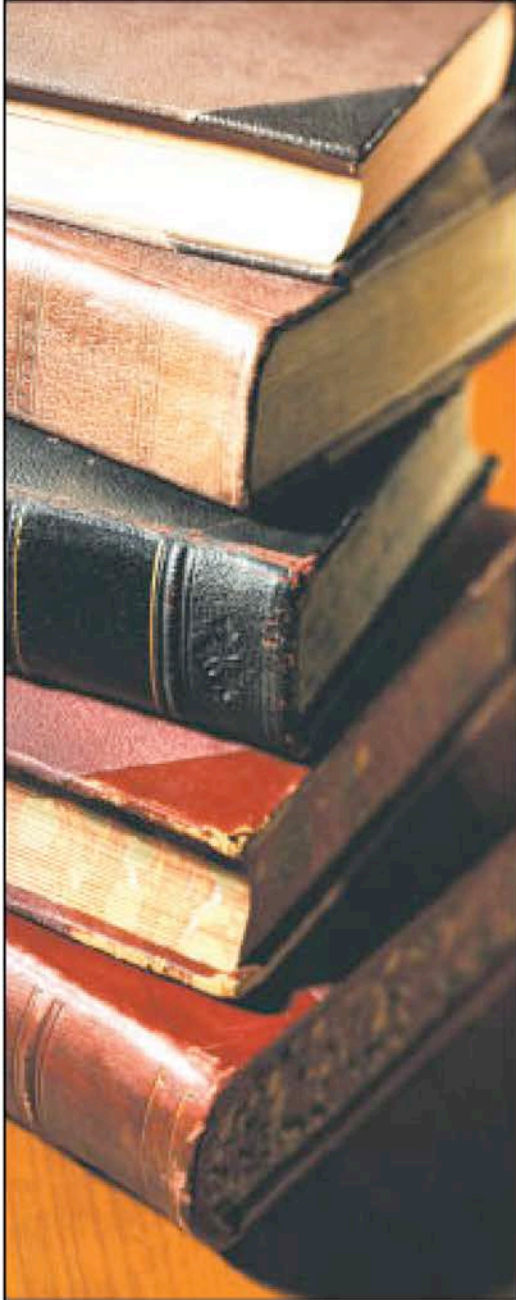


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Compilation and Review: Independence Rules (Course #6885/QAS6885)

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Compilation and Review: Independence Rules

1. Changes in 2012 and 2013

In 2012 and 2013, the AICPA's Professional Ethics Executive Committee (PEEC) issued several important revisions to ethics rulings and interpretations.

In 2012, the AICPA issued a revised Interpretation 101-3, *Nonattest Services*, and other changes to ethics rules. The changes were effective on August 31, 2012.

In January 2013, the PEEC passed a revised document entitled, *Omnibus Statement, Revised and New Interpretations and Deletion of Ethics Rulings*, which makes further changes to Rule 101, *Independence*, in general, and specific changes to Interpretation 101-3.

Following are the changes made to the ethics codification in 2012 and 2013.

Revision to Definition of Holding Out:

In January 2013, the PEEC voted to remove the definition of "*holding out*" from the Code of Professional Conduct and to remove the language "*holding out as CPAs*" from the definitions of *practice of public accounting* and *professional services*.

The existing definition of *holding out* that is **deleted** effective May 31, 2013 follows:

Holding out:

"In general, any action initiated by a member that informs others of his or her status as a CPA or AICPA accredited specialist constitutes holding out as a CPA. This would include, for example, any oral or written representation to another regarding CPA status, use of the CPA designation on business cards or letterhead, the display of a certificate evidencing a member's CPA designation, or listing as a CPA in local telephone directory" [entire paragraph deleted effective May 2013].

A comparison of the definitions before and after the change follows:

Definition	Existing Definition	New Definition Effective May 2013
Professional services Rule 92.30	Professional services include all services performed <u>while holding out as a CPA</u>	Professional services include all services performed by a member for a client, employer or on a volunteer basis, requiring accountancy or related skills including but not limited to accounting, audit and other attest services, tax, bookkeeping, management consulting, financial management, corporate governance, personal financial planning, business valuation, litigation support, educational and those services for which standards are promulgated by bodies designated by Council [deleted 'while holding out as a CPA']
Practice of public accounting (Public Practice) Rule 922.29	The practice of public accounting consists of the performance for a client, by a member or a member's firm, <u>while holding out as CPA(s)</u> , of the professional services of accounting, tax, personal financial planning, litigation support services, and those professional services for which standards are promulgated by bodies designated by Council. Such standards include Financial Accounting Standards Board (FASB) <i>Accounting Standards Codification</i> TM (ASC), Statements on Auditing Standards, Statements on Standards for Accounting and Review Services, Statements on Standards for Consulting Services, Statements of Governmental Accounting Standards, International Financial Reporting Standards and International Accounting Standards, Statements on Standards for Attestation Engagements and Statements on Standards for Valuation Services.	Public practice consists of the performance of professional services [deleted while holding out as a CPA"].

Observation: In eliminating the language “*holding out as a CPA*” from the definitions of *professional services* and *practice of public accounting*, all members are now bound by the rules of the AICPA Code of Professional Conduct, regardless of whether they hold out as CPAs or not. There are many AICPA members who are not CPAs but that were not previously subject to the AICPA ethics code. Those non-CPA members include

members in public accounting and business, who choose not to hold out as CPAs, and certain individuals who are not CPAs but are AICPA members. Now, effective in May 2013, all members, CPA and non-CPA, are subject to the AICPA ethics.

Revisions to Ethics Rule 101, Independence:

a. General

In September 2003, the Professional Ethics Executive Committee of the AICPA issued a revision to Interpretation 101-3 entitled *Performance of Nonattest Services*. The Interpretation was further amended in 2006 and recently amended again in 2012 and 2013.

For years, there has been confusion as to when an accountant performs management services for an attest client to the extent that he or she is no longer independent with respect to that client. This issue has become more important as CPA firms have expanded consulting services directed at existing compilation, review and audit clients. For example, today, many firms offer their services to clients as part-time controllers whereby they perform most of the functions as a controller one or two days per week. Such tasks may include managing accounting personnel, signing checks, negotiating with the banks or investors, etc. Do these functions impair the independence of the accountant with respect to that client? At a simpler level, an accountant may perform write-up services and wish to perform a compilation, review or audit on that same client. Is the write-up service a management function?

The general rule is that an accountant is precluded from issuing a review or audit report on the financial statements of any entity to which he or she is not independent. SSARS No. 19 carves out a special exception for an accountant who performs compilation engagements. That accountant may compile financial statements if he or she is not independent, provided he or she disclaims independence within the compilation report with the following language added to that report:

“We are (I am) not independent with respect to ABC Company.”

Prior to the issuance of SSARS No. 19, an accountant was not permitted to disclose the reason for the lack of independence. Now, SSARS No. 19 permits an accountant to disclose the reason for the lack of independence.

More than a decade ago, the AICPA Professional Ethics Executive Committee issued Ethics Interpretation 101-3, *Performance of Other Services*. The purpose of this interpretation was to clarify when an accountant who performs certain nonattest services violates his or her independence. The original version of Interpretation 101-3 provided guidelines on independence segregated into:

- Bookkeeping (including payroll and other disbursements)
- Benefit plan administration
- Investment advisory and management services
- Corporate finance, consulting and advisory services
- Appraisal, valuation, and actuarial services
- Executive or employee service
- Business risk consulting
- Information systems design, installation, and integration

In 2006, the PEEC further amended Interpretation 101-3 with specific changes made to address whether any of the following activities impaired independence:

- Compliance services, including preparing a tax return, transmitting the tax return and related payment to the taxing authority.
- The signing and filing of a tax return on behalf of a client.
- Forensic accounting services, including litigation and investigative services.

Once again, in 2012 and 2013, the PEEC made additional changes to Interpretation 101-3 including clarifying that certain communications between the member (CPA) and client, such as recommending adjusting entries, are part of the attest engagement, and not nonattest services.

In the following sections, wherever there is reference to the term "member", the Interpretation is referring to a member of the AICPA. The author uses the terms "CPA", "accountant" and "member" interchangeably within the remainder of this chapter, even though, in limited cases, a member can be a non-CPA.

Moreover, when referring to an attest engagement, the author refers to the following types of engagements:

- Audit of financial statements
- Review of financial statements
- Compilation with no disclaimer for independence
- Attestation engagement under SSAE No. 10, such as an agreed-upon procedures engagement

b. Changes Made to Rule 101, Independence:

The following are the 2012 and 2013 changes made to Rule 101.

CHANGE 1: Nonattest Services:

The PEEC decided to clarify the issue pertaining to whether a member (CPA) who previously performed nonattest services for a client, would have his or her independence impaired in subsequent periods.

Rule 101 is amended to state that a member's (CPA's) independence *would not be impaired* if the member (CPA) performed nonattest services that would have impaired independence during the period covered by the financial statements, provided that *all of the following conditions exist*.

- a. The nonattest services were provided prior to the period of the professional engagement,
- b. The nonattest services related to periods prior to the period covered by the financial statements, and
- c. The financial statements for the period to which the nonattest services relate were audited by another firm (or the case of a review engagement, reviewed or audited by another firm).

Example: Joe CPA is hired to review the financial statements of Company X for the year ended December 31, 2013.

- Joe performed nonattest services for Company X in 2011 and part of 2012. The nonattest services consisted of part-time controllership including Joe being a signatory on X's bank accounts and having authorization to hire and fire certain employees of X.
- Joe stopped his controllership services on or about October 2012 and started the December 31, 2013 year-end review engagement in January 2014. After terminating his controllership services, Joe's only nonattest services performed for X was the preparation of X's 2013 corporate tax returns.
- The financial statements for 2011 and 2012 were reviewed by another CPA firm.

Conclusion: Joe's independence is not impaired for 2013. Therefore, Joe is permitted to perform his review engagement on X's 2013 financial statements.

The analysis is based on the revised Ethics Ruling 101, using the following facts:

- a. The nonattest services (controllership) were provided prior to the period of the professional engagement: Joe performed nonattest services through October 2012, prior to January 1, 2013, the beginning of the year of the review engagement.
- b. The nonattest services related to periods prior to the period covered by the financial statements: Joe's controllership related to 2011 and part of 2012, periods prior to 2013.
- c. The financial statements for the period to which the nonattest services relate were audited or reviewed by another firm: According to the facts, another firm reviewed the financial statements for 2011 and 2012, the periods during which Joe performed his nonattest services.

Therefore, Joe is permitted to perform a review of the 2013 financial statements even though Joe performed nonattest services in 2011 and 2012 that, if they had been performed in 2013, would have impaired his independence because Joe had made management decisions during his controllership tenure.

What about the fact that Joe is performing a nonattest service in 2013 by preparing X's tax return?

The fact that Joe performs a nonattest service for an attest client in 2013, does not, in and of itself, mean that Joe's independence is impaired.

Performing nonattest services for an attest client, such as preparation of a tax return, bookkeeping services, payroll services, where the accountant does not make management decisions or act in the capacity of management, does not result in the accountant impairing his or her independence, as long as Joe complies with the requirements of Interpretation 101-3. Those requirements include: 1) Joe cannot make management decisions or assume management responsibility, 2) The client, rather than Joe, must agree to assume all management responsibilities for the nonattest service, and 3) The understanding must be in writing (e.g., engagement letter). These three requirements are discussed further on in this section.

CHANGE 2: Change in the Definition of a Covered Member:

Background:

Interpretation 101 states the following:

Independence shall be considered impaired if:

- a. During the period of the professional engagement, a “**covered member**”:
 1. Had or was committed to acquire any direct or material indirect financial interest in the client,
 2. Was a trustee of any trust or executor or administrator of any estate if such trust or estate had or was committed to acquire any direct or material indirect financial interest in the client....
 3. Had a joint closely held investment that was material to the covered member, and
 4. Except as specifically permitted in Interpretation 101-5, had any loan to or from the client.....

Change made in 2013 to definition of a covered member:

The 2013 Omnibus Statement changes the definition of a covered member to include a **partner equivalent**.

ET 92.07 expands the definition of a “covered member” subject to the independence rules as follows:

A covered member is:

- a. an individual on the attest engagement team,
- b. an individual in the position to influence the attest engagement,
- c. a partner, **partner equivalent**, or manager who provides nonattest services to the attest client.....,

- d. a partner or **partner equivalent** in the office in which the lead attest engagement partner or partner equivalent primarily practices in connection with the attest engagement,
- e. the firm, including the firm's employee benefit plans, or
- f. an entity whose operating, financial, or accounting policies can be controlled by any of the individuals or entities in (a) to (e), or two or more such individuals or entities if they act together.

Ethics Rule 92.27 includes a *new definition of a partner equivalent* as follows:

A **partner equivalent** is a professional employee who is not a partner of the firm (as defined in Ethics Ruling 92.26), but who:

- a. has the authority to bind the firm to conduct an attest engagement without partner approval, for example, the professional employee has the authority to sign or affix the firm's name to an attest engagement letter or contract to conduct an attest engagement without partner approval, or
- b. has the ultimate responsibility for the conduct of an attest engagement, including the authority to sign or affix the firm's name to an attest report, or issue, or authorize others to issue, an attest report on behalf of the firm without partner approval.

Note: The PEEC states that firms may use different titles to refer to professional employees, although a title is not determinative of a partner equivalent. The partner equivalent definition only pertains to Rule 101 independence issues and related interpretations and rulings, and should not be relied upon with respect to any other context, such as whether a partner equivalent is an owner of the firm.

Further, the definition states that the term "*partner approval*" does not include the firm's normal approval and quality control review procedures.

The *2013 Omnibus Statement* inserts the new term "partner equivalent" in numerous sections of the ethics codification.

Definition of a manager:

The Statement also changes the definition of a **manager**, which is a covered member. A manager is now defined as:

"A professional employee of the firm who has continuing responsibility for the planning and supervision of engagements for specified clients."

The new guidance is effective for engagements covering periods *beginning on or after December 15, 2014.*

CHANGE 3: Activities Related to Attest Services:

Effective August 2012, the PEEC made the following change to Interpretation 101-3 pertaining to certain communications that are now considered part of the attest engagement, and not nonattest services.

Performing attest services often involves communication between the member (CPA) and client management.

The following communications are considered a normal part of the attest engagement and would not constitute a nonattest service:

- a. the client's selection and application of accounting standards, or policies and financial disclosure requirements,
- b. the appropriateness of the client's methods used in determining the accounting and financial reporting,
- c. adjusting journal entries that the member (CPA) has prepared or proposed for client management consideration, and
- d. the form or content of the financial statements.

However, the member (CPA) should exercise judgment in determining whether his or her involvement has become so extensive that it would constitute performing a separate service which would be subject to the interpretation's General Requirements for Performing Nonattest Services.

CHANGE 4: Financial Statement Preparation and Cash-to-Accrual Conversions-Nonattest Services:

The 2013 Omnibus Statement makes a significant change to current practice. More specifically, certain activities are now considered outside the scope of an attest engagement and constitute a nonattest service: Those activities include:

- Financial statement preparation,
- Cash-to-accrual conversions, and
- Reconciliations such as cash, accounts receivable and payable reconciliations.

The above activities are nonattest services and would not impair independence as long as the accountant complies with the three requirements of Interpretation 101-3, which is discussed elsewhere in this section.

Note: In 2011, there were revisions to the *Government Auditing Standards*, with the most significant changes relating to its standards for auditor independence, in particular the performance of nonattest services for an audit client. Although the changes made by the GAO created greater consistency between the AICPA's and the GAO's nonattest independence standards, the preparation of financial statements and cash-to-accrual conversions, were identified as services where the PEEC believed Interpretation No. 101-3 should be revised. The GAO ruled that the preparation of financial statements was a nonattest service separate from the audit attest engagement. In the end, the PEEC

changed Interpretation 101-3 to make it consistent with GAO standards, by stating that the preparation of financial statements, cash-to-accrual conversions, and reconciliations are all nonattest services.

CHANGE 5: Internal Audit Assistance Services:

The 2013 Omnibus Standard makes changes to the independence rules as they relate to an accountant who provides internal audit assistance service for an attest client.

Internal audit services involve assisting the client in the performance of its internal audit activities, sometimes referred to as *internal audit outsourcing*. In evaluating whether independence would be impaired with respect to an attest client, the nature of the service needs to be considered.

Interpretation 101-3 segregates the internal audit assistance services into two categories:

- Assisting the client in performing financial and operational internal audit activities, and
 - Designing, implementing, or maintaining the client's *monitoring* activities of a client's internal control.
1. Assisting the client in performing financial and operational internal audit activities:
 - a. An example of assisting a client in performing a financial and operational internal audit is where the member assesses whether performance is in compliance with management's policies and procedures, to identify opportunities for improvement, and to develop recommendations for improvement or further action for management consideration and decision making.
 - b. Such assisting would impair independence, unless the member takes appropriate steps to be satisfied that the client accepts its responsibility for designing, implementing, and maintaining internal control and for directing the internal audit function, including the management thereof.
 - 1) Any outsourcing of the internal audit function to the member whereby the member, in effect, manages the internal audit activities of the client would impair independence.
 2. Designing, implementing, or maintaining the client's monitoring activities (of a client's internal control):
 - a. Such activities are management responsibilities and would impair a member's independence if a member accepts responsibility for performing such activities.
 - b. Monitoring activities are procedures performed to assess whether components of internal control are present and functioning.
 - c. Monitoring can be done through either ongoing evaluations or separate evaluations, or some combination of the two.

Monitoring	
Type of monitoring	Effect on member's independence
Ongoing evaluations	<ul style="list-style-type: none"> • Independence <i>is impaired</i>. • Member is deemed to be accepting management's responsibility for the client's internal control. • No safeguards can reduce a member's management participation threat to an acceptable level.
Separate evaluations	<ul style="list-style-type: none"> • Independence generally is <i>not impaired</i>. Independence is impaired only if member accepts management responsibility. • Member is generally not deemed to be accepting responsibility for the client's internal control. • Threat of a member's management participation is low.

- 1) *Ongoing evaluations* are generally defined, routine operations, built in to the client's business processes and performed on a real-time basis. Such monitoring, including managerial activities and everyday supervision of employees, monitor the presence and functioning of the components of internal control in the ordinary course of managing the business.
 - A member who performs such ongoing evaluations for a client would be considered to be accepting responsibility for maintaining the client's internal control. Therefore, the management participation threat created by a member performing ongoing evaluations is so significant that *no safeguards could reduce the threat to an acceptable level*. Therefore, member independence would be impaired, regardless of whether any other actions are taken.
- 2) *Separate evaluations* are conducted periodically and are generally not ingrained within the business but can be useful in taking a fresh look at whether internal controls are present and functioning.
 - Separate evaluations include observations, inquiries, reviews, and other examinations to determine whether controls are designed, implemented, and conducted.

- The scope and frequency of separate evaluations is a matter of judgment and vary depending on assessment of risks, effectiveness of ongoing evaluations, and other considerations. Because separate evaluations are not built into the client's business process (and performed on a real-time basis), separate evaluations generally do not create a significant management participation threat to independence.
- As long as the member complies with the three requirements for performing nonattest services for an attest client (including not assuming management responsibility (as discussed further on in this section), the accountant's independence is not impaired by performing separate evaluations.

Note: Members should use judgment in determining whether the internal audit services performed, including separate evaluations, may result in a significant management participation threat to independence, considering factors such as:

- The significance of the controls being tested,
- The scope or extent of the controls being tested in relation to the overall financial statements of the client, and
- The frequency of the internal audit services.

If there is a significant threat to independence, the member should apply safeguards to eliminate or reduce the threat to an acceptable level. If no safeguards could reduce the threat to an acceptable level, independence would be impaired.

3. With respect to internal audit services, to reduce the threat of the member assuming management responsibility, in addition to the general requirements of this interpretation, the member should be satisfied that client management:
 - a. designates an individual or individuals, who possess suitable skill, knowledge, and/or experience, preferably within senior management, to be responsible for the internal audit function,
 - b. determines the scope, risk, and frequency of internal audit activities, including those to be performed by the member providing internal audit assistance services,
 - c. evaluates the findings and results arising from the internal audit activities, including those performed by the member providing internal audit assistance services, and
 - d. evaluates the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures.

