



BACKGROUND AND BASIS FOR CONCLUSIONS OUTSOURCING

NEW AND REVISED ETHICS RULINGS UNDER RULE 102 - INTEGRITY AND OBJECTIVITY, RULE 201 - GENERAL STANDARDS, RULE 202 - COMPLIANCE WITH STANDARDS AND RULE 301 – CONFIDENTIAL CLIENT INFORMATION

**ADOPTED BY THE AICPA PROFESSIONAL ETHICS EXECUTIVE COMMITTEE - JANUARY 26,
2005**

- Ethics Ruling No. 112 Under Rule 102 - Integrity and Objectivity (New)**
- Ethics Ruling No. 12 Under Rule 201 – General Standards and Rule 202 Compliance with Standards (New)**
- Ethics Ruling No. 1 Under Rule 301 – Confidential Client Information (Revised)**
- Ethics Ruling No. 5 Under Rule 301 – Confidential Client Information (Deleted)**

This document summarizes considerations that were deemed significant by the Professional Ethics Executive Committee (the Committee) during 2004 in the development of two new ethics rulings, Ethics Ruling No. 112 - *Use of Third-Party Service Provider to Assist a Member in Providing Professional Services* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.224-.225) and Ethics Ruling No. 12 - *Applicability of General and Technical Standards When Using a Third-Party Service Provider* (AICPA, *Professional Standards*, vol. 2, ET sec. 291.023-.024); revisions to Ethics Ruling No. 1 – *Computer Processing of Clients' Returns* (AICPA, *Professional Standards*, vol. 2, ET sec. 391.001-.002), and the deletion of Ethics Ruling No. 5 – *Records Retention Agency* (AICPA, *Professional Standards*, vol. 2, ET sec. 391.009-.010). It includes reasons for accepting certain recommendations for change and rejecting others and is intended to assist users in understanding the additions, revisions and deletions and the rationale for them.

BACKGROUND

1. In January 2004, the Committee added a project to its three-year agenda to study the issues associated with the use of third-party services providers by members when providing services to clients. The Committee initially focused on the issues of due professional care, confidentiality of client information, and the possibility of broadening existing guidance (Ethics Ruling No. 1, Under Rule 301 - Computer Processing of Clients' Returns) to apply to any outsourcing arrangements, not just the computer processing of clients' tax returns.
2. In addition, the Committee also considered issues such as information security concerns, internal controls used by outside service providers to safeguard information, policies and procedures of the member and/or member's firm to ensure compliance with standards, various types of services being outsourced by members (for example tax return preparation, financial statement preparation, bookkeeping, etc.), regulatory controls such as The Gramm-Leach-Bliley Act, outsourcing within the United States versus overseas, defining what is meant by outsourcing for purposes of the rules, and whether disclosure to the client or consent from the client should be required when using the services of third-party service providers.

BACKGROUND AND BASIS FOR CONCLUSIONS OUTSOURCING

-
3. The Committee appointed a task force to study these issues which included individuals from small, medium and large size firms with relevant expertise in these areas. To bring local regulatory perspectives to the reexamination process, a member associated with the National Association of State Boards of Accountancy (NASBA) was appointed to the task force. The task force also included one of the Committee's public members (non-CPA) to ensure that the public interest perspective was represented.
 4. Upon completing its examination of the relevant issues associated with the practice of outsourcing, on August 9, 2004 the Committee issued for public comment, an Omnibus Ethics Exposure Draft (Exposure Draft) with a 60-day comment period. The Exposure Draft proposed new ethics rulings under Rule 102, *Integrity and Objectivity*, Rule 201, *General Standards*, and Rule 202, *Compliance With Standards* and revisions to the existing Ethics Ruling No. 1, "Computer Processing of Clients' Returns," under Rule 301, *Confidential Client Information*, as follows:
 - a. The proposed ethics ruling under Rule 102, *Integrity and Objectivity*, would require that a member inform the client that he or she may use a third-party service provider when providing professional services to the client, prior to sharing confidential client information with the service provider.
 - b. The proposed ethics ruling under Rule 201, *General Standards*, and Rule 202, *Compliance With Standards*, would clarify the application of rules 201 and 202 to members who use a third-party service provider in providing professional services to clients, and make clear the Committee's position that the member is responsible for all work performed by the service provider.
 - c. The proposed revisions to Ethics Ruling No. 1, "Computer Processing of Clients' Returns," under Rule 301, *Confidential Client Information*, would update and broaden the application of the ethics ruling beyond that of an outside tax service bureau and make it applicable to any third-party service provider used by the member. The revised ethics ruling also would clarify that disclosing confidential client information to a third-party service provider for the purpose of providing professional services to clients or for administrative support purposes would not be in violation of rule 301; however, the member would be required to enter into a contractual agreement with the third-party service provider to maintain the confidentiality of the client's information, and use reasonable care in determining that the third-party service provider has appropriate procedures in place to prevent the unauthorized release of confidential client information
 5. The Committee received 49 comment letters on its proposal, and on October 28-29, 2004, a public meeting was held to discuss the comments and further deliberate the relevant issues. As a result of its deliberations, the Committee made certain modifications to the proposed revisions before adopting the final standards.

