



BACKGROUND AND BASIS FOR CONCLUSIONS:

NEW ETHICS RULINGS UNDER RULE 102 - INTEGRITY AND OBJECTIVITY AND RULE 101 – INDEPENDENCE

- ETHICS RULING NO. 113 UNDER RULE 102 – INTEGRITY AND OBJECTIVITY (NEW)**
 - ETHICS RULING NO. 114 UNDER RULE 101 – INDEPENDENCE (NEW)**
 - ETHICS RULING NO. 1 UNDER RULE 101 – INDEPENDENCE (DELETION)**
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This document summarizes considerations that were deemed significant by the Professional Ethics Executive Committee (the Committee) in the development of two new ethics rulings, Ethics Ruling No. 113 – *Acceptance or Offering of Gifts or Entertainment* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.226-.227) and Ethics Ruling No. 114 – *Acceptance or Offering of Gifts and Entertainment to or From an Attest Client* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.228 -.229); and the deletion of Ethics Ruling No. 1 – *Acceptance of a Gift* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.001-.002). It includes reasons for accepting certain recommendations for change and rejecting others and is intended to assist users in understanding the additions, revisions and deletions and the rationale for them.

BACKGROUND

1. In late 2003, the Committee added a project to its three-year agenda to study the issues associated with the offer and acceptance of gifts by members in order to determine if existing guidance adequately addressed these matters. While the Committee initially focused on how gifts or entertainment impact members in public practice with respect to attest clients (those requiring independence) and nonattest clients (from the perspective of objectivity), as work progressed the scope of the study was expanded to also cover members in business and industry with respect to gifts offered to, or received from, customers or vendors of the member's employer.
2. The Committee appointed a task force to study these issues which included individuals from small, medium and large size firms to ensure that any resulting guidance adequately addressed the issues faced by firms of various sizes. In addition, to bring local regulatory perspectives to the process, a committee member associated with the National Association of State Boards of Accountancy (NASBA) was appointed to the task force.
3. In studying these matters, the Committee considered gift and entertainment policies of various CPA firms. It also considered relevant guidance set forth in the *Code of Ethics* of the International Federation of Accountants (IFAC). For example, the Committee believed that the IFAC term of "clearly insignificant" for purposes of determining the threshold for gifts received by certain covered members from attest clients of the firm was clearer and better understood than the term "token" as used in ethics ruling No. 1, *Acceptance of a Gift* (see paragraph 10a).
4. The Committee identified specific threats to independence when a member accepts or offers gifts or entertainment from or to a client or a customer or vendor of the member's employer. Specifically, the Committee concluded that the acceptance of a gift or entertainment by a member can result in a financial self-interest and undue influence threat to independence, as described in the Conceptual Framework for AICPA Independence Standards. The Committee also concluded that the offering of a gift or entertainment by a member can result in a familiarity threat to independence, as described in the Conceptual Framework.

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5. Upon completing its study of the relevant issues associated with the acceptance and offer of gifts or entertainment by members, on June 17, 2005 the Committee issued for public comment, an Omnibus Ethics Exposure Draft (Exposure Draft) with a 60-day comment period. The Exposure Draft proposed new ethics rulings under Rule 102, *Integrity and Objectivity* and Rule 101, *Independence*. The proposed ethics rulings incorporated the substance of the existing guidance contained in ethics ruling no. 1, *Acceptance of a Gift*, which the PEEC proposed deleting.
 - a. The proposed ethics ruling under Rule 102, which covers gift and entertainment from the perspective of *integrity and objectivity*, was applicable to members in public practice with respect to all professional services provided to all clients and to all members, whether or not in public practice, with respect to the customers and vendors of their employers, and provided that objectivity would not be considered to be impaired if a member offers or accepts gifts or entertainment to or from a client (including certain individuals associated with a client) or a customer or vendor of the member's employer (including representatives of the customer or vendor), provided the gift or entertainment is "reasonable in the circumstances." In addition, the proposal made it clear that permitted gifts or entertainment should not violate a member, client, customer, or vendor's own policies governing gifts and entertainment, or applicable laws and regulations.
 - b. The proposed ethics ruling under Rule 101, *Independence*, was applicable to members in public practice who are "covered members" with respect to an attest client of the member's firm, and provided that independence would be considered impaired if any covered member *accepts* a gift from an attest client unless the gift is "clearly insignificant." And since a member may also *offer a gift* to an attest client, the proposal also provided that as long as the gift offered was "reasonable in the circumstances," independence would not be considered impaired. With respect to entertainment, the proposal provided that covered members should be able to offer *or* accept entertainment to or from an attest client provided the entertainment is "reasonable in the circumstances."
6. The Committee received seven comment letters on its proposal, and on October 26-27, 2005, a public meeting was held to discuss the comments and further deliberate the relevant issues. As a result of the comments and further deliberations, the Committee made certain modifications to the proposed ethics rulings before adopting the final standards.

