



# Professional Ethics Executive Committee

May 16-17, 2017 Open Meeting Agenda  
Chicago, IL

**AICPA Professional Ethics Executive Committee  
Open Meeting Agenda  
May 16-17, 2017  
Chicago**

May 16 <sup>th</sup>	<i>Open Meeting Begins</i>	
9:00 a.m. – 11:15 a.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 1A Agenda Item 1B Agenda Item 1C Agenda Item 1D</b>
11:15 a.m. – 12:15 p.m.	<b>Part C Task Force – IESBA Convergence</b> Mr. Berman and Mr. Evans will discuss the comments received on the exposure draft and request the Committee's approval to adopt the proposals. ❖ <b>External Link:</b> <a href="#">Exposure Draft</a> ❖ <b>External Link:</b> <a href="#">Comment Letters</a>	<b>Agenda Item 2A Agenda Item 2B Agenda Item 2C Agenda Item 2D Agenda Item 2E</b>
12:15 p.m. – 1:00 p.m.	<b>Lunch</b>	
1:00 p.m. – 3:00 p.m.	<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 3A Agenda Item 3B</b>
3:00 p.m. – 3:15 p.m.	<b>PM Break</b>	
3:15 p.m. – 4:45 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 4A Agenda Item 4B Agenda Item 4C Agenda Item 4D</b>
4:45 p.m. – 4:50 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>
4:50 p.m.	<i>Open Meeting Concludes for the Day</i>	
May 17 <sup>th</sup>	<i>Open Meeting Reconvenes</i>	
9:00 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 6A Agenda Item 6B Agenda Item 6C Agenda Item 6D</b>
10:00 a.m. – 10:45 a.m.	<b>IESBA Update</b> Ms. Snyder will update the Committee on the March meeting of the IESBA. She will also seek feedback on the IESBA's survey related to what issues the Committee believes the IESBA should address starting next year. ❖ <b>External Link:</b> <a href="#">IESBA New Strategy and Work Plan Survey</a>	
	<i>Open Meeting Concludes</i>	
Informational Purposes Only	<b>Committee Project Agenda</b> ❖ <b>External Link -</b> <a href="#">Project Agenda</a>	
	<b>Future Meeting Dates</b> • July 25-26, 2017 – TBD	

## Leases Task Force

### Task Force Members

Blake Wilson (Chair), Bill Mann, Alan Gittelson, David East, Nancy Miller, Chris Cahill  
Staff: Brandon Mercer; Observer: Lisa Snyder

### 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

The Task Force held conference calls in March 2017 and April 2017 to discuss feedback received from the February 2017 meeting PEEC and to prepare an updated proposal. The purpose of this agenda item is to update PEEC on the Task Force's discussions and present a proposed standard to PEEC for consideration and possible exposure to membership.

### Background

The extant AICPA Code addresses leasing arrangements and independence at the Leases Interpretation (1.260.040) presented below. In the extant standard, threats are at an acceptable level if the lease is an operating lease, the lease terms are comparable with leases of a similar nature, and amounts are paid in accordance with the lease terms. Capital (i.e. finance) leases are considered loans that impair independence, with no safeguards available to reduce the threat to an acceptable level. The lone exception to the extant standard is for automobile leases with lending institutions collateralized by the automobile, which are addressed by the Loans and Leases with Lending Institutions (1.260.020) interpretation.

#### 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

PEEC previously indicated its preference for a conceptual approach with certain minimum requirements, without any reference to GAAP lease categorization. The basis for this was that the accounting treatment of a lease has little impact on the significance of the threats to independence; for example, whether a lease is operating or capital lease does not impact the significance of the self-interest threat to the same extent that as other factors, such as materiality and the character of the lease terms and entry of the lease (i.e. on market terms established at arm's length). At the February 2017 PEEC meeting, the Task Force presented three revision options that removed reference to GAAP lease categorization and applied a conceptual approach to leases with certain minimum safeguards required. PEEC members requested that the Task Force combine certain elements of the revisions presented into a single proposed standard that contains a guided conceptual approach with minimum safeguards/requirements, removes the broad materiality test, and include factors to consider when evaluating threats. In addition, PEEC members requested the Task Force consider the appropriateness of an exception for primary residence leases due to potential unintended consequences of any materiality test.

## Proposed Leases Standard

The proposed leases standard (below) can be found at **Agenda Item 1** in both final and markup format. Under the proposed standard, leases impair independence unless certain minimum safeguards are met. Once those minimum safeguards are met, members must evaluate any other threats created by the lease while considering factors as listed in the standard. If threats are at an acceptable level after the evaluation and application of necessary safeguards, independence would not be impaired. The Task Force requests that PEEC approve any edits to the proposal below pursuant to its discussion, and expose the proposal to membership for comment.

Additions to the extant standard appear in **bold underlined** font, and deletions are in ~~strikethrough~~ font.

## 1.260.040 Leases

**.01 When** ~~If a covered member enters into a leasing agreement with an attest client during the period of 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** ~~would be at an acceptable level and independence would not be impaired if all of 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" 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, unless all of the following safeguards are met during the period of the professional engagement:~~

- ~~a. The lease is on market terms and established at arm's length;~~
- ~~b. All amounts are paid in accordance with the lease terms or provisions; [and]~~
- ~~c. [The lease is not material to the firm, an individual participating on the attest engagement team, or an individual in a position to influence the attest engagement.]~~

~~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."~~

~~.03 If the covered member meets the safeguards in paragraph .02 above, 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. Whether the covered member is a member of the attest engagement team and if so, the role of the individual;~~
- ~~b. The position of the covered member within the firm and whether they are an individual in a position to influence the attest engagement;~~
- ~~c. Materiality of the lease to the covered member;~~
- ~~d. Materiality of the lease to the attest client or the financial statements;~~
- ~~e. Whether multiple leases are entered into with the attest client, and if so, the aggregate materiality of those leases to the covered member, the attest client, or the financial statements;~~
- ~~f. The extent to which the lease will be subject to attest procedures or financial statements disclosures;~~
- ~~g. The extent to which the covered member and attest client are involved in managing the leased property or negotiating, executing, or enforcing the lease.~~

#### **Grandfathered Lease Relationships**

~~.04 Threats would be at an acceptable level, and independence would not be impaired by an operating lease that existed prior to the effective date of this interpretation, provided the lease was permitted under the preexisting requirements of the Independence rule and its interpretations and all of the following safeguards are met:~~

- ~~a. All amounts are paid in accordance with the lease terms and provisions during the period of the professional engagement; and~~
- ~~b. The terms of the lease do not change in any manner not provided for in the original lease agreement.~~

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**.05 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].**

Paragraph .01 Threats to Independence

The first paragraph of the proposal notes that entering a lease may cause self-interest, familiarity, and undue influence threats to independence. PEEC previously discussed these threats and agreed with their inclusion as specific threats in leasing transactions.

Paragraph .02 Minimum Safeguards

*Market Terms Established at Arm’s Length and Lease Payment Compliance*

The second paragraph notes that a lease between a covered member and an attest client impairs independence, unless certain minimum safeguards are met during the period of professional engagement. The minimum safeguards are: a) the lease is on market terms and established at arm’s length and b) all amounts are paid in accordance with the lease. PEEC previously expressed the view that these two minimum requirements should remain for all leases and agreed with the terminology contained in the proposal.

Note that these requirements must be met during the period of professional engagement, regardless of when the lease was entered into. For example, if a lease is entered prior to the period of engagement and is not on market terms or at arm’s length, the parties should renegotiate the terms at arm’s length and on market terms to meet safeguard a), otherwise independence would be impaired. The same would apply to situations where an attest client becomes a party to the lease by purchase of the property or by assignment; i.e., if the terms are not on market terms or were not originally established at arm’s length, the two minimum safeguards would not be met during the period of professional engagement unless the terms were renegotiated at arm’s length on market terms.

*Materiality*

In addition to minimum safeguards a) and b), the Task Force previously asked PEEC for feedback on the possible inclusion of a materiality test as a minimum requirement. In general, PEEC was not comfortable with a broad materiality test for all covered members; however, PEEC members acknowledged that materiality should at least be a factor that impacts the significance of the threats to independence for all leases addressed by the proposed standard (see paragraph .03 discussed below). During the previous PEEC discussions, various concerns were expressed regarding the likelihood of a lease being material to a small firm or staff member, versus a large firm or experienced partner, respectively. The difficulty in applying materiality broadly rendered it problematic as a bright line test for all situations; thus PEEC recommended the Task Force further discuss materiality and look at limiting requirements of the proposed standard to certain covered members.

A majority of the Task Force felt that the firm, members of the engagement team, and individuals in a position to influence the attest engagement should not have a material lease with the attest client due to the self-interest threat. Even if the self-interest threat is otherwise at an acceptable level, the appearance of such material relationships with members connected to the engagement may be too much to overcome with the application of safeguards. The Task Force did not view the self-interest threat as being as significant if the lease is not material to the covered member, even if it is material to the attest client. After discussion, a majority of the

Task Force agreed that materiality test applicable to a subset of covered members was appropriate to include in paragraph .02:

- c. **[The lease is not material to the firm, an individual participating on the attest engagement team, or an individual in a position to influence the attest engagement.]**

In its consideration of limiting the application of the materiality safeguard, the Task Force discussed removing certain individuals in a position to influence the attest engagement from the materiality test. Although some members were concerned with the appearance of material leases the firm, engagement team, and individuals in a position to influence the attest engagement, some also questioned whether some members in a position to influence the engagement should not be subject to the safeguard. For example, the individual who evaluates the engagement partner's performance would not be allowed to have a material lease with any attest client of the firm, regardless of the individual's impact on the engagement or connection to the engagement team. No safeguards, such as having another qualified partner perform the quality review partner's role (if any) on that engagement, would be available. Members noted that similar reductions in the population are applied in the Code as it relates to Statements on Standards for Attestation Engagements (SSAE) (1.297.020). See **Agenda Item 1C** for a visual aid on the impact of materiality tests on various covered members. After discussion, a majority of the Task Force did not support further narrowing of the population of individuals in a position to influence the attest engagement.

**Action Needed:**

**The Task Force requests that PEEC consider the proposal and decide whether safeguard c) should be included as a minimum safeguard applied to only the covered members noted.**

**If materiality is a minimum safeguard, should the population subject to the test be narrowed to exclude certain members in a position to influence the attest engagement?**

**If materiality is a minimum safeguard, new material operating leases with certain covered members, which would not normally impair independence under the extant standard, would impair independence under the proposal. Thus, the Task Force also recommends including a question for membership in the Exposure Draft regarding any unintended consequences or the appropriateness of such a change and the limiting of the requirement to certain covered members.**

*Material Primary Residences*

An additional concern related to materiality was that a staff member on an attest engagement may lease an apartment or other material primary residence owned by an attest client or purchased by an attest client; in those situations the staff person could have to move in order to continue to be connected to the engagement. Typically in practice, primary residence leases do not impair independence because they qualify as operating leases. If materiality is included as a minimum safeguard in the proposed standard, any new material operating leases with certain covered members will impair independence, including non-partners and others with less than significant roles on the engagement team. Some members did not think this was the intent of the proposal, but may be an unintended consequence or hardship. The Task Force discussed including a primary residence exception and considered ways to do so, but some members had

concerns regarding tracking of primary residence information that is not currently tracked, and questioned whether a primary residence exception was necessary to protect the public interest although there may be hardships on some members. Some members had concerns that there was not an appropriate basis to conclude that primary residence leases should be exempt from the guidance, and that there are other safeguards available, such as removal of the person from the engagement team. In addition, some thought that at the engagement partner level, the appearance may be too much to overcome for a material primary residence lease, as it would any other lease. At the same time, materiality is less likely to be an obstacle as one matriculates up the chain of command, and is more likely to impact a new staff member versus a long-time partner. After discussion of these concerns, the Task Force agreed to not include any exception for primary residence leases, but suggests that PEEC pose the question to membership in the exposure draft regarding a possible exception and related impacts on clients and members.

**Action Needed:**

**What is PEEC's position on material primary residence leases held by certain covered members, pursuant to the discussion above? Does PEEC believe that threats to independence created by a primary residence lease are different from other leases and warrant exemption?**

**The Task Force requests that PEEC approve inclusion of a question in the exposure draft for membership regarding the impact of any primary residence leases and a possible exemption.**

Paragraph .03 Evaluation of Threats / Safeguards – All Leases

The third paragraph of the proposal states that even if the safeguards in paragraph .02 have been met, members are required to evaluate any other threats created by the lease and apply safeguards as available. The paragraph also provides a guided conceptual approach that lists examples of factors that should be considered when evaluating of the significance of threats to independence, per PEEC's request. The factors address various threats to independence while capturing the most significant factors that contribute to threats.

**Action Needed: The Task Force requests that PEEC review the list of factors and recommend the addition of any other factors it deems necessary.**

**Other Issues**

Consistency with SEC Rules and IESBA Convergence

*Securities Exchange Commission (SEC)*

The SEC independence rule addresses leases as business relationships as follows:

(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.

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The SEC rule and SEC Codification with examples appears at **Agenda Item 1D**. The SEC Codification states: "...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 Task Force's proposed standard does not contain a specific exemption for immaterial landlord/tenant relationships, but the fact that such a relationship is immaterial would meet any materiality safeguard in the proposed standard, and independence would not be impaired if the other requirements of the proposed standard are met. For other types of leases, the SEC rule disallows such direct business relationships regardless of materiality, which makes the proposed standard less restrictive for those other types of leases. Under both standards, an immaterial landlord/tenant relationship would not impair independence if the other requirements of the standard are met.

### *IESBA Convergence*

The 2015 IESBA Handbook of the Code of Ethics for Professional Accountants (the "IESBA Code") does not define or directly address leases as it relates to independence. The IESBA Code does define a financial interest, which includes loans and other securities, but does not specifically include or exclude leases. The IESBA Code also addresses business relationships such as joint ventures, although that section also does not specifically include leases. The IESBA Code requires that business relationship be immaterial to the firm and certain members (i.e. members of the audit team, their immediate families, and the firm). Without any specific mention of leases, it appears that practitioners would be expected to use the Conceptual Framework and evaluate the significance of the self-interest threat to independence caused by the lease. The Task Force's proposed standard takes a similar approach to leases in requiring a conceptual evaluation of threats to independence, but also contains minimum requirements regarding the lease terms, payment compliance, and possibly materiality. In addition, the Task Force's proposed standard would be broader in application to more members. Thus the proposed standard does not appear to be less restrictive than the IESBA Code.

### Questions for Exposure Draft

The Task Force recommends inclusion of the following questions in the exposure draft:

Do members believe that a materiality test for certain covered members connected to the engagement is appropriate?

Do members believe that material leases between the attest client and certain covered members create a threat to the appearance of independence that cannot be reduced by the application of safeguards? If so, would members support materiality as a minimum safeguard for certain covered members, and which covered members should the safeguard apply to?

Do members believe that certain individuals in a position to influence the attest engagement should be exempt from any materiality test?

Do members think it is necessary to provide an exemption from the minimum materiality safeguard for primary residence leases? Do members believe that the appearance of a material primary residence lease is too much to overcome by application of safeguards?

**The Task Force requests that PEEC suggest any other question for membership to include in the exposure draft.**

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**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.

<b>Does PEEC agree with an effective date of fiscal years beginning after December 15, 2019, with early adoption permitted?</b>
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**Action Needed**

The Task Force requests that PEEC discuss the issues regarding the Task Force's revisions to the Leases Interpretation and approve a standard for exposure to membership.

**Communications Plan**

The exposure draft would be distributed to membership and the public via the normal distribution channels, and comment letters with any recommended revisions would be presented to PEEC at the November 2017 PEEC meeting.

**Materials Presented**

**Agenda Item 1B:** Proposed Leases Interpretation

**Agenda Item 1C:** Visual Aid

**Agenda Item 1D:** SEC Codification with examples

## Proposed Revisions to the AICPA Code

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

Markup Version

### 1.260.040 Leases

~~.01~~ **When** ~~if a covered member enters into a leasing agreement with an attest client during the period of 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 would be at an acceptable level and independence would not be impaired if all of 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" 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.~~ **unless all of the following safeguards are met during the period of the professional engagement:**

- a. **The lease is on market terms and established at arm's length;**
- b. **All amounts are paid in accordance with the lease terms or provisions;**  
**[and]**
- c. **[The lease is not material to the firm, an individual participating on the attest engagement team, or an individual in a position to influence the attest engagement.]**

~~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."~~

**.03** **If the covered member meets the safeguards in paragraph .02 above, 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,**

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**independence would be impaired. The significance of the threats will depend on factors such as the following:**

- a. **Whether the covered member is a member of the attest engagement team and if so, the role of the individual;**
- b. **The position of the covered member within the firm and whether they are an individual in a position to influence the attest engagement;**
- c. **Materiality of the lease to the covered member;**
- d. **Materiality of the lease to the attest client or the financial statements;**
- e. **Whether multiple leases are entered into with the attest client, and if so, the aggregate materiality of those leases to the covered member, the attest client, or the financial statements;**
- f. **The extent to which the lease will be subject to attest procedures or financial statements disclosures;**
- g. **The extent to which the covered member and attest client are involved in managing the leased property or negotiating, executing, or enforcing the lease.**

#### **Grandfathered Lease Relationships**

**.04 Threats would be at an acceptable level, and independence would not be impaired by an operating lease that existed prior to the effective date of this interpretation, provided the lease was permitted under the preexisting requirements of the Independence rule and its interpretations and all of the following safeguards are met:**

- a. **All amounts are paid in accordance with the lease terms and provisions during the period of the professional engagement; and**
- b. **The terms of the lease do not change in any manner not provided for in the original lease agreement.**

**.05 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].**

Final Version

#### **1.260.040 Leases**

**.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.

**.02** 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 and independence would be impaired, unless all of the following safeguards are met during the period of the professional engagement:

- a. The lease is on market terms and established at arm’s length;

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- b. All amounts are paid in accordance with the lease terms or provisions; [and]
  - c. [The lease is not material to the firm, an individual participating on the attest engagement team, or an individual in a position to influence the attest engagement.]

**.03** If the covered member meets the safeguards in paragraph .02 above, 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. Whether the covered member is a member of the attest engagement team and if so, the role of the individual;
- b. The position of the covered member within the firm and whether they are an individual in a position to influence the attest engagement;
- c. Materiality of the lease to the covered member;
- d. Materiality of the lease to the attest client or the financial statements;
- e. Whether multiple leases are entered into with the attest client, and if so, the aggregate materiality of those leases to the covered member, the attest client, or the financial statements;
- f. The extent to which the lease will be subject to attest procedures or financial statements disclosures;
- g. The extent to which the covered member and attest client are involved in managing the leased property or negotiating, executing, or enforcing the lease.

#### ***Grandfathered Lease Relationships***

**.04** Threats would be at an acceptable level, and independence would not be impaired by an operating lease that existed prior to the effective date of this interpretation, provided the lease was permitted under the preexisting requirements of the Independence rule and its interpretations and all of the following safeguards are met:

- a. All amounts are paid in accordance with the lease terms and provisions during the period of professional engagement; and
- b. The terms of the lease do not change in any manner not provided for in the original lease agreement.

**.05** 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].

Agenda Item 1C

<u>CM Type</u>	<u>Material lease to covered member</u>	<u>Material lease to Client</u>	<u>Primary residence lease material to CM</u>
Firm	Impaired	Evaluate	n/a
Attest engagement team member	Impaired	Evaluate	Impaired
Partner or partner equivalent in the office with engagement partner	Evaluate	Evaluate	Evaluate
Partner, partner equivalent or manager providing 10 hours of nonattest services to attest client in a fiscal year	Evaluate	Evaluate	Evaluate
Entity controlled by a covered member	Evaluate	Evaluate	Evaluate
Individuals In a Position to Influence the Engagement (see below)	Impaired	Evaluate	Impaired
One who evaluates the performance or recommends the compensation of the attest engagement partner;	*Exempt from AUP independence requirements at 1.297.020		
One who directly supervises or manages the attest engagement partner, including all successively senior levels above that individual through the firm's chief executive;	*Required independence for AUP under 1.297.020		
One who consults with the attest engagement team regarding technical or industry-related issues specific to the attest engagement; or	*Required independence for AUP under 1.297.020		
One who participates in or oversees, at all successively senior levels, quality control activities, including internal monitoring, with respect to the specific attest engagement.	*Exempt from AUP independence requirements at 1.297.020		

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\*1.297.020 *Agreed-Upon Procedure Engagements Performed in Accordance With SSAEs*

(excerpts only)

.04 In addition, when performing an AUP engagement under the SSAEs, *threats* would be at an *acceptable level* and *independence* would not be *impaired*, if the following *covered members* and their *immediate families* are independent of the responsible party(ies):

- a. Individuals participating on the AUP engagement team
- b. Individuals who directly supervise or manage the AUP engagement *partner* or *partner equivalent*
- c. Individuals who consult with the *attest engagement team* regarding technical or industry-related issues specific to the AUP engagement

.05 Furthermore, *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 the *firm* had a material financial relationship with the responsible party(ies) that was covered by any of the following interpretations of the “[Independence Rule](#)”:

- a. [Paragraph .02](#) of “Overview of Financial Interests” [1.240.010]
- b. “[Trustee or Executor](#)” [1.245.010]
- c. “[Joint Closely Held Investments](#)” [1.265.020]
- d. “[Loans](#)” [1.260.010] [Prior reference: paragraph .13 of ET section 101]

## 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.

## IFAC Convergence – Part C

### Task Force Members

Stanley Berman (Chair), Elizabeth Pittlekow, Joe Schiavo, and Steven Reed. Staff: Jason Evans. Observer: Lisa Snyder

### Task Force Charge

The Task Force is charged with reviewing revisions made to Part C of the International Ethics Standards Board for Accountants' (IESBA) Code. Phase I will focus on Sections 320, *Preparation and Presentation of Information* and 370, *Pressure to Breach the Fundamental Principles*. The Task Force will consider necessary revisions to the AICPA Code for purposes of convergence.

