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Independence compliance : checklists and tools for complying with AICPA and GAO independence requirements;

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A I C P A P r a c t i c e A i d S e r i e s

**Independence Compliance:
Checklists and Tools for
Complying With AICPA and
GAO Independence
Requirements**

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA[®]

Notice To Readers

This publication, *Independence Compliance: Checklists and Tools for Complying With AICPA and GAO Independence Standards*, is a practice aid that helps practitioners comply with AICPA and Government Accountability Office (GAO, formerly the U.S. General Accounting Office) independence rules that apply if a practitioner is engaged in an audit or attestation engagement.

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This publication was developed in May 2006 and the content herein reflects the AICPA and GAO independence rules that were in effect at that time. AICPA and GAO independence rules may have changed since this publication was developed. Practitioners should be aware of and comply with current AICPA and GAO independence rules.

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**Independence Compliance:
Checklists and Tools for
Complying With AICPA and
GAO Independence
Requirements**

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About the Author

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INTRODUCTION

U.S. auditor independence rules have undergone many significant changes in the last decade and the rules continue to evolve. With rules covering many situations in which independence might be impaired, from business relationships and services to fee arrangements and other relationships, it has become increasingly difficult for practitioners to keep up with the standards. This Practice Aid will assist practitioners and firms in identifying and addressing independence matters to help ensure their compliance with applicable AICPA Professional Standards and *Government Auditing Standards* (GAS, also known as the Yellow Book).

SCOPE OF THIS PRACTICE AID

This Practice Aid addresses two diverse sets of auditor independence rules, and is categorized into two independence compliance tools. The first independence compliance tool (the Compliance Tool) addresses requirements of Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.01), of the AICPA *Code of Professional Conduct* (the Code) and its related rulings and interpretations. This rule applies to all engagements requiring independence under AICPA Professional Standards. Some examples are:

- Audits and reviews of financial statements,
- Compilations of financial statements in which the firm does not disclose a lack of independence,
- Reports issued under Statements on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended, and
- Other attestation services, such as agreed-upon procedures.

The second Compliance Tool addresses the GAO independence rules, which apply to financial statement audits, attestation services, and performance audits of government entities, programs, and federal awards administered by contractors, nonprofit entities, and other nongovernmental entities. These entities are also subject to the AICPA rules described in Part I of the Compliance Tool. To streamline the compliance process, to the extent AICPA rules are identical to the GAO rules, the GAO Compliance Tool will not repeat those questions. Rather, it will address only those matters that have not already been addressed in the AICPA Compliance Tool.

If the client is privately owned and not subject to government audit standards, only the AICPA Compliance Tool should be completed.¹

¹Practitioners should also be aware of various other regulations that may apply to engagements. See Appendix C, “Sources of Guidance,” for further information.

SEC and PCAOB Independence Rules

This Practice Aid does not address the independence rules of the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB). Auditors of SEC issuers are required to comply with the SEC and PCAOB rules on auditor independence.

HOW TO USE THIS PRACTICE AID

To assess independence:

1. Determine which Compliance Tools apply to your attest client (i.e., AICPA only or AICPA plus GAO).
2. Read all portions of the Practice Aid applicable to your client.
3. Complete the relevant questionnaire(s) found in Part I of the Compliance Tool(s).
4. Review the follow-up section(s) for all *yes* answers, or if an answer is not known.
5. For GAO engagements, complete both the AICPA and GAO Compliance Tools.
6. Review the appendices for additional information that may be relevant for your client.

THE AICPA AND GAO INDEPENDENCE COMPLIANCE TOOLS

Each Compliance Tool is a mechanism to help you consider whether your firm is independent to perform an attest engagement under the relevant rules. The Compliance Tools are divided into two equally important parts.

Part I of the Compliance Tool is a series of questions designed to help you identify potential independence issues. You should answer all of the questions listed in Part I of the Compliance Tool. The response to each question will be *yes* or *no*, although certain questions allow for a *N/A* (not applicable) response. Refer to the glossaries in Appendixes A, “AICPA Independence Terms,” and B, “GAO Independence Terms,” to ensure that you fully understand the terms used in the question before providing your answer. Defined terms are shown in boldface type each time they appear in the Compliance Tools. Then, ask the appropriate person(s) in your firm to determine the proper reply to the question.

It is important to note that the questionnaire summarizes the most frequently encountered independence rules; accordingly, the questions do not identify all the possible factors that determine whether independence under the applicable rules is achieved. Further, some areas of the rules are very fact-specific and may not be fully addressed with a simple *yes* or *no* answer. Therefore, you should not assume that all *yes* answers indicate an infraction of

the rules; but rather that further consideration of the rules themselves and additional advice and counsel may be needed to determine if there is an issue.