NEW ETHICS RULINGS ADOPTED BY THE COMMITTEE AND BASIS FOR CONCLUSIONS

7. The following ethics rulings were adopted by the Committee at its October 26-27, 2005 meeting. The provisions of these ethics rulings become effective the last day of the month in which they are published in the *AICPA Journal of Accountancy* and therefore are effective January 31, 2006.
 - a. The Committee adopted a new ethics ruling no. 113 under Rule 102, *Integrity and Objectivity*, which provides that a member's objectivity will be impaired if he or she offers or accepts gifts or entertainment to or from a client (including any individual in a key position with the client or any individual owning 10 percent or more of the client's outstanding equity securities or other ownership interests), or a customer or vendor of the member's employer (including representatives of the customer or vendor), unless the gift or entertainment is "reasonable in the circumstances." In addition, the ruling makes it clear that a member would be presumed to lack integrity if he or she accepted or offered gifts or entertainment

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that he or she knew or was reckless in not knowing would violate the member, client, customer, or vendor's policies or applicable laws and regulations.

- b. The Committee adopted a new ethics ruling no. 114 under Rule 101, *Independence*, which provides that independence would be considered to be impaired if a member's firm, a member on the attest engagement team or in a position to influence the attest engagement, *accepts a gift* from an attest client (including any individual in a key position with the client or any individual owning 10 percent or more of the client's outstanding equity securities or other ownership interests) unless the value of the gift was clearly insignificant to the recipient. The ruling further provides that independence would not be considered to be impaired if a covered member *accepts entertainment* from an attest client provided the entertainment is reasonable in the circumstances. Finally, the ruling provides that independence would not be considered to be impaired if a covered member *offers a gift or entertainment* to an attest client, provided the gift or entertainment is reasonable in the circumstances.

Broadening the Scope of the Guidance Beyond Ethics Ruling No. 1 under Rule 101, Independence

8. Prior to the adoption of the new ethics rulings, existing guidance under ethics ruling no. 1, *Acceptance of a Gift*, was limited to the impact that the *acceptance* of a gift had on a covered member's independence. Accordingly, existing guidance did not differentiate between gifts and entertainment, did not address the *offer* of a gift by a covered member to a client, and did not address the objectivity concerns associated with the offer or acceptance of gifts or entertainment to or from nonattest clients (that is, clients for which the member does not provide any services requiring independence), or when a member in business, industry, education or government accepts or offers gifts or entertainment to or from his or her employer's customers and vendors. As described in the background paragraphs, the new ethics rulings broaden the scope of the guidance contained in ethics ruling no. 1 by providing guidance on these other matters.

Differentiating Between Gifts and Entertainment

9. The Committee concluded that gifts differ fundamentally from entertainment on the basis of "joint participation" between two or more parties. That is, entertainment typically involves "joint participation" by the client/customer/vendor and the member in the activity whereas gifts generally do not. The Committee believes that joint participation in an activity by the member and the client/customer/vendor may enhance the member's professional relationship with such individuals because of the opportunity for the member and the client/customer/vendor to conduct business (either before, during, or after the entertainment) which is typically not present in a gift scenario. For example, a member's receipt of tickets to a baseball game from a client would be considered a "gift," whereas attending a baseball game with the client as the client's guest would be considered to be "entertainment". The Committee agreed that in the latter scenario, because both the member and the client jointly participate in the activity, the client would be entertaining the member and thus, there has been no gift. It should also be noted that the conduct of business would not be required for the activity to be considered entertainment for purposes of the guidance.
10. The Committee also concluded that a charitable contribution to a charitable organization would not be considered a gift for purposes of the ethics rulings.

