PCAOB
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Interim Ethics & Independence Standards

of the Public Company Accounting Oversight Board

This booklet displays PCAOB interim ethics and independence standards before September 30, 2008.

This booklet was prepared by staff of the Office of the Chief Auditor from the interim ethics and independence standards on the PCAOB's website. In the event of typographical or other technical errors in the standards presented in this document, the rule text that the PCAOB Board adopted, and the Securities and Exchange Commission ("SEC") approved as presented in the relevant SEC rule release, shall govern.

Interim Ethics & Independence Standards*

In April 2003, the PCAOB adopted the interim independence standards listed below. Our interim independence standards do not supersede the SEC's Rule 2-01 of Regulation S-X; the more restrictive rule should be applied.

- **ET Section 101 - Independence**
- **ET Section 102 - Integrity and Objectivity**
- **ET Section 191 - Ethics Rulings on Independence, Integrity, and Objectivity**
- ISB Standard No. 1 Independence Discussions with Audit Committees
- ISB Interpretation 00-1 The Applicability of ISB Standard No. 1: When "Secondary Auditors" Are Involved in the Audit of a Registrant
- ISB Interpretation 00-2 The Applicability of ISB Standard No. 1: When "Secondary Auditors" Are Involved in the Audit of a Registrant, An Amendment of Interpretation 00-1
- ISB No. 2 Certain Independence Implications of Audits of Mutual Funds and Related Entities
- ISB No. 3 Employment with Audit Clients
- ISB Interpretation 99-1 Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)

* In April 2003, the Board adopted certain preexisting standards as its interim standards. Pursuant to Rule 3500T, Interim Ethics Standards consist of ethics standards described in the AICPA's Code of Professional Conduct Rule 102, and interpretations and rulings thereunder, as in existence on April 16, 2003, to the extent not superseded or amended by the Board.

Pursuant to Rule 3500T, Interim Independence Standards consist of independence standards described in the AICPA's Code of Professional Conduct Rule 101, and interpretations and rulings thereunder, as in existence on April 16, 2003, to the extent not superseded or amended by the Board, and certain standards, and interpretations, of the Independence Standards Board, to the extent not superseded or amended by the Board.

As mentioned in Rule 3500T, the Board's Interim Independence Standards do not supersede the Commission's auditor independence rules. See Rule 2-01 of Reg. S-X, 17 C.F.R.§ 210.2-01. Therefore, to the extent that a provision of the Commission's rule is more restrictive – or less restrictive – than the Board's Interim Independence Standards, a registered public accounting firm must comply with the more restrictive rule.

ET Section 100
Independence, Integrity, and Objectivity

ET Section 101
Independence

.01

Rule 101–Independence. A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council.

[As adopted January 12, 1988.]

Interpretations under Rule 101 –Independence

In performing an attest engagement, a member should consult the rules of his or her state board of accountancy, his or her state CPA society, the U.S. Securities and Exchange Commission (SEC) if the member's report will be filed with the SEC, the U.S. Department of Labor (DOL) if the member's report will be filed with the DOL, the AICPA SEC Practice Section (SECPS) if the member's firm is a member of the SECPS, the General Accounting Office (GAO) if law, regulation, agreement, policy or contract requires the member's report to be filed under GAO regulations, and any organization that issues or enforces standards of independence that would apply to the member's engagement. Such organizations may have independence requirements or rulings that differ from (e.g., may be more restrictive than) those of the AICPA.

.02

101-1—Interpretation of Rule 101. Independence shall be considered to be impaired if:

A. During the **period of the professional engagement** [fn *] 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 and

   (i) The covered member (individually or with others) had the authority to make investment decisions for the trust or estate; or

   (ii) The trust or estate owned or was committed to acquire more than 10 percent of the client's outstanding equity securities or other ownership interests; or

   (iii) The value of the trust's or estate's holdings in the client exceeded 10 percent of the total assets of the trust or estate.

3. Had a **joint closely held investment** that was material to the covered member.

4. Except as specifically permitted in interpretation 101-5 [ET section 101.07], had any **loan** to or from the client, any officer or director of the client, or any individual owning 10 percent or more of the client's outstanding equity securities or other ownership interests.

B. During the period of the professional engagement, a **partner** or professional employee of the **firm**, his or her **immediate family**, or any group of such persons acting together owned more than 5 percent of a client's outstanding equity securities or other ownership interests.

C. During the period covered by the **financial statements** or during the period of the professional engagement, a firm, or partner or professional employee of the firm was simultaneously associated with the client as a(n)

1. Director, officer, or employee, or in any capacity equivalent to that of a member of management;

2. Promoter, underwriter, or voting trustee; or

3. Trustee for any pension or profit-sharing trust of the client.

Transition Period for Certain Business and Employment Relationships

A business or employment relationship with a client that impairs independence under interpretation 101-1.C [ET section 101.02], and that existed as of November 2001, will not be deemed to impair independence provided such relationship was permitted under rule 101 [ET section 101.01], and its interpretations and rulings as of November 2001, and the individual severed that relationship on or before May 31, 2002.

Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated With a Client

An individual who was formerly (i) employed by a client or (ii) associated with a client as a(n) officer,

director, promoter, underwriter, voting trustee, or trustee for a pension or profit-sharing trust of the client would impair his or her firm's independence if the individual—

1. Participated on the **attest engagement team** or was an **individual in a position to influence the attest engagement** for the client when the **attest engagement** covers any period that includes his or her former employment or association with that client; or

2. Was otherwise a covered member with respect to the client unless the individual first dissociates from the client by—

    (a) Terminating any relationships with the client described in interpretation 101-1.C [ET section 101.02];

    (b) Disposing of any direct or material indirect financial interest in the client;

    (c) Collecting or repaying any loans to or from the client, except for loans specifically permitted or grandfathered under interpretation 101-5 [ET section 101.07];

    (d) Ceasing to participate [fn 1] in all employee benefit plans sponsored by the client, unless the client is legally required to allow the individual to participate in the plan (for example, COBRA) and the individual pays 100 percent of the cost of participation on a current basis; and

    (e) Liquidating or transferring all vested benefits in the client's defined benefit plans, defined contribution plans, deferred compensation plans, and other similar arrangements at the earliest date permitted under the plan. However, liquidation or transfer is not required if a penalty [fn 2] significant to the benefits is imposed upon liquidation or transfer.

Application of the Independence Rules to a Covered Member's Immediate Family

Except as stated in the following paragraph, a covered member's immediate family is subject to rule 101 [ET section 101.01], and its interpretations and rulings.

The exceptions are that independence would not be considered to be impaired solely as a result of the following:

1. An individual in a covered member's immediate family was employed by the client in a position other than a **key position**.

2. In connection with his or her employment, an individual in the immediate family of one of the following covered members participated in a retirement, savings, compensation, or similar plan that is a client, is sponsored by a client, or that invests in a client (provided such plan is normally offered to all employees in similar positions):

    a. A partner or **manager** who provides ten or more hours of non-attest services to the client; or

b. Any partner in the **office** in which the lead attest engagement partner primarily practices in connection with the attest engagement.

For purposes of determining materiality under rule 101 [ET section 101.01] the financial interests of the covered member and his or her immediate family should be aggregated.

Application of the Independence Rules to Close Relatives

Independence would be considered to be impaired if—

1. An individual participating on the attest engagement team has a **close relative** who had
   a. A key position with the client, or
   b. A financial interest in the client that
      (i) Was material to the close relative and of which the individual has knowledge; or
      (ii) Enabled the close relative to exercise **significant influence** over the client.
2. An individual in a position to influence the attest engagement or any partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement has a close relative who had
   a. A key position with the client; or
   b. A financial interest in the client that
      (i) Was material to the close relative and of which the individual or partner has knowledge; and
      (ii) Enabled the close relative to exercise significant influence over the client.

Grandfathered Employment Relationships

Employment relationships of a covered member's immediate family and close relatives with an existing attest client that impair independence under this interpretation and that existed as of November 2001, will not be deemed to impair independence provided such relationships were permitted under preexisting requirements of rule 101 [ET section 101.01], and its interpretations and rulings.

Other Considerations

It is impossible to enumerate all circumstances in which the appearance of independence might be questioned. Members should consider whether personal and business relationships between the member and the client or an individual associated with the client would lead a reasonable person aware of all the relevant facts to conclude that there is an unacceptable threat to the member's and the firm's

independence.

[Paragraph added by adoption of the Code of Professional Conduct on January 12, 1988. Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, November 1991, effective January 1, 1992, with earlier application encouraged, by the Professional Ethics Executive Committee. Revised, effective February 28, 1998, by the Professional Ethics Executive Committee. Revised, November 2001, effective May 31, 2002, with earlier application encouraged, by the Professional Ethics Executive Committee. Revised, effective July 31, 2002, by the Professional Ethics Executive Committee. Revised, effective March 31, 2003, by the Professional Ethics Executive Committee. Revised, effective April 30, 2003, by the Professional Ethics Executive Committee.]

[.03]

[Formerly paragraph .02 renumbered by adoption of the Code of Professional Conduct on January 12, 1988. Formerly interpretation 101-1, renumbered as 101-4 and moved to paragraph .06, April 1992.]

.04

101-2—Employment or association with attest clients. A firm's independence will be considered to be impaired with respect to a client if a partner or professional employee leaves the firm and is subsequently employed by or associated with that client in a key position unless all the following conditions are met:

1. Amounts due to the former partner or professional employee for his or her previous interest in the firm and for unfunded, vested retirement benefits are not material to the firm, and the underlying formula used to calculate the payments remains fixed during the payout period. Retirement benefits may also be adjusted for inflation and interest may be paid on amounts due.
2. The former partner or professional employee is not in a position to influence the accounting firm's operations or financial policies.
3. The former partner or professional employee does not participate or appear to participate in, and is not associated with the firm, whether or not compensated for such participation or association, once employment or association with the client begins. An appearance of participation or association results from such actions as:
    - The individual provides consultation to the firm.
    - The firm provides the individual with an office and related amenities (for example, secretarial and telephone services).
    - The individual's name is included in the firm's office directory.
    - The individual's name is included as a member of the firm in other membership lists of business, professional, or civic organizations, unless the individual is clearly designated as retired.

4. The ongoing attest engagement team considers the appropriateness or necessity of modifying the engagement procedures to adjust for the risk that, by virtue of the former partner or professional employee's prior knowledge of the audit plan, audit effectiveness could be reduced.

5. The firm assesses whether existing attest engagement team members have the appropriate experience and stature to effectively deal with the former partner or professional employee and his or her work, when that person will have significant interaction with the attest engagement team.

6. The subsequent attest engagement is reviewed to determine whether the engagement team members maintained the appropriate level of skepticism when evaluating the representations and work of the former partner or professional employee, when the person joins the client in a key position within one year of disassociating from the firm and has significant interaction with the attest engagement team. The review should be performed by a professional with appropriate stature, expertise, and objectivity and should be tailored based on the position that the person assumed at the client, the position he or she held at the firm, the nature of the services he or she provided to the client, and other relevant facts and circumstances. Appropriate actions, as deemed necessary, should be taken based on the results of the review.

Responsible members within the firm should implement procedures for compliance with the preceding conditions when firm professionals are employed or associated with attest clients.

With respect to conditions 4, 5, and 6, the procedures adopted will depend on several factors, including whether the former partner or professional employee served as a member of the engagement team, the positions he or she held at the firm and has accepted at the client, the length of time that has elapsed since the professional left the firm, and the circumstances of his or her departure. [fn 3]

Considering Employment or Association With the Client

When a member of the attest engagement team or an individual in a position to influence the attest engagement intends to seek or discuss potential employment or association with an attest client, or is in receipt of a specific offer of employment from an attest client, independence will be impaired with respect to the client unless the person promptly reports such consideration or offer to an appropriate person in the firm, and removes himself or herself from the engagement until the employment offer is rejected or employment is no longer being sought. When a covered member becomes aware that a member of the attest engagement team or an individual in a position to influence the attest engagement is considering employment or association with a client, the covered member should notify an appropriate person in the firm.

The appropriate person should consider what additional procedures may be necessary to provide reasonable assurance that any work performed for the client by that person was performed with objectivity and integrity as required under rule 102 [ET section 102.01]. Additional procedures, such as reperformance of work already done, will depend on the nature of the engagement and the individual involved.

[Replaces previous interpretation 101-2, *Retired Partners and Firm Independence,* August, 1989, effective August 31, 1989. Revised, effective December 31, 1998, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Revised, effective April 30, 2003, by the Professional Ethics Executive Committee.]

.05

101-3—Performance of other services. A member or his or her firm ("member") who performs an attest engagement for a client may also perform other nonattest services ("other services") for that client. Before a member performs other services for an attest client, he or she must evaluate the effect of such services on his or her independence. In particular, care should be taken not to perform management functions or make management decisions for the attest client, the responsibility for which remains with the client's board of directors and management.

Before performing other services, the member should establish an understanding with the client regarding the objectives of the engagement, the services to be performed, management's responsibilities, the member's responsibilities, and the limitations of the engagement. It is preferable that this understanding be documented in an engagement letter. In addition, the member should be satisfied that the client is in a position to have an informed judgment on the results of the other services and that the client understands its responsibility to—

1. Designate a management-level individual or individuals to be responsible for overseeing the services being provided.
2. Evaluate the adequacy of the services performed and any findings that result.
3. Make management decisions, including accepting responsibility for the results of the other services.
4. Establish and maintain internal controls, including monitoring ongoing activities.

General Activities

The following are some general activities that would be considered to impair a member's independence:

- Authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of a client or having the authority to do so
- Preparing source documents [fn 4] or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders)
- Having custody of client assets
- Supervising client employees in the performance of their normal recurring activities
- Determining which recommendations of the member should be implemented

- Reporting to the board of directors on behalf of management
- Serving as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent

The examples in the following table identify the effect that performance of other services for an attest client can have on a member's independence. These examples are not intended to be all-inclusive of the types of other services performed by members.

Impact on Independence of Performance of Other Services

Type of Other Service	*Independence Would Not Be Impaired*	*Independence Would Be Impaired*
Bookkeeping	■ 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. ■ Provide data-processing services.	■ 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 or originate data. ■ Make changes to source documents without client approval.
Payroll and other disbursement	■ Using payroll time records provided and approved by the client, generate unsigned checks, or process client's payroll. ■ 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. ■ Make electronic payroll tax payments in accordance with U.S. Treasury Department	■ Accept responsibility to authorize payment of client funds, electronically or otherwise, except as specifically provided for with respect to electronic payroll tax payments. ■ 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.

	guidelines provided the client has made arrangements for its financial institution to limit such payments to a named payee.[fn 5]	■ Sign payroll tax return on behalf of client management. ■ Approve vendor invoices for payment.
Benefit plan administration [fn 6]	■ 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.	■ 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 or management	■ 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 balances including providing a comparative analysis of the client's investments to third-party benchmarks. ■ 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	■ 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. ■ Have custody of client assets, such as taking temporary possession of securities purchased by a client.

	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.	
Corporate finance—consulting or advisory	■ 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.	■ 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, or guarantor of client securities, or distributor of private placement memoranda or offering documents. ■ Maintain custody of client securities.
Appraisal, valuation or actuarial	■ Test the reasonableness of the value placed on an asset or liability included in a client's financial statements by preparing a separate valuation of that asset or liability. ■ Perform a valuation of a client's business when all significant matters of judgment are determined or approved by the client and the client is in a position to have an informed judgment on the results of the valuation.	■ Prepare a valuation of an employer's securities contained in an employee stock ownership plan (ESOP) to support transactions with participants, plan contributions, and allocations within the ESOP, when the client is not in a position to have an informed judgment on the results of this valuation. ■ Prepare an appraisal, valuation, or actuarial report using assumptions determined by the member and not approved by the client.

Executive or employee search	■ 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.	■ Commit the client to employee compensation or benefit arrangements. ■ Hire or terminate client employees.
Business risk consulting	■ 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.	■ Make or approve business risk decisions. ■ Present business risk considerations to the board or others on behalf of management.
Information systems—design, installation or integration	■ Design, install or integrate a client's information system, provided the client makes all management decisions. ■ Customize a prepackaged accounting or information system, provided the client makes all management decisions. ■ Provide the initial training and instruction to client employees on a newly implemented information and control system.	■ Supervise client personnel in the daily operation of a client's information system. ■ Operate a client's local area network (LAN) system when the client has not designated a competent individual, preferably within senior management, to be responsible for the LAN.

[Formerly paragraph .04, renumbered by adoption of the Code of Professional Conduct on January 12, 1988. Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, effective May 31, 1999, by the Professional Ethics Executive Committee. Revised, effective April 30, 2000, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

.06

101-4—Honorary directorships and trusteeships of not-for-profit organization. Partners or professional employees of a firm (individual) may be asked to lend the prestige of their names to not-for-profit organizations that limit their activities to those of a charitable, religious, civic, or similar nature by being named as a director or a trustee. An individual who permits his or her name to be used in this manner would not be considered to impair independence under rule 101 [ET section 101.01] provided his or her position is clearly honorary, and he or she cannot vote or otherwise participate in board or management functions. If the individual is named in letterheads and externally circulated materials, he or she must be identified as an honorary director or honorary trustee. [Formerly paragraph .05, renumbered by adoption of the Code of Professional Conduct on January 12, 1988. Formerly interpretation 101-1. Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Renumbered as interpretation 101-4 and moved from paragraph .03, April, 1992. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

.07

101-5—Loans from financial institution clients and related terminology. Interpretation 101-1.A.4 [ET section 101.02] provides that, except as permitted in this interpretation, independence shall be considered to be impaired if a **covered member** [fn ||] has any **loan** to or from a **client**, any officer or director of the client, or any individual owning ten percent or more of the client's outstanding equity securities or other ownership interests. This interpretation describes the conditions a covered member (or his or her **immediate family**) must meet in order to apply an exception for a "Grandfathered Loan" or "Other Permitted Loan."

Grandfathered Loans

Unsecured loans that are not material to the covered member's net worth, home mortgages, [fn 7] and other secured loans [fn 7] are grandfathered if:

(1) they were obtained from a **financial institution** under that institution's **normal lending procedures, terms, and requirements**,

(2) after becoming a covered member they are kept current as to all terms at all times and those terms do not change in any manner not provided for in the original loan agreement, [fn 8] and

(3) they were:

  (a) obtained from the financial institution prior to its becoming a client requiring independence; or

  (b) obtained from a financial institution for which independence was not required and were later sold to a client for which independence is required; or

  (c) obtained prior to February 5, 2001 and met the requirements of previous provisions of

Interpretation 101-5 [ET section 101.07] covering grandfathered loans; or

(d) obtained between February 5, 2001 and May 31, 2002, and the covered member was in compliance with the applicable independence requirements of the SEC during that period; or

(e) obtained after May 31, 2002 from a financial institution client requiring independence by a borrower prior to his or her becoming a covered member with respect to that client

In determining when a loan was obtained, the date a loan commitment or line of credit is granted must be used, rather than the date a transaction closes or funds are obtained.

For purposes of applying the grandfathered loans provision when the covered member is a partner in a partnership:

- a loan to a limited partnership (or similar type of entity) or a general partnership would be ascribed to each covered member who is a partner in the partnership on the basis of their legal liability as a limited or general partner if:
  - the covered member's interest in the limited partnership, either individually or combined with the interest of one or more covered members, exceeds 50 percent of the total limited partnership interest; or
  - the covered member, either individually or together with one or more covered members, can control the general partnership.
- even if no amount of a partnership loan is ascribed to the covered member(s) identified above, independence is considered to be impaired if the partnership renegotiates the loan or enters into a new loan that is not one of the permitted loans described below.

Other Permitted Loans

This interpretation permits only the following new loans to be obtained from a financial institution client for which independence is required. These loans must be obtained under the institution's normal lending procedures, terms, and requirements and must, at all times, be kept current as to all terms.

1. Automobile loans and leases collateralized by the automobile.
2. Loans fully collateralized by the cash surrender value of an insurance policy.
3. Loans fully collateralized by cash deposits at the same financial institution (e.g., "passbook loans").
4. Credit cards and cash advances where the aggregate outstanding balance on the current statement is reduced to $5,000 or less by the payment due date.

Related prohibitions that may be more restrictive are prescribed by certain state and federal agencies

having regulatory authority over such financial institutions. Broker-dealers, for example, are subject to regulation by the Securities and Exchange Commission.

