

**AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
DIVISION OF PROFESSIONAL ETHICS
PROFESSIONAL ETHICS EXECUTIVE COMMITTEE
OPEN MEETING MINUTES
May 5 – 6, 2016
DURHAM, NC**

The Professional Ethics Executive Committee (Committee) held a duly called meeting on May 5, 2016. The meeting convened 9 a.m. and concluded at 4:30 p.m. The meeting reconvened on May 6th at 9 a.m. and concluded at 9:06 a.m.

<p><u>Attendance:</u> Samuel L. Burke, Chair Carlos Barrera Stanley Berman Michael Brand Tom Campbell Richard David Robert E. Denham Anna Dourdourekas Jana Dupree Brian S. Lynch William Darrol Mann</p>	<p>Andrew Mintzer* Lawrence I. Shapiro James Smolinski Shelly Van Dyne</p> <p><u>Not In Attendance:</u> Janice Gray Greg Guin Jarold Mittleider Steven Reed Laurie Tish</p>
<p><u>Staff:</u> Lisa Snyder, Director James Brackens, VP - Ethics & Practice Quality Michael Buddendeck, General Counsel Mike Jones, Assistant General Counsel Amy Pawlicki, Director - Business Reporting Assurance & Advisory Services**</p>	<p>Ellen Gorla, Sr. Manager Jason Evans, Sr. Technical Manager Liese Faircloth, Technical Manager Michele Craig, Technical Manager Brandon Mercer, Technical Manager April Sherman, Technical Manager Shannon Ziemba, Technical Manager James West, Technical Manager</p>
<p><u>Guests:</u> Jeff Lewis, Chair, Independence/Behavioral Standards Subcommittee Ian Benjamin, Chair, Technical Standards Subcommittee Nancy Miller, KPMG Dan Dustin, VP State Board Relations, NASBA Eric Holbrook, GAO Steven Booth, Independence/Behavioral Standards Subcommittee Jennifer Kary, Independence/Behavioral Standards Subcommittee Catherine Allen, Audit Conduct Blake Lewis, BDO Vincent DiBlanda, DT* Sonja Araujo, PwC* George Dietz, PwC* Edith Yaffe, E&Y* Stacey Lockwood, Louisiana* Vassilios Karapanos, SEC* Karen Liu, SEC* Chris Halterman**</p> <p style="text-align: center;">*Via Phone</p> <p style="text-align: center;">** Via Phone for the ASEC Cyber Security Working Group Discussion Only</p>	

1. **Definition of Client**

Mr. Mintzer explained to the Committee that after the last Committee meeting the Task Force realized there were possible independence consequences related to the entity that engages a member to perform an attest engagement (“engaging entity”) on another entity (“target entity”). Mr. Mintzer went on to explain that the Task Force had some specific questions for the Committee in order to assist the Task Force in deciding how to best move forward with the definition of client (currently contemplated as only including the engaging entity) and attest entity/attest client (currently contemplated as only including the target entity).

One Committee member asked if changes to the current definitions, aside from the government provision, were necessary. Another Committee member explained that under the current definitions a member would technically be required to show the target entity the member’s report for the attest engagement even if the member was engaged by a different entity to provide the attest engagement. This member noted that in previous discussions the Committee concluded this should no longer be permitted without the engaging entity’s consent.

Mr. Mintzer explained that although previously, the Task Force had recommended that the independence rules only apply to the target entity, after further thought, it might be more appropriate if at least some of the independence interpretations applied to the engaging entity that is not also the target entity.

One Committee member recommended that the independence rule and interpretations should apply to the engaging entity that is not also the target entity, similar to the Affiliates interpretation. Another Committee member suggested it might not be necessary to apply the independence interpretations specifically to the engaging entity because any independence interpretations would be captured under the Conflict of Interest interpretation of the Integrity and Objectivity Rule. Yet another Committee member, who is also a Task Force member, suggested the right answer might be requiring the member to apply the Conflict of Interest interpretation along with the financial interest interpretations of the Independence Rule to the engaging entity that is not also the target entity.

The question was then raised whether audit or review engagements should be addressed differently than other attest engagements. It was suggested that perhaps when performing an audit or review engagement, a member should apply the financial interest interpretations from the Independence Rule along with the Conflict of Interest interpretation to the engaging entity that is not also the target entity. But, with regards to all other attest engagements, members should only apply the Conflict on Interest interpretation to the engaging entity. Some members did not believe it was appropriate to only apply the Conflict of Interest interpretation in these situations.

A straw poll was taken which asked the Committee if they believed all the independence interpretations should apply to an engaging entity that is not also a target entity, if just some of the independence interpretations should be applied or if none of the independence interpretations should be applied. A majority of the Committee members voted that some of the independence interpretations should apply.

