Professional Ethics Executive Committee Open Meeting November 7 – 8, 2018
Highlights

LEASES PROPOSAL (Independence Rule):

Task Force Chair Lisa Snyder reviewed the revised language in the proposal issued in October 2017, which describes the types of leasing relationships that impair (or may impair) independence.

New or renegotiated leases

As revised, when an attest team member, person able to influence the attest engagement, or the firm enters into or renegotiates a lease, certain safeguards are required, e.g., lease must be at market terms, arm's length, immaterial to all parties. Other covered members who enter into or renegotiate a lease should evaluate threats using the conceptual framework.

Members discussed the intent behind the requirement to consider leases both individually and in the aggregate when assessing materiality, e.g., does "in the aggregate" apply to all leases with an attest client held by a covered member or all leases held collectively by covered members? The PEEC concluded that members should aggregate all of a covered member's leases with an attest client in determining materiality. If more than one covered member holds leases with an attest client, the member should assess threats using the conceptual framework.

Existing leases

As revised, an attest team member, person able to influence the attest engagement, or firm should also apply the conceptual framework when he, she or the firm enters into or renegotiates a lease before certain circumstances occur, e.g., becoming a covered member, lease becoming material or change in client status (new attest client).

Ms. Snyder also reviewed the revised factors members should consider in assessing threats to independence and language that requires members to comply with all lease terms during the period of the professional engagement (applicable to all permissible lease arrangements). She also discussed the new provision in the Client Affiliates interpretation, which indicates that certain covered members (attest team, those able to influence the attest engagement and the firm) may have leases with attest client affiliates described in items c – l of the client affiliate definition but should use the conceptual framework to assess independence and apply safeguards, if necessary.

Lastly, Ms. Snyder raised the concern that the Public Company Accounting Oversight Board (PCAOB) adopted the AICPA's independence rules (as of April 2003) as interim independence standards, including the existing interpretation on leases, which determines independence based on whether a lease is classified as a capital or operating lease. These categories will no longer be relevant with the new lease accounting standard, which may create issues for firms that audit public companies, so the PCAOB may wish to consider the revised standard.

NEXT STEPS: The PEEC unanimously agreed to issue the proposed interpretation, as revised, as a final standard (subject to a one year delay in the effective date).

STAFF AUGMENTATION PROPOSAL (Independence Rule):

Task Force Chair Lisa Snyder described the changes to a proposal to allow firms to lend staff to attest clients to perform certain services under the client's supervision when certain safeguards are met.

Duration of the engagement
Given concerns raised at the last PEEC meeting, the task force considered the safeguard that the engagement be of a duration that is "temporary in nature," which they amended to read, "limited period of time" (i.e., the engagement cannot go on indefinitely). The task force considered a similar provision in the International Ethics Standards Board for Accountants (IESBA) Code and the Securities and Exchange Commission (SEC) investigation report but determined that "short period of time" (as used by IESBA) may imply a shorter period than intended. Ms. Snyder said that the task force is reluctant to provide a precise time frame, preferring to leave that to member judgment. The task force thought that a few months would be considered a limited period (although it could be longer); however, a year would be pushing the boundaries. One member indicated that some could interpret the phrase to mean several years, which is still limited and questioned whether the phrase captured the notion of shortness. Another member asked whether it would be better to use the term "short," which would converge with the IESBA Code. The PEEC considered asking a question in the exposure draft but ultimately decided to use the term "short period of time" in the exposure draft (ED) and examine the feedback.

Other comments
One member asked that participation in a client's compensation plan be added to par. 3 which states that independence would be impaired if augmented staff participate in any of the client's benefit plans (e.g., group health insurance).

Another member questioned the placement of the proposed interpretation under nonattest services when the IESBA includes its provision under employment relationships. Ms. Snyder noted that this was discussed early on by the PEEC and that it was agreed these situations are services engagements, albeit unique, that can include various types of nonattest services. One difference noted is that IESBA, having the provision in the employment section, would not include a "not subject to audit exception" for services performed for certain attest client affiliates. Ms. Snyder replied that a question on that point could also be included in the exposure draft (ED).