Note: The member may assist the individual(s) responsible for the internal audit function in performing preliminary audit risk assessments, preparing audit plans, and recommending audit priorities. The member should also be satisfied that those charged with governance are informed about the member's and management's respective roles

and responsibilities in connection with the engagement. Such information should provide those charged with governance a basis for developing guidelines for management and the member to follow in carrying out these responsibilities, and monitoring how well the respective responsibilities have been met.

4. The following are examples of activities that, if performed as part of an internal audit services engagement, would impair independence (new items are identified in ***bold italic*** type):

- *Performing ongoing monitoring activities or control activities* (for example, reviewing loan originations as part of the client's approval process or reviewing customer credit information as part of the customer's sales authorization process) that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both, and performing routine activities in connection with the client's operating or production processes that are equivalent to those of an ongoing compliance or quality control function
- ***Performing separate evaluations on the effectiveness of a significant control such that the member is, in effect, performing routine operations that are built into the client's business process***
- ***Having client management rely on the member's work as the primary basis for the client's assertions on the design or operating effectiveness of internal controls***
- Determining which, if any, recommendations for improving the internal control system should be implemented
- Reporting to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function
- Approving or being responsible for the overall internal audit work plan, including the determination of the internal audit risk and scope, project priorities, and frequency of performance of audit procedures, and
- Being connected with the client as an employee, or in any capacity equivalent to a member of client management (for example, being listed as an employee in client directories or other client publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the client's internal audit function, or using the client's letterhead or internal correspondence forms in communications).

5. When a member performs internal audit services that would not impair independence under this interpretation and is subsequently engaged to perform an attestation engagement to report on management's assertion regarding the effectiveness of its internal control, independence would not be considered impaired, provided the member is satisfied that client management does not rely on the member's work as the primary basis for its assertion.

CHANGE 6: Engagements Subject to Independence Rules of Certain Bodies:

Rule 101 is amended to require compliance with independence regulations of authoritative regulatory bodies when a member performs nonattest services for an attest client and is required to be independent of the client under the regulations of the applicable regulatory body. Failure to comply with the nonattest services provisions

contained in the independence rules of the applicable regulatory body that are more restrictive than the provisions of this Interpretation, would constitute a violation of this Interpretation.

The interpretation expands the list of identified applicable regulatory bodies to include:

- SEC
- Government Accountability Office (GAO)
- Department of Labor (DOL)
- Public Company Accounting Oversight Board (PCAOB)
- State boards of accountancy

CHANGE 7: Expanded List of Unacceptable Nonattest Services- CPA Assumes Management Responsibilities:

The 2012 revision to Interpretation 101-3 expands the examples of activities that, if performed by an accountant, would result in the accountant assuming management responsibility. Therefore, the accountant's independence would be impaired if any of the following were to be performed by an accountant for an attest client:

- Authorizing, executing or consummating transactions, otherwise exercising authority on behalf of a client or having the authority to do so
- Preparing source documents, in electronic or other form, evidencing the occurrence of a transaction
- Having custody of client assets
- Deciding which recommendations of the member or other third parties to implement or prioritize
- Reporting to those in charge of governance (typically the board of directors) on behalf of management
- Serving as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent
- ***Setting policies or strategic direction for the client***
- ***Directing or accepting responsibility for the actions of the client's employees except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards***
- ***Accepting responsibility for the management of a client's project***
- ***Accepting responsibility for the preparation and fair presentation of the client's financial statements in accordance with the applicable financial reporting framework***
- ***Accepting responsibility for designing, implementing, or maintaining internal controls***
- ***Performing ongoing evaluations of the client's internal control as part of its monitoring services***

Note: New items added by the revised Interpretation 101-3 are identified in ***bold italic*** and apply effective August 31, 2012. If any of the above listed activities are performed, an accountant's independence is impaired.

CHANGE 8: Expanded List of Acceptable Nonattest Services:

Interpretation 101-3 is amended to add two new nonattest services to the list of nonattest services that do not impair an accountant's independence with respect to a nonattest client:

- Prepare a reconciliation (for example, cash and accounts receivable) that identifies reconciling items for the client's evaluation.
- Perform network maintenance, such as updating virus protection, applying routine updates and patches, or configuring user settings consistent with management's request.

As long as an accountant satisfies the three general requirements for performing nonattest services (see Change 9 below), an accountant is permitted to perform the above two nonattest services for an attest client and not impair independence.

CHANGE 9: Changes to the General Requirements for Performing Nonattest Services:

a. General requirements for performing nonattest services for an attest client:

Interpretation 101-3 amends the *three requirements* that must be satisfied in order for a member (CPA) to perform certain nonattest services for an attest client:

1. Member (CPA) should not assume management responsibilities for the attest client:

The member (accountant) should not assume management responsibilities for the attest client.

Exception: The member may provide advice, research materials, and make recommendations to assist management in performing its own functions and making decisions, provided the member does not make those decisions.

2. Client must agree to perform certain functions:

Before performing nonattest services, the member should determine that the client has agreed to:

- Assume all management responsibilities,
- Oversee the service, by designating an *individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience,*
- Evaluate the adequacy and results of the nonattest services performed, and
- Accept responsibility for the results of the nonattest services.

- a) The member (CPA) should assess and be satisfied that such individual understands the services to be performed sufficiently to oversee them. **However, the individual is not required to possess the expertise to perform or re-perform the service.**
- b) To avoid assuming management responsibilities when providing nonattest services to the client, the member (CPA) should be satisfied that management will be able to meet all of these criteria, make an informed judgment on the results of the member's nonattest services, and be responsible for making the significant judgments and decisions that are the proper responsibility of management.
- c) If the client is unable or unwilling to assume these responsibilities (for example, the client cannot oversee the nonattest services provided, or is unwilling to carry out such responsibilities due to lack of time or desire), the member's performance of these services would impair independence.

3. Written establishment and documentation with client:

Before performing the nonattest services, the member should establish and *document in writing* his or her understanding with the client (such as the board of directors, audit committee, or management) regarding:

- Objectives of the nonattest engagement
- Nonattest services to be performed
- Client's acceptance of its responsibilities
- Member's responsibilities
- Any limitations of the engagement

- a) The documentation requirement does not apply to nonattest services performed prior to the client becoming an attest client.

Observation: The revised interpretation makes subtle changes to the three requirements that must be satisfied in order for a CPA to perform nonattest services for an attest client.

Failure to pass cumulative effect on independence when providing nonattest services:

In the exposure draft of the 2013 *Omnibus Statement*, the PEEC proposed language to deal with a situation in which nonattest services could individually not impair independence, but in the aggregate could impair independence. In its January 2013 ethics committee meeting, the PEEC voted not to include in the ethics codification the requirement that a member consider the cumulative effect of performing several nonattest services on overall independence.

Even though the requirement to consider independence based on aggregated nonattest services is not codified, there is an implicit need for a member to consider his or her overall independence for each client. Such an evaluation should consider independence for each individual nonattest service, but also all nonattest services performed in the aggregate.

2. Three Requirements For a CPA to Perform Nonattest Services for an Attest Client

As identified above, Interpretation 101-3, as amended, provides that in order for a CPA to perform nonattest services (such as bookkeeping services or tax return preparation) for an attest client, the CPA must satisfy three requirements. Following is a discussion of each of the three requirements.

REQUIREMENT 1: Member (CPA) should not assume management responsibilities for the attest client:

The first requirement of the revised Interpretation is that the member (CPA) should not assume management responsibilities for the attest client.

The revised Interpretation 101-3 addresses certain issues related to a CPA's requirement that he or she not assume management responsibilities for an attest client.

- a. If a member were to assume a management responsibility for an attest client, the management participation threat created would be so significant that no safeguards could reduce the threat to an acceptable level.
- b. Management responsibilities involve leading and directing an entity, including making significant decisions regarding acquisition, deployment, and control of human, financial, physical, and intangible resources.
- c. Whether an activity is a management responsibility depends on the circumstances and requires the exercise of judgment.

Examples of activities that would be considered a management responsibility and, therefore, impair independence if performed for an attest client include the following:

- Authorizing, executing or consummating transactions, otherwise exercising authority on behalf of a client or having the authority to do so
- Prepare source documents, in electronic or other form, evidencing the occurrence of a transaction
- Having custody of client assets
- Deciding which recommendations of the member or other third parties to implement or prioritize
- Report to those in charge of governance (typically the board of directors) on behalf of management
- Serving as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent
- ***Setting policies or strategic direction for the client***
- ***Directing or accepting responsibility for the actions of the client's employees except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards***
- ***Accepting responsibility for the management of a client's project***

- ***Accepting responsibility for the preparation and fair presentation of the client's financial statements in accordance with the applicable financial reporting framework***
- ***Accepting responsibility for designing, implementing, or maintaining internal controls***
- ***Performing ongoing evaluations of the client's internal control as part of its monitoring services***

Note: New items added by the revised Interpretation 101-3 are identified in ***bold italic*** and apply effective August 31, 2012.

REQUIREMENT 2: Client must agree to perform certain functions:

The second requirement in order for a CPA to perform nonattest services for an attest client is that the client must agree to perform certain functions.

More specifically, before performing nonattest services, the member should determine that the client has agreed to:

- a. Assume all management responsibilities,
- b. Oversee the service, by designating an *individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience,*
- c. Evaluate the adequacy and results of the nonattest services performed, and
- d. Accept responsibility for the results of the nonattest services

Note: The member (CPA) should assess and be satisfied that such individual understands the services to be performed sufficiently to oversee them. **However, the individual is not required to possess the expertise to perform or re-perform the service.**

What if the client does not have an individual with the necessary skill, knowledge, and/or experience to oversee the nonattest services?

The Ethics Committee has stated that in establishing the requirement that the CPA should assess and be satisfied that such individual understands the services to be performed sufficiently to oversee them. Moreover, the individual is not required to possess the expertise to perform or re-perform the service. That means that if the nonattest service performed by the CPA is the preparation of the corporate tax return of the entity for whom the CPA is performing a review engagement, the designated individual does not have to possess sufficient skill to prepare the tax return.

Instead, the designated employee should have a sufficient level of understanding of the results of the services rendered so that he or she could effectively oversee them, including making any necessary management decisions related to the nonattest service. In all cases, the skill, knowledge, and/or experience level should be sufficient to allow the employee to understand the nonattest service to be rendered and allow him or her to make all management decisions and perform all management functions associated with that service, and to evaluate the adequacy and results of the service, accept responsibility for those results, including monitoring activities, over the subject matter of the service. Note further that the individual is not required to have any expertise regarding the services being performed.

Example: A member is hired by an attest client to perform bookkeeping services. The client designates an employee with suitable skill, knowledge, and experience to oversee the bookkeeping services.

Conclusion: The designated employee should be able to understand the bookkeeping service to be rendered and to perform all management functions related to that bookkeeping service, including understanding the adequacy of the member's services performed. In doing so, for example, the employee should be able to assess the journal entries and general ledger account classifications proposed by the member. This would suggest that the employee must, at a minimum, have a general understanding of the accounting function in order to understand the entries and classifications proposed by the member.

Observation: It would appear that in most small business scenarios, there is someone within the entity who can take responsibility as a designated employee. In the worst case, the owner/manager should be able to act as the designated employee as that person usually has enough overall knowledge of the business to be considered to have suitable skill, knowledge, and/or experience to oversee the services performed. Also, although the Interpretation, as revised, suggests that it is preferable for a senior manager to play the role as a designated employee to oversee the nonattest function, there is no requirement to do so. That means that a bookkeeper or controller could be assigned the role as the designated employee.

If an owner/manager has an inadequate knowledge of accounting to approve the accountant's proposed entries and general ledger classifications, that owner-manager still could be the designated employee by having the bookkeeper or controller review the entries and classifications for the owner/manager.

Must the designated person be an employee?

No. One change previously made to Interpretation 101-3 is the removal of the term "employee" and replacing it with the term "individual" so the client must designate an individual who may or may not be an employee. By doing so, an owner or individual outside the company, such as an outsourced bookkeeper or controller, can act as the designated individual.

REQUIREMENT 3: Written establishment and documentation with client:

The third requirement in order for a CPA to perform nonattest services for an attest client is that there must be a written establishment and documentation with the client as to the nonattest work to be performed.

Before performing the nonattest services, the member should establish and *document in writing* his or her understanding with the client (such as the board of directors, audit committee, or management) regarding:

- Objectives of the nonattest engagement
- Nonattest services to be performed
- Client's acceptance of its responsibilities
- Member's responsibilities
- Any limitations of the engagement

Here is some guidance on achieving this requirement:

- a. The documentation of the understanding can be in the form of:
 - 1) An engagement letter to the client, or
 - 2) An internal memorandum to the member's file that is not issued to or signed by the client.
- b. The documentation requirement does not apply to certain routine activities performed by the member including providing advice and responding to the client's technical inquiry as part of the client-member relationship.
- c. The member's failure to prepare the required documentation would not impair independence, provided the member did establish the understanding with the client.

Example: Mary CPA is hired by her attest client to perform bookkeeping services. Mary meets with the client and establishes an understanding of the services to be provided including:

- Objectives of the engagement
- Services to be performed
- Client's acceptance of its responsibilities
- Member's responsibilities
- Any limitations of the engagement.

Mary forgets to document the understanding either in an engagement letter or in a memorandum to her file. One year later, the failure to document the understanding is discovered while Mary goes through a peer review. She immediately documents the understanding upon discovery of her failure to do so.

Conclusion: Mary's independence is not impaired with respect to the attest client. Mary's failure to document the understanding does not impair independence because she established an understanding with the client.

The author suggests *two options* with which to document the understanding with the client as follows:

- a. Include reference to the nonattest service within the attest engagement letter assuming one is obtained for the engagement, or
- b. Prepare an internal memorandum to be placed in the accountant's file and not to be distributed to the client.

Following are examples of each of the two documents.

OPTION 1: Include reference to the nonattest service within the attest engagement letter.

The clearest way to document the client's understanding of the nonattest services to be performed for an attest client is to simply include reference to the nonattest service in the attest engagement letter.

Example: An accountant is hired to perform a review engagement for a company, as required by the company's bank. The client has no bookkeeper and seeks to hire the accountant to perform bookkeeping services prior to performing the review engagement including:

- Coding all checks and deposits for the year
- Posting all cash receipts and disbursements to the general ledger

The accountant is also hired to prepare the tax return for the company.

Conclusion: The accountant should document the client's understanding of the nonattest services to be provided (bookkeeping and tax return preparation). One way to do so is to include language in the review engagement letter that clarifies the:

- Objectives of the engagement
- Services to be performed
- Client's acceptance of its responsibilities
- Member's responsibilities
- Any limitations of the engagement.

Following is the author's nonauthoritative language that can be placed in the engagement letter.

REVISED INTERPRETATION 101-3 LANGUAGE (EFFECTIVE ON AUGUST 31, 2012):

Part of Engagement Language for the Attest Engagement Letter

In addition to the performance of our review engagement, we will perform certain nonattest services including bookkeeping services, payroll tax return preparation, and the preparation of the Company's federal and state income tax returns.

We, in our sole professional judgment, reserve the right to refuse to do any procedure or take any action that could be construed as assuming management responsibilities, including determining general ledger account classifications of certain transactions and approving journal entries.

We will advise you, with regard to tax positions taken in the preparation of the tax returns, but you must take all management responsibility with regard to those matters.

You agree that in connection with our performance of any nonattest service, you will:

- Assume all management responsibilities,*
- Oversee the nonattest service, by designating an individual, preferably within senior management, who possesses the skill, knowledge and experience,*
- Evaluate the adequacy and results of the services, and*
- Accept responsibility for the results of our services.*

OPTION 2: Prepare an internal memorandum to be placed in the accountant’s file and not to be distributed to the client.

Interpretation 101-3, as revised, requires that there be *written documentation* of the client’s understanding of the nonattest services to be performed for an attest client. That documentation does not have to be in the form of an engagement letter. Instead, the accountant can draft a memorandum of the understanding and place it in his or her file.

The author has drafted the following non-authoritative memorandum.

Firm Name: _____ Memorandum on Performance of Non Attest Services for an Attest Client- Interpretation 101-3 (revised)					
Client name: _____ Year end of attest engagement: _____					
Type of attest engagement: _____ Review _____ Audit _____ Attestation- SSAE No. 10 _____ Compilation with no disclaimer for lack of independence					
Type of nonattest services to be performed: <table style="width: 100%; border: none;"> <tr> <td style="width: 50%; border: none;"> _____ Bookkeeping _____ Payroll tax prep/other disbursements _____ Benefit plan services _____ Investment advisory/management _____ Corporate finance/consulting/ advisory _____ Tax return preparation </td> <td style="width: 50%; border: none;"> _____ Appraisal, valuation or actuarial services _____ Business risk consulting _____ Information systems _____ Other: _____ </td> </tr> </table>				_____ Bookkeeping _____ Payroll tax prep/other disbursements _____ Benefit plan services _____ Investment advisory/management _____ Corporate finance/consulting/ advisory _____ Tax return preparation	_____ Appraisal, valuation or actuarial services _____ Business risk consulting _____ Information systems _____ Other: _____
_____ Bookkeeping _____ Payroll tax prep/other disbursements _____ Benefit plan services _____ Investment advisory/management _____ Corporate finance/consulting/ advisory _____ Tax return preparation	_____ Appraisal, valuation or actuarial services _____ Business risk consulting _____ Information systems _____ Other: _____				
Comments: nonattest services:					
		Yes	No	Comments	
1.	Is the client aware of the objectives of the engagement?				
2.	Does the client understand the type of nonattest services the accountant is about to perform?				
3.	Before performing the nonattest services, has the client agreed to the following:				
a.	Assume all management responsibilities for the nonattest service?				
b.	Oversee the service by designating an individual who possesses suitable skill, knowledge, and/or experience, (preferably someone within senior management)? Name: _____				
c.	Evaluate the adequacy and results of the nonattest services performed?				
d.	Accept responsibility for the results of the nonattest services?				

	Yes	No	Comments
<p>4. Does the designated individual understand the nonattest services to be performed by the CPA?</p> <p>NOTE: The designated individual is not required to possess the expertise to perform or re-perform the service.</p>			
<p>5. Is the accountant satisfied that management can meet all of the above criteria in (3)(a) through (d), can make an informed judgment as to the results of the nonattest services, and be responsible for making the significant judgments and decisions that are proper responsibility of management?</p>			
<p>6. Is there any indication that the client is unable or unwilling to assume the responsibilities in (3)(a) through (d), such as the client cannot oversee the nonattest services provided, or is unwilling to carry out such responsibilities due to lack of time or design?</p> <p>NOTE: If the answer to this question is “yes”, the accountant’s independence is impaired.</p>			
<p>Conclusion:</p> <p>_____ The accountant has documented an understanding with the client with respect to the nonattest services to be performed. Independence is not impaired based on the Interpretation 101-3, as revised, requirements.</p> <p>_____ The requirements of Interpretation 101-3 have not been satisfied. By performing the nonattest service, the firm’s independence will be impaired with respect to that client and any attest service that is performed for that client.</p> <p>Comments:</p>			

3. AICPA Q&A- Interpretation 101-3

Following are excerpts from an AICPA Q&A related to Interpretation 101-3, some of which have been modified by the author. The Q&A reflects the author’s edits to incorporate 2012 and 2013 changes made to Interpretation 101-3, which the AICPA has yet to make to its Q&A.

What clients are affected by the documentation requirement?

The documentation requirement applies to any nonattest service (such as bookkeeping, tax or consulting services) performed by the member for an attest client. An attest client is any client for which the member performs any service for which independence is required such as a (an):

- Audit
- Review of financial statements
- Compilation in which the compilation report does not disclose lack of independence
- Attestation under the SSAEs.