[Revised, November 30, 1987, by the Professional Ethics Executive Committee. Formerly paragraph .06, renumbered by adoption of the Code of Professional Conduct on January 12, 1988. References revised to reflect issuance of AICPA Code of Professional Conduct on January 12, 1988. Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, November 1991, effective January 1, 1992 with earlier application encouraged, by the Professional Ethics Executive Committee. Revised, effective February 28, 1998 by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Revised, November 2002, by the Professional Ethics Executive Committee.]

.08

101-6—The effect of actual or threatened litigation on independence. In some circumstances, independence may be considered to be impaired as a result of litigation or the expressed intention to commence litigation as discussed below.

Litigation between client and member

The relationship between the management of the client and a covered member must be characterized by complete candor and full disclosure regarding all aspects of the client's business operations. In addition, there must be an absence of bias on the part of the covered member so that he or she can exercise professional judgment on the financial reporting decisions made by the management. When the present management of a client company commences, or expresses an intention to commence, legal action against a covered member, the covered member and the client's management may be placed in adversarial positions in which the management's willingness to make complete disclosures and the covered member's objectivity may be affected by self-interest.

For the reasons outlined above, independence may be impaired whenever the covered member and the covered member's client or its management are in threatened or actual positions of material adverse interests by reason of threatened or actual litigation. Because of the complexity and diversity of the situations of adverse interests which may arise, however, it is difficult to prescribe precise points at which independence may be impaired. The following criteria are offered as guidelines:

1. The commencement of litigation by the present management alleging deficiencies in audit work for the client would be considered to impair independence.
2. The commencement of litigation by the covered member against the present management alleging management fraud or deceit would be considered to impair independence.
3. An expressed intention by the present management to commence litigation against the covered member alleging deficiencies in audit work for the client would be considered to impair independence if the auditor concludes that it is probable that such a claim will be filed.
4. Litigation not related to performance of an attest engagement for the client (whether threatened

or actual) for an amount not material to the covered member's firm [fn 9] or to the client company [fn 9] would not generally be considered to affect the relationship in such a way as to impair independence. Such claims may arise, for example, out of disputes as to billings for services, results of tax or management services advice or similar matters.

Litigation by security holders

A covered member may also become involved in litigation ("primary litigation") in which the covered member and the client or its management are defendants. Such litigation may arise, for example, when one or more stockholders bring a stockholders' derivative action or a so-called "class action" against the client or its management, its officers, directors, underwriters and covered members under the securities laws. Such primary litigation in itself would not alter fundamental relationships between the client or its management and the covered member and therefore would not be deemed to have an adverse impact on independence. These situations should be examined carefully, however, since the potential for adverse interests may exist if cross-claims are filed against the covered member alleging that the covered member is responsible for any deficiencies or if the covered member alleges fraud or deceit by the present management as a defense. In assessing the extent to which independence may be impaired under these conditions, the covered member should consider the following additional guidelines:

1. The existence of cross-claims filed by the client, its management, or any of its directors to protect a right to legal redress in the event of a future adverse decision in the primary litigation (or, in lieu of cross-claims, agreements to extend the statute of limitations) would not normally affect the relationship between client management and the covered member in such a way as to impair independence, unless there exists a significant risk that the cross-claim will result in a settlement or judgment in an amount material to the covered member's firm [fn 10] or to the client.
2. The assertion of cross-claims against the covered member by underwriters would not generally impair independence if no such claims are asserted by the client or the present management.
3. If any of the persons who file cross-claims against the covered member are also officers or directors of other clients of the covered member, independence with respect to such other clients would not generally be considered to be impaired.

Other third-party litigation

Another type of third-party litigation against the covered member may be commenced by a lending institution, other creditor, security holder, or insurance company who alleges reliance on financial statements of the client with which the covered member is associated as a basis for extending credit or insurance coverage to the client. In some instances, an insurance company may commence litigation (under subrogation rights) against the covered member in the name of the client to recover losses reimbursed to the client. These types of litigation would not normally affect independence with respect to a client who is either not the plaintiff or is only the nominal plaintiff, since the relationship between the covered member and client management would not be affected. They should be examined carefully, however, since the potential for adverse interests may exist if the covered member alleges, in his defense,

fraud, or deceit by the present management.

If the real party in interest in the litigation (e.g., the insurance company) is also a client of the covered member ("the plaintiff client"), independence with respect to the plaintiff client may be impaired if the litigation involves a significant risk of a settlement or judgment in an amount which would be material to the covered member's firm [fn 11] or to the plaintiff client.

Effects of impairment of independence

If the covered member believes that the circumstances would lead a reasonable person having knowledge of the facts to conclude that the actual or intended litigation poses an unacceptable threat to independence, the covered member should either (*a*) disengage himself or herself, or (*b*) disclaim an opinion because of lack of independence. Such disengagement may take the form of resignation or cessation of any attest engagement then in progress pending resolution of the issue between the parties.

Termination of impairment

The conditions giving rise to a lack of independence are generally eliminated when a final resolution is reached and the matters at issue no longer affect the relationship between the covered member and client. The covered member should carefully review the conditions of such resolution to determine that all impairments to the covered member's objectivity have been removed.

[Formerly paragraph .07, renumbered by adoption of the Code of Professional Conduct on January 12, 1988. Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, effective September 30, 1995, by the Professional Ethics Executive Committee, by deletion of subhead and paragraph and reissuance as ethics ruling No. 100, *Actions Permitted When Independence is Impaired*, under rule 101. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[.09]

[101-7]—[Deleted] [Formerly paragraph .08, renumbered by adoption of the Code of Professional Conduct on January 12, 1988.]

.10

101-8—Effect on independence of financial interests in nonclients having investor or investee relationships with a covered member's client.

Introduction

Financial interests in nonclients that are related in various ways to a client may impair independence. Situations in which the nonclient investor is a partnership are covered in other rulings [ET section 191.138–.139, .158–.159, and .162–.163].

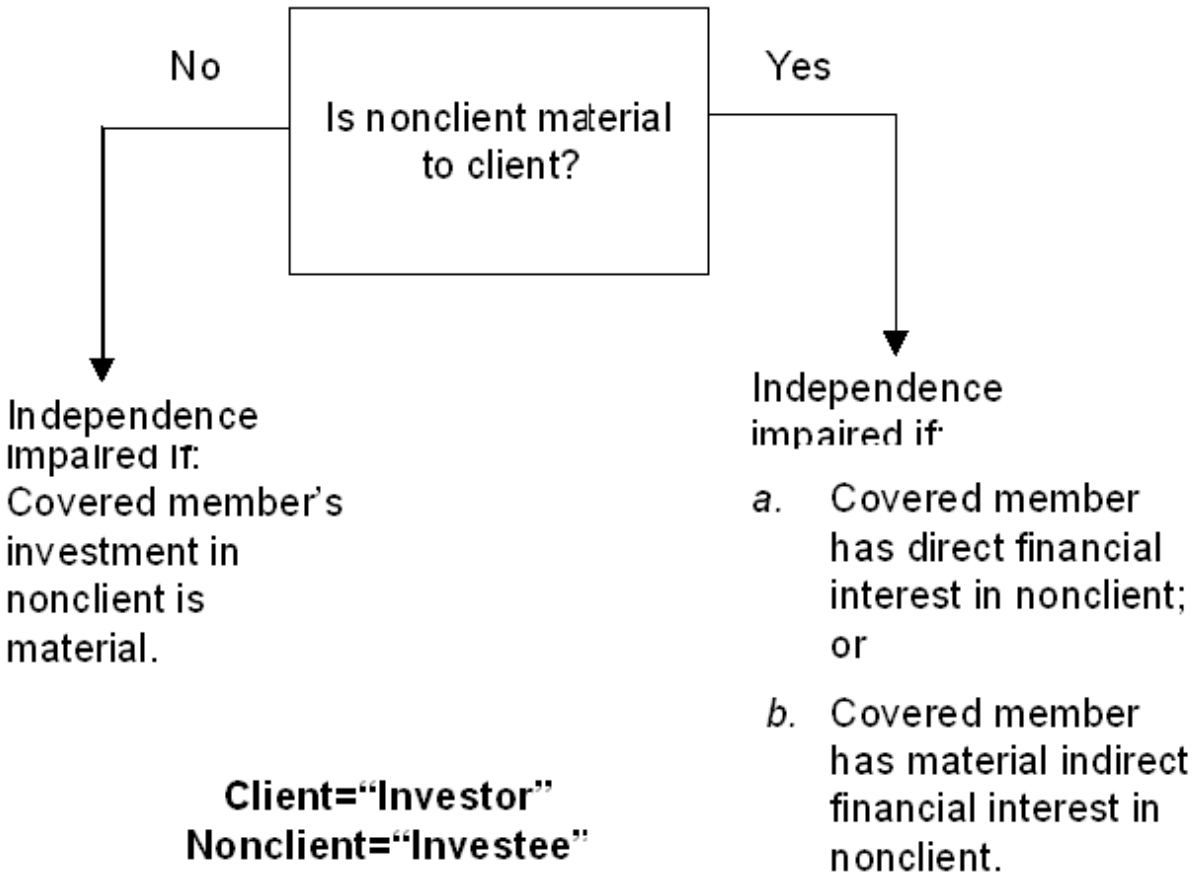
Terminology

The following specifically identified terms are used in this interpretation as indicated:

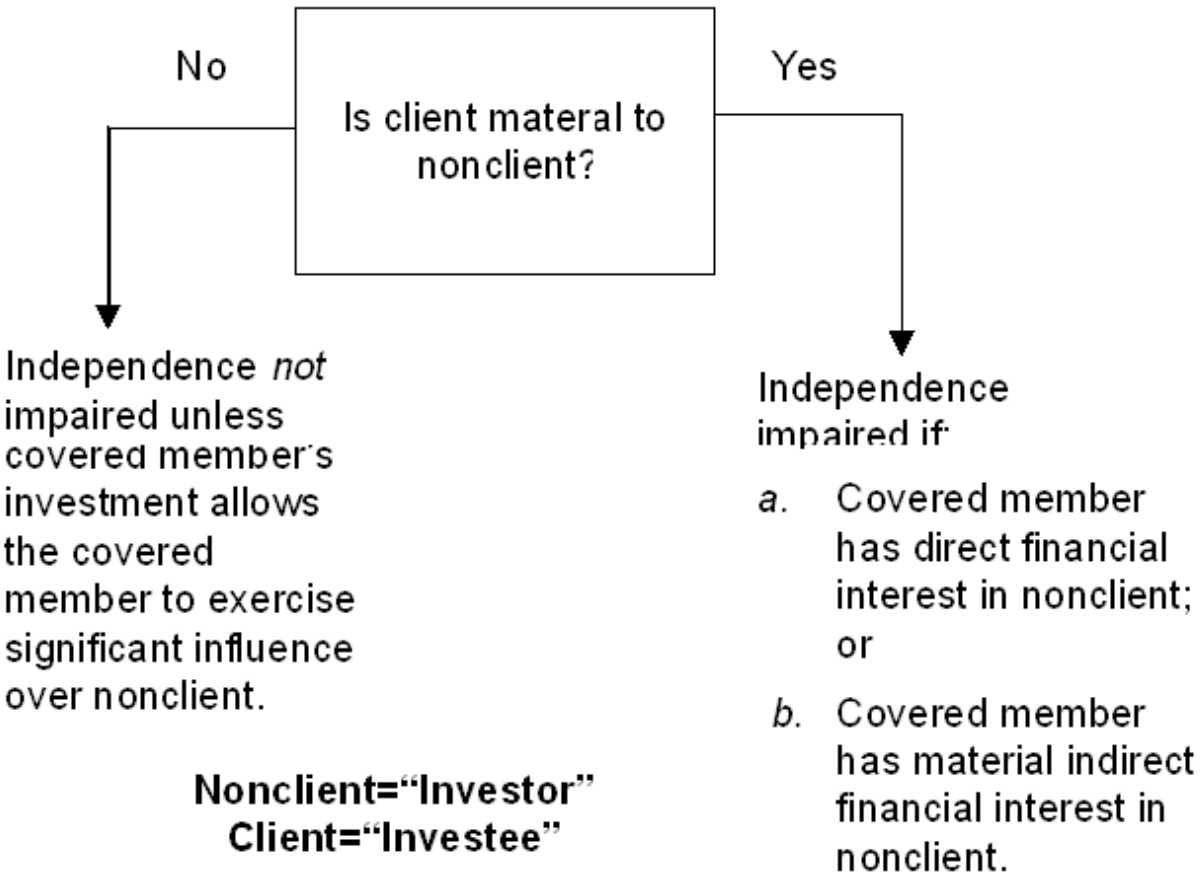
1. Client. The term client means the person or entity with whose financial statements a covered member is associated.
2. Significant Influence. The term significant influence is as defined in Accounting Principles Board (APB) Opinion 18 [AC I82].
3. Investor. The term investor means (*a*) a parent, (*b*) a general partner, or (*c*) a natural person or corporation that has the ability to exercise significant influence.
4. Investee. The term investee means (*a*) a subsidiary or (*b*) an entity over which an investor has the ability to exercise significant influence.

Interpretation

Where a nonclient investee is material to a client investor, any direct or material indirect financial interest of a covered member in the nonclient investee would be considered to impair independence with respect to the client investor. If the nonclient investee is immaterial to the client investor, a covered member's material investment in the nonclient investee would cause an impairment of independence.



Where a client investee is material to nonclient investor, any direct or material indirect financial interest of a covered member in the nonclient investor would be considered to impair independence with respect to the client investee. If the client investee is immaterial to the nonclient investor, and if a covered member's financial interest in the nonclient investor allows the covered member to exercise significant influence over the actions of the nonclient investor, independence would be considered to be impaired.



Other relationships, such as those involving brother-sister common control or client-nonclient joint ventures, may affect the appearance of independence. The covered member should make a reasonable inquiry to determine whether such relationships exist, and if they do, careful consideration should be given to whether the financial interests in question would lead a reasonable observer to conclude that the specified relationships pose an unacceptable threat to independence.

In general, in brother-sister common control situations, an immaterial financial interest of a covered member in the nonclient investee would not impair independence with respect to the client investee, provided the covered member could not exercise significant influence over the nonclient investor. However, if a covered member's financial interest in a nonclient investee is material, the covered member could be influenced by the nonclient investor, thereby impairing independence with respect to the client investee. In like manner, in a joint venture situation, an immaterial financial interest of a covered member in the nonclient investor would not impair the independence of the covered member with respect to the client investor, provided that the covered member could not exercise significant influence over the nonclient investor.

If a covered member does not and could not reasonably be expected to have knowledge of the financial interests or relationship described in this interpretation, independence would not be considered to be impaired under this interpretation.

[Revised, December 31, 1983, by the Professional Ethics Executive Committee. Formerly paragraph .09 renumbered by adoption of the Code of Professional Conduct on January 12, 1988. References changed to reflect the issuance of the AICPA Code of Professional Conduct on January 12, 1988. Replaces previous interpretation 101-8, *Effect on Independence of Financial Interests in Nonclients Having Investor or Investee Relationships With a Member's Client,* April 1991, effective April 30, 1991. Revised, December 31, 1991, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[.11]

[101-9]—[Deleted]

.12

101-10—The effect on independence of relationships with entities included in the governmental financial statements. [fn 12] For purposes of this Interpretation, a financial reporting entity's basic financial statements, issued in conformity with generally accepted accounting principles in the United States of America, include the government-wide financial statements (consisting of the entity's governmental activities, business-type activities, and discretely presented component units), the fund financial statements (consisting of major funds, nonmajor governmental and enterprise funds, internal service funds, blended component units, and fiduciary funds) and other entities disclosed in the notes to the basic financial statements. Entities that should be disclosed in the notes to the basic financial statements include, but are not limited to, related organizations, joint ventures, jointly governed organizations, and component units of another government with characteristics of a joint venture or jointly governed organization.

Auditor of Financial Reporting Entity

A covered member issuing a report on the basic financial statements of the financial reporting entity must be independent of the financial reporting entity, as defined in paragraph 1 of this Interpretation. However, independence is not required with respect to any major or nonmajor fund, internal service fund, fiduciary fund, or component unit or other entities disclosed in the financial statements, where the primary auditor explicitly states reliance on other auditors reports thereon. In addition, independence is not required with respect to an entity disclosed in the notes to the basic financial statements, if the financial reporting entity is not financially accountable for the organization and the required disclosure does not include financial information. For example, a disclosure limited to the financial reporting entity's ability to appoint the governing board members would not require a member to be independent of that organization.

However, the covered member and his or her immediate family should not hold a key position with a major fund, nonmajor fund, internal service fund, fiduciary fund, or component unit of the financial reporting entity or other entity that should be disclosed in the notes to the basic financial statements.

Auditor of a Major Fund, Nonmajor Fund, Internal Service Fund, Fiduciary Fund,

or Component Unit of the Financial Reporting Entity or Other Entity That Should Be Disclosed in the Notes to the Basic Financial Statements

A covered member who is auditing the financial statements of a major fund, nonmajor fund, internal service fund, fiduciary fund, or component unit of the financial reporting entity or an entity that should be disclosed in the notes to the basic financial statements of the financial reporting entity, but is not auditing the primary government, should be independent with respect to those financial statements that the covered member is reporting upon. The covered member is not required to be independent of the primary government or other funds or component units of the reporting entity or entities that should be disclosed in the notes to the basic financial statements. However, the covered member and his or her immediate family should not hold a key position within the primary government. For purposes of this Interpretation, a covered member and immediate family member would not be considered employed by the primary government if the exceptions provided for in ET section 92.03 are met. [fns 13–14]

[Formerly paragraph .11, renumbered by adoption of the Code of Professional Conduct on January 12, 1988. References changed to reflect the issuance of the AICPA Code of Professional Conduct on January 12, 1988. Replaces previous interpretation 101-10, *The Effect on Independence of Relationships Proscribed by Rule 101 and its Interpretations With Nonclient Entities Included With a Member's Client in the Financial Statements of a Governmental Reporting Entity*, April 1991, effective April 30, 1991. Replaces previous interpretation 101-10, *The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements*, January 1996, effective January 31, 1996. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Revised, effective March 31, 2003, by the Professional Ethics Executive Committee.]

.13

101-11—Modified application of rule 101 for certain engagements to issue restricted-use reports under the Statements on Standards for Attestation Engagements

Rule 101: *Independence* [ET section 101.01], and its interpretations and rulings apply to all attest engagements. However, for purposes of performing engagements to issue reports under the Statements on Standards for Attestation Engagements (SSAEs) that are restricted to identified parties, only the following covered members, and their immediate families, are required to be independent with respect to the responsible party [fn 15] in accordance with rule 101 [ET section 101.01]:

- Individuals participating on the attest engagement team;
- Individuals who directly supervise or manage the attest engagement partner; and
- Individuals who consult with the attest engagement team regarding technical or industry-related issues specific to the attest engagement.

In addition, independence would be considered to be impaired if the firm had a financial relationship covered by interpretation 101-1.A [ET section 101.02] with the responsible party that was material to the

firm.

In cases where the firm provides non-attest services to the responsible party that are proscribed under interpretation 101-3 [ET section 101.05] and that do not directly relate to the subject matter of the attest engagement, independence would not be considered to be impaired.

In circumstances where the individual or entity that engages the firm is not the responsible party or associated with the responsible party, individuals on the attest engagement team need not be independent of the individual or entity, but should consider their responsibilities under interpretation 102-2 [ET section 102.03] with regard to any relationships that may exist with the individual or entity that engages them to perform these services.

This interpretation does not apply to an engagement performed under the Statements on Auditing Standards or Statements on Standards for Accounting and Review Services, or to an examination or review engagement performed under the Statements on Standards for Attestation Engagements.

[Replaces previous interpretation 101-11, *Independence and Attest Engagements*, January 1996, effective January 31, 1996. Revised, effective November 30, 2001, by the Professional Ethics Executive Committee.]

.14

101-12—Independence and cooperative arrangements with clients. Independence will be considered to be impaired if, during the period of a professional engagement, a member or his or her firm had any cooperative arrangement with the client that was material to the member's firm or to the client.