NEW AND REVISED ETHICS RULINGS ADOPTED BY THE COMMITTEE AND BASIS FOR CONCLUSIONS

6. The following revisions and additions to the Code of Professional Conduct were adopted by the Committee at its October 28-29, 2004. The provisions of these ethics rulings are effective for all professional services performed on or after July 1, 2005, except for professional services performed pursuant to agreements in existence on June 30, 2005 that are completed by December 31, 2005. Earlier application is encouraged.

BACKGROUND AND BASIS FOR CONCLUSIONS OUTSOURCING

- a. The Committee adopted new Ethics Ruling No. 112 under Rule 102, Integrity and Objectivity, which requires a member, prior to sharing confidential client information with the service provider, to inform the client, preferably in writing, that he or she may use a third-party service provider when providing professional services to the client. The ethics ruling also emphasizes that members are not required to inform clients of third-party service providers used only to provide administrative support services, such as record storage, software application hosting, and authorized e-file tax transmittal services, to the member.
- b. The Committee adopted new Ethics Ruling No. 12 under Rule 201, General Standards, and Rule 202, Compliance With Standards, which clarifies the application of rules 201 and 202 to members who use a third-party service provider in providing professional services to clients, and makes clear the Committee's position that the member is responsible for all work performed by the service provider. The ethics ruling does not however, extend the member's responsibility for planning and supervising the work of a third-party service provider beyond the requirements of applicable professional standards which may vary depending on the nature of the engagement.
- c. The Committee adopted revisions to Ethics Ruling No. 1 under Rule 301, Confidential Client Information which updates and broadens the application of the ethics ruling beyond that of an outside tax service bureau and makes it applicable to any third-party service provider used by the member, including those who provide only administrative support services. While the revised ethics ruling does not require that a member obtain specific client consent prior to disclosing confidential client information to a third-party service provider, it does require a member to enter into a contractual agreement with the third-party service provider to maintain the confidentiality of the client's information. The ethics ruling also requires that members be reasonably assured that the third-party service provider has appropriate procedures in place to prevent the unauthorized release of confidential client information

Defining Third-Party Service Providers

7. A “third-party service provider” is defined by the Committee as any entity that the member individually or collectively with his or her firm, does not control (as defined by U.S. GAAP), and any individual who is not employed by the member. Accordingly, the ethics rulings would apply where a member uses an outside firm or individual to perform for example, a physical inventory observation, input client tax return information for the member, or uses a specialist engaged by the member.
8. With respect to defining a third-party service provider “entity,” the Committee agreed that the criteria used should be consistent with an existing provision of the Code of Professional Conduct; specifically Interpretation 505-2, Application of rules of conduct to members who own a separate business. This interpretation requires that where a member has an interest in an entity that allows the member individually or collectively with his or her firm or with members of his or her firm to control (as defined by U.S. GAAP) that entity, then that entity and other owners and employees must comply with all provisions of the Code. Thus for purposes of the outsourcing rulings, the Committee concluded that if an entity is subject to the control of the member or the member’s firm, that entity is considered to be part of the firm and accordingly, would not be considered a third-party service provider. This crucial underpinning of the rule provisions acknowledge and support the notion that when a client engages a firm to provide services; the client expects that those services will be provided by the member, or partners or employees of the member’s firm. The Committee considered concerns of certain large multi-national firms with respect to overseas related entities that are not controlled by the U.S. firm.

BACKGROUND AND BASIS FOR CONCLUSIONS OUTSOURCING

Specifically, members of these firms questioned the rationale for considering such related entities to be third-party service providers when these affiliates are subject to the same controls and policies of the U.S. firm. The Committee concluded that the notion of “control” was appropriate under these circumstances and therefore such overseas affiliates should be subject to the rule provisions.

