mercer

### 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

At the November 2016 PEEC meeting, the Leases Task Force (the “Task Force”) presented revisions to the extant Leases Interpretation and issues related to the revisions. The Task Force held a conference call in January 2017 to further discuss the feedback received from PEEC. The purpose of this agenda item is to update PEEC on the Task Force’s discussions and present additional revisions and issues for consideration.

### Background

The extant AICPA Code addresses leasing arrangements and independence at the Leases Interpretation (1.260.040), which is presented below. 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). 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.

#### 1.260.040 Leases

**.01** If a *covered member* enters into a leasing agreement (as described in GAAP) 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]

## Summary of Issues

At the November 2016 PEEC meeting, the Task Force presented revision options for the Leases Interpretation. After PEEC discussion of the options and related issues presented by the Task Force, it was determined that a conceptual approach without reference to GAAP lease categorization was appropriate and preferred by PEEC. Pursuant to this conclusion, the Task Force presented an alternative revision (Option A, below) to PEEC at that time, which eliminated the GAAP reference and took a more conceptual approach.

### Option A – No reference to GAAP – discussed at November 2016 PEEC meeting

#### **1.260.040 Leases**

~~.01~~ If a *covered member* enters into has a lease~~ing~~ agreement (as described in GAAP) with an *attest client* during the *period of the professional engagement*, ~~the self-interest, familiarity, and undue influence threats 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, during the period of the professional engagement, the lease is material to the covered member or the attest client. Accordingly, independence would not be impaired. For other leases, threats 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. ~~b.~~ 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].

#### **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.

~~.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]~~

PEEC discussed Option A, noting several concerns that the Task Force discussed on a subsequent conference call. These prior meeting issues and the Task Force conclusions are explained below. In considering issues discussed at the November 2016 PEEC meeting, the

Task Force has prepared a two new revision options (Option B and Option C, below); both are presented in the discussion below and at **Agenda Item 4B**. A “clean” version of Option B is presented below, and explanation of the issues addressed by this revision follows.

#### Option B – Conceptual Approach to all Leases with Minimum Requirements

##### **1.260.040 Leases**

**.01** If during the *period of the professional engagement*, a covered member has a lease or leases with an attest client, self-interest, familiarity, and undue influence *threats* to the *covered member’s* compliance with the “[Independence Rule](#)” [1.200.001] may exist. Accordingly, the covered member should evaluate the significance of these and any other *threats* to determine if the *threats* are at an *acceptable level*. If the covered member determines that *threats* are not at an *acceptable level*, he or she should apply *safeguards* to eliminate or reduce the *threats* to an *acceptable level*.

**.02** However, *threats* 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. the terms and conditions set forth in the lease are not comparable with other leases of a similar nature,
- b. any amounts are not paid in accordance with the lease terms or provisions, or
- c. the lease is material to the covered member or the attest client. **[Staff note: See discussion on materiality below]**

**.03** This interpretation 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].

**.04** 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.

#### *Structure of Option A*

The construct of the Option A presented to PEEC left a potential safe harbor for immaterial leases. For example, a material lease would impair independence, but an immaterial lease would not as long as it met the requirements on terms/conditions and payment compliance. PEEC generally agreed that the conceptual approach should apply to all leases, not only material or only immaterial leases, with certain minimum requirements (i.e. under comparable terms, payments remain compliant, and not material). The Task Force has addressed this concern in paragraph .01 of Option B above, in that the conceptual framework approach is contemplated for all leases, and does not allow all immaterial leases meeting the minimum requirements.

#### *Normal course of business and arm’s length transactions*

PEEC discussed the term “normal course of business” and whether it should be reflected in the guidance. The Option A revision did not include an explicit reference to a lease being in the “normal course of business” because the Task Force viewed it as adding confusion; the term is not used elsewhere in the Code and may be used differently by other regulators or bodies. One

member noted that if a lessor is not in the business of leasing, the lease may not in the normal course of business, and the lease is at a higher risk of not being at arm's length. There was concern that the Option A revision may not address this type of situation. Additionally, one member noted concern that similar leases for comparison may not be available if the lessor does not do other leases, leaving leases of other entities as only potentially comparable leases. Although market rental rates or some third party rental rate information may be available, specific lease terms and conditions may not be available to compare. If the terms and conditions are not comparable to similar leases, the transaction may not be seen as at arm's length.

The Task Force discussed these concerns and noted that the conceptual framework approach should address transactions that are not at arm's length by considering the self-interest, undue influence, and familiarity threats that are caused by a "sweetheart deal" or less than arm's length transaction. However, the Task Force also noted that the issue of a lease being outside the course of business or part of normal business operations of an entity could be resolved by requiring that leases be held with lending institutions. Lending institutions are already defined in the Code and leasing would be part of many of their normal business operations. If PEEC prefers this approach, leases with non-lending institutions would receive separate treatment. Those leases would either be subject to further evaluation under the conceptual framework approach, or be disallowed.

**The Task Force requests that PEEC discuss the issue of leases being at less than arm's length and whether limiting permitted leases to those with lending institutions would address the issue of leases being outside normal business or not at arm's length.**

**Does PEEC believe that leases with non-lending institutions should be disallowed, or should they be subject to a conceptual framework approach?**

**If PEEC does not wish to limit permitted leases to those with lending institutions, does PEEC believe that it is appropriate to explicitly state that leases should be "at arm's length" in the Interpretation?**

**~~b. The terms and conditions set forth in the lease agreement are comparable with other leases of a similar nature~~ established at arm's length.**

#### *Materiality – Impact of Explicit Inclusion*

Although PEEC has previously indicated that materiality is a factor in determining whether a lease presents significant threats to independence, the Task Force has additional concerns regarding whether the materiality concept should be implied by use of the conceptual approach, or explicitly noted in the Interpretation as a minimum requirement, along with comparable terms and payment compliance. For example, if a material lease is held with a covered member who is not on the engagement team or in a position to influence the attest engagement, the conclusion that threats are so significant that no safeguards are available may not be the correct conclusion. In addition, the conceptual framework approach would not be available for those covered members because the lease is material. In this regard, the Task Force had concerns that materiality is a bright-line test that may not lend itself to the appropriate conclusion in those situations.

An additional impact of explicit mention of materiality is an inconsistency regarding automobile leases. In paragraph .03, leases addressed by the Loans and Leases Interpretation are excluded from the Leases Interpretation requirements. Under the Loans and Leases Interpretation, automobile leases with lending institutions are permitted, without regard to

materiality, if they are collateralized by the automobile. If materiality is an explicit requirement, then material collateralized automobile leases with a lending institution will be permitted, while the same automobile lease with a non-lending institution client would result in impairment due to materiality, with no safeguards available.

As previous agendas have noted, a 2003 Exposure Draft proposing materiality as an explicit criteria was not adopted, in part due to concerns over materiality measurement and perceived inconsistencies in the treatment of immaterial leases with attest clients versus immaterial loans with lending institution attest clients. Members are likely to require additional guidance regarding these issues and inconsistencies if materiality is an explicit requirement.

**The Task Force requests that PEEC discuss the potential broad application of the materiality requirement if explicitly included in the Interpretation and clarify whether PEEC intended materiality to be a bright line requirement for all covered members.**

**Does PEEC agree that evaluation of materiality of the lease is implied in the use of the conceptual approach, or should materiality be explicitly noted as a requirement?**

**If materiality is to be explicitly noted, should the guidance be limited to only certain covered members? If so, to which covered members should it be limited?**

**Does PEEC agree that there will be an inconsistency regarding auto leases if materiality is explicit in the Interpretation?**

#### *Paragraph .01 – Naming of specific threats*

The Task Force has identified self-interest, familiarity, and undue influence as the threats present in a leasing relationship, and has provided brief examples below. The full Code descriptions of the threats can be found at **Agenda Item 4C**.

*Self-interest threat: The threat that a member could benefit, financially or otherwise, from an interest in, or relationship with, an attest client or persons associated with the attest client. A member may benefit financially from either a leasehold interest in property (as lessee), or the income from the property lease (as lessor).*

*Familiarity threat: The threat that, because of a long or close relationship with an attest client, a member will become too sympathetic to the attest client's interests or too accepting of the attest client's work or product. The lease relationship, similar to a business relationship or professional service relationship, may create familiarity threats with respect to the client. For example, a member who has leased property from an attest client or a non-client for a period of time may have a closer relationship due to the lease relationship, and may accept certain representations from the client regarding the lease collectability or other future contingencies related to the lease. In addition, the member may become sympathetic to the attest client's interests in that the member has an interest in the continued leasing of the property, and the client's financial ability to continue to pay or receive rents, particularly when the member is the lessor.*

*Undue influence threat: The threat that a member will subordinate his or her judgment to that of an individual associated with an attest client or any relevant third party due to that individual's reputation or expertise, aggressive or dominant personality, or attempts to coerce or exercise excessive influence over the member. Similar to the familiarity threat,*



the lease relationship presents a situation where leverage due to circumstances surrounding the lease may be used by one or both parties in a way that influences the attest engagement. For example, a lessor or lessee client may have leverage via the lease to influence the extent of audit procedures or the audit fee; particularly in a situation where loss of the lease would have a significant impact on either party.

The advocacy, adverse interest, and self-review threats were not identified by the Task Force as threats inherent in a leasing relationship, although if additional circumstances arise, these threats could come up.

**Does PEEC agree that specific threats should be identified in the Interpretation? If so, does PEEC agree with the Task Force’s identification of threats to independence as shown in paragraph .01 above?**

*Paragraph .04 – Grandfathering of Leases prior to effective date*

The Task Force continues to agree with PEEC’s position that all permitted operating leases in existence at the effective date of the revision would not impair independence, as is reflected in this paragraph.

Guided Conceptual Framework Approach – Option C

In the course of the Task Force’s discussions above, the question was raised regarding whether the PEEC should take a “guided conceptual framework” approach to leases. Under this approach, the guidance would inform members that threats to independence may exist when a member has a lease with an attest client, explain that if threats are so significant that no safeguards are available, and provide considerations that the PEEC believes are significant in applying the threats / safeguards approach. An example of this approach appears below:

Option C - Guided Conceptual Framework Approach

**1.260.040 Leases**

**.01** If during the *period of the professional engagement*, a covered member has a lease or leases with an attest client, self-interest, familiarity, and undue influence *threats* to the *covered member’s* compliance with the “[Independence Rule](#)” [1.200.001] may exist. Accordingly, the covered member should evaluate the significance of these and any other *threats* to determine if the *threats* are at an *acceptable level*. If the covered member determines that *threats* are not at an *acceptable level*, and no safeguards are available to eliminate or reduce the threats to an acceptable level, independence would be impaired. This interpretation 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** Examples of factors the covered member should consider in evaluating the significance of threats to independence include the following:

- a. the covered member’s role on the engagement team;
- b. materiality of the lease to the covered member;
- c. materiality of the lease to the attest client or the financial statements;
- d. whether the lease terms and conditions are established at arm’s length;
- e. whether all amounts are paid in accordance with the lease terms;



- f. the extent to which the lease will be subject to attest procedures or financial statements disclosures
- g. [\*\*\*\*any other items the committee deems to be important\*\*\*\*]

.03 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.