The Committee also discussed if the Task Force should take an “exception approach” or an “add-on approach.” The directive from the Committee was to have the Task Force recommend whether it made more sense for the guidance to conclude that members should

apply all the independence interpretations to the engaging entity that is not also a target entity, except for specific situations or for the guidance to conclude that members should only apply certain specific independence interpretations to these entities.

Mr. Mintzer explained that the Task Force will have an all-day in-person meeting in June to discuss these recommendations and decide on how to best proceed with the definitions. He hoped that the Task Force would be in a position to bring proposals to the July PEEC meeting that are ready for exposure.

2. Information Technology and Cloud Services

Hosting Services

Ms. VanDyne explained that based upon the feedback received from the Committee in February, the Task Force revised the proposal so that a member would be considered to be providing hosting services when a member has been engaged to either have custody or control over an attest client's data or records. This revision accommodates for situations where a member may not have both custody and control such as when the member has the ability to authorize disbursements of client funds from a bank. The Committee requested that the first occurrence be changed back to "custody and control" since this statement is explaining client management's responsibilities.

Ms. VanDyne also explained that an example was added to address the Committee's concern that a member not be considered to be providing hosting services when a portal is used to send a member's work product to a third party at the client's request. The Committee requested a minor revision to this example. The Committee also requested that the lead-in to the examples of situations that are not considered hosting services should stipulate that the examples included would not impair independence.

The Committee did not believe that a transition period was necessary. Rather, the Committee believed a delayed effective date would adequately address the Task Force's concern that the interpretation not be effective when issued but allow members time to discontinue providing hosting services before independence would be considered impaired.

A motion was made to expose the interpretation as revised by the Committee. The motion was seconded and unanimously passed.

Cloud Based Services

Ms. VanDyne explained that the Task Force believes the phrase "cloud based services" is appropriate and streamlined the text to address the Committee's concerns regarding readability. The Task Force was asked to determine if the guidance was really needed as many members of the Committee noted that they do not receive inquiries about this. The Committee agreed that if the Task Force continues to believe guidance is necessary, it should consider drafting guidance in the form of a FAQ instead of as an addition to the "Scope and Applicability of Nonattest Services" interpretation.

Off-the-Shelf

Ms. VanDyne went on to explain that the Task Force believes it would be helpful to provide guidance on what “install or integrate” could involve and what would be an “off-the-shelf” accounting package and the amount of customization that could be done to an “off-the-shelf” accounting package without impairing independence. For example, she noted the Task Force has begun discussing whether something more complex, such as an Oracle implementation where there is a lot of customization or configuration, would be covered.

None of the members of the Committee indicated that their firms are applying the “insignificant coding exception” found in the FAQ but one member noted that if the software permits changes to the coding or how the data works inside the software, then the software probably shouldn’t be considered off-the-shelf software. It was noted this is different than when the program allows one to decide which modules to activate or deactivate.

The Committee agreed that the Task Force should consider whether it could develop a project management FAQ that focused on providing information technology services or if it believes a separate task force should be appointed to address project management as a whole.

3. ASEC Cyber Security Working Group

Ms. Pawlicki and Mr. Halterman, the Chair of the ASEC Cyber Security Working Group joined the meeting.

Mr. Halterman explained that the Working Group is developing a guide on attestation standards for cybersecurity related work. He explained that these engagements can touch upon all aspects of IT including significant controls over financial reporting. He believes that almost all entities will require assistance with cybersecurity, which may be rendered either as attestation or consulting services. He explained that the Working Group would like to understand how the Code's independence rules address cybersecurity related work or if additional guidance is necessary. The Committee agreed that members should participate in a brainstorming session with AICPA subject matter experts to determine the types of nonattest services that would be performed and whether a task force should be appointed to consider possible amendments to the Code

4. Leases

Mr. Wilson explained that the Leases Task Force was re-established to evaluate the need to update the independence guidance in the AICPA Code related to leasing arrangements since FASB recently issued its final Leases Standard (the “Update”). The Update made significant accounting changes to leases effective after years beginning after December 2018 (public companies) and 2019 (private companies).