### Reason for Agenda Item

To review comments received on the proposed interpretations during exposure and adopt final standards.

### Summary of Issues

On January 9, 2017, the PEEC issued an exposure draft containing two proposals: revisions to the “Knowing Misrepresentations in the Preparation of Financial Statements or Records” interpretation (ET sec 2.130.010) under the “Integrity and Objectivity Rule” and new interpretation, “Pressure to Breach the Rules” (ET sec 2.140.010), under the “Integrity and Objectivity Rule” that apply to members in business. The comment deadline was April 17, 2017 and two comment letters were received from the NYSSCPA’s Professional Ethics Committee and the PICPA Professional Ethics Committee. Both committees were supportive of the proposals but provided a number of comments and proposed edits for the PEEC’s consideration. The Committee should note that both proposals were shared with the AICPA Business and Industry Executive Committee prior to exposure and that Committee was supportive of the proposals.

The Part C Convergence Task Force conducted a conference call to consider the comments and has proposed certain revisions to the interpretations that it deems appropriate. Staff has prepared a comment letter summary that lists each comment and the Task Force’s response to each comment (Agenda 2D).

The Task Force continues to believe that the proposed interpretations are substantially consistent with the International Ethics Standards Board for Accountants' (IESBA's) new ethics standards, section 320, *Preparation and Presentation of Information* and section 370, *Pressure to Breach the Fundamental Principles*. Minor differences exist that the PEEC believed were necessary to enhance the clarity of the proposed interpretations and make them relevant to AICPA members in business in the United States.

### Action Needed:

1. The Committee is asked to review the comment letter summary and Task Force responses. Edits made as a result of comments are highlighted in yellow.
2. The Committee is asked to consider whether a delayed effective date is necessary.
3. The Committee is asked to approve the proposed interpretations for adoption.

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**Materials Presented**

Agenda 2A – This Agenda Item

Agenda 2B – Proposed “Knowing Misrepresentations in the Preparation of Financial Statements” Interpretation

Agenda 2C – Proposed “Pressure to Breach the Rules” Interpretation

Agenda 2D – Comment Letter Summary

Agenda 2E – IESBA Final Standards

(Edits made to the exposed standard are highlighted)

2.130.010 Knowing Misrepresentations in the Preparation **and Presentation** of **Information**  
~~Financial Statements or Records~~

**.01 Members at all levels in an employing organization may be involved in the preparation and presentation of information **for use** both within and outside the employing organization. Stakeholders for whom such information is prepared or presented include the following:**

- a. **Management and those charged with governance**
- b. **Investors, lenders and other creditors**
- c. **Regulators**

**.02 This information may assist stakeholders in understanding and evaluating aspects of the employing organization's **state of affairs operations** and in making decisions concerning the employing organization. This includes financial and non-financial information that may be made public or used for internal purposes such as the following:**

- a. **Operating and performance reports**
- b. **Decision support analyses**
- c. **Budgets and forecasts**
- d. **Information provided to the internal and external auditors**
- e. **Risk analyses**
- f. **General and special purpose financial statements**
- g. **Tax returns**
- h. **Reports filed with regulators for legal and compliance purposes**

**.03 Members who are responsible for recording, maintaining, preparing, approving or presenting information should do so in accordance with the "Integrity and Objectivity Rule [2.100.001]" as follows:**

- a. **Presenting the information in accordance with a relevant reporting framework, where applicable**

- b. ***Preparing or presenting information in a manner that is intended not to mislead, including not to influence contractual or regulatory outcomes inappropriately***
- c. ***Preparing or presenting information without omissions that would render the information misleading***

***.04 This responsibility involves using professional judgment to do the following:***

- a. ***Representing the facts accurately and completely in all material respects.***
- b. ***Describing clearly the true nature of business transactions or activities.***
- c. ***Classifying and recording information in a timely and proper manner.***

#### ***Preparation and Presentation of Financial Statements and Records***

***.04 .05 Threats to compliance with the “Integrity and Objectivity Rule” [2.100.001] would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards, and the member would be considered to have knowingly misrepresented facts in violation of the “Integrity and Objectivity Rule,” if the member***

- a. ***makes, or permits or directs another to make, materially false and misleading entries in an entity’s financial statements or records;***
- b. ***fails to correct an entity’s financial statements or records that are materially false and misleading when the member has the authority to record the entries; or***
- c. ***signs, or permits or directs another to sign, a document containing materially false and misleading information.***

***.06 Preparing or presenting information may require the exercise of discretion in making professional judgments. Preparing or presenting such information in compliance with the “Integrity and Objectivity Rule” [2.100.001] requires the member not to exercise such discretion with the intention of misleading.***

#### ***Preparation and Presentation of Information Not Subject to a Reporting Framework***

***.07 When performing professional activities, especially those that do not require compliance with a relevant reporting framework, the member should use professional judgment to identify and take into account the purpose for which the information is to be used, the context in which it is provided, and the audience to whom it is addressed. For example, when preparing or presenting pro forma reports, budgets, or forecasts, the inclusion of relevant estimates, approximations, and assumptions, where appropriate, would enable those who may rely on such information to form their own judgments. The member may also consider clarifying the intended audience, context, and purpose of the information presented.***

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## **Reliance on the Work of Others**

**.08 A member who intends to rely on the work of others, either internal or external to the organization, should use professional judgment to determine what steps to take, if any, to ensure that the requirements set out in paragraphs .03, .04, and .05 are fulfilled. Factors to consider in determining whether reliance on others is reasonable include reputation, expertise, **objectivity**, resources available to the individual or organization, and whether the other individual is subject to applicable professional and ethical standards. Such information may be gained from prior association with, or from consulting others about, the individual or the organization.**

## **Association With Misleading Information**

**.09 If the member knows or has reason to believe that the information with which he or she is associated is misleading, the member should apply appropriate safeguards to seek to resolve the matter, including the following:**

- a. Consulting the employing organization's policies and procedures (for example, an ethics or whistleblowing policy) regarding how such matters should be addressed internally**
- b. Discussing concerns that the information is misleading with the member's supervisor or the appropriate level(s) of management within the member's employing organization or those charged with governance and requesting such individuals to take appropriate action to resolve the matter. Such action may include the following:**
  - i. Having the information corrected**
  - ii. If the information has already been disclosed to the intended users, informing them of the correct information**

**.10 If the member determines that appropriate action has not been taken and continues to have reason to believe that the information is misleading, threats to compliance with the "Integrity and Objectivity Rule" [2.100.001] would not be at an acceptable level. In such circumstances, the member, while being alert to the requirements of the "Confidential Information Obtained From Employment or Volunteer Activities" interpretation [2.400.070], should consider one or more of the following safeguards:**

- a. Consulting with a relevant professional body**
- b. Consulting with the employing organization's internal **auditor** and **external auditor-accountant**.**
- c. Determining whether any requirements exist to communicate to third parties, including users of the information, the organization's external accountant, or regulatory authorities**
- d. Consulting legal counsel regarding his or her responsibilities**

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- .11 If after exhausting all feasible options, the member determines that appropriate action has not been taken and there is reason to believe that the information is still misleading, the member should refuse to be or to remain associated with the information. The member also should consider whether to continue a relationship with the employing organization.**
- .12 Nothing in this interpretation precludes a member from resigning from the organization at any time. However, resignation may not relieve the member of responsibilities in the situation, including any responsibility to disclose concerns to third parties, such as regulatory authorities or the employing organization's (or former employing organization's) external accountant.**
- .13 The member is also encouraged to document **his or her understanding of** the facts, the accounting principles or other relevant professional standards involved, and the communications and parties with whom these matters were discussed, the courses of action considered, and how the member attempted to address the matter(s).**
- .14 When threats to compliance with the Integrity and Objectivity Rule [2.100.001] are due to differences of opinion between a member and his or her supervisor (or any other person within the member's organization) relating to the application of accounting principles, auditing standards, or other relevant professional standards, the member should also refer to the "Subordination of Judgment" interpretation [2.130.020].**

**Effective date**

**TBD**

(Edits made to the exposed standard are highlighted)

### 2.140.010 Pressure to Breach the Rules

- .01 This interpretation addresses pressures that could result in a *member* taking actions that breach or cause others to breach the rules particularly, the “Integrity and Objectivity Rule” [2.100.001] [2.110.010].
- .02 A *member* may face pressure that could create *threats*, for example undue influence *threats*, to compliance with the “Integrity and Objectivity Rule” [2.100.001] [2.110.010] when undertaking a *professional service*. Pressure may be explicit or implicit. Pressure may come from within the *employing organization*, for example, from a colleague or superior, from an external individual or organization such as a vendor, customer or lender, or from the need to meet internal or external targets and expectations.
- .03 A *member* should not allow pressure from others to result in a breach of the “Integrity and Objectivity Rule” [2.100.001] [2.110.010]. A *member* also should not place pressure on others that the *member* knows, or has reason to believe, would result in the other individuals breaching the rules of the AICPA Code of Professional Conduct.
- .04 Examples of pressure that could result in a breach of the “Integrity and Objectivity Rule” include the following:
  - a. Pressure related to conflicts of interest. For example, Pressure from a family member bidding to act as a vendor to the *member’s employing organization* to select them over another prospective vendor.

Refer to the “Conflicts of Interest for Members in Business” interpretation [2.110.010] for additional guidance.

- b. Pressure to influence presentation of information:
  - i. Pressure to report misleading financial results to meet investor, analyst, or lender expectations.
  - ii. Pressure from elected officials on government accountants to misrepresent programs or projects to voters.
  - iii. Pressure from colleagues to misstate income, expenditure, or rates of return to bias decision-making on capital projects and acquisitions.
  - iv. Pressure from superiors to approve or process expenditures that are not legitimate business expenses.
  - v. Pressure to suppress internal audit reports containing adverse findings.

Refer to the “Knowing Misrepresentations in the Preparation and Presentation of Information” interpretation [2.130.010] for additional guidance.

- c. Pressure to act without sufficient competence or due care:
  - i. Pressure from superiors to inappropriately reduce the extent of work performed.
  - ii. Pressure from superiors to perform a task without sufficient skills or training or within unrealistic deadlines.

Refer to the “General Standards Rule” [2.300.001] for additional guidance.

- d. Pressure related to financial interests. For example, pressure to manipulate performance indicators from superiors, colleagues or others, such as those who may benefit from participation in compensation or incentive arrangements.
- e. Pressure related to gifts or entertainment:
  - i. Pressure from others, either internal or external to the *employing organization*, to offer gifts or entertainment to inappropriately influence the judgment or decision-making process of an individual or organization.
  - ii. Pressure from colleagues to accept inappropriate gifts or entertainment from potential vendors in a bidding process.

Refer to the “Offering or Accepting Gifts or Entertainment” interpretation [2.120.010] for additional guidance.

.05 In determining whether the pressure could result in a breach of the “Integrity and Objectivity Rule,” the *member* might consider factors including the following:

- a. The intent of the individual who is exerting the pressure and the nature and significance of the pressure.
- b. The application of relevant laws, regulations, and professional standards to the circumstances.
- c. The culture and leadership of the employing organization including the extent to which it emphasizes the importance of ethical behavior and the expectation that employees will act in an ethical manner. For example, a corporate culture that tolerates unethical behavior may increase the likelihood that the pressure would result in a breach of the rules.
- d. Policies and procedures, if any, that the *employing organization* has established, such as ethics or human resources policies that address pressure.

.06 In considering the factors in paragraph .05 along with other factors, and being alert to the requirements of the “Confidential Information Obtained From Employment or Volunteer Activities” interpretation [2.400.070], the *member* may consult with the following:

- a. A colleague, superior, human resources personnel, internal compliance personnel or another professional accountant.
- b. Relevant professional or regulatory bodies or industry associations.
- c. Legal counsel.

.07 If the *member* determines that the pressure would result in a breach of the “Integrity and Objectivity Rule,” the *member* might consider *safeguards*, including these:

- a. Discussing the matter with the individual who is exerting the pressure to seek to resolve it.
- b. Discussing the matter with the member’s supervisor, if the supervisor is not the individual exerting the pressure.
- c. Escalating the matter within the *employing organization*, for example, with higher levels of management, internal or external auditors, or *those charged with governance*, including independent directors and, when appropriate, explaining any consequential risks to the organization.
- d. Requesting restructuring or segregating certain responsibilities and duties so that the member is no longer involved with the individual or entity exerting the pressure, when doing so would eliminate the pressure to breach the “Integrity and Objectivity Rule.” For example, if a member is pressured in relation to a conflict of interest,

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the pressure to breach the rule may be eliminated if the *member* avoids being associated with the matter creating the conflict.

- e. Disclosing the matter in accordance with the *employing organization's* policies, including ethics and whistleblowing policies, using any established mechanism, such as a confidential ethics hotline.
  - f. Consulting with legal counsel.
- .08 In situations in which the *member* determines that the pressure to breach the “Integrity and Objectivity Rule” has not been eliminated, the *member* should do the following:
- a. Decline to undertake or discontinue the professional activity that would result in a breach of the rule.
  - b. Consider whether to continue a relationship with the *employing organization*.
- .09 The member is also encouraged to document the facts, the communications, the courses of action considered, the parties with whom these matters were discussed, and how the matter was addressed.

**Effective date**

**TBD**

**COMMENT SUMMARY**  
**PROPOSED “Knowing Misrepresentations in the Preparation and Presentation of Information”**  
**and “Pressure to Breach the Rules” Interpretations**

Comment Letter	Feedback Highlights	Task Force Response
<p><a href="#"><u>CL 1</u></a> PICPA Professional Ethics Committee</p> <p><b>Support with Recommendations</b></p>	<ul style="list-style-type: none"> <li>In general, the committee finds the guidance to be helpful in assisting members in business with their responsibilities for preparing and presenting information and agrees with the underlying principles included in the proposed revisions.</li> <li>The committee requests clarification as to how a member can support their compliance with this new guidance (e.g., is there a documentation requirement?). While the committee believes that a documentation requirement would be onerous, it is unclear how a member would defend against an alleged ethics violation of this new guidance in the absence of supporting documentation.</li> <li>The committee requests that PEEC consider issuing practice guidance for these types of circumstances.</li> </ul>	<p>While the Task Force (TF) acknowledges that supporting documentation is helpful for purposes of defending against an alleged violation, it continues to believe that encouraging members to document, as proposed, is appropriate and most members will document even if not required.</p> <p>The TF recommends that the PEEC should follow up with the Business and Industry Executive Committee (BIEC) after the standard is issued to determine if members in business require additional (non-authoritative) guidance.</p>
<p><a href="#"><u>CL 2</u></a> NYSSCPA Professional Ethics Committee</p>	<p><b>General Recommendations:</b></p> <ul style="list-style-type: none"> <li>Recommend that the effective dates of the revised and new interpretations be delayed by a minimum of three months after the last day of the month in which they are published in the <i>Journal of Accountancy</i> in order to</li> </ul>	<p>The TF does not believe a delayed effective date is needed as there are no specific procedures that would take time to put in place. The TF agreed, however, to publicize the proposals once</p>

Comment Letter	Feedback Highlights	Task Force Response
<p><b><i>Support with Recommendations</i></b></p>	<p>provide sufficient time for members to become familiar with their provisions and with members' responsibilities and possible safeguards to be considered.</p> <ul style="list-style-type: none"> <li>Recommend that the PEEC consider developing comparable guidance on these subjects for members in public practice.</li> </ul> <p><b>Recommended revisions to the “Knowing Misrepresentations in the Preparation of Financial Statements or Records” Interpretation:</b></p> <ul style="list-style-type: none"> <li>ET 2.130.010 – Consider replacing the word “Knowing” in the title with “Known”, which would seem more appropriate, or perhaps consider an entirely new title to reflect the additional matters now covered in the revised interpretation. If a new title is adopted, then conforming changes will need to be made throughout the guidance.</li> <li>ET 2.130.010.0 – Consider providing clarification for the phrase “..... in the preparation of information both within and outside the employing organization” by inserting “for use” after the word “information.”</li> <li>ET 2.130.010.02 – In the second line, consider replacing the term “state of affairs” with a term such as “operations.”</li> </ul>	<p>adopted, including emails to BIEC constituents, so that members are aware of the new standards.</p> <p>The TF noted that the <i>Preparation and Presentation of Financial Statements and Records</i> provision in the Interpretation exists in Part 1 of the Code for members in public practice. The TF did not believe other sections of the proposal were applicable for members in public practice with respect to their clients.</p> <p>The TF does not recommend changing the title in order to remain consistent with the title used in Part 1 of the Code (see 1.130.010).</p> <p>Edit accepted by the TF.</p> <p>Edit accepted by the TF.</p>

Comment Letter	Feedback Highlights	Task Force Response
	<ul style="list-style-type: none"> <li>• ET 2.130.010.02 – In the second sentence, consider replacing “...such as...” with “...including, but not limited to...”</li> <li>• ET 2.130.010.03 – In paragraphs .03a., .03b., and .03c., consider beginning the paragraphs with “Present” and “Prepare or present” rather than “Presenting” and “Preparing or presenting.”</li> <li>• ET 2.130.010.05a. and .05b. (and the preceding caption ) – Consider using the term “financial information” instead of “financial statements or records,” to be consistent with the change in the title of the interpretation.</li> <li>• ET 2.130.010.05b. – Consider changing the phrase “has the authority to record the entries” to “has the authority to make the corrections” to recognize that not all corrections to information may involve entries.</li> <li>• ET 2.130.010.06 – We suggest that this section be deleted, as it is already adequately covered in the interpretation.</li> <li>• ET 2.130.010.07 – Consider clarifying the last sentence, as a member may not believe sufficient guidance has been provided.</li> <li>• ET 2.130.010.08 – We recommend that documentation of factors considered in determining whether reliance on others is reasonable be required. Additionally, we</li> </ul>	<p>The TF did not accept this edit as proposal is consistent with Code drafting conventions.</p> <p>The TF kept the proposed verb tense but agreed to change the bullets in .04 to “present participle” for consistency.</p> <p>The TF did not make this change in order to remain consistent with the language in Part 1 of the Code. It also believed this section was intended to focus on financial statements and records.</p> <p>The TF did not make this change in order to remain consistent with the language in Part 1 of the Code.</p> <p>The TF believes the use of discretion is important guidance and should be maintained for purposes of convergence to the IESBA standard.</p> <p>The TF believes the sentence is clear.</p> <p>The TF believes the documentation requirement in par. 13 is appropriate and there is no need to document consideration of reliance on others as it would be onerous.</p>

Comment Letter	Feedback Highlights	Task Force Response
	<p>suggest that independence, if applicable, be included as another factor to consider in determining whether to rely on others.</p> <ul style="list-style-type: none"> <li>• ET 2.130.010.10b. and c. – There is a reference in paragraph .10b. to “external auditor” and in .10c. to “external accountant.” Consider whether the same identification should be used in each instance, and if so, which one it should be.</li> <li>• ET 2.130.010.11: <ul style="list-style-type: none"> <li>○ We recommend that examples be provided illustrating how members would disassociate themselves from the information believed to be misleading.</li> <li>○ We believe that clarification of a member’s responsibilities is needed when they refuse to be associated with the misleading information that has not been withdrawn and is presented to its intended users.</li> <li>○ We suggest that the responsibilities to discuss concerns to third parties be expanded and that examples be provided.</li> <li>○ We believe that complying with the provisions of this paragraph may have a profound negative effect on a member’s career and livelihood. Therefore we suggest that robust guidance be provided to assist</li> </ul> </li> </ul>	<p>The TF did not believe “independence” should be a factor as it might be confusing (since members in business are not required to be independent) but agreed to add “objectivity” to the list of factors to consider.</p> <p>The TF revised 10b. to state “internal auditor and external accountant” for consistency.</p> <p>The TF does not believe that additional examples and clarification is needed at this time. Rather, the TF recommends that the PEEC should follow up with the Business and Industry Executive Committee (BIEC) after the standard is issued to determine if members in business require additional (non-authoritative) guidance in these areas.</p> <p>The TF also noted that specific steps and considerations are provided under the Subordination of Judgment interpretation which is referred to within the proposal.</p>

Comment Letter	Feedback Highlights	Task Force Response
	<p>members when dealing with these difficult situations, and whether there is any relief from these provisions should a member have the misfortune of finding themselves in these situations</p> <ul style="list-style-type: none"> <li>ET 2.130.010.12 – Consider providing specific guidance and clarification on the responsibility to disclose concerns to third parties. In addition, we believe that such responsibilities should be discussed in the context of ET 2000.020, “Ethical Conflicts.”</li> <li>ET 2.130.010.13 – We suggest that documentation not only be encouraged, but required.</li> </ul> <p><b>Recommended revisions to the revisions to the “Pressure to Breach the Rules” Interpretation</b></p> <ul style="list-style-type: none"> <li>ET 2.140.010.01, .02, and .03 –The “Integrity and Objectivity Rule” is found at 2.100.001, not 2.110.010.</li> <li>ET 2.140.010.07d. – Consider providing guidance addressing circumstances where the pressure on the member is eliminated, but the breach still exists in the organization and the pressure may be transferred to others.</li> <li>ET 2.140.010.08 – Consider providing guidance to address the possible negative effects on a member’s career when the</li> </ul>	<p>The TF does not believe guidance and clarification is needed. The TF noted that the outstanding NOCLAR proposal will address responsibilities when encountering fraud and illegal acts.</p> <p>The TF continues to believe that documentation should only be encouraged.</p> <p>Change accepted by TF.</p> <p>The TF does not believe additional guidance is needed.</p> <p>The TF does not believe additional guidance is needed.</p>

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Comment Letter	Feedback Highlights	Task Force Response
	member complies with the provisions of this paragraph. Please refer to our comment in ET 2.130.010.11 above.	