If you answer *yes* to any of the questions or you are unable to answer a question, you should also review Part II of the Compliance Tool. Part II will help you to address and, if necessary, document any potential independence issues that have been identified in Part I. Part II suggests possible follow-up actions that you and your firm may wish to consider and apply in addressing an independence issue. However, applying the suggested follow-up actions may or may not avoid a violation of the Code. Only the AICPA Professional Ethics Executive Committee (PEEC) has the authority to interpret the Code.

To be effective, you should use the Compliance Tool(s) in a timely manner. The following scenarios illustrate the meaning of *timely*.

Scenario 1: The engagement is a new audit, review, or other attest engagement.

You should utilize the Compliance Tool *prior* to accepting an attest engagement or performing any attest work for the client. In a number of cases, this will allow the firm to resolve issues that surface as a result of the review. *Prior* to issuing your report, you should review your previous results to confirm that no changes have occurred since your initial assessment and that any matters identified during the initial assessment have been appropriately addressed, resolved, and documented.

Scenario 2: The engagement is an ongoing audit, review, or other attest engagement.

You should use the Compliance Tool early in the audit planning stage, and at other times throughout the year, as needed. *Prior* to issuing your report, you should review the previous results to confirm that no changes have occurred since your initial assessment and that any matters identified during the initial assessment have been appropriately addressed, resolved, and documented.

INDEPENDENCE COMPLIANCE TOOL: AICPA INDEPENDENCE RULES

AICPA professional standards require a firm, its partners, and professional employees to be independent in accordance with AICPA Rule 101 of the *Code of Professional Conduct* whenever a firm performs an attest service for a client. Attest services include:

- Financial statement audits
- Financial statement reviews

- Other attest services as defined in the Statements on Standards for Attestation Engagements (SSAEs)

Performing a compilation of a client's financial statements does not require independence. However, if a firm that is not independent issues a compilation report, the report must state, "I am (we are) not independent with respect to XYZ Company." If the firm does not include this disclosure in the compilation report, it must maintain independence under Rule 101.

The questionnaire listed below addresses five general categories under AICPA independence rules:

1. Personal financial interests and relationships
2. Employment and business relationships
3. Nonattest services engagements
4. Fee arrangements
5. Miscellaneous

A citation to the applicable AICPA rule follows each question. You should refer directly to the AICPA rules if you do not understand the question or need further information (Also see Appendix C, "Sources of Guidance"). Words appearing in boldface type are defined in Appendix A; it is very important that you understand the meaning of all terms used in the questions before you provide a response.

The independence rules are frequently augmented and amended. Consequently, the independence rules addressed and citations referred to in the questionnaire may have changed after the time this Practice Aid was developed, which was May 2006. You should be aware of and comply with current independence rules.

Part I: Questionnaire

Category 1: Personal Financial Interests and Relationships

The following are important points:

1. The time period you should consider for purposes of these questions is the *period of the professional engagement*. This period begins on the earlier of the date the firm (a) formally agrees to perform attest services for the client or (b) begins providing attest services. It continues until the firm or the client terminates the attest relationship, or the final report is issued, whichever is later.
2. For purposes of these questions, *covered member* includes the covered member's *immediate family*, namely, his or her spouse, *spousal equivalent*, and *dependents*.

- Q1. Has a **covered member**² had or been committed to acquire any **direct financial interest** in the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.02 and ET sec. 101.17] Yes No
- Q2. Has a **covered member** had a **direct financial interest** or a material **indirect financial interest** in the **client** through his or her participation in a retirement, savings, compensation, or similar plan? [AICPA, *Professional Standards*, vol. 2, ET secs. 101.02 and 101.17] Yes No
- Q3. Has a **covered member** had an insurance policy that had an investment option which provided the **covered member** a **direct financial interest** or a material **indirect financial interest** in the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.17] Yes No
- Q4. Has a **covered member** had or been committed to acquire any material **indirect financial interest** in the **client**, other than an indirect financial interest held through a **diversified mutual fund**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.17] Yes No
- Q5. Has a **covered member** acquired a **direct financial interest** or material **indirect financial interest** in the **client** as a result of an unsolicited gift or inheritance? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.17] Yes No
- Q6. If the **client** is a Section 529 savings plan, has a **covered member** been an account owner in the plan? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.17] Yes No N/A
- Q7. Has a **covered member** been the account owner of any Section 529 savings plan (including nonclient plans) that invested in the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.17] Yes No
- Q8. Has a **covered member** participated in an investment club that invested in the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 191.071-72] Yes No
- Q9. Has a **covered member** invested as a general partner in a partnership (or held another position that allowed the individual to control the partnership or participate in its investment decision-making) which invested in the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 191.158-59] Yes No

(continued)

² Please note that the term *covered member* includes the firm.