The Task Force acknowledges that the guided approach above may be a significant loosening from the extant AICPA Code position, in that it would be principles based; however the Task Force believes this approach is consistent with IESBA in that IESBA does not address leases and thus requires a conceptual framework approach. This approach would be more consistent with the SEC in that the member must use judgement to evaluate the threats to independence and the appearance of independence depending on the circumstances and factors present. An FAQ could be issued as supplemental guidance that provides examples of situations where independence would be impaired, such as a member of the engagement team having a material lease with the attest client.

**Considering the discussions on Options B and C, does PEEC believe that the guided approach outlined in Option C is the appropriate approach compared to Option B?**

**If PEEC wishes to pursue Option C, does PEEC agree that FAQ addressing impairment situations would be appropriate to provide to assist members in applying this approach?**

**Does PEEC believe that specific examples of safeguards should also be provided in the guided approach, or should members refer to the examples already in the Conceptual Framework?**

### **Effective Date**

The FASB Update is effective for fiscal years beginning after December 15, 2018 for public companies and December 15, 2019 for private companies. At this time, the Task Force sees no reason to deviate from a similar timeline to the private company effective date, with early adoption permitted.

**Does PEEC agree with an effective date of fiscal years beginning after December 15, 2019?**

### **Action Needed**

The Task Force requests that PEEC discuss the issues regarding the Task Force's revisions to the Leases Interpretation. The Task Force tentatively plans to finalize the revision based upon PEEC feedback and subsequent Task Force discussion, and bring a possible draft for exposure to membership to the next PEEC meeting.

### **Communications Plan**

The Task Force will take PEEC's input on the issues noted above and tentatively plans to bring a possible draft for exposure to membership to PEEC at its next meeting in May 2017.

### **Materials Presented**

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**Agenda Item 4B:** Revisions to the Leases Interpretation  
**Agenda Item 4C:** Threats to Independence  
**Agenda Item 4D:** SEC Codification with examples  
**Agenda Item 4E:** Other Examples

## Sample Revisions to the AICPA Code

Additions are **bold underlined**, deletions are struck through.

Option B – Conceptual Approach with Minimum Requirements – changes tracked

### 1.260.040 Leases

**.01 If during the period of professional engagement, a covered member has enters into a leaseing or leases agreement (as described in GAAP) with an attest client during the period of the professional engagement, the self-interest, familiarity, and undue influence threats to the covered member's compliance with the "Independence Rule" [1.200.001] may exist. Accordingly, the covered member should evaluate the significance of these and any other threats to determine if the threats are threat would be at an acceptable level. If the covered member determines that threats are not at an acceptable level, he or she should apply safeguards to eliminate or reduce the threats to an acceptable level. and independence would not be impaired if all the following safeguards are met:**

**.02 However, threats 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. The lease meets the criteria of an operating lease (as described in GAAP).
- b. **a.** The terms and conditions set forth in the lease agreement are **not** comparable with other leases of a similar nature.
- c. **b.** All amounts are paid in accordance with the lease terms or provisions, **or**
- c. The lease is material to the covered member or the attest client.**

**.03 This interpretation 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]**~~

**.04 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.**

## 1.260.040 Leases

**.01 If during the period of professional engagement, a covered member has entered into a leasing or leases agreement (as described in GAAP) with an attest client during the period of the professional engagement, the self-interest, familiarity, and undue influence threats to the covered member's compliance with the "Independence Rule" [1.200.001] may exist. Accordingly, the covered member should evaluate the significance of these and any other threats to determine if the threats are would be at an acceptable level. If the covered member determines that threats are not at an acceptable level, and no safeguards are available to eliminate or reduce the threats to an acceptable level, independence would be impaired.**

~~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 **interpretation** 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 Examples of factors the covered member should consider in evaluating the significance of threats to independence include the following:**

- a. the covered member's role on the engagement team;**
- b. materiality of the lease to the covered member;**
- c. materiality of the lease to the attest client or the financial statements;**
- d. whether the lease terms and conditions are established at arm's length;**
- e. whether all amounts are paid in accordance with the lease terms;**
- f. the extent to which the lease will be subject to attest procedures or financial statements disclosures**
- g. [\*\*\*any other items the committee deems to be important\*\*\*]**

~~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]~~

**.03 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.**

## Threats to Independence – AICPA Conceptual Framework for Independence

.11 Examples of *threats* associated with a specific relationship or circumstance are identified in the *interpretations* of the code. [Paragraphs .12–.18](#) in this section define and provide examples, which are not all inclusive, of each of these *threat* categories. In certain circumstances, the code specifies that because of the type of *threat* and its potential effect, either no *safeguards* can eliminate or reduce the *threat* to an *acceptable level*, or a *member* would need to apply specific *safeguards* to eliminate or reduce an *independence threat* to an *acceptable level*. When *independence interpretations* in the code address one of these examples, a specific reference to the *independence interpretation* is provided in brackets after that example. If an example does not contain a specific reference to an *independence interpretation*, a *member* should use this “Conceptual Framework for Independence” interpretation to evaluate whether a *threat* is significant.

.12 **Adverse interest threat.** The *threat* that a *member* will not act with objectivity because the *member’s* interests are in opposition to the interests of an *attest client*. An example is either the *attest client* or the *member* commencing litigation against the other or expressing the intent to commence litigation. [[1.290.010](#)]

.13 **Advocacy threat.** The *threat* that a *member* will promote an *attest client’s* interests or position to the point that his or her *independence* is compromised. Examples of advocacy *threats* include the following:

- a. A *member* promotes the *attest client’s* securities as part of an initial public offering. [[1.295.130](#)]
- b. A *member* provides expert witness services to an *attest client*. [[1.295.140](#)]
- c. A *member* represents an *attest client* in U.S. tax court or other public forum. [[1.295.160](#)]

.14 **Familiarity threat.** The *threat* that, because of a long or close relationship with an *attest client*, a *member* will become too sympathetic to the *attest client’s* interests or too accepting of the *attest client’s* work or product. Examples of familiarity *threats* include the following:

- a. A *member* of the *attest engagement team* has an *immediate family member* or *close relative* in a *key position* at the *attest client*, such as the *attest client’s* CEO. [[1.270.020](#) and [1.270.100](#)]
- b. A *partner* or *partner equivalent* of the *firm* has been a *member* of the *attest engagement team* for a prolonged period.
- c. A *member* of the *firm* has recently been a director or an officer of the *attest client*. [[1.277.010](#)]
- d. A *member* of the *attest engagement team* has a close friend who is in a *key position* at the *attest client*.

.15 **Management participation threat.** The *threat* that a *member* will take on the role of *attest client* management or otherwise assume management responsibilities for an *attest client*. Examples of management participation *threats* include the following:

- a. A *member* serves as an officer or a director of the *attest client*. [1.275.005]
- b. A *member* accepts responsibility for designing, implementing, or maintaining internal controls for the *attest client*. [1.295.030]
- c. A *member* hires, supervises, or terminates the *attest client's* employees. [1.295.135]

.16 **Self-interest threat.** The *threat* that a *member* could benefit, financially or otherwise, from an interest in, or relationship with, an *attest client* or persons associated with the *attest client*. Examples of self-interest *threats* include the following:

- a. A *member* has a *direct financial interest* or material *indirect financial interest* in the *attest client*. [1.240.010]
- b. A *member* has a *loan* from the *attest client*, an officer or a director of the *attest client*, or an individual who owns 10 percent or more of the *attest client's* outstanding equity securities. [1.260.010]
- c. A *member* or his or her *firm* relies excessively on revenue from a single *attest client*.
- d. A *member* or *member's firm* has a material joint venture or other material joint business arrangement with the *attest client*. [1.265]

.17 **Self-review threat.** The *threat* that a *member* will not appropriately evaluate the results of a previous judgment made, or service performed or supervised by the *member* or an individual in the *member's firm* and that the *member* will rely on that service in forming a judgment as part of an *attest engagement*. Certain self-review *threats*, such as preparing *source documents* used to generate the *attest client's financial statements* [1.295.120], pose such a significant self-review *threat* that no *safeguards* can eliminate or reduce the *threats* to an *acceptable level*.

.18 **Undue influence threat.** The *threat* that a *member* will subordinate his or her judgment to that of an individual associated with an *attest client* or any relevant third party due to that individual's reputation or expertise, aggressive or dominant personality, or attempts to coerce or exercise excessive influence over the *member*. Examples of undue influence *threats* include the following:

- a. Management threatens to replace the *member* or *member's firm* over a disagreement on the application of an accounting principle.
- b. Management pressures the *member* to reduce necessary audit procedures in order to reduce audit fees.
- c. The *member* receives a gift from the *attest client*, its management, or its significant shareholders. [1.285.010]

## SEC Rules and Examples

### SEC Independence Rules: 210.2-01 (c)(3)

(3) Business relationships. An accountant is not independent if, at any point during the audit and professional engagement period, **the accounting firm or any covered person in the firm has any direct or material indirect business relationship** with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders. The relationships described in this paragraph **do not include a relationship in which the accounting firm or covered person in the firm provides professional services to an audit client or is a consumer in the ordinary course of business.**

#### 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:

[AICPA Staff Note: Examples 1-8 and 13-22 not presented]

#### 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.

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### 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 Lease Relationship Scenarios**

1. The firm, a member of the attest engagement team or an individual in a position to influence the engagement has a material real estate lease with an attest client.
2. The firm has a material computer equipment lease with an attest client. The computer lease is material to the firm, but not material to the attest client.
3. The firm has a material copier lease with an attest client. The lease is not material to the firm, but is material to the attest client.
4. The managing partner of a firm has an automobile lease his family's vehicles through a local automobile dealership that is not a lending institution as defined by the AICPA Code. The leases are collateralized by the automobiles. In the aggregate, the automobile leases are material to the managing partner's net worth.
5. A covered member who provides 15 hours of non-attest services to the attest client but is not otherwise a covered member has a minority interest in an LLC that has a lease with the attest client. The lease is material to the attest client and the LLC, but the minority interest in the LLC is not material to the covered member.
6. A tax practice partner in the same office as the audit engagement partner (i.e. a covered member) controls an LLC that leases office space to the attest client. The tax partner is not connected to the attest engagement and does not provide any services to the attest client. The lease is material to the attest client and the LLC, and the LLC is also material to the tax practice partner or the attest client's financial statements.
7. The firm leases office space from a landlord entity for a period of time. Upon a subsequent renewal of the lease, the landlord entity requests that the firm bid on its financial statement audit. When the landlord client receives the bid, the landlord offers to significantly reduce the rental rate in the renewal if the firm caps the proposed audit fees at a certain amount, and promises to refer firm clients to the attest client to help the attest client's business. The firm offsets the cap in audit fees by reducing audit procedures regarding the collectability of receivables and other areas of the engagement.
8. The firm along with select partners controls an LLC that owns an office building that the firm also occupies. The LLC is material to the firm and the partners. The LLC leases the remaining space to the attest client for 5 years. Upon the first renewal, the market is such that the firm is not likely to find a new tenant for many months, which will have a significant financial impact on the LLC and the firm. With this knowledge, the attest client tenant threatens to leave the property if the firm does not reduce its audit fees or audit procedures, or provide pro bono tax services for individuals in key positions.

**AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS  
DIVISION OF PROFESSIONAL ETHICS  
PROFESSIONAL ETHICS EXECUTIVE COMMITTEE  
OPEN MEETING MINUTES  
NOVEMBER 3-4, 2016  
AUSTIN, TX**

The Professional Ethics Executive Committee (Committee) held a duly called meeting on November 3-4, 2016. The meeting convened 8:30 a.m. and concluded at 5:00 p.m. on November 3<sup>rd</sup> and reconvened at 8 a.m. and concluded at 10:00 a.m. on November 4<sup>th</sup>.

<p><b><u>Attendance:</u></b>  Samuel L. Burke, Chair  Carlos Barrera  Stanley Berman  Michael Brand  Tom Campbell  Richard David  Robert E. Denham  Anna Dourdourekas  Janice Gray  Greg Guin  Brian S. Lynch</p>	<p>William Darrol Mann  Andrew Mintzer  Jarold Mittleider  Steven Reed* (November 4<sup>th</sup> only)  James Smolinski  Laurie Tish  Shelly Van Dyne  Blake Wilson</p> <p><b><u>Not In Attendance:</u></b>  Jana Dupree</p>
<p><b><u>Staff:</u></b>  Lisa Snyder, Director  Susan Coffey, Exec. VP – Public Practice  James Brackens, VP - Ethics &amp; Practice Quality  Jason Evans, Sr. Technical Manager</p>	<p>Shelley Truman, Coordinator  Ellen Gorla, Sr. Manager  Brandon Mercer, Technical Manager*  April Sherman, Technical Manager*  Shannon Ziemba, Technical Manager*  James West, Technical Manager*</p>
<p><b><u>Guests:</u></b>  Jeff Lewis, Chair, Independence/Behavioral Standards Subcommittee  Ian Benjamin, Chair, Technical Standards Subcommittee  Kelly Hnatt, Counsel  Nancy Miller, KPMG  Dan Dustin, VP State Board Relations, NASBA  Catherine Allen, Audit Conduct (November 3<sup>rd</sup> only)  Sonja Araujo, PwC  Harrison Greene, FDIC  David L. Patrick, Cyber Accountants  George Dietz, PwC*  Vassilios Karapanos, SEC*  Debra Hann, GT*  Cynthia Waer, Deloitte*  Jennifer Beneke, EY* (November 3<sup>rd</sup> only)  Vince DiBlanda, Deloitte* (November 4<sup>th</sup> only)  *Via Phone</p>	

**1. Definition of Client**

Mr. Mintzer gave an overview of the Task Force's recommended edits to the definition of client and attest client. Mr. Mintzer explained that the Task Force is not fundamentally changing the

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definition of client but recommends making two clarifying changes to the definition. One change is to clarify to members that when the engaging entity and target entity are not the same, there are two clients, not one. The other clarification is to relocate the government exception from the client definition to the simultaneous employment interpretation. The Committee expressed concern over the use of the term “target entity” since it is not a defined term and some believed it had too many connotations. It was recommended and agreed to use the term “subject entity” instead of “target entity.” To accommodate the proposed change of potentially having two clients as part of one engagement, the Task Force recommended revisions to the Records Request interpretation and clarifications on how the Confidential Client Information Rule should be applied in this situation.

Mr. Mintzer explained that the Task Force is recommending that the term “attest client” only be the “subject entity” of an attest engagement. The Committee agreed with the Task Force that the independence rules and interpretations should only be applied to the subject entity. Mr. Mintzer further explained to the Committee that if the engaging entity is not the subject entity, then the member would only be required to be objective and free of conflicts of interest with regard to the engaging entity which is similar to the treatment for engaging entities in the Application of the Independence Rule to Engagements Performed in Accordance With SSAEs” [1.297.010] when the engaging entity and responsible party are not the same.

The Committee moved, seconded and unanimously approved to expose the revised definitions of client and attest client, the Records Request interpretation, the Disclosing Information to Persons or Entities Associated with Clients interpretation of the Confidential Client Information Rule as well as the other related changes proposed by the Task Force. It was further agreed that the exposure draft should be issued as soon as possible and the comment period should run through May 15, 2017.

## **2. Information Technology and Cloud Services**

### *Hosting Services*

Due to time constraints, the Committee did not have an opportunity to provide the Task Force with feedback on many of the questions posed by the Task Force. However, the Committee did recommend that the Task Force clarify what components of “management responsibilities” are impacted when providing hosting services and to develop guidance, authoritative or otherwise, that if the member was the sole repository of the client’s schedules or ledgers, the member would be providing hosting services.

### *Information Technology Services*

Although the Committee did not have time to discuss the strawman, it was suggested that the Task Force consider the appearance of independence when providing information technology services associated with a large commercial off-the-shelf (COTS) such as, Oracle.

## **3. Cybersecurity Services**

Ms. Tish reported that the while the Cybersecurity Task Force believes that the guidance in the Nonattest Services subtopic appears to be sufficient for use by members to determine if their cybersecurity related services would impair independence, the Task Force could develop non-authoritative guidance, such as FAQs related to cybersecurity. The Committee agreed that it would be beneficial for members if FAQs were developed to address common cybersecurity-related nonattest services. The Task Force was asked to develop FAQs for the Committee to consider at its February 2017 meeting.

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#### 4. **Part C Task Force – IESBA Convergence**

Mr. Berman noted that at the July 2016 meeting of the PEEC, the Task Force reviewed the revisions made by the IESBA to Part C of the IESBA Code. The newly revised and new sections of the IESBA Code are titled: Section 320, *Preparation and Presentation of Information* and Section 370, *Pressure to Breach the Fundamental Principles*. Mr. Berman noted that based on the feedback of the PEEC from the previous meeting, the Task Force proposed revisions to the *Knowing Misrepresentations in the Preparation and Presentation of Information* interpretation and drafted a new proposed interpretation, *Pressure to Breach the Rules*. Mr. Berman stated that the AICPA's Business and Industry Executive Committee reviewed the proposed standards and presented no concerns.

Mr. Berman reviewed the content of the proposed revisions in the *Knowing Misrepresentations in the Preparation and Presentation of Information* interpretation and asked the Committee for feedback. A member of the PEEC questioned a bullet point in proposed paragraph .04 which states that a member should not use discretion to achieve inappropriate outcomes in: "Selecting or changing an accounting policy or method among two or more alternatives permitted under the applicable financial reporting framework. For example, selecting a policy for accounting for long-term contracts in order to misrepresent profit or loss." The PEEC member inquired as to why the proposed guidance would put into question the use of accounting policies that are permitted under the applicable financial reporting framework.

Mr. Evans noted that the Task Force proposed deletion of the respective bullet point at the previous meeting of the PEEC, however, one member of the Committee had requested its inclusion.

Ms. Snyder noted that while the IESBA was developing the guidance, results of studies were presented showing that CFOs had admitted to using certain accepted accounting policies to present positive financial results for their company.

After review and discussion of all of the bullet points (i.e., examples) within the respective paragraph in question, the Committee agreed to remove all of the bullet points due to fact that that they place into question the acts of a member who is performing accepted practices within the profession, which could create confusion. The PEEC did agree, however, to include two specific examples within the exposure draft document to explain the meaning of the paragraph.

Mr. Berman reviewed the content of the new proposed interpretation, *Pressure to Breach the Rules*, and asked the Committee for feedback. Mr. Burke inquired if the Task Force deliberately changed the term "inducements," as used in the IESBA Code, to "gifts" as used in the proposed guidance. Ms. Snyder replied noting that the term "gifts" is used in the extant AICPA Code and the term "inducements" was previously viewed by the PEEC as having a negative connotation.

Ms. Coffey asked if the Task Force believed the IESBA Code's guidance is broader due to the use of the term "inducements" as opposed to "gifts." Ms. Snyder confirmed that inducements is a broader term, however, the IESBA is presently drafting guidance concerning inducements which will be considered by the PEEC upon release.

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There being no further discussion or comments, it was moved, seconded and unanimously approved to expose the proposed guidance, as amended above, with an effective date of the last day of the month in which the guidance is published in the Journal of Accountancy.

## 5. Leases

Mr. Wilson reported on the activities of the Leases Task Force.

### *Revision Option 2 – Capital Leases and Material Operating Leases Impair Independence*

Mr. Wilson discussed the Task Force's position on issues raised with Revision Option 2. Revision Option 2 retained the extant standard's reference to GAAP lease categorization, while adding language to indicate that materiality is also a factor. Mr. Wilson indicated that the Task Force's discussions on these issues resulted in the formulation of Revision Option 3, which retained materiality as a factor but proposed elimination of the concept of capital/finance and operating leases from the standard (see below).

### *Normal Course of Business*

The Task Force recommended excluding the term "normal course of business" from the guidance. Mr. Wilson explained that the Task Force viewed usage of the term as likely to add confusion, and that the existing terminology ("terms and conditions are comparable with other leases of a similar nature") adequately addresses the concerns of arm's length transactions and "sweetheart deals." It was noted that the extant AICPA Code uses "normal business operations" to describe loan operations of a lending institution in the Loans and Leases Interpretation. One PEEC member expressed concern that if this is the only lease an audit client makes, it may not be at arm's length, and the extant language regarding "comparable" terms and conditions with other similar natured leases may not address that concern. Another PEEC member questioned how to compare leases of a similar nature if the entity is not in the business of leasing, and expressed concern of applying such a safeguard when there are no other leases to compare, other than leases of other entities. After brief discussion of additional topics (see below), the PEEC did not come to a consensus to include or exclude the term "normal course of business" in the revision(s), but will further discuss the issue as the project proceeds.

### *Materiality*

Mr. Wilson noted that PEEC previously expressed its preference for a revised standard that is conceptual or principles-based in nature and that PEEC did not disagree with the Task Force's view that leases are similar to other business relationships where materiality is a significant factor impacting independence, while the GAAP categorization of the lease is not. Mr. Wilson noted that materiality drives objectivity much more so than whether the lease meets GAAP criteria for a capital lease.