Where a member only provides nonattest services to a client, the requirements of the interpretation, including the documentation requirement, are not effective until the client becomes an attest client.

Example: A member provides only tax planning and bookkeeping services for a client and is subsequently asked to perform a review of the client's financial statements.

Conclusion: The member could perform the tax planning and bookkeeping services if, upon acceptance of the review engagement, he or she prepares the required documentation and can demonstrate that he or she has complied with the other general requirements of the Interpretation during the period covered by the financial statements, including the requirement to establish an understanding with the client regarding the matters identified above.

What form of documentation is required?

The rule requires that the understanding with the client be in writing, but leaves the form of such documentation to the member's discretion. The method of documentation is not as important as the content of the documentation.

Example: A member performs a consulting engagement for an audit client.

Conclusion: The member may decide to document the required elements of the consulting engagement in the audit engagement letter. Alternatively, the understanding could be documented in a separate engagement letter specific to the consulting engagement, in a memo to the audit files, or in a checklist that is completed as part of the audit.

If a client engages a member to perform tax services, the understanding could be documented in a tax organizer, in a memo contained in the tax working papers, or in the member's billing or correspondence files (e.g., separate from the client work paper files).

Would independence be impaired if a member establishes an understanding with the client, but failed to document that understanding with the client about a nonattest service to be performed?

No. The Interpretation states that the failure to prepare the required documentation would not impair independence provided the member did establish an understanding with the client. However, it would be considered a violation of Rule 202, *Compliance with Standards*.

Definition of suitable skill, knowledge and/or experience:

The Interpretation requires that the client agree to perform certain functions in connection with the engagement to perform nonattest services. One of those requirements is that the client designate an individual who possesses suitable skill, knowledge, and/or experience, preferably within senior management, to oversee the services.

What does “suitable skill, knowledge and/or experience” mean in the context of the Interpretation?

Suitable skill, knowledge, and/or experience means that the designated individual has the ability to understand the nature, objective and scope of the nonattest service.

To oversee the services, the employee is not required to supervise the member in the day-to-day rendering of the services. Instead, the employee should:

- Agree on the nature, objectives and scope of the services
- Receive periodic progress reports where appropriate
- Make all significant judgments
- Evaluate the adequacy and results of the service
- Accept responsibility for the service results
- Ensure that the resulting work product meets the agreed-upon specifications.

The skill, knowledge, and/or experience needed will vary depending on the nature of the nonattest service performed.

Example: The skill, knowledge, and/or experience needed to oversee a payroll service can be expected to be different than the skill, knowledge, and/or experience needed to oversee a complex tax service.

Moreover, the requirement for the client employee to possess suitable skill, knowledge and/or experience, does not, however, require that the individual possess the technical expertise that the member possesses, or the competence of performance, or to re-perform the services.

Why must an individual possess suitable skill, knowledge and/or experience under the Interpretation?

If a designated employee does not possess suitable skill, knowledge and/or experience to oversee the nonattest service, there would be no one, other than the member, to make significant judgments that are needed during the delivery of the service or to discharge the other client responsibilities under the Interpretation. Performing those activities on behalf of the attest client would be inconsistent with the member's requirement to be independent of the client.

How should a member assess the skill, knowledge and/or experience of an individual designated by a client to oversee a nonattest service?¹

The assessment might include factors such as the individual's:

- Understanding of the nature of the service
- Knowledge of the client's business
- Knowledge of the client's industry
- General business knowledge
- Education, and
- Position at the client.

Certain factors might be weighed more than others, depending on the nature of the service.

Example: A client employee who understands the nature of the service and possesses sufficient knowledge of the client's business and industry, may have the skill, knowledge and/or experience to oversee the nonattest service, regardless of the level of education he or she possesses.

Example: Many small business owners know their company's operations and financial position better than any other person, and they understand the nonattest services to be performed by the member and what those services are expected to accomplish. Because they are business owners, they regularly make important decisions about all matters affecting their business. Consequently, members might conclude that those individuals possess the skills, knowledge and/or experience to understand the services being performed, make any management decisions, and determine whether the results of the services meet the agreed-upon specifications.

Who, within the client, could serve as the designee?

The designee will depend on the structure of the client's organization and the nature of the nonattest engagement being performed.

In an owner-managed business, that person will often be the owner. However, it could also be a controller, bookkeeper, another employee, or a third-party not employed depending on the nature of the nonattest services and the qualifications of other client employees.

Example: Assume there is a nonattest engagement where the member has been asked to provide investment advisory services, including recommendations on the allocation of funds that the client should invest in various asset classes based on the client's desired rate of return and risk tolerance. Assume further that the owner makes all investment decisions related to the allocation of funds and investment selections and accepts responsibility for the resulting investment plan.

Conclusion: With respect to the nonattest engagement, the member may conclude that the owner possesses the skill, knowledge and/or experience to oversee the service.

Change the facts: Assume the engagement involves the installation of off-the-shelf accounting software and the set up of a chart of accounts and financial statement format for a small business client. The owner is traveling and designates the office manager to oversee the installation service. The office manager performs routine clerical and receptionist functions, has a limited understanding of the company's operations, and has never used accounting or financial software such as the application being installed by the practitioner. Further, because the company hires a part-time bookkeeper to maintain the general ledger and subsidiary records, the office manager has no understanding of the company's books and records and financial statements.

Conclusion: For purposes of the performance of the nonattest engagement (installation of off-the-shelf accounting software and the set up of a chart of accounts and financial statement format), it is unlikely that the office manager would be deemed to possess the skill, knowledge and/or experience as he or she is not in a position to understand the services being performed sufficiently to oversee them and accept responsibility for the resulting accounting system.

May a client contract with a third party who is not an employee of the client to oversee or advise on the member's performance of the nonattest service?

Yes. The client may contract with a third party to advise management about the nature of the services and the evaluation of the adequacy and results of the services in order to enable management to oversee the services, perform all management functions, make management decisions, accept responsibility for the services performed, and maintain internal controls over the services.

If the client outsources employee functions to a third party, that third party may serve as the individual who possesses the skill, knowledge and/or experience, functions in a capacity equivalent to that of a client employee, and has the authority to make decisions on behalf of the client.

How can a member be satisfied that the client designee understands the nonattest services performed and the work product?

Members must utilize their professional judgment and experience to recognize which individuals are able and willing to fulfill the client responsibilities. Practitioners should be able to assess whether the designated client employee possesses the skill, knowledge and experience to effectively oversee the nonattest services. This can be accomplished through interaction with the client owner or individual.

What are examples of nonattest services and the level of understanding that the client designee should possess to be considered competent under the Interpretation?

Bookkeeping services: If bookkeeping services are performed for an audit, review or compilation client, the member should be satisfied that the designated individual understands the reason why the journal entries are being proposed and the effect on the financial statements.

Recurring/standard entries: For recurring or standard journal entries (such as depreciation), the client may require no explanation as to the reason for the entry if the member has previously discussed the entries with the individual.

More complex journal entries: For more complex entries such as those related to deferred income taxes, the member may need to explain the reason for the entry and the basis for the entry and its impact on the financial statements. The individual should be in the position to approve the proposed entries and to accept responsibility for its financial statements.

Tax services: For tax return preparation engagements, the individual does not have to understand tax law. Instead, the member should have the individual review the tax return with emphasis on the key tax positions taken and be satisfied that the individual understands the company's tax situation, and has a general understanding of how the amounts on the tax return were determined. The individual must also make all decisions regarding significant tax positions taken in the return.

Valuation services: For permitted valuation services, the member may need to explain to the individual the valuation methodologies used and all significant assumptions. The individual should approve all significant assumptions and accept responsibility for the resulting valuation.

4. Nonattest Services That Impair a CPA's Independence

One of the requirements in Interpretation 101-3 is that in performing a nonattest service for an attest client, the accountant *should not assume management responsibilities* for the attest client.

The accountant should avoid certain nonattest activities that will be considered assuming management responsibilities, and thus impair his or her independence.

The following are some nonattest services that the revised Interpretation 101-3 states ***would impair*** a member's independence because the accountant would be considered to assume management responsibilities for the attest client:

- Authorizing, executing or consummating transactions, otherwise exercising authority on behalf of a client or having the authority to do so
- Prepare source documents, in electronic or other form, evidencing the occurrence of a transaction²
- Having custody of client assets
- Deciding which recommendations of the member or other third parties to implement or prioritize
- Report to those in charge of governance (typically the board of directors) on behalf of management
- Serving as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent
- Setting policies or strategic direction for the client

- Directing or accepting responsibility for the actions of the client's employees except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards
- Accepting responsibility for the management of a client's project
- Accepting responsibility for the preparation and fair presentation of the client's financial statements in accordance with the applicable financial reporting framework
- Accepting responsibility for designing, implementing, or maintaining internal controls
- Performing ongoing evaluations of the client's internal control as part of its monitoring services

If an accountant does any of the above list of nonattest services during the period during which an attest engagement relates, the accountant's independence is impaired and NOTHING can cure him or her of the lack of independence. Thus, the accountant cannot perform an attest engagement (compilation, review or audit engagement) for that client. However, the accountant could compile the financial statements and disclaim independence.

5. List of Acceptable Non-Attest Services for an Attest Client

Unlike the list of nonattest services that impair an accountant's independence, an accountant is permitted to perform certain non-attest services for an attest client as long as the accountant complies with the three requirements previously discussed in this section.

- Member (CPA) should not assume management responsibilities for the attest client.*
- Client must agree to perform certain functions.*

Before performing nonattest services, the member should determine that the client has agreed to:

- Assume all management responsibilities,
 - Oversee the service, by designating an *individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience,*
 - Evaluate the adequacy and results of the nonattest services performed, and
 - Accept responsibility for the results of the nonattest services.
- There must be a written establishment and documentation with client as to the nonattest services to be performed.

The examples in the following table identify the effect that performance of certain nonattest services for an attest client can have on a member's independence. These examples presume that the *three general requirements have been met* and are not intended to be all-inclusive of the types of nonattest services performed by a member.

NON-ATTEST SERVICES		
TYPE OF OTHER SERVICE	INDEPENDENCE WOULD NOT BE IMPAIRED (accountant does not assume management responsibilities)	INDEPENDENCE WOULD BE IMPAIRED (accountant assumes management responsibilities)
Bookkeeping	<ul style="list-style-type: none"> • Record transactions for which management has determined or approved the appropriate account classification or post coded transactions to a client's general ledger. • Prepare financial statements based on information in the trial balance. • Post client approved entries to a client's trial balance. • Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client provided the client reviews the entries and the member is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements. • <i>Preparation of financial statements.</i> • <i>Cash to accrual conversion.</i> • <i>Prepare a reconciliation (for example, bank, account receivable, and so forth) that identifies reconciling items for the client's evaluation.</i> 	<ul style="list-style-type: none"> • Determine or change journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval. • Authorize or approve transactions. • Prepare source documents. • Make changes to source documents without client approval.
Non-tax Disbursement	<ul style="list-style-type: none"> • Using payroll time records provided and approved by the client, generate unsigned checks or process client's payroll. 	<ul style="list-style-type: none"> • Accept responsibility to authorize payment of client funds, electronically or otherwise, except as

	<ul style="list-style-type: none"> • Transmit client approved payroll or other disbursement information to a financial institution provided the client has authorized the member to make the transmission and has made arrangements for the financial institution to limit the corresponding individual payments as to amount and payee. In addition, once transmitted, the client must authorize the financial institution to process the information. 	<p>specifically provided for with respect to electronic payroll tax payments.</p> <ul style="list-style-type: none"> • Accept responsibility to sign or cosign client checks, even if only in emergency situations. • Maintain a client's bank account or otherwise have custody of a client's funds or make credit or banking decisions for the client. • Approve vendor invoices for payment.
Benefit Plan Administration	<ul style="list-style-type: none"> • Communicate summary plan data to plan trustee. • Advise client management regarding the application or impact of provisions of the plan document. • Process transactions (e.g., investment/benefit elections or increase/decrease contributions to the plan; data entry; participant confirmations; and processing of distributions and loans) initiated by plan participants through the member's electronic medium, such as an interactive voice response system or Internet connection or other media. • Prepare account valuations for plan participants using data collected through the member's electronic or other media. • Prepare and transmit participant statements to plan participants based on data collected through the member's electronic or other medium. 	<ul style="list-style-type: none"> • Make policy decisions on behalf of client management. • When dealing with plan participants, interpret the plan document on behalf of management without first obtaining management's concurrence. • Make disbursements on behalf of the plan. • Have custody of assets of a plan. • Serve a plan as a fiduciary as defined by ERISA.
Investment Advisory & Management	<ul style="list-style-type: none"> • Recommend the allocation of funds that a client should invest in various asset classes, depending upon the client's desired rate of return, risk tolerance, etc. • Perform recordkeeping and reporting of client's portfolio 	<ul style="list-style-type: none"> • Make investment decisions on behalf of client management or otherwise have discretionary authority over a client's investments. • Execute a transaction to buy or sell a client's investment.

	<p>balances including providing a comparative analysis of the client's investments to third party benchmarks.</p> <ul style="list-style-type: none"> • Review the manner in which a client's portfolio is being managed by investment account managers, including determining whether the managers are: (1) following the guidelines of the client's investment policy statement; (2) meeting the client's investment objectives; and (3) conforming to the client's stated investment styles. • Transmit a client's investment selection to a broker dealer or equivalent provided the client has authorized the broker dealer or equivalent to execute the transaction. 	<ul style="list-style-type: none"> • Have custody of client assets, such as taking temporary possession of securities purchased by a client.
Corporate Finance Consulting or Advisory	<ul style="list-style-type: none"> • Assist in developing corporate strategies. • Assist in identifying or introducing the client to possible sources of capital that meet the client's specifications or criteria. • Assist in analyzing the effects of proposed transactions including providing advice to a client during negotiations with potential buyers, sellers or capital sources. • Assist in drafting an offering document or memorandum. • Participate in transaction negotiations in an advisory capacity. • Be named as a financial adviser in a client's private placement memoranda or offering documents. 	<ul style="list-style-type: none"> • Commit the client to the terms of a transaction or consummate a transaction on behalf of the client. • Act as a promoter, underwriter, broker dealer, guarantor of client securities, or distributor of private placement memoranda or offering documents. • Maintain custody of client securities.
Appraisal, Valuation or Actuarial	<ul style="list-style-type: none"> • Appraisal, valuation, or actuarial service where the results, individually or in the aggregate, would not be material to the financial statements, and the appraisal, valuation, or actuarial service does not involve a significant degree of subjectivity such as an actuarial valuation of a client's pension or postemployment benefit liabilities. • Appraisal, valuation, and actuarial services performed for nonfinancial 	<ul style="list-style-type: none"> • Appraisal, valuation, or actuarial service where the results, individually or in the aggregate, would be material to the financial statements, and the appraisal, valuation, or actuarial service involves a significant degree of subjectivity such as those in connection with employee stock ownership

	statement purposes that otherwise meet all other requirements of the Interpretation, including those performed for tax compliance, estate and gift taxation and divorce proceedings.	plans, business combinations, or appraisals of assets or liabilities.
Executive or Employee Search	<ul style="list-style-type: none"> • Recommend a position description or candidate specifications. • Solicit and perform screening of candidates and recommend qualified candidates to a client based on the client-approved criteria (e.g. required skills and experience). • Participate in employee hiring or compensation discussions in an advisory capacity. 	<ul style="list-style-type: none"> • Commit the client to employee compensation or benefits arrangements. • Hire or terminate client employees.
Business Risk Consulting	<ul style="list-style-type: none"> • Provide assistance in assessing the client's business risks and control processes. • Recommend a plan for making improvements to a client's control processes and assist in implementing these improvements. 	<ul style="list-style-type: none"> • Make or approve business risk decisions. • Present business risk considerations to the Board or others on behalf of management.
Information Systems Design, Installation & Integration	<ul style="list-style-type: none"> • Install or integrate a client's financial information system, that was not designed or developed by the member (e.g., an off-the-shelf accounting package). • Assist in setting up the client's chart of accounts and financial statement format with respect to the client's financial information system. • Design, develop, install, or integrate a client's information system that is unrelated to the client's financial statements or accounting records. • Provide training and instruction to client employees on an information and control system. • Perform network maintenance, such as updating virus protection, applying routine updates and patches, or configuring user settings consistent with management's request. 	<ul style="list-style-type: none"> • Design or develop a client's financial information system. • Make other than insignificant modifications to source code underlying a client's existing financial information system. • Supervise client personnel in the daily operation of a client's information system. • Operate a client's local area network (LAN) system.

Note: This items identifies in **bold italic** are new under the revised Interpretation 101-3 (2012).

Source: *Interpretation 101-3 (revised), as modified by the Author.*

Each of the categories of nonattest services is addressed in the following section.

Performing Bookkeeping Services and Financial Statement Preparation for an Attest Client

Perhaps the most common nonattest service conducted by accountants for their attest clients is the performance of bookkeeping services. The revised Interpretation 101-3 offers a framework for conducting bookkeeping services and clarifies those bookkeeping functions that impair independence from those that do not.

Specifically, bookkeeping services include the performance of any of the following:

- Recording (cash receipts and disbursement) transactions to the general ledger
- Prepare financial statements based on information in the trial balance³
- Proposing and/or posting standard, adjusting, or correcting entries to a client's trial balance
- Preparing a bank reconciliation or reconciliation of accounts receivable or accounts payable
- Conversion of cash to accrual basis

In 2013, a new ethics ruling concluded that the following services are now considered nonattest services and not part of an audit, review or compilation engagement:

- Preparation of financial statements
- Conversion of cash to accrual basis
- Reconciliations such as cash, accounts receivable and accounts payable

Prior to the issuance of the 2013 opinion, the ethics committee had ruled that the preparation of financial statements and the conversion of cash to accrual were a part of the normal attest engagement process, not part of nonattest services.

Although the above list includes services categorized as bookkeeping nonattest services, the performance of some bookkeeping services taint independence, while others do not.

The key factor in determining whether the performance of bookkeeping services impairs an accountant's independence is *whether the accountant assumes management responsibilities in performing those services*. For example, if a client determines the general ledger accounts in which to post transactions and the accountant merely posts those transactions to the client-selected general ledger accounts, the accountant is simply recording transactions authorized by the client. Conversely, if the accountant selects the general ledger accounts to post checks and deposits, the accountant is making a decision in the capacity of management and, thus, impairs his or her independence.

A quick summary is that in order for an accountant to perform bookkeeping services for an attest client without impairing his or her independence, the *client (not the accountant) must*:

- Approve all standard, journal, correcting, and audit entries
- Approve all general ledger account classifications
- Approve all bank, receivable, payable or other reconciliations regardless of whether the accountant prepares them or not
- Prepare all source documents such as invoices, deposits, or checks
- Be a signatory to any bank accounts
- Oversee, direct, or accept responsibility for the client's bookkeeping or accounting function
- Make the ultimate management decisions for a client involving accounting and bookkeeping functions
- Accept responsibility for the financial statements whether or not prepared by the accountant
- Accept responsibility for the client's internal control

The accountant can initially prepare entries and make decisions as to general ledger account classifications of income and expense items. However, those journal entries and account classifications *must ultimately be reviewed and approved by the client*. Moreover, with respect to proposed journal entries, the accountant must be satisfied that management *understands the nature of the proposed entries and the impact they have on the financial statements*. Another issue that is critical with respect to bookkeeping is that the accountant may not prepare or alter any source documents. To do so means the accountant is acting in the capacity as a member of management. A source document is defined by Interpretation 101-3 as a document upon which evidence of an accounting transaction is initially recorded. Examples include payroll time cards, customer orders, and purchase orders. Checks are not source documents, so an accountant may prepare a check but may not sign it on behalf of the client.

Can a client approve the journal entries and account classifications after the accountant performs the bookkeeping services?

The Interpretation, as revised, does not address the timing of any approval. Presumably, an accountant can complete his or her bookkeeping services and then submit the general ledger and entries to the client for approval. Otherwise, there would be a logistical challenge in that the accountant would be precluded from preparing any proposed journal entries or account classifications until the client approved each entry and classification.