Q10. Has a **covered member** invested as a limited partner in a partnership, which invested in the **client** and was material to the **covered member**? [AICPA, *Professional Standards*, vol. 2, ET sec. 191.162-63] Yes No

Q11. Has a **covered member** served as the manager of a limited liability company (LLC), or held another position that allowed the individual to control the LLC or participate in its investment decision-making, and that LLC invested in the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.17] Yes No

Q12. Was a member of the **attest engagement team** aware that a **close relative** had or was committed to acquire a material **financial interest** in the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.02] Yes No N/A

Q13. Did a **close relative** of a member of the **attest engagement team** have the ability to exercise **significant influence** over the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.02] Yes No N/A

Q14. Did a **close relative** of (a) a **partner** or manager providing nonattest services to the **client** or (b) a **partner** in the **office** of the lead audit **partner** for this engagement have a financial interest that was both material to the **close relative** and allowed the **close relative** to exercise **significant influence** over the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.02] Yes No N/A

Q15. Has a **covered member** served as a trustee of a trust that had or was committed to acquire a **direct financial interest** or material **indirect financial interest** in the **client** such that (a) the **covered member** (individually or with others) had the authority to make investment decisions for the trust; or (b) the trust owned or was committed to acquire more than 10 percent of the client's outstanding equity securities or other ownership interests; or (c) the value of the trust's holdings in the **client** exceeded 10 percent of the total assets of the trust? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.02] Yes No

Q16. Has a **covered member** been the grantor of a trust that had or was committed to acquire a **direct financial interest** or material **indirect financial interest** in the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.17] Yes No

Q17. Has a **covered member** been a beneficiary of a trust that had or was committed to acquire a material **indirect financial interest** in the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.17] Yes No

Q18. Has a **covered member** been the beneficiary of a trust who was able to control or participate in investment decision-making for the trust, and such trust had or was committed to acquire a financial interest in the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.17] Yes No

Q19. Has a **covered member** been a beneficiary of a blind trust that had or was committed to acquire a **financial interest** in the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.17] Yes No

Q20. Has a **covered member** *actually served* as an executor of an estate that had or was committed to acquire a **direct financial interest** or material **indirect financial interest** in the client? [AICPA, *Professional Standards*, vol. 2, ET sec. 191.021-022] Yes No

Q21. Has a **covered member** had a **joint closely held investment** that was material to the **covered member's** net worth? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.02] Yes No

Q22. Has a **covered member** had a **loan** from a **client**, or from the **client's** significant shareholders, officers, or directors, that was neither a **grandfathered** nor a **permitted** loan? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.07] Yes No

Q23. Has a **covered member** had a **loan** with a nonclient subsidiary of the **client** that was neither a **grandfathered loan** nor a **permitted loan**? [AICPA, *Professional Standards*, vol. 2, ET sec. 191.196-197] Yes No

Q24. Has a **partner** or professional employee of the **firm**, or his or her **immediate family**, or a group of such persons acting together, owned more than 5 percent of the **client's** outstanding equity securities, or similar interests? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.02] Yes No

Q25. Did the **firm** hire professional staff or admit a **partner** who was a **covered member** with respect to the **client** and who had a direct or material **indirect financial interest** in the **client** or a **loan** that was neither **grandfathered** nor **permitted**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.02] Yes No

(continued)

- Q26. Has a **covered member** had a bank account (checking, savings, money market, certificate of deposit) with a **client** holding funds that were not fully insured by a federal or state agency (such as Federal Deposit Insurance Corporation [FDIC]) or other insurer and were material to the **covered member's** net worth? [AICPA, *Professional Standards*, vol. 2, ET sec. 191.140-41] Yes No
- Q27. Has a **covered member** had a margin **loan** with a broker that was a **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.07] Yes No
- Q28. Has a **covered member** invested in an entity that had **significant influence** over a **client** and that was material to the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.10] Yes No
- Q29. Has a **covered member** invested in an entity over which a **client** had **significant influence** and the entity was material to the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.10] Yes No
- Q30. Has a **covered member** had an investment or other relationship with an entity that gave the **covered member significant influence** over the entity, and such entity had **significant influence** over the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.10] Yes No
- Q31. Has a member of the **attest engagement team** accepted a gift from the **client** that would be considered to be more than clearly insignificant? [AICPA, *Professional Standards*, vol. 2, ET sec. 191.228-229]³ Yes No

³New addition to the AICPA Code of Professional Conduct; if not available in hardcopy version, see www.aicpa.org/download/ethics/2005_0617_ED.pdf.

Category 2: Employment and Business Relationships

Note: The time period you should consider for purposes of these questions is the **period of the professional engagement** and the period covered by the financial statements (or other subject matter of the attest engagement).

