



Professional Ethics Division

Exposure draft:

Proposed new and revised definitions and interpretations

Compliance audits

New definition "compliance audit"

New definition "compliance audit attest client"

Revised definition "financial statement attest client"

Revised "Client Affiliates" interpretation

Revised "State and Local Governments Client Affiliates" interpretation

June 3, 2022

Comments are requested by September 1, 2022

ethics-exposedraft@aicpa.org

Invitation to comment

June 3, 2022

If you're an AICPA member or someone interested in the ethics of auditing and accounting, we want to hear your thoughts on this ethics exposure draft.

The proposed changes are part of the AICPA Professional Ethics Executive Committee's (PEEC's) project to consider independence when performing compliance audits.

This exposure draft is an explanation of the proposed revisions to the AICPA Code of Professional Conduct and the full text of the guidance being considered.

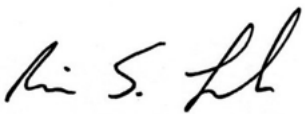
After the exposure period concludes and PEEC has evaluated the comments, PEEC may decide to publish the new definitions, revised definition, and revised interpretations.

Your comments are an important part of the standards-setting process; please take this opportunity to comment. Responses must be received at the AICPA by September 1, 2022. All written replies to this exposure draft will become part of the public record of the AICPA and will be available at www.aicpa.org/peecprojects. PEEC will consider comments at its subsequent meetings.

Please email comments to ethics-exposureDraft@aicpa.org.

You may also submit comments via our online form at www.aicpa.org/ethicscomments.

Sincerely,



Brian S. Lynch, Chair
Professional Ethics Executive Committee



Toni Lee-Andrews, CPA, PFS, CGMA
Director, Professional Ethics Division

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Explanation of the new definitions, revised definition, and revised interpretations

The number of compliance audits is on the rise.¹ Applying extant independence guidance in the AICPA Code of Professional Conduct (code) to compliance audits can be overly cumbersome and is currently being approached inconsistently.²

As a result, after outreach to members and careful consideration, the Professional Ethics Executive Committee (PEEC) is proposing changes to the code that will provide both clarity and relief to members who perform these audits by aligning requirements with applicable risks.

PEEC believes that the public will be better served by a membership that approaches these audits in a consistent manner.

With these considerations in mind, PEEC is exposing for comment two new definitions and minor related revisions to one definition and two interpretations.

- New definition *compliance audit* (ET sec. 0.400.09)
- New definition *compliance audit attest client* (ET sec. 0.400.10)
- Revised definition of *financial statement attest client* (ET sec. 0.400.18, currently 0.400.16)
- Revised “Client Affiliates” interpretation (ET sec. 1.224.010)
- Revised “State and Local Government Client Affiliates” interpretation (ET sec. 1.224.020)

¹ The Government Audit Quality Center believes that as many as 10,000 or more new compliance audits could be required because of COVID-19 relief funding. In addition, funding from the Infrastructure Investment and Jobs Act is also expected to increase the number of compliance audits.

² In December 2020, the AICPA Professional Ethics Division polled members who perform compliance audits to gain an understanding of how they are applying the extant code’s independence requirements to compliance audits. Approximately 50% of members polled believe additional guidance is necessary. Further, the results showed that there are inconsistent practices in the following three areas: (1) Determining which entities the independence requirements should apply to in a compliance audit; (2) Performing a compliance audit and an audit of the financial statements for the same attest client. Approximately 50% of members believe that evaluating independence related to the financial statement audit is sufficient. The other half believes that a separate evaluation is necessary for the compliance audit; (3) Performing a compliance audit only (meaning that another firm performs the audit of the entities’ financial statements). Eighty percent of members that perform these engagements believe that the evaluation of independence in the compliance audit is the same as the evaluation of independence in the entity’s financial statement audit.

The new definitions, the revised definition, and the two revised interpretations will be applicable to members in public practice.

Overview

1. For members performing compliance audits, the changes will provide relief from compliance with
 - a. the “Independence Rule” (ET sec. 1.200.001) and its interpretations with respect to any entity that
 - i. is not subject to compliance audit procedures and
 - ii. which reports trivial and clearly inconsequential amounts.
 - b. the requirements in the “Affiliates, including State and Local Government Affiliates” subtopic (ET sec. 1.224).
2. The scope of the proposed new definitions, the revised definition, and the two revised interpretations is specific to compliance audits performed under the Statements on Auditing Standards, regardless of whether the auditor also performs the audit of the client’s financial statements prepared in accordance with the applicable financial reporting framework (also referred to as a “financial statement audit”).
3. Independence requirements are unchanged when an attest engagement is performed on a reporting entity’s financial statements prepared in accordance with the applicable financial reporting framework (for example, generally accepted accounting principles).

What is a compliance audit?