“Clearly Insignificant” Versus “Reasonable in the Circumstances”

11. The Committee devoted considerable efforts to defining appropriate value thresholds for the adopted independence and objectivity guidance. Generally speaking, where independence is concerned for purposes of ethics ruling no 114, the Committee adopted a lower, or more restrictive, threshold of “*clearly insignificant*” with respect to the acceptance of gifts by certain classes of covered members who are closest to the attest engagement and a higher, or less restrictive threshold, of “*reasonable in the circumstances*” with respect to the acceptance of gifts by other covered members who are more removed from the attest engagement (see paragraphs 11c and 11d below). In addition, the Committee believed the threshold of “*reasonable in the circumstances*” was an appropriate threshold for purposes of the offer of gifts or entertainment by all covered members to attest clients and for the offer or acceptance of *entertainment* to or from an attest client. From the perspective of objectivity as discussed in ethics ruling no. 113, the Committee believed a threshold of “*reasonable in the circumstances*” was appropriate for all gifts and entertainment both offered and received by members.

It should be noted that the Committee did consider the application of dollar limitations to gifts and entertainment, but concluded that such limitations, while simple to apply, did not offer members sufficient latitude to use their professional judgment in deciding the point at which their objectivity and/or independence might be impaired. Accordingly, more subjective measures were ultimately utilized in the adopted rulings.

Clearly Insignificant

- a. In adopting the “clearly insignificant” threshold in ethics ruling no. 114, the Committee considered the *Code of Ethics* of the International Federation of Accountants (IFAC) (see paragraph 3), and agreed to substitute the term “clearly insignificant” for “token” as used in existing guidance contained in ethics ruling no. 1 – *Acceptance of a Gift*. The IFAC Code defines “clearly insignificant” as “*a matter that is deemed to be both trivial and inconsequential,*” and most Committee members agreed that this is substantially equivalent to the term “token.” In addition, the Committee also clarified that in considering whether or not a gift is clearly insignificant, the value of the gift should be considered in relation to the recipient of the gift (i.e., the firm or the individual).

Reasonable in the Circumstances

- b. In deliberating the notion of “reasonable in the circumstances,” the Committee acknowledged the importance of providing members with criteria to assist them in determining what is or is-not “reasonable in the circumstances.” To that end, in addition to instructing the reader to use his or her professional judgment, ethics ruling no. 113 under Rule 102 contains a number of relevant facts and circumstances that the member may wish to consider in making that determination. Specifically, the ethics ruling provides the following considerations:
 - *The nature of the gift or entertainment*
 - *The occasion giving rise to the gift or entertainment*
 - *The cost or value of the gift or entertainment*
 - *The nature, frequency, and value of other gifts and entertainment offered or accepted*
 - *Whether the entertainment was associated with the active conduct of business either directly before, during, or after the entertainment*

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- *Whether other clients, customers, or vendors also participated in the entertainment*
- *The individuals from the client, customer, or vendor and the member's firm or employer who participated in the entertainment*

Acceptance of Gifts by Covered Members on the Attest Engagement or in a Position to Influence the Attest Engagement

- c. While the original proposal provided that independence would be considered to be impaired if *any* covered member accepts a gift unless that gift was clearly insignificant, one commenter noted that this provision would prohibit any covered member – or the covered member's immediate family – from receiving a gift from a family member who for example, was in a key position at the client unless the gift was clearly insignificant to the member. It was noted that under Interpretation 101-1, the close relatives (as defined in ET Section 92 – *Definitions*) of covered members may hold a key position or have a material financial interest in an attest client without impairing independence. Therefore, to some extent, the proposed guidance may be inconsistent with other provisions of the Code.

The Committee reconsidered the threats to independence associated with the acceptance of a gift by a covered member from an attest client and concluded that when a covered member on the attest engagement team or in a position to influence the attest engagement accepts a gift from an attest client that is other than clearly insignificant, the risk exists for the client to exercise undue influence over the member (i.e., the “undue influence threat” as defined in the AICPA Conceptual Framework for Independence Standards), possibly resulting in the member being beholden to the client and thereby, compromising the member's objectivity and professional skepticism in the performance of the attest engagement. Accordingly, the Committee agreed that the more restrictive threshold of “clearly insignificant” remained appropriate for gifts received by those covered members who are closest to the attest engagement. In other words, the Committee did not believe that adequate safeguards could be implemented which could effectively mitigate the threats to independence associated with gifts received by covered members who participate on the attest engagement or who are in a position to influence the attest engagement unless such gifts are clearly insignificant.

