



**AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS**  
**DIVISION OF PROFESSIONAL ETHICS**  
**PROFESSIONAL ETHICS EXECUTIVE COMMITTEE**  
**OPEN MEETING MINUTES**  
**JULY 25, 2017**  
**DENVER**

The Professional Ethics Executive Committee (Committee) held a duly called meeting on July 25, 2017. The meeting convened 9:00 a.m. and concluded at 2:41 p.m. on July 25<sup>th</sup>.

<p><b><u>Attendance:</u></b>          Samuel L. Burke, Chair          Coalter Baker          Carlos Barrera          Stanley Berman          Chris Cahill          Tom Campbell          Robert E. Denham          Anna Dourdourekas          Janice Gray          Greg Guin          Brian S. Lynch</p>	<p>William Darrol Mann          William McKeown          Andrew Mintzer*          Jarold Mittleider          Steven Reed          James Smolinski          Laurie Tish          Shelly Van Dyne          Blake Wilson          Lisa Snyder</p> <p><b><u>Not In Attendance:</u></b>          Michael Brand</p>
<p><b><u>Staff:</u></b>          James Brackens, VP - Ethics &amp; Practice Quality          Ellen Gorla, Sr. Manager Independence &amp; Special Projects*          Shelley Truman, Coordinator</p>	<p>Michael Jones, Assistant General Counsel          Brandon Mercer, Technical Manager*          April Sherman, Technical Manager*          Shannon Ziemba, Technical Manager*          James West, Technical Manager*          Michele Craig, Technical Manager*          Liese Faircloth, Technical Manager*</p>
<p><b><u>Guests:</u></b>          Jeff Lewis, Chair, Independence/Behavioral Standards Subcommittee          Ian Benjamin, Chair, Technical Standards Subcommittee          Kelly Hnatt, Outside Counsel          Nancy Miller, KPMG          Dan Dustin, VP State Board Relations, NASBA          Catherine Allen, Audit Conduct*          George Dietz, PwC*</p> <p style="text-align: center;">*Via Phone</p>	

**1. Leases**

Mr. Wilson presented this agenda item to the Committee. Mr. Wilson began by explaining that PEEC had made some suggestions at the previous meeting and came to some conclusions regarding materiality and the treatment of primary residence leases, but that the Task Force

discussed the conclusions and required clarification from PEEC on those issues. In addition, Mr. Wilson explained that the Task Force prepared a proposed revision at Agenda Item 1B for the PEEC's review. The Task Force requested that PEEC review the proposal, clarify its position on materiality and primary residences, and expose the resulting proposal to membership for comment.

### ***Immediate Family***

Mr. Wilson noted that at the previous meeting, PEEC requested that immediate family be included in the proposed standard. The Task Force discussed this request and noted that immediate family are included in the standard without reference, as a separate interpretation in the Code provides the specific exceptions to immediate family, and leases are not one of the exceptions. Thus, there is no reference to immediate family in paragraph .01, shown below. There was no further discussion on the topic, and the paragraph was not edited further:

.01 When a covered member enters into a lease 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.

### ***Materiality***

Mr. Wilson explained that at the previous meeting, there was a straw vote to apply the materiality safeguard to the firm and the attest client, but it was not clear to the Task Force what PEEC's view was on the breadth of the materiality safeguard in relation to individuals. The Task Force previously discussed the matter and agreed that individuals on the attest engagement and individuals in a position to influence the engagement created significant threats to independence, thus the Task Force's proposal prohibits leases that are material to an individual on the engagement team or an individual in a position to influence the attest engagement.

Mrs. Gorla noted that the drafted language is not clear that the individual on the attest engagement or in a position to influence has to be a party to the lease in order for the requirements to apply. PEEC edited the proposal to add clarity in this regard in .02c.

Mr. Wilson asked PEEC if they agreed with the Task Force approach to materiality, and PEEC members indicated that they agreed with the approach noted by Mr. Wilson, but made some clarification edits to the Task Force's proposal. The resulting paragraph .02 was approved as shown below; edits are changes to the Task Force proposal:

.02 ***If a covered member enters into a lease with an attest client during the period of the professional engagement,*** ~~if~~ 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, unless all of the following safeguards are met during ~~the~~ ***that*** period of the professional engagement:

- a. The lease is entered into on market terms and established at arm's length;
- b. All amounts are paid in accordance with the lease terms or provisions;
- c. The lease is not material to ***any of the following parties to the lease:***
  - i. the firm
  - ii. ***an*** individual participating on the attest engagement team
  - iii. ***an*** individual in a position to influence the attest engagement
  - iv. ***the attest client.***

### ***Evaluation of Other Threats to Independence***

Mr. Wilson presented paragraph .03 of the proposal to PEEC, which requires all leases to be further evaluated for any threats to independence that are not addressed by paragraph .02. Mr. Wilson requested that PEEC review the list of factors to consider in the paragraph and provide feedback or edits. Members noted that factor “e” regarding use of a third party to negotiate the lease really does not impact the threat to independence, and did not believe it added or removed anything from the proposal, so the Committee agreed to delete factor e and ask a question in the exposure draft regarding any other factors that should be included. The changes to the Task Force’s proposal are as follows:

.03 If the covered member meets the safeguards in paragraph .02 above, as applicable, the covered member should evaluate the significance of 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 additional safeguards to eliminate or reduce the threats to an acceptable level. If no safeguards are available to eliminate or reduce threats to an acceptable level, independence would be impaired. The significance of the threats will depend on factors such as the following:

- a. The role of the covered member on the attest engagement and/or with the firm;
- b. Materiality of the lease to the covered member other than those covered members identified in paragraph .02 above;
- c. Whether multiple leases are entered into with the attest client, and if so, the aggregate materiality of those leases to the covered member and/or the attest client;
- d. The extent to which the lease will be subject to attest procedures or financial statements disclosures; and
- e. ~~The extents to which the covered member and/or attest client utilize third party service providers to conduct leasing activities on the covered member’s or attest client’s own behalf.~~

### ***Permitted or Grandfathered Leases***

Mr. Wilson presented paragraph .04 of the proposal, which permitted certain leases that were entered prior to independence being required or prior to a transaction such as an acquisition subjecting the lease to the Independence rule. Under the Task Force’s proposal, the lease would also not be required to be entered into on market terms at arm’s length, as the lease was entered into prior to independence being required. The Task Force acknowledged that this was inconsistent with loans in that loans entered into prior to independence being required are required to be on normal terms and conditions, but that the Task Force did not necessarily agree that leases would be able to be renegotiated at arm’s length at the time it is needed for independence purposes. A majority of PEEC members did not agree with the inconsistency with the loans provisions, and the PEEC added the requirement that the lease be entered into on market terms at arm’s length even if entered into prior to independence being required. Additionally, to be clear that materiality is not part of the conditions at paragraph .04, the proposal was revised to explicitly state that the conditions are irrespective of materiality. Some members had concerns that leases material to the attest client may not be addressed in paragraph .04. It was noted that materiality is only part of the loans provisions as it relates to collateral and that if materiality is a condition, there may be no use of paragraph .04 as the requirements would be the same for any lease. PEEC instructed staff to include a question in

the exposure draft for membership pointing out any other differences between paragraph .04 and the loans provisions and asking whether the differences are appropriate, and if there are any other situations that may need similar treatment. The Committee made edits to the proposal resulting in the following paragraph:

**Grandfathered Leases**

- .04 **Irrespective of materiality,** t Threats to compliance with the “Independence Rule” would be at an acceptable level and independence would not be impaired provided that, **the lease is entered into on market terms and established at arm’s length and** during the period of professional engagement, all amounts are paid in accordance with the lease terms and provisions, the terms do not change in any manner not provided for in the original lease, and any of the following **conditions safeguards** are met:
- a. The covered member entered into the lease with the attest client prior to becoming a covered member with respect to the attest client;
  - b. The covered member entered into the lease with a counterparty for which independence was not required, and that counterparty to the lease later becomes, acquires, or is acquired by an attest client;
  - c. The attest client entered into the lease with a counterparty which was not required to be independent of the attest client, and that counterparty to the lease later acquires or is acquired by the covered member.
  - d. The lease existed prior to **December 15, 2019** and the lease was permitted under the preexisting requirements of the Independence rule and its interpretations.

Automatic renewals provided for in the original lease are not considered changes in terms for purposes of this interpretation.

**Primary Residence Leases**

Mr. Wilson noted that the Task Force included options in the agenda for paragraph .05 regarding primary residence leases. The Task Force was in favor of the conditions in the proposal but requested that PEEC finalize its position and select the best option for addressing primary residence leases. After brief discussion, the Committee determined that the requirements for primary residence leases should be similar to those in paragraph .04, which are also similar to the home mortgage grandfathering provisions. It was pointed out that if the conditions for primary residences are the same as those for permitted leases addressed by paragraph .04, there may not be a need to have paragraph .05. However, PEEC members indicated that primary residence leases needed to be addressed in the proposal, as members and the public may not otherwise realize that primary residence leases are subject to the interpretation. Further, PEEC agreed that the paragraph should explicitly indicate that materiality is not a condition for those leases if they meet the other requirements contained in paragraph .04. To close the discussion, Mrs. Gorla made edits to the proposal which were approved by the PEEC below:

**Covered Member Leases Primary Residence from Attest Client**

- .05 **Irrespective of materiality,** if a covered member leases **his or her** ~~the covered member’s~~ primary residence from a lessor attest client, threats to compliance with the “Independence Rule” would be at an acceptable level and independence would

not be impaired, provided ***the member complies with the provisions in paragraph .04.:***

- a. ~~the ***conditions*** safeguards in paragraph .04 are met, ***OR*** [the lease is entered into on market terms established at arm's length (if entered into during the period of professional engagement),~~
- b. ~~all amounts are paid in accordance with the lease terms and provisions during the period of professional engagement,~~
- c. ~~[and the lease meets the criteria of an operating lease or a short term lease as defined by GAAP]~~

### ***Effective Date***

Mr. Wilson noted that the Task Force was not against an effective date that was concurrent with the FASB Update, but PEEC members noted concern that there may be additional tracking systems or procedures to be implemented by firms to comply with this proposal as well as the FASB Update. The Committee agreed to recommend an effective date similar to the FASB Update (periods beginning after December 15, 2019), but requested that staff include a question in the exposure draft regarding whether the effective date allows time for implementing systems and procedures to track data and comply with the proposal.