Q1. Has a **partner** or professional employee served as a director, officer, or in any other managerial position (e.g., general counsel, promoter, etc.) for the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.02] Yes No

Q2. Has a **partner** or professional employee served the **client** or the **client's** pension or profit-sharing trust as a promoter, underwriter, or voting trustee? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.02] Yes No

Q3. Has the **close relative** of a **covered member** (other than an individual who is a **covered member** solely because he or she provided non-attest services) or the **immediate family** of a **covered member** been employed in a **key position** by a **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.02, and ET sec. 92.17] Yes No

Q4. Did the **firm** hire professional staff or admit a **partner** who was associated with a **client** and who served on that **client's attest engagement team**, or was an individual in a position to influence the **attest engagement**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.02] Yes No

Q5. Did a **partner** or professional employee who resigned or retired from the **firm** and assumed a **key position** with the **client** have (a) an arrangement to be paid amounts due him or her (for a previous interest in the **firm** or retirement benefits) calculated on a variable formula, (b) amounts due him or her (per item a) that were material to the **firm**, or (c) continuing business relationships with the **firm** (e.g., consulting arrangements or other associations)? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.04] Yes No

Q6. Did the **firm** and the **client** participate in a cooperative arrangement (e.g., joint venture, subcontracting arrangement, distribution, or marketing arrangement) that was material to the **firm** or to the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.14] Yes No

Q7. Did a member of the **attest engagement team** or an individual in a position to influence the attest engagement negotiate a potential employment position with the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.04] Yes No

Category 3: Nonattest Services Engagements

The following are important points:

1. Before answering the questions in this category, you should determine whether your firm provided any nonattest services during the period described in item 2 below. If no nonattest services engagements were performed for the client, this section may be skipped.
2. For purposes of questions in this category, the **firm** includes all professionals performing services on behalf of the **firm**.
3. The time period you should consider for purposes of these questions is the **period of the professional engagement** and the period covered by the financial statements (or other subject matter of the attest engagement).

Q1. Did the **firm** perform any management functions or make managerial decisions for the **client** in connection with nonattest services? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No

Q2. Were there any instances in which the **client** was unable (i.e., lacked the competence) or unwilling to oversee the **firm's** nonattest services (i.e., perform management functions, set the scope of the services, evaluate and accept responsibility for the results of the services, and establish and maintain internal controls)? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05; AICPA Guidance is available at www.aicpa.org/download/ethics/101-3_Competyency_Guidance.pdf] Yes No

Q3. Were there any instances in which an understanding between the **firm** and the **client** (i.e., engagement objectives, nonattest services to be performed, **client's** acceptance of its responsibilities, **firm's** responsibilities, and engagement limitations, if any) was *not* reached and documented in the **firm's** files? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05, AICPA Guidance is available at www.aicpa.org/download/ethics/Int._101-3_documentation_guidance.pdf] Yes No

Q4. Did the **firm** at any time have custody of the **client's** assets (e.g., handle **client** cash, checks, or other financial instruments, or otherwise take responsibility for the safekeeping of assets)? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No

Q5. Did the **firm** at any time assume responsibility for making payments on behalf of the **client** (electronically or otherwise)? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No

Q6. Did the **firm** at any time assume responsibility for signing or cosigning **client** checks? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No

- Q7. Did the **firm** at any time maintain a bank account on behalf of the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q8. Did the **firm** at any time sign payroll tax returns on behalf of the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q9. Did the **firm** at any time authorize, execute, or consummate transactions on behalf of the **client** (e.g., approve vendor invoices for payment)? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q10. Did the **firm** at any time prepare **source documents** that evidenced accounting transactions (e.g., invoices, purchase orders, or payroll time cards) for the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q11. Did the **firm** at any time supervise the **client's** employees in their daily activities? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q12. Did the **firm** at any time lend its professional staff to the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.02 and 101.05] Yes No
- Q13. Did the **firm** at any time report to the board of directors (or other governing body) on behalf of management? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q14. Did the **firm** at any time design or implement policies or procedures for the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q15. Did the **firm** at any time serve as the **client's** escrow agent, stock transfer agent, registrar, general counsel, or in a similar capacity? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q15. Did the **firm** at any time serve as a fiduciary to the **client** (e.g., Benefit Plan Administrator under Department of Labor regulations)? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05 and ET sec. 102.03] Yes No
- Q16. Did the **firm** at any time make investment decisions for the **client** or have discretionary authority over **client** investments? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No

(continued)

- Q17. Did the **firm** at any time execute transactions to buy or sell investments on behalf of the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q18. Did the **firm** at any time negotiate transactions on behalf of the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q19. Did the **firm** at any time commit the **client** to the terms of an arrangement without the **client's** involvement or advanced agreement to the terms? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q20. Did the **firm** perform any ongoing compliance or quality control functions for the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q21. Did the **firm** perform bookkeeping services for the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] (If the answer is *no*, skip questions 22 through 24.) Yes No
- Q22. Did the **firm** determine or change journal entries without obtaining **client** approval? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q23. Did the **firm** change **source documents** or account codings on transactions without **client** approval? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q24. Did the **firm** determine the assumptions underlying journal entries (e.g., useful lives, bad-debt percentages) for the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q25. Did the **firm** design or develop a financial information system for the **client** (including selling or licensing software that the firm designed or developed)? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q26. Did the **firm** modify the source code underlying the **client's** financial information system (excluding insignificant modifications)? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q27. Did the **firm** manage or operate the **client's** local area network (LAN)? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q28. Did the **firm** provide valuation or appraisal services to the **client**, which was subject to significant subjectivity and whose results were material to the financial statements? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No