One member noted that given public interest concerns, the PEEC representatives from NASBA are opposed to the proposal but will vote to expose it as they are interested to see the feedback. He explained that as a former chair of a state board of accountancy, optically he has issues with independence in these scenarios. A primary concern is the impact on the smaller firms that cannot apply safeguards and may not realize what they are getting into. Another member (small firm representative) indicated that the needs of the smaller client are very different - their needs are ongoing and staff augmentation may cross the line.

Since some firms are performing these types of engagements today, the task force recommended a six-month lead time on the effective date of the proposed interpretation, if adopted.

NEXT STEPS: The PEEC unanimously agreed to expose the proposed interpretation, as revised, for comment.

TAX PRACTICE QUALITY REVIEW PROPOSAL (Confidential Information Rule):

AICPA staff Brandon Mercer discussed the revisions made to the June 2018 proposal that would allow members undergoing tax practice quality reviews to disclose client data to a reviewer without obtaining explicit permission from the client.

The PEEC discussed whether to include a statement that the member should be satisfied that the reviewer is aware of the relevant treasury regulations and/or have a confidentiality agreement, particularly when the reviewer is not an AICPA member. AICPA attorney Kelly Hnat thought that would put an unnecessary burden on members. Others noted that CPAs, enrolled agents and attorneys typically perform these reviews, all of whom are subject to Circular no 230 confidentiality requirements and US Treasury (Internal Revenue Service) regulation 7216.

NEXT STEPS: The PEEC unanimously agreed to adopt the proposed interpretation, as revised, effective on the last day of the month the interpretation is published in the Journal of Accountancy.

HOSTING SERVICES FAQS AND INFORMATION SYSTEM SERVICES PROPOSAL (Independence Rule):

Hosting services (Frequently-asked-questions)

Task Force Member Nancy Miller reported on the task force's deliberations regarding whether the draft frequently-asked-questions (FAQs) on hosting services are consistent with the hosting services interpretation (adopted last year but subject to a deferred effective date until 7.1.19). The task force adjusted the FAQs, concluding that the FAQs specific to general ledger (G/L) services were consistent with the interpretation. Specifically, because G/L services are all-encompassing, they do not meet the situation described in par. 4(g) of the interpretation. That is, a member may prepare a depreciation schedule for the client, give that schedule and calculation to the attest client so that attest client's books and records are complete, and will not be hosting the information. In general, the task force believes the FAQs represent the intent and substance of the interpretation.

The task force also considered whether a member looking to avoid hosting services must turn a client's access to the firm's portal off (as opposed to limiting the client's access to the content). Task force members believe that a client's ongoing access to the information, which should be temporary in nature, impairs independence. The question then was "what length of time is too long"? The task force believes the member should remove access as soon as practicable but no longer than 60 days after completion of the services, which is consistent with the lock-down period for audit engagements. Even though access is removed, this does not imply that the

member cannot give the client access to the same information at some future date, if requested or needed in connection with a subsequent engagement. The objective is that the member's server or cloud does *not* become the client's repository for the client's financial records.

One member asked about FAQ 9, i.e., what if the client is using software to create its own sales tax document using the firm's hosted technology? Does the member still need to remove access to the portal after a certain period? Ms. Miller replied that for the same reason just discussed, the firm should remove access to the portal to avoid a hosting situation. The PEEC member added that the firm has no original data or records; they are copies only. Ms. Miller thinks in those scenarios, the member should still safeguard against the client's possible use of the portal as a repository for its records.

AICPA staff Jim Brackens raised concerns about preliminary results from a survey of firms conducted by the AICPA's Private Companies Practice Section (PCPS). Specifically, maintaining an attest client's G/L on a member's server and providing F/S and a detailed copy of the ledger has traditionally been considered acceptable under the AICPA Code (that is, assuming member compliance with all requirements of 1.295). The PCPS survey asked members a series of questions about bookkeeping services and what steps they take to conform to independence rules, e.g., does the firm evaluate the client's skills, knowledge and experience? Of 260 firms responding, 25 percent are performing G/L services, compilation or review services, following the AICPA Code requirements, and believe they are independent.