4. A compliance audit is an attest engagement that is performed under the Statements on Auditing Standards when the member is asked to report on an entity’s compliance with specific requirements.
5. For example, the member may report on compliance requirements of a contractual agreement or regulatory requirements in accordance with AU-C section 806, or report on compliance under governmental audit requirements such as Uniform Guidance, in accordance with AU-C section 935.
6. In addition to reporting under AU-C section 806 or 935, for example, the compliance audit engagement may also require reporting on the accuracy of a schedule, such as a schedule of expenditure of federal awards, or statement, under AU-C section 725 or 805.
7. Specific examples of compliance audits may include the following:

- a. Audits subject to the U.S. Department of Housing and Urban Development *Consolidated Audit Guide*
- b. Audits subject to the U.S. Department of Education Office of Inspector General *Guide For Audits of Proprietary Schools and For Compliance Attestation Engagements of Third-Party Servicers Administering Title IV Programs*
- c. Single audits under the Uniform Guidance³
- d. Program-specific audits under Uniform Guidance

What is a compliance audit attest client?

8. The proposed term “compliance audit attest client” is defined as an entity with respect to which a compliance audit is performed unless the entity
 - a. is not subject to compliance audit procedures and
 - b. reports amounts that are trivial and clearly inconsequential.

Objective of a compliance audit

9. The reporting objective and use of a compliance audit differs from the objective and use of a financial statement audit.
10. A financial statement audit includes reporting on whether the financial statements are fairly stated in their entirety.
11. Third parties, such as investors or lenders or funding organizations, rely on financial statement audits to obtain assurance over the audit client’s financial statements (for example, financial position, changes in net position, and cash flows).
12. In contrast, a compliance audit focuses on compliance with identified requirements, such as those contained in Uniform Guidance. Although the compliance audit may include reporting on a schedule or statement, this reporting is not usually the primary objective of the compliance audit engagement.
13. The schedule or statement is often used to determine the scope of the compliance audit procedures. Those compliance audit procedures are performed for financial and nonfinancial measures, as specified in the identified requirements, that may be driving the amounts reported on the schedule or statement itself.
14. As a result, those who use compliance audits rely on the results of compliance with the

³ Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*

identified requirements, rather than on financial position or operating results.

15. For example, funding organizations often rely on compliance audits to provide assurance on the entity's compliance with applicable compliance requirements of grants, contracts, or agreements.
16. Because the objective of a compliance audit is different from the objective of a financial statement audit, PEEC believes two exceptions should be allowed, as discussed in the following section.

Exceptions

Not subject to audit and trivial and clearly inconsequential exception

17. An entity must meet two criteria to qualify for the exception in the definition of compliance audit attest client:
 - a. It must be an entity that is not subject to compliance audit procedures.
 - b. The amounts the entity is reporting must be trivial and clearly inconsequential.
18. A compliance audit may include multiple entities in the reporting entity's schedule or statement. For example, in a compliance audit performed in accordance with Uniform Guidance for a state and local government, there may be multiple entities (departments, agencies, component units) that include amounts in the reporting entity's schedule of expenditures of federal awards (SEFA).
19. Using the applicable compliance audit requirements, auditors determine which entities are subject to compliance audit procedures. A reporting entity's schedule or statement is often used in making this determination.
20. One or more of the entities reporting amounts on the reporting entity's schedule or statement may be reporting trivial and clearly inconsequential amounts.
21. The auditor should use professional judgment to determine what amounts are considered trivial and clearly inconsequential.
22. Entities reporting trivial and clearly inconsequential amounts could be subject to compliance audit procedures. For example, this may occur when an entity reports federal program amounts that are included in a federal program cluster that is subject to compliance procedures in an audit performed in accordance with Uniform Guidance.
23. If an entity with respect to which a compliance audit is performed reports trivial and clearly inconsequential amounts but is subject to compliance audit procedures, it is a compliance

audit attest client and independence is required with respect to that entity.

24. When an entity that is not subject to compliance audit procedures reports trivial and clearly inconsequential amounts, threats created from relationships or circumstances with the entity are unlikely to be significant given the objective of a compliance audit.
25. An exception was deemed appropriate to more closely align the cost of compliance with the potential threats.
26. Thus, the proposed definition provides an exception when both criteria are met.

Application example of the “not subject to audit and trivial and clearly inconsequential” exception

27. An auditor will consider the “not subject to audit and trivial and clearly inconsequential” exception in the definition of compliance audit attest client when identifying entities requiring independence in a compliance audit.
28. For example, a state government compliance audit subject to Uniform Guidance may include hundreds of entities (departments, agencies, component units) reporting federal program expenditures on a reporting entity’s SEFA. Federal program expenditures on the SEFA could total over \$1 billion.
29. Under Uniform Guidance, the auditor selects certain programs to be subject to compliance audit procedures.
30. If an entity reports two federal programs totaling \$1,000 in federal expenditures, for example, the auditor may consider that total amount to be trivial and clearly inconsequential. If considered trivial and clearly inconsequential and the entity is not subject to compliance audit procedures, the entity is not a compliance audit attest client.
31. All other entities would be considered compliance audit attest clients. Therefore, the auditor would be required to comply with the “Independence Rule” (ET sec. 1.200.001) and its interpretations (other than as described in paragraphs 32–40 below) with respect to such entities.