**Close-Off Document**  
March 2016

**Agenda Item 2E**

*International Ethics Standards Board for  
Accountants®*

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## Changes to Part C of the Code Addressing Preparation and Presentation of Information and Pressure to Breach the Fundamental Principles

## **CHANGES TO PART C OF THE CODE (PHASE 1) (CLEAN)**

### **SECTION 320**

#### **Preparation and Presentation of Information**

320.1 Professional accountants in business at all levels in an employing organization are involved in the preparation and presentation of information both within and outside the employing organization. Stakeholders to whom, or for whom, such information is prepared or presented, include:

- Management and those charged with governance.
- Investors, lenders and other creditors.
- Regulators.

This information may assist stakeholders in understanding and evaluating aspects of the organization's state of affairs and in making decisions concerning the organization. This includes financial and non-financial information that may be made public or used for internal purposes.

Examples include:

- Operating and performance reports.
- Decision support analyses.
- Budgets and forecasts.
- Information provided to the internal and external auditors.
- Risk analyses.
- General and special purpose financial statements.
- Tax returns.
- Reports filed with regulators for legal and compliance purposes.

320.2 Professional accountants in business who are responsible for recording, maintaining, preparing, approving or presenting information shall do so in accordance with the fundamental principles. This includes:

- Presenting the information in accordance with a relevant reporting framework, where applicable.
- Preparing or presenting information in a manner that is intended neither to mislead nor to influence contractual or regulatory outcomes inappropriately.
- Not omitting information with the intention of rendering the information misleading or of influencing contractual or regulatory outcomes inappropriately.

An example of influencing a contractual or regulatory outcome inappropriately is using an unrealistic estimate with the intention of avoiding violation of a contractual requirement such as a debt covenant or of a regulatory requirement such as a capital requirement of a financial institution.

This responsibility involves using professional judgment to:

- Represent the facts accurately and completely in all material respects.
- Describe clearly the true nature of business transactions or activities.
- Classify and record information in a timely and proper manner.

320.3 Preparing or presenting information may require the exercise of discretion in making professional judgments. Preparing or presenting such information in accordance with the fundamental principles requires the professional accountant not to exercise such discretion with the intention of misleading or influencing contractual or regulatory outcomes inappropriately. This includes not using discretion to achieve inappropriate outcomes in one or more of the following ways:

- Determining estimates. For example, determining fair value estimates in order to misrepresent profit or loss.
- 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.
- Determining the timing of transactions. For example, timing the sale of an asset near the end of the fiscal year in order to mislead.
- Determining the structuring of transactions. For example, structuring financing transactions in order to misrepresent assets and liabilities or classification of cash flows.
- Selecting disclosures. For example, omitting or obscuring information relating to financial or operating risk in order to mislead.

320.4 When performing professional activities, especially those that do not require compliance with a relevant reporting framework, the professional accountant shall use professional judgment to identify and take into account the purpose for which the information is to be used, the context in which it is provided and the audience to whom it is addressed. For example, when preparing or presenting pro forma reports, budgets or forecasts, the inclusion of relevant estimates, approximations and assumptions, where appropriate, would enable those who may rely on such information to form their own judgments. The professional accountant in business may also consider clarifying the intended audience, context and purpose of the information presented.

320.5 A professional accountant who intends to rely on the work of others, either internal or external to the organization, shall use professional judgment to determine what steps to take, if any, to ensure that the obligations set out in paragraph 320.2 are fulfilled. Factors to consider in determining whether reliance on others is reasonable include: reputation, expertise, resources available to the individual or organization and whether the other individual is subject to applicable professional and ethical standards. Such information may be gained from prior association with, or from consulting others about, the individual or the organization.

320.6 If the professional accountant knows or has reason to believe that the information with which the professional accountant is associated is misleading, the professional accountant shall take appropriate actions to seek to resolve the matter. Such actions include:

- Consulting the employing organization's policies and procedures (for example, an ethics or whistle-blowing policy) regarding how such matters should be addressed internally.

- Discussing concerns that the information is misleading with the professional accountant's supervisor and/or the appropriate level(s) of management within the professional accountant's organization or those charged with governance and requesting such individuals to take appropriate action to resolve the matter. Such action may include:
  - Having the information corrected.
  - If the information has already been disclosed to the intended users, informing them of the correct information.

In situations where the misleading information may involve a violation of a law or regulation, Section 360 provides guidance relating to non-compliance with laws and regulations.

320.7 If the professional accountant determines that appropriate action has not been taken and continues to have reason to believe that the information is misleading, the professional accountant, while being alert to the fundamental principle of confidentiality, shall consider one or more of the following:

- Consulting with a relevant professional body.
- Consulting with the employing organization's internal and external auditor.
- Determining whether any requirements exist to communicate to third parties, including users of the information, or regulatory authorities.
- Consulting legal counsel.

320.8 If after exhausting all feasible options, the professional accountant determines that appropriate action has not been taken and there is reason to believe that the information is still misleading, the professional accountant shall refuse to be or to remain associated with the information. The professional accountant also may consider resigning from the employing organization.

The professional accountant is also encouraged to document the facts, the accounting principles or other relevant professional standards involved, and the communications and parties with whom these matters were discussed, the courses of action considered, and how the professional accountant attempted to address the matter(s).

320.9 Where threats to compliance with the fundamental principles relating to the preparation and presentation of information arise from financial interests, including compensation and incentive linked to financial reporting and decision making, the guidance in Section 340 is relevant.

320.10 Where threats to compliance with the fundamental principles relating to the preparation and presentation of information arise from pressure, the guidance in Section 370 is relevant.

## SECTION 370

### Pressure to Breach the Fundamental Principles

370.1 This section addresses pressures that could result in a professional accountant taking actions that breach or cause others to breach the fundamental principles.

370.2 A professional accountant in business may face pressure that could create threats, for example, intimidation threats, to compliance with the fundamental principles when undertaking a professional activity. Pressure may be explicit or implicit. Pressure may come from within the organization, for example, from a colleague or superior, from an external individual or organization such as a vendor, customer or lender, or from meeting internal or external targets and expectations.

The professional accountant shall not allow pressure from others to result in a breach of the fundamental principles. The professional accountant also shall not place pressure on others that the professional accountant knows, or has reason to believe, would result in the other individuals breaching the fundamental principles.

370.3 Examples of pressure that could result in a breach of the fundamental principles include:

- Pressure related to conflicts of interest:
  - Pressure from a family member bidding to act as a vendor to the professional accountant's employing organization to select them over another prospective vendor.  
  
The guidance in Section 310 is relevant.
- Pressure to influence presentation of information:
  - Pressure to report misleading financial results to meet investor, analyst or lender expectations.
  - Pressure from elected officials on public sector accountants to misrepresent programs or projects to voters.
  - Pressure from colleagues to misstate income, expenditure or rates of return to bias decision-making on capital projects and acquisitions.
  - Pressure from superiors to approve or process expenditures that are not legitimate business expenses.
  - Pressure to suppress internal audit reports containing adverse findings.  
  
The guidance in Section 320 is relevant.
- Pressure to act without sufficient expertise or due care:
  - Pressure from superiors to inappropriately reduce the extent of work performed.
  - Pressure from superiors to perform a task without sufficient skills or training or within unrealistic deadlines.  
  
The guidance in Section 330 is relevant.

- Pressure related to financial interests:
  - Pressure to manipulate performance indicators from superiors, colleagues or others, for example, those who may benefit from participation in compensation or incentive arrangements.

The guidance in Section 340 is relevant.
- Pressure related to inducements:
  - Pressure from others, either internal or external to the employing organization, to offer inducements to inappropriately influence the judgment or decision-making process of an individual or organization.
  - Pressure from colleagues to accept a bribe or other inducement, for example, to accept inappropriate gifts or entertainment from potential vendors in a bidding process.

The guidance in Section 350 is relevant.
- Pressure related to non-compliance with laws and regulations:
  - Pressure to structure a transaction to evade tax.

The guidance in Section 360 is relevant.

370.4 In determining whether the pressure could result in a breach of the fundamental principles, the professional accountant may consider factors including:

- The intent of the individual who is exerting the pressure and the nature and significance of the pressure.
- The application of relevant laws, regulations, and professional standards to the circumstances.
- The culture and leadership of the employing organization including the extent to which it emphasizes the importance of ethical behavior and the expectation that employees will act in an ethical manner. For example, a corporate culture that tolerates unethical behavior may increase the likelihood that the pressure would result in a breach of the fundamental principles.
- Policies and procedures, if any, that the employing organization has established, such as ethics or human resources policies that address pressure.

In considering these and other factors, and being alert to the fundamental principle of confidentiality, the professional accountant in business may consult with:

- A colleague, superior, human resources personnel, or another professional accountant;
- Relevant professional or regulatory bodies or industry associations; or
- Legal counsel.

370.5 If the professional accountant determines that the pressure would result in a breach of the fundamental principles, the professional accountant may consider actions, including:

- Discussing the matter with the individual who is exerting the pressure to seek to resolve it.

- Discussing the matter with the professional accountant's supervisor, if the supervisor is not the individual exerting the pressure.
- Escalating the matter within the employing organization, for example, with higher levels of management, internal or external auditors, or those charged with governance, including independent directors and, when appropriate, explaining any consequential risks to the organization.
- Requesting restructuring or segregating certain responsibilities and duties so that the professional accountant is no longer involved with the individual or entity exerting the pressure, where doing so would eliminate the pressure to breach the fundamental principles. For example, if a professional accountant is pressured in relation to a conflict of interest, the pressure to breach the fundamental principles may be eliminated if the professional accountant avoids being associated with the matter creating the conflict.
- Disclosing the matter in accordance with the employing organization's policies, including ethics and whistleblowing policies, using any established mechanism, such as a confidential ethics hotline.
- Consulting with legal counsel.

370.6 In situations where the professional accountant determines that the pressure to breach the fundamental principles has not been eliminated, the professional accountant shall:

- Decline to undertake or discontinue the professional activity that would result in a breach of the fundamental principles; and
- Consider resigning from the employing organization.

The professional accountant is also encouraged to document the facts, the communications, the courses of action considered, the parties with whom these matters were discussed, and how the matter was addressed.



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**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**

At the February meeting the Committee requested that the Task Force consolidate the basis for the revisions, visual aids and any examples it believes would help users of the exposure draft. The Committee also requested that the Task Force prepare an impact analysis and include a question in the exposure draft that would solicit feedback on whether the “more than minimal influence” concept is clear and if it is creating a new concept. To do this, the Task Force prepared a draft exposure draft (see **Agenda Item 3B**).

At the February meeting the Committee agreed that when looking upstream, instead of requiring members be independent of the primary government when it has more than minimal influence over the accounting or financial reporting process of a material fund or component unit that is a financial statement attest client, the interpretation should require an evaluation of relationships and circumstances that the member has with the primary government using the conceptual framework. The Task Force updated the interpretation to reflect this position as noted below:

- .09 When a material fund or component unit is a [financial statement attest client](#) and is required to be included in another financial reporting entity which is not a [financial statement attest client](#), [members](#) should use the [Conceptual Framework for Independence](#) to evaluate relationships and circumstances that a [member](#) has with a primary government that exerts more than minimal influence over the accounting or financial reporting process of the [financial statement attest client](#).

Since the interpretation provides guidance on how to handle entities that are excluded from the financial statement attest client’s financial reporting entity but required to be included under the applicable framework, the Task Force recommends the title of the interpretation be revised as follows:

~~Entities Included in State and Local Government~~ *Entities Financial Statements*

The Task Force made some clarifying edits to paragraph .03 which explains to members that certain terms or phrases in the independence interpretations could create translation challenges for a member who practices in the SLG sector. This paragraph now reads:

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.03 When an interpretation of the “[Independence Rule](#)” [1.200.001] is applied in a state or local government environment and the [interpretation](#) uses terminology that is not applicable in this environment, the member should use their professional judgement to determine if there is an equivalent term . For example, certain interpretations use the terms “officer, director or owner” of the [attest client](#). In some state or local government environments, it may be necessary for the member to extend these interpretations to “officials” of the [financial statement attest client](#) when the individual has governance responsibilities or control over financial reporting.

The Task Force also added some additional examples to item “b.” of paragraph .04 of state and local government entities that it had previously planned to include as a FAQ. Item “b.” now reads:

- b. State and Local Governmental Entities. Entities whose GAAP standard setter is the Governmental Accounting Standards Board. Examples of 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, public airports, public housing authorities, financing authorities, public transportation systems, public utilities, public employee retirement systems (PERSs), post-employment benefit plans, pension plans, public entity risk pools, external investment pools, public colleges and universities, Indian tribes, state tuition programs and other special districts.

**Question For the Committee**

1. Does the Committee agree with the Task Force’s recommendations?
2. Does the Committee have any concerns with the draft exposure draft?

**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.

**Question For The Committee**

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

**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 approve the proposed revision to this definition for exposure?

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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]

<b>Question For The Committee</b>
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- |  |
|--|
| 1. Does the Committee approve the proposed revision to this interpretation for exposure? |
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#### **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

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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.

**Question For The Committee**

1. Does the Committee approve the issuance of the exposure draft?

**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 3B – Draft Exposure Draft

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# EXPOSURE DRAFT

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## ENTITIES INCLUDED IN STATE AND LOCAL GOVERNMENT FINANCIAL STATEMENTS

## PROPOSED REVISED INTERPRETATION AND OTHER GUIDANCE

## AICPA PROFESSIONAL ETHICS DIVISION

May xx, 2017

Comments are requested by August xx, 2017

Prepared by the AICPA Professional Ethics Executive Committee for comments from those interested in independence, behavioral, and technical standards matters.

Comments should be addressed to Lisa A. Snyder, Director of the Professional Ethics Division, at [lsnyder@aicpa.org](mailto:lsnyder@aicpa.org)

DRAFT

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New York, NY 10036-8775

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May xx, 2017

This exposure draft contains an important proposal for review and comment by the AICPA's membership and other interested parties regarding a pronouncement for possible adoption by the Professional Ethics Executive Committee (PEEC). The text and an explanation of the proposed pronouncement are included in this exposure draft.

After the exposure period is concluded and the PEEC has evaluated the comments, the PEEC may decide to publish the proposed pronouncement. Once published, the pronouncement will become effective on the last day of the month in which it is published in the Journal of Accountancy, unless otherwise stated in the pronouncement.

Your comments are an important part of the standard-setting process; please take this opportunity to comment. Responses must be received at the AICPA by August xx, 2017. All written replies to this exposure draft will become part of the public record of the AICPA and will be available at <http://www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/Pages/ExposureDrafts.aspx>. Comments received will be considered by the PEEC at its meeting in November 2017.

Please email comments to Lisa A. Snyder, Director of the Professional Ethics Division ([lisa.snyder@aicpa-cima.com](mailto:lisa.snyder@aicpa-cima.com)).

Sincerely,

Samuel L. Burke, Chair  
AICPA Professional Ethics Executive Committee

Lisa A. Snyder, Senior Director  
AICPA Professional Ethics Division

## **Professional Ethics Executive Committee (2016–2017)**

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Coalter Baker  
Carlos Barrera  
Stanley Berman  
Michael Brand  
Tom Campbell  
Robert E. Denham  
Anna Dourkourekas  
Jana Dupree  
Janice Gray

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Lee Klumpp  
Flo Ostrum  
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### **Ethics Division Task Force Staff**

Ellen Gorla, CPA, CGMA  
Senior Manager, Independence and Special Projects

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## Explanation of the Proposed Revisions

The Professional Ethics Executive Committee (committee) is exposing for comment a revised “Entities Included in State and Local Government Financial Statements” interpretation (ET sec. 1.224.020), a conforming revision to the definition of a Financial Statement Attest Client (ET sec. 0.400.16) and revision to the “Plan Is an Attest Client or Is Sponsored by an Attest Client interpretation” (ET sec. 1.250.010).

### ***I. Background***

In December 2014, the committee added a project to its three-year agenda to consider incorporating the threats and safeguards approach into the Entities Included in State and Local Government Financial Statements interpretation and to determine if a conceptual framework assessment could be utilized to determine when a member needs to be independent of state and local governmental (SLG) entities for which he or she is not providing financial statement attest services. The committee also sought to clarify who at the firm and which immediate family members the interpretation should extend to and if the interpretation should contain any exceptions.

The committee began its analysis by looking at the [Client Affiliates](#) interpretation [1.224.010] and related [affiliate](#) definition [0.400.02] that is applicable to commercial sector entities to determine if this guidance could be extended to the SLG sector. The committee does not believe the Client Affiliates interpretation is effective at identifying relationships requiring independence in the SLG sector because of the fundamental differences in the financial reporting objectives and financial statement presentation of these two sectors. However, the committee tried to be conceptually consistent with the underlying principles of that affiliates guidance unless there was a compelling reason to differ from those principles.

### ***Financial Reporting Objectives Differ Between SLG and Commercial Sector Entities***

The financial reporting objectives in the commercial sector rely heavily on FASB definitions of control and significant influence, which are not used in the Governmental Accounting Standards Board’s (GASB) reporting standards. Instead, GASB uses a concept of financial accountability to identify when an entity should be included in a state or local government’s financial statements. As a result, financial accountability may require inclusion of an entity in the financial reporting entity of a primary government that might not meet the FASB definitions of control or significant influence by the primary government over the entity. Some of the more significant examples of how GASB standards differ from commercial financial reporting include:

- the view that capital assets are primarily used to provide services to citizens rather than to contribute to future cash flows;
- the measurement and recognition of certain types of revenues (for example, taxes and grants);
- the use of fund accounting and budgetary reporting to meet public accountability needs; and
- 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, “entities” included in a set of financial statements 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 are legally separate entities. Primary governments may not have control or significant influence over component units in the same way that a commercial sector entity has over its subsidiaries. Component units that are included in a governmental financial reporting entity can operate autonomously from each other by, for example, having separate governing boards, accounting systems, financial reporting systems, operations and even separate strategic directions. The financial accountability criteria requiring inclusion in the financial reporting entity may merely be due to the appointment of a majority of the otherwise autonomously operating governing board along with a significant financial benefit /burden relationship where the governmental financial

reporting entity is legally obligated to provide significant operating subsidies or financial support to that entity. Component units may interact with the primary government in an adversarial fashion that is typically foreign in a corporate environment. Officials at a component unit may not report up an organizational structure to someone at the primary government as they would in a corporate environment. Often there is no communication regarding governance or operations between a component unit and the primary government which includes the component unit in its financial reporting entity. Affiliates guidance does not effectively identify entities requiring independence in the SLG sector because the assumptions of control and significant influence that underpin the Accounting Standards Codification (ASC) accounting guidance in the affiliates definition is not the basis for inclusion in a governmental financial reporting entity.

### ***Financial Statement Presentation Differ Between SLG and Commercial Sector Entities***

SLG financial statements are not consolidated into a single column like commercial sector entities. Instead, government-wide financial statements and fund financial statements are presented in columnar formats. Interfund activities are not always eliminated as they would be in a consolidated presentation. 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.