Cooperative Arrangement—A cooperative arrangement exists when a member's firm and a client jointly participate in a business activity. The following are examples, which are not all inclusive, of cooperative arrangements:

1. Prime/subcontractor arrangements to provide services or products to a third party
2. Joint ventures to develop or market products or services
3. Arrangements to combine one or more services or products of the firm with one or more services or products of the client and market the package with references to both parties
4. Distribution or marketing arrangements under which the firm acts as a distributor or marketer of the client's products or services, or the client acts as the distributor or marketer of the products or services of the firm

Nevertheless, joint participation with a client in a business activity does not ordinarily constitute a cooperative arrangement when all the following conditions are present:

a. The participation of the firm and the participation of the client are governed by separate agreements, arrangements, or understandings.

b. The firm assumes no responsibility for the activities or results of the client, and vice versa.

c. Neither party has the authority to act as the representative or agent of the other party.

In addition, the member's firm should consider the requirements of rule 302 [ET section 302.01] and rule 503 [ET section 503.01].

[Effective November 30, 1993. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

.15

101-13—Extended audit services. A member or his or her firm ("member") may be asked by a client, for which the member performs an attest engagement, to perform extended audit services. These services may include assistance in the performance of the client's internal audit activities and/or an extension of the member's audit service beyond the requirements of generally accepted auditing standards (hereinafter referred to as "extended audit services").

A member's performance of extended audit services would not be considered to impair independence with respect to a client for which the member also performs an attest engagement, provided that the member or his or her firm is not an employee of the client or does not act or appear to act in a capacity equivalent to a member of client management .

The responsibilities of the client, including its board of directors, audit committee, and management, and the responsibilities of the member, as described below, should be understood by both the member and the client. It is preferable that this understanding be documented in an engagement letter that indicates that the member may not perform management functions or make management decisions.

A member should be satisfied that the client understands its responsibility for establishing and maintaining internal control and directing the internal audit function, if any. As part of its responsibility to establish and maintain internal control, management monitors internal control to assess the quality of its performance over time. Monitoring can be accomplished through ongoing activities, separate evaluations or a combination of both.

Ongoing monitoring activities are the procedures designed to assess the quality of internal control performance over time and that are built into the normal recurring activities of an entity and include regular management and supervisory activities, comparisons, reconciliations and other routine actions. Separate evaluations focus on the continued effectiveness of a client's internal control. A member's independence would not be impaired by the performance of separate evaluations of the effectiveness of a client's internal control, including separate evaluations of the client's ongoing monitoring activities.

The member should understand that, with respect to the internal audit function, the client is responsible for—

- Designating a competent individual or individuals, preferably within senior management, to be responsible for the internal audit function

- Determining the scope, risk and frequency of internal audit activities, including those to be performed by the member providing extended audit services
- Evaluating the findings and results arising from the internal audit activities, including those performed by the member providing extended audit services
- Evaluating the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining reports from the member

The member should be satisfied that the board of directors and/or audit committee is informed of roles and responsibilities of both client management and the member with respect to the engagement to provide extended audit services as a basis for the board of directors and/or audit committee to establish guidelines for both management and the member to follow in carrying out these responsibilities and monitoring how well the respective responsibilities have been met.

The member should be responsible for performing the audit procedures in accordance with the terms of the engagement and reporting thereon. The day-to-day performance of the audit procedures should be directed, reviewed, and supervised by the member. The report should include information that allows the individual responsible for the internal audit function to evaluate the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures. This report may include recommendations for improvements in systems, processes, and procedures. The member may assist the individual responsible for the internal audit function in performing preliminary audit risk assessments, preparing audit plans, and recommending audit priorities. However, the member should not undertake any responsibilities that are required, as described above, to be performed by the individual responsible for the internal audit function.

Performing procedures that are generally of the type considered to be extensions of the member's audit scope applied in the audit of the client's financial statements, such as confirming of accounts receivable and analyzing fluctuations in account balances, would not impair the independence even if the extent of such testing exceeds that required by generally accepted auditing standards.

The following are examples of activities that, if performed as part of an extended audit service, would be considered to impair independence:

- 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
- 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

- Authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client
- Preparing source documents on transactions
- Having custody of assets
- 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
- 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)

The foregoing list in not intended to be all inclusive.

[Effective August 31, 1996. Revised, effective September 30, 1999, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

.16

101-14—The effect of alternative practice structures on the applicability of independence rules. Because of changes in the manner in which **members** [fn #] are structuring their practices, the AICPA's professional ethics executive committee (PEEC) studied various alternatives to "traditional structures" to determine whether additional independence requirements are necessary to ensure the protection of the public interest.

In many "nontraditional structures," a substantial (the nonattest) portion of a member's practice is conducted under public or private ownership, and the attest portion of the practice is conducted through a separate firm owned and controlled by the member. All such structures must comply with applicable laws, regulations, and Rule 505, *Form of Organization and Name* [ET section 505.01]. In complying with laws, regulations, and rule 505 [ET section 505.01], many elements of quality control are required to ensure that the public interest is adequately protected. For example, all services performed by members and persons over whom they have control must comply with standards promulgated by AICPA Council-designated bodies, and, for all other firms providing attest services, enrollment is required in an AICPA-approved practice-monitoring program. Finally, and importantly, the members are responsible, financially and otherwise, for all the attest work performed. Considering the extent of such measures, PEEC believes that the additional independence rules set forth in this interpretation are sufficient to ensure that attest services can be performed with objectivity and, therefore, the additional rules satisfactorily protect the public interest.

Rule 505 [ET section 505.01] and the following independence rules for an alternative practice structure

(APS) are intended to be conceptual and applicable to all structures where the "traditional firm" engaged in attest services is closely aligned with another organization, public or private, that performs other professional services. The following paragraph and the chart below provide an example of a structure in use at the time this interpretation was developed. Many of the references in this interpretation are to the example. PEEC intends that the concepts expressed herein be applied, in spirit and in substance, to variations of the example structure as they develop.

The example APS in this interpretation is one where an existing CPA practice ("Oldfirm") is sold by its owners to another (possibly public) entity ("PublicCo"). PublicCo has subsidiaries or divisions such as a bank, insurance company or broker-dealer, and it also has one or more professional service subsidiaries or divisions that offer to clients nonattest professional services (e.g., tax, personal financial planning, and management consulting). The owners and employees of Oldfirm become employees of one of PublicCo's subsidiaries or divisions and may provide those nonattest services. In addition, the owners of Oldfirm form a new CPA firm ("Newfirm") to provide attest services. CPAs, including the former owners of Oldfirm, own a majority of Newfirm (as to vote and financial interests). Attest services are performed by Newfirm and are supervised by its owners. The arrangement between Newfirm and PublicCo (or one of its subsidiaries or divisions) includes the lease of employees, office space and equipment; the performance of back-office functions such as billing and collections; and advertising. Newfirm pays a negotiated amount for these services.

APS Independence Rules for Covered Members

The term **covered member** in an APS includes both employed and leased individuals. The **firm** in such definition would be Newfirm in the example APS. All covered members, including the firm, are subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety. For example, no covered member may have, among other things, a direct financial interest in or a loan to or from an attest client of Newfirm.

Partners of one Newfirm generally would not be considered partners of another Newfirm except in situations where those partners perform services for the other Newfirm or where there are significant shared economic interests between partners of more than one Newfirm. If, for example, partners of Newfirm 1 perform services in Newfirm 2, such owners would be considered to be partners of both Newfirms for purposes of applying the independence rules.

APS Independence Rules for Persons and Entities Other Than Covered Members

As stated above, the independence rules normally extend only to those persons and entities included in the definition of covered member. This normally would include only the "traditional firm" (Newfirm in the example APS), those covered members who own or are employed or leased by Newfirm, and entities controlled by one or more of such persons. Because of the close alignment in many APSs between persons and entities included in covered member and other persons and entities, to ensure the protection of the public interest, PEEC believes it appropriate to require restrictions in addition to those required in a traditional firm structure. Those restrictions are divided into two groups:

1. *Direct Superiors.* Direct Superiors are defined to include those persons so closely associated with a partner or manager who is a covered member, that such persons can *directly control* the activities of such partner or manager. For this purpose, a person who can *directly control* is the immediate superior of the partner or manager who has the power to direct the activities of that person so as to be able to directly or indirectly (e.g. through another entity over which the Direct Superior can exercise significant influence [fn 16]) derive a benefit from that person's activities. Examples would be the person who has day-to-day responsibility for the activities of the partner or manager and is in a position to recommend promotions and compensation levels. This group of persons is, in the view of PEEC, so closely aligned through direct reporting relationships with such persons that their interests would seem to be inseparable. *Consequently, persons considered Direct Superiors, and entities within the APS over which such persons can exercise significant influence* [fn 17] *are subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety*.

2. *Indirect Superiors and Other PublicCo Entities.* Indirect Superiors are those persons who are one or more levels above persons included in Direct Superior. Generally, this would start with persons in an organization structure to whom Direct Superiors report and go up the line from there. PEEC believes that certain restrictions must be placed on Indirect Superiors, but also believes that such persons are sufficiently removed from partners and managers who are covered persons to permit a somewhat less restrictive standard. Indirect Superiors are not connected with partners and managers who are covered members through direct reporting relationships; there always is a level in between. The PEEC also believes that, for purposes of the following, the definition of Indirect Superior also includes the **immediate family** of the Indirect Superior.

PEEC carefully considered the risk that an Indirect Superior, through a Direct Superior, might attempt to influence the decisions made during the engagement for a Newfirm attest client. PEEC believes that this risk is reduced to a sufficiently low level by prohibiting certain relationships between Indirect Superiors and Newfirm attest clients and by applying a materiality concept with respect to financial relationships. If the financial relationship is not material to the Indirect Superior, PEEC believes that he or she would not be sufficiently financially motivated to attempt such influence particularly with sufficient effort to overcome the presumed integrity, objectivity and strength of character of individuals involved in the engagement.

Similar standards also are appropriate for Other PublicCo Entities. These entities are defined to include PublicCo and all entities consolidated in the PublicCo financial statements that are not subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety.

The rules for Indirect Superiors and Other PublicCo Entities are as follows:

A. Indirect Superiors and Other PublicCo Entities may *not* have a relationship contemplated by interpretation 101-1.A [ET section 101.02] (e.g., investments, loans, etc.) with an attest client of Newfirm that is material. In making the test for materiality for financial relationships of an Indirect Superior, all the financial relationships with an attest client held by such person should be aggregated and, to determine materiality, assessed in relation to the person's net worth. In making the materiality test for financial relationships of Other PublicCo Entities, all the financial relationships with an attest client held by such entities should be aggregated and, to determine materiality, assessed in relation to the consolidated financial statements of PublicCo. In addition,

any Other PublicCo Entity over which an Indirect Superior has direct responsibility cannot have a financial relationship with an attest client that is material in relation to the Other PublicCo Entity's financial statements.

B. Further, financial relationships of Indirect Superiors or Other PublicCo Entities should not allow such persons or entities to exercise significant influence [fn 18] over the attest client. In making the test for significant influence, financial relationships of all Indirect Superiors and Other PublicCo Entities should be aggregated.

C. Neither Other PublicCo Entities nor any of their employees may be connected with an attest client of Newfirm as a promoter, underwriter, voting trustee, director or officer.

D. Except as noted in C above, Indirect Superiors and Other PublicCo Entities may provide services to an attest client of Newfirm that would impair independence if performed by Newfirm. For example, trustee and asset custodial services in the ordinary course of business by a bank subsidiary of PublicCo would be acceptable as long as the bank was not subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety.

Other Matters

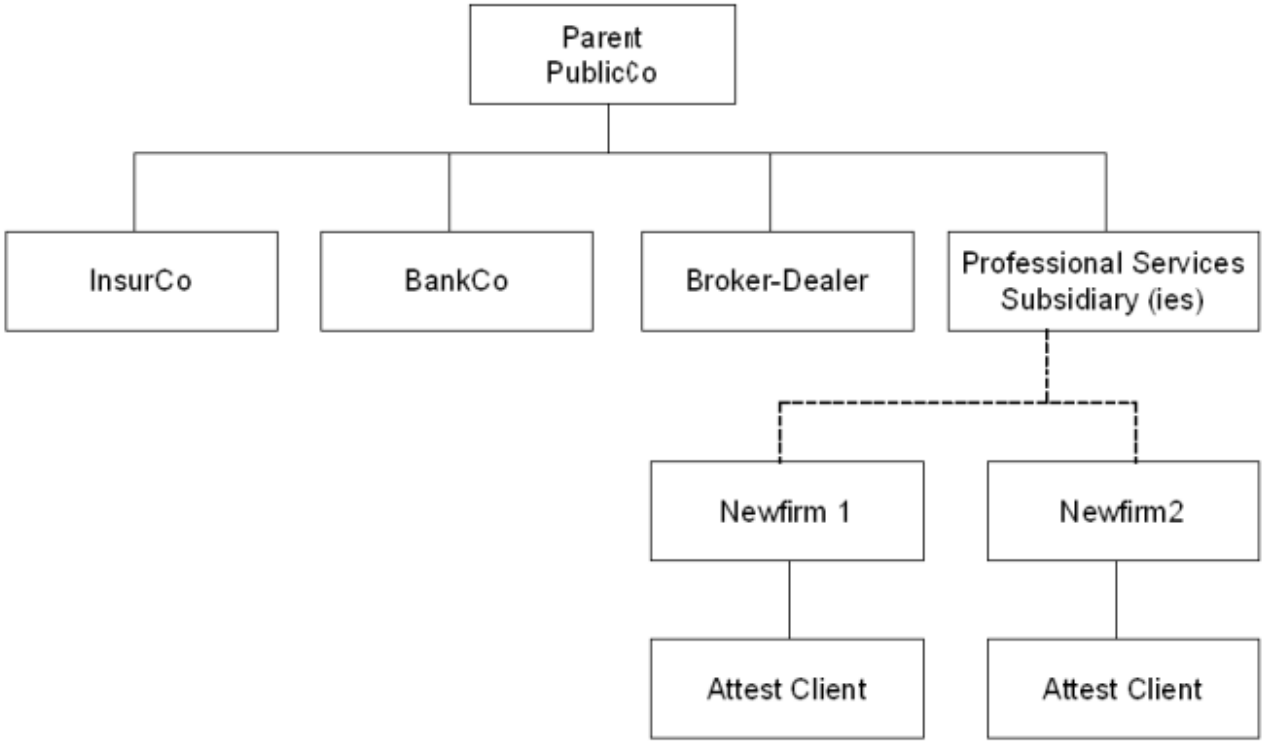
1. An example, using the chart below, of the application of the concept of Direct and Indirect Superiors would be as follows: The chief executive of the local office of the Professional Services Subsidiary (PSS), where the partners of Newfirm are employed, would be a Direct Superior. The chief executive of PSS itself would be an Indirect Superior, and there may be Indirect Superiors in between such as a regional chief executive of all PSS offices within a geographic area.

2. PEEC has concluded that Newfirm (and its partners and employees) may not perform an **attest engagement** for PublicCo or any of its subsidiaries or divisions.

3. PEEC has concluded that independence would be considered to be impaired with respect to an attest client of Newfirm if such attest client holds an investment in PublicCo that is material to the attest client or allows the attest client to exercise significant influence [fn 19] over PublicCo.

3. When making referrals of services between Newfirm and any of the entities within PublicCo, a member should consider the provisions of Interpretation 102-2, *Conflicts of Interest* [ET section 102.03].

Alternative Practice Structure (APS) Model



[Effective February 28, 1999; Revised, November 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

Footnotes (ET Section 101 — Independence):

fn * Terms shown in **boldface** type upon first usage in this interpretation are defined in ET section 92, *Definitions*. [Footnote added, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

fn 1 See Ethics Ruling No. 107, "Participation in Health and Welfare Plan of Client" [**ET section 191.214–.215**], for instances in which participation was the result of permitted employment of the individual's spouse or spousal equivalent.

fn 2 A penalty includes an early withdrawal penalty levied under the tax law but excludes other income taxes that would be owed or market losses that may be incurred as a result of the liquidation or transfer.

fn 3 An inadvertent and isolated failure to meet conditions 4, 5, and 6 would not impair independence provided that the required procedures are performed promptly upon discovery of the failure to do so, and all other provisions of the interpretation are met. [Footnote added, effective April 30, 2003, by the Professional Ethics Executive Committee.]

fn 4 The documents upon which evidence of an accounting transaction are 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. [Footnote renumbered by the revision of interpretation 101-2, April 2003.]

fn 5 Although this type of transaction may be considered by some to be similar to signing checks or disbursing funds, the Professional Ethics Executive Committee concluded that making electronic payroll tax payments under the specified criteria would not impair a member's independence. [Footnote renumbered by the revision of interpretation 101-2, April 2003.]

fn 6 When auditing plans subject to the Employee Retirement Income Security Act (ERISA), Department of Labor (DOL) regulations, which may be more restrictive, must be followed. [Footnote renumbered by the revision of interpretation 101-2, April 2003.]

fn || Terms shown in **boldface** type upon first usage in this interpretation are defined in ET section 92, *Definitions*.

fn 7 The value of the collateral securing a home mortgage or other secured loan should equal or exceed the remaining balance of the grandfathered loan during the term of the loan. If the value of the collateral is less than the remaining balance of the grandfathered loan, the portion of the loan that exceeds the value of the collateral must not be material to the covered member's net worth. [Footnote added, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote renumbered by the revision of interpretation 101-2, April 2003.]

fn 8 Changes in the terms of the loan include, but are not limited to, a new or extended maturity date, a new interest rate or formula, revised collateral, or revised or waived covenants. [Footnote added, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote renumbered by the revision of interpretation 101-2, April 2003.]

fn 9 Because of the complexities of litigation and the circumstances under which it may arise, it is not possible to prescribe meaningful criteria for measuring materiality; accordingly, the covered member should consider the nature of the controversy underlying the litigation and all other relevant factors in reaching a judgment. [Footnote renumbered and revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote subsequently renumbered by the revision of interpretation 101-2, April 2003.]

fn 10 See footnote 9. [Footnote renumbered, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote subsequently renumbered by the revision of interpretation 101-2, April 2003.]

fn 11 See footnote 9. [Footnote renumbered, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote subsequently renumbered by the revision of interpretation 101-2, April 2003.]

fn 12 Except for a financial reporting entity's basic financial statements, which is defined within the text of this Interpretation, certain terminology used throughout the Interpretation is specifically defined by the Governmental Accounting Standards Board. [Footnote renumbered, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote subsequently renumbered by the revision of interpretation 101-2, April 2003.]

[fns 13–14] [Footnotes deleted by the Professional Ethics Executive Committee, March 2003. Footnotes renumbered by the revision of interpretation 101-2, April 2003.]

fn 15 As defined in the SSAEs. [Footnote renumbered, July 2002, to reflect conforming changes

necessary due to the revision of interpretation 101-1. Footnote subsequently renumbered by the revision of interpretation 101-2, April 2003.]

fn # Terms shown in **boldface** type upon first usage in this interpretation are defined in ET section 92, *Definitions*. [Footnote added, November 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

fn 16 For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in Accounting Principles Board Opinion No. 18 [AC section I82] and its interpretations to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive. [Footnote added, November 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote renumbered by the revision of interpretation 101-2, April 2003.]

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ET Section 102
Integrity and Objectivity

.01

Rule 102 – Integrity and objectivity. In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

[As adopted January 12, 1988.]

Interpretations under Rule 102
—Integrity and Objectivity

.02

102-1—Knowing misrepresentations in the preparation of financial statements or records. A member shall be considered to have knowingly misrepresented facts in violation of rule 102 [ET section 102.01] when he or she knowingly—

a. Makes, or permits or directs another to make, materially false and misleading entries in an entity's financial statements or records; or

b. Fails to correct an entity's financial statements or records that are materially false and misleading when he or she has the authority to record an entry; or

c. Signs, or permits or directs another to sign, a document containing materially false and misleading information.

[Revised, effective May 31, 1999, by the Professional Ethics Executive Committee.]

.03

102-2—Conflicts of interest. A conflict of interest may occur if a member performs a professional service for a client or employer and the member or his or her firm has a relationship with another person, entity, product, or service that could, in the member's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the member's objectivity. If the member believes that the professional service can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client, employer, or other appropriate parties, the rule shall not operate to prohibit the performance of the professional service. When making the disclosure, the member should consider

Rule 301, *Confidential Client Information* [ET section 301.01].

Certain professional engagements, such as audits, reviews, and other attest services, require independence. Independence impairments under rule 101 [ET section 101.01], its interpretations, and rulings cannot be eliminated by such disclosure and consent.