Affiliates exception

32. To qualify for the affiliates exception provided for in the proposed revision to the definition of “financial statement attest client,” the entity must meet the definition of “compliance audit attest client.”
33. Under the extant guidance, when a compliance audit engagement includes reporting on the accuracy of a schedule or a statement in connection with the compliance audit, the schedule or statement is a “financial statement” as defined in the code.

34. As a result, the client is a “financial statement attest client” as currently defined in the code. For clients that meet the definition of a “financial statement attest client,” the code requires that the auditor be independent of both the financial statement attest client and its affiliates. Therefore, the code currently requires the auditor to comply with the “Independence Rule” and its interpretations with respect to the compliance audit attest client’s affiliates as well.
35. Affiliates are not often responsible for the compliance audit attest client’s compliance with the requirements subject to the compliance audit.
36. Given that the primary objective of a compliance audit is to report on the client’s compliance with specific requirements, significant threats to independence generally do not exist for relationships and circumstances with affiliates of a compliance audit attest client.
37. PEEC deems an exception appropriate to more closely align the cost of compliance with the potential threats.
38. To implement the affiliates exception, PEEC is proposing revisions to exclude a compliance audit attest client from the definition of a “financial statement attest client.” If the proposed revisions are implemented, the requirements in the “Client Affiliates” interpretation (ET sec. 1.224.010) and the “State and Local Government Client Affiliates” interpretation (ET sec. 1.224.020) will not apply with respect to compliance audits and compliance audit attest clients.
39. Currently, attest clients in a compliance audit that includes reporting on the accuracy of a schedule or statement are considered “financial statement attest clients.” Therefore, PEEC is proposing revisions to the “Client Affiliates” interpretation (ET sec. 1.224.010) and the “State and Local Government Client Affiliates” interpretation (ET sec. 1.224.020) to highlight that the requirements do not apply in a compliance audit.
40. To encompass all attest engagements in which the requirements of these interpretations do not apply, the proposed revisions also include a reminder that the interpretations do not apply to engagements subject to the [“Independence Standards for Engagements Performed in Accordance with Statements on Standards for Attestation Engagements”](#) subtopic (ET sec. 1.297) of the “Independence Rule” (ET sec. 1.200.001).

Other situations

41. Upon encountering other relationships or circumstances that may create threats to independence, the member should apply the “Conceptual Framework for Independence” (ET sec. 1.210.010) to evaluate whether threats are at an acceptable level.
42. For example, when an entity that does not include amounts in the schedule or statement (and therefore does not meet the definition of a “compliance audit attest client”) supports a

compliance audit attest client in a way that results in that entity being subject to compliance audit procedures, the auditor should use the “Conceptual Framework for Independence” to evaluate threats to independence related to any relationships or circumstances that exist with such entity.

43. In a compliance audit subject to Uniform Guidance, there may be an entity that does not include amounts in the SEFA but provides support activities for a compliance audit attest client. Those activities, such as providing the accounting and financial reporting support for the client, may be subject to compliance audit procedures.
44. If the auditor is considering providing financial information system design services, for example, to an entity that is providing accounting and financial reporting support to the compliance audit attest client, the auditor should use the “Conceptual Framework for Independence” to evaluate whether threats are at an acceptable level or whether threats can be reduced to an acceptable level by applying appropriate safeguards.

Engagements performed under the Statements on Standards for Attestation Engagements

45. PEEC considered whether the proposed revisions for compliance audits are consistent with the requirements for similar engagements performed under the Statements on Standards for Attestation Engagements (SSAEs).
46. Specifically, PEEC considered whether the code should be revised to create an exception in such engagements for entities that are not subject to compliance attestation procedures and that report trivial and clearly inconsequential amounts.
47. Currently, the “Independence Standards for Engagements Performed in Accordance with Statements on Standards for Attestation Engagements” subtopic (ET sec. 1.297) applies to responsible parties, as defined in the SSAEs. The SSAEs state that a responsible party is a party responsible for the subject matter of the engagement.
48. PEEC concluded that an entity that is not subject to compliance attestation procedures is not a responsible party. PEEC is not proposing revisions to this subtopic.

Effective date

49. PEEC recommends that the proposed revisions be effective for compliance audits commencing after June 15, 2023, with early implementation allowed.