In the course of discussing materiality, Mr. Wilson noted that the extant AICPA standard is not consistent in this regard with IESBA, SEC, or GAO. Mr. Wilson further noted that GASB is issuing its final leases standard in 2016, pointing out that the GASB standard does not include the concept of finance or operating leases. PEEC members agreed that if the concept of GAAP lease categories remains in the Code, and GAAP is revised again in the future, PEEC may need to revise the Code again as well. PEEC agreed after some discussion that principles-based guidance without reference to capital/finance/operating leases is appropriate. Mr. Wilson noted that the Task Force had prepared a Revision Option 3 that reflected this approach. Mr. Wilson presented Option 3 and indicated the Task Force's support

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of the conceptual approach in Option 3, which eliminates the extant references to GAAP lease categorization.

During the PEEC discussion, one member expressed concerns that the construct of Option 3 provided a safe harbor for other leases that are immaterial leases, and felt that the criteria a.-c. should be deleted. The member stated (and another agreed) that the revision should take a threats/safeguards approach to *all* leases; i.e. For both material and other leases, a threats/safeguards approach should be applied with certain minimal requirements. After brief discussion, PEEC requested that the Task Force revise the guidance to reflect this approach. In addition, the PEEC requested that the Task Force provide examples that will facilitate discussion of the approach and threats to independence. Mr. Wilson agreed that the Task Force would revisit the issues discussed and bring a revised proposal to the next meeting with some examples to assist in the discussion.

#### **6. Entities Included in State and Local Government (SLG) Financial Statements**

Ms. Miller provided the Committee with an overview of the Task Force's current direction including its proposed definition of a "primary government". She noted that the proposed revisions would provide guidance related to the independence requirements when a fund or component unit is excluded from the financial reporting entity but is required to be included under the financial reporting framework.

Ms. Miller also explained that the revised guidance would require independence be maintained with respect to entities that members presently do not have to remain independent of. For example, when considering "downstream" entities, the Task Force believes that even when a member makes reference to another auditor's report for a fund or component unit, independence should be maintained with respect to any fund or component unit that is material to the primary government and the primary government has more than minimal influence over the fund or component unit's accounting or financial reporting process. In this situation, however, the Task Force believes that members could still provide the fund or component unit with nonattest services that would impair independence provided it is reasonable to conclude the nonattest services will not be subject to the attest procedures.

Ms. Miller also explained that with regard to "upstream" entities, the Task Force believes that independence should be maintained when the financial statement attest client is material to the primary government and the primary government has more than minimal influence over the accounting or financial reporting process of the financial statement attest client.

Ms. Miller went on to explain that the Task Force believes the interpretation should clarify when members need to extend the independence rules to investments held by state and local government entities.

The Committee requested that the Task Force obtain feedback on the proposal from practitioners in the SLG discipline including smaller firm practitioners.

#### **7. IESBA Update**

Ms. Snyder reported on the IESBA's September 2016 meeting. She noted the following:

##### *Long Association of Audit Firm Personnel with an Audit Client*

The IESBA unanimously approved final changes to the Code relating to the three remaining issues that were included in the February 2016 re-Exposure Draft, *Limited Re-exposure of*



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*Proposed Changes to the Code Addressing the Long Association of Personnel with an Audit Client.* She explained that these issues were: the duration of the cooling-off period for the engagement quality control reviewer (EQCR) on the audit of a public interest entity (PIE); whether to allow a reduction in the cooling-off period for engagement partners (EPs) and EQCRs on PIE audits where jurisdictions have established alternative requirements to address threats created by long association; and how long an individual should cool off from a PIE audit after having served in a combination of EP, EQCR or other key audit partner roles. Ms. Snyder explained that the revised provisions are subject to approval by the Public Interest Oversight Board (PIOB).

#### *Review of Safeguards in the Code*

The IESBA considered and provided feedback on a revised draft of the text of Phase 1 of its Safeguards project, comprising revisions to the provisions in the extant Code relating to the conceptual framework and the application of the conceptual framework to professional accountants in public practice (PAPPs). Topics discussed included: the description of the reasonable and informed third party; the description of the term “safeguards;” and the relationship between conditions, policies and procedures established by the profession, legislation, regulation and the firm, and the professional accountant’s identification and evaluation of threats. Ms. Snyder reported that the IESBA also considered a second-read draft of revisions to proposed Section 600, *Provisions of Non-assurance Services to an Audit Client* (Phase 2) and safeguards-related conforming amendments to other areas of the Code.

#### *Structure of the Code*

The IESBA considered a further analysis of respondents’ comments on its December 2015 Exposure Draft *Improving the Structure of the Code of Ethics for Professional Accountants – Phase 1* (ED-1) and related Task Force proposals on Phases 1 and 2 of the project, including a revised draft of the restructured text in ED-1. The IESBA broadly supported the direction of the Task Force’s proposals. Topics discussed included: clarification of the provisions in the introductions to the sections of the restructured Code regarding compliance with the fundamental principles, maintaining independence where required and applying the conceptual framework; avoidance of repetition regarding the requirement to apply the conceptual framework; the ordering of requirements and application material; clarification of the scope of the International Independence Standards with respect to audits of specific elements, accounts or items of a financial statement; and the title of the restructured Code.

#### *Review of Part C of the Code*

The IESBA considered a third read of the restructured text of the Part C Phase 1 close-off document, including conforming amendments arising from the Safeguards project, and a revised explanatory paragraph clarifying how Part C applies to PAPPs. The IESBA also discussed proposed refinements to the glossary definition of the term “professional accountant in business” (PAIB). The IESBA broadly supported the revised restructuring proposals.

The IESBA also considered a revised “straw man” outlining a proposed approach to developing enhancements to extant Section 350, *Inducements*.

#### *Responding to Non-Compliance with Laws and Regulations (NOCLAR)*

The IESBA considered a draft of the restructured text of its recently issued Sections 225 and 360 on NOCLAR, prepared using the proposed new Structure format for the Code. The IESBA also provided input on draft IESBA Staff Q&A publications intended to form part of the tools

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and resources it has agreed to commission to facilitate implementation of the NOCLAR provisions.

#### *Professional Skepticism*

The IESBA was briefed on feedback to the International Auditing and Assurance Standards Board's (IAASB's) Invitation to Comment, *Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism* as it relates to professional skepticism. The IESBA considered preliminary recommendations from the joint IAASB-IESBA-International Accounting Education Standards Board (IAESB) Professional Skepticism Working Group (PSWG) regarding actions that the three standard-setting boards could take, individually and in coordination, to enhance the application of professional skepticism in their respective standards. It also considered a "straw man" that outlined how the concept of professional skepticism could be enhanced in the Code. In addition, it discussed the merits of a short-term initiative to develop enhancements to the Code relating to the application of professional skepticism as it pertains to audit and other assurance engagements. The IESBA asked its representatives on the PSWG to explore the feasibility of developing the short-term enhancements for potential inclusion in an Exposure Draft to be issued contemporaneously with the Phase 2 Exposure Draft of the restructured Code, scheduled for approval at the December 2016 IESBA meeting.

### **8. Compilation of Pro-Forma Financial Information and Specified Procedures Engagements**

Mr. Glynn explained that when performing an examination or review of pro-forma financial information, the engagement is performed under the SSAEs and so the modified level of independence is applicable. However, now that the standards related to compilations of pro-forma financial information were moved out of the SSAEs and into the SSARS, this lower level engagement is not afforded the modifications to independence. The Committee agreed that a Task Force should review the independence guidance applicable to engagements under the SSAEs and determine if it needs to be updated.

Mr. Glynn also explained that a project to develop a new service referred to as "Specified Procedures" is underway. He explained that while similar to an AUP engagement, it would provide more flexibility because the member would not be required to obtain an assertion from management or the responsible party. However, unlike AUPs, the report would not be required to be restricted. Mr. Glynn explained the project team would appreciate the Committee's input regarding whether it believes this new service would be afforded modified independence. He noted that the new standard is expected to be exposed in May 2017.

### **9. Non-compliance with Laws and Regulations (NOCLAR) Task Force**

Mr. Denham began presenting the topic noting that the Task Force provided two draft interpretations for the PEEC's consideration: 1.170.010, *Responding to Non-Compliance with Laws and Regulations* (for members in public practice) and 2.170.010 – *Responding to Non-Compliance with Laws and Regulations* (for members in business).

Mr. Denham spoke of highlights in the proposed guidance noting:

- A member in public practice is required to raise the issue of a NOCLAR within the ranks of the client;
- If the member in public practice is not comfortable with how a NOCLAR is addressed, the member should consider resigning from the engagement; and,
- A member in public practice is required to raise the issue of a NOCLAR within the firm



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Mr. Denham addressed the topic of overriding confidentiality in order to report a NOCLAR to an appropriate authority. At its previous meeting, the PEEC concluded that due to state confidentiality laws restricting such disclosure, the guidance should not permit such disclosure unless required by law. A member suggested that the guidance should include a statement that a member would be permitted to disclose a NOCLAR to an appropriate authority if done so with the consent of the client. Mr. Denham confirmed that the Task Force would amend the proposed guidance to include a reference to permitted disclosures included in the Confidential Client Rule.

There being no further discussion, Mr. Denham closed the discussion noting the Task Force would consider all comments of PEEC when revising the proposed guidance.

**10. Transfer of Client Files**

Mr. Mann raised concerns that the *Transfer of Files and Return of Client Records in Sale, Transfer, Discontinuance or Acquisition of a Practice* interpretation was inconsistent with the Confidential Client Information Rule in that it would permit a member to disclose confidential client information to the owners of the successor firm (without client consent) provided the member retained an ownership interest in the successor firm. Mr. Mann believes the Rule would require consent so if the Committee believes consent is not required if the member complies with the *Transfer of Files and Return of Client Records in Sale, Transfer, Discontinuance or Acquisition of a Practice* interpretation, the FAQ should specify such. The Committee directed staff to work with Mr. Mann to revise the FAQ to clarify that compliance with the interpretation would not result in violation of the Rule.

**11. Minutes of the Professional Ethics Executive Committee Open Meeting**

It was moved, seconded and unanimously carried to approve the minutes from the July 2016 open meeting.

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## Cybersecurity Services

### Cybersecurity Task Force Members

Laurie Tish (Chair), James Smolinski, Nancy Miller, Daimon Geopfert and Julie Winger.

Staff: Lisa Snyder and Ellen Gorla

### Task Force Charge

Determine if independence guidance should be developed related to the provision of nonattest cybersecurity services.

### Reason for Agenda Item

The Committee is asked to provide input on certain issues identified by the Task Force and on the draft FAQs.

### Summary of Issues

At its November 2016 meeting, the Committee requested the Task Force develop FAQs to assist members in determining whether the provision of nonattest cybersecurity services could impact their independence. Following are some of the issues the Task Force identified for the PEEC's consideration. The draft FAQs can be found in **Agenda Item 6B**. The FAQs are based on input received from firms on the types of activities being performed for clients related to cybersecurity.