Ms. Miller stated that FAQs 4 and 5 are specific to the G/L situation but suggested a distinction may be made between G/L maintenance in a cloud-based environment (real-time and ongoing) vs. a member's server (static engagement with a beginning and an end). She described the latter as follows: Client brings their check stubs to the firm, so the member can generate the G/L and the financial statements (assumes requirements of 1.295 on bookkeeping services are applied). Upon completion, the member provides the G/L and financial statements to the client. As described, she believes the service may meet the exception in the hosting services interpretation for discrete items. However, if the services are performed in the cloud on a real-time, ongoing basis the engagement is not discrete and would not meet the exception. In those instances, providing a copy of the G/L to the client would not avoid hosting the client's data because maintenance of the client's G/L is ongoing and the member is hosting the client's financial records.

PEEC members discussed whether the (non-cloud) G/L services can recur – e.g., can the member perform monthly G/L services on its server in the manner described? Mr. Brackens noted that many small firm clients are not looking at their G/L as a real time tool; rather, the G/L is used to prepare the tax return. Another member questioned whether there's a good conceptual basis for prohibiting ongoing (cloud-based) G/L services. For example, the interpretation allows members to perform discrete engagements (e.g., payroll and depreciation), which are performed monthly. Ms. Miller thinks that ongoing G/L services performed for an attest client in the cloud – where services are real time and continuous – constitute hosting but does not believe a member is hosting client data if the firm performs the G/L services on a periodic basis.

NEXT STEPS: The PEEC agreed to ask the task force to review the FAQs again and determine whether making the distinction discussed (server / periodic vs. cloud-based / ongoing) would satisfy the par. 4(g) exception in the hosting interpretation. It was also suggested to share the FAQs with the TIC (AICPA Technical Issues Committee) for their input before presenting revised versions to the PEEC at its February 2018 meeting.

Information System Services (Proposal)

Ms. Miller noted that the task force has begun clarifying the March 2018 proposed interpretation for better understandability and to help guard against obsolescence in a short period of time due to the rapid changes in technology.

In par. 01, the task force clarified that the interpretation applies to nonattest services, that is, does not address audit services, which resolved some of the comments.

The interpretation is financial statement audit-centric; the task force did not address other assurance engagements although they are considering a statement that would require members to analogize the interpretation to other nonaudit attest engagements, such as SOC engagements. Staff asked whether it would be preferable to revise the modified independence interpretation in the Code (1.297), which is applicable to nonaudit attestation engagements (e.g., SSAEs). One member thought adding a statement about other attest engagements would "muddy up" the interpretation. Ms. Miller noted that the Code does not include such independence guidance for other nonattest services and asked PEEC to consider other approaches. Some thought if the issue would not be discussed in detail in the interpretation, the task force should remove it completely as it adds confusion.

Jim Dalkin of the Government Accountability Office (GAO) thought this was an important issue – both in the US government and internationally. Another attendee noted that the issue of independence for nonaudit assurance engagements is currently on the IESBA's standard-setting agenda.

Ms. Miller noted that the task force's biggest challenge identified so far has been defining a financial information system (FIS). Defining certain prohibited activities is also a challenge. One member asked whether the task force would consider giving examples of a system that is not a FIS, e.g., e-mail, network systems, or SharePoint sites that (apparently) don't touch the financial statements.

The task force believes members will need implementation guidance, e.g., illustrations, etc. AICPA staff is keeping a running list. Guidance would be nonauthoritative; since technology changes so rapidly, using nonauthoritative guidance, e.g., a thought paper, and keeping the Code's interpretation to concepts rather than detailed guidance, which may improve ongoing relevance.

NEXT STEPS: The task force will continue to review the comment letters, rework the draft proposal and report back to the PEEC in February 2019.

IESBA UPDATE:
AICPA Staff Ellen Goria provided an update on the IESBA's recent activities. She indicated that the professional skepticism project (renamed), which would apply to all professional accountants (not solely auditors) is moving forward, as are projects to examine nonaudit services and fees. Ms. Goria informed the PEEC that IESBA issued its inducement standard and the AICPA staff has performed a gap analysis, concluding (at this point) that the AICPA Code appears to be stricter from an independence standpoint, but possibly less restrictive with respect to the Code overall (e.g., AICPA does not address the involvement of immediate family members). She will confirm whether IESBA considers inducements and independence an open issue, and if not, the PEEC can proceed with a convergence project on the subject.