Request for comments

50. PEEC welcomes comments on all aspects of the proposed new definitions, the revised definition, and the two revised interpretations.
51. In addition, PEEC is seeking feedback on the following specific aspects of this proposal:

- a. Is the definition of “compliance audit” clear? If not, please explain how it should be clarified.
- b. Is the definition of “compliance audit attest client” clear? If not, please explain how it should be clarified.
- c. Do you agree that there should be an exception to the independence requirements in a compliance audit for entities that are not subject to compliance audit procedures and report amounts that are trivial and clearly inconsequential? If you disagree, please explain why.
- d. Do you agree that the affiliates interpretations should not apply in a compliance audit? If you disagree, please explain why.
- e. Do you agree that the revision in each of the affiliates interpretations serves as a useful reminder that these interpretations do not apply to specific attest engagements (e.g. compliance audits and engagements performed under the SSAEs)? If you disagree, please explain why.
- f. Do you agree that entities that are not subject to compliance attestation procedures in an engagement performed under the SSAEs are not considered responsible parties and therefore are not subject to the “Independence Standards for Engagements Performed in Accordance with Statements on Standards for Attestation Engagements” subtopic (ET section 1.297)? If you disagree, please explain why.
- g. Do you agree that the effective date provides adequate time to implement the proposals? If you disagree, please explain why.
- h. What independence requirements applicable to compliance audits would you like further explained through nonauthoritative guidance?

Text of proposed new definitions “compliance audit” and “compliance audit attest client”

0.400 Definitions

.09 **Compliance audit.** An [attest engagement](#) that is performed under the Statements on Auditing Standards when the [member](#) is requested to report on an entity’s compliance with specific requirements. For example, the *member* may report on compliance requirements of a contractual agreement or regulatory requirements in accordance with AU-C section 806, or report on compliance under governmental audit requirements, such as the Uniform Guidance, in accordance with AU-C section 935.

A compliance audit attest engagement may include multiple compliance audit attest clients. For example, multiple compliance audit attest clients may have amounts included in a schedule of expenditures of federal awards in a compliance audit performed in accordance with the Uniform Guidance.

.10 **Compliance audit attest client.** An entity with respect to which a *compliance audit* is performed, unless the entity

- a. is not subject to compliance audit procedures and
- b. reports amounts that are trivial and clearly inconsequential.

When an entity meets this definition, it is not considered a [financial statement attest client](#).

Proposed additions appear in ***bold italic text***. Deletions appear in ~~strikethrough~~.

Text of proposed revised definition “financial statement attest client”

0.400 Definitions

~~16.18~~ **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 definition does not include a compliance audit attest client.***

Text of proposed revised interpretation “Client Affiliates”

(Additions are presented in ***bold italic*** text.)

1.224.010 Client Affiliates

[Paragraphs .01–.04 are unchanged]

.05 This interpretation does not apply to a compliance audit or an engagement subject to the “Independence Standards for Engagements Performed in Accordance with Statements on Standards for Attestation Engagements” subtopic [1.297] of the “Independence Rule” [1.200.001].

[Paragraphs .05–.14 are renumbered as .06–.15 but are otherwise unchanged]

Text of proposed revised interpretation “State and Local Government Client Affiliates”

(Additions are presented in ***bold italic*** text.)

1.224.020 State and Local Government Client Affiliates

[Paragraphs .01–.06 are unchanged]

Exceptions

.07 This interpretation does not apply to a compliance audit or an engagement subject to the “Independence Standards for Engagements Performed in Accordance with Statements on Standards for Attestation Engagements” subtopic [1.297] of the “Independence Rule” [1.200.001].

[Paragraphs .07–.11 are renumbered as .08–.12 but are otherwise unchanged.]

Acknowledgments

Professional Ethics Executive Committee

Brian S. Lynch, Chair

Catherine Allen

Claire Blanton

Thomas Campbell

Robert E. Denham

Anna Dourdourekas

Anika Heard

Jennifer Kary

Jefferey Lewis

G. Alan Long

Nancy Miller

Randy Milligan

James Newhard

Stephanie Saunders

Katherine Savage

Lewis Sharpstone

Lisa Snyder

Peggy Ullmann

Dan W. Vuckovich

Douglas E. Warren

Lawrence A. Wojcik

Compliance Audits Task Force

Nancy Miller, Chair

Ian Benjamin

Ralph DeAcetis

Anna Dourdourekas

Staci Henshaw

Lee Klumpp

Flo Ostrum

Lewis Sharpstone

Brittney Williams

AICPA staff

Jennifer Kappler, Senior Manager – Professional Ethics

Melissa Powell, Manager – Professional Ethics

Michael Schertzinger, Manager – Professional Ethics

Many thanks

The Professional Ethics Division and PEEC are grateful for the input we received from observers and stakeholders while drafting these proposed changes to the AICPA Code of Professional Conduct.



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