### *Developing and Designing an Attest Client's Cybersecurity Program*

The Task Force has taken the position that assisting a client with the design and development of its cybersecurity policies and practices (e.g., based on benchmarking the client's current practices to established frameworks) would not impair independence provided the services are advisory in nature and the member complied with the [General Requirements for Performing Nonattest Services](#) interpretation. The Task also agreed that *accepting responsibility* for designing or developing the client's cybersecurity policies and practices would impair independence since the member would be assuming a management responsibility. The proposed FAQs in **Agenda Item 6B** reflect these positions.

### *Configuring a Client's Information System*

One of the cybersecurity services that members are performing for clients involve configuring a client's information system to reflect changes made to the client's cybersecurity program based upon the member's best practice review of the client's cybersecurity program. The Committee should note that the Task Force has intentionally focused on "configuration" services rather than "implementation services" which cover a broader spectrum of activities.

The Task Force did not reach a consensus regarding whether or not independence would be impaired if a member provided such services. Some members of the Task Force believed these activities would result in the member accepting responsibility for implementing the client's internal controls which would impair independence while others believed such activities are comparable to IT services whereby the member reconfigures existing systems controls to meet established standards that have been approved by the client. Provided any modifications to the source code are insignificant, some believe independence should not be considered impaired as similar activities would be permitted under the Information Systems Design, Implementation, or Integration interpretation [1.295.145]. It was noted, however, that on occasion the member might be required to customize the source code on a client's legacy system which could be considered

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significant modifications and beyond the client's technical expertise. The primary difference between typical IT configuration services and cybersecurity-related configuration services is that the cybersecurity services specifically involve modifications to controls.

The Committee may wish to note that its IT and Cloud Services Task Force (IT Task Force) is also deliberating independence matters as it relates to "configuration" services in an IT systems environment (see **Agenda Item 3D**). Specifically, that Task Force has discussed services involving configuration of a commercial off-the-shelf ("COTS") software solution (defined as "a software package developed, distributed, maintained and supported by a third party vendor). COTS solutions generally refer to traditional on-premises software that runs on a client's own computers or on a vendor's "cloud" infrastructure. COTS solutions range from software packages requiring only installation on a computer and ready to run or to large scale, complex enterprise applications.

The IT Task Force is proposing that "configuring a COTS software solution would involve selecting the software features, functionality options, and settings of the COTS software solution that determine how the software will perform certain transactions and process data. Configuring a COTS software solution would not generally involve developing new software code or features to modify or alter the functionality of the COTS software solution in ways not pre-defined by the vendor." The IT Task Force believes that when a member configures a COTS software solution, even if a financial information system, threats may be reduced to an acceptable level provided specific safeguards are applied.

The Committee is therefore asked to discuss and determine whether configuring an attest client's information system to reflect changes made to its cybersecurity program should be treated similar to the guidance under internal control services (which would typically result in an independence impairment) or rather, be treated similar to IT systems services which would not impair independence provided certain conditions and safeguards exist.

If the Committee believes the cybersecurity services should be treated similar to the IT systems services, then it would appear that as long as the attest client is using a COTS information system and all the requirements of the "[General Requirements for Performing Nonattest Services](#)" interpretation [1.295.040] are met, (including that all significant assumptions and matters of judgment are determined or approved by the attest client), the member could configure an attest client's COTS information system to reflect changes made to the client's cybersecurity practices without impairing independence. On the other hand, if the Committee believes such services are closer aligned to internal control services (i.e., accepting responsibility for implementing internal controls), independence would be impaired.

**Questions for the Committee**

1. Does the Committee believe cybersecurity services involving the configuration of a client's information system to reflect changes made to the client's cybersecurity practices should be treated comparable to IT systems services or internal control services for purposes of independence?
2. Should a FAQ be issued on this topic now or should it be deferred until the Committee adopts guidance related to configuration services as part of its broader IT and cloud services project?
3. Does the Committee agree with the answers to the proposed FAQs in **Agenda 6B** and if so, does the Committee approve issuing them as non-authoritative guidance?

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**Action Needed**

The Committee's feedback would be appreciated.

**Materials Presented:**

<b>Agenda Item 6A</b>	This agenda item
<b>Agenda Item 6B</b>	Draft FAQs

## CYBER SECURITY SERVICES

1. May a member provide general training or informational sessions on cybersecurity issues to an attest client without impairing independence?

Yes, provided the member's services are only advisory in nature and the member complies with the applicable interpretations under the Nonattest Services Subtopic [1.295] including the "[General Requirements for Performing Nonattest Services](#)" interpretation [1.295.040] and the [Advisory Services](#) interpretation [1.295.105]. For example, the member may provide informational training sessions related to guidance issued by the National Institute of Standards and Technology (NIST).  
[Added February 2017]

- 2a. May a member conduct a best practice review relating to an attest client's cybersecurity practices that would include benchmarking the client's current cybersecurity infrastructure and procedures against NIST Cybersecurity Framework (NIST CSF) or other established framework without impairing independence?

Yes, provided the member's services are only advisory in nature (i.e., only result in recommendations to the attest client) and the member complies with the applicable interpretations under the Nonattest Services Subtopic [1.295] including the "[General Requirements for Performing Nonattest Services](#)" interpretation [1.295.040] and the [Advisory Services](#) interpretation [1.295.105].

- 2b. Would a member's independence be impaired if the member configured an attest client's information system to reflect changes made to the client's cybersecurity practices resulting from the member's **best practice review** as described in FAQ 2a.?

TBD based on PEEC's discussion.

3. Would a member's independence be impaired if the member accepted responsibility for the design, development or implementation of an attest client's policies and procedures relating to cybersecurity threats and practices?

Yes. A member's independence would be impaired because the member would have assumed a management responsibility.

4. Would a member's independence be impaired if the member evaluated an attest client's cybersecurity program and provided advice and recommendations to the attest client on improving the company's policies, procedures and internal control relating to cybersecurity threats and practices?

No, provided the member's services are only advisory in nature and the member complies with the applicable interpretations under the Nonattest Services Subtopic [1.295] including the "[General Requirements for Performing Nonattest Services](#)" interpretation [1.295.040] and the [Advisory Services](#) interpretation [1.295.105].

5. Would a member's independence be impaired if the member provides an attest client with "attack and penetration" testing relating to its cybersecurity?

It depends. A member's independence would be impaired if the "attack and penetration" testing is done by performing ongoing evaluations of the client's controls as part of the client's monitoring activities. Ongoing evaluations monitor the presence and functioning of controls in the ordinary course of managing the client's business. These activities would result in the member accepting responsibility for maintaining the attest client's internal control which would be assuming a management responsibility.

However, the member may be able to provide "attack and penetration" testing without impairing independence if the testing is done by performing separate evaluations of the controls. The scope and frequency of such separate evaluations are a matter of judgment. They may be conducted periodically but unlike ongoing evaluations, are not routine operations built into the client's business processes. As with the provision of any nonattest service, the member would need to comply with the applicable interpretations under the Nonattest Services Subtopic [1.295] including the "[General Requirements for Performing Nonattest Services](#)" interpretation [1.295.040] and the "[Advisory Services](#)" interpretation [1.295.105].

**PROPOSED REVISION TO EXISTING FAQ (See **highlighted text**)**

**PROJECT MANAGEMENT SERVICES**

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

Yes, taking responsibility for the management of a client's project 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 how to improve the attest client's **infrastructure security**, (b) **providing advice about** either the tagging of XBRL-formatted or preparation of IFRSs-based financial statements, (c) providing feedback on management's plans, including how management will prioritize its activities, and (d) assisting the client with its understanding of the general considerations for the project (issued February 2010.)

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## Agenda Item 7A

### Transfer of Files and Return of Client Records in Sales, Transfer, Discontinuance or Acquisition of Practice

**Staff:** Lisa Snyder, Director, Professional Ethics Division, Public Accounting

#### Reason for Agenda Item

At the November meeting, it was reported that an inquiry from a state CPA society about the new [Transfer of Files and Return of Client Records in Sale, Transfer, Discontinuance or Acquisition of Practice](#) interpretation was received and sought the Committee's input on whether another FAQ should be issued to assist members with applying the new interpretation.

The hypothetical situation presented was whether the requirements of the interpretation would need to be complied with when one firm (Firm A) is acquired by another firm (Firm B) and only some of the partners from Firm A become partners of Firm B. While it was agreed that the intent of the interpretation was that as long as at least one partner from Firm A would become a partner in Firm B, the requirements of the interpretation did not apply, some concern was raised that the Transfer of Files and Return of Client Records in Sale, Transfer, Discontinuance or Acquisition of Practice interpretation was inconsistent with the Confidential Client Information Rule. Specifically, it was explained that the interpretation seemed to allow a member to disclose confidential client information to the owners of the successor firm (without client consent) provided the member retained an ownership interest in the successor firm. It was suggested that the FAQ clarify that it would not be a violation of the Rule.

#### Summary of Issues

Staff worked with Messrs. Barrera, Reed and Guin to develop the following FAQ to address the issue raised by the state society and the Committee.

#### TRANSFER OF CLIENT FILES IN A MERGER

**Question:** The "Confidential Client Information Rule" does not prohibit the review of a member's professional practice, which, per the "Disclosing Client Information in Connection with a Review or Acquisition of the Member's Practice" interpretation, includes a review performed in conjunction with a prospective purchase, sale, or merger of all or part of a member's practice. Would the "Confidential Client Information Rule" prohibit a member from disclosing confidential client information to the owners of the successor firm after the consummation of such a purchase, sale, or merger?

**Answer:** The "Confidential Client Information Rule" would not prohibit the member from disclosing confidential client information to the other owners of the successor firm after the purchase, sale, or merger of all, or part of, a member's practice, provided the member retains an ownership interest in the successor firm and complies with the requirements of the "Transfer of Files and Return of Client Records in Sale, Transfer, Discontinuance or Acquisition of a Practice."

#### Action Needed

Does the Committee's agree with the position reflected in the proposed FAQ?

#### Materials Presented

Agenda 10B – 1.400.205



### 1.400.205 Transfer of Files and Return of Client Records in Sale, Transfer, Discontinuance or Acquisition of a Practice

#### **Sale or Transfer of Member's Practice**

- .01 A *member* or *member's firm* (member) that sells or transfers all or part of the member's practice to another person, *firm*, or entity (successor firm) and will no longer retain any ownership in the practice should do all of the following:
- Submit a written request to each *client* subject to the sale or transfer, requesting the *client's* consent to transfer its files to the successor firm and, notify the *client* that its consent may be presumed if it does not respond to the member's request within a period of not less than 90 days, unless prohibited by law, including but not limited to the rules and regulations of the applicable state boards of accountancy. The member should not transfer any *client* files to the successor firm until either the *client's* consent is obtained or the 90 days has lapsed, whichever is shorter. The member is encouraged to retain evidence of consent, whether obtained from the *client* or presumed after 90 days.
  - With respect to files not subject to the sale or transfer, make arrangements to return any *client* records that the member is required to provide to the *client* as set forth in the "[Records Request](#)" interpretation [1.400.200] unless the member and *client* agree to some other arrangement.
- .02 In cases in which the member is unable to contact the *client*, *client* files and records not transferred should be retained in a confidential manner and in accordance with the *firm's* record retention policy or as required by applicable legal or regulatory requirements, whichever is longer. When practicing before the IRS or other taxing authorities or regulatory bodies, members should ensure compliance with any requirements that are more restrictive.