9. A number of commenters expressed concern that the Exposure Draft defined “individual” third-party service providers as individual(s) not employed by the member or the member’s firm and therefore would scope in individual contractors such as those utilized by a firm during tax busy season. Some viewed this provision as unfairly targeting smaller firms which may not possess the financial resources to “hire” temporary help during busy periods in their business cycle. The Committee gave significant consideration to this issue, and concluded that although individual contractors are frequently viewed by firms as being employee equivalents and subject to the firm’s control with respect to the professional services they provide, it was crucial to utilize clear-cut distinctions as to who was and who was not considered to be a third-party service provider. Accordingly, the Committee agreed that independent contractors would be considered third-party service providers for purposes of the rules whereas employees of the firm would not.
10. Although representatives of federal and certain state governments and the media have focused much attention on the issue of “offshoring” (i.e., outsourcing services outside the United States), the Committee believed it was appropriate to focus on the ethical issues when a member uses the services of a third-party service provider and not address the geopolitical concerns associated with outsourcing. Accordingly, the definition of third-party service provider applies to service providers located both domestically and abroad, but not to controlled entities or employees located outside of the United States.

Broadening the Scope of the Guidance beyond Outside Tax Service Bureaus

11. Consistent with the position taken by AICPA General Counsel Richard I. Miller and Senior Vice President - Member and Public Interests, Alan Anderson in their paper, Legal and Ethical Considerations Regarding Outsourcing, the proposed and adopted rules broadened the scope of services covered beyond tax services. Prior to the revision, Ethics Ruling No.1 under Rule 301 – Computer Processing of Clients’ Returns was limited to the use of outside service bureaus to process client tax returns.
12. Additionally, the Committee proposed and adopted final rules which include “related clerical and data entry functions” as part of the rendering of professional services, because it is generally believed that providing such functions involves reviewing and processing a client’s confidential information and those who perform these functions are deemed to have an active role in the preparation of the final work product, regardless of whether these services require no professional judgment or are ministerial in nature.
13. The Committee noted during its deliberations that when that guidance was developed many years ago, affordable computer systems and internet technology which facilitate the use of third-party service providers were still in their infancy. Today, aided by technological improvements and advances in overnight delivery services, third-party service providers located worldwide are now readily accessible by firms of any size, to perform a wide range of services for firms. Many firms have begun to use such service providers to provide the full spectrum of services to their clients which in many cases allows for faster turn-around of work.

BACKGROUND AND BASIS FOR CONCLUSIONS OUTSOURCING

Professional Services versus Administrative Support Services

14. The proposed and adopted rules distinguish between the use of third-party service providers who assist in providing professional services to clients and those used for administrative support services. The Committee considered services such as record storage, software application hosting, or authorized e-file tax transmittal services to be administrative support functions (as differentiated from related clerical and data entry functions – see paragraph No. 12) because these services are used primarily for the purpose of providing internal support functions for the firm and do not involve an active role in the preparation of a work product for a client.
15. The Committee concluded it was appropriate to exclude third-party service providers used solely for purposes of providing administrative support functions from the provisions of the adopted rulings with the exception of the revisions to Ethics Ruling No. 1, under Rule 301, Confidential Client Information (see paragraph Nos. 17 and 24).

Client Disclosure

16. As previously noted, the Committee believes that when a member is engaged to perform professional services the client expects that those services will be provided by the member, or partners or employees of the member's firm. Conversely, if the firm makes use of individuals and/or entities which do not meet the criteria as noted in paragraph No. 7 (and are accordingly classified as third-party service providers), the Committee believed that the client should be informed and given the opportunity to ask questions concerning the use of the service provider. The Committee believes this is consistent with the provisions of ET § 54 – Integrity of the Code of Professional Conduct, which requires a member be “among other things, honest and candid within the constraints of client confidentiality.” Accordingly, the new Ethics Ruling No. 112 under Rule 102, Integrity and Objectivity, requires that prior to sharing confidential client information with a third-party service provider; a member should inform the client that he or she may be using a third-party service provider when providing professional services to the client.
17. The Committee proposed and adopted final rules that do not require disclosure in the case where a third-party services provider is used solely to provide administrative support services such as record storage, software application hosting, or authorized e-file tax transmittal services. As noted in paragraph No. 14, the Committee concluded that utilizing service providers for these types of services should not require disclosure because the service provider does not have an active role in the preparation of a work product for the client.
18. The Committee did not propose or adopt any requirements regarding the specific items that must be disclosed, believing instead that if a member makes a good faith effort to inform the client that a third-party service provider may be used to provide professional services to the client, then the client would then have the opportunity to inquire about the details of the arrangement if he or she has questions or concerns regarding the use of the third-party provider.
19. Some commenters recommended that the required disclosure under Ethics Ruling No. 112 be “in writing.” While the Committee agreed that written disclosure was preferable, it did not believe there was any compelling argument to require members to prepare a written disclosure statement. Accordingly, Ethics Ruling No. 112 was revised to state that the member should inform the client “preferably in

BACKGROUND AND BASIS FOR CONCLUSIONS OUTSOURCING

writing” that he or she may use a third-party provider. The Committee also acknowledged that where the member does provide disclosure to the client in writing, the format for such written disclosure should be left to the member’s discretion and may be included in a client engagement letter, in a tax organizer, in the disclosure required under the Gramm Leach Bliley Act, or in a separate disclosure statement.