Furthermore, auditors may not necessarily opine solely on the financial statements as a whole. Instead, auditors (often multiple auditors) typically opine separately on the financial statements by auditing individual opinion units. Opinion units may be comprised of a single entity, such as a discretely presented component unit, or may include several discretely presented component units or funds. [Exhibit A](#) is a graphic that provides an overview of a typical SLG financial statement presentation.

### ***Terminology - Downstream, Upstream and Brother-Sister Entities***

In this exposure draft, as well as in the proposed interpretation, the committee makes use of the terms downstream and upstream entities. The committee believes that use of this terminology will assist members in appropriately considering which entities are subject to evaluation in determining whether the independence rules and related interpretations should apply. The term downstream is used to refer to those entities that are “below” the financial statement attest client in its organizational structure. This would be the case in circumstances where the financial statement attest client is the primary government and the funds and component units to be evaluated are those required to be included in the primary government’s financial reporting entity. In contrast, the term upstream is used to refer to those entities that are “above” the financial statement attest client in its organizational structure. This would be the case in circumstances where the financial statement attest client is a fund or component unit that is required to be included in a financial reporting entity of a primary government.

The concept of brother-sister entities refers to other funds and component units that the member does not provide attest services to but are included in the same upstream financial reporting entity as the financial statement attest client. These entities would be comparable to commercial sector entities covered by item e. of the [affiliate definition](#).

## ***II. Applicability***

The interpretation addresses independence with respect to entities that are required to be included in a financial reporting entity under the applicable reporting framework<sup>Error! Bookmark not defined.</sup>. The extant interpretation refers explicitly to financial statements issued in conformity with GAAP. However, given that many state and local governments issue financial statements under reporting frameworks other than GAAP (e.g., cash basis or regulatory basis) the committee proposes that the independence evaluation is based on the reporting framework applied by the state and local government entity.

<sup>1</sup> So that the proposal is clear as to when the guidance extends to excluded entities that are required to be included in another financial reporting entity under the applicable framework, the committee used the phrase “*is required to be included ...*”.

### **III. Downstream View**

#### ***Independence of Funds and Component Units Required to be Included in the Financial Reporting Entity of the Financial Statement Attest Client (Paragraphs .05 through .08 of the Proposal)***

##### ***Making Reference to Another Auditor’s Report***

Under both the extant interpretation as well as the proposed revised interpretation, members must be independent of funds and component units that are included in the financial statement attest client’s financial reporting entity where the covered member does not make reference to another auditor’s report on the fund or component unit. *This provision appears in paragraph .05 of the proposal and [paragraph .04](#) of the extant interpretation.*

Under [paragraph .04](#) of the extant interpretation, members do not need to be independent of funds and component units that are included in the financial reporting entity of the financial statement attest client when the member explicitly states reliance on another auditor’s reports (i.e., makes reference to another auditor’s report). After further consideration, the committee believes that making reference to another auditor’s report will not always reduce threats to an acceptable level when the fund or component unit is material to the financial reporting entity 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 committee proposes that members be independent of material funds and component units when a primary government has more than minimal influence over the accounting or financial reporting process of such funds or component units *even when* the member makes reference to another auditor in the auditor’s report. *This provision appears in paragraph .06 of the proposal.* See the discussion below under “More Than Minimal Influence Over Accounting or Financial Reporting Process” for further clarification.

##### ***Funds and Component Units Excluded from the Financial Reporting Entity***

The extant interpretation does not provide any independence guidance related to funds and component units that are excluded from the financial reporting entity but are required to be included under the applicable framework (for example, GAAP, regulatory or cash basis). It is not uncommon for a primary government to exclude a fund or component unit from its financial reporting entity for a variety of reasons such as unavailability of a component unit’s audited financial statements. The committee proposes incorporating guidance when a material fund or component unit is excluded from the financial statement attest client’s financial reporting entity but is required under the applicable framework to be included in that financial reporting entity. In this situation, the committee believes members should apply the independence rule and related interpretations to the material excluded fund or component unit if the primary government has more than minimal influence over its accounting or financial reporting process. *This provision appears in paragraph .07 of the proposal.*

##### ***Not Subject to Attest Procedures - Exception***

In the commercial sector, the [Client Affiliates](#) interpretation [1.224.010] provides an exception that may be applied to all affiliates other than those defined as [type a and b](#). This exception permits the provision of nonattest services that would impair independence to affiliates provided 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 (particularly those relating to management participation), the member should apply safeguards to eliminate or reduce the threats to an acceptable level. The committee is proposing that this exception be applicable to downstream funds and component units, except for those that are included in the financial reporting entity where the member does not make reference to another auditor’s report. *This exception appears in paragraph .08 of the proposal.*

When considering if this exception can be applied, a member should evaluate whether the otherwise prohibited services provided to a downstream entity are subject to a member's attest procedures at the primary government. For example, a member may be considering whether they can apply this exception to the provision of financial system implementation and design at an entity where this exception might be available. In this example, the member has determined that this service would be prohibited if performed directly for an audit client. The member will need to consider the impact on threats to independence related to the attest procedures at the primary government. The determination of whether the otherwise prohibited service can be performed at the downstream entity is a matter of professional judgment after considering the significance of threats to independence in fact and in appearance.

#### *Materiality Considerations*

When materiality is used to determine whether independence is required of an entity in the above situations, the committee believes that materiality should be considered in relation to the financial reporting entity and not to materiality as determined at the individual opinion unit.

#### *Other Downstream Entities*

For downstream entities that are not addressed by the guidance referenced above, members would only need to apply the [Conceptual Framework for Independence](#) if the member knows or has reason to believe that a relationship or circumstance exists with the entity that would create threats to independence. *This provision appears in paragraph .10 of the proposal.* The committee believes this is appropriate because these entities are unlikely to create significant threats to the member's independence. See the discussion below under "Other Funds, Component Units or Activities" for further clarification.

#### *Investments Held by State or Local Government Entity*

Members may also need to apply the Independence Rule and related interpretations to investments held by a state or local governmental entity that is the financial statement attest client *as described in paragraphs .11 through .13 of the proposal.* See the discussion below under "Investments" for further clarification.

#### *Downstream Visual Aid – Table A*

Table A provides a visual of how the Independence Rule and related interpretations are applied currently and under the proposal when looking downstream:

## Table A - 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 minimis to the primary government.	has significant influence over and is material to the primary government.	included in reporting entity where the auditor makes reference to another auditors report for that fund or component unit	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.

### IV. Upstream View

#### ***Independence When the Financial Statement Attest Client is Included in Another Financial Reporting Entity as a Fund or Component Unit and the Primary Government of That Financial Reporting Entity is Not a Financial Statement Attest Client (Paragraph .09 of the Proposal)***

##### *Financial Statement Attest Client Is a Material Fund or Component Unit*

Under [paragraph .07](#) of the extant interpretation, when the member does not audit the primary government, independence is not required of entities included in the financial reporting entity that the member doesn't audit (i.e., upstream entity). However, [paragraph .08](#) prohibits covered members and their immediate family and close relatives from having a key position within the primary government.

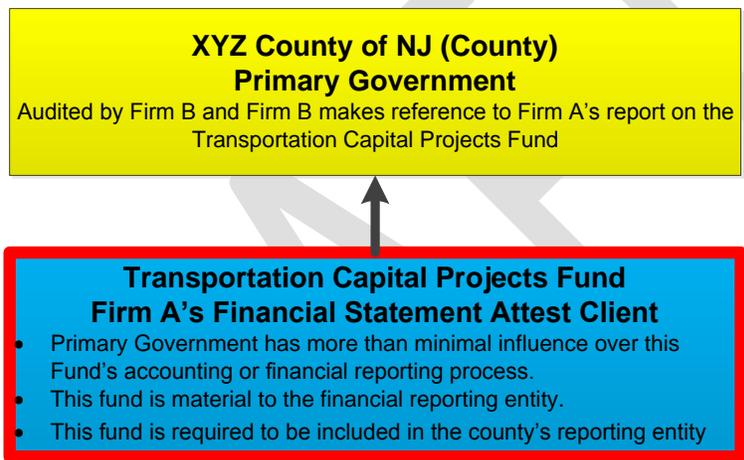
After further thought, the committee believes that there could be circumstances where a member has a relationship that creates a threat(s) that is (are) not at an acceptable level. The committee believes these situations are more likely to occur when a material fund or component unit is a financial statement attest client that is required to be included in another financial reporting entity where the primary government of that financial reporting entity can exert more than minimal influence over the accounting or financial reporting process of the financial statement attest client. As such, the committee proposed that in these situations members be required to evaluate these relationships and circumstances that a member has with that primary government using the [Conceptual Framework for Independence](#). The member will be required to identify those entities that meet the criteria of materiality and more than minimal influence over the accounting or financial reporting process of the financial statement attest client. Then the member will be required to consider whether there are any relationships or circumstances that create threats to independence. This requirement goes beyond simply responding when

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member knows or has reason to believe that threats exist. Rather, the member must identify those entities that meet the criteria and subsequently evaluate whether significant threats exist that require a response. *This provision appears in paragraph .09 of the proposal.*

For example, a member is auditing a transportation capital projects fund that is a material fund of a county government. The fund is required to be included in the county’s financial statements. The county has more than minimal influence over the fund’s accounting or financial reporting process. In this circumstance, the member would need to identify whether any relationships or circumstances with the county exist that would impair independence with respect to the fund. If so, the member would then need to determine if safeguards can be applied to eliminate or reduce threats to an acceptable level. Table B provides a visual of this example:

**Table B**  
**Financial Statement Attest Client is a Material Fund and Required to be Included in the Primary Government’s Reporting Entity and The Primary Government Has More Than Minimal Influence Over Fund**



**CONCLUSIONS**

The member needs to evaluate relationships and circumstances that the member has with the County because the fund is material to the financial reporting entity and the County has more than minimal influence over the fund’s accounting or financial reporting process.

**Color Key**

- Firm A's Financial Statement Attest Client
- Firm A - Independence required
- Firm A – Must evaluate relationships and circumstances it has with the County using the Conceptual Framework.

**Materiality Considerations**

When materiality is used to determine whether independence is required of a primary government when the financial statement attest client is required to be included in the upstream financial reporting entity, the committee believes that materiality should be considered in relation to the financial reporting entity and not to materiality as determined at the individual opinion unit.

**Other Upstream Entities**

For all other upstream entities, members would only need to apply the [Conceptual Framework for Independence](#) if the member *knows or has reason to believe* that a relationship or circumstance exists with the entity that would create threats to independence. The committee believes that this is appropriate because relationships or circumstances that may exist with these entities are unlikely to create significant threats to the member’s

independence. See the discussion below under “Other Funds, Component Units or Activities” for additional clarification. *This provision appears in paragraph .10 of the proposal.*

#### *Inclusion in Another Financial Reporting Entity and Investments Held by State or Local Government Entity*

The committee expects that when the financial statement attest client is required to be included in another primary government’s financial reporting entity, the member will need to perform an analysis both upstream of the financial statement attest client (*that is, paragraph .09 of the proposal*) as well as downstream (*that is, paragraphs .05 through .08 of the proposal*), for those entities that are required to be included in the financial reporting entity of the financial statement attest client. Members may also need to apply the Independence Rule and related interpretations to investments held by a state or local governmental entity that is the financial statement attest client *as described in paragraphs .11 through .13 of the proposal*. See the discussion above under “downstream entities” as well as below under “Investments” for additional clarification.

## **V. Other Upstream and Downstream Entities**

### **Other Funds, Component Units or Activities – Paragraph .10 of the Proposal**

The committee believes that it is possible that a member may encounter circumstances or relationships with funds or component units or other activities or entities that are not addressed in paragraphs .05 through .09 that could give rise to threats that are not at an acceptable level. However, since threats to independence are unlikely for immaterial funds or component units or where the primary government does not have more than minimal influence over the financial accounting or reporting the committee does not believe members should have to track all these circumstances or relationships. Rather, if the member knows or has reason to believe that a relationship or circumstance would create threats to independence, the committee believes the member should then evaluate the situation using the [Conceptual Framework for Independence](#). Some examples of entities where a member may encounter relationships or circumstances that might create threats to independence could include:

- Funds or component units that are included or excluded from the financial reporting entity (but required to be included under the applicable framework) that the primary government has only minimal influence over the financial accounting or reporting process.
- Funds or component units that are included or excluded (but required to be included under the applicable framework) from the financial reporting entity that are immaterial to the primary government.
- Government employee benefit plans that are not required to be included in the financial reporting entity under the applicable framework
- Fiduciary funds that are not required to be included in the financial reporting entity under the applicable framework
- Joint ventures
- Related organizations
- Guarantees of debt service
- Creative financing
- Public private partnerships
- Equity method investments that do not meet the GASB investment definition
- Brother-sister funds or component units of a financial statement attest client included in the primary government’s financial reporting entity

The committee does not intend that members will be required to evaluate customers and vendors under this interpretation, including paragraph .10. For example, when a service provider is used to provide administration services to an employee benefit plan, members would not need to extend the independence rules to the service provider as long as (1) the service provider is not a state or local government entity that would meet the requirements of the Entities Included in State and Local Government Financial Statements interpretation; or (2) any investment the plan has in the service provider does not meet criteria outlined in paragraph .11 of the

interpretation. Another example would be where an entity provides grant funds to another organization. Ordinarily, a grantor-grantee relationship is that of a customer-vendor relationship and independence is not required of the grantor or grantee in this circumstance.

## **VI. Defined Terms**

### ***Investments– Paragraphs 04d and .11 - .13 of the Proposal***

The extant interpretation does not provide any guidance on when members should apply the Independence Rule and related interpretations to entities in which the financial statement attest client has an investment. Accordingly, members were left to address these situations using the [Conceptual Framework for Independence](#). The committee proposes including guidance on how entities in which the financial statement attest client has an investment should be treated. Specifically, the committee believes that members should apply the independence rules and related interpretations to certain entities that the financial statement attest client invests in. The committee believes the independence rules should be extended to entities where the financial statement attest client can control the entity and the investment in that entity is not de minimis to the financial statement attest client's financial reporting entity. The committee is including a de minimis 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. *This provision appears in item a. of paragraph .11 of the proposal.*

The Committee considers de minimis to be something less than immaterial. De minimis reflects circumstances where the investment would be insignificant or clearly inconsequential to the financial statement attest client's financial reporting entity. Determination of when an investment is de minimis is a matter of professional judgment by the member considering independence of mind and in appearance.

The committee also believes the independence rule and related interpretations should be extended to include circumstances when a financial statement attest client has significant influence over an entity in which it has a material investment. *This provision appears in item b. of paragraph .11 of the proposal.*

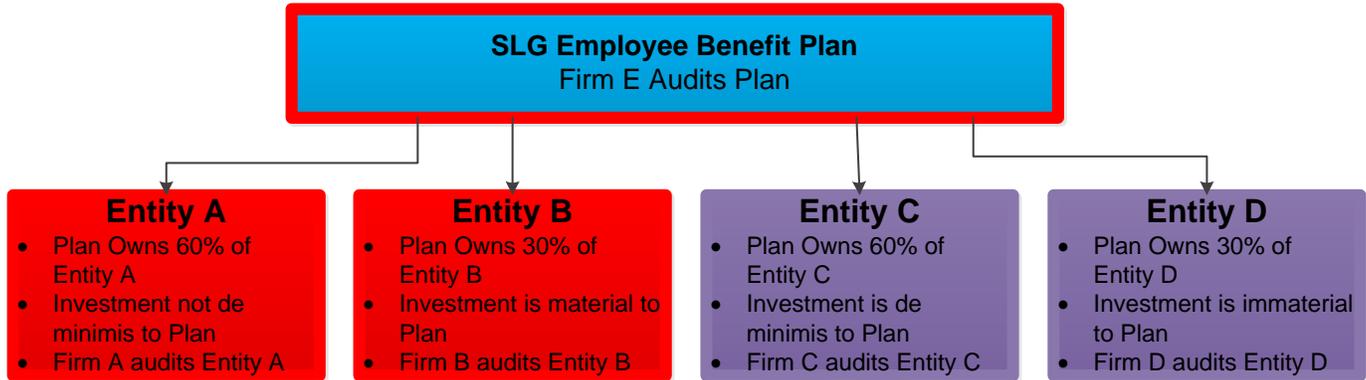
Investments as defined in the interpretation exclude entities that would otherwise be considered a fund or component unit. In addition, the investments definition excludes temporary investments for interests obtained by a financial statement attest client as a result of an action by a third party, such as through a bequest or a grant, and that the entity does not intend to retain. Temporary investments were excluded because the committee believes SLG entities are more likely to be passive recipients of investments than commercial entities. *The definition appears in item d. of paragraph .04 of the proposal.*

While investments can be encountered anywhere, often they can be found in primary governments, component units and funds where there is excess cash and long term investment objectives such as:

- a. Business type activities associated with Tribal Organizations
- b. Pension and OPEB Plans
- c. Endowment Funds and foundations related to public colleges and universities
- d. External Investment Pools
- e. IRS Section 529 Plans
- f. Controlling Investment in a REIT
- g. An investment qualifying for the equity method of accounting under applicable GASB standards such as an investment in what is commonly known as an "alternative investments"

Table C provides a visual of how to apply the investment guidance to a SLG Employee Benefit Plan:

## Table C Investments Held By SLG Employee Benefit Plan



### Conclusions With Respect To Firm E's Independence

Firm E must be independent of Entity A because the Plan has a controlling investment in Entity A. Since the plan's investment in Entity B gives it significant influence over Entity B and the investment is material to the plan, Firm E must also be independent of Entity B. Firm E does not have to monitor its independence with respect to Entity C (since the investment is de minimis to the Plan) or to Entity D (since the investment isn't material to the plan). However, Firm E only has to evaluate relationships or circumstances with Entity C or D once the firm knows or becomes aware of them.

- Firm E's financial statement attest client.
- Firm E is required to be independent of entity.
- Firm E is not required to monitor independence but is required to evaluate relationships or circumstances the firm has with Entity C or D that creates threats to independence once Firm E knows or becomes aware of them.

### **More Than Minimal Influence Over Accounting or Financial Reporting Process – Paragraphs .14 - .15 of the Proposal**

Although the committee believes that 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 believes that this presumption will often 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. Alternatively, 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. To assist members in assessing their unique facts and circumstances the committee 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. *This guidance is found in paragraphs .14 - .15 of the proposal.*

In the SLG sector, the evaluation as to whether a fund or component unit should be included into the financial reporting entity's financial statements is determined using a financial accountability concept that is based in the GASB standards. Alternatively, in the commercial sector, the evaluation as to whether an entity should be included in the client's financial statements is determined by whether the client has control or significant influence over the entity as a whole. Since the determination differs between the two sectors, the committee believes the control and significant influence concepts are not workable in this proposal. The Committee believes that the concept of whether the primary government has more than minimal influence *over the accounting and financial reporting process* of the fund or component unit is the appropriate concept to use to determine whether

independence should be applied to funds and component units that are required to be included in the financial reporting entity under the applicable framework. The more than minimal influence criteria is a facts and circumstances analysis that is applied *solely* to the accounting and financial reporting process of the fund or component unit. This is a targeted evaluation of one aspect of the relationship between the primary government and the fund or component units as opposed to a broad evaluation of relationships between entities using a “significant influence” criteria as used in ET 1.224.010. See the discussion above under “Financial Reporting Objectives Differ Between State and Local Government (SLG) Entities and Commercial Sector Entities” and “Financial Statement Presentation Differ Between SLG and Commercial Sector Entities” for further clarification.

The committee believes that the impact of this evaluation should not require the member to obtain additional information not already available as a result of other audit procedures. Furthermore, the committee believes that some entities and engagements are more likely than others to be able to rebut the presumption. Larger governments and component units are more likely to meet criteria that will rebut the presumption. Smaller governments and funds are less likely to meet criteria that could rebut the presumption. However, these are broad generalizations that may not be applicable to a member’s specific facts and circumstances.

The committee believes that members should take a substantive approach to evaluating the criteria. For example, a government may have the ability to exercise influence over the financial accounting and reporting over a fund through an ability to approve financial reports. However, if the primary government does not exercise that ability, the member can consider that as a mitigating factor in the determination of whether more than minimal influence exists.

The committee does not believe that any one criteria will necessarily cause the more than minimal influence determination to be rebutted (or not). Rather, the member should consider the facts and circumstances for each situation to make the determination regarding whether more than minimal influence exists. In some cases, a single factor may cause the member to believe that factor is determinative for their situation. In other cases, a member may consider a number of factors that are indicators of minimal influence and indicators that minimal influence doesn’t exist in order to reach a conclusion.

Therefore, the determination of whether “more than minimal influence” exists is a matter of the member’s professional judgment after considering specific facts and circumstances relevant to the attest client.