- Q29. Did the **firm** perform an actuarial valuation for the **client** (except for those related to the **client's** pension or post-employment benefit obligations), which was material to the financial statements? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q30. Did the **firm** provide internal audit services to the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] (If the answer is *no*, skip questions 31 through 35.) Yes No
- Q31. Did the **firm** manage internal audit activities for the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q32. Did the **firm** determine the scope, risk, or frequency of internal audit activities for the **client**, including those performed by the firm (e.g., prepare or approve the audit work plan)? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q33. Did the **firm** evaluate the findings of internal audit activities, including those performed by the **firm**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q34. Did the **firm** determine the adequacy of internal audit activities, including those performed by the **firm**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q35. Did the **firm** report internal audit findings to the board of directors or other governing body on behalf of the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No
- Q36. Except for a power of attorney limited to tax-related activities, did the **firm** obtain a power of attorney to act on behalf of the **client**? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05] Yes No

Category 4: Fee Arrangements

Note: The time period you should consider for purposes of these questions is the **period of the professional engagement** and the period covered by the financial statements.

- Q1. Except for a **client** that is currently in bankruptcy, does or will the **client** owe fees to the **firm** for services rendered more than one year prior to the date of the current year's report? [AICPA, *Professional Standards*, vol. 2, ET sec. 191.103-104] Yes No

(continued)

Q2. Did the **firm** provide any of the following services for the **client**: (a) financial statement audit or review; (b) financial statement compilation in which the **member** expected third-party reliance and the **member** did not disclose a lack of independence in the report; or (c) an examination of prospective financial information? [AICPA, *Professional Standards*, vol. 2, ET sec. 302.01] (If the answer is *no*, skip questions 3-7.)

Yes No

Q3. Did the **firm** also provide any service, other than tax services, for a **contingent fee**, which was not fixed by a court or other public authority? [AICPA, *Professional Standards*, vol. 2, ET sec. 302.01]

Yes No

Q4. Did the **firm** provide tax services for the **client** for a **contingent fee**, such that the **firm** did *not* have a reasonable expectation that the fee would be determined based on the results of judicial proceedings or the findings of governmental agencies? [AICPA, *Professional Standards*, vol. 2, ET sec. 302.02]

Yes No

Q5. Did the **firm** sell goods or services to the **client** for a **commission**? [AICPA, *Professional Standards*, vol. 2, ET sec. 503.01]

Yes No

Q6. Did the **firm** receive a **commission** for recommending or referring the **client** to a third party to purchase goods or services (excluding services provided by a CPA)? [AICPA, *Professional Standards*, vol. 2, ET sec. 503.01]

Yes No

Q7. Did the **firm** receive a **commission** for recommending or referring a third party to the **client** to purchase goods or services (excluding services provided by a CPA)? [AICPA, *Professional Standards*, vol. 2, ET sec. 503.01]

Yes No

Category 5: Miscellaneous

Note: The time period you should consider for purposes of these questions is the **period of the professional engagement**.

Q1. Does the engagement letter for this audit or other attest service include a provision that indemnifies a **member** or the **member's firm** for situations other than knowing misrepresentations made by **client** management? [AICPA, *Professional Standards*, vol. 2, ET sec. 191.188-189]

Yes No

Q2. Has there been any actual or threatened litigation between the **client** and the **firm** involving amounts that would be considered material to either party? [AICPA, *Professional Standards*, vol. 2, ET sec. 101.08]

Yes No

Q3. Has a **covered member** accepted entertainment (e.g., dinner or events) *from* the **client** that would not be considered reasonable under the circumstances (e.g., gifts or events that were lavish or extravagant, not consistent with the occasion, or otherwise inappropriate under the circumstances)? [AICPA, *Professional Standards*, vol. 2, ET sec. 191.226-27]⁴

Yes No

Q4. Has a **covered member** given gifts or entertainment (e.g., dinner, events) *to* the **client** that would not be considered reasonable under the circumstances (e.g., gifts that were lavish or extravagant, not consistent with the occasion, or otherwise inappropriate under the circumstances)? [AICPA, *Professional Standards*, vol. 2, ET sec. 191.226-27]⁴

Yes No

Q5. Have **covered members** and other appropriate parties in the **firm** considered all possible conflicts of interest to determine whether the performance of a professional service for the **client** would be affected by the **member** or his or her **firm's** relationship with another person, entity, product, or service that could be viewed by the **client** or other appropriate parties as impairing the **member's** objectivity, and as a result of this review has any matter materialized that requires additional investigation? [AICPA, *Professional Standards*, vol. 2, ET sec. 102.03]

Yes No

Part II: Resolution of Potential Independence Issues

Please review the following categories carefully for any *yes* response you provided in the “Questionnaire” and for any questions that you were unable to answer. An illustration of a documented independence matter appears in Appendix D, “Documenting Independence Matters.” In addition, in April 2006 the AICPA adopted the *Conceptual Framework for AICPA Independence Standards* which is effective for all independence decisions made after April 30, 2007. Earlier application of the Conceptual Framework, a risk-based approach to analyzing independence matters, is encouraged and therefore may be used to address and resolve matters that are not addressed in the *Code of Professional Conduct*. See www.aicpa.org/about/code/et_100.html for further information.

