



Recent Independence Issues Under AICPA's Revised Code of Professional Conduct

By Alan Reinstein, DBA, CPA, CGMA; Gerald W. Hepp, CPA, MBA; and Natalie Tatiana Churyk, Ph.D., CPA

AICPA revised its *Code of Professional Conduct (Code)* effective Dec. 15, 2014, and has since added additional interpretations that affect CPA practitioners, including several that impact independence issues. This article discusses independence as it is affected by:

- Mergers and acquisitions
- Employment and association situations
- Breaches
- Commission and referral fees

1.220.040 - Firm Mergers and Acquisitions

This Interpretation addresses needed safeguards for when threats arise when one CPA firm merges or acquires another firm

(collectively a “merger”). The threat arises when a partner or professional employee of one firm has a prohibited relationship with an entity that is the other firm’s attest client. The typical prohibited relationship includes association as a manager, director, officer, employee, promoter, underwriter, voting trustee, trustee of an entity’s pension or profit sharing plan, or in any other capacity as a member of management for the period covered by the financial statements or the period of the professional engagement.

The Interpretation provides that threats will be at an acceptable level if all of the following safeguards are put in place:

- a. Terminate the prohibited relationship prior to the merger or acquisition closing date;
- b. Isolate the partner or professional employee from the attest engagement and position of influence over the engagement team;



THE FIRST STEP WHEN A BREACH OCCURS IS COMMUNICATION.



- c. Implement the safeguards appropriate for a former attest client employee listed in Code paragraph 1.277.010.04 prior to the merger or acquisition closing date (e.g., the covered member disposes of any direct financial interest or material indirect financial interests in the attest entity client, and collects or repays any loans to or from the attest entity client, except for those specifically permitted or grandfathered by the interpretations of the Loans, Leases, and Guarantees);
- d. Appoint a responsible individual to assess whether the threat was reduced to an acceptable level; and
- e. Discuss prior to issuing the attest report by the responsible individual with those charged with governance as to the safeguards applied. [Code 1.220.040.03]

The threat to independence also could arise if a merger member performed bookkeeping or other nonattest services for the other member's attest client [Code 1.295]. Here, the parties should identify the acquirer and acquiree firms. Code section 1.220.040.02 refers to paragraph 11-15 of FASB ASC 805-10-55 to make this determination. If the acquirer provided prohibited (e.g., appraisal, valuation or internal audit) nonattest services, and it is not possible to attain an acceptable level of threat, the member cannot provide the attest service. Acquirees providing prohibited nonattest services should establish safeguards by applying all of the following:

- Terminate the banned nonattest services before the merger or acquisition closing date;
- Participants in providing the prohibited nonattest services must not be on the attest engagement team nor in a position to influence the attest engagement; and
- Perform an assessment as to the level of the threat and the adequacy of any safeguards [Code 1.220.040.07].

The Interpretation also calls for considering the following in the evaluation process:

- Whether the nonattest services or the results will be subject to attest procedures;

- The significance of the results of the nonattest services to the attest financial statements;
- The attest client's management's involvement and skills in overseeing the services; and
- Whether the nonattest services involved an assumption of management responsibility. [Code 1.220.040.08]

The overall process evaluates the level of threat before determining whether the firm can reach an acceptable level of safeguards, including reviewing the situation with those in the firm charged with governance. The Interpretation also cautions that other interests and relationships with an attest client can create threats for the CPA to consider, such as relationships with close relatives holding key attest client positions; e.g., a CPA firm's manager married to a new audit client's controller.¹

1.275.005 - Simultaneous Employment or Association with an Attest Client

This section examines issues when a CPA works concurrently for both a CPA firm and a firm's attest client as a director, officer, employee, promoter, underwriter, voting trustee, trustee of the attest client's pension or profit-sharing trust, or equivalent member of client management during the financial statements or engagement periods. It provides that the threats in such situations cannot be at an acceptable level and that no safeguards would be adequate; independence would be impaired. However, it provides a carve-out for educational institutions. A CPA firm employee can serve concurrently as an adjunct faculty member of the employer-CPA firm's educational institution attest client, as long as the firm employee:

- Holds no key position at the educational institution;
- Is not part of the attest engagement team;
- Is not in a position to influence the client's attest engagement;
- Works for the educational institution only on a part-time and non-tenure basis;
- Does not participate in the educational institution's required employee benefit plans, unless participation is required; and
- Assumes no management or policy responsibilities for the educational institution. (Code 1.275.005.03)

Code 1.275 deals specifically with such other attest client employment situations as:

- 1.275.010 – Honorary Director or Trustee of a Not-for-Profit Organization
- 1.275.015 – Member of Advisory Board
- 1.275.020 – Member of Governmental Advisory Committee
- 1.275.025 – Individual in a Campaign Treasurer or Similar Financial Position
- 1.275.030 – Member of Federated Fund-Raising Organization
- 1.275.035 – Member of Organization that Receives Funds From Fund-Raising Organization

continued on next page

The Code also discusses, separately, Former Employment or Association With an Attest Client (Code 1.277) and Subsequent Employment or Association With an Attest Client (Code 1.279). The Code refers to non-authoritative guidance for many such relationships.

1.298 - Breach of Independence

This guidance, effective March 31, 2016, addresses situations where a CPA firm finds that its employees have breached attest engagement independence standards; e.g., purchased a client's stock. It helps assess the consequences of a breach and its effect on the attest engagement team's integrity, objectivity and professional skepticism – and provides specific actions upon finding the breach. The guidance is founded on the requirements under Quality Control [QC] section 10, *A Firm's System of Quality Control* (AICPA, Professional Standards) for a firm to establish policies and procedures designed to provide reasonable assurance that the firm, its personnel, and others subject to independence requirements, maintain those standards.