The following are examples, not all-inclusive, of situations that should cause a member to consider whether or not the client, employer, or other appropriate parties could view the relationship as impairing the member's objectivity:

- A member has been asked to perform litigation services for the plaintiff in connection with a lawsuit filed against a client of the member's firm.
- A member has provided tax or personal financial planning (PFP) services for a married couple who are undergoing a divorce, and the member has been asked to provide the services for both parties during the divorce proceedings.
- In connection with a PFP engagement, a member plans to suggest that the client invest in a business in which he or she has a financial interest.
- A member provides tax or PFP services for several members of a family who may have opposing interests.
- A member has a significant financial interest, is a member of management, or is in a position of influence in a company that is a major competitor of a client for which the member performs management consulting services.
- A member serves on a city's board of tax appeals, which considers matters involving several of the member's tax clients.
- A member has been approached to provide services in connection with the purchase of real estate from a client of the member's firm.
- A member refers a PFP or tax client to an insurance broker or other service provider, which refers clients to the member under an exclusive arrangement to do so.
- A member recommends or refers a client to a service bureau in which the member or partner(s) in the member's firm hold material financial interest(s).

The above examples are not intended to be all-inclusive.

[Replaces previous interpretation 102-2, *Conflicts of Interest*, August 1995, effective August 31, 1995.]

.04

102-3—Obligations of a member to his or her employer's external accountant. Under rule 102 [ET section 102.01], a member must maintain objectivity and integrity in the performance of a professional service. In dealing with his or her employer's external accountant, a member must be candid and not

knowingly misrepresent facts or knowingly fail to disclose material facts. This would include, for example, responding to specific inquiries for which his or her employer's external accountant requests written representation.

[Effective November 30, 1993.]

.05

102-4—Subordination of judgment by a member. Rule 102 [ET section 102.01] prohibits a member from knowingly misrepresenting facts or subordinating his or her judgment when performing professional services. Under this rule, if a member and his or her supervisor have a disagreement or dispute relating to the preparation of financial statements or the recording of transactions, the member should take the following steps to ensure that the situation does not constitute a subordination of judgment: [fn 1]

1. The member should consider whether (*a*) the entry or the failure to record a transaction in the records, or (*b*) the financial statement presentation or the nature or omission of disclosure in the financial statements, as proposed by the supervisor, represents the use of an acceptable alternative and does not materially misrepresent the facts. If, after appropriate research or consultation, the member concludes that the matter has authoritative support and/or does not result in a material misrepresentation, the member need do nothing further.
2. If the member concludes that the financial statements or records could be materially misstated, the member should make his or her concerns known to the appropriate higher level(s) of management within the organization (for example, the supervisor's immediate superior, senior management, the audit committee or equivalent, the board of directors, the company's owners). The member should consider documenting his or her understanding of the facts, the accounting principles involved, the application of those principles to the facts, and the parties with whom these matters were discussed.
3. If, after discussing his or her concerns with the appropriate person(s) in the organization, the member concludes that appropriate action was not taken, he or she should consider his or her continuing relationship with the employer. The member also should consider any responsibility that may exist to communicate to third parties, such as regulatory authorities or the employer's (former employer's) external accountant. In this connection, the member may wish to consult with his or her legal counsel.
4. The member should at all times be cognizant of his or her obligations under interpretation 102-3 [ET section 102.04].

[Effective November 30, 1993.]

.06

102-5—Applicability of rule 102 to members performing educational services. Educational services (for example, teaching full- or part-time at a university, teaching a continuing professional education course, or

engaging in research and scholarship) are professional services as defined in ET section 92.11, and are therefore subject to rule 102 [ET section 102.01]. Rule 102 [ET section 102.01] provides that the member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

[Effective March 31, 1995.]

.07

102-6—Professional services involving client advocacy. A member or a member's firm may be requested by a client—

1. To perform tax or consulting services engagements that involve acting as an advocate for the client.
2. To act as an advocate in support of the client's position on accounting or financial reporting issues, either within the firm or outside the firm with standard setters, regulators, or others.

Services provided or actions taken pursuant to such types of client requests are professional services [ET section 92.11] governed by the Code of Professional Conduct and shall be performed in compliance with Rule 201, *General Standards* [ET section 201.01], Rule 202, *Compliance With Standards* [ET section 202.01], and Rule 203, *Accounting Principles* [ET section 203.01], and interpretations thereof, as applicable. Furthermore, in the performance of any professional service, a member shall comply with rule 102 [ET section 102.01], which requires maintaining objectivity and integrity and prohibits subordination of judgment to others. When performing professional services requiring independence, a member shall also comply with rule 101 [ET section 101.01] of the Code of Professional Conduct.

Moreover, there is a possibility that some requested professional services involving client advocacy may appear to stretch the bounds of performance standards, may go beyond sound and reasonable professional practice, or may compromise credibility, and thereby pose an unacceptable risk of impairing the reputation of the member and his or her firm with respect to independence, integrity, and objectivity. In such circumstances, the member and the member's firm should consider whether it is appropriate to perform the service.

[Effective August 31, 1995.]

Footnotes (ET Section 102 — Integrity and Objectivity):

fn 1 See paragraph 5.b. of Auditing Standard No. 10, *Supervision of the Audit Engagement*, and paragraph 12.d. of Auditing Standard No. 3, *Audit Documentation.*

ET Section 191
Ethics Rulings on Independence, Integrity, and Objectivity

1. Acceptance of a Gift

.001

Question—Would independence be considered to be impaired if a member accepts a gift or other unusual consideration from a client?

.002

Answer—Independence would be considered to be impaired if a *covered* member accepts more than a token gift from a client, even with the knowledge of the member's firm.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

2. Association Membership

.003

Question—Would independence be considered to be impaired if a member joined a trade association that is a client of the firm?

.004

Answer—Independence would not be considered to be impaired provided the member did not serve as an officer, director, or in any capacity equivalent to that of a member of management.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[3.] Member as Signer or Cosigner of Checks

[.005–.006]

[Deleted May 1999]

[4.] Payroll Preparation Services

[.007–.008]

[Deleted May 1999]

[5.] Member as Bookkeeper

[.009–.010]

[Deleted June 1991]

[6.] Member's Spouse as Accountant of Client [.011–.012]

[Deleted November 2001]

[7.] Member Providing Contract Services [.013–.014]

[Deleted May 1999]

8. Member Providing Advisory Services

.015

Question—A member provides extensive advisory services for a client. In that connection, the member attends board meetings, interprets financial statements, forecasts and other analyses, counsels on potential expansion plans and on banking relationships. Would independence be considered to be impaired under these circumstances?

.016

Answer—Independence would not be considered to be impaired because the member's role is advisory in nature.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

9. Member as Representative of Creditor's Committee

.017

Question—A member performs the following functions for a creditors' committee in control of a debtor corporation which will continue to operate under its existing management subject to extension agreements:

- Signs or co-signs checks issued by the debtor corporation.
- Signs or co-signs purchase orders in excess of established minimum amounts.
- Exercises general supervision to insure compliance with budgetary controls and pricing formulas established by management, with the consent of the creditors, as part of an overall program aimed at the liquidation of deferred indebtedness.

Would independence be considered to be impaired with respect to the debtor corporation?

.018

Answer—Independence would be considered to be impaired if *any* partner or professional employee of the firm performed any of the functions described, since these are considered to be management functions.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July

2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

10. Member as Legislator

.019

Question—A member is an elected legislator in a local government (a city). The city manager, who is responsible for all administrative functions, is also an elected official. Would independence be considered to be impaired with respect to the city?

.020

Answer—Independence would be considered to be impaired if *any* partner or professional employee of the firm served as an elected legislator for a city at the same time his or her firm was engaged to perform the city's attest engagement, even though the city manager is an elected official rather than an appointee of the legislature.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

11. Member Designated to Serve as Executor or Trustee

.021

Question—A member has been designated to serve as an executor or trustee of the estate of an individual who owns the majority of a client's stock. Would independence be considered to be impaired with respect to the client?

.022

Answer—The mere designation of a *covered* member as executor or trustee would not be considered to impair independence, however, if a covered member actually served in such capacity, independence would be considered to be impaired.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

12. Member as Trustee of Charitable Foundation

.023

Question—A charitable foundation is the sole beneficiary of the estate of the foundation's deceased organizer. If a member becomes a trustee of the foundation, would independence be considered to be impaired with respect to (1) the foundation or (2) the estate?

.024

Answer—If a *covered* member served as trustee of the foundation, independence would be considered to be impaired with respect to both the foundation and the estate.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[13.] Member as Bank Stockholder

[.025–.026]

[Deleted November 1993]

14. Member on Board of Federated Fund-Raising Organization

.027

Question—A member serves as a director or officer of a United Way or similar federated fund-raising organization (the organization). Certain local charities receive funds from the organization. Would independence be considered to be impaired with respect to such charities?

.028

Answer—Independence would be considered to be impaired if *any* partner or professional employee of the firm served as a director or officer of the organization and the organization exercised managerial control over the local charities. (See ethics ruling No. 93 [ET section 191.186–.187] under rule 101 [ET section 101.01] for additional guidance.)

[Replaces previous ruling No. 14, *Member on Board of Directors of United Fund*, April 1991. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[15.] Retired Partner as Director
[.029–.030]

[Deleted June 1991]

16. Member on Board of Directors of Nonprofit Social Club

.031

Question—Would independence be considered to be impaired if a member served on the board of directors of a nonprofit social club?

.032

Answer—Independence would be considered to be impaired if *any* partner or professional employee of the firm served on the board of directors since the board has ultimate responsibility for the club's affairs.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

17. Member of Social Club

.033

Question—Would independence be considered to be impaired if a member belongs to a social club (for example, country club, tennis club) that requires him or her to acquire a pro rata share of the club's equity or debt securities?

.034

Answer—As long as membership in a club is essentially a social matter, a *covered* member's association with the club would not impair independence because such equity or debt ownership would not be considered to be a direct financial interest within the meaning of rule 101 [ET section 101.01]. Also see interpretation 101-1.C [ET section 101.02].

[Replaces previous ruling No. 17, *Member as Stockholder in Country Club*, February 1991. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[18.] Member as City Council Chairman
[.035–.036]

[Deleted June 1991]

19. Member on Deferred Compensation Committee

.037

Question—Would independence be considered to be impaired if a member served on a committee that administers a client's deferred compensation program?

.038

Answer—Independence would be considered to be impaired if *any* partner or professional employee of the firm served on the committee since such service constitutes participation in the client's management functions. The partner or professional employee could however render consulting assistance without joining the committee.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

20. Member Serving on Governmental Advisory Unit

.039

Question—A member serves on a citizens' committee which is studying possible changes in the form of a county government that the firm audits. The member also serves on a committee appointed to study the financial status of a state. Would independence be considered to be impaired with respect to a county in that state?

.040

Answer—Independence would not be considered to be impaired with respect to the county through the member's service on either committee.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

21. Member as Director and Auditor of an Entity's Profit Sharing and Retirement Trust

.041

Question—A member serves in the dual capacity of director of an entity and auditor of the financial statements of that entity's profit sharing and retirement trust (the trust). Would independence be considered to be impaired with respect to the trust?

.042

Answer—Service as director of an entity constitutes participation in management functions that affect the entity's trust. Accordingly, independence would be considered to be impaired if *any* partner or professional of the firm served in such capacity.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[22.] Family Relationship, Brother
[.043–.044]

[Deleted June 1991]

[23.] Family Relationship, Uncle by Marriage
[.045–.046]

[Deleted June 1991]

[24.] Family Relationship, Father
[.047–.048]

[Deleted June 1991]

[25.] Family Relationship, Son
[.049–.050]

[Deleted June 1991]

[26.] Family Relationship, Son
[.051–.052]

[Deleted June 1991]

[27.] Family Relationship, Spouse as Trustee
[.053–.054]

[Deleted June 1991]

[28.] Cash Account With Brokerage Client
[.055–.056]

[Superseded by ethics ruling No. 59.]

29. Member as Bondholder

.057

Question—Would independence be considered to be impaired if a member owned an immaterial amount of a municipal authority's outstanding bonds?

.058

Answer—Ownership of a client's bonds constitute a loan to that client. Accordingly, if a *covered* member owned such bonds, independence would be considered to be impaired.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[30.] Financial Interest by Employee
[.059–060]

[.059–060] [Deleted July 1979]

31. Performance of Services for Common Interest Realty Associations (CIRAs), Including Cooperatives, Condominium Associations, Planned Unit Developments, Homeowners Associations, and Timeshare Developments

.061

Question—A member belongs to a common interest realty association (CIRA) as the result of the ownership or lease of real estate. Would independence be considered to be impaired with respect to the CIRA?

.062

Answer—Independence would be considered to be impaired if a *covered* member was a member of a CIRA unless all of the following conditions are met:

a. The CIRA performs functions similar to local governments, such as public safety, road maintenance, and utilities.

b. The covered member's annual assessment is not material to either the covered member or the CIRA's operating budgeted assessments.

c. The liquidation of the CIRA or the sale of common assets would not result in a distribution to the covered member.

d. The CIRA's creditors would not have recourse to the covered member's assets if the CIRA became insolvent.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

Also see interpretation 101-1.C [ET section 101.02] for additional restrictions related to associations with a client.

If the member has a relationship with a real estate developer or management company that is associated with the CIRA, see interpretation 102-2 [ET section 102.03] for guidance.

[Revised, effective May 31, 1998, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[32.] Mortgage Loan to Member's Corporation
[.063–.064]

[Deleted December 1991]

[33.] Member as Participant in Employee Benefit Plan

[.065–.066]

[Deleted May 1998]

[34.] Member as Auditor of Common Trust Funds
[.067–.068]

[Deleted February 1991]

35. Stockholder in Mutual Funds

.069

Question—A member owns shares in a non-regulated mutual investment fund (the fund) which holds shares of stock in a client. Would independence be considered to be impaired with respect to the client whose stock is held by the fund?

.070

Answer—Client securities held by the fund represent indirect financial interests. Accordingly, if a *covered* member has such an indirect financial interest, which is material to the covered member, independence would be considered to be impaired. In addition, if *any* partner or professional employee in the firm has significant influence over the fund, independence would be considered to be impaired.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

36. Participant in Investment Club

.071

Question—A member participates in an investment club. Would independence be considered to be impaired with respect to a client in which the investment club holds shares?

.072

Answer—Independence would be considered to be impaired if a *covered* member owned stock in a client through an investment club as such holdings would be deemed to be a direct financial interest. Accordingly, any of the club's investments in a client would be deemed to impair independence regardless of materiality of the investment to the covered member's net worth.

See interpretation 101-1.B [ET section 101.02] for additional restrictions relating to all partners and professionals of the firm.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[37.] Retired Partners as Co-Trustee
[.073–.074]

[Deleted November 1980]

38. Member as Co-Fiduciary With Client Bank

.075

Question—A member serves with a client bank in a co-fiduciary capacity with respect to an estate or trust. Would independence be considered to be impaired with respect to the bank or the bank's trust department?

.076

Answer—Independence would not be considered to be impaired provided the assets in the estate or trust were not material to the total assets of the bank and/or the bank's trust department.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[39.] Member as Officially Appointed Stock Transfer Agent or Registrar

[.077–.078]

[Deleted May 1999]

[40.] Controller Entering Public Practice

[.079–.080]

[Deleted June 1979]

41. Financial Services Company Client Has Custody of a Member's Assets

.081

Question—A financial services company client (for example, insurance company, investment adviser, broker-dealer, bank, or other depository institution) has custody of a member's assets (other than depository accounts), including retirement plan assets. Would independence be considered to be impaired?

.082

Answer—If a covered member's assets were held by a financial services company client, independence would not be considered to be impaired provided the services were rendered under the company's normal terms, procedures, and requirements and any of the covered member's assets subject to the risk of loss were immaterial to the covered member's net worth. Risk of loss may include losses arising from the bankruptcy of or defalcation by the client but would exclude losses due to a market decline in the value of the assets. When considering the materiality of assets subject to the risk of loss, the covered member should consider the following:

- Protection provided by state or federal regulators (for example, state insurance funds)
- Private insurance or other forms of protection (for example, the Securities Investor Protection Corporation) obtained by the financial services company to protect the assets
- Protection from creditors (for example, assets held in a pooled separate account)

For guidance dealing with depository accounts, see ethics ruling No. 70 [ET section 191.140 and

.141].

[Replaces previous ruling No. 41, *Member as Auditor of Mutual Insurance Company*, November, 1990. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Revised, effective March 31, 2003, by the Professional Ethics Executive Committee.]

[42.] Member as Life Insurance Policy Holder
[.083–.084]

[Deleted April 1991]

[43.] Member's Employee as Treasurer of a Client
[.085–.086]

[Deleted June 1991]

[44.] Past Due Billings
[.087–.088]

[Superseded by ethics ruling No. 52.]

[45.] Past Due Fees: Client in Bankruptcy
[.089–.090]

[Deleted November 1990]

[46.] Member as General Counsel
[.091–.092]

[Superseded by ethics ruling No. 51.]

[47.] Member as Auditor of Mutual Fund and Shareholder of Investment Advisor/Manager
[.093–.094]

[Deleted February 1991]

48. Faculty Member as Auditor of a Student Fund
.095

Question—A full or part-time faculty member employed by a university is asked to audit the financial statements of the Student Senate Fund. The university:

1. Acts as a collection agent for student fees and remits them to the Student Senate.
2. Requires that a university administrator approve and sign Student Senate checks.

Would independence be considered to be impaired under these circumstances?

.096

Answer—Independence would be considered to be impaired with respect to the Student Senate Fund if *any* partner or professional employee (individual) performed the functions described since the individual would be auditing several of the management functions performed by the university, the individual's employer.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[49.] Investor and Investee Companies
[.097–.098]

[Superseded by interpretation 101-8.]

[50.] Family Relationship, Brother-in-Law
[.099–.100]

[Deleted June 1983]

[51.] Member Providing Legal Services
[.101–.102]

[Deleted May 1999]

52. Unpaid Fees

.103

Question—A client of the member's firm has not paid fees for previously rendered professional services. Would independence be considered to be impaired for the current year?

.104

Answer—Independence is considered to be 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.

This ruling does not apply to fees outstanding from a client in bankruptcy.

[Replaces previous ruling No. 52, *Past Due Fees*, November 1990. Revised, effective November 30, 1997, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[53.] Member as Auditor of Employee Benefit Plan and Sponsoring Company
[.105–.106]

[Deleted June 1991]

[54.] Member Providing Appraisal, Valuation, or Actuarial Services
[.107–.108]

[Deleted May 1999]

[55.] Independence During Systems Implementation [.109–.110]

[Deleted May 1999]

[56.] Executive Search [.111–.112]

[Deleted May 1999]

[57.] MAS Engagement to Evaluate Service Bureaus [.113–.114]

[Deleted August 1995]

[58.] Member as Lessor [.115–.116]

[Deleted May 1998]

[59.] Account With Brokerage Client [.117–.118]

[Deleted November 1987]

60. Employee Benefit Plans—Member's Relationships With Participating Employer

.119

Question—A member has been asked to audit the financial statements of an employee benefit plan ("the plan") that may have one or more participating employer(s). Would independence be considered to be impaired with respect to the plan if the member had financial or other relationships with a participating employer(s)?

.120

Answer—Independence would be considered to be impaired with respect to the plan if *any* partner or professional employee of the firm had significant influence over such employer, was in a key position with the employer, or was associated with the employer as a promoter, underwriter, or voting trustee.

When auditing plans subject to the Employee Retirement Income Security Act of 1974 (ERISA), Department of Labor (DOL) regulations must be followed. [fn 1]

[Replaces previous ruling No. 60, *Employee Benefit Plans—Member's Relationships With Participating Employer(s)*, November 1993. Revised, effective November 30, 2001, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[61.] Participation of Member's Spouse in Client's Stock Ownership Plans (Including an ESOP) [.121–.122]

[Deleted May 1998]

[62.] Member and Client Are Limited Partners in a Limited Partnership [.123–.124]

[Deleted April 1991]

[63.] Review of Prospective Financial Information—Member's Independence of Promotors [.125–.127]

[Deleted August 1992]

64. Member Serves on Board of Organization for Which Client Raises Funds

.128

Question—A member serves on the board of directors of an organization. A fund-raising foundation functions solely to raise funds for that organization. Would independence be considered to be impaired with respect to the fund-raising foundation?