### ***Conforming Revisions***

The committee is proposing striking the last sentence in the definition of “financial statement attest client” since this term is now being used in the SLG interpretation. The committee believes that the reference to “public employee retirement plan” in item a. in paragraph .01 of the Plan Is an Attest Client or Is Sponsored by an Attest Client interpretation (1.250.010) is too limiting as there are many other types of plans aside from just public employee retirement plans. As such, the committee is proposing this phrase be changed to “public employee benefit plan” so that all plans are covered.

### ***Phase 2***

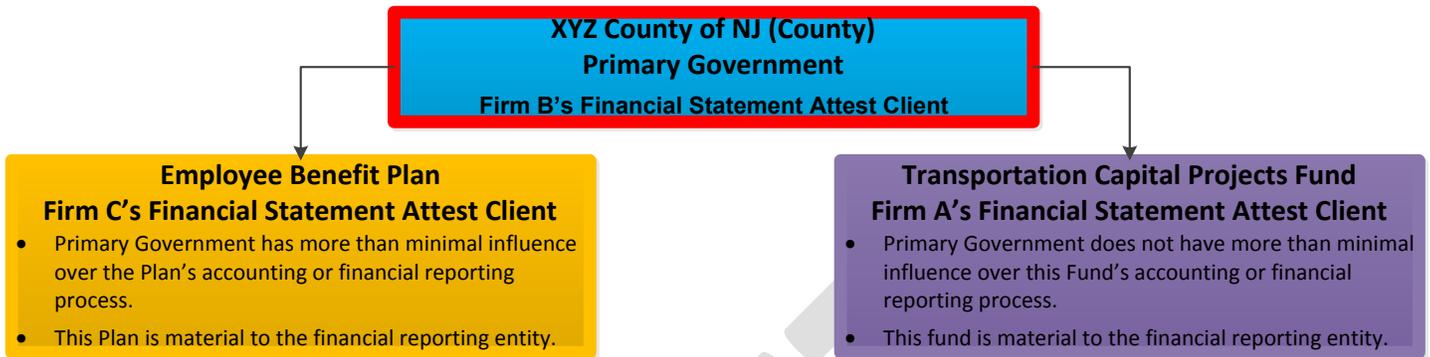
Once revisions to the Entities Included in State and Local Government Financial Statements interpretation are adopted, the committee will begin phase 2 of this project which would include determining whether the guidance should be applied to compliance audits and to the federal government.

### ***Visual Aid Examples***

Following are some visual aids that demonstrate how the proposed interpretation would be applied.

## Table D

### Financial Statement Attest Client is Primary Government Downstream Example – Paragraphs .05 - .08



- Firm B audits the County and makes reference to Firm's C's report on the Plan and to Firm A's audit report for the Transportation Capital Projects Fund.
- Firm A audits Transportation Capital Projects Fund but does not provide any financial statement attest services to County or to the Employee Benefit Plan. The Fund is material to the County but the County does not have more than minimal influence over the Fund's accounting or financial reporting process.
- Firm C audits the Employee Benefit Plan but does not provide any financial statement attest services to County or to the Fund. The Plan is material to the County and the County has more than minimal influence over the Plan's accounting and financial reporting process.

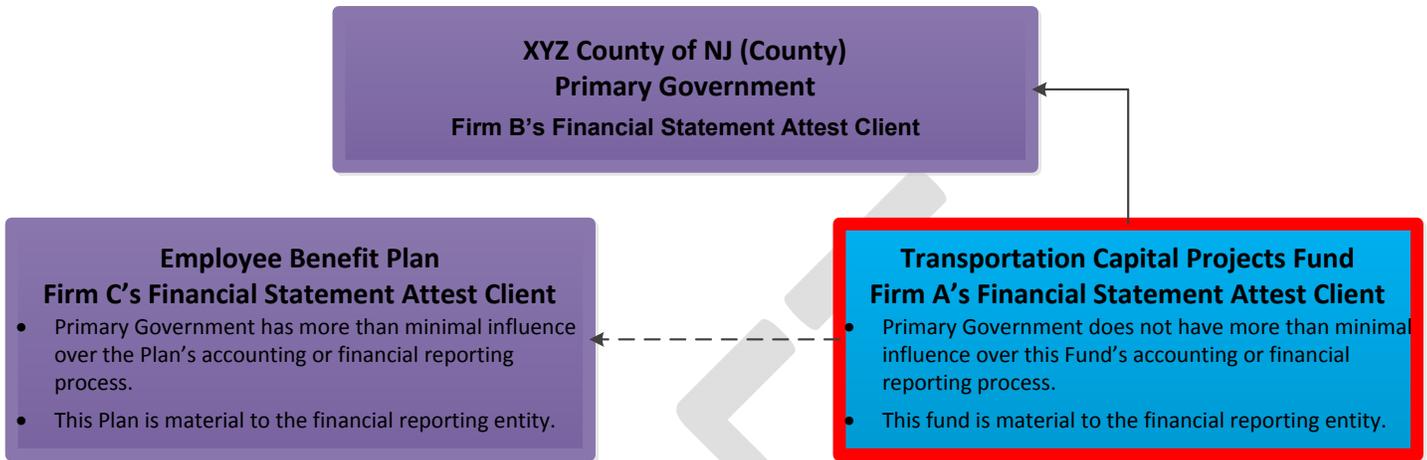
**Conclusions With Respect to Firm B's Independence**

Firm B must be independent of the Plan except Firm B may provide nonattest services that would impair independence to the Plan when it is reasonable to conclude that the services do not create a self-review threat with respect to the County 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 to the Plan that are not at an acceptable level (particularly those relating to management participation), the member should apply safeguards to eliminate or reduce the threats to an acceptable level. In addition, Firm B must evaluate relationships or circumstances with the Transportation Capital Projects Fund that creates threats to independence once Firm B knows or has reason to believe the relationship or circumstance exists.

- Firm B's Financial Statement Attest Client.  
Firm B Required to be Independent.
- Firm B Required to evaluate relationships or circumstances with the County or Plan that creates threats to independence once Firm B knows or has reason to believe they exist.
- Firm B required to be independent of the Plan but can provide prohibited nonattest services if it is reasonable to conclude that the services do not create self-review threats with respect to the financial statement attest client.

## Table E

### Financial Statement Attest Client is a Material Fund Upstream Example – Paragraph .09



- Firm A audits Transportation Capital Projects Fund but does not provide any financial statement attest services to County or to the Employee Benefit Plan. The Fund is material to the County but the County does not have more than minimal influence over the Fund's accounting or financial reporting process.
- Firm C audits the Employee Benefit Plan. The Plan is material to the County and the County has more than minimal influence over the Plan's accounting and financial reporting process.
- Firm B audits the County and makes reference to Firm's C's report on the Plan and to Firm A's audit report for the Transportation Capital Projects Fund.

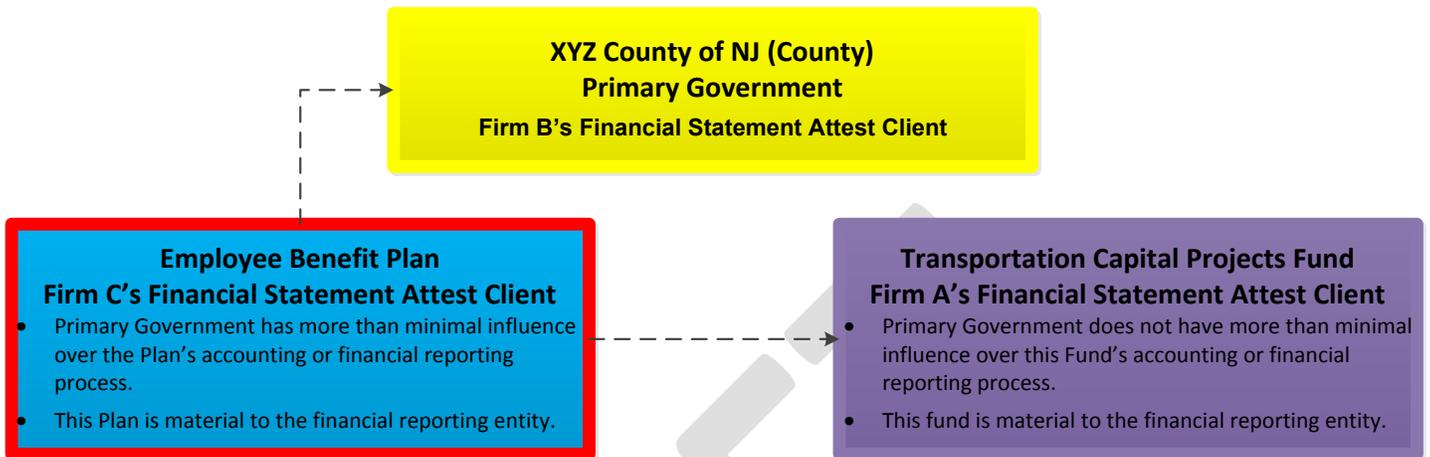
#### Conclusions With Respect to Firm A's Independence

Since the County does not have more than minimal influence over the Fund, Firm A only has to evaluate relationships or circumstances with the County or Plan that creates threats to independence once Firm A knows or has reason to believe they exist.

- Firm A's Financial Statement Attest Client
- Firm A Required to be Independent
- Firm A Required to evaluate relationships or circumstances with the County or Plan that creates threats to independence once Firm A knows or has reason to believe they exist.

## Table F

### Financial Statement Attest Client is a Material Plan Upstream Example – Paragraph .09



- Firm C audits the Employee Benefit Plan but does not provide any financial statement attest services to County or to the Fund. The Plan is material to the County and the County has more than minimal influence over the Plan's accounting and financial reporting process.
- Firm A audits Transportation Capital Projects Fund but does not provide any financial statement attest services to County or to the Employee Benefit Plan. The Fund is material to the County but the County does not have more than minimal influence over the Fund's accounting or financial reporting process.
- Firm B audits the County and makes reference to Firm's C's report on the Plan and to Firm A's audit report for the Transportation Capital Projects Fund.

#### Conclusions With Respect To Firm C's Independence

Since the plan is material and the County has more than minimal influence over the plan, Firm C must evaluate relationships and circumstances it has with the County using the Conceptual Framework For Independence. In addition, Firm C must evaluate relationships or circumstances with Fund that creates threats to independence once Firm C knows or has reason to believe exist.

- Firm C's Financial Statement Attest Client.
- Firm C Required to be Independent.
- Firm C Required to evaluate relationships or circumstances with the County or Plan that creates threats to independence once Firm C knows or has reason to believe exist.
- Firm C Required to evaluate relationships and circumstances with the County using the Conceptual Framework.

## ***Impact Analysis***

The committee prepared an impact analysis that summarizes the main differences between the extant interpretation and the proposal. The impact analysis is found as [Exhibit B](#) in this exposure draft.

## ***Request for Specific Comments***

Although the committee welcomes comments on all aspects of these proposals, it specifically requests feedback on the following:

1. 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.
2. Paragraph .03 of the proposed revised interpretation notes that when an interpretation of the "[Independence Rule](#)" [1.200.001] is applied in a state or local government environment and the [interpretation](#) uses terminology that is not applicable in this environment, the member should use their professional judgement to determine if there is an equivalent term and provides an example of one such situation where the committee believes this could occur. Are there any other terms or concepts included in the interpretations to the Independence rules that the committee should highlight as an example or consider providing additional application guidance for?
3. Are the entities that would be included in the proposed definition of a primary government in paragraph .04a, the entities that should be evaluated for independence purposes? If not, what entities should be evaluated for independence purposes and should the term "primary government" be used to describe these entities?
4. The committee believes that the criteria necessary to undertake the "more than minimal influence evaluation" in paragraph .14 is already available to the auditor as a result of other audit procedures. Do you believe that there are circumstances where this information is not readily available to the auditor? If so, provide examples of circumstances where a member may have difficulty in performing this evaluation.
5. The phrase "more than minimal influence over the accounting or financial reporting process over that fund or component unit" concept would require an analysis that is intended to be different than the analysis required for determining which entities are in a primary government's financial reporting entity. In the context of the proposed guidance, is that objective clear? If not, how would you better describe the analysis?
6. Paragraph .13 provides a "best efforts" provision that addresses those situations in which a member is unable to obtain the information necessary to identify investments held by a financial statement attest client. Are there any other situations where you believe a best efforts provision would be necessary, either upstream or downstream, because the financial statement attest client may have difficulty identifying all the entities in the financial reporting entity?
7. Is it clear that the interpretation does not apply to an entity that provides grant funds to the financial statement attest client (or vice versa) unless that entity is a fund or component unit that would otherwise be covered by the interpretation? If not, provide examples of situations where you believe additional guidance is needed.

## ***Effective Date***

The Committee 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.

## Text of Proposed Revised Entities Included in State and Local Government Financial Statements Interpretation

(Due to the Extensive Revisions Made to the Extant Interpretation the Proposed Revisions Are Not Marked Aside from the Proposed Title Change)

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

#### Introduction

- .01 This [interpretation](#) provides guidance on which entities [members](#) should be independent of because the entities have a relationship to a [financial statement attest client](#) that is a state or local government entity.
- .02 This [interpretation](#) applies to [financial statement attest clients](#) that are 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 financial 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 in a state or local government environment and the [interpretation](#) uses terminology that is not applicable in this environment, the member should use their professional judgement to determine if there is an equivalent term. For example, certain interpretations use the terms "officer, director or owner" of the [attest client](#). In some state or local government environments, it may be necessary for the member to extend these interpretations to "officials" of the [financial statement attest client](#) when the individual has governance responsibilities or control over financial reporting.

#### Terminology

- .04 The following terms are defined here solely for use with this interpretation:
  - a. Primary Government. The primary government is a state and local governmental entity that includes (1) the [financial statement attest client](#) and all entities that are required to be included in the [financial statement attest client's](#) financial reporting entity (that is, downstream entities) under the applicable financial reporting framework as well as (2) the financial reporting entity (that is, upstream entities) 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. Entities whose GAAP standard setter is the Governmental Accounting Standards Board. Examples of 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, public airports, public housing authorities, financing authorities, public transportation systems, public utilities, public employee retirement systems (PERSs), post-employment benefit plans, pension plans, public entity risk pools,

- external investment pools, public colleges and universities, Indian tribes, state tuition programs and other special districts.
- 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, 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.

***Independence of Funds and Component Units Required to Be Included in the Financial Reporting Entity (Downstream Entities) 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](#) financial 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](#) financial 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](#) financial 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 Financial Reporting Entity (Upstream Entities)***

.09 When a material fund or component unit is a [financial statement attest client](#) and is required to be included in another financial reporting entity which is not a [financial statement attest client](#), [members](#) should use the [Conceptual Framework for Independence](#) to evaluate relationships and circumstances that a [member](#) has with a primary government that exerts more than minimal influence over the accounting or financial reporting process of 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 has reason to believe that a relationship or circumstance exists with the entity that would create [threats](#) to [independence](#).

### ***Investments***

- .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 minimis to the [financial statement attest client](#) as a whole. De minimis 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 the Primary Government of the Financial Reporting Entity 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

**Less Influence**

**More Influence**

<ul style="list-style-type: none"> <li>• Fund or component unit prepares its own <a href="#">financial statements</a></li> </ul>	1. Primary government prepares the fund or component unit's <a href="#">financial statements</a>
<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.

## Text of Conforming Revision to The Definition of Financial Statement Attest Client

(Deletions are stricken)

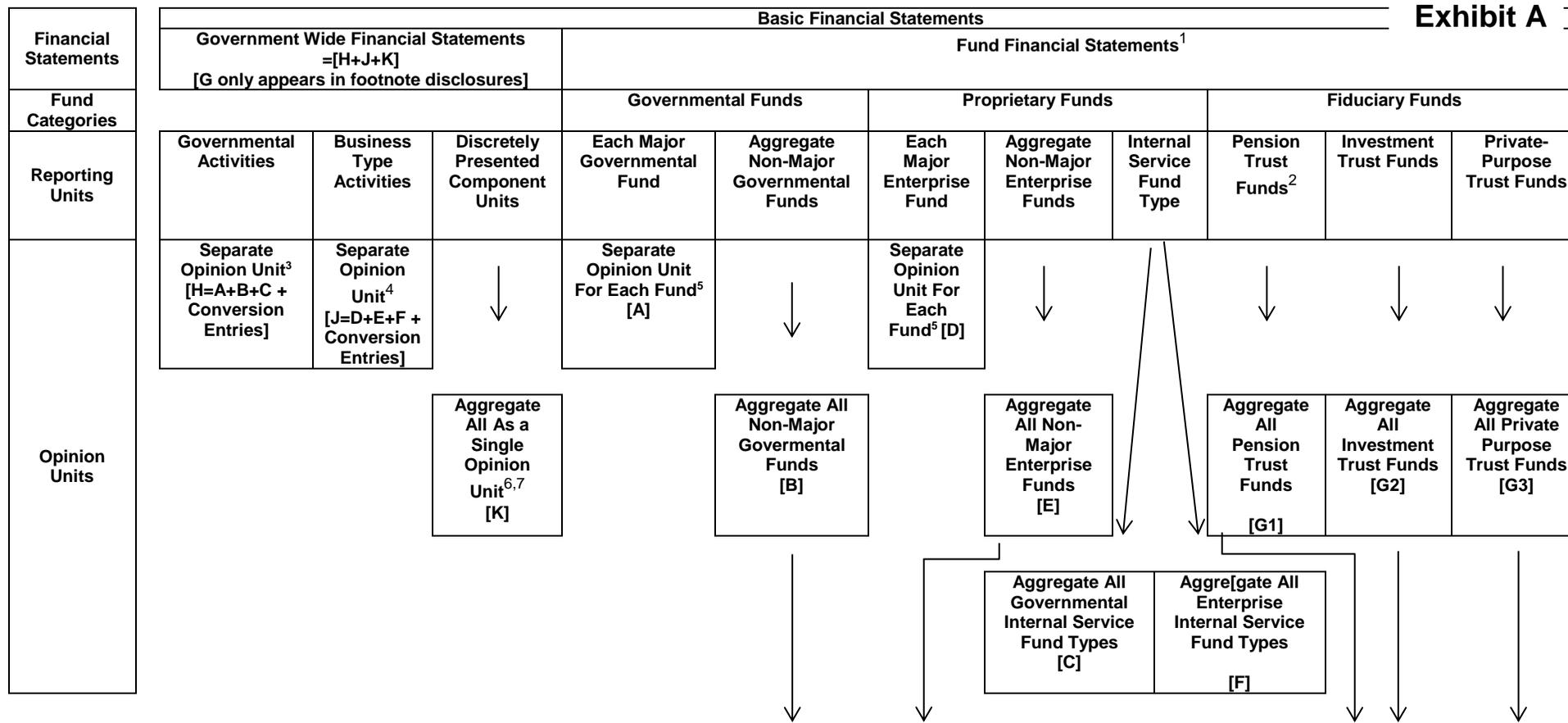
**Financial statement attest client.** An entity whose *financial statements* are audited, reviewed, or compiled when the *member's* compilation report does not disclose a lack of *independence*. This term is used in the "Client Affiliates" interpretation [1.224.010] of the "Independence Rule" [1.200.001]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

## Text of Proposed Revision to The Plan Is an Attest Client or Is Sponsored by an Attest Client Interpretation

(Additions appear in boldface italic and deletions are stricken)

### 1.250.010 *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]



**Aggregate All Non-Major Governmental Funds and Enterprise Funds, Internal Service Funds and Fiduciary Funds into a Single Opinion Unit [L=B+E+C+F+G1+G2+G3]<sup>7</sup>**

<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.

<sup>7</sup> In certain circumstances the aggregate remaining fund information opinion unit (L) may be combined with the aggregate discretely presented opinion unit (K) to form one opinion unit.