Example: An accountant is hired to perform bookkeeping services for an attest client. He receives the bank statements from the client that include all checks and deposits for the fiscal year. The client has not coded the checks or deposits with general ledger account classifications. The accountant selects the general ledger accounts to which to post the checks and deposits and also makes a series of journal entries to adjust the trial balance to accrual basis GAAP. All source documents such as invoices, sales orders, etc. have been prepared by the client, not the accountant. Upon completion, the accountant prints out the general ledger and all journal entries and submits them to the client to review. The client reviews the categorization of the checks and deposits, and journal entries, and approves them. The accountant is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.

Conclusion: The accountant's *independence is not impaired* by his performance of bookkeeping services for an attest client. First, the client approves all journal entries and account classifications even though that approval is done after the accountant performs his bookkeeping function. Further, the accountant is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.

How must an accountant obtain evidence that a client has approved the accountant's journal entries and general ledger account classifications?

There is no answer. The author recommends that the accountant ask the client to review the final adjusted general ledger and to approve it. The accountant can send a transmittal letter to the client that looks something like this:

Mr. Jimmy Smith
Smith's Silly Biscuits
Boston, MA

Dear Mr. Smith:

In accordance with our engagement letter dated January 18, 20X2, we have performed certain bookkeeping services for Smith's Silly Biscuits as of December 31, 20X1 and for the year then ended.

Enclosed please find the company's general ledger for the year ended December 31, 20X1, that reflects our proposed account classifications for transactions we recorded, and general journal entries we recommend be made.

Please review the enclosed general ledger and note your approval or disapproval of all account classifications and general journal entries. [If we do not receive your response by March 15, 20X2, we will assume you have reviewed the enclosed documents and are approving the classifications and entries.]⁴

We also assume that you understand the nature of the proposed entries and the impact they have on the financial statements.

We would appreciate your indicating approval of all transactions and entries by initialing the first page of both the general ledger and schedule of general journal entries, and returning both to our office. Any exceptions should be highlighted. Upon receiving your approved documents, we will begin our review engagement.

Please call my office with questions.

Very truly yours,

Mary Macky, CPA
Macky, Wacky and Daffy, LLP

May the client approval be noted in management's representation letter for the review or audit engagement?

Practically, the answer is yes. In many instances a bookkeeping service is performed in conjunction with the attest service. That is, an accountant might perform bookkeeping services while he or she is also conducting his or her review or audit engagement. For example, a portion of the adjustments made by an accountant during an attest engagement might be entries that are actually part of the bookkeeping service such as adjustments of accruals, prepaid expense accounts, or adjustments to convert standard journal entries to actual. Such entries are actually part of bookkeeping which is interrelated with the review or audit engagement. It may not be practical for a client to approve such entries until the accountant has completed the review or audit engagement. If the accountant wishes to document that management has approved the entries and classifications, one way to do so is to include the client approval in the management representation letter obtained for the engagement.

The author suggests that the following language can be inserted into the representation letter:

We have reviewed all journal entries and account classifications proposed by you (the accountant) and approve them. We understand the nature of the proposed entries and the impact the entries have on the financial statements. We also take responsibility for the journal entries and account classifications proposed and for establishing and maintaining internal controls over your bookkeeping services performed as part of your review (audit) engagement.

Observation: Some individuals conclude that approval of the entries and classifications cannot be included in the management representation letter. Their opinion is based on the assertion that management must approve all entries and classifications *before* the attest engagement begins. Otherwise, the accountant is reviewing or auditing his own work. The author believes that in theory, client approval should be obtained prior to commencing the review or audit engagement. However, in practice, there is not necessarily a clear cut delineation between the end of bookkeeping services and the beginning of the review or audit engagement. The reason is because some bookkeeping services might be performed during the review or audit engagement.

Must management's approval for the entries and classification be in writing?

There is no requirement that management notes its approval for the entries and classifications in writing. However, absent such a written confirmation, the accountant has no evidence that management has, in fact, given approval.

The author believes that in substance, management approves journal entries by recording them. That is, if an accountant submits proposed entries to a client and that client or his/her bookkeeper/controller records the proposed entries, the recording could be considered an approval and acceptance of those entries.

Is the preparation of financial statements from a client trial balance a nonattest bookkeeping service?

Yes. Interpretation 101-3 was revised in 2012 to state that the preparation of financial statements is a nonattest service. The good news is that the preparation of financial statements does not impair independence provided the documentation requirements of the Interpretation are met.

However, the revised Interpretation 101-3 (2012) states that communication between the client and accountant regarding the form and content of the financial statements is not considered a nonattest service.

Is a written understanding required if an accountant performs nonattest services (e.g., bookkeeping services) as part of a compilation engagement?

Yes. The written documentation requirement of Interpretation 101-3 applies in situations in which nonattest services are performed for an attest client (e.g., review, audit, or compilation that does not disclaim independence). Therefore, written documentation is required.

Moreover, the same issues regarding independence apply to a compilation engagement as they do an audit or review engagement. If an accountant performs bookkeeping services for a client for whom he or she also performs a compilation engagement, the accountant will violate his or her independence by assuming management responsibilities in performing the bookkeeping service.

Therefore, the accountant cannot assume management responsibilities by doing any of the following:

- Authorizing, executing or consummating transactions, otherwise exercising authority on behalf of a client or having the authority to do so
- Preparing source documents, in electronic or other form, evidencing the occurrence of a transaction⁵
- Having custody of client assets
- Deciding which recommendations of the member or other third parties to implement or prioritize
- Reporting to those in charge of governance (typically the board of directors) on behalf of management
- Serving as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent
- Setting policies or strategic direction for the client
- Directing or accepting responsibility for the actions of the client's employees except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards
- Accepting responsibility for the management of a client's project
- Accepting responsibility for the preparation and fair presentation of the client's financial statements in accordance with the applicable financial reporting framework

- Accepting responsibility for designing, implementing, or maintaining internal controls
- Performing ongoing evaluations of the client's internal control as part of its monitoring services

If bookkeeping services are performed, the client (rather than the accountant) must:

- Approve any standard, journal, correcting, and audit entries
- Approve any general ledger account classifications
- Accept responsibility for the financial statements
- Prepare any source documents
- Be a signatory on a bank account
- Accept responsibility for internal control
- Accept responsibility for the results of the nonattest services

If the accountant performs any of the above functions, his or her independence would be impaired and he or she would have to disclaim independence in the compilation report as follows:

We are (I am) not independent with respect to ABC Company.

Although not required by Interpretation 101-3, nothing precludes an accountant from documenting the client's understanding in writing in a compilation engagement letter.

Example: Fred CPA is hired to perform monthly write-up and bookkeeping services for Company X. Fred also issues a monthly compilation report with no footnotes. The bookkeeping services will include:

- Coding all checks and deposits
- Posting all cash receipts and disbursements to the general ledger
- Posting adjusting entries to convert the general ledger to the accrual basis of accounting.

Conclusion: The accountant is performing a nonattest service for an attest client. The reason is because the accountant is coding checks and deposits and posting cash receipts and disbursements in developing a trial balance. Transactions performed to create a general ledger are considered a nonattest service. Posting adjusting entries to convert the general ledger to the accrual basis are also considered a nonattest service.

Because the accountant is performing some nonattest services for an attest client, the accountant is required to comply with the Interpretation 101-3 requirements, including documenting the client's understanding of the nonattest services to be provided (bookkeeping services).

In order for Fred not to impair his independence with respect to the Company X, Fred must comply with the three requirements of the revised Interpretation 101-3:

1. *Fred should not assume management responsibilities for the attest client:*

Company X, rather than Fred, must assume management responsibilities by:

- Approving any standard, journal, correcting, and audit entries
- Approving any general ledger account classifications
- Preparing any source documents, not the accountant
- Establishing and maintain internal controls over the bookkeeping services, including monitoring ongoing activities.

2. *Company X must agree to perform certain functions:*

Before performing nonattest services, Fred should determine that Company X has agreed to:

- Assume all management responsibilities,
- Oversee the service, by designating an *individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience,*
- Evaluate the adequacy and results of the nonattest services performed, and
- Accept responsibility for the results of the nonattest services.

3. *There must be a written establishment and documentation with Company X as to the nonattest services (bookkeeping services) to be performed.*

If Fred complies with the three requirements above, Fred is permitted to perform his bookkeeping services for Company X and not impair his independence. If Fred does not comply with the three requirements, Fred's independence is impaired. Because he is performing a compilation engagement, Fred could still perform a compilation engagement, but would have to disclaim independence. Fred would not be able to perform a review or audit engagement.

AICPA Q&A on bookkeeping services

The AICPA has issued a Q&A related to the performance of bookkeeping services for an attest client. Following are excerpts from that Q&A, as modified by the author. The following Q&A has been modified by the author to reflect 2012 and 2013 ethics opinion changes made to Interpretation 101-3, issued by the AICPA's ethics committee. The AICPA has not formally updated the Q&A to reflect those changes resulting in the author making the necessary changes to the following document.

Example 1:

A member records journal entries while performing monthly bookkeeping services without obtaining client approval. Is independence impaired?

Yes. The client must review and approve the journal entries and the member must be satisfied that management understands the nature of the proposed entries and their impact on the financial statements.

Example 2:

In performing bookkeeping services, the following services are performed:

- The client approves the invoice for payment and notes the appropriate general ledger account classification.
- The member receives approved invoices from the client.
- The member prepares the client's checks for payment and records the transactions in the client's general ledger system, and returns the checks to the client for approval and signature.
- The member has no signature authority.

Is the member's independence impaired?

No. The reason is because management determined and approved the appropriate account classifications, approved the invoices for payment, and reviewed and signed the prepared checks.

Example 3:

In performing monthly bookkeeping services, the following services are performed:

- The member discusses with the client the need to record recurring journal entries (such as depreciation) each month in the general ledger.
- The client approves the recurring entries and makes any necessary decisions, such as the useful lives of the assets.
- The member records the entries in the client's general ledger each month.
- The member is satisfied that the client understands the general nature of the entries and their impact on the financial statements.

Is the member's independence impaired?

No. Because the client approves the entries and understands the general nature of the entries and their impact on the financial statements, independence is not impaired.

Example 4:

In performing monthly bookkeeping services, the following services are performed:

- The client records all disbursements in its checkbook and identifies the type of expense (such as telephone, rent, etc.) on the checkbook stubs.
- The member assigns the general ledger account number based on the type of expense identified by the client on the checkbook stub) and the member records the cash disbursements in the client's accounting system.

Is the member's independence impaired?

No. The client coded the transactions on the check stubs. In doing so, the client approved the classification of the cash disbursements. The member merely recorded the client's classifications in the client's accounting system.

Example 5:

A member is engaged to perform an audit, review or compilation of the client's financial statements. During the course of the engagement, the member proposes audit adjustments to the financial statements as follows:

- Current tax accrual
- Deferred tax adjustment
- Depreciation and amortization adjustment

The client reviews the entries and understands their impact on the financial statements and records the adjustments in the client's general ledger.

Is the proposal of such entries a nonattest service subject to Interpretation 101-3?

No. The 2012 change to Interpretation 101-3 provides that communication between a member (CPA) and client management, regarding adjusting journal entries that the member (CPA) has prepared or proposed is considered a normal part of the attest engagement and would not constitute performing a nonattest service.

Example 6:

Same facts as Example 5 except the proposed adjustments relate to converting the general ledger from the cash basis to accrual basis, including:

- Adjusting accruals and prepaid accounts to actual.
- Recording accounts receivable to actual.
- Recording accounts payable to actual.

Is the proposal of such entries a nonattest service subject to Interpretation 101-3?

Yes. A key change made to Interpretation 101-3 in 2013 states that entries to convert the client's general ledger from a cash basis to an accrual basis constitutes a nonattest service (bookkeeping service) subject to Interpretation 101-3.

Example 6A: What if the accountant records cash receipts and cash disbursements entries to convert the general ledger to cash basis?

Such entries are a nonattest service subject to the requirements of Interpretation of 101-3.

A client's books and records need to be substantially complete and current to conduct the attest engagement of those books and records. If the member performs a service to bring those books and records current or complete (such as reconciling subsidiary information such as an accounts receivable and accounts payable, or performing cash receipt and disbursement transactions), the service does constitute a nonattest service subject to Interpretation 101-3.

Further, the Interpretation would also apply if the member is engaged to perform a stand-alone engagement to perform bookkeeping services for the client (e.g., cash receipts and disbursements), such as in the case where a member is engaged to perform monthly bookkeeping services, including the preparation of monthly compiled financial statements.

Example 7:

A member performs year-end tax planning and prepares the tax returns for an attest client.

Are these tax services considered nonattest services subject to Interpretation 101-3?

Yes. Tax services are considered nonattest services and are therefore subject to the general requirements of Interpretation 101-3, including the member's understanding with the client with respect to the tax services being documented in writing.

Example 8:

A member prepares a bank reconciliation of a client's bank account in connection with monthly bookkeeping services. The client reviews and approves the reconciliation.

Are these services considered nonattest services subject to Interpretation 101-3?

Yes. The performance of bookkeeping services, including creating reconciliations and converting from cash to accrual basis for an attest client, is considered a nonattest service subject to Interpretation 101-3.

Is the member's independence impaired?

No. Because the client reviews and approves the bank reconciliation, and understands the service being performed, the member's independence is not impaired.

Example 9:

With respect to the performance of a nonattest service for an attest client, Interpretation 101-3 requires a member to establish and document in writing his or her understanding with the client about the a) objectives of the engagement, b) services to be performed, c) client's acceptance of its responsibilities, d) member's responsibilities, and e) any limitations of the engagement.

Is the member in compliance with this requirement if the documentation comes in the form of a) an engagement letter, b) a planning memorandum, or c) a memo of understanding in the member's billing files?

Yes. All of the above forms would be in compliance. However, the general requirements of the Interpretation only require that the member document in writing his or her understanding. It does not suggest any specific method of documentation. As a result, the above methods would be appropriate, along with other methods that are not identified.

Example 10:

During 20X6, a member performs only nonattest services (bookkeeping services) for a client for the year ended December 31, 20X6. In February 20X7, the member is asked to perform a review of the client's year-end 20X6 financial statements.

Is independence impaired because the firm did not comply with the documentation requirement under Interpretation 101-3 with respect to the nonattest services performed in 20X6?

No. The documentation requirement does not apply to nonattest services performed prior to the client becoming an attest client. However, once the member accepts the review engagement, the member should prepare written documentation demonstrating his or her compliance with the other general requirements of Interpretation 101-3 during the period covered by the financial statements (January 1 to December 31, 20X6).

Example 11:

A member performs bookkeeping services recording adjusting and reclassification entries and compiles financial statements. The member delivers the financial statements and compilation report to the client and provides the client with copies of the general ledger, journals and adjusting entries, which contain a description of the nature of each entry.

The member asks the client to review the entries and then asks whether the client has any questions about any of the entries. The client has no comments or questions.

Are the requirements of Interpretation 101-3 met?

Yes, they are met. The client has reviewed the entries and approved them. Provided the member is satisfied that the client understands the nature and impact of the entries, the requirements of the Interpretation are met. Moreover, the member must obtain a written understanding of the nonattest services to be performed.

Example 12:

A member prepares proposed journal entries.

Must the member review them with the client and explain their impact on the financial statements in person, or can the review take place by phone, fax, mail, or email?

The review can take place in person, by phone, fax, mail, e-mail, or any combination thereof. Regardless of the method used, the member must be satisfied that the client understands the nature and impact the entries have on the financial statements.

Example 13:

In performing a nonattest service, a member prepares journal entries to be reviewed and approved by the client.

Must the member document the review and approval of the entries by the client?

No. Interpretation 101-3 does not require that the member document the client's review and approval of the entries. However, the member may wish to document the name of the client representative who reviewed and approved the journal entries and the date of his or her review and approval to provide evidence that such review and approval took place.

Example 14:

Interpretation 101-3 requires that the client designate a competent employee, preferably within senior management, to oversee the nonattest service.

Which individual at the client is expected to possess the skill, knowledge and experience (e.g., the owner(s), controller, bookkeeper)?

The designated individual(s) will likely depend on the nature of the client's organization and the nature of the nonattest engagement. In an owner-manager business, it will often be the owner. But depending on the nature of the nonattest services and the skill, knowledge and experience of other client employees or individuals, it could be the controller, bookkeeper or an outside individual. In larger organizations, a senior officer might be designated to oversee the services.

Regardless of the selection, the designated individual needs to understand the services sufficiently to oversee them, but does not need to possess the technical qualifications to perform or reperform the services.

Example 15:

As part of a bookkeeping service, a member prepared journal entries related to a tax provision involving deferred income taxes. In obtaining the client's approval of the entries, the member is concerned the client does not understand the nature and impact the deferred income tax entries have on the financial statements.

What must a client know about deferred income taxes in order to meet the competency requirement under Interpretation 101-3?

Interpretation 101-3 does not require that the client possess a level of technical expertise commensurate with that of the member. In connection with deferred income taxes, the client should understand the general basis for the deferred income taxes and their impact on the financial statements.

Is the member permitted to assist the client in understanding the nature of the adjusting entries related to deferred income taxes and their impact on the financial statements?

Yes. The member may assist by explaining the accounting principles giving rise to the adjustments, as well as their impact on the financial statements.

Example 16: Intentionally deleted.

Example 17:

A member prepares tax returns for its attest client. As a matter of practice, a member does not require its clients to sign engagement letters for tax return preparation services.

How does the documentation requirement under Interpretation 101-3 apply with respect to these nonattest services?

Tax services are nonattest services subject to Interpretation 101-3. As a result, the documentation requirement applies where the member provides tax services to a client for which the member also provides attest services. However, the method of documentation is not stated within the Interpretation. Ways in which such documentation could be made include, but are not limited to:

- Documentation in the engagement letter of the attest engagement
- A tax organizer or attest service working papers memorandum

Example 18:

A member prepares personal tax returns for the owners of an attest client.

Does Interpretation 101-3 apply?

No. If the personal returns are prepared without having to rely on representations of the client, the Interpretation does not apply. Also, the mere fact that the client pays for the services also does not cause the Interpretation to apply.

Example 19:

A member provides temporary controllership services and other types of accounting services for clients during client maternity leaves, illness, and sudden departures.

Are these services subject to Interpretation 101-3?

Yes. These services are subject to the Interpretation.

Do these activities impair independence under Interpretation 101-3?

Perhaps. If the member performs controller-type activities, independence is impaired since such activities usually involve the performance of management functions or the supervision of client employees. However, if the member performs temporary accounting and other services in compliance with the requirements of the Interpretation (including documentation of the understanding with the client), and does not perform management functions or make any management decisions, independence is not impaired. The key is that the member not perform any management functions or make any management decisions while he or she is performing the controller-type activities. Moreover, the member should ensure that he or she does not have the title of controller as such a title would clearly impair independence based on the assumption that such a title holds with it, the authority to perform management functions and the performance of management services.

Example 20:

As part of performing bookkeeping services, a member records adjusting and reclassification entries and prepares the client's preliminary financial statements. The member does not review each and every journal entry with the client but rather, the member describes the nature of the journal entries and their impact on the financial statements. The client approves the financial statements and issues them to the bank.

Would the requirements of Interpretation 101-3 be met?

Yes, provided all of the other requirements of the Interpretation are met, such as having a written understanding of the nonattest services to be performed.

Example 21:

The Interpretation states that a member should not assume management responsibilities for the attest client.

What are some examples of activities that would involve a member assuming management's responsibilities?