⁴New addition to the AICPA *Code of Professional Conduct*; if not available in hardcopy version, see www.aicpa.org/download/ethics/2005_0617_ED.pdf.

Category 1: Personal Financial Interests and Relationships

The AICPA prohibition on personal financial interests and relationships applies during the period of the professional engagement; hence, caught early, timely actions may avoid an independence issue. The following facts, though not all-inclusive, should be gathered and considered:

- The nature of the financial interest or relationship
- The applicable time period(s), e.g., the period of professional engagement, how long the interest was held, when the holder became a covered member
- The nature of the attest work, e.g., audit, review, agreed-upon procedures⁵
- Whether the interest was material to the covered member's net worth
- Who was aware of the financial interest and when they became aware of it
- Whether the interest is a(n) direct or indirect financial interest (See Appendix A, "AICPA Independence Terms")
- Whether the interest is held in a retirement or similar employee benefit plan, whether the plan participant is the covered member or his or her immediate family, and whether the plan participant is currently employed by the plan sponsor
- Whether the interest arose as a result of an unsolicited inheritance or gift (See ET section 101.17, "Unsolicited Financial Interests")

For matters involving loans, the following facts, though not all-inclusive, should be gathered and considered:

- When the loan was obtained and by whom
- Whether the loan was obtained from a financial institution
- Whether the borrower was a covered member at the time the loan was obtained
- Whether the lender was an attest client when the loan was obtained
- Whether the loan met requirements for grandfathering
- The type of loan
- Specifics surrounding loan renewals and revisions
- Whether the loan is secured by property

⁵ See Appendix E, "Modified AICPA Independence Requirements for Certain SSAE Engagements," for specific guidance on AUP engagements.

Possible follow-up actions are:

- Remove the individual from the engagement team whose interest or relationship caused the independence issue.
- Dispose of the financial interest or relationship (e.g., loan, checking account) that caused the independence issue.
- Discuss the matter with the client's governance board (e.g., board of directors, audit committee or other equivalent body) to determine the board's views on the matter, especially with respect to the appearance of independence.
- Review the work of the individual whose interest or relationship caused an independence issue.
- Reperform the audit procedures performed by an individual deemed to have caused the independence issue.
- Decline to perform the audit for the affected period(s).
- When appropriate, consider AU section 561, *Subsequent Events*, (AICPA, *Professional Standards*, vol. 1).

Category 2: Employment and Business Relationships

Employment and business relationships are prohibited during the period of the professional engagement *and* the period covered by the financial statements. Restrictions on employment and business relationships also generally apply to more people in the firm, i.e., all partners and professional staff, than the restrictions on financial interests and relationships, which, with some exceptions, apply only to covered members and certain family members. As such, they can be more difficult to address than issues arising from financial interests and relationships. The following facts, though not all-inclusive, should be gathered and considered:

- The nature of the employment or business relationship
- Individuals who held (hold) the position and their relationship to the firm or a member of the firm
- If a relative has an employment or business relationship, the nature of the relationship with the firm member and the firm member's position in the firm
- The applicable time frames, e.g., period of professional engagement, period covered by financial statements, period of the employment or business relationship
- For former partners or professional staff, actions taken to disassociate from the firm
- For former partners or professional staff of the firm, pending relationships with the firm
- For persons formerly associated with the client, actions taken to disassociate from the client

- For persons formerly associated with the client, pending interests or relationships with the client

Possible follow-up actions are:

- Cease the employment or business relationship that caused the independence issue.
- Discuss the matter with the client's governance board (e.g., board of directors, audit committee, or other equivalent body) to determine the board's views on the matter, especially with respect to the appearance of independence.
- Review the work of the individual whose relationship caused the independence issue.
- Reperform audit procedures performed by an individual deemed to have caused the independence issue.
- Decline to perform the audit for the affected period(s).
- When appropriate, consider AU section 561, *Subsequent Events*, (AICPA, *Professional Standards*, vol. 1).

Category 3: Nonattest Services Engagements

Like employment and business relationships, restrictions on certain nonattest services apply during the period of the professional engagement and the period covered by the financial statements. The following facts, though not all-inclusive, should be gathered and considered:

- The nature of the work or other activities performed
- The nature of the attest work, e.g., audit, review, agreed-upon procedures (AUP)⁶
- The applicable time frames, e.g., the period of professional engagement, the period covered by the financial statements, and the period during which prohibited services or activities were performed
- The individuals who performed the services or activities and their relationship, if any, to the attest engagement team
- The client designee assigned to oversee the firm's work, their title, background, and experience
- Whether an agreement on the firm's and the client's respective roles was reached prior to performing the services
- Whether the agreement on the firm's and the client's respective roles was documented prior to performing the services

⁶ See Appendix E, "Modified AICPA Independence Requirements for Certain SSAE Engagements," for specific guidance on AUP engagements.