Impact of Accounting Treatment on Independence: Mr. Wilson explained that the existing independence guidance in the AICPA Code is based in part upon the accounting treatment of a lease and requested feedback regarding whether this continues to be appropriate. The Committee generally agreed that a bright-line independence distinction based upon the accounting treatment of a lease does not address the interests or relationship(s) under a leasing arrangement and thus may not adequately address the threats to independence. Several members agreed that leases should be evaluated based upon the nature of the lease or leasing relationship, rather than upon the accounting treatment of a lease. One member believed that all leases should be treated the same regardless of accounting treatment, and

an auditor should not be evaluating the auditor's payment of a future obligation to a financial statement attest client, given that those obligations are included in the client's financial statements, particularly if those items are material to the financial statements. Another member noted the extended effective date of the Update, and recommended that the Task Force approach leases as commercial transactions (rather than as loans or business relationships) and evaluate what impact newly entered leases will have on independence, rather than basing the evaluation upon the accounting treatment.

Materiality: Mr. Wilson asked the Committee for feedback on the position taken in the 2003 Exposure Draft, which contained a rejected proposal to revise the position on leases to be based on materiality. Committee members generally agreed that materiality of a lease has an impact on independence and should be a consideration included in any guidance proposed by the Task Force. The Committee agreed that materiality should not be defined rather, the Task Force should deliberate on the appropriate way to assess materiality of a lease for independence purposes. One member noted that the SEC independence rules allow certain immaterial real estate leases.

New Leases and Grandfathering Existing Leases: One member noted that leases already in existence should be grandfathered by applying the extant AICPA Code, and that the primary issue before the Committee is how to treat new leases. The member noted that the Task Force should provide guidance regarding newly entered leases, and apply the extant guidance to leases which are commenced prior to the effective date.

5. Entities Included in State and Local Government (SLG) Financial Statements

Ms. Miller provided the Committee with a recap of the overall structure of the SLG financial statements as well as some background regarding how the SLG environment differs from the typical FASB environment.

Ms. Miller then went on to explain that the Task Force believes that the SLG guidance should require members that are auditing the primary government to apply the independence rules to all funds and component units included or required to be included in the reporting entity under the applicable framework but then allow for some exceptions. She noted that this premise is similar to how the Client Affiliate interpretation treats entities covered by that interpretation.

Ms. Miller explained that the current guidance for SLGs does not require members monitor their independence with respect to any entities that the primary government is required to include but for some reason chooses to exclude. In such situations the Task Force is considering a change in position because it believes that members should remain independent of the excluded entity if the excluded entity is material to the primary government and the primary government has more than minimal influence over the accounting or financial reporting process of the excluded entity. However, the Task Force is considering including a provision that independence wouldn't be impaired if the member provided a prohibited nonattest service to the excluded entity if it is reasonable to conclude that the prohibited nonattest service will not be subject to audit procedures.

Ms. Miller further explained that the current day guidance for SLGs does not require members to monitor their independence with respect to any entities that are audited by another auditor where the member references the other auditor's report. In such situations the Task Force is also considering a change in position because it believes there are situations that could

threaten a member's independence. One such situation is when the primary government has more than minimal influence over the accounting or financial reporting process of the entity. In this situation, the Task Force is considering requiring the member be independent of these entities but allow for an exception that would conclude that independence wouldn't be impaired if the member provided a prohibited nonattest service to the entity if it is reasonable to conclude that the prohibited nonattest service will not be subject to audit procedures.

Another situation where the Task Force is considering a change of position is when the member references another auditors report on an entity where the primary government doesn't have more than minimal influence but the entity is material to the primary government and will be subject to financial statement attest procedures of the member (such as when the primary government makes significant modifications to the entity's financial statements in order to be included in the primary government's basic financial statements). In this situation, the Task Force is considering allowing members to evaluate the threats created by relationships that impair independence to determine if they are at an acceptable level.

Ms. Miller reviewed Agenda Item 4B with the Committee which is a visual aid developed to help explain the Task Force's preliminary direction. While the Committee supported the idea of a visual aid, it did recommend that additional work be done on the visual aid so that it could better stand on its own without as much explanation.

6. IESBA Update

Ms. Snyder provided the Committee with an overview of the recent activities of the IESBA. Some of the specific items she noted were that the IESBA approved the NOCLAR guidance in April and the guidance is pending PIOB approval. She also noted that an exposure draft was reissued to address three specific issues involving "long association": (1) the cooling off period for the engagement quality control reviewer (EQCR) of a public interest entity (PIE); (2) the impact of jurisdictional safeguards; and (3) how to account for situations where an individual is only the engagement partner and EQCR for part of the 7 year period.

Ms. Snyder also explained that the IESBA agreed to undertake a fact-finding assessment to determine what, if any, relationship there may be between fees and threats to auditor independence and compliance with fundamental principles. She also noted that Phase II of the Part C review project had just begun.

7. Compliance with Standards

The Committee provided staff with some suggestions on its nonauthoritative FAQ that explains that members may apply alternative standards when there are no technical standards established by a body designated by AICPA Council provided the member applies the General Standards Rule as well.