A management function would generally include doing or having the authority to:

- Authorizing, executing, or consummating transactions, otherwise exercising authority on behalf of a client or having the authority to do so
- Prepare source documents, in electronic or other form, evidencing the occurrence of a transaction⁶
- Having custody of client assets
- Deciding which recommendations of the member or other third parties to implement or prioritize
- Report to those in charge of governance (typically the board of directors) on behalf of management
- Serving as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent
- Setting policies or strategic direction for the client
- Directing or accepting responsibility for the actions of the client's employees except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards
- Accepting responsibility for the management of a client's project
- Accepting responsibility for the preparation and fair presentation of the client's financial statements in accordance with the applicable financial reporting framework
- Accepting responsibility for designing, implementing, or maintaining internal controls
- Performing ongoing evaluations of the client's internal control as part of its monitoring services

Providing advice, research materials, and recommendations to assist the client's management in performing its functions and making decisions do not constitute the performance of a management function.

Confusion: work performed during an attest engagement versus before the engagement

As discussed previously in this section, bookkeeping services are a nonattest service separate and distinct from an attest engagement, and subject to the Interpretation's documentation and other requirements.

Moreover, based on changes made in 2013, the following services are now considered nonattest services and not part of an audit, review or compilation engagement:

- Preparation of financial statements
- Conversion of cash to accrual basis (adjusting journal entries)
- Reconciliations such as cash, accounts receivable and accounts payable

Included in the list of bookkeeping services identified in the Interpretation are the following:

Bookkeeping Services Subject to Interpretation 101-3
<ul style="list-style-type: none">• Record transactions for which management has determined or approved the appropriate account classification or post coded transactions to a client's general ledger.• Prepare financial statements based on information in the trial balance.• Post client approved entries to a client's trial balance.• Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client provided the client reviews the entries and the member is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.• <i>Preparation of financial statements (1)</i>• <i>Cash to accrual conversion (1)</i>• <i>Prepare a reconciliation (for example, bank, accounts receivable, and so forth) that identifies reconciling items for the client's evaluation. (1)</i>

(1): Added to the list with changes made in 2013.

Included in the list of bookkeeping services is the accountant proposing and/or posting standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client provided the client reviews the entries and the accountant is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.

The ethics rules differentiate between whether proposed entries are part of a nonattest or attest engagement.

Here are the basic rules:

Types of Proposed Entries	Treatment
Proposed entries (transaction entries and others) to convert the general ledger to cash basis	Nonattest service, subject to the requirements of Interpretation 101-3
Proposed entries to convert the general ledger from cash to accrual basis	Nonattest service, subject to the requirements of Interpretation 101-3 (1)
Proposed entries made during the audit, review or compilation engagement	Attest service. Communication between a member (CPA) and client management regarding adjusting journal entries that the member (CPA) has prepared or proposed is considered a normal part of the attest engagement and would not constitute performing a nonattest service
(1): New based on 2013 Omnibus Statement change.	

There are instances in which an accountant performs adjusting entries or communicates with the client during an attest engagement. Such work is considered to be part of the attest engagement, and not a separate nonattest engagement.

In general, all proposed entries up to the conversion to accrual basis are considered a nonattest service. That means, transaction entries (cash receipts and cash disbursements) to convert to cash basis, and then all adjusting entries to convert from cash to accrual basis, are part of a bookkeeping function which is a nonattest service, subject to the requirements of Interpretation 101-3.

Once the general ledger is converted to accrual basis, any adjusting entries proposed during the audit, review or compilation engagement are part of the attest engagement, and not a nonattest service.

Of course, there are instances in which there is overlap. For example, what happens when an accountant who is performing a review engagement, makes a series of entries to adjust accruals and prepaid accounts. Are those entries part of a nonattest service (converting from cash to accrual basis), or are they the communication of proposed adjusting entries made during the attest engagement?

The answer is that it is unclear as Interpretation 101-3 (as revised), does not give a bright line delineation between proposed entries that occur as part of a nonattest service versus entries proposed as part of the attest engagement.

The author suggests that the guiding determination should be based on the type of proposed entries instead of the timing. That is, if an accountant proposes a series of adjusting entries to convert from cash to accrual basis, and those entries are proposed

to the client during the attest engagement, those entries should be considered a nonattest service even though the entries are made and communicated during the attest service.

Change the facts. Assume that during a review engagement, the accountant proposes a couple of adjusting entries consisting of a year-end depreciation adjustment and a final tax entry. These proposed entries are part of the attest service and not a nonattest service.

What about communications made between an accountant and a client during an attest engagement?

The 2012 revision to Interpretation 101-3 makes one change involving communications between the CPA and client during an attest engagement.

The Interpretation states that the following communications are considered a normal part of the attest engagement and would not constitute a nonattest service:

- a. the client's selection and application of accounting standards or policies and financial disclosure requirements,
- b. the appropriateness of the client's methods used in determining the accounting and financial reporting,
- c. adjusting journal entries that the member (CPA) has prepared or proposed for client management consideration, and
- d. the form or content of the financial statements.

What this list means is that if during an attest engagement, an accountant communicates with a client with respect to a) the client's selection and application of accounting standards or policies and financial disclosure requirements, b) the appropriateness of the client's methods used in determining the accounting and financial reporting, c) adjusting journal entries that the member (CPA) has prepared or proposed for client management consideration, and d) the form or content of the financial statements, such communications are considered part of the attest engagement and not a nonattest engagement.

Although the exclusion of communications during an attest service from the definition of a nonattest service might appear helpful, in practice, all it does is create confusion. For example, if an accountant is hired to actually perform bookkeeping services such as propose journal entries, that bookkeeping function is a nonattest service. Yet, if, during the performance of an attest service (e.g., review engagement), an accountant discusses (communicates) with a client with respect to proposed journal entries, that communication is part of the attest service, and not a nonattest service.

The problem is that in practice, there is no bright line between actually proposing journal entries (a nonattest service) and communicating the proposal to make entries (part of the attest service). Moreover, in most closely held business engagements, the accountant performs some bookkeeping function as part of the attest engagement.

The author believes that in cases in which an accountant is going to be involved in proposing journal entries, the accountant should treat such entries as being a nonattest service and should ensure that he or she complies with the three requirements of Interpretation 101-3 to ensure that his or her independence is not impaired.

Tax Compliance and Tax Preparation Services, Including Payroll Services

Dealing with the Preparation of Tax Returns for an Attest Client:

Under Interpretation 101-3 as revised, an accountant who prepares tax returns or performs tax consulting is performing a nonattest service for an attest client, and therefore must comply with the requirements of the Interpretation as they relate to nonattest services. Those requirements include:

1. The accountant should not assume management responsibilities for the attest client.
2. The client must agree to perform certain functions in connection with the nonattest tax services such as:
 - Assume all management responsibilities,
 - Oversee the service, by designating an *individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience,*
 - Evaluate the adequacy and results of the nonattest services performed, and
 - Accept responsibility for the results of the nonattest services.
3. *Written establishment and documentation with client.* The member should establish and *document in writing* his or her understanding with the client with respect to:
 - Objectives of the nonattest tax engagement
 - Nonattest tax services to be performed
 - Client's acceptance of its responsibilities
 - Member's responsibilities
 - Any limitations of the engagement

Accountants may provide a variety of payroll-related and income tax services for attest clients that include:

- a. Preparation of payroll returns for client signature.
- b. Preparation of federal and state income tax returns, including transmitting the tax returns and related tax payment to the taxing authority electronically.

Tax compliance services:

An amendment to Interpretation 101-3 clarifies whether an accountant who provides tax compliance services for attest clients impairs his or her independence with respect to that client.

For purposes of the Interpretation, tax compliance services include:

- Preparation of a tax return.⁷
- Transmittal of a tax return and transmittal of any related tax payment to the taxing authority.
- Signing and filing a tax return.
- Authorized representation of clients in administrative proceedings before a taxing authority.

As with all other non-attest services performed on an attest client, an accountant who performs non-attest services for an attest client must follow *three steps* to maintain his or her independence with respect to the attest client:

1. The accountant may not assume management responsibilities as they relate to the tax return or other tax compliance services performed.
2. The client must agree to perform certain functions in connection with the nonattest tax services such as:
 - Assume all management responsibilities.
 - Oversee the service, by designating an *individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience.*
 - Evaluate the adequacy and results of the nonattest services performed.
 - *Accept responsibility for the results of the nonattest services.*
3. *Written establishment and documentation with client:* The accountant should establish and *document in writing* his or her understanding with the client with respect to:
 - Objectives of the nonattest tax engagement.
 - Nonattest tax services to be performed.
 - Client's acceptance of its responsibilities.
 - Member's responsibilities.
 - Any limitations of the engagement.

Observation: In most instances, a client does not have an individual who has an expertise in taxation. Consequently, how could a person be designated to possess the skill, knowledge, and experience to oversee the accountant's preparation of tax returns? In general, in complying with Interpretation 101-3, the designated individual should have a general understanding of how the amounts presented on the tax return were obtained, through the general ledger, etc. Moreover, the individual should understand basic, significant tax positions taken such as whether the company is on the accrual basis, and whether equipment purchases were expensed under Section 179 of the IRC. The individual should also approve those significant tax positions. What the individual is not required to do is have a technical understanding of the tax law and its regulations. That skill belongs to the accountant and is the reason why the accountant is hired in the first place.

In an earlier Q&A published by the Ethics Committee of the AICPA, the Q&A makes reference to an individual who hires an electrician to perform work on the individual's home. That individual would oversee the electrician by having a general understanding of the work that he or she wants the electrician to perform and a basic knowledge of how electricity works (e.g., turn on a switch and the lights go on). However, the individual does not have to have technical expertise as to how to wire the house or fix the electrical problem at hand.

With respect to tax compliance services, when is an accountant deemed to perform management functions and make management decisions (step 1) thereby impairing his or her independence?

The rules found in the amendment to Interpretation 101-3 address the issue of an accountant assuming management responsibilities in conducting tax compliance services for an attest client. How far can an accountant go in performing tax compliance services beyond which he or she is deemed to perform management functions and make management decisions, thereby impairing independence?

The rules are as follows:

- a. Preparing a tax return and transmitting the tax return and related tax payment to a taxing authority (in paper or electronic form) would not impair independence provided the accountant does not have custody or control over the client's funds and the individual designated by the client to oversee the tax services:
 - Reviews and approves the tax return and related tax payment, and
 - Signs the tax return (if signature is required) prior to the accountant transmitting the return to the taxing authority.

Note: Making electronic tax payments under a taxing authority's specified criteria or remitting a check payable to a taxing authority and signed by the client would not be considered having custody or control over a client's funds.

- b. The signing and filing of a tax return on behalf of client management impairs independence, unless the accountant has the legal authority to do so, and
 - 1) The taxing authority has prescribed procedures in place for a client to permit an accountant to sign and file a tax return on behalf of the client and such procedures meet, at a minimum, standards for electronic originators and officers outlined in IRS Form 8879,

Examples:

Form 8879 for *IRS e-file Signature Authorization*, or
Form 8453: *U.S. Individual Income Tax Declaration for an IRS e-file return*

or

- 2) An individual in client management who is authorized to sign and file the client's tax return provides the accountant with a signed statement that clearly identifies the return being filed and represents that:

- Such individual is authorized to sign and file the tax return,
- Such individual has reviewed the tax return, including accompanying schedules and statements, and it is true, correct and complete to the best of his or her knowledge and belief, and
- Such individual authorizes the accountant or another named individual in the accountant's firm to sign and file the tax return on behalf of the client.

Observation: An accountant who signs a tax return on behalf of a client impairs his or her independence unless certain conditions are satisfied. The term "on behalf" means signing the return under a power of attorney or similar document. It does not apply to a situation in which an accountant signs a return as a preparer, which would not, by itself, impair independence.

- c. Authorized representation of a client in administrative proceedings before a taxing authority would not impair independence provided the accountant obtains client agreement prior to committing the client to a specific resolution with the taxing authority.
 - 1) Representing a client in a court or in a public hearing to resolve a tax dispute would impair an accountant's independence.

What is the definition of a tax return under the Interpretation?

The Interpretation defines a tax return to include informational tax forms, such as estimated tax vouchers and extensions, and tax forms such as Forms 990, 5500, W-2, 1120, 1120S, and 1065, among others. The list is not all inclusive and presumably extends to other related tax forms such as Forms 941, 940, and W-3.

What if the accountant signs an extension to file?

Typically, an accountant files an extension in the capacity as a paid preparer. The Interpretation states that preparing a tax return and transmitting the tax return and related tax payment to a taxing authority would not impair independence provided the accountant does not have custody or control over the client's funds and the individual designated by the client to oversee the tax services:

- Reviews and approves the tax return and related tax payment, and
- If required for filing, the designated individual signs the tax return prior to the accountant transmitting the return to the taxing authority.

Making electronic tax payments under a taxing authority's specified criteria or remitting a check payable to a taxing authority and signed by the client would not be considered having custody or control over a client's funds.

Assuming the accountant does not have custody or control over client funds (e.g., he or she is not a signatory on the cash account), the signing of an extension does not impair independence provided the client reviews and approves the extension and related payment. Thus, an accountant should send a copy of an extension to a client for review and approval.

Example 1: Joe CPA performs a review on Company X. Joe also prepares paper form federal and state tax returns, and sends them to the client for review, signature and payment.

Conclusion: Joe has not performed management functions or made management decisions with respect to the preparation of the tax returns. The client reviews and approves the tax returns and related payments, and signs the return. Provided Joe complies with the other requirements of Interpretation 101-3 (e.g., the client agrees to perform certain functions in connection with the tax services and there is a written understanding of the services), Joe has not impaired his independence with respect to Company X.

Example 2: Same facts as Example 1 except that the following actions occur:

- Joe prepares the federal and state tax returns.
- Joe sends a copy of the returns to Mary, who is Company X's controller and the individual designated by X to oversee the tax services. Mary reviews and approves the tax returns.
- Company X (Mary) signs a Form 8879 authorization for e-filing and returns it to Joe.
- Joe files the tax returns and related tax payments electronically with each taxing authority.
- Joe does not have custody or control over the client's funds.

Conclusion: Joe has not performed management functions or made management decisions with respect to the preparation and filing of the tax returns and related tax payments.

The reasons are as follows:

- Joe does not have custody or control over the client's funds even though Joe has filed the tax payment electronically along with the filing of the tax return.
- Mary reviewed and approved the tax return and related payment.
- Mary signs Form 8879 prior to Joe filing the tax return.

Provided Joe complies with the other requirements of Interpretation 101-3 (e.g., the client agrees to perform certain functions in connection with the tax services and there is a written understanding of the services), Joe has not impaired his independence with respect to Company X.

Example 3: Same facts as Example 2 except that Joe is also a signatory to Company X's bank account.

Conclusion: The fact that Joe is a signatory to the bank account means Joe has custody over X's funds. As a result, Joe's independence is impaired with respect to Company X regardless of all other factors related to his tax service.

Example 4: Elisa, CPA performs a review engagement for Company Y. Elisa represents Company Y in an IRS audit and receives a power of attorney from the client.

Conclusion: Elisa's independence is not impaired provided Elisa obtains agreement from Y prior to committing Y to a specific resolution with the IRS.

The same conclusion would be reached if Elisa represented Y in an IRS appeal conference as it is an administrative proceeding. Interpretation 101-3 states that authorized representation of a client in administrative proceedings before a taxing authority would not impair independence provided the accountant obtains client agreement prior to committing the client to a specific resolution with the taxing authority.

Change in facts: Assume Elisa represents Y in tax court.

Conclusion: Elisa's independence is impaired regardless of all other factors. Representing a client in court or in a public hearing to resolve a tax dispute impairs an accountant's independence.

Payroll services:

Similar to other nonattest functions, an accountant impairs his or her independence if he or she acts like a member of management by having authority to consummate payroll transactions, has custody of company assets, or prepares source documents.

With respect to payroll services, an accountant *impairs independence* if he or she:

- Authorizes and approves payment of payroll and payroll taxes, or
- Has custody or control over client funds by being a signer or cosigner of payroll checks or payroll tax disbursements, or
- Signs a payroll tax return on behalf of a client without the client reviewing the return and approving it in advance.

Independence is *not impaired* if the accountant:

- Processes client payroll and generates unsigned checks from the client approved payroll time records.
- Transmits client-approved and reviewed payroll tax returns and tax payments.
- Signs a payroll tax return on behalf of a client after the client has reviewed and approved the return and authorized the signing and submission of the return and related payment.

Observation: An accountant should ensure that he or she does not have custody of any client assets such as being a co-signer on a payroll or checking account, having custody of investments, etc. To do so automatically impairs the accountant's independence. Many accountants perform payroll services for their clients. The Interpretation gives examples of payroll functions that do and do not impair independence. The general rule is that independence is impaired in a payroll function if the accountant can authorize payment of funds for payroll, is a signer or co-signer of checks, maintains a client's payroll account, signs payroll tax returns, or approves any payroll records for payment. Again the key point is authorization and custody of assets. However, the Interpretation

permits an accountant to execute or record transactions that have been reviewed and approved by a client, including submission of tax returns and related payments. The Ethics committee took the position that the accountant's ability to make electronic payroll tax payments or other client-approved transmittals does not impair independence provided the client reviews and approves the transaction in advance. With such a limit, the accountant actually does not have authority and, instead, is merely executing a previously approved client transaction. Further, signing a payroll or other return in the capacity as an outside accountant, rather than management, does not impair the accountant's independence.

What if an accountant is a signatory on a client's bank account?

In some instances, a client may ask an accountant to be a backup signatory on the company's bank account. The reason may be to allow the accountant to sign checks in the client's absence. If the accountant is a signatory on an attest client's bank account, he or she has custody of client assets (the bank account) and authority, and is acting in the capacity as a member of management. Therefore, he or she is not independent with respect to the attest client. This is the fact even if the accountant never actually signs checks and merely acts as a backup signatory for emergency purposes only.

What if an accountant prepares the payroll tax returns (Forms 941, 940, W-3, etc.) and transmits the tax return and related tax payments directly to the taxing authority (IRS, state tax bureau, etc.)?

The amended Interpretation states that preparing a tax return and transmitting the tax return and related tax payments to the taxing authority, in paper or electronic form, would not impair independence provided:

- a. The accountant does not have custody or control over the client's funds, and
- b. The client (designated individual of the client) reviews and approves the tax return and related payment, and, if required for filing, signs the tax return prior to the accountant transmitting the return to the taxing authority.

What this means is that an accountant may prepare the payroll tax returns (e.g., Forms 941, 940, W-3, and state forms) and may submit them electronically along with the tax payment as long as the accountant does not sign the payroll tax check(s) and the client reviews and approves the returns before they are submitted. If the payroll taxes are filed electronically, the accountant is required to give the client a copy of the returns any way, and the client is required to file an e-file authorization. The e-file authorization signed by the client states that the client has examined a copy of the payroll tax returns filed. The result is that the standard electronic filing procedures for payroll tax returns do not impair an accountant's independence with respect to that e-file client.

Doesn't the fact that the accountant is making the electronic payments to the IRS or state agency mean that the accountant has custody or control over the client's funds?

No. Footnote 12 to Interpretation 101-3 states:

"Making electronic tax payments under a taxing authority's specified criteria or remitting a check payable to the taxing authority and signed by the client would not be considered having custody or control over a client's funds."

The key is that the accountant is merely executing the transfer of the funds from the client's account to the taxing authority. In such a situation, the accountant's control is limited to defining the amount of the funds transferred with no discretion over where the funds are transferred. Thus, the Interpretation considers control or custody to be limited because the accountant does not have full decision-making over the funds being transferred.

What if the accountant signs and files the payroll tax returns on behalf of the client, and not as a tax preparer?

The Interpretation states that the signing and filing of a tax return on behalf of a client impairs independence unless the accountant has legal authority to sign the return, and either:

1. The taxing authority has procedures in place for a client to permit the accountant to sign and file the return on behalf of the client (similar to a Form 8879 being filed), or
2. The individual in client management provides the accountant with a signed statement that clearly identifies the return filed and states that:
 - The individual is authorized to sign and file the return,
 - The individual has reviewed the tax return and believes it is correct and complete, and
 - The individual authorizes the accountant to sign and file the return on behalf of the client.