Possible follow-up actions are:

- Cease performing the prohibited services or activities.
- Discuss the matter with the client's governance board (e.g., board of directors, audit committee, or other equivalent body) to determine the board's views on the matter, especially with respect to the appearance of independence.
- Decline to perform the audit (or other attest) engagement for the affected period(s).
- Have an independent third party reperform the non-attest services that gave rise to an independence issue.
- When appropriate, consider AU section 561, *Subsequent Events*, (AICPA, *Professional Standards*, vol. 1).

Category 4: Fee Arrangements

Unpaid Fees. An AICPA ethics ruling states that fees outstanding for any previously rendered professional services exceeding 12 months that remain unpaid at the date of the attest report are an impairment of independence. The following facts, though not all-inclusive, should be considered to address fee arrangement issues:

- The length of time the fees have been outstanding
- Whether the client has the financial means to pay the outstanding fees in full prior to issuance of the report
- Whether the client is willing to pay the fees in full prior to issuance of the report
- Whether the firm can rely on the client's promise to pay the outstanding fees prior to issuance of the report for the current year
- Whether the firm is willing to compromise on previously owed amounts, including forgiving the debt in full

Possible follow-up actions are:

- Obtain assurance from the client that all fees will be paid in full prior to issuance of the report for the current year.
- Forgive all or part of the client's fees to enable the attest engagement to be performed (provided there will be no remaining balance).
- Decline to perform the current-year attest engagement due to the continuing existence of unpaid fees that will not be resolved by the report date.

Commissions and Contingent Fees. The AICPA prohibition on commissions and contingent fees applies during the period in which a member or member's firm is engaged to per-

form any of the four listed services and the period covered by any historical financial statements involved in any of the four listed services. The following facts, though not all-inclusive, should be gathered and considered:

- The applicable time period(s)
- The nature of the service, e.g., audit or review of financial statements, or other listed service
- Whether the contingent fee was material to the member or the member's firm
- The significance of the result of the service to the client
- The specific terms of the fee arrangement, such as a description of the contingency event, the parties involved, or, for a commission arrangement, the name of the purchaser or supplier of the product or service and a description of the client relationship
- Whether the fee is fixed by the courts or another public authority

Possible follow-up actions are:

- Restructure the contingent fee arrangement so that it is not *contingent* (e.g., set a fixed fee for the engagement or a fixed hourly rate plus expenses) as defined in ET section 302 (AICPA, *Professional Standards*, vol. 2).
- Cancel commission agreements involving an attest client purchase or an attest client supplier.
- Decline to perform the services outlined in ET sections 302 and 503 (AICPA, *Professional Standards*, vol. 2), covering the period of any historical financial statements during which prohibited commissions or contingent fees were received.

Category 5: Miscellaneous

Considerations and follow-up for items falling into the miscellaneous category will vary but are similar to categories 1 to 4. Additional follow-up actions, though not all-inclusive, include:

- *Indemnification agreements.* These agreements revoke the indemnification provision.
- *Gifts and entertainment.* Gifts can be returned to the client. Alternatively, the client can be reimbursed for gifts or entertainment.

INDEPENDENCE COMPLIANCE TOOL: GAO INDEPENDENCE RULES

Government Auditing Standards, Amendment No. 3, *Independence*

The GAO standards apply to audits, other attest engagements (e.g., reports on internal controls or compliance with specific regulations), and performance audits provided to federal, state, and local governments and organizations receiving federal (and some state) funds, including profit and not-for-profit entities. Various laws require compliance with *Govern-*

ment Auditing Standards in connection with the audits of federal entities and funds; many states, local governments, and other entities have also adopted these standards.

The second general standard of generally accepted government auditing standards (GAGAS) is:

In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, should be free both in fact and appearance from personal, external, and organizational impairments to independence.

Government Auditing Standards (GAS) Amendment No. 3, *Independence*, constitutes the GAO rule on independence. In addition, in 2002, the GAO issued *Answers to Independence Standards Questions*, (Q+A), which provides guidance on how to implement the GAO's independence rules.

The questionnaire below addresses two general categories under GAO rules:

1. Personal impairments
2. Nonaudit services

A citation to the applicable GAO rule or Q+A follows each question. You should refer directly to the GAO rules and Q+A guidance if you do not understand the question or need further information. Words appearing in boldface type are defined in Appendix B; it is very important that you understand the meaning of all terms used in the questions before you provide a response.

The GAO independence rules addressed and citations referred to in the questionnaire may have changed after the time this Practice Aid was developed, which was May 2006. You should be aware of and comply with current GAO independence rules.