Acceptance of Gifts by Other Members in Public Practice and Members in Industry

- d. On the other hand, the Committee agreed that the risks to independence due to the “undue influence threat” (see paragraph 11c) are less significant for those covered members who are more removed from the attest engagement (e.g., partners or managers who provide nonattest services to the client and partners in the office in which the lead attest engagement partner practices in connection with the engagement), since the covered member's ability to influence the attest engagement is greatly reduced. Accordingly, the Committee believed that the threats to independence for such covered members could be sufficiently mitigated provided the gift received was “reasonable in the circumstances.” Thus, the independence guidance in ethics ruling no. 114 under Rule 101 allows a covered member who is not on the attest engagement and not in a position to influence the attest engagement to accept a gift from an attest client of the firm provided the gift is “reasonable in the circumstances”.

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The Committee also agreed that for purposes of mitigating the threats to a member's objectivity due to the acceptance of gifts from clients or the customers and vendors of the member's employer, the threshold of "reasonable in the circumstances" was appropriate. Accordingly, ethics ruling no. 113 under Rule 102 covering the acceptance or offer of gifts or entertainment by members in public practice with respect to all clients (attest and nonattest) and to members in business, industry, education and government with respect to the customers and vendors of their employers, permits the acceptance of a gift by such members provided the gift is "reasonable in the circumstances".

Applicability to Individuals With 10% or More Client Ownership

12. Some commenters questioned the appropriateness of applying the proposed independence guidance (ethics ruling no. 114) to an individual owning 10 percent or more of the client's outstanding equity securities or other ownership interests. In addition to covering those individuals in a key position at the client, these commenters believed the guidance should apply to owners that have "significant influence" over the operations of the attest client rather than referring to a numerical threshold such as 10%. Specifically, these commenters believed that it would be more appropriate for owners with less than 10% ownership who have *significant involvement* in the operations of the client to be covered by the guidance, rather than those who may own more than 10% of the client but who have no significant involvement in the operations of the business. While a few Committee member's agreed with this notion, most remained committed to the 10% threshold primarily for consistency with current independence guidance as it relates to loans (Interpretation 101-1A4 under Rule 101) which prohibits a covered member (except as specifically permitted in interpretation 101-5), from having any loan to or from a client, any officer or director of the client, or any individual owning 10% or more of the client's outstanding equity securities or other ownership interests.

Gifts or Entertainment in Violation of the Member, Client, Customer, or Vendor's Policies or Applicable Laws and Regulations

13. Some commenters questioned the Committee's intent with respect to the proposed provision contained in ethics ruling no. 113, which stated that members should not offer or accept gifts or entertainment in violation of the member, client, customer, or vendor's policies or applicable laws and regulations. Commenters pointed out that that the proposal did not describe the consequences of violating such policies, laws or regulations, and questioned whether failure to comply with this provision would result in a member's objectivity to be considered impaired. Commenters also were concerned that this provision would require members to be aware of all client, customer or vendor policies on gifts and/or entertainment, thereby placing an undue burden on the member to monitor the policies of potentially many different entities and that there was no exception for inadvertent violations of this provision.

In deliberating this matter, the Committee questioned whether violations of such policies, laws or regulations would truly impair a member's *objectivity* and concluded it would be more appropriate to consider a member's failure to comply with such policies, laws or regulations to be a lack of the member's *integrity*. However, the Committee agreed that a member should only be considered in violation of this provision where the member "knew or was reckless in not knowing" that the gift or entertainment would be in violation of the client, customer, or vendor's policies or applicable laws and regulations. Accordingly the final standard provides that "*a member would be presumed to lack integrity if he or she accepted or offered gifts or entertainment that he or she knew or was reckless in not*



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knowing would violate the member, client, customer, or vendor's policies or applicable laws and regulations."

Deletion of Ethics Ruling No. 1 – Acceptance of a Gift, under Rule 101

14. The Committee deleted ethics ruling no. 1 – *Acceptance of a Gift*, under Rule 101 because the substance of that guidance has been incorporated into the new ethics ruling no. 114 under Rule 101.

The new standards are available at:

http://www.aicpa.org/download/ethics/Gifts_and_Entertainment_Rulings.pdf