.129

Answer—Independence would be considered to be impaired with respect to the fund-raising foundation if *any* partner or professional employee of the firm served on the organization's board of directors. However, if the directorship were clearly honorary (in accordance with ET section 101.06, *Honorary directorships and trusteeships of not-for-profit organization*), independence would not be considered to be impaired.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

65. Use of the CPA Designation by Member Not in Public Practice

.130

Question—A member who is not in public practice wishes to use his or her CPA designation in connection with financial statements and correspondence of the member's employer. The member also wants to use the CPA designation along with employment title on business cards. Is it permissible for the member to use the CPA designation in these manners?

.131

Answer—Yes. However, if the member uses the CPA designation in a manner to imply that he or she is independent of the employer, the member would be knowingly misrepresenting facts in violation of rule 102 [ET section 102.01]. Therefore, it is advisable that in any transmittal within which the member uses his or her CPA designation, he or she clearly indicate the employment title. In addition, if the member states affirmatively in any transmittal that a financial statement is presented in conformity with generally accepted accounting principles, the member is subject to rule 203 [ET section 203.01].

[Replaces previous ruling No. 65, *Use of the CPA Designation by Member Not in Public Practice*, February 1996, effective February 29, 1996.]

66. Member's Retirement or Savings Plan Has Financial Interest in Client

.132

Question—A member's retirement or savings plan has a financial interest in a client. Would independence be considered to be impaired?

.133

Answer—Any direct or material indirect financial interest in a client held through a retirement or savings plan would be considered to be a direct or material indirect financial interest in the client. Accordingly, if a *covered* member had such a financial interest, independence would be considered to be impaired.

See interpretation 101-1.B [ET section 101.02] for additional restrictions relating to all partners and professionals of the firm.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

67. Servicing of Loan

.134

Question—Would the mere servicing of a loan by a client financial institution impair independence with respect to the client?

.135

Answer—No.

[Replaces previous ruling No. 67, *Servicing of Loan*, November 1993. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

68. Blind Trust

.136

Question—Would independence be considered to be impaired if a member transferred a direct financial interest in a client into a blind trust?

.137

Answer—Independence would be considered impaired if a *covered* member had a direct financial interest in a client, whether or not the interest was placed in a blind trust. Further, the covered member should ensure that any blind trust for which he or she is a beneficiary does not hold a direct or material indirect financial interest in any clients with respect to which he or she is a covered member.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

69. Investment With a General Partner

.138

Question—A private, closely held entity is the general partner and controls (as defined in Generally

Accepted Accounting Principles) limited partnership A. The member has a material financial interest in limited partnership A. The member's firm has been asked to perform an attest engagement for a new limited partnership (B), which has the same general partner as limited partnership A. Would independence be considered to be impaired with respect to limited partnership B?

.139

Answer—Because the general partner has control over limited partnership A, the *covered* member would be considered to have a joint closely held investment with the general partner, who has significant influence over limited partnership B, the proposed client. Accordingly, independence would be considered to be impaired with respect to limited partnership B if the covered member had a material investment in limited partnership A.

[Replaces previous ruling No. 69, *Joint Investment With a Promoter and/or General Partner*, April 1991, effective April 30, 1991. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

70. Member's Depository Relationship With Client Financial Institution

.140

Question—A member maintains checking or savings accounts, certificates of deposit, or money market accounts at a client financial institution. Would these depository relationships impair independence?

.141

Answer—If an individual is a covered member, independence would not be considered to be impaired provided that—

- The checking accounts, savings accounts, certificates of deposit, or money market accounts were fully insured by the appropriate state or federal government deposit insurance agencies or by any other insurer; or
- The uninsured amounts, in the aggregate, were not material to the net worth of the covered member. (When insured amounts were considered material, independence would not be considered impaired provided the uninsured balance was reduced to an immaterial amount no later than 30 days from the date the uninsured amount becomes material.)

A firm's depository relationship would not impair its independence provided that the likelihood of the financial institution experiencing financial difficulties was considered to be remote.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Revised, effective March 31, 2003, by the Professional Ethics Executive Committee.]

71. Use of Nonindependent CPA Firm on an Engagement

.142

Question—Firm A is not independent with respect to a client. Partners or professional employees of Firm A are participating on Firm B's attest engagement team for that client. Would Firm B's independence be considered to be impaired?

.143

Answer—Yes. The use by Firm B of partners or professional employees from Firm A as part of the attest engagement team would impair Firm B's independence with respect to that engagement.

However, use of the work of such individuals in a manner similar to internal auditors is permissible provided that there is compliance with the Statements on Auditing Standards. Applicable literature contained in the Statements on Auditing Standards should be consulted.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

72. Member on Advisory Board of Client

.144

Question—Would service on a client's advisory board impair independence?

.145

Answer—Independence would be considered to be impaired if *any* partner or professional employee of the firm served on the advisory board unless all the following criteria are met: (1) the responsibilities of the advisory board are in fact advisory in nature; (2) the advisory board has no authority to make nor does it appear to make management decisions on behalf of the client; and (3) the advisory board and those having authority to make management decisions (including the board of directors or its equivalent) are distinct groups with minimal, if any, common membership.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[73.] Meaning of the Period of a Professional Engagement

[.146–.147]

[Deleted February 1998]

74. Audits, Reviews, or Compilations and a Lack of Independence

.148

Question—If a member or his or her firm is not independent with respect to a client, is it permissible to issue an audit, review, or compilation report for that client?

.149

Answer—A member or his or her firm may not issue an audit or review report if not independent of the client. A compilation report may be issued provided that the report specifically discloses the lack of independence without giving reasons for the impairment.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

75. Membership in Client Credit Union

.150

Question—Does membership in a client credit union impair independence?

.151

Answer—A *covered* member's association with a client credit union would not impair independence provided all of the following criteria are met:

1. The covered member individually qualifies to join the credit union (other than by virtue of the professional services provided to the client).
2. Any loans from the credit union to the covered member meet the conditions specified in interpretation 101-1.A.4 [ET section 101.02] and are made under normal lending procedures, terms, and requirements (see interpretation 101-5 [ET section 101.07]).
3. Any deposits with the credit union meet the conditions specified in ruling No. 70 [ET section 191.140–.141] under rule 101 [ET section 101.01].

Partners and professional employees may be subject to additional restrictions as described in interpretation 101-1.B [ET section 101.02].

[Effective February 28, 1992, earlier application is encouraged. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[76.] Guarantee of Loan
[.152–.153]

[Deleted December 1991]

[77.] Individual Considering or Accepting Employment With the Client
[.154–.155]

[Deleted April 2003]

[78.] Service on Governmental Board
[.156–.157]

[Deleted August 1995]

79. Member's Investment in a Partnership That Invests in Client

.158

Question—Would independence be considered to be impaired if a member had a direct financial interest in a partnership that invests in a client?

.159

Answer—If a *covered* member is a general partner, or functions in a capacity similar to that of a general partner, in a partnership that invests in a client, the covered member is deemed to have a direct financial interest in the client. Independence is considered to be impaired.

If a *covered* member is a limited partner in a partnership that invests in a client, the covered

member is considered to have an indirect financial interest in the client. Independence would be considered to be impaired if the indirect financial interest is material to the covered member's net worth.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[80.] The Meaning of a Joint Closely Held Business Investment [.160–.161]

[Deleted November 2001]

81. Member's Investment in a Limited Partnership

.162

Question—A member is a limited partner in a limited partnership (LP), including a master limited partnership. A client is a general partner in the same LP. Is independence considered to be impaired with respect to (1) the LP, (2) the client, and (3) any subsidiaries of the LP?

.163

Answer—**1.** A *covered* member's limited partnership interest in the LP is a direct financial interest in the LP that would impair independence under interpretation 101-1.A.1 [ET section 101.02].

2. The LP is an investee of the client because the client is a general partner in the LP. Therefore, under interpretation 101-8 [ET section 101.10], if the investment in the LP were material to the client, a *covered* member's financial interest in the LP would impair independence. However, if the client's financial interest in the LP were not material to the client, a *covered* member's immaterial financial interest in the LP would not impair independence.

3. If the *covered* member is a limited partner in the LP, the covered member is considered to have an indirect financial interest in all subsidiaries of the LP. If the indirect financial interest in the subsidiaries were material to the covered member, independence would be considered to be impaired with respect to those subsidiaries under interpretation 101-1.A.1 [ET section 101.02].

If the covered member or client general partner, individually or together can control the LP, the LP would be considered a joint closely held investment under ET section 92.16.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

82. Campaign Treasurer

.164

Question—A member serves as the campaign treasurer of a mayoral candidate. Would independence be considered to be impaired with respect to (1) the political party with which the candidate is associated, (2) the municipality of which the candidate may become mayor, or (3) the campaign organization?

.165

Answer—Independence would not be considered to be impaired with respect to the political party or municipality. However, if *any* partner or professional employee of the firm served as campaign treasurer, independence would be considered to be impaired with respect to the campaign organization.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[83.] Member on Board of Component Unit and Auditor of Oversight Entity [.166–.167]

[Deleted January 1996]

[84.] Member on Board of Material Component Unit and Auditor of Another Material Component Unit

[.168–.169]

[Deleted January 1996]

85. Bank Director

.170

Question—May a member in public practice serve as a director of a bank?

.171

Answer—Yes; however, before accepting a bank directorship, the member should carefully consider the implications of such service if the member has clients that are customers of the bank.

These implications fall into two categories:

a. Confidential Client Information—Rule 301 [ET section 301.01] provides that a member in public practice shall not disclose any confidential client information without the specific consent of the client. This ethical requirement applies even though failure to disclose information may constitute a breach of the member's fiduciary responsibility as a director.

b. Conflicts of Interest—Interpretation 102-2 [ET section 102.03] provides that a conflict of interest may occur if a member performs a professional service (including service as a director) and the member or his or her firm has a relationship with another entity that could, in the member's professional judgment, be viewed by appropriate parties as impairing the member's objectivity. If the member believes that the professional service can be performed with objectivity and the relationship is disclosed to and consent is obtained from all appropriate parties, performance of the service shall not be prohibited.

In view of the above factors, it is generally not desirable for a member in public practice to accept a position as bank director where the member's clients are likely to engage in significant transactions with the bank. If a member is engaged in public practice, the member should avoid the high probability of a conflict of interest and the appearance that the member's fiduciary obligations and

responsibilities to the bank may conflict with or interfere with the member's ability to serve the client's interest objectively and in complete confidence.

The general knowledge and experience of CPAs in public practice may be very helpful to a bank in formulating policy matters and making business decisions; however, in most instances, it would be more appropriate for the member as part of the member's public practice to serve as a consultant to the bank's board. Under such an arrangement, the member could limit activities to those which did not involve conflicts of interest or confidentiality problems.

[86.] Partially Secured Loans
[.172–.173]

[Deleted February 1998]

[87.] Loan Commitment or Line of Credit
[.174–.175]

[Deleted February 1998]

[88.] Loans to Partnership in Which Members are Limited Partners
[.176–.177]

[Deleted February 1998]

[89.] Loan to Partnership in Which Members are General Partners
[.178–.179]

[Deleted February 1998]

[90.] Credit Card Balances and Cash Advances
[.180–.181]

[Deleted February 1998]

91. Member Leasing Property to or From a Client

.182

Question—Would independence be considered to be impaired if a member leased property to or from a client?

.183

Answer—Independence would not be considered to be impaired if the lease meets the criteria of an operating lease (as described in Generally Accepted Accounting Principles), the terms and conditions set forth in the lease agreement are comparable with other leases of a similar nature, and all amounts are paid in accordance with the terms of the lease.

Independence would be considered to be impaired if a *covered* member had a lease that meets the criteria of a capital lease (as described in Generally Accepted Accounting Principles) unless the lease is in compliance with interpretations 101-1.A.4 [ET section 101.02] and 101-5 [ET section 101.07],

because the lease would be considered to be a loan to or from the client.

[Revised, effective May 31, 1998, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

92. Joint Interest in Vacation Home

.184

Question—A member has a joint interest in a vacation home with a client (or one of the client's officers or directors, or any owner who has the ability to exercise significant influence over the client). Would the vacation home constitute a "joint closely held investment" as defined in ET section 92.16?

.185

Answer—Yes. The vacation home, even if solely intended for the personal use of the owners, would be considered a joint closely held investment as defined in ET section 92.16 if it meets the criteria described in the aforementioned definition.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

93. Service on Board of Directors of Federated Fund-Raising Organization

.186

Question—A member serves as a director or officer of a local United Way or similar organization that operates as a federated fund-raising organization from which local charities receive funds. Some of those charities are clients of the member's firm. Does the member have a conflict of interest under rule 102 [ET section 102.01]?

.187

Answer—Interpretation 102-2 [ET section 102.03] provides that a conflict of interest may occur if a member performs a professional service for a client and the member or his or her firm has a relationship with another entity that could, in the member's professional judgment, be viewed by the client or other appropriate parties as impairing the member's objectivity. If the member believes that the professional service can be performed with objectivity and the relationship is disclosed to and consent is obtained from the appropriate parties, performance of the service shall not be prohibited. (If the service being provided is an attest engagement, consult ethics ruling No. 14 [ET section 191.027-.028] under rule 101 [ET section 101.01]).

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

94. Indemnification Clause in Engagement Letters

.188

Question—A member or his or her firm proposes to include in engagement letters a clause that provides that the client would release, indemnify, defend, and hold the member (and his or her partners, heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management. Would inclusion of

such an indemnification clause in engagement letters impair independence?

.189

Answer—No.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

95. Agreement With Attest Client to Use ADR Techniques

.190

Question—Alternative dispute resolution (ADR) techniques are used to resolve disputes (in lieu of litigation) relating to past services, but are not used as a substitute for the exercise of professional judgment for current services. Would a predispute agreement to use ADR techniques between a member or his or her firm and a client cause independence to be impaired?

.191

Answer—No. Such an agreement would not cause independence to be impaired since the member (or the firm) and the client would not be in threatened or actual positions of material adverse interests by reason of threatened or actual litigation.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

96. Commencement of ADR Proceeding

.192

Question—Would the commencement of an alternative dispute resolution (ADR) proceeding impair independence?

.193

Answer—Except as stated in the next sentence, independence would not be considered to be impaired because many of the ADR techniques designed to facilitate negotiation and the actual conduct of those negotiations do not place the member or his or her firm and the client in threatened or actual positions of material adverse interests. Nevertheless, if a *covered* member and the client are in a position of material adverse interests because the ADR proceedings are sufficiently similar to litigation, ethics interpretation 101-6 [ET section 101.08] should be applied. Such a position would exist if binding arbitration were used.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[97.] Performance of Certain Extended Audit Services

[.194–.195]

[Deleted August 1996]

98. Member's Loan From a Nonclient Subsidiary or Parent of an Attest Client

.196

Question—A member has obtained a loan from a nonclient. The member's firm performs an attest engagement for the parent or a subsidiary of the nonclient. Does the loan from the nonclient subsidiary or parent impair independence?

.197

Answer—A *covered* member's loan that is not a "grandfathered" or "permitted" loan under interpretation 101-5 [ET section 101.07] from a nonclient subsidiary would impair independence with respect to the client parent. However, a loan from a nonclient parent would not impair independence with respect to the client subsidiary as long as the subsidiary is not material to its parent.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

99. Member Providing Services for Company Executives

.198

Question—A member has been approached by a company, for which he or she may or may not perform other professional services, to provide personal financial planning or tax services for its executives. The executives are aware of the company's relationship with the member, if any, and have also consented to the arrangement. The performance of the services could result in the member recommending to the executives actions that may be adverse to the company. What rules of conduct should the member consider before accepting and during the performance of the engagement?

.199

Answer—Before accepting and during the performance of the engagement, the member should consider the applicability of Rule 102, *Integrity and Objectivity* [ET section 102.01]. If the member believes that he or she can perform the personal financial planning or tax services with objectivity, the member would not be prohibited from accepting the engagement. The member should also consider informing the company and the executives of possible results of the engagement. During the performance of the services, the member should consider his or her professional responsibility to the clients (that is, the company and the executives) under Rule 301, *Confidential Client Information* [ET section 301.01].

100. Actions Permitted When Independence Is Impaired

.200

Question—If a member or a member's firm (member) was independent when its report was initially issued, may the member re-sign the report or consent to its use at a later date when his or her independence is considered to be impaired?

.201

Answer—Yes. A member may re-sign the report or consent to its use at a later date when his or her independence is considered to be impaired, provided that no "post-audit work" is performed by the member during the period of impairment. The term "post-audit work," in this context, does not include inquiries of successor auditors, reading of subsequent financial statements, or such

procedures as may be necessary to assess the effect of subsequently discovered facts on the financial statements covered by the member's previously issued report.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

101. Client Advocacy and Expert Witness Services

.202

Question—Would the performance of expert witness services be considered as acting as an advocate for a client as discussed in interpretation 102-6 [ET section 102.07]?

.203

Answer—No. A member serving as an expert witness does not serve as an advocate but as someone with specialized knowledge, training, and experience in a particular area who should arrive at and present positions objectively.

102. Indemnification of a Client

.204

Question—As a condition to retaining a member or his or her firm to perform an attest engagement, a client or prospective client requests that the member (or the firm) enter into an agreement providing, among other things, that the member (or the firm) indemnify the client for damages, losses, or costs arising from lawsuits, claims, or settlements that relate, directly or indirectly, to client acts. Would entering into such an agreement impair independence?

.205

Answer—Yes. Such an agreement would impair independence under interpretation 101-1.A [ET section 101.02] and interpretation 101-1.C [ET section 101.02].

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

103. Attest Report on Internal Controls

.206

Question—If a member or his or her firm provides extended audit services for a client in compliance with interpretation 101-13 [ET section 101.15], would the firm be considered to be independent in the performance of an attestation engagement to report on the client's assertion regarding the effectiveness of its internal control over financial reporting?

.207

Answer—Independence would not be considered to be impaired with respect to the issuance of such a report if both of the following conditions are met:

1. Management has assumed responsibility to establish and maintain internal control.
2. Management does not rely on the firm's work as the primary basis for its assertion and accordingly has (*a*) evaluated the results of its ongoing monitoring procedures built into the normal recurring activities of the entity (including regular management and supervisory

activities) and (*b*) evaluated the findings and results of the firm's work and other separate evaluations of controls, if any.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

104. Operational Auditing Services

.208

Question—As part of an extended audit engagement, a member or his or her firm reviews certain of the client's business processes, as selected by the client, for how well they function, their efficiency, or their effectiveness. For example, a member (or the firm) may assess 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. Would independence be considered to be impaired in performing such services?

.209

Answer—Independence would not be considered to be impaired provided that during the course of the review the member (and other members of his or her firm) is not employed by the client and does not act or appear to act in any capacity equivalent to that of a member of client management. The decision as to whether any of the member's (or the firm's) recommendations will be implemented must rest entirely with management.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

105. Frequency of Performance of Extended Audit Procedures

.210

Question—In providing extended audit services, would the frequency with which a member or his or her firm performs an audit procedure impair independence?

.211

Answer—Independence would not be considered to be impaired provided that the member's (or the firm's) activities have been limited in a manner consistent with interpretation 101-13 [ET section 101.15] and the procedures performed constituted separate evaluations of the effectiveness of the ongoing control and monitoring activities/procedures that are built into the client's normal recurring activities.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

106. Member Has Significant Influence Over an Entity That Has Significant Influence Over a Client

.212

Question—Would independence be considered to be impaired if a member or his or her firm had significant influence, as defined in ET section 92.27, over an entity that has significant influence over

a client?

.213

Answer—Independence would be considered to be impaired if *any* partner or professional of the firm had significant influence over an entity that has significant influence over a client. By having such influence over the nonclient entity, the partner or professional employee would also be considered to have significant influence over the client.

See interpretation 101-8 [ET section 101.10] for further guidance.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

107. Participation in Health and Welfare Plan Sponsored by Client

.214

Question—A member participates in or receives benefits from a health and welfare plan (the "plan") sponsored by a client. Would independence be considered to be impaired with respect to the client sponsor or the plan?

.215

Answer—A *covered* member's participation in a plan sponsored by a client would impair independence with respect to the client sponsor and the plan. However, if the covered member's participation in the plan, or benefits received thereunder, arises as a result of the permitted employment of the covered member's immediate family in accordance with interpretation 101-1 [ET section 101.02], independence would not be considered to be impaired provided that the plan is normally offered to all employees in equivalent employment positions.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Revised, November 2002, by the Professional Ethics Executive Committee.]