## Impact Analysis of Proposed Revisions to The State and Local Government Entities Interpretation

Extant Interpretation	Additional Independence Requirements Under The Exposure Draft	Rationale of Proposed Change
<b>Downstream Entities of the Financial Reporting Entity Including Benefit Plans</b>		
A. Members need to remain independent of funds and component units that are included in the financial statement attest client's financial reporting entity where the covered member does not make reference to another auditor's report on a fund or component unit. <i>(Refer to paragraph .04 of the extant interpretation)</i>	The requirement is the same under the proposal.	Not applicable.
B. Members do not need to remain independent of funds and component units that are included in the financial reporting entity of the financial statement attest client when the member makes reference to another auditor's report. <i>(Refer to paragraph .04 of the extant interpretation)</i>	When making reference to another auditor's report, members will need to remain independent of material funds and component units that are included in the financial reporting entity of the financial statement attest client when the primary government has more than minimal influence over the accounting or financial reporting process of the fund or component unit. <i>(Refer to provision paragraph .06 of the proposal)</i>	The committee believes that making reference to another auditor's report will not always reduce threats to an acceptable level when the fund or component unit is material to the financial reporting entity and the primary government has more than minimal influence over the accounting or financial reporting process of the fund or component unit.
C. The extant interpretation does not provide any independence guidance related to funds and component units that are excluded from the financial reporting entity but are required to be included under the applicable framework	Members should apply the independence rule and related interpretations to material funds and component units that are excluded from the financial reporting entity but required to be included under the applicable framework if the primary government has more than minimal	It is not uncommon for a primary government to exclude a fund or component unit from the financial reporting entity for a variety of reasons such as unavailability of a component unit's audited financial statements, therefore, the committee incorporated guidance in its proposal related

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Extant Interpretation	Additional Independence Requirements Under The Exposure Draft	Rationale of Proposed Change
(for example, GAAP, regulatory or cash basis).	influence over its accounting or financial reporting process. <i>(Refer to provision paragraph .07 of the proposal)</i>	to a material fund or component unit that is excluded from the financial statement attest client's financial reporting entity but is required under the applicable framework to be included.
D. The extant interpretation does not have any exceptions for nonattest services.	Members may provide nonattest services that would impair independence to funds and component units identified in rows B and C above, provided 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 (particularly those relating to management participation), the member should apply safeguards to eliminate or reduce the threats to an acceptable level. <i>(Refer to paragraph .08 of the proposal)</i>	The exception was incorporated so that the proposed interpretation would be conceptually consistent with the underlying principles of the Client Affiliates interpretation since the committee did not identify a compelling reason to differ from those principles.
<b>Upstream Entities (e.g., Financial Reporting Entity or Primary Government) of Financial Statement Attest Client Including Benefit Plans</b>		
E. 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 does not audit (e.g., upstream entity) <b>except covered members and their immediate family and close relatives may not have a key position within the primary</b>	Members would be required to evaluate relationships and circumstances that a member has with the primary government using the <a href="#">Conceptual Framework for Independence</a> when the financial statement attest client is material to the financial reporting entity and the primary government has more than minimal influence over the accounting or financial reporting process of the financial statement attest client. The	The committee believes that there could be circumstances where a member could have a relationship that creates a threat(s) that is (are) not at an acceptable level.  Furthermore, the committee believes these situations are more likely to occur when a material fund or component unit is a financial statement attest client and is required to be included in another financial reporting entity

Extant Interpretation	Additional Independence Requirements Under The Exposure Draft	Rationale of Proposed Change
<p><b>government.</b> (Refer to paragraphs .07 and .08 of the extant interpretation)</p>	<p>member is expected to actively consider threats when applying the Conceptual Framework. (Refer to paragraph .09 of the Proposal).</p>	<p>and the primary government of that financial reporting entity can exert more than minimal influence over the accounting or financial reporting process of the financial statement attest client.</p>
<b>Other Funds, Component Units or Activities Not Identified In Rows A through F Including Benefit Plans</b>		
<p>F. The extant interpretation does not have a requirement to evaluate threats to independence created by relationships or circumstances the member has with funds, component units or activities that aren't covered by the interpretation.</p>	<p>If a member knows or becomes aware of relationships or circumstances with a fund, component unit or activity that is not identified in rows A through F that would create threats to independence, the member would be required to evaluate the matter using the <a href="#">Conceptual Framework for Independence</a>. (Refer to paragraph .10 of the Proposal)</p>	<p>Member may encounter circumstances or relationships with certain entities that could give rise to threats that are not at an acceptable level.</p>
<b>Investments</b>		
<p>G. Under the extant interpretation there is no guidance on when members should extend the Independence Rule and related interpretations to investments held by a state or local entity; therefore, members would use the <a href="#">Conceptual Framework for Independence</a> when evaluation is required.</p>	<p>Under the proposal, the independence rules and related interpretations are extended to investments that are not de minimis to the financial statement attest client where the financial statement attest client:</p> <ul style="list-style-type: none"> <li>• can control the investment. (refer to item a. of paragraph .11 of the Proposal), or</li> <li>• has significant influence over an entity in which it has a material investment. (refer to item b. of paragraph .11 of the Proposal)</li> </ul>	<p>The committee believes that members should apply the independence rules and related interpretations to certain investments of a state and local government entity.</p> <p>Furthermore, a de minimis threshold is applied 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.</p>

### IT and Cloud Services Task Force

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

#### 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 interpretation and discuss the Task Force's preliminary recommendations on how to revise the Information Systems Services interpretation.

#### Summary of Issues – Hosting Services

##### *Description of Hosting Services and Underlying Threats*

At the February 2017 Committee meeting the Task Force recommended that when describing hosting services, it would be clearer if the custody and control concepts were replaced by a responsibility concept and that a FAQ provide additional clarity regarding why the safeguards in the [General Requirements for Performing Nonattest Services](#) interpretation were not enough to eliminate or reduce the management participation threats to an acceptable level. While the Committee agreed that hosting services would involve a member becoming responsible for the internal controls over the records or data, it recommended that the guidance in the FAQ be incorporated into a basis for conclusion document.

Staff prepared a basis for conclusion document but after reviewing it, the Task Force was concerned that members may not read the basis document and decided instead to incorporate the guidance from the FAQs into the interpretation so that the guidance would not be overlooked. Accordingly, the Task Force recommends that this rational be added to paragraph .02 of the interpretation as follows:

When a *member* provides hosting services, the *member* would be accepting responsibility for maintaining the *attest client's* internal control over its data or records. Accordingly, the management participation threat 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*.

In addition to adding the rational for why the management participation threat would be so significant, the Task Force also recommends that the description of what would constitute hosting services be clarified. Specifically, the Task Force believes that it would be clearer if the description listed "accepting responsibility for providing electronic security or backup services" as a separate service instead of including it as one of a number of services. Accordingly, the Task Force recommends that paragraph .01 be revised as follows:

For purpose of this interpretation, hosting services are nonattest services that involve a *member* accepting responsibility for

- a. the custody or storage of an *attest client's* data or records whereby, the data or records are only available to the *attest client* from the *member*, such that the *attest client's* data or records are otherwise incomplete, or
- b. providing electronic security or back-up services for an *attest client's*

#### Question for The Committee

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

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### Examples of Services

The Task Force developed a number of Frequently Ask Questions and Answers (FAQs) to satisfy requests for additional examples of services that would *and* would not be considered hosting services.

#### Bookkeeping

At the February 2017 meeting, the Committee discussed at length the bookkeeping scenarios presented in the proposed FAQ document (FAQs 3, 4 and 5) especially the caveat concerning the location of the general ledger (i.e., on the attest client's servers, on a third-party vendor's servers or on servers owned or leased by the member). A straw poll was taken and unanimously carried that when the general ledger is housed on *only* the firm's servers or servers leased by the member, that the member would be providing hosting services. The Committee directed Staff to ensure that this point would be highlighted. The Committee also agreed that the Task Force should prepare a basis for conclusions document and incorporate the points made in the draft FAQs into the basis document. As noted above the Task Force was concerned that members may not read the basis document and decided instead to incorporate the guidance from the FAQs into the interpretation so that the guidance would not be overlooked.

FAQ 3 explained that a member would be providing hosting services when a member houses the attest client's general ledger on the member's server or servers leased by the member because the member would have become part of the attest client's internal controls over its financial information. This guidance was added as example "b." to paragraph .03 of the interpretation which lists examples of hosting services:

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

FAQ 4 and 5 provide guidance on situations where the member is not considered to be providing hosting services in connection with the provision of bookkeeping services and the use of general ledger software. The guidance from these two FAQs was added to item "c." of paragraph .04

- c. Using general ledger software to facilitate the delivery of bookkeeping services when either
  - i. the *member* and the *attest client* maintain separate instances of the software on their respective servers and the *member* provides updated financial information electronically to the *attest client*, or
  - ii. the *attest client* enters into an agreement with a third-party service provider to maintain its software in a cloud based solution and grants the *member* access to the software so that the *member* is able to perform the bookkeeping service for the *attest client*.

#### Miscellaneous Other Examples of Services That Are Not Hosting Services

FAQ 2 explained that a 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. This guidance was added as example "g." to paragraph .04 of the interpretation:

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- g. Retaining a depreciation schedule prepared by the *member* provided the depreciation schedule and calculation is given to the *attest client* so that *attest client's* books and records are complete.

FAQ 6 was drafted based upon a comment letter that asked if a member would be providing hosting services if the member performed a survey for the attest client and kept the data collected that supported the work product (the report that summarizes the survey results). The guidance from this FAQ was added as item "d." of paragraph .04

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

The exposure draft included an example of a situation where a member would not be considered to be providing hosting services when the member allows an attest client to input its data into a member's software in order to generate reports for the attest client's use. FAQ 7 was drafted based upon a comment letter that asked for a specific example to be provided. An example was added to item "f." of paragraph .04

- f. Licensing software to an *attest client* that the *attest client* uses to input its data and receive an output that the *attest client* is responsible for maintaining. For example, a *member* licenses tax provision software to an *attest client* whereby the *attest client* inputs the relevant data and the product produces a tax provision report. However, the *member* must not license software to an *attest client* that performs an activity that, if performed directly by the *member*, would *impair independence*.

At the November 2016 and February 2017 meetings the Committee discussed concerns raised by a member regarding whether a member would be providing hosting services when the member take possession of an attest client's data or records to perform a nonattest service. The Committee agreed that this was not the intention of the proposed interpretation. This was clarified by adding item "h." to paragraph .04

- h. Retaining an *attest client's* original data or records to facilitate the performance of a nonattest service (for example, obtaining original records to prepare the attest client's tax return) provided that the data or records are returned to the *attest client* at the end of the engagement or, in a multi-year engagement, at least annually. This does not apply to ongoing hosting services as described in paragraph .01 of this interpretation.

**Question for The Committee**

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

*Effective Date*

Given the additional time taken to discuss this proposal, the Task Force recommends the effective date be modified to allow members adequate time to implement the new requirements. Specifically, the Task Force continues to believe that the interpretation should be effective for engagement periods beginning on or after December 31, 2017 but require engagements entered prior to December 31, 2017 that do not comply with the requirements of this interpretation, be restructured or terminated by June 30, 2018.

**Question for The Committee**

1. Should the proposal be adopted as revised in **Agenda Item 4B**?

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### **Information Systems Services**

As explained in previous agenda materials provided to the Committee, the Task Force believes that the existing Information Systems Design, Implementation, or Integration interpretation is in need of clarification. The proposed revised interpretation can be found in **Agenda Item 4D**. To help with the clarification, the Task Force has identified what it believes are the most common categories of services members are requested to provide in this area and then developed guidance to explain what the Task Force believes these services would include and when these services would or would not impair independence. The categories identified by the Task Force are:

- Design or Development of an Information System
- Implementation Services
- Installing a Software Solution
- Configuring a Commercial-Off-The Shelf Software Solution
- Customization of a Commercial-Off-The Shelf Software Solution
- Integrating a Commercial-Off-The Shelf Software Solution
- Data Conversion Services
- Other Information Systems Services

<b>Question for The Committee</b>
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- |  |
|--|
| <ol style="list-style-type: none"><li>1. Are there any other categories that the Committee believes should be included?</li><li>2. Is the Committee in agreement with the guidance included so far in each category?</li></ol> |
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#### *Examples of Services That Do Not Impair Independence*

Paragraph .02 of the extant interpretation lists 5 examples of information systems design, implementation and integration services that don't impair independence provided the provisions of the Nonattest Services subtopic are met (e.g., the general requirements). Following are the examples from paragraph .02 of the extant interpretation that do not impair independence:

- a. install or integrate an *attest client's* financial information system that the member did not design or develop (for example, an off-the-shelf accounting package).
- b. assist in setting up the *attest client's* chart of accounts and *financial statement* format with respect to the *attest client's* financial information system.
- c. design, develop, install, or integrate an *attest client's* information system that is unrelated to the *attest client's financial statements* or accounting records.
- d. provide training and instruction to an *attest client's* employees on an information and control system.
- e. perform network maintenance, such as updating virus protection, applying routine updates and patches, or configuring user settings consistent with management's request.

The Task Force believes **example a** "install or integrate an *attest client's* financial information system that the member did not design or develop (for example, an off-the-shelf accounting package)" is addressed in greater detail in paragraphs .06, .08, .09 and .15 through .17 of the proposed revised interpretation.

The Task Force believes **example b** "assist in setting up the *attest client's* chart of accounts and *financial statement* format with respect to the *attest client's* financial information system" is would be a configuration service covered by paragraphs .10 and .11.

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The Task Force believes **example c** “design, develop, install, or integrate an *attest client’s* information system that is unrelated to the *attest client’s financial statements* or accounting records” is addressed in greater detail in paragraphs .06, .08, .09 and .15 through .17 of the proposed revised interpretation.

The Task Force believes **example d** “provide training and instruction to an *attest client’s* employees on an information and control system” would be covered by example a in paragraph .22. It is envisioned that this subtopic will cover a board array of services that don’t necessary “fit” into any of the other subtopics.

The Task Force seeks feedback from the Committee regarding **example e** “perform network maintenance, such as updating virus protection, applying routine updates and patches, or configuring user settings consistent with management’s request”. The Task Force is concerned that as drafted, the example seems to imply that the attest client has outsourced its management responsibilities to design, implement and maintain internal control over its information systems and as such would result in the member taking on a management responsibility. Since this thinking fundamentally differs from the extant position, it could be viewed as a significant departure from what members believe they can do today. Accordingly, the Task Force seeks feedback from the Committee on its preliminary thinking.

**Questions for Committee**

1. Does the Committee believe **examples a through d** are addressed adequately in the proposed revised interpretation?
2. Does the Committee agree with the Task Force’s preliminary thinking that **example e** would result in the member taking on a management responsibility?

*Examples of Services That Impair Independence*

Paragraph .03 of the extant interpretation lists 4 examples of information systems design, implementation and integration services that impair independence. Following are the services that do impair independence in the extant interpretation:

- a. designs or develops an *attest client’s* financial information system.
- b. makes other than insignificant modifications to source code underlying an *attest client’s* existing financial information system.
- c. supervises *attest client* personnel in the daily operation of an *attest client’s* information system.
- d. operates an *attest client’s* network

The Task Force believes **example a** “designs or develops an *attest client’s* financial information system” is covered in paragraph .05 of the proposed revised interpretation.

The Task Force seeks feedback from the Committee related to **example b** “makes other than insignificant modifications to source code underlying an *attest client’s* existing financial information system”. The Task Force is concerned that as drafted, the example is unclear what would constitute insignificant modifications to source code. Some members of the Task Force noted that their firms have taken the position that no modifications should be done since they have no idea how to determine what “insignificant” means. Some members of the Task Force have also noted that this example is not really used by their firms to perform these services, rather as a way to evaluate situations where the firm inadvertently made modifications to the source code and question whether it is still necessary now that the [Breach of an Independence Interpretation](#) has been added to the Code.

The Task Force believes **example c** “supervises *attest client* personnel in the daily operation of an *attest client’s* information system” is covered in the [Management Responsibilities](#) interpretation. This interpretation explains in part that management responsibilities involve

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leading and directing an entity, including making significant decisions regarding the acquisition, deployment, and control of **human**, financial, physical, and intangible resources” (emphasis added). By way of example, it also concludes in part that “directing or accepting responsibility for actions of the *attest client’s* employees...” would be considered a management responsibility. Accordingly, the Task Force has not added this as a specific example in the proposed revised interpretation as it believes it is adequately covered elsewhere.

The Task Force seeks feedback from the Committee related to **example d** “operates an *attest client’s* network”. The Task Force is concerned that as drafted, the example is somewhat vague as to what specific activities the member is doing but does agree that it implies that the attest client has outsourced its management responsibilities to maintain internal control over its information systems and as such would result in the member taking on a management responsibility. In fact, the Task Force believes this could be interpreted as being the same activities discussed above in example e “perform network maintenance, such as updating virus protection, applying routine updates and patches, or configuring user settings consistent with management’s request”. Accordingly, the Task Force seeks feedback from the Committee regarding where best to include this example in the proposed revised interpretation.

**Question for the Committee**

1. Does the Committee agree example a are addressed adequately in the proposed revised interpretation?
2. How does the Committee believe the insignificant modification to source code should be addressed?
3. Does the Committee agree that example c is adequately addressed in the Management Responsibilities interpretation?
4. How does the Committee believe the “operates an attest client’s network” should be addressed?

*Reminder Paragraph*

The Task Force recommends that the interpretation remind members that when providing information system services that members must comply with all the interpretations in the nonattest services subtopic and highlight three interpretations that the Task Force believes will be most frequently referenced when providing these types of services. This reminder was added to paragraph .02.

The Task Force believes that when providing information systems services, members should have a heightened awareness that the services could taking on providing some management responsibilities and as such, chose to highlight this interpretation in paragraph .02. In addition, the Task Force included 2 examples of management responsibilities (accepting responsibility for designing, implementing, or maintaining internal control or for the management of an attest client’s project) as it believes these may be activities that could often be embedded in services they are asked to perform.

If however, the service does not involve any management responsibilities, in order to maintain independence members will still need to comply with the “[General Requirements for Performing Nonattest Services](#)” interpretation and so this is also highlighted in paragraph .02. In lieu of stating in each subsection that members may provide advisory only services, the Task Force recommends the Advisory Services interpretation also be highlighted.

**Question for Committee**

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| 1. Does the Committee find the reminder paragraph helpful and are there any other interpretations that should be highlighted? |
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*Comparison to IESBA Rules*

For informational purposes, the Task Force asked Ms. Snyder to compare its proposed revision to the comparable IESBA guidance to ensure that the proposal is not less restrictive than the IESBA. Ms. Snyder believes that paragraphs .05, .13, .16 and .19 of our proposal are more restrictive than the IESBA's guidance for non-PIEs. She believes that in these situations the IESBA would require threats and safeguards approach and would most likely result in safeguards such as separate engagement teams and/or another individual to review the work (see pars. 290.200 -.202). She noted that with respect to paragraphs .16 and .19 that while it is a matter of professional judgement, that the firm may conclude that no safeguards can reduce threats to an acceptable level. Ms. Snyder also noted that the IEBSA only refers to "design or implementation" of systems but she believes installation and configuration would fall under their "implementation services."

*Project Management Services*

The Committee also asked the Task Force to consider if guidance should be developed related to a member acting as a project manager for an information systems service project. The Task Force recommends that example "i." from the Management Responsibilities interpretation (accept responsibility for the management of an attest client's project) be added to item a of paragraph .02 of the proposed revised interpretation found in **Agenda Item 4D**.

<b>Question for Committee</b>
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| 1. Does the Committee have any feedback on the proposed revised interpretation found in <b>Agenda Item 4D</b> ? |
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**Communication Plan**

The Committee 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**

- Agenda Item 4B** Hosting Services Interpretation – Proposed for Adoption by Task Force
- Agenda Item 4C** Hosting Services Interpretation – As Exposed
- Agenda Item 4D** Proposed Revised Information Systems Services Interpretation

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### Text of Proposed Hosting Services Interpretation

#### 1.295.143 - Hosting Services

- .01 For purpose of this interpretation, hosting services are nonattest services that involve a *member* accepting responsibility for
- a. the custody or storage of an *attest client's* data or records whereby, that data or records are only available to the *attest client* from the *member*, such that the *attest client's* data or records are otherwise incomplete, or
  - b. providing electronic security or back-up services for an *attest client's* data or records.
- .02 When a *member* provides hosting services, the *member* would be accepting responsibility for maintaining the *attest client's* internal control over its data or records. Accordingly, the management participation threat 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 Examples of activities that would be considered hosting services, and as such would *impair independence* if performed for an *attest client*, include:
- a. Accepting responsibility to be the *attest client's* business continuity or disaster recovery provider.
  - b. Housing the *attest client's* financial or non-financial information system(s) on the *member's firm's* servers or servers licensed by the *member's firm*. For example, the *firm* hosts the *attest client's* financial system or website on *firm* servers.
  - c. Accepting responsibility for keeping the *attest client's* data or records on the *attest client's* behalf. For example, the *attest client's* general ledger, supporting schedules (such as, depreciation or amortization schedules), lease agreements or other legal documents are stored on the *member's firm's* servers or servers licensed by the *member's firm* or the *member* is responsible for storing hard copy versions of the data or records.
- .04 Examples of activities that would not be considered to be hosting services, and as such would not *impair independence* provided *members* comply with the requirements of the other *interpretations* of the Nonattest Services subtopic include:
- a. Retaining a copy of an *attest client's* data or records as documentation to support a service the *member* provided to the *attest client*. For example, the *member* retains a copy of:
    - i. the payroll data that supports a payroll tax return prepared by the *member* for the *attest client*.
    - ii. a bank reconciliation that supports attest procedures performed by the *member* on the *attest client's* cash account.
    - iii. the *attest client's* vendor data used to prepare an analysis of vendor activity.
  - b. Retaining, for a *member's* records, a copy of a work product prepared by the *member* (for example, a tax return).
  - c. Using general ledger software to facilitate the delivery of bookkeeping services when either
    - i. the *member* and the *attest client* maintain separate instances of the software on their respective servers and the *member* provides updated financial information electronically to the *attest client*, or
    - ii. the *attest client* enters into an agreement with a third-party service provider to maintain its software in a cloud based solution and grants the *member* access to the software so that the *member* is able to perform the bookkeeping service for the *attest client*.
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- d. Retaining data collected by the *member* related to a work product that the *member* prepared for an *attest client*. For example, the *member* conducts an employee survey and provides the *attest client* with a report. The *member* retains the survey data collected to support the work product.
  - e. 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. For example, the *member* uses a portal to:
    - i. exchange data and records with the *attest client* related to *professional services* provided by the *member* to the *attest client*, or
    - ii. 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 conclusion of the engagement.