MONITORING (MG): Ms. Goria has learned that the Public Interest Oversight Board and the MG have drafted a public interest framework. It was noted that the SEC Chief Accountant Wes Bricker has been named chair of the MG. More information is expected in the coming months.

NOCLAR TASK FORCE UPDATE (Integrity and Objectivity Rule):

Task Force Chair Bob Denham said the task force is continuing to meet but does not yet have a proposal for the PEEC regarding the March 2017 exposure draft. Given a desire to get it right, he believes it will be a while before that happens. The AICPA Staff and Mr. Denham met with the AICPA/NASBA Uniform Accountancy Act (UAA) committee September 12-13 along with the IESBA chair and senior staff who presented information on the Board's development of the NOCLAR standard. He described the breakout sessions where PEEC and UAA members split into small groups to discuss issues and concerns. No uniform view emerged although there appeared to be more of an appetite to proceed with a NOCLAR standard for auditors than for those performing tax and consulting services. Though he did not rule out including all members in public practice in a future NOCLAR proposal, Mr. Denham believes that due to the complexities involved, determining disclosure in the nonaudit services setting should be deferred until a later date. He noted that the NOCLAR task force is being expanded to include additional AICPA and NASBA members (including the UAA co-chairs). He believes this will help streamline the process as the groups try to work toward a solution on the same timeline.

Mr. Denham said that he and the AICPA staff have reached out to several jurisdiction at the National Standards Setters meeting in May and hope to talk with others about their experiences implementing the IESBA NOCLAR standard.

EXTERNAL DIRECTORS TASK FORCE (Independence Rule):

Task force chair Bill McKeown asked for the PEEC's feedback on two issues:

1) Does PEEC agree with an approach that first considers whether external directors are covered members, that is, are they in a position to influence attest engagements? If yes:
   a) Does that apply to all the firm's attest clients?
   b) Would separate entities controlled by an external director be subject to independence rules?
   c) Would that include the director's immediate family members?

d) Would safeguards, e.g., recusal from board responsibilities with respect to an attest client, mitigate threats to independence?

2) If external directors are not covered members, should they be subject to independence rules that apply to all partners and professional employees in the firm?

One member commented that if the role of directors play on firms' boards is like most businesses, i.e., they typically don't get involved with operational decision or too heavily in strategic decisions, they should not be treated as covered members. However, if an important client issue comes before the board, the firm could treat the matter on a case-by-case basis.

Mr. McKeown stated that the issue has limited application to certain larger audit firms and therefore believes the right approach is to issue guidance rather than opening the code for revisions. Another approach may be to treat external directors as the equivalent of a professional employee.

A member said that guidance could indicate what to avoid as an external director, e.g., material business relationships or interests and refer the firm to the conceptual framework as the appearance of firm's independence may be impacted.

NEXT STEPS: The task force will circulate guidance in advance of bringing the matter back to at the February 2019 meeting.

STATE AND LOCAL GOVERNMENT (SLG) AFFILIATE PROPOSAL (Independence):

Ms. Miller discussed the latest revisions to the July 2017 ED that defines the affiliates of a SLG for purposes of independence.

"Upstream" Entities

Task Force Chair Nancy Miller said the task force believes there could be significant threats when an upstream entity (i.e., an entity that is "above" the financial statement attest client in its organizational structure) is affiliated with an audit client. However, the feedback received on the ED was that the operational cost of mandating the conceptual framework could outweigh the benefits. The task force offered the following compromise regarding when to apply the conceptual framework:

- Eliminate the mandate to consider upstream entities but say there could be situations where you would apply the framework; give several examples that are specific to the government environment.
- Create implementation guidance to assist members.

This results in an upstream entity not being treated as an affiliate, but members would consider situation when the application of the conceptual framework may be appropriate. Members expressed agreement with this approach.

Re-exposure

Ms. Miller stated that the task force believes there could be benefits gained from re-exposing the revised proposal, which they believe is responsive to the comments. However, they did not think re-exposure was necessary and asked the PEEC for their preference. PEEC members agreed it would be best to make final edits to the revised interpretation and vote on whether to re-expose to the membership for comment.

NEXT STEPS: The PEEC unanimously agreed to re-expose the revised, proposed interpretation for a 60-day period.

NEXT MEETING:
The next open PEEC meeting will be held February 12-13, 2019 in New Orleans, LA.