The Use of Specialists

20. The proposed rules included guidance in Ethics Ruling No. 12 under Rule 201, General Standards and Rule 202, Compliance with Standards, to enhance and underscore a long standing position that a member is responsible for any and all services performed for his or her clients regardless of whether the member uses the services of a third-party service provider. Some commenters expressed concern that as written, the ruling provisions seemed to imply that a member using a third-party service provider for a task outside the member’s area of expertise was being held to a higher standard than currently required by professional standards. The Committee acknowledged that this was not its intent and the final rule was revised to explicitly state that the member’s responsibility for planning and supervising the work of a third-party service provider does not extend beyond what is currently required by applicable professional standards.

Client Consent

21. A number of comment letters raised the issue of whether specific client consent should be obtained when using third-party service providers. The provisions under Ethics Ruling No.1 under Rule 301, Computer Processing of Clients’ Returns had long held that using an outside service bureau for processing client tax returns would not constitute the release of confidential client information and therefore would not require specific client consent in accordance with the provisions of Rule 301, Confidential Client Information. The Committee remained committed to this belief and therefore concluded that specific client consent would not be required provided the member enters into a contractual agreement with the service provider to maintain the confidentiality of the client’s information (see paragraph 23) and the member is reasonably assured that the service provider has appropriate procedures in place to prevent the unauthorized release of confidential client information (see paragraphs 23 and 26).
22. Where a member does not enter into a confidentiality agreement with the third-party service provider, specific client consent would be required prior to disclosing confidential client information to the service provider (see paragraph 25).

Contractual Agreement to Maintain Confidentiality and Reasonable Assurance that Appropriate Policies and Procedures are in Place

23. The Committee also remained committed to the belief that members remain responsible to obtain reasonable assurance that confidential client information will not be disclosed by the third-party service provider. Accordingly, the proposed and final rules contain a provision that requires the member to enter into a “contractual agreement” with the third-party service provider to maintain the confidentiality of the client’s information, and be “reasonably assured” that the third-party service provider has the necessary policies and procedures in place to prevent the unauthorized release of confidential information.
24. The Committee believes it is important that the contractual agreement be entered into prior to the release of client information to the third-party service provider. The Committee also believed that it was

BACKGROUND AND BASIS FOR CONCLUSIONS OUTSOURCING

appropriate to extend this requirement to all third-party service providers – i.e., those who perform professional services to clients as well as those who provide administrative support functions to the firm. Specifically, the Committee believes that whenever confidential client information is turned over to a third-party service provider, the member should take all necessary precautions to prevent the release of that information to any unauthorized individual or entity.

25. The Committee also discussed the issue of what a member should do when despite his or her best efforts; the member is unable to enter into the required contractual agreement with a third-party service provider. Under such circumstances, the Committee believed that the member should obtain the specific consent of the client prior to the release of any information. Accordingly the final rules require that where a member does not enter into a contractual arrangement with the third-party service provider, he or she would be required to obtain specific client consent prior to the release of the client's confidential information to the service provider.
26. The Committee recognized that the extent of research necessary for members to obtain the necessary level of assurance that a third-party service provider has appropriate policies and procedures in place to adequately safeguard the client's confidential information may depend on a number of factors including but not limited to available public information. In the absence of publicly available information regarding such policies and procedures, the Committee believes it is the responsibility of the member to perform the research necessary such as making appropriate inquiries and reviewing the service provider's security policies and procedures to be satisfied that the service provider has implemented appropriate policies and procedures to safeguard client information.

Deletion of Ethics Ruling No. 5 – Records Retention Agency under Rule 301

27. The Committee deleted Ethics Ruling No. 5 – Records Retention Agency under Rule 301 because the guidance has been incorporated into the revised Ethics Ruling No.1 under Rule 301.

Transition

28. The Committee agreed that the provisions of these ethics rulings should be effective for all professional services performed on or after July 1, 2005, except for professional services performed pursuant to agreements in existence on June 30, 2005 that are completed by December 31, 2005. The Committee encouraged early application where possible.