- f. Licensing software to an *attest client* that the *attest client* uses to input its data and receive an output that the *attest client* is responsible for maintaining. For example, a *member* licenses tax provision software to an *attest client* whereby the *attest client* inputs the relevant data and the product produces a tax provision report. However, the *member* must not license software to an *attest client* that performs an activity that, if performed directly by the *member*, would *impair independence*.
- g. Retaining a depreciation schedule prepared by the *member* provided the depreciation schedule and calculation is given to the *attest client* so that *attest client's* books and records are complete.
- h. Retaining an *attest client's* original data or records to facilitate the performance of a nonattest service (for example, obtaining original records to prepare the attest clients tax return) provided that the data or records are returned to the *attest client* at the end of the engagement or, in a multi-year engagement, at least annually. This does not apply to ongoing hosting services as described in paragraph .01 of this interpretation.

### **Effective Date**

- .05 This interpretation is effective for engagement periods beginning on or after December 31, 2017. Engagements entered into prior to December 31, 2017 that do not comply with the requirements of this interpretation, must be restructured or terminated by June 30, 2018.

**Text of Proposed Hosting Services Interpretation  
As Exposed**

[Terms in italic only are defined terms]

**1.295.143 - Hosting Services**

- .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 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*.
- .02 Examples of hosting services that would *impair independence* include these:
- a. 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) on the *member's firm's* servers. For example, the *firm* hosts the *attest client's* financial system or website on *firm* servers.
  - c. Keeping the *attest client's* data or records in the *member's* office for safekeeping. For example, the *attest client's* original lease agreements or other legal documents are stored in the *member's* office.
- .03 Following are examples of situations in which a *member* would not be considered to be hosting 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 the payroll data that supports a payroll tax return the *member* prepared or a copy of a bank reconciliation that supports attest procedures performed on the cash account.
  - 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.  
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.  
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**

- .04 This interpretation is effective [6 months from the date it is published in the *Journal of Accountancy*].

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### Proposed Revised Information Systems Services Interpretation

- .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 the requirements of the [Nonattest Services](#) subtopic [1.295] of the Independence Rule [1.200.001] should be met. For example, the member should comply with the requirements of the:
  - a. "[Management Responsibilities](#)" interpretation [1.295.030] including not accepting responsibility for designing, implementing, or maintaining internal control or for the management of an attest client's project.
  - b. "[General Requirements for Performing Nonattest Services](#)" interpretation [1.295.040] 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.
  - c. "[Advisory Services](#)" interpretation [1.295.1050] when providing advice or recommendations related to information system services.

#### **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

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an acceptable level provided the safeguards outlined in paragraph .02 of this interpretation are applied.

### ***Implementation Services***

.07 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.

### ***Installing a Software Solution***

.08 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.

.09 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***

.10 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.

.11 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.

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

.12 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.

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- .13 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.
  - .14 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.

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

- .15 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 the integration 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 integration involves an attest client's financial information system.
- .16 When a member provides integration services that involve an attest client's financial information system and the integration involves designing or developing software code, 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.
- .17 If however, the member provides integration services unrelated to the attest client's financial statements or accounting records or if the integration services are related to the attest client's financial statements or accounting records but the integration does not involve designing or developing software code, 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 use an Application Program Interface (API) developed by a third party to integrate a COTS software solution to an attest client's financial information system provided the member does not need to design or develop additional software code so that the API will function as required by the client or will only develop data mapping rules that will be used to match data to be moved between systems connected by the API.

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

- .18 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.
- .19 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.
- .20 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.
- .21 Sometimes an Application Program Interface (API) that is developed by a third party may be used to convert legacy system data so that it is compatible in structure to that of the new COTS software solution. To determine if the use of the API will create threats to independence that would not be at an acceptable level, the member should determine if the member will need to design or develop code for the API to work and if so, if the data is unrelated to the attest client's financial statements or accounting records. If the member will not need to design or develop code for the API to work, or if the member will develop

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data mapping rules to match data to be moved between systems connected by an API, threats will be at an acceptable level. In addition, if the data is unrelated to the attest client's financial statements or accounting records, threats will be at an acceptable level even if the member must design or develop code for the API to work.

**Other Information Systems Services**

.22 If the member applies 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* when the member performs

- a. training or instruction on a new system

.23 However, *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, for example, a member performs professional services that involve accepting responsibility for maintaining internal control or the management of, an attest client's information system. Examples of such services include

- a.

<p>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>.</p>
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**AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS  
DIVISION OF PROFESSIONAL ETHICS  
PROFESSIONAL ETHICS EXECUTIVE COMMITTEE  
OPEN MEETING MINUTES  
FEBRUARY 9-10, 2017  
SAN JUAN, PR**

The Professional Ethics Executive Committee (Committee) held a duly called meeting on February 9-10, 2017. The meeting convened 9 a.m. and concluded at 4:53 p.m. on February 9<sup>th</sup> and reconvened at 8:00 a.m. and concluded at 8:40 a.m. on February 10<sup>th</sup>.

<p><b><u>Attendance:</u></b> Samuel L. Burke, Chair Coalter Baker Carlos Barrera* Stanley Berman Michael Brand Tom Campbell Robert E. Denham* Anna Dourdourekas Janice Gray</p>	<p>Greg Guin* Brian S. Lynch William Mann Andrew Mintzer* Jarold Mittleider Steven Reed James Smolinski Laurie Tish Shelly Van Dyne Blake Wilson</p>
<p><b><u>Staff:</u></b> Lisa Snyder, Director James Brackens, VP - Ethics &amp; Practice Quality Jason Evans, Sr. Technical Manager Ellen Gorla, Sr. Manager Independence &amp; Special Projects</p>	<p>Shelley Truman, Coordinator 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 Nancy Miller, KPMG William McKeown, KPMG Dan Dustin, VP State Board Relations, NASBA Catherine Allen, Audit Conduct Sonja Araujo, PwC Vince DiBlanda, Deloitte David L. Patrick (For the first 3 items)</p> <p style="text-align: right;">*Via Phone</p>	

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

Ms. Miller explained that the Task Force was able to simplify the proposed revised interpretation by identifying the entities that members need to be independent of and requiring a conceptual framework evaluation for relationships with other entities that come to the member's attention. She noted that since the new GASB 84 changes the governmental reporting structure relative to fiduciary funds, including benefit plans, the interpretation does not need to address these separately. She explained that the Task Force is drafting a number

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of FAQs and visual aids to assist with the overall implementation of the interpretation and some of the FAQs will specifically highlight benefit plans.

Ms. Miller explained that when looking “downstream,” the Task Force’s starting point is the applicable reporting framework. By using the applicable reporting framework as the first cut, the proposed interpretation scopes in some excluded entities that were not addressed in the extant interpretation. She explained that in addition to the applicable reporting framework, there are two main concepts that are included in the interpretation: (1) does the primary government have more than minimal influence over the accounting or financial reporting process of the fund or component unit and (2) is the fund or component unit material to the primary government. Ms. Miller then explained each situation where the Task Force believes independence should be required when looking downstream.

A member asked if the “more than minimal influence” criteria would require an analysis that is not already required. Two members of the Committee who practice in the State and Local Government (SLG) arena noted that they believe these concepts are already being dealt with and would likely be part of the audit planning process so these are not new concepts to practitioners in this industry.

Ms. Miller went on and explained how the “upstream” guidance would work. She noted that trying to find the words to describe the entity that has more than minimal influence over the client proved to be challenging. She noted that some members of the SLG Expert Panel read the guidance to mean the “legal entity”. Ms. Miller explained that the Task Force believes the legal entity is too broad. For example, if a member’s financial statement attest client is a pension plan, and the state meets the more than minimal influence criteria, if the entire state was scoped in then any bonds issued by the state would be restricted investments.–Ms. Miller explained that was not the intention and so the Task Force is hoping to receive feedback during exposure to clarify. One member asked if one way to solve the issue would be to use paragraph .10, the conceptual framework evaluation, to cover upstream situations. Another member countered and suggested instead of paragraph .10, which would only require a conceptual framework evaluation when a relationship or circumstance comes to the member’s attention, that an evaluation under the conceptual framework be required. This member went on to explain that the criteria in paragraph .09 would remain (i.e., more than minimal influence and materiality) but would require that any relationships or circumstances that the member has with this entity be evaluated using the Conceptual Framework for Independence. This would allow the member to use professional judgement to determine the extent of the threats and impact the safeguards would have. The Committee was supportive of this approach.

Ms. Miller went on to explain the investment proposal. She noted that the Task Force has received feedback that this could present operational difficulties when implementing because of the frequent investment changes. To help with this, the Task Force is proposing a de minimis concept (less than immaterial) be incorporated.

After some discussion, it was agreed that the Task Force should come back with a proposal in May that is ready for exposure and to:

- Draft the basis for the proposed revisions and incorporate the visual aids and information currently contemplated to be included in the FAQs as examples to help explain the basis for the revisions.
- Draft an impact analysis.

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- Include questions in the exposure draft that would solicit feedback on whether the “more than minimal influence” concept is clear and if it is creating a new concept.

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

Mr. Denham introduced the topic noting that the Task Force was requesting the PEEC approve the proposed draft interpretations for exposure for comment. Mr. Denham reviewed some of the specific topics of significance within the exposure draft.

A committee member noted that the draft interpretation for members in public practice did not permit a predecessor auditor to disclose a NOCLAR to a successor auditor without the client’s permission. The member further inquired as to the “red flag” noted in the agenda alerting the successor auditor to a potential issue. Mr. Evans and another member of the PEEC explained that it would be a red flag if the predecessor auditor was not granted permission by the client to disclose confidential information to the successor auditor and that the successor auditor must consider this situation before accepting a new client.

Mr. Denham reviewed certain key decisions of the PEEC concerning the proposed interpretations noting the specific documentation requirement included in the proposed NOCLAR interpretation for members in public practice. Some PEEC members expressed concern about the documentation requirement stating that it may be missed by members performing non-attest services. Further, it was questioned whether a documentation standard positively contributes to the public interest. The PEEC agreed to include a specific question concerning the respective documentation requirement within the exposure draft.

Mr. Denham noted a suggestion that the reference in the interpretation to the Confidential Client Information Rule should include an explanation as to why the respective rule was being specifically identified. Ms. Gorla responded noting that the accepted drafting conventions of the Code do not include explanations of references. It was concluded that it could potentially be appropriate to include the reference to the Confidential Client Information Rule in multiple paragraphs. Mr. Evans voiced a preference to include an overarching reference at the beginning of the interpretation. Ms. Hnatt agreed, explaining that a user could conclude that the Confidential Client Information Rule applies only to the specific paragraph in which it is addressed rather than to the interpretation as a whole. The PEEC agreed to include the reference once, at the beginning of the interpretation with the intention of applying the reference to the entire interpretation.

Ms. Snyder questioned whether the interpretation is practicable if the member in public practice is engaged to perform a professional service over a short period, for example, for a two week non-attest engagement with no planned future relationship with the client. A member of the committee stated that the interpretation may not be practicable in that situation and may put members at legal risk in that they may not be able to fulfil the expectations created by the draft interpretation. Another member of the PEEC noted that in their firm, if a NOCLAR were noted during a two week engagement, the member would seek guidance from their legal department. Another member noted that in the two-week-engagement scenario, it would be in the public interest to attempt to follow the guidance in the proposal, however, management may not respond to the inquires of the member. Ms. Hnatt replied stating that if management does not reply, it does not mean that the member did not comply with the interpretation.

A member questioned whether the guidance should cover members in public practice that perform non-attest services. The member further noted that the guidance places members at

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a competitive disadvantage to those that do not have to follow the Code. Ms. Snyder replied by stating that the IESBA considered the same issue. The IESBA concluded that it would still be in the public interest for those not bound by the Code to bring a NOCLAR to the attention of the client's management. Another member noted that non-CPAs not bound by the Code may be exposed to law suits if they do not disclose a NOCLAR based on the fact that they are not bound by State Board confidentiality laws, thus, there is balance.

It was moved, seconded and unanimously approved to expose the proposed interpretations for comment.

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

Mr. Patrick explained that he is concerned that the Committee would conclude that a member is providing hosting services that would impair independence when a member takes possession of an attest client's data or records to perform a nonattest service, especially when the underlying application he is using to provide those nonattest services will generate data files. To help make his point, he provided an example where his attest client would provide him with an approved invoice so that he could post the necessary entry and create the necessary check for the attest client. In this scenario he would be in possession of the approved vendor invoice, a record of the attest client, as well as the general ledger data file and check, both of which would be the attest client's data and records.

A member of the Committee noted that he believes hosting services would involve a member becoming responsible for the internal controls over the records or data and not just taking possession to provide a professional service. Ms. VanDyne explained that when exposed, the proposal used the notion of custody or control but commenters believed this to be unclear and so replaced it instead with a responsibility notion.

The Committee discussed at length the bookkeeping scenarios presented in the proposed frequently asked question (FAQ) document, especially the caveat concerning the location of the general ledger (i.e., on the attest client's servers, on a third party vendor's servers or on servers owned or leased by the member). A straw poll was taken and unanimously carried that when the general ledger is housed on *only* the firm's servers or servers leased by the member, that the member would be providing hosting services. The Committee directed Staff to ensure that this point would be highlighted. The Committee also agreed that the Task Force should prepare a basis for conclusions document and incorporate the points made in the draft FAQs into the basis document.

Ms. VanDyne reported that the Task Force had made progress with the strawman and had not made a cut based on the size of the Commercial Off-The-Shelf (COTs) products. Due to time constraints, the Committee did not get to discuss the Information Systems Services strawman but was asked if there was any feedback on the Task Force's direction. In response to a question, Ms. VanDyne noted that the reason why so much of the guidance keyed in on COTs was because a non-COTs system would likely involve the member providing some level of design or development which would impair independence. She also noted that the Task Force has yet to conclude whether the guidance should continue to permit the member to make insignificant modifications to source code underlying the attest client's existing financial information system. The Task Force was asked to discuss the impact these services have on internal control, especially with respect to configuration services.

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Ms. Gorla asked the Committee to email her with any scenarios in which they believe data conversions could be done without having to manipulate the data from the old system in order for the new system to accept it.

#### 4. Leases

Mr. Wilson presented the Leases Task Force agenda item to the Committee. Mr. Wilson explained that the Task Force previously brought proposed revisions to PEEC that reflected a more conceptual approach to leases, eliminating the concept of GAAP lease categorization from the guidance and taking a more principles based approach. Mr. Wilson presented highlights of the Task Force's discussions, and presented two additional revision options prepared by the Task Force (Options B and C below) for PEEC consideration.

##### *Option B – Conceptual Approach to All Leases with Minimum Requirements*

Option B states that all leases should be evaluated using a threats / safeguards approach, while leases that do not meet certain minimum requirements would impair independence. The thresholds for impairing independence (i.e. minimum requirements) noted in Option B are:

- a. *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*
- c. *The lease is material to the covered member or the attest client.*

Mr. Wilson explained that Option B addressed several issues previously raised by the PEEC; additionally the Task Force raised other issues with Option B. Mr. Wilson noted that the Task Force's discussions regarding these issues led to the creation of a revision Option C, which takes a "guided" Conceptual Framework approach to leases by providing factors to consider in evaluating all leases.

##### *Safe harbor for immaterial leases*

Mr. Wilson explained that the restructuring of paragraph .01 of Option B removed a perceived safe harbor for immaterial leases in the prior proposal, in that any immaterial lease meeting the minimum requirements (a-c) would be allowed. Mr. Wilson explained that under the new structure of paragraph .01, there is no safe harbor as the conceptual framework approach applies to all leases; immaterial leases would be subject to further evaluation without a bright line safe harbor for those leases. There was no further discussion on this issue.

##### *Normal Course of Business and Arm's Length Transactions*

Mr. Wilson noted that previously, PEEC had discussed potentially using the term "normal course of business" to reference leases that are entered into at arm's length and for legitimate business reasons. PEEC and the Task Force previously noted concerns surrounding consistency of the use of the term with other regulators and approved bodies, whether the lease is at higher risk of not being at arm's length because if the lessor is not in the business of leasing, and the lack of availability of other parties' leases to compare terms and conditions. The Task Force noted that the conceptual framework approach considers whether the transaction is at arm's length by considering the self-interest, undue influence, and familiarity threats caused transactions that are not at arm's length.

Mr. Wilson noted that the Task Force contemplated whether the perceived risk of a lease being at less than arm's length would be mitigated if the standard required leases to be with a lending institution. It was noted that automobile leases are part of a lending institution's

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operations under the AICPA Code definition of lending institutions. One PEEC member noted that the lending institution leases are limited to automobile leases in the definition, and office leases are typically held with a real estate investment trust (REIT) or another entity that is not a lending institution. Therefore, limiting the guidance to leases with lending institutions would not be appropriate for leases in general. There was no disagreement on this point from other PEEC members.

Mr. Wilson posed the question to PEEC of whether the guidance should explicitly use the term “at arm’s length” in the interpretation to address the primary concern of leases being in the normal course of business and not “sweetheart deals” that threaten independence. Mr. Cahill (Task Force member) noted that there are certain limitations to how far an auditor can go to say a contract is at arm’s length, and expressed concern that this may be an unattainable requirement. One PEEC member noted further that if other leases are done in a different market, comparability may not be enough, while “arm’s length” would scope in all things to be considered. Another PEEC member noted that the term “arm’s length” refers to the process of establishing the lease (process-focused), while the concept of comparing the ultimate terms/conditions is outcome focused; for this reason, the member favored referring to comparability of terms/conditions rather than to arm’s length transactions. Another PEEC member noted that another way to ask the question is to ask what the unusual benefit is of a transaction that is not at arm’s length. In concluding the discussion, a PEEC member recommended replacing the requirement regarding comparability with the phrase “on market terms and established at arm’s length.” There was no disagreement from the PEEC on the recommended terminology:

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

#### *Materiality – Implicit or Explicit inclusion as a Requirement*

Mr. Wilson noted that PEEC previously indicated that materiality is a factor in the independence threats related to a lease, but that the Task Force has concerns that materiality as a bright line test may not lead to the correct conclusion. In this regard, the Task Force was concerned about whether the materiality evaluation should be implied by use of the conceptual framework approach or should be explicitly noted in the guidance as a requirement (i.e. a bright line test). Mr. Wilson noted an example where a material lease is held by a covered member who is not connected to the engagement team, and questioned whether the conclusion that no safeguards can be applied is the correct conclusion. Mr. Wilson further noted that the conceptual framework approach would not be available for those covered members because the lease would be material, regardless of the connection of the covered member to the engagement. One PEEC member noted that a building lease could have very different materiality for a small firm versus a large firm; other members noted that economies of scale do impact materiality, but that there cannot be a different path for analysis for firms based on their size. After brief discussion of other issues noted below, PEEC determined that materiality should not be included as a minimum requirement but should be a factor of consideration in evaluating the threats created by a lease.

#### *Limiting Requirements to Certain Covered Members*

Mr. Wilson questioned whether the guidance should be limited to certain covered members that are connected to the engagement. One member agreed that materiality and other considerations are different for those connected to the engagement. Another member noted that the real threat surrounds entering into the lease, rather than the existence of a lease, and wondered if the PEEC should look at a conceptual framework approach that is based on the

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individual and entering into the lease. Another member questioned what would happen if the building a member/firm occupies is purchased by an attest client.

Several members agreed that the threat to independence is lower for some covered members than others. Ms. Miller (Task Force member) noted that the IESBA Code addresses business relationships, and limits those requirements to certain members connected to the engagement, an approach that she supports. Ms. Miller also noted that other areas of the Code limit certain provisions to specific covered member categories. Ms. Snyder noted that the IESBA Code does not specifically address leases nor does it explicitly include leases in the IESBA guidance regarding business relationships. During discussion of other matters noted below, a PEEC member suggested that the Task Force move toward limiting requirements to certain covered members similar to the IESBA's business relationships guidance. It was noted that a "sweetheart deal" may not impact the engagement team, but may be more of an appearance issue.

Mr. Wilson noted that the Task Force had additional concerns regarding the automobile lease inconsistency if materiality is an explicit requirement in that automobile leases with lending institutions are not subject to materiality evaluation. One member noted he did not think this was a concern, and there was no further discussion of the issue.