The Interpretation culls out two types of breaches: (1) those that can significantly compromise the engagement team's integrity, objectivity and professional skepticism, and (2) where an engagement partner or individual in a position to influence the attest engagement (1) commits or (2) knows about a breach but fails to deal with it. The first type can terminate the attest engagement and the second creates a rebuttable presumption that the game is over.

The first step when a breach occurs is communication. The information should be provided to the attest engagement partner or an individual with responsibility for independence policies and procedures, who should inform all appropriate parties that the issue affects. This individual should be satisfied that the interest or relationship that caused the breach was terminated, suspended or eliminated, and should address the consequences of the breach.

The significance of the breach should be evaluated, considering factors such as:

- The nature and duration of the breach;
- The number and nature of prior breaches with respect to the current attest engagement;
- Whether someone knew the details of the breach;
- Whether the individual who caused the breach is a member of the attest engagement team or another individual for whom there are independence requirements;
- The individual's role if the breach relates to a member of the attest engagement team;

- If the breach was caused by nonattest services, the effect of the service on the accounting records or the attest client's financial statements;
- Whether a firm partner or partner equivalent knew about the breach and did not promptly communicate to an appropriate individual within the firm;
- Whether the breach involved solely an affiliate of a financial statement attest client and, if so, the nature of the affiliate relationship; and
- The extent of self-interest, advocacy, undue influence, or other threats from the breach (Code 1.298.010.07).

While many appropriate actions exist, the key is whether some action will be sufficient to overcome the effects of the breach. Actions that should be considered include:

- Remove the relevant individual from the engagement;
- Have different people re-perform any questionable work;
- Recommend the client hire another firm to re-perform any questionable work; or
- Engage another firm to deal with questionable nonattest services (Code 1.298.010.09).

If no available action can overcome the effects of the breach, the firm may need to terminate the engagement. However, there are situations where laws or regulations do not permit termination. It is critical to be aware of any such situations and any reporting or disclosure requirements.

The guidance in this area is extensive. The material in the Code should be consulted upon the discovery of any independence breach.

1.520 - Commissions and Referral Fees

While not under the independence rules, the subject of commissions and referral fees still forms much concern for CPA attesters. In general, a CPA can receive commissions for referring products or services; a CPA can also accept a referral fee for recommending or referring a CPA to any person or entity or pay a referral fee to obtain a client.

A commission is deemed as received upon completing the service. The Interpretation gives the example of a fixed percentage of a future renewal insurance policy premium as received when the policy is originally sold. (Thus future commissions do not affect future periods' engagement.) It also distinguishes a spouse's commissions when such activities are separate from the CPA's practice and the CPA is not significantly involved in those activities.

Alan Reinstein, DBA, CPA, CGMA

is George R. Husband professor of accounting at Mike Ilitch School of Business, Wayne State University, Detroit, Michigan. He may be reached at a.reinstein@wayne.edu.

Gerald W. Hepp, CPA, MBA

is with Gnosis Praxis Ltd in Novi, Michigan. He may be reached at gwhepp@gnosispraxis.com.

Natalie Tatiana Churyk, Ph.D., CPA

is William F. Doyle endowed professor of accountancy at Northern Illinois University in DeKalb, Illinois. She may be reached at nchuryk@niu.edu.

While as a general principle commissions and referral fees are allowable, they are prohibited if they involve a client for whom the CPA provides an audit or review of financial statements. A CPA providing compiled financial statements that a third party might expect to use can accept such commissions and referral fees only if the compiled statements disclosed a lack of the CPA's independence therein.

It is important to recognize two exceptions to the above prohibitions. First, if a member purchases a product, taking title to the product and assuming all the associated risks of ownership, any profit the member receives on reselling to a client would not constitute a commission.²

Second, if in providing professional services to a client, a member subcontracts the services of another person or entity, any mark-up of the cost of the subcontracted services would not constitute a commission.³ Under these circumstances, there would be no prohibitive effect on an attest engagement.

Where the commissions and referral fees are allowable, the CPA must disclose their existence to the client. Effective with commissions and referral fees in arrangements entered into on or after Jan. 31, 2017, the disclosure is required to be in writing.

Ethics Resolution

These four areas provide guidance to help resolve some potential ethical questions regarding a member's independence. The revised Code provides relatively easy access to search for rules and guidance on all ethics questions and is available at the following website:

<http://www.aicpa.org/Research/Standards/CodeofConduct/DownloadableDocuments/2014December15ContentAsof2016June21CodeofConduct.pdf>. ■

Footnotes

1. See Code 1.270 – Family Relationships with attest Clients.
2. Code 1.520.060.01
3. Code 1.520.070.01

Call today for a free, confidential valuation of your practice.



IMAGINE... A CHAIR WITHOUT A DESK



DELIVERING RESULTS - ONE PRACTICE AT A TIME

Call or Email APS Today to get started and see how simple it can be with APS working for YOU.



ACCOUNTING PRACTICE SALES
THE GLOBAL LEADER IN PRACTICE SALES

North Texas

The Holmes Group

Toll-Free 1-800-397-0249

ryan@accountingpracticesales.com

Central & West Texas

Bill Ancelle

Toll-Free 1-866-809-8705

Bill@ATP4S.com

Southeast Texas

Wade Holmes

Toll-Free 1-888-847-1040 x 2

wade@accountingpracticesals.com

www.APS.net