#### **Discontinuance of Member's Practice**

- .03 A member who discontinues his or her practice but does not sell or transfer the practice to a successor firm, should do all of the following:
- Notify each *client* in writing of the discontinuance of the practice. The member is encouraged to retain evidence of notification made to *clients*. The member is not required to provide notification to former *clients* of the *firm*.
  - Make arrangements to return any *client* records that the member is required to provide to the *client* as set forth in the "[Records Request](#)" interpretation [1.400.200] unless the member and *client* agree to some other arrangement.
- .04 In cases in which the member is unable to contact the *client*, *client* files should be retained in a confidential manner and in accordance with the *firm's* record retention policy or as required by applicable legal or regulatory requirements, whichever is longer. When practicing before the IRS or other taxing authorities or regulatory bodies, members should ensure compliance with any requirements that are more restrictive.

#### **Acquisition of Practice by a Member**

- .05 A member who acquires all or part of a practice from another person, *firm*, or entity (predecessor firm) should be satisfied that all *clients* of the predecessor firm subject to the acquisition have, as required in [paragraph .01](#), consented to the member's continuation of *professional services* and retention of any *client* files or records the successor firm retains
- .06 A member will be considered in violation of the "[Acts Discreditable Rule](#)" [1.400.001] if the member does not comply with any of the requirements of this interpretation.

#### **Effective Date**

- .07 This interpretation is effective June 30, 2017. Early implementation is allowed.

Nonauthoritative questions and answers related to form of communication and transfer of client files to another partner in the firm are available in the FAQ document at [www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf](http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics-General-FAQs.pdf).



**IFAC Convergence – Long Association**

**Task Force Members - TBD**

Staff: Jason Evans

**Proposed Task Force Charge**

The Task Force is charged with reviewing the International Ethics Standards Board for Accountants' (IESBA) standard entitled, Long Association of Personnel with an Audit or Assurance Client (Long Association) and recommend to PEEC revisions to the AICPA Code for purposes of convergence.

**Reason for Agenda Item**

To review the newly adopted guidance of the IESBA (the Board) concerning Long Association and consider the formation of a Task Force for the proposed charge noted above.

**Summary of Issues**

**Background**

The Public Interest Oversight Board (PIOB) approved the IESBA's Long Association standard on January 19, 2017. At its December 2016 meeting, the IESBA approved edits to two provisions of the Long Association proposal (as approved at the September 2016 meeting of the IESBA). These changes were in response to comments of the PIOB. The edits are as follows:

- The jurisdictional provision, which permitted a reduction of the cooling off period for engagement partners (EPs) on audits of public interest entities (PIEs) where jurisdictions have established alternative requirements to address threats created by long association was replaced with a revised formulation. The formulation retains the main objective of the original provision; for example, where a jurisdiction has established a cooling off period of less than five years, the higher of that period or three years may be substituted for the five year cooling off period, provided the applicable time on period does not exceed seven years; and,
- The withdrawal of the exception permitting, under certain strict conditions, an EP or an engagement quality control reviewer who has rotated off a PIE audit engagement to provide consultation to the engagement team on a technical or industry-specific issue after two years have elapsed during the cooling-off period.

The final long association provisions will be effective for periods beginning on or after December 15, 2018. Early adoption is permitted. However, the revised jurisdictional provision will have effect only for audits of financial statements for periods beginning prior to December 15, 2023. This transitional provision is intended to facilitate an eventual changeover to the cooling-off period of five years for the EP in those jurisdictions that have established a cooling-off period of less than five years.

**Staff Recommendation**

The PEEC is asked to read the IESBA's Long Association standard in Agenda Item 8B. The key points of the standard will be reviewed at the meeting.

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Staff recommends the PEEC agree to charge a task force to review the IESBA's Long Association standard as it relates to non-PIEs and recommend to PEEC revisions to the AICPA Code for purposes of convergence.

Staff does not believe it is necessary for the PEEC to consider the guidance concerning partner rotation for PIEs, as, the SEC has established (more restrictive) partner rotation requirements for PIEs (i.e., listed entities).

**Action Needed:**

1. The PEEC is asked to read Agenda Item 8B and consider forming a task force to undertake the proposed charge noted above.
2. The PEEC is asked to provide input as to whether the IESBA guidance pertaining to long association for non-PIEs should be contemplated for potential convergence.

**Materials Presented**

Agenda 8A – This Agenda Item

Agenda 8B – IESBA Long Association Standard

**Close-Off Document**  
*[January 2017]*

*International Ethics Standards Board for  
Accountants®*

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**Changes to the Code  
Addressing the Long  
Association of Personnel with  
an Audit or Assurance Client**



International  
Ethics Standards  
Board for Accountants®

This document was developed and approved by the International Ethics Standards Board for Accountants® (IESBA®).

The IESBA is an independent standard-setting board that develops and issues high-quality ethical standards and other pronouncements for professional accountants worldwide. Through its activities, the IESBA develops the *Code of Ethics for Professional Accountants™*, which establishes ethical requirements for professional accountants.

The objective of the IESBA is to serve the public interest by setting high-quality ethical standards for professional accountants and by facilitating the convergence of international and national ethical standards, including auditor independence requirements, through the development of a robust, internationally appropriate code of ethics.

This close-off document has received the approval of the Public Interest Oversight Board (PIOB), which concluded that due process was followed in the development of the document and that proper regard was paid to the public interest.

The structures and processes that support the operations of the IESBA are facilitated by the International Federation of Accountants® (IFAC®).

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**CHANGES TO THE CODE ADDRESSING THE LONG ASSOCIATION OF  
PERSONNEL WITH AN AUDIT OR ASSURANCE CLIENT**

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## **SECTION 290**

### **INDEPENDENCE—AUDIT AND REVIEW ENGAGEMENTS**

#### **(CLEAN)**

#### **Long Association of Personnel (Including Partner Rotation) with an Audit Client**

##### *General Provisions*

290.148 Familiarity and self-interest threats, which may impact an individual's objectivity and professional skepticism, may be created and may increase in significance when an individual is involved in an audit engagement over a long period of time.

Although an understanding of an audit client and its environment is fundamental to audit quality, a familiarity threat may be created as a result of an individual's long association as a member of the audit team with:

- The audit client and its operations;
- The audit client's senior management; or
- The financial statements on which the firm will express an opinion or the financial information which forms the basis of the financial statements.

A self-interest threat may be created as a result of an individual's concern about losing a longstanding client or an interest in maintaining a close personal relationship with a member of senior management or those charged with governance, and which may inappropriately influence the individual's judgment.

290.149 The significance of the threats will depend on factors, individually or in combination, relating to both the individual and the audit client.

(a) Factors relating to the individual include:

- The overall length of the individual's relationship with the client, including if such relationship existed while the individual was at a prior firm.
- How long the individual has been a member of the engagement team, and the nature of the roles performed.
- The extent to which the work of the individual is directed, reviewed and supervised by more senior personnel.
- The extent to which the individual, due to the individual's seniority, has the ability to influence the outcome of the audit, for example, by making key decisions or directing the work of other members of the engagement team.
- The closeness of the individual's personal relationship with senior management or those charged with governance.
- The nature, frequency and extent of the interaction between the individual and senior management or those charged with governance.

(b) Factors relating to the audit client include:

- The nature or complexity of the client's accounting and financial reporting issues and whether they have changed.
- Whether there have been any recent changes in senior management or those charged with governance.
- Whether there have been any structural changes in the client's organization which impact the nature, frequency and extent of interactions the individual may have with senior management or those charged with governance.

290.150 The combination of two or more factors may increase or reduce the significance of the threats. For example, familiarity threats created over time by the increasingly close relationship between an individual and a member of the client's senior management would be reduced by the departure of that member of the client's senior management and the start of a new relationship.

290.151 The significance of any threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

- Rotating the individual off the audit team.
- Changing the role of the individual on the audit team or the nature and extent of the tasks the individual performs.
- Having a professional accountant who was not a member of the audit team review the work of the individual.
- Performing regular independent internal or external quality reviews of the engagement.
- Performing an engagement quality control review.

290.152 If a firm decides that the threats are so significant that rotation of an individual is a necessary safeguard, the firm shall determine an appropriate period during which the individual shall not be a member of the engagement team or provide quality control for the audit engagement or exert direct influence on the outcome of the audit engagement. The period shall be of sufficient duration to allow the familiarity and self-interest threats to independence to be eliminated or reduced to an acceptable level. In the case of a public interest entity, paragraphs 290.153 to 290.168 also apply.

#### *Audits of Public Interest Entities*

290.153 In respect of an audit of a public interest entity, an individual shall not act in any of the following roles, or a combination of such roles, for a period of more than seven cumulative years (the "time-on" period):

- (a) The engagement partner;
- (b) The individual appointed as responsible for the engagement quality control review; or
- (c) Any other key audit partner role.

After the time-on period, the individual shall serve a "cooling-off" period in accordance with the provisions in paragraphs 290.155 – 290.163.

- 290.154 In calculating the time-on period, the count of years cannot be restarted unless the individual ceases to act in any one of the above roles for a consecutive period equal to at least the cooling-off period determined in accordance with paragraphs 290.155 to 290.157 as applicable to the role in which the individual served in the year immediately before ceasing such involvement. For example, an individual who served as engagement partner for four years followed by three years off can only act thereafter as a key audit partner on the same audit engagement for three further years (making a total of seven cumulative years). Thereafter, that individual is required to cool off in accordance with paragraph 290.158.

#### Cooling-off Period

- 290.155 If the individual acted as the engagement partner for seven cumulative years, the cooling-off period shall be five consecutive years.
- 290.156 Where the individual has been appointed as responsible for the engagement quality control review and has acted in that capacity for seven cumulative years, the cooling-off period shall be three consecutive years.
- 290.157 If the individual has acted in any other capacity as a key audit partner for seven cumulative years, the cooling-off period shall be two consecutive years.