*Option C – Guided Conceptual Framework Approach*

Pursuant to previous Task Force discussions regarding Option B and whether materiality should be explicit, Mr. Wilson presented an additional option (Option C) to PEEC for consideration. Under Option C, a conceptual framework approach is applied to all leases (excluding automobile leases), and provides examples of factors that members should consider when evaluating the significance of threats to independence as shown below:

*.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\*\*\*\*]*

Mr. Wilson explained that in addition to maintaining the preferred conceptual approach, Option C does not include materiality as a bright line test but includes it as a factor in evaluating the significance of the threat. Ms. Miller (Task Force member) questioned whether, for an immaterial lease, it raises less concern about a "sweetheart deal," but felt that the factors should be evaluated both individually and cumulatively. Ms. Miller also noted that there is likely no one-size-fits-all approach. One PEEC member expressed preference for a combination of Options B and C, in which there are the minimum requirements in Option B ("a", "b" only) combined with examples of the factors to consider in Option C. Ms. Miller recommended utilizing factors "d" and "e" above as hurdles that apply to the firm and the covered member, and then the guided conceptual approach contemplated in Option C would apply if those hurdles are met. There was no objection to this approach to the guidance.

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Ms. Snyder asked the Committee if item “d” in paragraph .02 should be required in order to remain independent, and one member responded that it should be required, along with item “e” regarding compliance with payments under the lease. These are also the requirements “a” and “b” noted in Option B. Ms. Snyder also recommended revising item “a” to state “...*whether the covered member is a member of the engagement team.*”

*Naming of specific threats to independence*

Mr. Wilson noted that both Option B and Option C include the specific threats identified by the Task Force as existing when there is a lease between a covered member and the attest client as follows:

.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...*

One member did not believe the existence of the familiarity threat and undue influence threat were obvious, but was not against their inclusion. Staff explained that the familiarity threat was due to the fact that the lease is an additional contractual relationship between the parties and adds a layer of potential familiarity that can exist prior to, as well as during, the period of professional engagement. Mr. Cahill (Task Force member) noted that the Task Force included the phrase, “any other threats” to ensure that other potential threats are considered. There was no objection to inclusion of the other threats and was no further discussion on the issue.

*Possible Exceptions*

One PEEC member expressed concern that some covered members live in apartments or other residential rentals that are owned by a REIT or other investment vehicle that is an attest client of the firm. The member noted that if an attest client buys an apartment building in which a covered member lives, the covered member should not have to move their personal residence to maintain independence. Another PEEC member noted that he was in favor of treating apartments and automobiles covered by the Loans Interpretation as “carve outs” not subject to the Leases Interpretation requirements. The Task Force agreed to discuss this issue in its future discussions.

There being no further topics, the Leases Task Force agreed that it would take the points made by PEEC into consideration, and tentatively planned to have a draft for exposure to membership at the next PEEC meeting.

**5. IESBA Update**

Ms. Snyder introduced the topic providing an update of the activities of the Part C Task Force. At the December meeting of the IESBA, the Board approved to expose a revised description of a professional accountant in business and revised provisions on how Part C applies to professional accountants in public practice. The exposure draft was released in January with comments due on April 25, 2017. Also at the previous meeting, the Board considered the first draft of amendments to Section 350, Inducements.

Mr. Evans provided an update of the Long Association Task Force. The Board approved the changes to the Long Association guidance in response to comments made by the Public Interest Oversight Board (PIOB). The changes pertained to the jurisdictional provisions providing cooling off periods to partner rotation and consultation of the engagement partner or engagement quality control reviewer during the cooling off period. The guidance is effective

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for financial statements beginning on or after December 15, 2018 with the exception of the jurisdictional provision which will be effective for periods beginning prior to December 15, 2023.

The Structure of the Code Task Force agreed in principle to the text of the guidance in the first exposure draft, subject to any changes that may be necessary as a result of the second exposure draft. The Phase 2 exposure draft was approved by the Board, which contains corresponding changes to other sections of the Code based on the drafting agreed to in Phase 1 of the project. The Board anticipates approval of both phases by the end of 2017.

Mr. Evans provided an update of the Safeguards Task Force noting that the IESBA agreed to the text of the literature in Phase 1, in principle. The guidance contained in Phase 2 was approved for exposure at the December meeting. The comments are due on April 25, 2017. This exposure draft contains edits to the non-assurance service guidance based on the enhanced text provided in Phase 1 of the project.

The IESBA considered a proposal for a short-term project concerning professional scepticism. This project began in response to stakeholders calling for greater emphasis on professional scepticism in the Code. The proposed enhancements discussed included a new requirement for professional accountants to apply a critical mindset when applying the conceptual framework and new application material linking professional scepticism as defined by the International Audit and Assurance Standards Board, the fundamental principles and independence.

The IESBA considered an update from the Fees Working Group concerning fee related laws and regulations in G20 jurisdictions. The Working Group will be reaching out to stakeholders to further understand their perspectives on fee related issues.

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

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

**7. Cybersecurity Services**

Ms. Tish presented FAQ's that were approved by the Task Force and explained that 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. It was explained that the Task Force did not reach a consensus regarding whether or not independence would be impaired if the member provided such services as some members believe these activities would result in a member accepting responsibility for implementing the client's internal controls that would impair independence while others believed such activities are comparable to IT services where the member reconfigures existing systems controls to meet established standards that have been approved by the client. That is, the answer could depend upon whether the configuration involved designing or developing the internal controls and if there was an impact on the financial statements.

It was noted that the Information Technology and Cloud Services Task Force is analyzing implementation services which includes configuration services. As such, the Committee agreed it would be prudent for Staff to hold off issuing "FAQ 2b" until the Information Technology and Cloud Services Task Force has concluded its work.

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Ms. Tish was asked to consider if the pre-existing project management FAQ should be clarified to confirm that when it comes to a member providing project management services, the member is always responsible for the management of its own professional service.

**8. Transfer of Files and Return of Client Records in Sales, Transfer, Discontinuance or Acquisition of Practice**

Ms. Snyder explained that the hypothetical situation presented for consideration was whether the requirements of the Transfer of Files and Return of Client Records in Sales, Transfer, Discontinuance or Acquisition of Practice 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 became partners of Firm B. She further explained that the Task Force agreed that the intent of the interpretation was that if at least one partner from Firm A would become a partner in Firm B, the requirements of the interpretation did not apply. Some concern, however, 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, 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. In an effort to clarify that the member would not be in violation of this rule when complying with the interpretation, the following FAQ was drafted by Staff:

**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.”

The Committee agreed that this FAQ was consistent with its discussions.

A member of the Committee confirmed that the interpretation covered both complete sales and partial sales of a practice and that if no partners went to the new firm, the requirements within the interpretation would apply. This member also noted that he believed paragraph .01 was inconsistent with paragraph .05. Specifically, this member noted that while both paragraphs require the client consent to its files or records being retained by the new firm, paragraph .05 adds in an additional requirement, that the client retain the successor firm to provide services. It was agreed to discuss this concern with the Task Force to see if the following editorial revision to paragraph .05 was appropriate:

.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, consented to the **transfer of its** ~~member’s continuation of professional services and retention of any client files or records~~ **to** the successor firm retains.

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

Mr. Brand explained that the Task Force had been asked to consider if the modified independence approach currently contained in the Code for SSAE engagements, should be applicable for compilations of pro-forma financial statements performed under the SSARS and specified procedures engagements that are currently under development. He explained that to answer this question, the Task Force considered the basis for the modified independence approach and determined that it appeared to be based upon whether the report was restricted in use and if the engagement was performed under the SSAEs. Mr. Brand reported that the Task Force is thinking that perhaps the basis for whether the modified independence approach would be appropriate should be aligned to factors that could be applied consistently to any service that may be developed down the line, such as the level of assurance and whether the report is restricted. He noted that the Task Force plans to also consider the approach taken by the IESBA which requires certain steps and communications be made in order to apply the modified independence approach.

## **10. IESBA Convergence – Long Association**

Mr. Evans noted that the IESBA approved for adoption the guidance concerning Long Association. Mr. Evans explained the guidance as it related to all clients, both PIEs and non-PIEs. Mr. Evans also noted the final enhancements made to the guidance based on the comments of the PIOB.

It was recommended by Mr. Evans that the PEEC agree to charge a task force with reviewing the IESBA standard entitled, Long Association of Personnel with an Audit or Assurance Client and recommend to PEEC revisions to the AICPA Code for purposes of convergence.

A member inquired as to the IESBA guidance for PIEs. Mr. Evans explained the terms for partner rotation and further stated that the PEEC should not consider the guidance for adoption, as, the SEC has more restrictive rules pertaining to partner rotation for PIEs located in the United States.

The PEEC agreed to form and charge a task force as suggested.

## IFAC Convergence – Long Association

### Task Force Members

Anna Dourdourekas (Chair), Coalter Baker, Bob Denham, and Shelly Van Dyne. Staff: Jason Evans. Observer: Lisa Snyder.

### 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 proposed interpretation 1.267.010, Long Association of Senior Personnel with an Attest Client, under the proposed topic 1.267, Long Association with an Attest Client, and agree to expose the interpretation for comment.

### Summary of Issues

#### **Background**

At the February 2017 meeting of the PEEC, the Committee approved of the Task Force charge noted above and recommended the Task Force consider the IESBA Long Association standard for convergence. Staff suggested that the PEEC only consider the guidance applicable to all audit and review clients for convergence, as, the SEC has more restrictive rules pertaining to partner rotation for PIEs located in the United States. There was no objection by the Committee to the respective suggestion.

#### **Task Force Activity**

The Task Force conducted two meetings via phone to discuss key topics of the IESBA guidance and to review draft interpretation 1.267.010, Long Association of Senior Personnel with an Attest Client. The Task Force considered the following:

1. Applicability of the guidance;
2. The requirement to determine a rotation period if rotation is deemed a necessary safeguard (see the IESBA guidance in Long Association Close-Off Document, Attachment 6B, paragraph 290.152; and
3. The title and placement of the proposed interpretation.

#### **Applicability of the Guidance - Personnel**

The IESBA believes that any member of the audit or assurance team, not just senior personnel, could be associated with the audit or assurance client long enough to create threats to independence, depending on the nature of the roles they perform. Therefore, the general provisions (par. 290.148 – 290.152) of the IESBA's Long Association standard apply to evaluating potential threats created by the long association of any individual on the audit team with any audit client. This is a change in approach from the former standard included in the IESBA Code which addresses senior personnel only.

In response to this proposal in its comment letter, the PEEC did not support applying the general provisions to all individuals on the engagement team because key audit partners (KAPs) have the

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responsibility for all significant judgments. Non-senior members of audit or assurance team do not participate in key decisions, lest they be reviewed by senior members of the team. The PEEC stated that firms should not be required to devote time and resources to evaluate threats resulting from the long association of non-senior personnel on the audit or assurance engagement.

The Task Force considered the scope of the IESBA standard and the PEEC's response noted in its comment letter. The Task Force agreed that key decisions are made by senior personnel of the attest engagement team. The Task Force further agreed that a key decision that is made by an attest engagement team member that is not considered senior personnel would be reviewed by a member of the senior personnel. Thus, the threats to independence based on the long association with an attest client of a member of the attest engagement team that is not included in the senior personnel would be mitigated due to review processes. Therefore, the Task Force concluded that the proposed interpretation 1.267.010 would apply only to senior personnel of the attest engagement team. The Task Force further concluded that adopting guidance as such would not create a situation where the AICPA Code would be considered less restrictive than the IESBA Code, as, due to the review processes on attest engagements, threats created due to long association of non-senior personnel would be reduced to an acceptable level.

**Action Needed:**

1. Does the PEEC agree that the proposed interpretation, 1.267.010, Long Association of Senior Personnel with an Attest Client, should be applicable only to senior personnel of an attest engagement team? If not, why?
2. Does the PEEC agree that the adoption of such guidance would not result in the AICPA Code being less restrictive than the IESBA Code?

**Applicability of the Guidance – Engagement Types**

The IESBA standard is bifurcated. The first part of the IESBA Long Association standard addresses audits and reviews and is located in Section 290, Independence – Audit and Review Engagements. The second part of the IESBA Long Association Standard applies to all other assurance engagements and is located in Section 291, Independence – Other Assurance Engagements. The Task Force agreed the proposed standard should apply to all attest engagements, as do most of the independence interpretations in the extant Code.

**Action Needed:**

1. Does the PEEC agree that the proposed interpretation should apply to all attest engagements? If not, why?

**Applicability of the Guidance – Clients**

As noted above, at the last meeting of the PEEC, the Committee agreed that the IESBA guidance pertaining to PIEs should not be considered for adoption, as, the SEC already provides more restrictive rules pertaining to partner rotation of listed entities. The Task Force agreed this approach to be appropriate. As such, the Task Force only considered paragraphs 290.148 to 290.152 for convergence.

**Action Needed:**

1. Does the PEEC agree that the IESBA guidance pertaining to PIEs should not be considered for convergence? If not, why?

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### **Applicability of the Guidance - Threats**

The IESBA's Long Association standard states that familiarity threats and self-interest threats may be created due to long association of an accountant with an assurance client. The standard states that a self-interest threat may be created as a result of the individual's concern about losing a longstanding client which may inappropriately influence the individual's judgment (paragraph 290.148). The extant AICPA Code includes guidance concerning long association under the familiarity threat in the Conceptual Framework for Members in Public Practice (1.000.010). The self-interest threat is described in the AICPA Code as follows: "the threat that a member could benefit, financially or otherwise, from an interest in, or relationship with, a client or persons associated with the client."

The Task Force considered the threats created by long association with an attest client and the threats noted in the IESBA standard. The Task Force agreed that the familiarity threat is applicable, however, the self-interest threat is not. Thus, the draft interpretation mentions only the familiarity threat.

#### **Action Needed:**

1. Does the PEEC believe that familiarity threats, and not self-interest threats, may be created due to long association with an attest client? If not, why?

### **Requirement to Determine a Rotation Period if Rotation is Necessary**

The general provisions of the IESBA Long Association standard establishes a requirement that, if a firm decides rotation of an individual on the audit or assurance team is a necessary safeguard, the firm determines an appropriate period during which the individual shall not participate in the audit or assurance engagement or exert direct influence on the outcome of the audit or assurance engagement. The respective paragraphs are as follows:

*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.*

*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.*

In response to this proposal, in its comment letter, the PEEC did not support a requirement for the firm to determine an appropriate rotation period when it concludes that rotation of an individual is an appropriate safeguard. Since there is no rotation requirement in the Code (for non-PIEs), it is counter intuitive to require the firm to determine a rotation period. Firms should be able to evaluate if rotation is needed on an as need basis and not be locked into a policy, lest the policy not be necessary in some instances. In practice, firms most likely determine an appropriate period if they believe rotation is necessary considering the facts and circumstances at that time.

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The Task Force agreed with the comments and suggestions in the PEEC's comment letter. Thus, there is no corresponding paragraph in proposed interpretation 1.267.010 to those noted above. Rotation of a member as a safeguard against threats created by long association is noted in the examples of safeguards in proposed paragraph .06 of the draft standard.

The Task Force concluded that not including the requirement would not result in the AICPA Code being less restrictive than the IESBA Code, as, both sets of guidance would conclude with the same result if appropriately applied (i.e. rotation would be implemented for an appropriate period to eliminate the threat or reduce it to an acceptable level).

**Action Needed:**

1. The PEEC is asked if it agrees that the requirement noted above in the IESBA standard should not be included in the AICPA Code? If not, why?
3. If the PEEC concludes that the requirement is not necessary in the Code, does the PEEC agree that it would not result in the AICPA Code being less restrictive than the IESBA Code? If not, why?

**Title and Placement of the Proposed Interpretation**

The Task Force agreed that the topic would be numbered and titled as follows: 1.267 Long Association with an Attest Client and the sub-topic would be: 1.267.010, Long Association of Senior Personnel with an Attest Client. The Task Force agreed that the topic would provide an appropriate section of the Code for further developments concerning relationships with the personnel of the firm and the attest client, if necessary.

**Action Needed:**

1. Does the PEEC agree with the title of the topic and sub-topic? If not, why?
2. Does the PEEC agree with the proposed placement of the topic and sub-topic? If not, why?

**Materials Presented**

Agenda 6A – This Agenda Item

Agenda 6B – IESBA Long Association Standard – Close-Off Document

Agenda 6C – Proposed Draft Interpretation 1.267.010, Long Association of Senior Personnel with an Attest Client (Mark Up From IESBA Standard)

Agenda 6D – Proposed Draft Interpretation 1.267.010, Long Association of Senior Personnel with an Attest Client (Clean)

**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

**IESBA**

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.

290.1498B 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.

290.15048C 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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Draft Interpretation 1.267.010 Long Association of Senior Personnel with an Attest Client

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

**1.267.010 Long Association of Senior Personnel with an Attest Client**

*General Provisions*

~~.01 For purposes of this interpretation, senior personnel of the attest engagement team are partners, partner equivalents and any other individuals on the attest engagement team who have responsibility for decision making on significant auditing, accounting and reporting matters that affect the results of the attest engagement or who maintain regular contact with client management or those who are charged with governance.~~

~~.02290.148 —When a member is included in senior personnel of an attest engagement team over a long period of time, familiarity and self-interest threats to the member’s compliance with the Independence Rule [1.200.001] may exist and may increase in significance over time. , 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.~~

~~.03 Although an understanding of an attest audit client and its environment is fundamental to providing high-quality attest services and contributes to audit quality when performing an audit, a familiarity threat may be created as a result of a member’s individual’s long inclusion association among the senior personnel a member of the attest audit engagement team with the:~~

- ~~• Attest The audit client and its operations;~~
- ~~• Attest The audit client’s senior management;~~
- ~~• Subject matter of the attest engagement; 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.~~

~~.04290.149 The significance of the threats will depend on factors, individually or in combination, relating to both the member individual and the attest audit client.~~

~~(a) Factors relating to the member individual include:~~

- ~~• The overall length of the member individual’s relationship with the attest client, including if such relationship existed while the member individual was at a prior firm.~~
- ~~• How long the member individual has been a member of on the engagement team, and the nature of the roles performed.~~

- The extent to which the work of the member individual is directed, reviewed and supervised by other more senior personnel.
- The extent to which, due to the member's seniority, the member individual, due to the individual's seniority, has the ability to influence the outcome of the attest engagement audit, for example, by making key decisions or directing the work of other members of the engagement team.
- The closeness of the member individual's personal relationship with senior management or those charged with governance.
- The nature, frequency and extent of the interaction between the member individual and senior management or those charged with governance.

(b) Factors relating to the attest audit client include:

- The nature or complexity of the attest 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 member individual may have with senior management or those charged with governance.

.05290.150 — 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 member individual and an individual in member of the client's senior management would be reduced by the departure of that individual member of the client's senior management and the start of a new relationship.

.06290.151 — 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 member individual on the attest engagement audit team or the nature and extent of the tasks the member individual performs.
- Having a professional accountant who was not included in a member of the attest engagement audit team review the work of the member individual.
- Performing regular independent internal or external quality reviews of the engagement.
- Performing an engagement quality control review.
- Rotating the member off the attest engagement team for an appropriate period based on the significance of the threats

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.~~

**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.~~

Draft Interpretation 1.267.010 Long Association of Senior Personnel with an Attest Client

**1.267 Long Association with an Attest Client**

**1.267.010 Long Association of Senior Personnel with an Attest Client**

.01 For purposes of this interpretation, senior personnel of the attest engagement team are partners, partner equivalents and any other individuals on the attest engagement team who have responsibility for decision making on significant auditing, accounting and reporting matters that affect the results of the attest engagement or who maintain regular contact with client management or those who are charged with governance.

.02 When a member is included in senior personnel of an attest engagement team over a long period of time, familiarity threats to the member's compliance with the Independence Rule [1.200.001] may exist and may increase in significance over time.

.03 Although an understanding of an attest client and its environment is fundamental to providing high-quality attest services and contributes to audit quality when performing an audit, a familiarity threat may be created as a result of a member's long inclusion among the senior personnel of the attest engagement team with the:

- Attest client and its operations;
- Attest client's senior management;
- Subject matter of the attest engagement; or
- Financial statements on which the firm will express an opinion or the financial information which forms the basis of the financial statements.

.04 The significance of the threats will depend on factors, individually or in combination, relating to both the member and the attest client.

(a) Factors relating to the member include:

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

- The nature, frequency and extent of the interaction between the member and senior management or those charged with governance.

(b) Factors relating to the attest client include:

- The nature or complexity of the attest 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 member may have with senior management or those charged with governance.

.05 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 a member and an individual in the client's senior management would be reduced by the departure of that individual of the client's senior management and the start of a new relationship.

.06 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:

- Changing the role of the member on the attest engagement team or the nature and extent of the tasks the member performs.
- Having a professional accountant who was not included in the attest engagement team review the work of the member.
- Performing regular independent internal or external quality reviews of the engagement.
- Performing an engagement quality control review.
- Rotating the member off the attest engagement team for an appropriate period based on the significance of the threats