Both of the above requirements are almost the equivalent of the accountant having power of attorney to sign on behalf of the client. The one key difference is that in either case, the client has reviewed and approved the return prior to the accountant signing and filing on behalf of the client. In requirement 1 above, procedures are similar to those found on Form 8879 (the e-filing authorization form) that require the client to certify that he or she has reviewed the tax return and believes it is correct and accurate. In the second requirement, the client is authorizing the accountant to sign the return on its behalf, but only after the client has reviewed the return for correctness and completeness. Thus, in both cases, responsibility for reviewing and approving the tax return prior to filing rests with the client, not the accountant.

Consider the following difference. If an accountant has power of attorney to sign a tax return on behalf of a client, the accountant is acting in the capacity of management and impairs his or her independence. Change the facts. If, instead, the accountant has power of attorney to sign on behalf of the client, but the client is required to review and approve the return first, then the client, and not the accountant, retains his or her capacity as management.

Examples illustrating the application of revised Interpretation 101-3

The author has drafted the following examples to illustrate his understanding of Interpretation 101-3 as it relates to bookkeeping and payroll transactions.

Example 1:

Harry is an accountant who performs bookkeeping services for his client and has been asked to perform a review engagement. Harry satisfies all three of the general requirements for performing nonattest services for an attest client including obtaining, in writing, an engagement letter from the client establishing an understanding of the services to be performed and each party's responsibilities. In that letter, the client has agreed to:

-
- Assume all management responsibilities with respect to the bookkeeping function,
- Oversee the bookkeeping service, by designating an *individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience,*
- Evaluate the adequacy and results of the bookkeeping services performed, and
- Accept responsibility for the results of the bookkeeping services.

In performing the bookkeeping function, Harry receives a shoebox of source documents (e.g., bills, receipts, deposit slips), check stubs and bank statements, all of which are prepared by the client. From the bank statements, Harry performs the following functions:

- a. Enters the checks and deposits into the computer and develops a cash basis general ledger and trial balance. On most of the checks, the client has a notation describing the type of expense to which the check relates. Each deposit slip has a description of the source of the deposit. For those checks and deposit slips that are missing notations or descriptions, Harry calls the client who tells him what the checks or deposits relate to and the general ledger account to which each unidentified item should be posted.
- b. Makes a series of general journal entries to adjust the general ledger to a cash basis.
- c. Sends the journal entries and general ledger to the client and receives client approval.

The accountant believes that the client understands the nature of the entries and the impact the entries have on the financial statements.

From the adjusted trial balance, the accountant performs review engagement procedures and prepares financial statements and notes.

Conclusion:

First, does Interpretation 101-3 apply? Yes. Harry is performing nonattest services for an attest client. Those nonattest services consist of entering the checks and deposits into the computer and developing a cash basis general ledger and trial balance. The entries to convert from cash to accrual basis are also a nonattest bookkeeping service.

Second, is Harry independent with respect to the bookkeeping service?

According to Interpretation 101-3, Harry's independence is not impaired and he may perform a review engagement. The client (not the accountant) has approved the journal entries, and approved all general ledger account classifications by coding the checks. Further, the client prepared all source documents, not the accountant.

Through the signing of the engagement letter, the client has agreed to:

- Assume all management responsibilities with respect to the bookkeeping function
- Oversee the bookkeeping service by designating an individual who possesses the skill, knowledge, and experience to oversee the bookkeeping function
- Evaluate the adequacy and results of the bookkeeping services performed, and
- Accept responsibility for the results of the bookkeeping services

Example 2:

Same facts as Example 1, except that Harry receives the bank statements from the client along with the deposit slips. None of the checks are coded, few have descriptions and there are no descriptions on the deposit slips. Because Harry is familiar with his client's business including vendors and customers, he is able to code most of the checks and deposit slips without asking the client. There are only a few items that he is unable to classify for which he asks the client for clarification.

Harry does not submit the journal entries and general ledger to the client for approval.

Conclusion:

Harry's *independence is impaired* and he is precluded from performing a review engagement. By performing the functions of account coding and classification of transactions without obtaining the client's approval, Harry is assuming management responsibilities for the general ledger. Thus, his independence is impaired.

Change the facts:

Assume that Harry's independence is impaired in Example 2. Is Harry permitted to perform a compilation engagement noting that he is not independent?

Conclusion:

Under existing authority, SSARS No. 19 permits Harry to issue a compilation report as long as he notes that he is not independent in his compilation report.

Example 3:

Mary is an accountant who performs payroll-related services for an attest client.

Mary obtains an engagement letter from her client noting the understanding of the nonattest service (e.g., payroll services) to be provided for the attest client.

Specifically, Mary receives weekly time sheets from the client with the number of hours worked, the pay rate and required withholdings elections. She calculates the payroll and related withholdings, by employee and prepares unsigned checks and payroll tax returns and depositories, all of which are delivered to the client for signature and distribution. Mary also performs a review engagement on the client's financial statements.

Conclusion:

Mary's *independence is not impaired* with respect to the attest client. Specifically, Interpretation 101-3 states that the processing of payroll and preparation of unsigned checks are functions that do not impair independence because neither function involves the use of authority or acting in the capacity of management. Moreover, Mary has complied with the three requirements of Interpretation 101-3 with respect to nonattest services performed on an attest client.

Therefore, Mary may perform a review engagement as her independence is not impaired.

Example 4:

Same facts as the previous example except that unsigned checks, payroll tax returns and depositories are not delivered to the client. Instead, Mary sends the payroll information to a bank who prepares the payroll checks for delivery back to the client and distribution. The bank calls the client for approval before issuing the checks. Mary makes the electronic tax payments from the client's account. The client has instructed the bank to limit the amounts and payees of the checks and to limit the payee of electronic payments to the taxing authorities. Mary prepares the payroll tax returns for delivery to the client for signature and mailing. Mary prepares a review of the client's financial statements. Mary has obtained an engagement letter that includes the necessary language regarding nonattest services performed for an attest client.

Conclusion:

Independence is *not impaired*. Interpretation 101-3 permits an accountant to transmit payroll information to a financial institution and to process electronic tax payments provided the accountant is merely processing client-authorized transactions. Specifically, the client must restrict the amount and payee of such transactions that are processed by the bank. In this example, the client continues to authorize the transactions, not the accountant.

Example 5:

Mary is processing the payroll as noted in the previous examples. However, the owner of the company suddenly becomes ill and is required to take an emergency vacation for six months in Bora Bora from September 30 to March 31. During this time, the client gives Mary control over all aspects of the payroll function. The company manager sends to Mary the weekly payroll information (e.g., hours and rates, by employee). Mary prepares the payroll checks and co-signs each check, delivering the batch back to the company manager for a second signature and distribution to the employees. Mary also prepares and executes the electronic tax payments and the transfer from the main checking account to the payroll account to cover the payroll. She also prepares the quarterly payroll returns, signs them and sends them to the taxing authorities.

Mary also performs a review of the client's December 31 year-end financial statements while the owner is on vacation. When the owner returns, Mary is removed from the payroll functions and is involved with only processing payroll that is authorized by the owner.

Mary obtains an engagement letter for the review engagement in which she properly includes the necessary language regarding performing a nonattest service for an attest client.

Is Mary's independence impaired with respect to the client while she is performing the review of the financial statements?

Conclusion:

Yes. Clearly, Mary is performing functions in the capacity as assuming management responsibilities. First, she is co-signing checks. Second, she is signing payroll tax returns. Third, she is transferring funds from the main checking account to the payroll account. None of these functions are subject to the owner's authorization. Thus, she is acting as if she were part of management and her independence is impaired, precluding her from issuing a review report.

The fact that Mary included the proper language in the engagement letter regarding performing nonattest services for an attest engagement, means that only two of the three requirements have been satisfied. That is, management has taken responsibility for the nonattest service (Requirement 2) and the responsibility has been placed in writing (Requirement 3). However, the fact that Mary is assuming management responsibilities violates Requirement 1. Thus, independence is impaired.

Investment Functions Performed for the Client

As it relates to investment functions, Interpretation 101-3 states that an accountant may not:

- Have custody of the client's portfolio
- Make investment decisions.

However, the accountant may:

- Record or execute transactions that are approved by the client
- Review the manner in which a client's portfolio is being managed
- Recommend the allocation of funds among various funds
- Prepare and transmit participant statements to plan participants.

For example, if an accountant acts as an investment advisor for a company's investment portfolio, the accountant's independence would not be impaired if the client first decides the investment transactions to make and the accountant merely executes the transaction. Conversely, if the accountant makes the investment decisions without client approval, the accountant's independence would be impaired with respect to that company.

Another issue is whether the independence rules apply to the owners or retirement plan of the company that the accountant reviews or audits. The independence rules that we are discussing apply to the company that the accountant audits, reviews or compiles. They do not apply to the owner of the company or to the company's retirement plan. That means that the accountant could manage the owner's personal portfolio or the assets of the company's 401(k) plan and not taint his or her independence with respect to the company.

Example 1:

Ralph is an outside accountant for a company owned by Fred. Ralph reviews the financial statements of the company. Ralph is also a CFP and a registered securities advisor who performs personal financial and tax planning for Fred's company on a fee basis. The investments are processed through Charles Schwab. Ralph recommends to

the company certain asset allocations that are in line with the company's investment objectives and risk level. Ralph also maintains all investment records on behalf of the company. However, the client executes all transactions directly with Schwab and has the investment statements sent directly to Ralph.

Is Ralph independent with respect to Fred's company?

Conclusion: Yes. Ralph merely advises the client of investment transactions and does not have authority to execute transactions on behalf of the client.

Change the facts: Ralph not only advises Fred about investment decisions, but also transmits the funds to the Schwab broker after it is approved and called into the broker by the client.

Conclusion: Ralph is still independent. The reason is that Ralph is only transmitting the transactions on behalf of the client. Ralph has no authority to execute transactions without client approval.

Change the facts again: Ralph advises the company of transactions and then is authorized to execute the transactions directly with the broker on behalf of the company.

Conclusion: Ralph is not independent. The fact that he can execute transactions for the company impairs independence unless the execution is merely transmitting the paperwork after the company authorizes the transaction directly with the broker. In this case, the client has no direct correspondence with the broker and is, thus, out of the authorization process.

Change the facts again: Ralph manages the investment portfolio of Harry, the owner of a company. Ralph advises Harry of transactions and then is authorized to execute the transactions directly with the broker on behalf of the client. Ralph deals with Harry's personal portfolio only and has nothing to do with the company's portfolio.

Conclusion: Ralph's independence with the company is not affected by the fact that he manages the personal portfolio of the company's owner. The same result would apply if Ralph managed the investment portfolio of the company's 401(k) plan as long as he is not auditing, reviewing or compiling the financial statements of the 401(k) plan.

Appraisal, Valuation and Actuarial Services

Interpretation 101-3 provides significant restrictions to an attest accountant's ability to perform appraisal, valuation, or actuarial services for an attest client.

Under the rules, an accountant *may not* perform appraisal, valuation and actuarial services for an attest client if two factors exist:

- a. The results of the service, individually or in the aggregate, would be material to the financial statements, and
- b. The service requires a significant degree of subjectivity.

Valuations performed that generally require a significant degree of subjectivity include:

- ESOPs
- Business combinations
- Appraisals of assets or liabilities

If material, these types of valuations are likely to impair independence.

Exceptions for certain appraisal, valuation, and actuarial services:

The Interpretation provides *two exceptions* under which the performance of an appraisal, valuation or actuarial service for an attest client does not impair independence with respect to that attest client, which follow:

1. Valuation services that typically produce reasonably consistent results and do not require a significant degree of subjectivity, such as:
 - An actuarial valuation of a client's pension or postemployment benefit liabilities.
2. Appraisal, valuation, and actuarial services performed for nonfinancial statement purposes such as:
 - Tax planning or compliance
 - Estate and gift taxation
 - Divorce proceedings
 - Cross purchase, buy-sell agreement among shareholders or partners.

For both exceptions not to impair independence, all other requirements of the Interpretation should be met, including having a written documentation of the understanding with the client as to the nonattest service to be performed.

Observation: An accountant might be asked to perform a business valuation of an attest client for estate and gift taxation or divorce purposes. The performance of such a valuation is one of the two exceptions under which the accountant does not impair independence. However, the general requirements in Interpretation 101-3 must be satisfied including the accountant documenting in writing the understanding with the client about the nonattest services to be performed.

Example: Ed is an accountant who is also a business valuation specialist. Ed is asked to perform a business valuation of the common stock of Company X for gift tax purposes. Ed's firm also issues a review report on the company. In performing the valuation, all significant assumptions are approved by the client.

Conclusion: Ed's independence is not impaired with respect to the attest client. Interpretation 101-3 states that when an accountant performs valuation services for nonfinancial statement purposes, the accountant's independence is not impaired. Examples of nonfinancial statement purposes include tax planning or compliance, estate and gift taxation, and divorce proceedings. The accountant still must satisfy all of the general requirements of the Interpretation including having the client approve all significant assumptions and matters of judgment used in the valuation.

The dilemma for valuation of GAAP statement components

The FASB has as its goal to move toward fair value accounting. Over the past decade, several important FASB statements have been issued, some of which have, as their basis, the requirement to determine fair value of the reporting entity or selected assets.

Examples include:

FASB Statement	Fair Value Requirement
• <i>Business Combinations (ASC 805)</i>	Requires that fair value be used in allocating the purchase price to net assets in a business combination
• <i>Intangibles- Goodwill and Other (ASC 350)</i>	Requires that fair value be used in performing an annual test of impairment of goodwill and other intangible assets
• <i>Property, Plant and Equipment (ASC 360)</i>	Requires that fair value be used to test the impairment of long-lived assets if certain criteria are met
• <i>Consolidation (ASC 810)</i>	Requires that fair value be used to determine whether an entity is a variable interest entity (VIE) that should be consolidated
• <i>Guarantees (ASC 460)</i>	Requires that fair value be used to measure the value of a guarantee obligation

The above list is just the beginning of what is likely to be a much more active use of fair value.

To no surprise, the FASB requires companies to measure fair value, yet gives little guidance on exactly how to do it. Larger publicly held companies can hire valuation specialists to determine fair value. Yet, it is usually not cost effective for smaller closely held businesses to obtain an outside valuation. Further, many closely held businesses look to the outside accountant to comply with GAAP and are unwilling to spend additional funds to obtain an outside valuation particularly when there is no financial gain to doing so other than satisfying the bank's need to issue GAAP financial statements.

Does an accountant impair his or her independence if he or she computes fair value for a client?

An accountant may not perform appraisal, valuation and actuarial services for an attest client if two factors exist:

- a. The results of the service, individually or in the aggregate, would be material to the financial statements, and
- b. The service requires a significant degree of subjectivity.

This means that an accountant cannot be involved in a valuation if that valuation involves an element(s) that will be material to the financial statements, and the valuation has a significant degree of subjectivity.

Note: In discussions with the AICPA Ethics Division staff, the author determined that the staff is taking a general position that a valuation performed by an accountant for a client in connection with the requirements of ASC 805 regarding business combinations, ASC 350 regarding goodwill and certain intangibles, or ASC 810 (formerly FIN 46R) involving variable interest entities, would require a significant degree of subjectivity. If the item being valued is material to the financial statements, independence would be impaired.

Example: Joe accountant is hired to review the financial statements of Company X. Company X has goodwill and is required to perform an annual test of goodwill for impairment in accordance with ASC 350 (formerly FASB No. 142). Because X does not have expertise in valuation, X asks its outside accountant to compute the entity's fair value for purposes of performing the goodwill test. The accountant did the fair value test for the client. Goodwill is material to the financial statements.

Conclusion: The accountant is not independent with respect to X. The reason is two-fold:

An accountant *may not* perform appraisal, valuation and actuarial services for an attest client if two factors exist:

- a. The results of the service, individually or in the aggregate, would be material to the financial statements, and
- b. The service requires a significant degree of subjectivity.

Both of these factors have been met.

Observation: The independence issue related to valuation came to the forefront due to the issuance of ASC 810 (formerly FIN 46R), involving the consolidation of variable interest entities. Specifically, ASC 810 deals with the consolidation of variable interest entities (VIEs) and can result in a related party real estate lessor being consolidated into an operating company lessee.

More particularly, under certain tests, ASC 810 requires that a valuation be done of the fair value of the real estate leasing entity. Depending on the results of that valuation, the entity might be categorized as a VIE and, thus, consolidated into the operating company.

Because of the complexity in valuing the real estate lessor, many small businesses will look to their accountants to perform an informal valuation to test under ASC 810.

It appears that if an accountant does perform a valuation under ASC 810, the accountant impairs his or her independence because:

- a. The results of the valuation would be material to the financial statements as they would result in the consolidation of another entity, and
- b. The service requires a significant degree of subjectivity.

One possible solution

One possible solution is for an accountant to perform a valuation test along with the client so that the client, rather than the accountant, is actually performing the test. In doing so, the accountant would have to explain the methodology, assumptions and computations used and ensure that the client takes responsibility for those items.

The problem with this approach is that it assumes the client has the skill, knowledge and experience needed to oversee this process. The Interpretation states that the member must be satisfied that the client can meet all of the criteria required and can make an informed judgment as to the results of the member's nonattest services. With respect to a valuation it is difficult to assume a client can make an informed judgment as to the results of the valuation services performed.

The author believes this approach is more "form over substance" in that most closely held businesses lack anyone with even minimal skill to oversee a valuation. The reality is that the valuation is the accountant's, not the client's regardless of the "window dressing."

Information Systems – Design, Installation, or Integration Services

Interpretation 101-3 addresses changes to the types of information systems nonattest services that can be performed for an attest client. In particular, under the revised Interpretation, an accountant may not design and develop a client's financial information system, while he or she may participate in certain installations of systems.

Specifically, an accountant's independence is impaired if he or she:

- Designs or develops a client's financial information system
- Makes more than insignificant modifications to source code underlying a client's existing financial information system
- Supervises client personnel in the daily operation of the client's information system
- Operates a client's local area network (LAN) system.

Conversely, an accountant is permitted to perform certain information system services for an attest client without impairing independence. Those services include:

- Installing or integrating a client's financial information system that was not designed or developed by the accountant, such as an off-the-shelf accounting package
- Assisting in setting up a chart of accounts and financial statement format
- Designing, developing, installing, or integrating a client's system that is unrelated to the client's financial statements

- Providing training and instruction to client employees on the information and control system.
- *Perform network maintenance, such as updating virus protection, applying routine updates and patches, or configuring user settings consistent with management's request. (new in 2012)*

Note: In the 2012 revision to Interpretation 101-3, the AICPA ethics committee added to the list of acceptable nonattest services for an attest client, the performance of network maintenance, such as updating virus protection, applying routine updates and patches, or configuring user settings consistent with management's request.

Example: An accountant is hired by his client to install QuickBooks® accounting software and to assist the client in setting up the chart of accounts and financial statement format on the new accounting package. The accountant also audits the client.

Conclusion: The accountant's independence is not impaired. The accountant is only involved in installing off-the-shelf software and assisting the client in setting up the chart of accounts and financial statements on the new system. These functions do not impair independence in accordance with Interpretation 101-3.

The AICPA issued a Q&A related to the performance of information technology services for an attest client. Following are excerpts from that Q&A, as modified by the author:

Question: Why does Interpretation 101-3 indicate that independence is impaired if a member is operating a client's local area network (LAN) system?

Reply: Operating a client's LAN is considered a management function that violates the general requirements of the Interpretation.

Question: Would outsourcing a client's entire network operation and independently operating the client's LAN system impair independence?

Reply: Yes.

Question: Would performing network maintenance (such as updating virus protection, applying updates and patches, or configuring user settings consistent with management's request) impair independence?

Reply: No. Performing network maintenance is not considered to be operating a client's network and does not impair independence provided a competent client employee is making all decisions and approving all activities.

Question: Does assisting a client with a server project (such as installing, migrating or updating a network operating system, adding equipment and users, or copying data to another computer) impair independence?

Reply: No, provided the member does not make other than insignificant modifications to the source code underlying the client's financial information system.

Question: Does the supervising of client personnel in the daily operation of the client's information system impair independence?