[108.] Participation of Member, Spouse or Dependent in Retirement, Savings, or Similar Plan Sponsored by, or That Invests in, Client

[.216–.217]

[Deleted November 2001]

109. Member's Investment in Financial Services Products That Invest in Clients

.218

Question—Amounts contributed by a member or a member's firm (member) for investment purposes, including retirement plans, are invested or managed by a nonclient financial services company that offers financial services products, for example, insurance contracts and other investment arrangements, which allow the member to direct his or her investment into debt or equity securities. Under what circumstances would independence be considered to be impaired?

.219

Answer—If a *covered* member is able to direct and does direct his or her investment through a

financial services product into a client, independence would be considered to be impaired because such investment is considered to be a direct financial interest in the client. If the covered member does not exercise his or her ability to direct the investment but the financial services product were to invest in a client, such investment would be a direct financial interest in the client and independence would be considered to be impaired.

If the covered member is not able to direct the investment and the financial services product invests in a client, the covered member is considered to have an indirect financial interest in the client. Independence would be considered to be impaired if the indirect financial interest becomes material to the covered member. (See ethics ruling No. 35 under rule 101 [ET section 191.069–.070] for additional guidance with respect to investments in mutual funds.)

Further, an investment in a financial services product that invests only in clients with respect to which an individual is considered to be a covered member would be considered to be a direct financial interest in such client, and independence would be considered to be impaired.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

110. Member is Connected With an Entity That Has a Loan to or From a Client

.220

Question—A member is associated with an entity as an officer, director, or a shareholder who is able to exercise significant influence over an entity. That entity has a loan to or from a client of the member's firm. Would independence be considered to be impaired with respect to the client?

.221

Answer—If a *covered* member has control over the entity (as defined in Generally Accepted Accounting Principles) the existence of a loan to or from the client would impair independence unless the loan from the client is specifically permitted under interpretation 101-5 [ET section 101.07].

If *any* partner or professional employee of the firm is connected with the entity as an officer, director, or shareholder who is able to exercise significant influence over the entity, but is unable to control the entity, he or she should consider interpretation 102-2 [ET section 102.03]. Interpretation 102-2 provides that a conflict of interest may occur if a member performs a professional service for a client and the member or his or her firm has a relationship with another entity that could, in the member's professional judgment, be viewed by the client or other appropriate parties as impairing the member's objectivity. If the member believes that the professional service can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client and other appropriate parties, the rule shall not operate to prohibit the performance of the professional service.

When making the decision as to whether to perform a professional service and in making disclosure to the appropriate parties, the member should consider Rule 301, *Confidential Client Information* [ET section 301.01].

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

111. Employee Benefit Plan Sponsored by Client

.222

Question—A member or his or her firm provides asset management or investment services that may include having custody of assets, performing management functions, or making management decisions for an employee benefit plan (the plan) sponsored by a client. Would independence be considered to be impaired with respect to the plan and the client sponsor?

.223

Answer—The performance of investment management or custodial services for a plan would be considered to impair independence with respect to the plan. Independence would also be considered to be impaired with respect to the client sponsor of a defined benefit plan if the assets under management or in the custody of the member are material to the plan or the client sponsor.

Independence would not be considered to be impaired with respect to the client sponsor of a defined contribution plan provided the member does not make any management decisions or perform management functions on behalf of the client sponsor or have custody of the sponsor's assets.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

Footnotes (ET Section 191 — Ethics Rulings on Independence, Integrity, and Objectivity):

fn 1 Currently, DOL regulations are more restrictive than the position taken in this ruling.

Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees*

Standard

1. This standard applies to any auditor intending to be considered an independent accountant with respect to a specific entity within the meaning of the Securities Acts ("the Acts") administered by the Securities and Exchange Commission. At least annually, such an auditor shall:

a. disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence;

b. confirm in the letter that, in its professional judgment, it is independent of the company within the meaning of the Acts; and

c. discuss the auditor's independence with the audit committee.

Effective Date

2. The above communications are required with respect to audits of companies with fiscal years ending after July 15, 1999, with earlier application encouraged. Auditors and audit committees of first-time registrants shall have these communications prior to the company's initial offering of securities to the public. These communications shall cover all audits of financial statements for periods subsequent to the effective date of this standard, included in a registration statement for an initial public offering of securities, whether performed by the current or a predecessor auditor.

Official Comment

3. In adopting this standard, the Board does not intend that an isolated and inadvertent violation of the standard's requirements would constitute a per se impairment of the auditor's independence, provided that the auditor is in compliance with all other independence rules. The Board believes, however, that in such circumstances the auditor must remedy violations of the standard's requirements promptly upon discovery.

Background and Basis for Conclusions

4. In May 1998 the ISB issued an Invitation to Comment (ITC 98-1) regarding a proposed recommendation to the Executive Committee of the SEC Practice Section (SECPS) of the American Institute of Certified Public Accountants. The proposed recommendation would have required audit firms that are members of SECPS to confirm annually to the audit committee (or board of directors) of each public company audit client, each year, that the firm was independent of the client. In the confirmation the auditor would also offer to meet with the audit committee to discuss independence matters.

5. The Board received twenty-six letters in response to the ITC. Most of the letters were supportive, but some urged the Board to go further and require communication to the audit committee of the important matters considered in each particular situation in reaching a conclusion that independence was maintained.

6. After deliberation, the Board concluded that it agreed with those who suggested that the proposal be expanded, and it also decided that it would itself address the matter as a proposed standard, rather than ask the Executive Committee of SECPS to do so. Consequently, the proposal was converted from an Invitation to Comment to an Exposure Draft of a Board pronouncement. In addition, the Board decided that the discussion about independence between the auditor and the audit committee should be required, rather than encouraged by the auditor's written communication.

7. The revised proposal was re-exposed as an Exposure Draft of an ISB standard. Comment was specifically solicited from those that had responded to the initial invitation to comment, and from several groups representing investors. Twenty-two comment letters were received, and most supported the proposal. The Board believes that the proposed pronouncement will improve corporate governance by affording to audit committees a mandated opportunity to deepen their understanding of auditor independence issues. Companies are required by the Acts to engage "independent" accountants, and this proposal will assist directors in satisfying themselves that the company has met that requirement. The Board also believes that a mandate that audit firms describe and discuss the judgmental matters that might impact on independence will bring more focus within firms on this important issue.

8. Some suggested that the Board provide guidance on how an auditor could “cure” a failure to comply with the standard. The Board did not believe it was appropriate to comply with that request, but it did add the “Official Comment” to clarify its intent in the event of an isolated and inadvertent violation.

9. Some respondents objected to the provision in the exposure draft that would seem to have imposed a requirement on audit committees to discuss independence with the auditor, on the basis that the Board did not have such

authority. Without concluding on that question, the Board decided that it would revise the provision to impose the discussion requirement solely on the auditor. The Board recognizes, however, that the auditor could withhold his or her audit report until such discussion took place with the audit committee so that the auditor was in compliance with this professional requirement.

10. The Board considered whether to require that the discussion between the audit committee and the auditor take place before any substantive audit procedures had begun. There are clear benefits to the audit committee to obtaining satisfaction about independence before the audit is started. The Board recognizes, however, that many audit committees have established meeting schedules which would not accommodate such a discussion before the audit begins, and it concluded that imposing such a requirement was not essential to achieving the objectives of this pronouncement.

11. The Board recognizes that every additional requirement imposes costs, but the Board believes that the costs to implement this pronouncement would be small when compared with the benefits.

12. This standard was adopted unanimously by the members of the Board.

Members of the Independence Standards Board

William T. Allen, Chair
John C. Bogle
Stephen G. Butler
Robert E. Denham
Manuel H. Johnson
Philip A. Laskawy
Barry C. Melancon
James J. Schiro

ISB Interpretation 00-1

Independence Standards Board
The Applicability of ISB Standard No. 1
When "Secondary Auditors" Are Involved in the Audit of a Registrant

Dates Discussed: November 19, 1999, and January 14, 2000

Date Issued: February 17, 2000

Issue:

1. In January 1999, the ISB issued its Independence Standard No. 1, "Independence Discussions with Audit Committees." ISB No. 1 states its applicability in paragraph 1 as: "This standard applies to any auditor intending to be considered an independent accountant with respect to a specific entity within the meaning of the Securities Acts (the Acts) administered by the Securities and Exchange Commission."

2. The ISB has been requested to interpret how its Standard No. 1 applies when "secondary auditors" are involved in the audit of a registrant. (Secondary auditors are those, other than from the firm serving as primary auditor, that audit a subsidiary or investee of a SEC registrant.) In essence, the question seeks clarification as to how ISB No. 1 allocates responsibilities between primary and secondary auditors, including whether independence discussions should be required with subsidiary or investee audit committees.

3. It is clear that when a subsidiary or investee is itself a registrant, the secondary auditor must comply with ISB No. 1. ISB No. 1 does not, however, directly address the question of secondary auditors where the subsidiary or investee is not a public company.

ISB Interpretation

4. The responsibility to comply with ISB No. 1 rests solely with the primary auditor. The report by the primary auditor to the audit committee under ISB Standard No. 1 should, however, include all relationships that might reasonably bear on the independence of all auditors participating, at the request of the primary auditor, in the audit of the registrant's consolidated financial statements, including those of any secondary auditors.

ISB Interpretation 00-2

Independence Standards Board

The Applicability of ISB Standard No. 1
When "Secondary Auditors" Are Involved in the Audit of a Registrant

An Amendment of Interpretation 00-1

ISB Interpretation 00-2

Dates Discussed: May 2, 2000 and July 11, 2000

Date Issued: July 11, 2000

Issue

1. The Board has been asked to reconsider its Interpretation 00-1 and has determined to amend that interpretation as follows.

ISB Interpretation

2. The responsibility to comply with ISB No. 1 rests solely with the primary auditor. The report by the primary auditor to the audit committee should include all of its relationships and those of its domestic and foreign associated[1] firms that could reasonably bear on the independence of the primary auditor. If the primary auditor is relying on the work of secondary auditors not associated with the primary auditor's firm, the report of the primary auditor should either describe any such secondary auditors' relationships, or it should state that it does not do so.

[1] For this purpose, an associated firm is a firm that is a member of, correspondent with, or similarly associated with the primary auditor's firm or association of firms.

ISB No. 2

Independence Standard No. 2

Certain Independence Implications of Audits of Mutual Funds and Related Entities

December 1999

(As Amended - July 2000)

ISB
Independence
Standards
Board

Independence Standards Board

Standard No. 2

Certain Independence Implications of Audits of Mutual Funds and Related Entities

December 1999

(As Amended - July 2000)

Independence Standards Board Standard No. 2

Certain Independence Implications of Audits of Mutual Funds and Related Entities

December 1999

(As Amended - July 2000)

SUMMARY

This Independence Standard, as described in more detail herein:

A. Requires the audit firm, certain of its retirement plans, the audit engagement team and those in a position to influence the audit, when the firm is auditing mutual funds, to be independent of all sister funds and all related non-fund entities. In addition, when auditing a related non-fund entity, independence would be required by the same entities and individuals of all funds in the mutual fund complex.

B. Permits:

   i. Direct investment in non-audit client sister funds by all other partners and employees of the firm.

   ii. Spouses and dependents of partners, other than of the audit engagement team and in a position to influence the audit, to invest through an employee benefit plan in mutual funds that are audit clients.

C. Is effective with respect to audits of financial statements for periods beginning 60 days after existing rules of the SEC are modified to remove conflicts with the Standard. The SEC has proposed rulemaking with regard to its independence rules, including consideration of the provisions of this Standard. Notification of relevant changes by the SEC will be posted to the ISB's website at www.cpaindependence.org when confirmation is received by the Board.

Independence Standards Board Standard No. 2

Certain Independence Implications of Audits of Mutual Funds and Related Entities

December 1999

(As Amended - July 2000)

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Independence Standards Board Standard No. 2

Certain Independence Implications of Audits of Mutual Funds and Related Entities

INDEPENDENCE STANDARD

(Please note that terms appearing for the first time in **bold** type are defined in paragraph 6.)

STANDARD

Applicability

1. This Standard applies to the determination of auditor independence with respect to audits of **mutual funds** and related entities which are subject to the independence requirements of the SEC.

Standard

2. The auditing firm will not be considered independent of all of the entities within the **mutual fund complex** if the partners in the firm, either individually or collectively, have significant influence over any entity in that complex.

3. In other situations:

a. The auditing firm itself, and its retirement plans *(other than self-directed defined contribution employee benefit plans, such as 401(k) plans)*, and

b. The audit engagement team and **those in a position to influence the audit**, when the firm is auditing:

i. A *fund*, must be independent of all ***sister funds***.

ii. A *related* ***non-fund entity***, must be independent of all *related non-client funds*—that is, all funds in the complex.[1]

iii. One or more *funds*, must be independent of all *related non-fund entities* in the mutual fund complex.[2]

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[1] If the related non-fund entity is an **investment adviser**, this would include all funds it advises, even if they are outside this mutual fund complex.

[2] If the fund's investment adviser is outside the mutual fund complex, the independence requirement still applies. That independence restriction further extends to any parent company to which the investment advisory fees from the client funds are material, and to all other subsidiaries of those covered parent companies.

4. A spouse, cohabitant or dependent of a partner not on the audit engagement team, and not in a position to influence the audit, is permitted to invest through an employer-sponsored benefit plan in mutual funds that are audit clients of the firm.

Effective Date

5. The above requirements are effective with respect to audits of financial statements for periods beginning 60 days after existing rules of the SEC are modified to remove conflicts with the Standard. The SEC has proposed rulemaking with regard to its independence rules, including consideration of the provisions of this Standard. Notification of relevant changes by the SEC will be posted to the ISB's website at www.cpaindependence.org when confirmation is received by the Board.
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Definitions

6. Terms and phrases noted in **bold** in the Standard are defined below:

a. **Investment adviser**. Manages the mutual fund's portfolio according to the objectives and policies described in the fund's prospectus, executes its portfolio transactions, and typically serves as distributor of its shares to investors. When a **"sub-adviser"** substantively acts in the overall management role of an investment adviser with respect to a fund, it is to be considered the same as an investment adviser. (A **sub-adviser** is an entity generally identified, subcontracted and overseen by the investment adviser for a portfolio management role.)

b. **Mutual funds**. Investment companies subject to the Investment Company Act of 1940. These include, for example, open-end and closed-end funds, and unit investment trusts.

c. **Mutual fund complex**. The mutual fund operation in its entirety, including all the funds, plus the sponsor, its ultimate parent company, and their subsidiaries.

d. **Non-fund entity.** For example, the investment adviser, a broker-dealer, a bank, or an insurance company in the mutual fund complex.

e. **Sister funds**. Mutual funds in a complex with a common investment adviser.

f. **Those in a position to influence the audit**. Those in a position to influence the audit are those who supervise or have direct management responsibility for, (including at all successively senior levels, up through the firm's chief executive), or provide technical consultation, quality control or other oversight of, the partners and staff members involved in the audit. (In determining whether an individual meets one of these criteria, firms must be sensitive to their immediate practice environment. For example, in a small office, practice unit or firm, all partners might be considered as in a position to influence the audit, even if in an informal manner.)

BACKGROUND

7. At its March 12, 1999 meeting, the Board agreed that certain mutual fund issues should be added to its project agenda, and that the project should be expedited by moving directly to an Exposure Draft (ED). The project had been recommended in a letter from the Chief Accountant of the SEC and also requested through practice experience. A Board oversight task force was appointed to provide guidance for the project, and a broad-based project task force reviewed the documents for completeness and clarity.

8. In September 1999 the ISB issued ED 99-1, *Certain Independence Implications of Audits of Mutual Funds and Related Entities.* The ED proposed rules similar to those in this final Standard, except that it also would have required independence of partners (and, in certain cases, those defined as "managerial employees") in an office participating in a significant portion of the audit engagement.

9. The Board received twelve letters in response to the ED, all of which were generally supportive, and many had specific suggestions for changes. After deliberation, the Board agreed with certain of those recommendations, as described in the "Basis for Conclusions."

10. In June 2000 the Board determined to modify the effective date of this Standard as described in paragraph 5. An exposure draft proposing this change was issued and seventeen comment letters were received, virtually all of which supported this amendment.

11. The Board's general rules (the published SEC rules adopted at the commencement of the Board) require an audit firm, and its "members" (as defined), to be independent of its audit clients. This general independence requirement is not changed by ISB Standard No. 2, except as to paragraph 4.

BASIS FOR CONCLUSIONS

Introduction

12. The Board's desire is to provide guidance in mutual fund auditor independence issues to help ensure, in a rapidly changing environment, the continued integrity of audited financial statements for the ultimate benefit of investors and other users of these statements.

13. It is believed the Standard will also significantly reduce a perceived lack of clarity in present guidance, and thereby reduce likely diversity in practice.

14. To accomplish its goal, the ISB weighed a variety of significant factors, some of which are described below, in reaching its determination of an appropriate Standard.

Attributes of the Mutual Fund Organizational Structure

15. The organizational structure of a mutual funds complex (See Appendices A and B) varies significantly from that of a typical corporation, and the Board believes these differences are relevant to the setting of auditor independence standards. Specifically, SEC Regulation S-X, Rule 2-01 (b) states that auditor independence is required as to the client and "…any of its parents, its subsidiaries, or other affiliates…," but the typical mutual fund/adviser relationship is not that of a subsidiary/parent. Among the principal differences are that:

a. In an investment adviser/mutual fund relationship, there is no majority ownership or voting control, as is present in a parent of a subsidiary; and

b. Unlike the case of a subsidiary, the investment income of a mutual fund, after the deduction of adviser management fees, distribution fees, and other fund expenses, is distributed to the fund shareholders as opposed to the related investment adviser.

On the other hand, while not having voting control of a fund, the investment adviser usually provides the fund's officers and performs substantially all services required in its operations, and thus plays an important, even controlling, role in its policies and operations.

Analysis of Common Service Providers

16. Mutual funds often use common service providers to centralize services and control costs, and the Board believes such common services are relevant to the related independence issues. In analyzing the key factors and threats relevant to the sister fund issue, the Board concluded that the use among funds of a common investment adviser was an important enough link to provide the basis for the independence restriction. In response to comments received on the ED, the circumstances under which "sub-advisers" also would be restricted

were clarified to cover only those situations in which the sub-adviser substantively acts in the overall management role of an investment adviser, because it is in that role, rather than as a portfolio manager, that any potential threat to independence exists.

17. The Board also considered the providers of other common services, including fund boards of directors and accounting systems, but concluded they were less relevant than a common investment adviser and that the independence restriction should be based solely on the presence of common investment advisers.

Difference between Defined Benefit and Defined Contribution Plan Investments

18. The Board distinguished between the firm-directed investments of firm defined benefit plans and the self-directed investment choices available in certain firm defined contribution plans (such as 401(k) plans), and concluded that the risks differed sufficiently to provide a lesser restriction for certain personnel in the defined contribution plans. That is, the direct beneficiary of investment performance in a defined benefit plan is the firm sponsor, since the level of further firm contributions will be affected by the investment performance. By contrast, the direct beneficiary of investment performance in a defined contribution plan is the employee. As a result, the Board concluded that the firm's defined benefit plans should not be able to invest in non-audit client sister funds, but that the firm could offer a sister fund investment alternative in its defined contribution plans to non-involved partners and staff without impairing its independence.

Partner Spousal Employee Benefit Plan Investments

19. The Board recognizes that permitting investments through employer-sponsored benefit plans by partners' spouses in mutual funds that are audit clients is not consistent with the present rules. However, the Board also believes this change to be warranted as a practical good in this changing social environment, because the risk that such investments will adversely affect audit quality appears trivial. A number of factors were considered in reaching this conclusion, including the following:

a. Many more spouses are working today;

b. Benefit plans (especially 401(k)s) have become much more common;

c. Audits of mutual funds in those plans have become more concentrated within a few large firms due to consolidation of both financial institutions and auditors;

d. A number of plans provide only one family of mutual fund investments. Under existing rules, if the funds are audit clients of a firm, the spouses and dependents of all partners in the firm would be prohibited from participating in the plans. As a result, the person would lose tax

deferral benefits and employer matching contributions, and sometimes have to forfeit accumulated benefits; and

e. It is highly unlikely that those who are exempted could influence the audit.