#### Service in a combination of key audit partner roles

- 290.158 If the individual acted in a combination of key audit partner roles and served as the engagement partner for four or more cumulative years, the cooling-off period shall be five consecutive years.
- 290.159 If the individual acted in a combination of key audit partner roles and served as the key audit partner responsible for the engagement quality control review for four or more cumulative years, the cooling-off period shall, subject to paragraph 290.160(a), be three consecutive years.
- 290.160 If an individual has acted in a combination of engagement partner and engagement quality control review roles for four or more cumulative years during the time-on period, the cooling-off period shall be:
- (a) Five consecutive years where the individual has been the engagement partner for three or more years; or
  - (b) Three consecutive years in the case of any other combination.
- 290.161 If the individual acted in any other combination of key audit partner roles, the cooling-off period shall be two consecutive years.

#### Service at a Prior Firm

- 290.162 In determining the number of years that an individual has been a key audit partner under paragraphs 290.153 to 290.154, the length of the relationship shall, where relevant, include time while the individual was a key audit partner on that engagement at a prior firm.

#### Position where Shorter Cooling-off Period is Established by Law or Regulation

- 290.163 Where a legislative body or regulator (or organization authorized or recognized by such legislative body or regulator) has established a cooling-off period for an engagement partner of less than five consecutive years, the higher of that period or three years may be substituted



for the cooling-off period of five consecutive years specified in paragraphs 290.155, 290.158 and 290.160(a) provided that the applicable time-on period does not exceed seven years.

#### Restrictions on Activities During the Cooling-off Period

290.164 For the duration of the relevant cooling-off period, the individual shall not:

- (a) Be a member of the engagement team or provide quality control for the audit engagement;
- (b) Consult with the engagement team or the client regarding technical or industry-specific issues, transactions or events affecting the audit engagement (other than discussions with the engagement team limited to work undertaken or conclusions reached in the last year of the individual's time-on period where this remains relevant to the audit);
- (c) Be responsible for leading or coordinating the firm's professional services to the audit client or overseeing the firm's relationship with the audit client; or
- (d) Undertake any other role or activity not referred to above with respect to the audit client, including the provision of non-assurance services, that would result in the individual:
  - (i) Having significant or frequent interaction with senior management or those charged with governance; or
  - (ii) Exerting direct influence on the outcome of the audit engagement.

The provisions of this paragraph are not intended to prevent the individual from assuming a leadership role in the firm, such as that of the Senior or Managing Partner.

#### Other Matters

290.165 There may be situations where a firm, based on an evaluation of threats in accordance with the general provisions above, concludes that it is not appropriate for an individual who is a key audit partner to continue in that role even though the length of time served as a key audit partner is less than seven years. In evaluating the threats, particular consideration shall be given to the roles undertaken and the length of the individual's association with the audit engagement prior to an individual becoming a key audit partner.

290.166 Despite paragraphs 290.153 – 290.161, key audit partners whose continuity is especially important to audit quality may, in rare cases due to unforeseen circumstances outside the firm's control, and with the concurrence of those charged with governance, be permitted to serve an additional year as a key audit partner as long as the threat to independence can be eliminated or reduced to an acceptable level by applying safeguards. For example, a key audit partner may remain in that role on the audit team for up to one additional year in circumstances where, due to unforeseen events, a required rotation was not possible, as might be the case due to serious illness of the intended engagement partner. The firm shall discuss with those charged with governance the reasons why the planned rotation cannot take place and the need for any safeguards to reduce any threat created.

290.167 When an audit client becomes a public interest entity, the length of time the individual has served the audit client as a key audit partner before the client becomes a public interest entity shall be taken into account in determining the timing of the rotation. If the individual has served the audit client as a key audit partner for a period of five cumulative years or less when the

client becomes a public interest entity, the number of years the individual may continue to serve the client in that capacity before rotating off the engagement is seven years less the number of years already served. If the individual has served the audit client as a key audit partner for a period of six or more cumulative years when the client becomes a public interest entity, the partner may continue to serve in that capacity with the concurrence of those charged with governance for a maximum of two additional years before rotating off the engagement.

- 290.168 When a firm has only a few people with the necessary knowledge and experience to serve as a key audit partner on the audit of a public interest entity, rotation of key audit partners may not be an available safeguard. If an independent regulator in the relevant jurisdiction has provided an exemption from partner rotation in such circumstances, an individual may remain a key audit partner for more than seven years, in accordance with such regulation, provided that the independent regulator has specified other requirements which are to be applied, such as the length of time that the key audit partner may be exempted from rotation or a regular independent external review.

**SECTION 291**  
**INDEPENDENCE—OTHER ASSURANCE ENGAGEMENTS**  
**(CLEAN)**

**Long Association of Personnel with an Assurance Client**

291.137 Familiarity and self-interest threats, which may impact an individual's objectivity and professional skepticism, may be created and may increase in significance when an individual is involved on an assurance engagement of a recurring nature over a long period of time.

A familiarity threat may be created as a result of an individual's long association with:

- The assurance client; or
- The subject matter and subject matter information of the assurance engagement.

A self-interest threat may be created as a result of an individual's concern about losing a longstanding assurance client or an interest in maintaining a close personal relationship with the assurance client or a member of senior management and which may inappropriately influence the individual's judgment.

291.138 The significance of the threats will depend on factors, considered individually or in combination, such as:

- The nature of the assurance engagement.
- How long the individual has been a member of the assurance team, the individual's seniority on the team, and the nature of the roles performed, including if such a relationship existed while the individual was at a prior firm.
- The extent to which the work of the individual is directed, reviewed and supervised by more senior personnel.
- The extent to which the individual, due to the individual's seniority, has the ability to influence the outcome of the assurance engagement, for example, by making key decisions or directing the work of other members of the engagement team.
- The closeness of the individual's personal relationship with the assurance client or, if relevant, senior management.
- The nature, frequency and extent of interaction between the individual and the assurance client.
- Whether the nature or complexity of the subject matter or subject matter information has changed.
- Whether there have been any recent changes in the individual or individuals who are the responsible party or, if relevant, senior management.

291.139 The combination of two or more factors may increase or reduce the significance of the threats. For example, familiarity threats created over time by the increasingly close relationship between an individual and the assurance client would be reduced by the departure of the person who is the responsible party and the start of a new relationship.

- 291.140 The significance of any threats shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards in relation to a specific engagement include:
- Rotating the individual off the assurance team.
  - Changing the role of the individual on the assurance team or the nature and extent of the tasks the individual performs.
  - Having a professional accountant who is not a member of the assurance team review the work of the individual.
  - Performing regular independent internal or external quality reviews of the engagement.
  - Performing an engagement quality control review.
- 291.141 If a firm decides that the threats are so significant that rotation of an individual is a necessary safeguard, the firm shall determine an appropriate period during which the individual shall not be a member of the engagement team or provide quality control for the assurance engagement or exert direct influence on the outcome of the assurance engagement. The period shall be of sufficient duration to allow the familiarity and self-interest threats to be eliminated or reduced to an acceptable level.

### **Effective Date**

Subject to the transitional provision below, paragraphs 290.148 to 290.168 are effective for audits of financial statements for periods beginning on or after December 15, 2018. Paragraphs 291.137 to 291.141 are effective as of December 15, 2018. Early adoption is permitted.

Paragraph 290.163 shall have effect only for audits of financial statements for periods beginning prior to December 15, 2023. This will facilitate the transition to the required cooling-off period of five consecutive years for engagement partners in those jurisdictions where the legislative body or regulator (or organization authorized or recognized by such legislative body or regulator) has specified a cooling-off period of less than five consecutive years.

## SECTION 290

### INDEPENDENCE—AUDIT AND REVIEW ENGAGEMENTS

#### (MARK-UP FROM RE-EXPOSURE DRAFT)<sup>1</sup>

#### Long Association of Personnel (Including Partner Rotation) with an Audit Client

##### *General Provisions*

290.148A Familiarity and self-interest threats, which may impact an individual's objectivity and professional skepticism, may be created and may increase in significance when an individual is involved in an audit engagement over a long period of time.

Although an understanding of an audit client and its environment is fundamental to audit quality, a familiarity threat may be created as a result of an individual's long association as a member of the audit team with:

- The audit client and its operations;
- The audit client's senior management; or
- The financial statements on which the firm will express an opinion or the financial information which forms the basis of the financial statements.

A self-interest threat may be created as a result of an individual's concern about losing a longstanding client or an interest in maintaining a close personal relationship with a member of senior management or those charged with governance, and which may inappropriately influence the individual's judgment.

290.149B The significance of the threats will depend on factors, individually or in combination, relating to both the individual and the audit client.

(a) Factors relating to the individual include:

- The overall length of the individual's relationship with the client, including if such relationship existed while the individual was at a prior firm.
- How long the individual has been a member of the engagement team, and the nature of the roles performed.
- The extent to which the work of the individual is directed, reviewed and supervised by more senior personnel.
- The extent to which the individual, due to the individual's seniority, has the ability to influence the outcome of the audit, for example, by making key decisions or directing the work of other members of the engagement team.
- The closeness of the individual's personal relationship with senior management or those charged with governance.
- The nature, frequency and extent of the interaction between the individual and senior management or those charged with governance.

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<sup>1</sup> February 2016 re-Exposure Draft, [\*Limited Re-Exposure of Proposed Changes to the Code Addressing the Long Association of Personnel with an Audit Client\*](#)

(b) Factors relating to the audit client include:

- The nature or complexity of the client's accounting and financial reporting issues and whether they have changed.
- Whether there have been any recent changes in senior management or those charged with governance.
- Whether there have been any structural changes in the client's organization which impact the nature, frequency and extent of interactions the individual may have with senior management or those charged with governance.

290.15048G The combination of two or more factors may increase or reduce the significance of the threats. For example, familiarity threats created over time by the increasingly close relationship between an individual and a member of the client's senior management would be reduced by the departure of that member of the client's senior management and the start of a new relationship.

290.15149A The significance of any threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

- Rotating the individual off the audit team.
- Changing the role of the individual on the audit team or the nature and extent of the tasks the individual performs.
- Having a professional accountant who was not a member of the audit team review the work of the individual.
- Performing regular independent internal or external quality reviews of the engagement.
- Performing an engagement quality control review.

290.15249B If a firm decides that the threats are so significant that rotation of an individual is a necessary safeguard, the firm shall determine an appropriate period during which the individual shall not be a member of the engagement team, or provide quality control for the audit engagement, or exert direct influence on the outcome of the audit engagement. The period shall be of sufficient duration to allow the familiarity and self-interest threats to independence to be eliminated or reduced to an acceptable level. In the case of a public interest entity, paragraphs 290.1530A to 290.16853 also apply.

#### ~~Audit Clients That Are Listed Entities~~ Audits of Public Interest Entities

290.1530A In respect of an audit of a ~~listed~~ public interest entity, an individual shall not act in any of the following roles, or a combination of such roles, not be a key audit partner for a period of more than seven cumulative years (the "time-on" period);

- (a) The engagement partner;
- (b) The individual appointed as responsible for the engagement quality control review; or
- (c) Any other key audit partner role.

aAfter which the time-on period, the individual shall serve a "cooling-off" period in accordance with the provisions in paragraphs 290.155 – 290.163.