Reply: Yes. By supervising client personnel, the member is performing management duties which impair independence.

Question: Does assisting a client with procuring and securing Internet access impair independence?

Reply: No, provided a competent client employee makes all decisions as to the Internet provider and services to be provided.

Question: The Interpretation provides that it does not apply to designing, developing, installing, or integrating a client's system that is *unrelated to the client's financial statements*. What criteria should a member use to determine whether a client's information system is unrelated to the financial statements or accounting records?

Reply: Information systems that produce information that is reflected in the amounts and disclosures in the client's financial statements, used in determining such amounts and disclosures, or used in effecting internal controls over financial reporting are considered to be related to the financial statements and accounting records. However, information systems that are used only in connection with controlling the efficiency and effectiveness of operations are considered to be unrelated to the financial statements and accounting records.

Question: What factors should a member consider in determining whether the modifications made to source code underlying a client's financial information system are "other than significant"?

Reply: If the modifications have more than an insignificant effect on the functionality of the software, they should be considered to be other than insignificant.

Forensic Accounting Services

One significant change made by an amendment to Interpretation 101-3 was to address the independence issues related to the performance of forensic accounting services for an attest client.

Forensic accounting services are defined as non-attest services that involve the application of special skills in accounting, auditing, finance, quantitative methods, and certain areas of law, research, and investigative skills to collect, analyze, and evaluate evidential matter and to interpret and communicate findings.

Forensic accounting services consist of:

- Litigation services, and
- Investigative services.

Rules for litigation services:

Litigation services consist of accountant services in the capacity as an expert or consultant and involve providing assistance for actual or potential legal or regulatory proceedings before a trier of fact in connection with the resolution of disputes between parties.

Litigation services are segregated into:

- Expert witness services,
- Litigation consulting services, and
- Other services related to litigation.

Following is a table that summarizes the rules of independence as they relate to the three litigation services previously noted.

Impact of Litigation Services on Independence		
Type of litigation service	Impact on independence	Exceptions
<p><u>Expert witness services:</u></p> <p>Accountant is engaged to render an opinion before a trier of fact as to the matter(s) in dispute based on the accountant's expertise, rather than his or her direct knowledge of the disputed facts or events.</p>	<p>Independence <i>is impaired</i>.</p> <p>Expert witness services create the appearance that the accountant is an advocate for and promoting a client's position.</p> <p>If the accountant conditionally or unconditionally agrees to provide expert witness testimony for a client, independence would be impaired.</p>	<p><u>Large group exception:</u></p> <p>Independence is <i>not impaired</i> if the accountant provides expert witness services for a large group of plaintiffs or defendants that includes one or more attest clients of the firm provided that at the outset of the engagement:</p> <ol style="list-style-type: none"> a. The attest clients constitute less than 20 percent of the members of the group, the voting interests of the group, and the claim, b. No attest client within the group is designated as a "lead" plaintiff or defendant of the group, and c. No attest client has the sole decision-making power to select or approve the expert witness. <p><u>Fact witness services:</u>⁸ Answering questions while testifying as a fact witness would not impair independence.</p>

<p><u>Litigation consulting services:</u> Litigation services where an accountant provides advice about the facts, issues, and strategy of a matter. The consultant does not testify as an expert witness before a trier of fact.</p>	<p>Independence is <i>not impaired</i> provided the accountant complies with the three general requirements under Interpretation 101-3 for providing non-attest services for an attest client.</p>	<p>If the accountant who provides litigation consulting services subsequently agrees to serve as an expert witness, independence <i>would be impaired</i>.</p>
<p><u>Other litigation services:</u> Consist of those litigation services where an accountant serves as a trier of fact, special master, court-appointed expert, or arbitrator (including serving on an arbitration panel) in a matter involving a client.</p>	<p>Independence <i>is impaired</i> as these services create the appearance that the accountant is not independent.</p>	<p>Independence is <i>not impaired</i> if the accountant serves as a mediator or any similar role in a matter involving a client provided the accountant is not making any decisions on behalf of the parties, but rather is acting as a facilitator by assisting the parties in reaching their own agreement.</p>

Rules for investigative services:

Investigative services include all forensic services not involving actual or threatened litigation such as performing analyses or investigations that may require the same skills as used in litigation services. Such services do not impair independence provided the accountant complies with the three general requirements under Interpretation 101-3 for an accountant who performs nonattest services for an attest client. Remember, the three general requirements are: 1) The accountant may not perform management functions or make management decisions, 2) The client must take responsibility for the non-attest services being performed, and 3) The understanding must be in writing.

Other Management Functions

Interpretation 101-3 provides other examples of services performed by an accountant which may be deemed management functions. These functions include corporate finance consulting, employee search, and consulting. All of these functions follow the same theme in determining if independence is impaired. If the accountant can authorize transactions, has custody of assets, or supervises employees, he or she is clearly not independent. A few areas are worth noting. If the accountant is asked to interview client personnel, the accountant may not negotiate employee compensation or benefits, or actually hire the employee. Instead, the final decision to hire the employee must be made by the client, not the accountant.

All other negotiation services follow a similar track in that an accountant may not negotiate on behalf of the client, suggesting that the accountant may not have authority to consummate the deal. If, instead, the accountant merely negotiates and reports back to the client who makes the ultimate decision, the accountant's independence may still be impaired because the accountant is acting in the capacity of management by meeting with the buyers or sellers in the first place.

Consider the following examples that illustrate these points:

Example 1: Elisa is an outside accountant for a client that she audits. The client is looking to hire a controller for the company and asks Elisa to assist in the process. The client interviews various candidates. After two interviews with a candidate, the client asks Elisa to interview a candidate and give her opinion as to whether the person should be hired and the rate of pay to offer. Elisa also recommends a few individuals to the client for consideration. The client makes the ultimate hiring decision. Is Elisa independent?

Conclusion: Yes. The fact that Elisa interviews candidates and participates in the hiring and compensation discussions does not impair independence. The client makes the ultimate decisions.

Example 2: Because Elisa will be working with the new controller, the client asks Elisa to find a controller for the company. The client gives Elisa an acceptable range of pay and full authority to hire a suitable person.

Conclusion: Elisa is not independent with respect to the client. Elisa has "crossed the line" and is now negotiating compensation and hiring an employee, both of which are management functions in accordance with Interpretation 101-3.

Example 3: An accountant's client is establishing a new operation in another locality. The client has asked the member to recruit and hire for the company a controller and a cost accountant for its new operation.

Conclusion: Independence is impaired because decisions as to employment of personnel are considered a management function. However, an accountant may perform services consisting of recommending a position description and candidate specifications, searching for and initially screening candidates, and recommending qualified candidates to the client. Such consulting assistance would not impair independence provided the client management is responsible for any ultimate hiring decision.

Example 4: Julie is an outside accountant for a client that she audits. The client has decided to sell the business and has asked Julie to negotiate the terms and conditions (including price) with three potential buyers. Once a portion of the terms is negotiated, Julie is to report back to the owners and receive feedback as to how the owners want to proceed. The ultimate decision on a sale and acceptance of the terms and conditions rest with the owners, not Julie. Is Julie independent with respect to the company?

Conclusion: No. Interpretation 101-3 states that negotiating or consummating a transaction on behalf of owners impairs independence. This is the case even though the decision rests with the owners, not the accountant. If instead, Julie assisted in the negotiation in terms of performing analysis and providing financial information to suited buyers, independence would not be impaired.

Observation: An accountant should be careful not to impair his or her independence in situations involving the sale or purchase of a business. If the firm is hired to negotiate the terms and conditions of a sale or purchase, this activity may be deemed to impair independence even though the client makes the ultimate decision. This can be a trap in the first year of an acquisition where the firm may be precluded from auditing or

reviewing the entity's financial statements. Instead, the firm should limit its negotiating to acting as an advisor as well as providing information and analysis on the transaction. The difference between negotiating and acting as an advisor is a subtle one. The author believes that if a negotiation is done solely by the accountant without the assistance of the client, the accountant is not acting as an advisor. Instead, he or she is acting as part of management and independence is impaired. Conversely, when the client is negotiating the transaction and the accountant only assists in the negotiating, the accountant's role is one of being an advisor and independence is not impaired.

How do consulting services fit into the Interpretation?

The AICPA's Division of Management Consulting Services has issued a Statement on Standards for Consulting Services (SSCS) that sets the definitions and standards for consulting services engagements. The term consulting supersedes the term management consulting services.

The Standard states that:

“The performance of Consulting Services for an attest client does not, in and of itself, impair independence. However, members and their firms performing attest services for a client should comply with applicable independence standards, rules and regulations issued by AICPA, the state boards of accountancy, state CPA societies, and other regulatory agencies.”

What this means is that the performance of a consulting engagement for a client does not, by definition, impair independence. The accountant should look at the other independence rules to determine whether he or she is independent. The concern is that in performing the consulting engagement, the accountant may inadvertently act in the capacity of management. In such circumstances, the accountant should follow the general rules found in Interpretation 101-3. That is, make sure he or she does not authorize transactions, supervise employees, make decisions on behalf of the client, etc. Specifically, the role of advisor and analyzer is not considered a management function.

Acting as a Trustee

It is quite common for an accountant to be asked to serve as a trustee for a client or as an executor of a client's estate. The client is alive and well and the trust does not become activated until the client dies. An example may be a trust that will hold the common stock of a company that the member presently audits or reviews, but again, not until the owner dies. There may also be an irrevocable insurance trust that owns an insurance policy that will be used to fund estate taxes. Or, the accountant will be an executor or co-executor of the owner's estate. How do these situations affect independence? Is the fact that the accountant will become a trustee or executor impair his or her independence now?

Interpretation 101-1 states that independence is impaired if the accountant:

“Was a trustee of any trust or executor or administrator of any estate if such trust or estate had or was committed to acquire any direct or material indirect financial interest in the enterprise during the period of a professional engagement or at the time of expressing an opinion.”

The Ethics Board has issued several rulings that deal with this issue on point. The fact that an accountant has been named as an executor or trustee in a client's will does not affect his or her independence now. The key is whether the accountant was independent during the year being audited or reviewed and the period up to the date the report is issued. The fundamental problem lies in the risk that a client may die in the middle of a year, and immediately the accountant is named as executor or trustee. At that point, independence is impaired and the accountant and his or her firm are precluded from performing the engagement. Let's look at a few examples that illustrate these important points:

Example 1: An accountant is the sole trustee of a trust that holds all of the voting stock of Company C. As the trustee, the accountant is actively involved in all management functions.

Conclusion: The accountant is not independent with respect to Company C because he is acting as a trustee of a trust that holds the company's stock.

Example 2: An accountant is a named trustee of a trust that **will hold** 100% of the common stock of Company B upon the death of Harry, the 100% shareholder. Presently, the trust has no assets and Harry, not the accountant, provides all of the management of Company B. The accountant reviews the financial statements of Company B for the year ended December 31, 20X1 and issues his review report on March 1, 20X2. Harry is alive and kicking for the entire period.

Conclusion: The accountant is independent provided he is not a trustee during the period January 1, 20X1 through March 1, 20X2. The fact that the accountant will become a trustee upon a certain event occurring (e.g., death of Harry) is not an issue in this case. Because the accountant was not a trustee during the period of the financial statements, the engagement period or at the date that the review report was issued, independence is not impaired.

Example 3: Same facts as Example 2, except that Harry dies on October 1, 20X1 and the accountant is named as the trustee of the trust that now holds 100% of the common stock of Company B.

Conclusion: Too bad for the accountant. Effective October 1, 20X1, he is not independent with respect to Company B, and therefore, taints the entire financial statement period. Thus, he is precluded from issuing a review report for the year ended December 31, 20X1. He could issue a compilation report and include a disclaimer for lack of independence.

Example 4: Same facts as Example 3, except that the accountant is one of four trustees and the trust only owns 10% of the common stock of the company.

Conclusion: The accountant is still not independent because the trust has a direct financial interest in Company B. Interpretation 101-1 provides a materiality threshold only for indirect financial interests, not direct interests. The fact that the accountant is a trustee means that he is deemed part of management, which impairs independence.

Example 5: Bill is the co-trustee of an insurance trust set up for a client who is deceased. The son of the deceased client is now the 100% shareholder of Company X, which is an audit client of Bill and one of the beneficiaries of the insurance trust.

Conclusion: The fact that Bill is a trustee of an insurance trust does not impair his independence with respect to Company X. The insurance trust has no direct or indirect investment in the common stock of Company X. The fact that the son happens to be both a beneficiary of the trust and a 100% shareholder of Company X has no effect on Bill's independence with respect to X.

Example 6: Same facts as Example 5, except that Bill is a co-trustee of the insurance trust. The trust has no direct or indirect investment in the common stock of Company X. The other trustee is the son of the deceased client who is also the 100% shareholder of Company X, an audit client.

Conclusion: Oddly enough, independence is not impaired. The trust does not have a direct or indirect financial interest in Company X. Further, the fact that the son is both the co-trustee and 100% shareholder of Company X has no bearing on Bill's independence with respect to Company X.

Observation: The author included Example 6 to illustrate a common scenario in practice. It is typical for an accountant to be named as a co-trustee with a family member. The client trusts (no pun intended) the accountant, but not enough to control the family affairs outright. The key point to remember is that the trust must have a direct or material indirect investment in the client in order to impair independence with respect to the client. The mere fact that there is commonality of control between the trust and the client with the same family member in both roles, is not important. We are not dealing with rules of attribution and related party issues as customarily used in tax law and accounting. The ethics rules are separate and distinct from other areas that may deal with attribution differently. There is further discussion made in this chapter about attribution with respect to spouses and close relatives in Interpretation 101-9.

Member of Social Club

Question: A member belongs to a social club (e.g., country club, tennis club) in which membership requirements involve the acquisition of a pro rata share of equity or debt securities. Is the member's independence impaired with respect to the club?

Response: Probably not. As long as membership in a club is essentially a social matter, independence is not impaired because such equity or debt ownership is not considered a direct financial interest within the meaning of Interpretation 101. However, the member should not serve on the club's governing board or take part in management. To do so would impair the member's independence.

Unpaid Fees

Question: A member's client has not paid fees for previously rendered professional services. Is independence impaired with respect to the client for the current year?

Response: Independence is impaired if, when the report on the client's current year is issued, billed or unbilled fees, or a note receivable arising from such fees, remain unpaid for any professional services provided more than one year prior to the date of the report. The rule does not apply if unpaid fees are due from a client in bankruptcy.

Observation: The author believes that this one-year rule should be changed to reflect a materiality threshold. There may be circumstances in which a client owes a de minimis amount of fees incurred more than one year from the date of the report. Yet, regardless of the amount outstanding, independence is impaired. In the present economic climate, unpaid fees has become a chronic problem among accounting firms. Firms are barraged with unpaid fees from good clients that have encountered short-term cash flow problems. The result is the firms are being placed in a very difficult position of having impaired independence with a large percentage of clients. The solution is not an easy one. A purist might suggest that an accountant give up an audit or review engagement for a long-term client who is unable to fully pay the prior year's audit or review fees before issuance of the audit or review report. However, there are a few possible options for the accountant to comply with the independence ruling and still keep the client.

1. Option one is for the accountant to delay issuance of the report until the bill is paid. That is, the field work and all other work related to the engagement could be completed but the report could be held by the accountant until the bill is paid. Of course, this may require cooperation with the third party (e.g., bank, etc.) who may insist on receiving the report on a timely basis.
2. Another option is to drop the engagement level to the issuance of a compilation report with a disclaimer for lack of independence. Although SSARS No. 19 permits (but does not require) disclosure of the reason for lack of independence (e.g., unpaid fees) in the accountant's compilation report, few clients would want to disclose this fact as it suggests that the client has cash flow problems.
3. As a last resort, the accountant could forgive a portion or all of the unpaid fees and, perhaps, make up the difference in later engagements. If the accountant does forgive a portion or all of the unpaid fees, he or she should not make an agreement to recover the fees in a later engagement. Such an arrangement could be construed to be the equivalent of a defacto loan which may still impair independence.

Leasing Property to or from a Client

Question: A member or his/her firm leases property to or from a client. Is independence impaired with respect to the client?

Response: It depends whether the lease qualifies as an operating lease or a capitalized lease based on ASC 840, *Leases* (formerly FASB No. 13) criteria.

Independence is not impaired if:

- The lease qualifies as an operating lease,
- The terms and conditions of the lease are arm's length, and
- Payments are being made in accordance with the lease terms.

Independence is impaired if the lease meets the criteria of a capital lease as defined in ASC 840 (formerly FASB No. 13), because the lease would be considered a loan to or from the client. The exception is where the lease qualifies for certain grandfathering rules found in Interpretations 101-1.A.4 and 101-1.A.5.

Observation: Under the above ruling, a member could rent office space from a client and still audit or review the client provided the lease terms and conditions were arm's length and payments were made in accordance with the payment terms. Typically the lease of real property will not qualify as a capitalized lease because the lease term is less than 75% of the remaining useful life of the building and the lease does not satisfy the other three criteria for capitalizing a lease found in ASC 840.

Member Performs Services for Common Interest Realty Association

Question: A member or his/her firm is associated with, or a member of, a common interest realty association (CIRA) as the result of the ownership or lease of real estate. Is the member or his/her firm's independence impaired with respect to the CIRA?

Response: Yes. However, there is an exception whereby independence is not considered impaired if all of the following conditions are met:

- The CIRA performs functions similar to local governments, such as public safety, road maintenance, and utilities.
- The member or his/her firm's annual assessment is not material to either the accountant or his/her firm or the CIRA's operating budgeted assessments.
- The liquidation of the CIRA or the sale of common assets would not result in a distribution to the accountant or his/her firm.
- Creditors of the CIRA would not have recourse to the accountant or CPA's firm if the CIRA became insolvent.
- The accountant or his/her firm does not act or appear to act in any capacity equivalent to a member of management or employee for the CIRA, including membership on the board of directors or committees (excluding advisory committees as defined in Ethics Ruling No. 72.)

If the accountant or his/her firm has a relationship with a real estate developer or management company that is associated with the CIRA, see Interpretation 102-2 for guidance.

6. AICPA Professional Ethics Division FAQ- Issued December 2012

In December 2012, the AICPA's Professional Ethics Division staff issued a FAQ regarding recent ethics inquiries.

The answers to these frequently asked questions (FAQs) are based on guidance the AICPA Professional Ethics Division staff provided in response to members' inquiries and cover the following topics:

- Blind Trusts
- Campaign Contributions
- Disclosure of Commissions
- Independent Contractors
- Letter of Intent to Purchase Practice
- Pro Bono/Below Cost Fees

Blind Trusts

Question: A covered member creates a blind trust and transfers assets into the blind trust. The covered member will not supervise or participate in the trust's investment decisions during the term of the trust. Will the trust and the underlying assets be considered the covered member's direct financial interests?

Answer: Although the covered member will not supervise or participate in the trust's investments decisions during the term of the trust, the trust and the underlying investments will be considered the covered member's direct financial interest if: (1) the covered member retains the right to amend or revoke the trust, or (2) the underlying trust investments will ultimately revert to the covered member as the grantor of the trust.

Campaign Contributions

Question: May a member make a political contribution to the campaign of an individual that is associated with an attest client in a key position (AICPA, *Professional Standards*, ET section 92.17) or holds a financial interest in the attest client that is material and/or enables the individual to exercise significant influence over the attest client without impairing independence or violating any other rule of conduct?

Answer: Yes. A member would not impair independence or be in violation of any other rule of conduct, provided the political contribution is not made with the intention of influencing the procurement of professional services or in contravention of federal or state laws or regulations.

Disclosure of Commissions

Question: When is a member required to disclose to a client that a commission will be received under Rule 503, *Commissions and Referral Fees*?

Answer: A member should disclose that a commission would be received at the time the referral is being made so that the client can decide whether to act on the recommendation.

Independent Contractors

Question: Would independence be impaired if a CPA firm retained an independent contractor (as defined by IRS regulations and other federal regulatory guidance such as case law and revenue rulings) on a part-time basis that is employed by or associated with an attest client in a key position (AICPA, *Professional Standards*, ET section 92.17)?