This decision will be reconsidered when the Board addresses the question of investment in audit clients comprehensively.

Firm Significant Influence Over an Entity in the Mutual Fund Complex

20. Paragraph 2 restricts a firm when its partners collectively have significant influence over an entity in the mutual fund complex. The intent in making such a determination is to address situations where partners are "acting together" in this investment. On the other hand, later knowledge that numerous partners, not having knowledge of one another's common investments, could have had "significant influence" over the entity if they acted together would not indicate that "significant influence" had existed at the earlier date.

Those in a Position to Influence the Audit

21. Paragraph 3 restricts firm partners and employees who are on the audit engagement team and those in a position to influence the audit. (The phrase "those in a position to influence the audit" was substituted for "chain of command," in response to comments received on the ED because it is more descriptive of the individuals included.) The definition of the phrase "those in a position to influence the audit" in paragraph 6 (f) describes two groups of individuals who may have such influence: those with direct management responsibility, and those who provide technical or related consultation. It is intended that the individuals with direct management responsibility for the audit and for related accounting, auditing and similar consultation services be subject to the restrictions of this Standard, whether or not they participate in any way in the audit. On the other hand, professionals in a consulting department, other than the person in charge, may be "recused" and therefore made not subject to the Standard's restrictions, if they in fact are not, and will not be, involved in any way in the audit.

Uninvolved Partners and Managerial Employees

22. Several respondents to the ED suggested that it was unnecessary to include all partners and managerial employees working in the office conducting the audit in the category of those in a position to influence the audit. After deliberation, the Board agreed that there was at most a remote threat to independence from such individuals, if they were otherwise uninvolved in the audit. Consequently, the final Standard does not restrict those persons from investing in sister mutual funds, or their immediate family members from investing in client mutual funds through an employer defined contribution

plan. Existing independence rules, however, prohibit their direct investment in client funds.

Analysis of Other Bases for Evaluating Independence Restrictions

23. In addition to considering the commonality of service providers for sister funds as described above, the Board also considered other and broader alternative bases for evaluating auditor independence in the mutual fund environment. For example, various applications of materiality tests were considered, as was the application of independence restrictions on a case-by-case basis to counter specific threats. The Board concluded that its Standard better fulfills its needs, in part because it provides a simpler but effective approach to addressing the independence threats raised.

Risks/Threats and Safeguards Analysis

24. In view of the importance of a risks/threats analysis and the need for related safeguards, the Board considered extensively the potential for particular independence concerns. This included those threats possible if an auditor were to encounter a systemic problem during the course of auditing one fund that would adversely impact another non-client fund in the complex, shares of which are owned by other individuals in the auditor's firm. (A safeguard to mitigate this potential threat is the fact that the non-client fund would be audited by a different firm.) The general concerns--the possible loss of objectivity in the audit and the need for independence in both fact and appearance--also were discussed. The Board's determination was that while some threats could be envisioned specific to mutual fund-related situations, any remaining threats to the auditor's independence, after considering existing controls and the application of this Standard, were insignificant.

Deferral of Effective Date

25. ISB Standard No. 2 is an integrated set of provisions which the Board believes is appropriately restrictive to protect the public interest and be responsive to the threats envisioned, while not imposing restrictions on those other individuals where the Board believed the risks to be minimal. The Standard developed under this new approach included provisions both more and less restrictive than current SEC rules, principally because of its "on the engagement" focus and spousal benefit plan exemption.

26. The Board initially decided, when ISB No. 2 was issued in December, 1999, that the more restrictive provisions of the document should go into effect on the then-scheduled effective date of June 15, 2000, regardless of whether or not the SEC had amended its more restrictive rules by that time. The "effective date" language in the original Standard read as follows:

> The above requirements are effective with respect to audits of financial statements for periods beginning after June 15, 2000, with earlier application encouraged. However, in certain respects, current

> rules of the SEC and, as to spousal employee benefit plan interests, of the AICPA, are more restrictive than the provisions of this Standard. Compliance with those existing more restrictive rules continues to be necessary unless and until both the SEC and the AICPA revise those rules. Notification that these changes have been made will be posted to the ISB's website at www.cpaindependence.org when confirmation is received by the Board. Where provisions of this Standard are more restrictive, those provisions are to be complied with as of the above effective date.

27. Subsequently, questions were raised as to the appropriateness of a partially effective Independence Standard, on the basis that it would add unnecessarily to the existing complexity of regulations.

28. Based upon its consideration of various factors, the Board determined that a deferral of the original June 15, 2000 effective date of ISB Standard No. 2 until 60 days after existing rules of the SEC are modified to remove conflicts with the Standard is in the best interests of its constituents and therefore appropriate.

29. In reaching this decision, the Board acknowledges the statutory oversight responsibility of the SEC for the activities of the Board. In light of that, it concluded that it would not be desirable to impose a set of new independence restrictions while existing rules remain in effect until the SEC endorsed (or indicated it did not object to) such new rules by modifying its existing ones.

30. In May 2000 the AICPA's Professional Ethics Executive Committee adopted the following policy statement:

> As to any pronouncement passed by the Independence Standards Board (ISB), the Professional Ethics Executive Committee (PEEC) will treat such a pronouncement as authoritative for any engagement requiring independence unless and until the PEEC announces that it will not view that pronouncement as authoritative. Accordingly, in situations where an AICPA standard is more restrictive, in total or in part, than an ISB pronouncement, the PEEC will not consider a member's independence to be impaired as a result of their non-compliance with respect to a more restrictive AICPA standard until members are given notice of the PEEC's rejection of the ISB's less restrictive pronouncement.

Consequently, the language regarding the AICPA's rules has been deleted from the effective date paragraph.

Summary

31. Based upon:

> a. Its consideration of the unique organizational structure of mutual fund entities;

b. The differences inherent in self-directed defined contribution employee benefit plans;

c. The lack of apparent significant independence risk from mutual fund audits; and

d. The very limited threats to auditor independence from participation in an employer-sponsored benefit plan by spouses and dependents of those neither on the audit engagement team nor in a position to influence the audit,

the Board believes its Standard is appropriately restrictive to protect the public interest and be responsive to those threats that were envisioned, while not imposing restrictions on those other individuals and plans where the Board believes the risks are minimal.

32. The Board recognizes that every additional requirement imposes costs, but the Board believes that the costs to implement this pronouncement will be small when compared with the benefits.

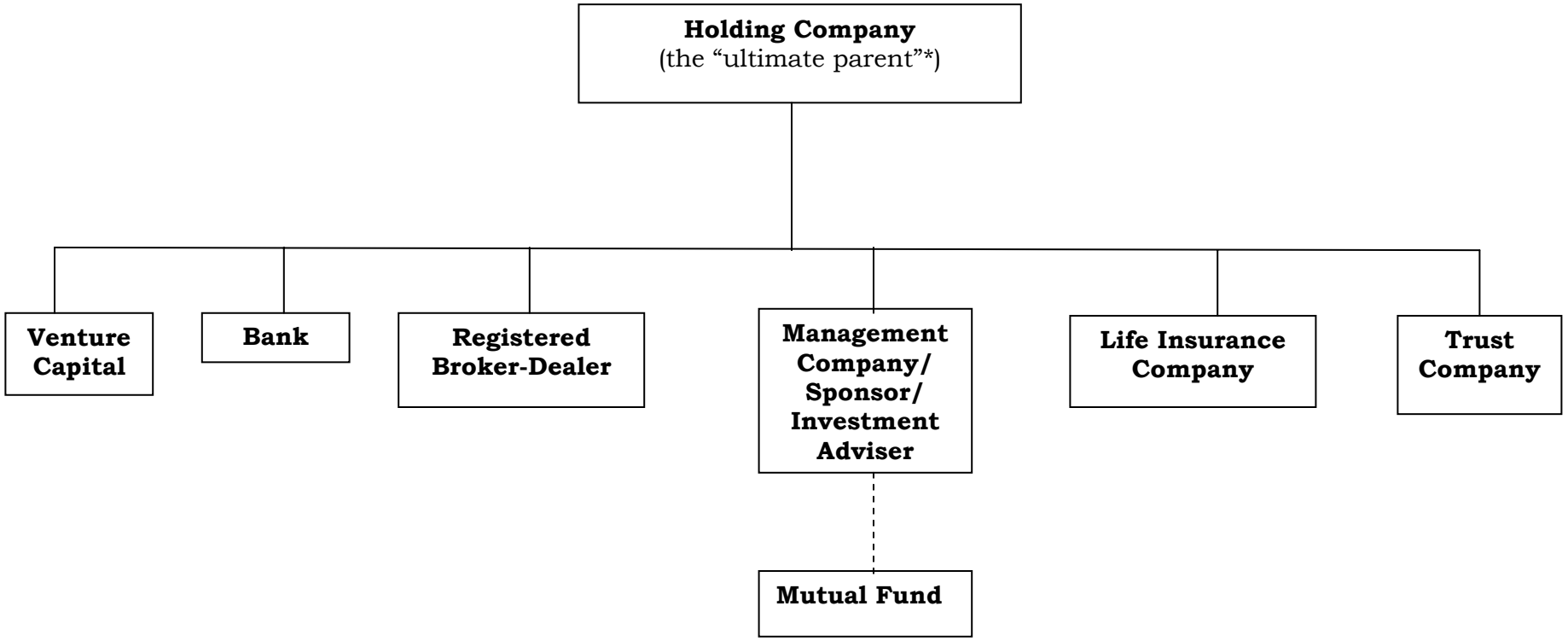
33. This Standard and its amendment were both adopted unanimously by the the Board.

Members of the Independence Standards Board

William T. Allen, Chair	Manuel H. Johnson
John C. Bogle	Philip A. Laskawy
Stephen G. Butler	Barry C. Melancon
Robert E. Denham	James J. Schiro

Appendix A

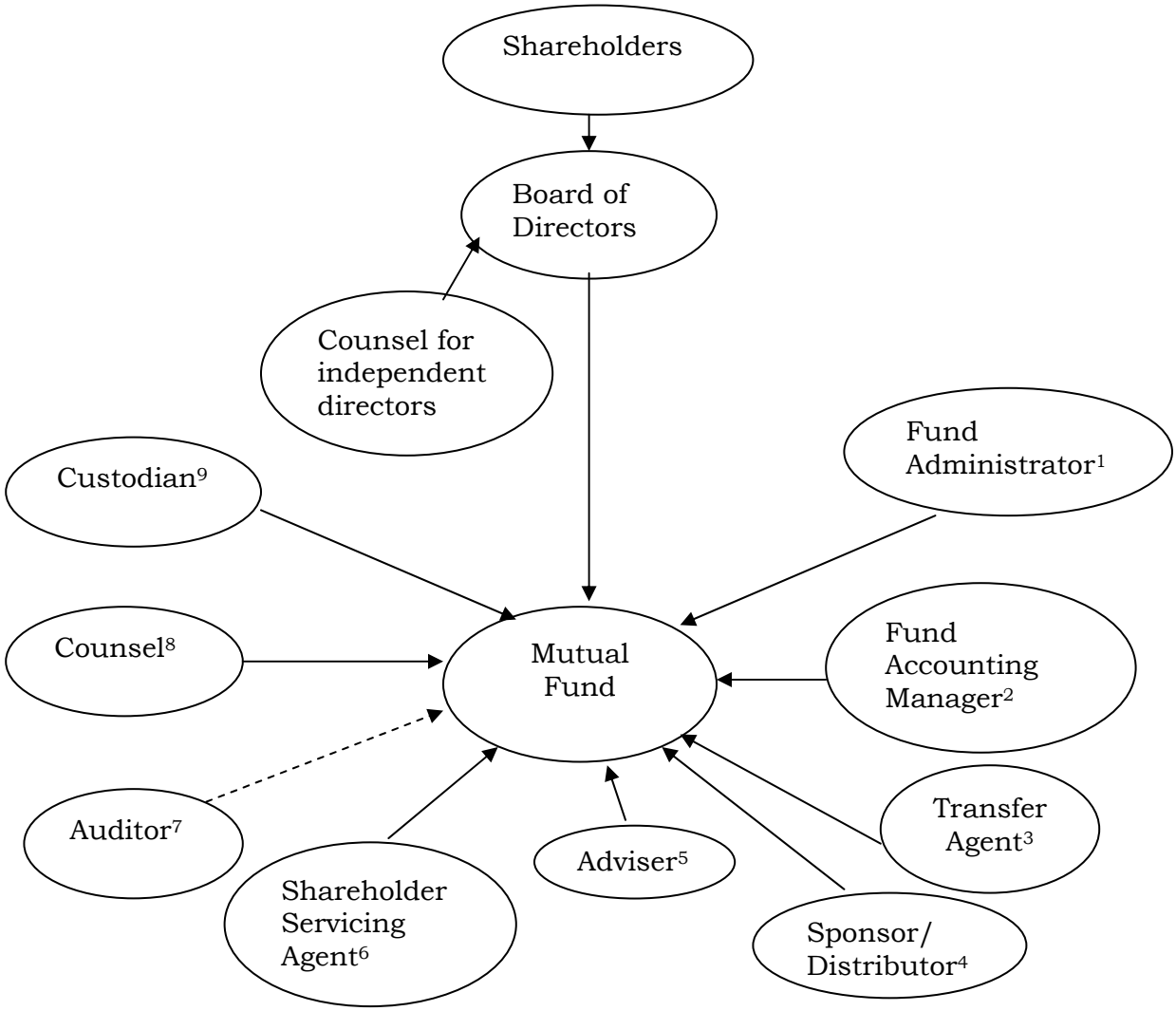
Organization Chart
The Structure of a Typical Mutual Fund *Complex*



*May include any number of levels of subsidiaries, and may be public or private.

Appendix B

Organization Chart
The Structure of a Typical Mutual *Fund*



1. Makes presentations for the board, and prepares SEC, tax and shareholder reports.
2. Maintains *fund's* accounting records, computes net asset value (NAV) daily and forwards NAV to transfer agent, and prepares the fund's financial statements.
3. Maintains s*hareholder* accounting records and issues share certificates.
4. Conceives the fund and markets it to investors.
5. Manages the fund and executes its portfolio transactions. Also provides portfolio management services and overall executive management of the fund, including (in consultation with the board) selection of other service providers.
6. Responds to shareholders' inquiries by accessing records maintained by Transfer Agent.
7. Audits the fund's financial statements.
8. Provides legal services.
9. Holds securities in safekeeping; receives and delivers securities as instructed. Except for the auditor, the only entity servicing the fund which (absent meeting certain incremental criteria) *must* be independent of the fund complex.

Important Note: The Securities and Exchange Commission recently released a comprehensive revision to its auditor independence requirements (the Revision). The Revision contains provisions covering settlement of capital and retirement interests when former firm professionals join firm audit clients, which supercede the requirements described in paragraph 2.b.iv of this standard. Consequently, at the next ISB meeting, the ISB staff will recommend that the Board delete paragraph 2.b.iv of this standard. All other provisions of this standard remain in effect. The Revision can be found at the SEC's website at www.sec.gov.

Independence Standard No. 3

Employment with Audit Clients

July 2000

ISB

Independence
Standards
Board

Independence Standards Board Standard No. 3

Employment with Audit Clients

July 2000

SUMMARY

This standard describes safeguards that firms should implement when their professionals join firm audit clients. These safeguards are designed to assist in ensuring that:

- professionals who are broadly evaluating their career options will exercise an appropriate level of skepticism while performing audits prior to their departure from the firm;

- a former firm professional now employed by the client cannot circumvent the audit because of familiarity with its design, approach, or testing strategy; and

- the remaining members of the audit team maintain objectivity when evaluating the work and representations of a former firm professional now employed by the audit client.

The procedures should be adapted depending on several factors, including whether the professional served as a member of the audit team, the positions he or she held at the firm and has accepted at the client, the length of time that has elapsed since the professional left the firm, and the circumstances of his or her departure.

The standard also specifies the circumstances under which capital and retirement balances owed to the departing professional should be liquidated or settled to preserve the firm's independence.

The standard's requirements are effective for employment with audit client situations arising after December 31, 2000.

Independence Standards Board Standard No. 3

Employment with Audit Clients

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Independence Standards Board Standard No. 3

Employment with Audit Clients

STANDARD

Underlying Principle

1. An audit firm's independence is impaired with respect to an audit client that employs a former firm professional who could, by reason of his or her knowledge of and relationships with the audit firm, adversely influence the quality or effectiveness of the audit, unless the firm has taken steps that effectively eliminate such risk.

Safeguards

2. An established program of safeguards including the following procedures, when conscientiously administered, is deemed to constitute steps that effectively eliminate the risk of independence impairment:

a. Pre-change in employment safeguards:

i. Firm professionals are required promptly to report to the firm conversations between themselves and an audit client respecting possible employment.

ii. Firm professionals engaged in negotiations respecting possible employment with an audit client are immediately removed from the audit engagement.

iii. Upon removal of a professional from the audit engagement as provided above, the firm reviews the professional's work to assess whether he or she exercised appropriate skepticism while working on the audit engagement.

b. Post-change in employment safeguards:

i. If a professional accepts employment with the audit client, the on-going engagement team gives active consideration to the appropriateness or necessity of modifying the audit plan to adjust for risk of circumvention.

ii. When a former firm professional joins an audit client and will have significant interaction with the audit team, the firm takes appropriate steps to provide that the existing audit team members

have the stature and objectivity to effectively deal with the former firm professional and his or her work.

iii. When a former firm professional joins an audit client within one year of disassociating from the firm and the professional has significant interaction with the audit team, the next following annual audit is separately reviewed by a firm professional uninvolved in the audit to determine whether the remaining engagement team maintained the appropriate skepticism when evaluating the representations and work of a former firm professional. The extent of this review should be tailored based on the position that the former professional has assumed at the audit client and other facts and circumstances that would heighten or mitigate threats to independence.

iv. The firm requires the prompt (1) liquidation of all capital balances of former firm partners who become employed by an audit client; (2) settlement[1] of all retirement balances[2] of former firm professionals who become so employed that are not both immaterial to the firm and fixed as to amount and timing of payment; and (3) settlement of retirement balances of any firm professional, regardless of the financial immateriality of such balances to the firm, when, within five years of disassociating from the firm the identity of such former firm professional as an officer or employee of the audit client is required to be disclosed in the audit client's proxy statement or annual report filed with the Securities and Exchange Commission (SEC) pursuant to its regulations.

Effective Date

3. The above requirements are effective for employment with audit client situations arising after December 31, 2000.

[1] In the United States, the payment of retirement benefits to the individual would immediately subject such benefits to income taxes. In some cases, this tax liability can be deferred by transferring the remaining retirement benefits to an Individual Retirement Account or similar vehicle, in which case the amounts become taxable only when paid to the individual. In other cases, the amount can be transferred to a "Rabbi Trust" which also serves to defer such income taxes. A Rabbi Trust is an irrevocable trust whose assets are not accessible to the firm until all benefit obligations have been met; however, such assets are subject to the claims of creditors in the event of the firm's bankruptcy or insolvency. To meet the requirements of this standard, such a trust can only be used if the amounts are fixed as to amount and timing of payment (i.e., the benefits do not fluctuate based on firm results, and the present value of benefits due to the departing professional can be calculated and placed in the trust), and the bankruptcy of the firm is considered remote.

[2] Retirement balances as used in this statement do not include a professional's benefits under the firm's defined contribution plan, such as a 401(k) plan, if the firm has no obligation to fund the individual's benefits after he or she disassociates from the firm.

BACKGROUND

4. The Board began to study the independence implications of audit firm professionals going to work for the firm's audit clients shortly after its formation. After determining that guidance was needed in these situations, the Board began the process of developing a standard concurrent with its work on a conceptual framework for auditor independence.

5. A Discussion Memorandum (DM 99-1, *Employment with Audit Clients*) covering the issues was prepared with the assistance of a Board oversight task force, and a broad-based project task force consisting of representatives from the investor, preparer, academic, and regulator communities, in addition to members of the auditing profession. The DM was released in March 1999 for a 90-day comment period. Comment from investors was specifically sought; the DM was mailed to several investor organizations and to 370 institutional investors in an effort to encourage responses from that constituency. Twenty-eight comment letters were received. After considering these letters, and with further assistance from the project and Board oversight task forces, the Board developed a proposed standard for public comment.