~~Subject to paragraph 290.150D the cooling-off period shall be:~~

~~Five consecutive years for a key audit partner who during the time-on period acted as the engagement partner or the individual responsible for the engagement quality control review, in either capacity or a combination of these roles, for either (a) four or more years or (b) at least two out of the last three years.~~

~~Two consecutive years for a key audit partner who acted in any other combination of key audit partner roles during the time-on period.~~

290.154 In calculating the time-on period, the count of years cannot be restarted unless the individual ceases to act in any one of the above roles for a consecutive period equal to at least the cooling-off period determined in accordance with paragraphs 290.155 to 290.157 as applicable to the role in which the individual served in the year immediately before ceasing such involvement. For example, an individual who served as engagement partner for four years followed by three years off can only act thereafter as a key audit partner on the same audit engagement for three further years (making a total of seven cumulative years). Thereafter, that individual is required to cool off in accordance with paragraph 290.158.

#### Cooling-off Period

290.155 If the individual acted as the engagement partner for seven cumulative years, the cooling-off period shall be five consecutive years.

290.156 Where the individual has been appointed as responsible for the engagement quality control review and has acted in that capacity for seven cumulative years, the cooling-off period shall be three consecutive years.

290.157 If the individual has acted in any other capacity as a key audit partner for seven cumulative years, the cooling-off period shall be two consecutive years.

#### Service in a combination of key audit partner roles

290.158 If the individual acted in a combination of key audit partner roles and served as the engagement partner for four or more cumulative years, the cooling-off period shall be five consecutive years.

290.159 If the individual acted in a combination of key audit partner roles and served as the key audit partner responsible for the engagement quality control review for four or more cumulative years, the cooling-off period shall, subject to paragraph 290.160(a), be three consecutive years.

290.160 If an individual has acted in a combination of engagement partner and engagement quality control review roles for four or more cumulative years during the time-on period, the cooling-off period shall be:

(a) Five consecutive years where the individual has been the engagement partner for three or more years; or

(b) Three consecutive years in the case of any other combination.

290.161 If the individual acted in any other combination of key audit partner roles, the cooling-off period shall be two consecutive years.

~~*Audit Clients that are Public Interest Entities other than Listed Entities*~~

~~290.150B In respect of an audit of a public interest entity that is not a listed entity, an individual shall not be a key audit partner for more than seven years ("the time-on period"), after which the individual shall serve a cooling-off period.~~

~~Subject to paragraph 290.150D, the cooling-off period shall be:~~

- ~~• Five consecutive years for a key audit partner who during the time-on period acted as the engagement partner for either (a) four or more years or (b) at least two out of the last three years.~~
- ~~• Three consecutive years for a key audit partner who during the time-on period was responsible for the engagement quality control review for either:~~
  - ~~(a) Four or more years; or~~
  - ~~(b) At least two out of the last three years; or~~
  - ~~(c) Who acted in a combination of engagement partner and engagement quality control review roles for four years or more or at least two out of the last three years.~~
- ~~• Two consecutive years for a key audit partner who acted in any other combination of key audit partner roles during the time-on period.~~

~~*Audit Clients that are Public Interest Entities*~~Service at a Prior Firm

~~290.16250C~~ In determining the number of years that an individual has been a key audit partner under paragraphs 290.153 to 290.154, the length of the relationship shall, where relevant, include time while the individual was a key audit partner on that engagement at a prior firm.

Position where Shorter Cooling-off Period is Established by Law or Regulation

~~290.16350D~~ ~~An independent standard setter, regulator or~~ Where a legislative body or regulator (or organization authorized or recognized by such legislative body or regulator) may have evaluated the familiarity and self-interest threats to independence that arise from long association with an audit client and determined that a different set or combination of safeguards to those required in this Code are appropriate to reduce the threats to an acceptable level. In such circumstances, has established a cooling-off period for an engagement partner of less than five consecutive years, the higher of that period or three years may be substituted for the cooling-off periods of five consecutive years specified in paragraphs 290.150A and 290.150B 290.155, 290.158 and 290.160(a) provided that the applicable time-on period does not exceed seven years. ~~may be reduced to three consecutive years if an independent standard setter, regulator or legislative body has:~~

- ~~(a) Implemented an independent regulatory inspection regime; and~~
- ~~(b) Established requirements for either:~~
  - ~~(i) A time-on period shorter than seven years during which an individual is permitted to be the engagement partner or the individual responsible for the engagement quality control review; or~~



- ~~(ii) Mandatory firm rotation or mandatory re-tendering of the audit appointment at least every ten years.~~

#### Restrictions on Activities During the Cooling-off Period

290.16450E For the duration of the relevant cooling-off period, the individual shall not:

- (a) Be a member of the engagement team or provide quality control for the audit engagement;
- (b) Consult with the engagement team or the client regarding technical or industry-specific issues, transactions or events affecting the audit engagement (other than discussions with the engagement team limited to work undertaken or conclusions reached in the last year of the individual's time-on period where this remains relevant to the audit); ~~However, if an individual who has acted as the engagement partner or the individual responsible for the engagement quality control review is also, or becomes, an individual whose primary responsibility is to be consulted within a firm on a technical or industry-specific issue, the individual may provide such technical consultation to the engagement team provided:~~
  - ~~(i) Two years have elapsed since the individual was a member of the engagement team or the individual responsible for the engagement quality control review;~~
  - ~~(ii) There is no other partner within the firm expressing the audit opinion with the expertise to provide the advice; and~~
  - ~~(iii) Such consultation is in respect of an issue, transaction or event that was not previously considered by that individual in the course of acting as engagement partner or the individual responsible for the engagement quality control review;~~
- (c) Be responsible for leading or coordinating the firm's professional services to the audit client or overseeing the firm's relationship with the audit client; or
- (d) Undertake any other role or activity not referred to above with respect to the audit client, including the provision of non-assurance services, that would result in the individual:
  - (i) Having significant or frequent interaction with senior management or those charged with governance; or
  - (ii) Exerting direct influence on the outcome of the audit engagement.

The provisions of this paragraph are not intended to prevent the individual from assuming a leadership role in the firm, such as that of the Senior or Managing Partner.

#### Other Matters

290.1650F There may be situations where a firm, based on an evaluation of threats in accordance with the general provisions above, concludes that it is not appropriate for an individual who is a key audit partner to continue in that role even though the length of time served as a key audit partner is less than seven years. In evaluating the threats, particular consideration shall be given to the roles undertaken and the length of the individual's association with the audit engagement prior to an individual becoming a key audit partner.

290.16654 Despite paragraphs ~~290.150A and 290.150B~~ 290.153 – 290.161, key audit partners whose continuity is especially important to audit quality may, in rare cases due to unforeseen

circumstances outside the firm's control, and with the concurrence of those charged with governance, be permitted to serve an additional year as a key audit partner as long as the threat to independence can be eliminated or reduced to an acceptable level by applying safeguards. For example, a key audit partner may remain in that role on the audit team for up to one additional year in circumstances where, due to unforeseen events, a required rotation was not possible, as might be the case due to serious illness of the intended engagement partner. The firm shall discuss with those charged with governance the reasons why the planned rotation cannot take place and the need for any safeguards to reduce any threat created.

- 290.16752 When an audit client becomes a public interest entity, the length of time the individual has served the audit client as a key audit partner before the client becomes a public interest entity shall be taken into account in determining the timing of the rotation. If the individual has served the audit client as a key audit partner for a period of five cumulative years or less when the client becomes a public interest entity, the number of years the individual may continue to serve the client in that capacity before rotating off the engagement is seven years less the number of years already served. If the individual has served the audit client as a key audit partner for a period of six or more cumulative years when the client becomes a public interest entity, the partner may continue to serve in that capacity with the concurrence of those charged with governance for a maximum of two additional years before rotating off the engagement.
- 290.16853 When a firm has only a few people with the necessary knowledge and experience to serve as a key audit partner on the audit of a public interest entity, rotation of key audit partners may not be an available safeguard. If an independent regulator in the relevant jurisdiction has provided an exemption from partner rotation in such circumstances, an individual may remain a key audit partner for more than seven years, in accordance with such regulation, provided that the independent regulator has specified alternative safeguards other requirements which are to be applied, such as the length of time that the key audit partner may be exempted from rotation or a regular independent external review.

**SECTION 291**  
**INDEPENDENCE—OTHER ASSURANCE ENGAGEMENTS**  
**(MARK-UP FROM RE-EXPOSURE DRAFT)**

**Long Association of Personnel with an Assurance Client**

291.137A Familiarity and self-interest threats, which may impact an individual's objectivity and professional skepticism, may be created and may increase in significance when an individual is involved on an assurance engagement of a recurring nature over a long period of time.

A familiarity threat may be created as a result of an individual's long association with:

- The assurance client; or
- The subject matter and subject matter information of the assurance engagement.

A self-interest threat may be created as a result of an individual's concern about losing a longstanding assurance client or an interest in maintaining a close personal relationship with the assurance client or a member of senior management and which may inappropriately influence the individual's judgment.

291.1387B The significance of the threats will depend on factors, considered individually or in combination, such as:

- The nature of the assurance engagement.
- How long the individual has been a member of the assurance team, the individual's seniority on the team, and the nature of the roles performed, including if such a relationship existed while the individual was at a prior firm.
- The extent to which the work of the individual is directed, reviewed and supervised by more senior personnel.
- The extent to which the individual, due to the individual's seniority, has the ability to influence the outcome of the assurance engagement, for example, by making key decisions or directing the work of other members of the engagement team.
- The closeness of the individual's personal relationship with the assurance client or, if relevant, senior management.
- The nature, frequency and extent of interaction between the individual and the assurance client.
- Whether the nature or complexity of the subject matter or subject matter information has changed.
- Whether there have been any recent changes in the individual or individuals who are the responsible party or, if relevant, senior management.

291.1397C The combination of two or more factors may increase or reduce the significance of the threats. For example, familiarity threats created over time by the increasingly close relationship between an individual and the assurance client would be reduced by the departure of the person who is the responsible party and the start of a new relationship.

291.14037D The significance of any threats shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards in relation to a specific engagement include:

- Rotating the individual off the assurance team.
- Changing the role of the individual on the assurance team or the nature and extent of the tasks the individual performs.
- Having a professional accountant who is not a member of the assurance team review the work of the individual.
- Performing regular independent internal or external quality reviews of the engagement.
- Performing an engagement quality control review.

291.14137E If a firm decides that the threats are so significant that rotation of an individual is a necessary safeguard, the firm shall determine an appropriate period during which the individual shall not be a member of the engagement team, or provide quality control for the assurance engagement, or exert direct influence on the outcome of the assurance engagement. The period shall be of sufficient duration to allow the familiarity and self-interest threats to be eliminated or reduced to an acceptable level.

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