After making edits to the proposal during the discussion, it was moved, seconded, and unanimously passed to expose the proposal as edited to membership for comment. The comment period should be sixty days and should include the questions for membership requested by PEEC above.

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

### ***Hosting Services***

Ms. VanDyne explained that at the May 2016 meeting, the Committee decided not to expose for comment an addition to the Scope and Applicability of Nonattest Services” interpretation that would explain that threats to independence would not be considered significant solely because a member provides a nonattest service that does not impair independence through a cloud-based solution. Instead, the Committee recommended that the Task Force discuss if additional guidance was necessary once the Hosting Services interpretation is adopted.

Ms. VanDyne explained that the Task Force believes that the [Hosting Services](#) interpretation provides sufficient guidance (in the form of examples of activities that are not considered hosting services) for members to conclude that providing nonattest services through a cloud based solution does not by itself impair independence. As such, the Task Force recommends that the issue be monitored and a FAQ be issued only if it necessary. The Committee was supportive of this recommendation.

### ***Information Systems Services***

Ms. VanDyne went on to explain that at the last meeting there was some confusion with how the interpretation was organized and what could be done with a system developed by the firm as opposed to a commercial off the shelf system. She explained that the Task Force re-organized the introduction of the interpretation in an effort to help clarify.

Ms. VanDyne explained that the [Information Systems Design, Implementation, or Integration](#) interpretation concludes that independence would be impaired when a member makes other than insignificant modifications to source code underlying an attest client’s existing financial

information system. However, the Task Force members don't believe their firms use the provision except when evaluating the impact to independence when the firm inadvertently modifies source code. Ms. VanDyne explained that Staff reached out to the PCPS Technical Issues Committee (TIC) to see if their firms use the provision and if not, do they believe that the guidance in the [Breach of an Independence Interpretation](#) would provide enough guidance. Overall the feedback received from TIC members was that they wouldn't touch the source code. The PEEC agreed they would not be concerned eliminating the insignificant modifications provision.

### 3. **Client**

Mr. Mintzer provided the Committee with an overview of the comment letters received from the Client and Attest Client Exposure Draft. He explained that one significant issue raised related to whether distinguishing the engaging entity from the subject entity in the definition of client could result in challenges to members who are retained to provide litigation services by an attorney for their client. An example given was a member who was hired directly by an attorney to perform services for the attorney's client. The attorney engages the member versus the attorney's underlying client in order to extend the attorney's work product privilege to the work to be performed by the member. Currently a member would have the attorney sign the engagement letter and the subject entity signs the same engagement letter acknowledging that the both parties are aware and agree to the engagement. The concern raised was if the client definition is changed as exposed, the member may need to have separate engagement letters and the terms of the engagement with each client would be different due to the differences in privilege.

Mr Mintzer explained to the Committee that the Task Force discussed this issue at length and the intention was to clarify that if the engaging entity and the subject entity are different then you are two separate clients and not one "super client". Based on the feedback received, the Task Force recommended added the phrase "while there is only one engagement" to the client definition. The Task Force believed the addition of this phrase would alleviate the concerns regarding separate clients but still only one engagement, so members can continue to have one engagement letter. The Committee agreed after some discussion that adding the phrase "while there is only one engagement" would alleviate the issue raised by commenters to the Exposure Draft especially related to privilege.

Mr. Mintzer explained that there was a comment related to the attest client definition and editing the following wording "*need not be independent of the engaging entity except as may be required by the "Client Affiliate" interpretation [1.224.010]*". The commenter believed that there should be an affirmative statement and did not like the phrase "need not be independent". The Committee agreed with this comment but requested some further edits from the Task Force recommendation, and after some discussion decided on the following phrase "*should refer to the "Client Affiliate" interpretation [1.224.010] to determine if the engaging entity is an affiliate for which the member should be independent.*"

Mr. Mintzer explained a few other clarifying edits based on comments received from the Exposure Draft. The Committee agreed to all the clarifying edits.

It was moved, seconded and agreed to adopt the proposals as revised by a vote of 15 to 1 against with 2 abstentions, effective the last day of the month the changes are published in the Journal of Accountancy.

4. **IESBA Update**

Ms. Snyder provided an update of the IESBA's current projects.

5. **State Tax Tribunals**

The Committee agreed the incorporation of Staff's frequently asked question and answer would provide helpful guidance to members.

6. **Committee Project Agenda**

This item was on the agenda for informational purposes only.

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

It was moved, seconded and unanimously agreed to adopt the minutes from the May 2017 open meeting.