6. An Exposure Draft (ED) of the proposed standard was released at the end of December 1999 with a comment period that ended on February 29, 2000. Copies of the ED were mailed to a variety of individuals and groups, including those representing investors, to encourage and solicit responses. Fourteen comment letters were received. After considering these comments, and with further assistance from the project and Board oversight task forces, the Board approved the issuance of this standard.

THREATS TO INDEPENDENCE

7. The concerns expressed when professionals leave firms to join audit clients are generally threefold:

a. That partners or other audit team members who resign to accept positions with audit clients may not have exercised an appropriate level of skepticism during the audit process prior to their departure.

b. That the departing partner or other professional may be familiar enough with the audit approach and testing strategy so as to be able to circumvent them once he or she begins employment with the client.

c. That remaining members of the audit team, who may have been friendly with, or respectful of a former partner or other professional when he or she was with the firm, would be reluctant to challenge the decisions of the former partner or professional and, as a result, might accept the client's proposed accounting without exercising appropriate skepticism or maintaining objectivity.

8. The perceived threats to auditor independence when the former partner or professional has retirement benefits or a capital account with the audit firm are as follows:

a. It may appear that ties between the audit firm and the partner or other professional have not been severed – that the firm has placed its "own man" (or woman) at the client, functioning as management, and is in effect auditing the results of its own work.

b. If the retirement benefits of the former partner or other professional vary based on the firm's profits, then the former partner or other professional may be inclined to pay the firm higher fees to inflate his or her retirement benefits (or to increase the likelihood of receiving benefits in unfunded plans). As a result, the firm may be less rigorous in its scrutiny of the client's accounting policies because its fees are overly rich.

c. If the former partner's or other professional's unfunded retirement benefits or other monies held by the firm are material to the firm and the firm is experiencing cash flow problems, the firm may be less rigorous in its audit of the client's financial statements in exchange for forbearance on the amounts owed to the former partner or other professional.

BASIS FOR CONCLUSIONS

9. The Board's desire is to protect the quality and integrity of audited financial statements for the ultimate benefit of investors and other users of those statements. To accomplish this goal, the Board weighed a variety of factors, some of which are described below, in determining an appropriate approach to address the threats to auditor independence posed by situations where firm professionals join audit clients.

Effectiveness of Safeguards

10. The Board believes that the safeguards described in this standard will effectively protect auditor independence in situations where firm professionals go to work for their audit clients. A requirement to review an individual's work after he or she enters into employment negotiations with an audit client and, when appropriate, review the engagement team's work on the subsequent audit, is expected to have a deterrent effect. First, the expectation is that professionals who are broadly evaluating their career options will be more careful to ensure that the work they perform, including the decisions they make during the audit, will withstand scrutiny when they know it will be subject to a special review if they enter into employment negotiations with the audit client. Second, the skepticism of the remaining audit team members when evaluating the statements of a former colleague or leader may be higher; knowing that their work will be reviewed, individuals will most likely be more sensitive to appearing to have acquiesced to a client's aggressive or incorrect accounting, and will be more likely to refrain from doing so.

11. Open discussion of the client's employment of audit firm professionals with the audit committee or board of directors, as required in certain circumstances by ISB Standard No. 1, *Independence Discussions with Audit Committees*, can also serve as an effective safeguard. Airing, "in the sunshine," the potential threats to independence posed by these situations, and the safeguards employed by the firm to protect auditor independence, is likely to sensitize those involved (both the former firm professional now with the client and the remaining audit team) to these issues, and make independence impairments less likely. In addition, while auditors are responsible for upholding their own professional standards, including those related to independence, the audit committee can "set the tone at the top," and emphasize the proper separation between management and the auditor.

12. In developing the standard, the Board allowed for flexibility in adapting the safeguards to the facts and circumstances of the employment situation. The Board believes, for example, that the concerns one would have when a partner joins a client would exist, but to a lesser extent, when professionals with lower levels of responsibility join clients. These concerns would also vary depending on the nature and level of responsibilities assumed by the professional in his or her new role at the client. In addition, the issues may vary for active versus retired partners and other professionals, those leaving the firm voluntarily

versus those terminated, and *engagement* professionals versus firm professionals having little or no direct prior professional relationship with the client. Therefore, the Board believes that an effective standard must establish principles that contemplate a variety of situations, especially as the structure of firms change, and more professionals are given new responsible, non-partner roles in firms.

13. The safeguards proposed in the ED contemplated a review of the former firm professional's work upon employment by the audit client. After further consideration, the Board determined that the trigger for this review should be instead the commencement of employment negotiations between the firm professional and the audit client. The Board believes that the concerns about the work of an audit team member contemplating employment with his or her audit client would exist regardless of whether the firm professional eventually accepted a position at the client. Audit team members in employment negotiations with an audit client should be returned to the engagement only if negotiations cease and employment is no longer sought.

14. When a former firm professional joins an audit client within one year of disassociating from the firm and the professional has significant interaction with the audit team, the standard requires an additional review of the next annual audit following the professional's acceptance of employment. This review is meant to determine whether the audit team had an appropriate level of skepticism when evaluating the work and representations of the former firm professional. Some asked whether such a review should always be performed prior to the firm's "sign-off" on the audit. The Board concluded that the primary benefit of the review is its deterrent effect. That is, members of the audit team, knowing that their work will be subject to an additional review, will be less likely to acquiesce to questionable client proposals. Further, mandating such a review prior to issuance of the audit report could result in deferring for a significant period of time release of the audited financial statements. Such a delay could impose a significant cost to users of financial statements and the Board did not consider the additional benefits, if any, of a pre-issuance review to justify such costs.

Peer Review

15. The ED proposed a requirement that firms have their compliance with the provisions of the standard evaluated in a peer review. The Board believes that peer review of firms' compliance with all auditing and quality control standards, including independence standards, is an important component of the profession's self-regulation. The Board ultimately concluded, however, that the scope or content of established peer review programs should be left to those that administer them, and that mandating participation in such a program should be left to other groups in the profession's regulatory system.

Settlement of Financial Interests

16. The Board considered the necessity of a "full-payout" requirement in situations where capital account and retirement obligations are immaterial to the firm, and fixed as to amount and timing of payment. The Board believes that a former partner of an audit firm who is employed by the firm's audit client should not remain an equity investee in the firm. Accordingly, the standard requires the firm to liquidate all capital accounts prior to the employment of the professional by the audit client, regardless of their materiality.

17. With respect to retirement obligations, the standard requires the firm to settle such obligations prior to employment by the client in all situations where a professional's benefits are not immaterial to the firm, and fixed as to amount and timing of payment. The Board concluded, however, that retirement obligations owed to a former professional that *are* both fixed and immaterial to the firm are not likely to impinge on the firm's independence. On the other hand, it recognized that unsettled amounts may present an "appearance" concern when a former firm professional joins an audit client in a visible position where his or her former employment at the client's audit firm is likely to be disclosed or known. Therefore, the standard mandates settlement of even immaterial retirement obligations when a former firm professional joins an audit client within five years of disassociating from the firm in a position where his or her name is required to be disclosed in the company's proxy statement or annual report to the SEC. However, because the character of retirement benefits is different from capital balances, the Board concluded that settlement of retirement obligations could be done through a "Rabbi Trust" or similar vehicle in certain circumstances.

18. In reaching its conclusions regarding retirement balances, the Board was concerned that a requirement to settle all obligations could create significant tax or other liabilities for the departing partner in either the United States or in a foreign country. In addition, such a requirement might jeopardize the tax status of certain qualified plans if all plan participants were not treated equally. Such a result could serve to either actively discourage the partner from accepting the employment position, require the client to engage a new audit firm, or drive firms to reduce benefits provided under its plans because of accelerated funding requirements. The Board did not believe such consequences were in the public interest except for benefits that were not both fixed and immaterial to the firm, and in the limited circumstances involving former partners identified in an SEC filing, as described in paragraph 2(b)(iv).

19. Some expressed concern that a former firm professional could join a large, multinational audit client several years after leaving the firm, perhaps at a foreign location. In these circumstances, it is possible that the firm would not be aware of the former professional's new position at the audit client, and may not have liquidated capital balances, or retirement benefits that are not both immaterial and fixed. The Board does not intend that an inadvertent and isolated failure to comply with these settlement provisions be deemed an impairment of independence. It does expect, however, that firms will impose conditions on former professionals who have remaining capital accounts or

other than immaterial and fixed retirement benefits with the firm. One of those conditions should be to advise the firm when they are contemplating a change in employment, to allow the firm to determine if the new employer is a client subject to this standard. These arrangements should eliminate the need to implement elaborate and burdensome partner and employee tracking systems to comply with the provisions of the standard – a concern of some of the respondents to the ED. However, any inadvertent failures to comply should be corrected as soon as identified.

20. In reaching these conclusions, the Board considered making several distinctions, suggested by respondents to the DM, in determining when standards should require a full-payout of retirement benefits. These respondents suggested that a settlement requirement distinguish between defined contribution plan benefits and defined benefit plan benefits, fully funded benefits versus unfunded amounts, fixed benefits versus those that vary based on profits, and other criteria. The Board concluded that benefits which are other than immaterial to the firm, or that vary based on, for example, firm profitability, should always be settled, regardless of the amount of time that has elapsed since the professional's departure from the firm. In addition, the Board concluded that the settlement requirement should not extend to defined contribution plan benefits such as those in a 401(k) plan if the firm has no ongoing obligation to fund the individual's benefits.

The Board's Consideration of a Mandated Cooling-Off Period

21. In studying these issues, the Board considered and rejected a mandated "cooling-off period" – a rule deeming an impairment of the firm's independence when certain firm professionals join an audit client. The Board concluded the costs of such a rule would exceed its benefits.

22. A cooling-off approach would mean either deeming independence to be impaired if *any* firm professional accepted an employment offer from an audit client, or specifying which types of persons would be included in such a rule and which would not. The former course seemed unnecessary, and the latter very complex or arbitrary, since the types of individuals who might represent threats would presumably depend upon their positions in the firm, their roles in the audit, and the positions they would be assuming at the audit client. Generalizing when that combination might constitute a threat to auditor independence and when it would not seemed to be a daunting task which should not be undertaken when an effective alternative is available.

23. The Board believes that with the appropriate safeguards in place, as called for by this standard, the threats to auditor independence are slight. In addition, the Board believes that the benefits to society and the profession of allowing firm professionals to accept employment with audit clients, without fear of jeopardizing their former firm's independence, outweigh the costs. In reaching this conclusion, the Board recognizes that a mandatory cooling-off period may promote the appearance of independence more completely, and might *eliminate* the risk that the audit team could be unduly influenced by a

former colleague, but it believes the differences in actual threats to independence under the two approaches are insignificant.

24. The Board recognizes that the attraction of future employment opportunities draws talented and ambitious recruits to the profession. Turnover at public accounting firms can be quite high, and many recruits do not intend to stay long enough to be promoted to partner. Furthermore, they join public accounting firms because of the broad experience they expect to gain at the firm, and the contacts they expect to make in industry. In addition, turnover within the partner ranks has increased in the last few years. If the future employment prospects of recruits and experienced auditors now working for audit firms were limited by a mandated cooling-off period, the Board is concerned that the caliber of professional attracted to public accounting might decline.

25. The Board agreed with several corporate officials and others responding to the DM who argued that companies benefit from the ability to hire staff at all levels from their audit team. An auditor who has worked for several years on an engagement is often thoroughly familiar with the client's systems, and knows most of the client's key people and their responsibilities. Beyond familiarity with the hiring company, the auditor brings broad experience "to the table" from working at a variety of companies, and sometimes in a variety of industries. In addition, partners and professionals in public accounting firms are generally recognized as experts in accounting, financial reporting, and internal control matters – skills needed by companies with financial reporting responsibilities to investors.

26. A mandated cooling-off period might force a client to choose between, for example, its audit partner and its audit firm, knowing that if the partner was hired, the audit firm would have to be replaced. The Board recognizes that replacement of an audit firm carries costs to firms, clients, and investors. There is a learning curve on a first-year audit; auditors spend significantly more time and resources on them (developing audit programs, familiarizing themselves with the system of internal controls, etc.), and client personnel spend more time answering the auditors' questions and producing documentation previously provided to the prior auditors. And because the Board believes that audits are strengthened by institutional continuity, rotation of auditors and the increased risk that the first-year audit poses carries a cost to investors.

27. The Board acknowledges the counter-argument that a fresh look by a new audit team may carry some benefits that cannot be achieved with the same audit team and approach year after year. The consideration of a requirement that companies change audit firms periodically, however, is beyond the scope of this project.

28. The Board also concluded that a restriction on hiring former audit partners or other professionals may be a heavier burden to smaller corporations in need of the accounting expertise provided by someone familiar with their business and industry, and to smaller firms. Smaller corporations may be at a

disadvantage in recruiting personnel when competing with larger companies with strong national or regional name recognition. Restricting these smaller companies from hiring directly from their audit firm (from among those who know the company well) may hurt them disproportionately.

29. Professionals from smaller accounting firms may face the same difficulties when competing in the job market with professionals from large, well-known firms. A rule that impairs the ability to go from an audit firm directly to a client, where management knows you and you have had a chance to demonstrate your abilities, may be more of a burden if you work for a smaller firm.

30. Finally, the Board concluded that a mandatory cooling-off period would be ineffective in preventing fraud or collusion between the auditor and client. If the firm professional and client management were intent on committing fraud, the professional might remain with the firm rather than risk turning the engagement over to another individual who may uncover the conspiracy. In addition, if management wanted to compensate a firm professional for his or her role in a fraud, a ban on hiring the professional for a certain period of time would not prevent the company from providing payments to the professional, after he or she resigns from the firm, via consulting contracts or other means.

Other Matters

31. The Board concluded that the threats to auditor independence described in this standard are in many respects different from those that arise when former firm professionals are elected as non-executive members of the Board of Directors. Existing rules cover these non-executive director situations and remain in effect.

32. This standard was adopted unanimously by the Board.

Members of the Independence Standards Board

William T. Allen, Chair	Manuel H. Johnson
John C. Bogle	Philip A. Laskawy
Stephen G. Butler	Barry C. Melancon
Robert E. Denham	James J. Schiro

ISB Interpretation 99-1

The Independence Standards Board (ISB) is examining the broader issue of an auditor's association with valuations and fairness opinions. This interpretation, which is based on existing guidance, will not be considered precedent when the ISB addresses the broader issue and may be subject to change based on the ISB's conclusions reached after the public comment process.

Independence Standards Board
Impact on Auditor Independence of
Assisting Clients in the Implementation of FAS 133 (Derivatives)

Date Discussed: March 12, 1999

Date Issued: March 12, 1999

Issue

1. In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 133, "Accounting for Derivative Instruments and Hedging Activities" (FAS 133). FAS 133 requires that all derivatives be recorded on the balance sheet at fair value. Changes in fair value flow through the income statement, unless the instrument qualifies as a hedge, as defined. The statement is effective for fiscal years beginning after June 15, 1999, but companies can adopt the statement as of the beginning of any fiscal quarter that begins after June 1998.

2. For many companies, the complexity of the statement and of the underlying financial instruments will make the implementation process difficult. Company management may need help in understanding the statement's requirements; derivatives must be identified, inventoried, and measured at fair value; hedging relationships must be designated anew and documented as of the implementation date; and many companies will need system modifications in advance of implementation to develop and track the various required fair value measurements.

3. As a consequence of the complexity and implementation challenges inherent in adopting FAS 133, audit firms are likely to find themselves responding to many types of client requests for assistance. This interpretation provides guidance on the auditor independence implications of likely areas of requested assistance, solely with respect to the implementation of FAS 133.

Independence Concerns

4. As it considered these issues, the Board discussed the potential threats to auditor independence. Appraisals and valuation services potentially threaten the auditor's independence because of a "self-review" concern. Under the existing rules, the auditor cannot be placed in the position of "auditing his or her own work" (or the work of someone else in his or her firm). In addition, acting in a capacity equivalent to that of management is viewed as a threat to auditor independence. The auditor may lose his or her objectivity if he or she makes decisions for or develops a mutuality of interest with the client by, for example, valuing the client's assets.

ISB Discussion and Interpretation

5. The Board considered two broad areas of likely assistance and how the existing independence rules would be applied. One category of services relates to the accounting application and the second involves valuation consulting services.

6. Management is responsible for the financial statements, and responsibility for the choices and judgments inherent in the preparation of those financial statements cannot be delegated to the auditor or to anyone else. Whatever the service being provided, the auditor must understand the level of management's expertise and must be satisfied that management has taken responsibility for the assumptions and judgments made during the course of the work, and for the results produced.

7. The Board has concluded that the auditor may provide consulting services on the proper application of FAS 133, including assisting a client in gaining a general understanding of the methods, models, assumptions, and inputs used in computing a derivative's value. To ensure, however, that the auditor's independence is not threatened, as discussed in paragraph 4, the auditor may not prepare accounting entries, compute derivative values or be responsible for key assumptions or inputs used by the client in computing derivative values.

8. The auditor's independence would be impaired if he or she created the initial journal entries that are used to implement or apply the standard, or if in providing the services described below, the auditor's level of assistance was tantamount to doing the work himself or herself.

9. Based on these general guidelines, the following is a list of illustrative services that the auditor may be asked to provide an audit client in implementing FAS 133, along with the Board's conclusions on which of these would impair the auditor's independence.

<u>Accounting Application Assistance</u>

10. Accountants are likely to work with clients in implementing the accounting requirements of FAS 133. Providing guidance to clients (which for this purpose encompasses discussing the requirements of FAS 133, providing advice, and expressing views as to how FAS 133 would be applied in the client's situation) would not impair independence. Performing services which would be subject to audit procedures such as compiling the inventory of derivatives, creating the

initial journal entries to be recorded, initially determining whether specific derivatives meet the relevant criteria as hedges, or making management decisions concerning the implementation of FAS 133 would impair the auditor's independence.

11. The provision of the following services would not impair the auditor's independence:

    a. Discuss the requirements of FAS 133 and the related concepts, terminology and implementation issues.

    b. Provide sample journal entries used to apply FAS 133.

    c. Provide guidance in compiling an inventory of derivatives, as defined by the new rules.

    d. Provide guidance in determining whether specific derivatives meet the relevant criteria as hedges, or provide examples and discuss factors to be considered in formally documenting any hedging relationships and the entity's risk management objective and strategy for undertaking the hedge.

    e. Discuss factors to be considered in making judgments that may become critical in the accounting process, including the separation of the intrinsic value of instruments from their "time value." This separation of an instrument's fair value into its component parts might have accounting consequences within the financial statements (FAS 133 permits the exclusion of the inherently ineffective portion of a derivative's change in value, such as the time value of options, from the "hedge effectiveness" assessment).

    f. Provide guidance in determining the accounting for hedged items.

    g. Provide guidance or assist management in developing and adapting systems to account for derivative instruments and hedged items under the new standard.

<u>Valuation Consulting Assistance</u>

12. The provision of the following services would not impair the auditor's independence:

    a. Provide guidance or assist in developing the client's own valuation model. The client takes responsibility for the model, by testing, evaluating, approving, and running it.

    b. Provide guidance on the nature of relevant model inputs (volatility, yield curves, etc.) and related market sources of information. The client makes the final decision as to the inputs and market sources of information to be used.

    c. Validate client or third-party models used.

    d. Validate reasonableness of inputs to models (client assumptions).

e. Provide a generic/standardized product (e.g., not unlike a Black-Scholes or binomial software model used for valuing options), which a client uses in valuing its derivative instruments. A generic or standardized product is one in which formulas are well-established and subject to only minor judgments or interpretations. It is reasonable to expect that the result produced by such a product will be similar to the result that would be produced by another vendor's product.

13. The provision of the following services would impair the auditor's independence:

a. Compute derivative values using either auditor or client-provided assumptions and a firm-developed, or third party model approved by the client.

b. Develop or be responsible for key assumptions or inputs for use by the client when it uses any valuation model or product.

c. Provide a firm-developed, non-standardized model (e.g., black box equivalent) which a client uses to value its derivatives. The model's methodology or formulas are not standardized, or assumptions are built into the model such that values produced may differ significantly from those produced by another vendor's models.

14. As mentioned above, the overarching principles underlying this interpretation are that the auditor cannot be placed in the position of "auditing his or her own work," or accepting responsibility for the choices and judgments inherent in the preparation of the financial statements such that the auditor is acting as a member of management.