Answer: Yes. Independence would be impaired if an independent contractor retained by the firm was simultaneously employed by or associated with an attest client in a key position.

However, if the independent contractor is employed by or associated with the attest client in a non-key position, a member should consider the following criteria when determining if independence (in fact and appearance) is impaired:

- a. Location of the firm office where the independent contractor will work in relation to the location of the office providing services to the attest client.
- b. Whether the independent contractor performs services for other firms or entities or solely to the member's firm. Factors to consider include but are not limited to:
 - The percentage of income the individual derives from the member's firm in relation to the individual's total "self-employed" or earned income.
 - The percentage of income the individual derives from the client entity in relation to the individual's total earned income.
 - The amount of time the individual devotes to the member's firm versus time devoted to the attest client.
 - The amount of time the individual devotes to the member's firm versus time devoted to other firms or entities.

In situations where the threats to independence (in fact or appearance) are deemed not significant, the member and/or the member's firm should consider the potential conflict of interest arising from such a relationship as set forth in Interpretation 102-2 – *Conflicts of Interest* (ET § 102.03.) under Rule 102, *Integrity and Objectivity*. If threats are deemed to be significant, the member should consider whether safeguards are available to eliminate or reduce them to an acceptable level. If no safeguards could eliminate or reduce threats to an acceptable level, independence would be considered impaired.

Letter of Intent to Purchase Practice

Question: Would independence be impaired if a member enters into a non-binding letter of intent to sell his or her practice to a purchaser that is not independent with respect to one or more of the member's attest clients?

Answer: No. A non-binding letter of intent to sell the member's practice would not impair the independence of the member if the purchaser is not independent with respect to one or more of the member's attest clients.

Pro Bono/Below Cost Fees

Question: May a member perform professional services for a client for no fee, or for a fee that is below cost without impairing independence or violating any other rule of conduct?

Answer: Yes. However, regardless of what fee is charged, members are required to comply with all professional standards that are applicable to the services performed. For example, a member must comply with the *General Standards* rule, which requires members to:

- only undertake those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.
- exercise due professional care in the performance of professional services.
- adequately plan and supervise the performance of professional services.
- obtain relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

The member's state board(s) of accountancy may have rules that are more restrictive than provided in the above guidance. Accordingly, members should consult with their state board(s) of accountancy for guidance.

7. New Ethics Interpretations in 2013

In 2012 and 2013, the PEEC voted to add several new ethics interpretations.

Following are the changes:

New Ethics Interpretations:

a. 501-11: Use of the CPA Credential:

A member should refer to applicable state accountancy laws and board of accountancy rules and regulations for guidance regarding the use of the CPA credential. A member who fails to follow the accountancy laws, rules, and regulations on use of the CPA credential in any of the jurisdictions in which the CPA practices, would be considered to have used the CPA credential in a manner that is false, misleading, or deceptive and in violation of Rule 501, *Acts Discreditable*. [Issued January 2013, Effective in May 2013]

b. 502-6: Use of the CPA Credential:

A member should refer to applicable state accountancy laws and board of accountancy rules and regulations for guidance regarding the use of the CPA credential. A member who fails to follow the accountancy laws, rules, and regulations on use of the CPA credential in any of the jurisdictions in which the CPA practices, would be considered to have used the CPA credential in a manner that is false, misleading, or deceptive and in violation of Rule 502, *Advertising and Other Forms of Solicitation*. [Issued January 2013, Effective in May 2013]

c. 505-4: Misleading Firm Names:

Rule 505 prohibits a member from practicing public accounting under a firm name that is misleading. A firm name would be considered misleading if the name contains any representation that would be likely to cause a reasonable person to misunderstand, or be confused about, the legal form of the firm or who the owners or members of the firm are, such as a reference to a type of organization or an abbreviation thereof that does not accurately reflect the form under which the firm is organized. In addition, the member should consider the rules and regulations of his or her state board(s) of accountancy concerning misleading firm names that may be more restrictive than the requirements contained in this ethics interpretation.

[Issued in 2012, Effective August 31, 2012]

d. 505-5: Common Network Brand in Firm Name:

Firms within a network sometimes share the use of a common brand or share common initials as part of the firm name. The sharing of a common brand name or common initials of a network as part of the member's firm name would not be considered misleading, provided the firm is a *network firm*, as defined by ET section 92, *Definitions*.

The sharing of a common brand name or common initials of a network as the entire name of the member's firm would not be considered misleading, provided the firm is a *network firm*, as defined in ET section 92, and shares one or more of the following characteristics with other firms in the network:

- Common control (as defined in Financial Accounting Standards Board *Accounting Standards Codification 810, Consolidation*) among the firms through ownership, management, or other means
- Profits or costs, excluding costs of operating the network; costs of developing audit methodologies, manuals, and training courses; and other costs that are immaterial to the firm
- Common business strategy that involves ongoing collaboration amongst the firms whereby the firms are responsible for implementing the network's strategy and are held accountable for performance pursuant to that strategy
- Significant part of professional resources
- Common quality control policies and procedures that firms are required to implement and that, are monitored by the network.

Members should refer to Interpretation No.101-17, "Networks and Network Firms," under Rule 101, *Independence*], for independence requirements applicable to network firms. [Issued in 2012, Effective August 31, 2012]

Deleted Ethics Interpretations:

In January 2013, the PEEC voted to delete the following ethics interpretations:

- Ethics Ruling 65, *Use of the CPA Designation by Member Not in Public Practice*
- Ethics Ruling 38, *CPA Title, Controller of Bank*
- Ethics Ruling 78, *Letterhead: Lawyer-CPA*

Observation: Ethics Rulings 65, 38 and 78 were deleted from the ethics codification and replaced by Interpretations 501-11 and 502-6. The reason is because the original ethics rulings did not address the jurisdiction of the state boards of accountancy. Both of the new interpretations 501-11 and 502-6 direct members to refer to their applicable state accountancy laws and board of accountancy rules and regulations for guidance regarding use of the CPA designation. Interpretation 501-11 concludes that failure to follow such rules, laws, or regulations would be considered a violation of Rule 501, *Acts Discreditable*, and would apply to both members in public practice and business. Interpretation 502-6 concludes that such behavior would be considered a violation of Rule 502, *Advertising and Other Forms of Solicitation*, and would apply only to members in public practice because this rule is only applicable to members in public practice.

Review Questions

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. Facts: Mary CPA is hired to review the financial statements of Company Y for the year ended December 31, 20X4. Mary performed nonattest services including controllership services for Y in 20X2 during a year during which Mary reviewed the financial statements. Which of the following is correct:
 - a) Mary's independence for 20X4 is not impaired
 - b) Mary's independence for 20X4 is impaired because Mary performed controllership services in 20X2
 - c) Mary's independence for 20X4 is impaired because Mary performed a review for Y in 20X2
 - d) there is no authority to deal with whether Mary's independence is impaired in 20X4

2. Before performing nonattest services, the member should establish and document in writing his or her understanding with the client regarding all of the following except:
 - a) objectives of the nonattest engagement
 - b) client's acceptance of its responsibilities
 - c) member's responsibilities
 - d) cost of the services

3. Which of the following is not true regarding the documentation requirement for nonattest services:
 - a) where a member only provides nonattest services to a client, the requirements are not effective until the client becomes an attest client
 - b) the rules for documentation do not dictate the form of the written documentation
 - c) the failure to prepare the required documentation would impair independence under any circumstances
 - d) if a client engages a member to perform tax services, the understanding could be documented in the member's billing or correspondence files

4. For tax services, which of the following is not one of skills, knowledge or experience a client should possess to be considered competent under the Interpretation:
 - a) the client should understand the tax law
 - b) the client should understand the company's tax position
 - c) the client should have a general understanding of how the amounts in the tax return were determined
 - d) the client should make all decisions regarding significant tax positions taken in the return

5. The key factor in determining whether the performance of bookkeeping services impairs the accountant's independence is:
 - a) the cost of the services
 - b) whether the accountant assumes management responsibilities for the attest client
 - c) the amount of time involved in performing the services
 - d) the accountant's experience level in performing the services

6. Which of the following is true regarding the performance of nonattest services as part of a compilation engagement:
 - a) the written documentation requirement of Interpretation 101-3 does not apply to compilation engagements that do not disclaim independence
 - b) the same issues apply to a compilation engagement as they do an audit or review
 - c) if the accountant prepares any source documents, he or she does not have to disclaim independence in the compilation report
 - d) the accountant is required to document the client's understanding of their responsibilities in a compilation engagement letter

7. With regard to tax compliance services, the accountant should:
 - a) assume all management responsibilities
 - b) evaluate the adequacy and results of the nonattest tax services
 - c) document in writing the objectives of the nonattest tax engagement
 - d) accept responsibility for the results of the nonattest tax services

8. Which of the following impairs an accountant's independence related to payroll services:
 - a) authorizing or approving payment of payroll taxes
 - b) processing the client's payroll from client-approved payroll time records
 - c) transmitting client-approved and reviewed payroll tax returns
 - d) all of the above

9. Harry Callahan, CPA reviews the financial statements of Company X for December 31, 20X1. During 20X1, Harry was a signatory of one of X's bank accounts solely in the capacity as a backup signatory when Jimmy Jacobs, X's sole owner, is on vacation. Harry did not actually sign any checks in 20X1. Which of the following is correct:
- a) Harry's independence is not impaired
 - b) Harry is permitted to perform his review engagement because his signatory status was only as a backup
 - c) Harry's independence is impaired
 - d) a key factor as to whether Harry's independence is impaired is whether Harry actually signed any checks during 20X1
10. Which of the following valuations would generally not impair independence:
- a) business combinations
 - b) appraisals of assets or liabilities
 - c) ESOPs
 - d) pension or postemployment benefit liabilities
11. Which of the following would impair an accountant's independence with respect to litigation services:
- a) answering questions while testifying as a fact witness
 - b) serving as a mediator by assisting the parties in reaching their own agreement
 - c) agreeing to serve as an expert witness after providing litigation consulting services
 - d) providing expert witness services for a large group under any circumstances
12. Which of the following services can an accountant perform for a client without impairing independence with regard to hiring personnel:
- a) interview the candidate
 - b) negotiate the candidate's employee compensation or benefits
 - c) actually hire the employee
 - d) making the decision on behalf of the client regarding personnel

Solutions and Suggested Responses

1. A: Incorrect. Mary's independence for 20X4 is impaired because Mary performed a review during the year (20X2) during which the nonattest services were performed.

B: Incorrect. The fact that Mary performed controllership services in 20X2 is not the key reason why her independence is impaired in 20X4. Instead, the reason is because Mary performed a review in 20X2, a period during which the nonattest services (controllership) were performed.

C: Correct. Mary's independence for 20X4 is impaired because Mary performed a review for Y in 20X2, a period during which Mary performed nonattest services.

D: Incorrect. There is an ethics ruling that addresses the performance of nonattest services during a prior period, making the answer incorrect.

(See page 3 of the course material.)

2. A: Incorrect. This is one of the items that should be included in the written document.

B: Incorrect. This is one of the items that should be included in the written document.

C: Incorrect. This is one of the items that should be included in the written document.

D: Correct. This is not one of the items that should be included in the written document.

(See page 15 of the course material.)

3. A: Incorrect. The documentation requirement does not become effective until the client becomes an attest client.

B: Incorrect. The method of documentation is not as important as the content of the documentation.

C: Correct. The Interpretation states the failure to prepare the required documentation would not impair independence provided the member did establish an understanding with the client.

D: Incorrect. If a client engages a member to perform tax services, the understanding could be documented in a tax organizer, in a memo contained in the tax working papers, or in the member's billing or correspondence files.

(See page 19 of the course material.)

4. **A: Correct.** The client does not need to understand the tax law.
- B: Incorrect. The client should understand the company's tax situation.
- C: Incorrect. The client should have a general understanding of how the amounts on the return were determined.
- D: Incorrect. The client must make all decisions regarding significant tax positions.
- (See page 25 of the course material.)
5. A: Incorrect. The cost of services is not the key factor.
- B: Correct.** The client must assume management responsibilities, not the accountant.
- C: Incorrect. The time spent performing the services is not the key factor.
- D: Incorrect. The level of experience of the accountant is not the key factor.
- (See page 33 of the course material.)
6. A: Incorrect. The written documentation requirement applies to compilation engagements that do not disclaim independence.
- B: Correct.** The same issues regarding independence apply to a compilation engagement as they do an audit or a review, meaning that independence would be impaired by making management decisions or performing management functions in performing the bookkeeping service.
- C: Incorrect. Preparing source documents is one of the tasks for which he or she would have to disclaim independence in the compilation report.
- D: Incorrect. Interpretation No. 101-3 does not require the accountant to document the client's understanding in writing in a compilation engagement letter.
- (See page 37 of the course material.)

7. A: Incorrect. The accountant may not assume management responsibilities as they relate to the tax return or other tax compliance services.

B: Incorrect. The client, not the accountant, should evaluate the adequacy and results of the nonattest tax services.

C: Correct. The accountant should establish and document in writing his or her understanding with the client with respect to the objectives of the nonattest tax engagement, the nonattest tax services to be performed, the client's acceptance of its responsibilities, the member's responsibilities, and any limitations of the engagement.

D: Incorrect. The client, not the accountant, should accept responsibility for the results of the nonattest tax services.

(See page 50 of the course material.)

8. **A: Correct.** Authorizing and approving payment of payroll and payroll taxes is considered performing a management function, and therefore impairs the accountant's independence.

B: Incorrect. Processing client payroll and generating unsigned checks would not impair the accountant's independence if the client approved the payroll time records and the client signs the checks.

C: Incorrect. If the payroll tax returns and the tax payments are approved by the client, the accountant can transmit them to the proper agencies.

D: Incorrect. Not all of the items listed would impair the accountant's independence.

(See page 55 of the course material.)

9. A: Incorrect. Because Harry was a signatory during 20X1, he had custody of an asset (cash) and, therefore, impaired his independence with respect to X.

B: Incorrect. Harry's independence is impaired because he was a signatory of X's bank account. Therefore, Harry is not permitted to perform his review engagement.

C: Correct. Harry's independence is impaired because he had custody of X's cash account, even though he actually did not sign checks.

D: Incorrect. Whether Harry's independence is impaired is based on whether Harry actually had custody of the cash account, and not whether he signed any checks during 20X1.

(See page 56 of the course material.)

10. A: Incorrect. An accountant generally cannot perform valuations on business combinations because they require a significant degree of subjectivity.

B: Incorrect. An accountant generally cannot perform appraisals of assets and liabilities because they require a significant degree of subjectivity.

C: Incorrect. An accountant generally cannot perform valuations on ESOPs because they require a significant degree of subjectivity.

D: Correct. One valuation service that typically does not impair independence is an actuarial valuation of a client's pension or postemployment benefit liabilities since it typically produces reasonably consistent results and does not require a significant degree of subjectivity.

(See page 63 of the course material.)

11. A: Incorrect. As a fact witness, the accountant's role is to provide factual testimony to the trier of fact. Answering questions in such a capacity would not impair independence.

B: Incorrect. If the accountant is not making any decisions on behalf of the parties, but instead is acting as a facilitator by assisting the parties in reaching their own agreement, he or she can serve as a mediator without impairing independence.

C: Correct. If an accountant provides litigation consulting services and complies with the three general requirements under Interpretation 101-3 for providing nonattest services for an attest client, then independence would not be impaired. If the accountant provides litigation consulting services, and subsequently agrees to serve as an expert witness, independence is impaired.

D: Incorrect. An accountant would not impair independence if: the attest clients constitute less than 20 percent of the members of the group, the voting interests of the group, and the claim; no attest client within the group is designated as the "lead"; and no attest client has the sole decision-making power to select or approve the expert witness.

(See pages 69 to 70 of the course material.)

12. **A: Correct.** The accountant cannot act in the capacity of management, but interviewing a candidate to provide feedback to management (who makes the final decision) would not be acting in the capacity of management.

B: Incorrect. Negotiating compensation or benefits would clearly be acting in the capacity of management, and would therefore impair independence.

C: Incorrect. Making the final hiring decision would be acting in the capacity of management, and would therefore impair independence.

D: Incorrect. If an accountant makes any decision on behalf of the client, such decision-making impairs the accountant's independence.

(See page 70 of the course material.)

Endnotes

1. The A&A Q&A was written before the 2012 amendment to Interpretation 101-3. The revised interpretation does not require the accountant to assess whether the designated individual has the skill, knowledge, and/or experience. Instead, the revised interpretation states that the accountant “should be satisfied” that management will be able to meet all of the criteria required by Interpretation 101-3. Implicit in that requirement is that the accountant should assess whether the designated individual has the skill, knowledge and/or experience.
2. A source document is defined as the documents upon which evidence of an accounting transaction is initially recorded. Source documents are often followed by the creation of many additional records and reports, which do not, however, qualify as initial recordings. Examples of source documents are purchase orders, payroll time cards, and customer orders.
3. In January 2013, the AICPA ethics committee issued an Omnibus Statement that concluded that the preparation of financial statements and the conversion of cash to accrual basis are nonattest services, not part of an audit, review or compilation engagement.
4. The author is suggesting that a negative confirmation of the client’s approval is acceptable. The Interpretation does not address the use of a negative confirmation of client approval.
5. A source document is defined as the document upon which evidence of an accounting transaction is initially recorded. Source documents are often followed by the creation of many additional records and reports, which do not, however, qualify as initial recordings. Examples of source documents are purchase orders, payroll time cards, and customer orders.
6. A source document is defined as the documents upon which evidence of an accounting transaction is initially recorded. Source documents are often followed by the creation of many additional records and reports, which do not, however, qualify as initial recordings. Examples of source documents are purchase orders, payroll time cards, and customer orders.
7. A tax return includes informational tax forms (such as estimated tax vouchers, extension forms, and Forms 990, 5500 and W-2) filed with a taxing authority or other regulatory agencies.
8. A fact witness is one who gives testimony based on his or her direct knowledge of the facts or events in dispute and for his or her direct knowledge of the facts or events in dispute from the performance of prior professional services for the client. As a fact witness, the accountant’s role is to provide factual testimony to the trier of fact.

Glossary

Assurance engagement – An engagement in which an accountant issues a report designed to enhance the degree of confidence of third parties and management about the outcome of an evaluation or measurement of financial statements (subject matter) against an applicable financial reporting framework (criteria).

Attest engagement – An engagement that requires independence, as defined in AICPA *Professional Standards*.

Engagement letter – An engagement letter spells out the type and extent of the services to be provided, any limitations of these services agreed to, the timing and deadlines for performance, as well as possibly describe what is expected of you, the client.

Fraud – An intentional act that results in a misstatement in compiled or reviewed financial statements.

Illegal act – A violation of laws or governmental regulations, excluding fraud.

Nonissuer – All entities except for those defined in Section 3 of the Securities Exchange Act of 1934 [15 U.S.C. 78c], the securities of which are registered under Section 12 of that Act (15 U.S.C. 78l), or that are required to file reports under Section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

Predecessor accountant – An accountant who has reported on the most recent compiled or reviewed financial statements or was engaged to perform but did not complete a compilation or review of the financial statements, and has resigned, declined to stand for reappointment, or been notified that his or her services have been or may be terminated.

Prescribed form – Is a standard preprinted (financial statement) form designed or adopted by the body to which it is to be submitted, such as a bank financial statement.

Privity standard – Accountant's liability is limited to those third parties with whom the accountant has a contractual relationship.

Representation letter – A letter that acknowledges management's responsibility for fair presentation in the financial statements, that management believes the statements are presented in conformity with GAAP or OCBOA, and management's acknowledgment of full and truthful responses to all inquiries, completeness of information, and that the accountant has been made aware of any subsequent events that could affect measurements or disclosures in the financial statements.

Successor accountant – An accountant who has been invited to make a proposal for an engagement to compile or review financial statements and is considering accepting the engagement, or an accountant who has accepted the engagement.

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