Part I: Questionnaire

Category 1: Personal Impairments

Q1. Did a partner or staff person on the **audit engagement team** perform **prohibited bookkeeping services** (other than a staff person who played only an insignificant role in providing the services) during the period of the professional engagement or the period covered by the financial statements? [GAS 3, par. 07(d); Q+A 39]

Yes No

Q2. Does a partner or staff person on the **audit engagement team** hold preconceived ideas toward individuals, groups, organizations, or objectives of a particular program, or harbor other biases or loyalties that could impair his or her objectivity in connection with the audit? [GAS 3, par. 07(e) and (f)]

Yes No

Q3. Did a member of the **audit engagement team** set policy for the client within the last two years, which directly and significantly affected the subject matter of the audit? [Q+A 40]

Yes No

Category 2: Nonaudit Services

(1) Before answering the questions in this category, you should determine whether your firm performed any **nonaudit services** during the period of the professional engagement or the period covered by the financial statements (or other subject matter of the attest engagement). If no **nonaudit services** were performed for the client, this section may be skipped.

(2) For purposes of the questions in this category, the firm includes all professionals performing services on behalf of the firm.

Q1. In performing **nonaudit services** for this client, or any related⁷ entities of the client, did you audit your own work (or the work of others in the firm) such that the amounts or services involved were **significant** or **material** to the **subject matter of the audit** (aggregating all **nonaudit services** for the period)? [GAS 3, par. 16, Q+A Nos. 15, 23 – 26]

Yes No

Q2. For **nonaudit services** performed for the client, were there any instances in which the firm did *not* document its consideration of the services, including the firm’s rationale for concluding that the services did not violate the two overarching principles, i.e., (a) the firm did not perform management functions or make management decisions for the client, and (b) the firm did not audit its own work or provide **nonaudit services** in situations in which the amounts or services involved were significant or material to the subject matter of the audit? [GAS 3, par. 17(a)]

Yes No

Q3. For **nonaudit services** performed for the client, were there instances in which the firm did *not* document its assessment of the client’s competence to oversee the services and take responsibility for the results of the services and that the client’s management level designee fulfilled these responsibilities? [GAS 3, par. 17(e)]

Yes No

Q4. For **nonaudit services** provided to the client (excluding **routine activities**, services having no relationship to the **subject matter** of the audit, or engagements that involved only a **de minimus amount of time**), will (or did) you allow personnel who provided the **nonaudit services** to plan, conduct, or review audit work related to the **nonaudit service**? [GAS 3, par. 17(c); Q+A Nos. 27, 30, and 31]

Yes No

Q5. Do you plan to (or did you) reduce the scope and extent of audit work because the firm performed **nonaudit services** for the client? [GAS 3, par. 17(d)]

Yes No

⁷The GAO discusses certain related entities in the context of related governmental agencies and nonaudit services in its Q+A document, questions 23 through 26.

- Q6. Does the firm lack quality control systems for compliance with independence requirements, including policies and procedures to assure consideration of the effect of providing **nonaudit services** on the ongoing, planned, and future audits of the client? [GAS 3, par. 17(e)] Yes No
- Q7. Did the firm perform internal audit services for the client? [Q+A No. 66] Yes No
- Q8. Did the firm provide valuation, appraisal, or actuarial services, including pension actuarial services, which involved amounts that were material to the client's financial statements? [GAS 3, par. 18(c), Q+A No. 79] Yes No
- Q9. Where payroll is considered to be material or significant to the subject matter of the audit, did the firm process the client's payroll? [GAS 3, par. 18(b)] Yes No
- Q10. Did the firm perform any **prohibited bookkeeping services** for the client? [GAS 3, par. 18(a); Q+A Nos. 46 – 65] Yes No
- Q11. Did the firm reconcile cash balances to bank statements for the client? [Q+A No. 56] Yes No
- Q12. Did the firm perform **prohibited bookkeeping services** for a client in a temporary or emergency situation? [Q+A No. 54] Yes No
- Q13. Did the firm perform any services for the client that would constitute monitoring or quality control activities? [Q+A No. 56] Yes No
- Q14. Did the firm design, develop, or install an information system (including selling or licensing software that the firm developed) which was material to the client's financial reporting system? [GAS 3, par. 18(e); Q+A Nos. 68-74] Yes No
- Q15. Did the firm prepare a client's indirect cost proposal or cost allocation plan if management had not taken responsibility for all significant assumptions and data or the results of the service were material to the client's financial statements? [GAS 3, par. 18(d); Q+A Nos. 64-65] Yes No
- Q16. Did the firm operate or supervise the operation of the client's information technology system or network? [GAS 3, par. 18(e)] Yes No
- Q17. In providing human resource advisory services, did the firm recommend a single individual for a specific position? [GAS 3, par. 18(f); Q+A Nos. 91-92] Yes No
- Q18. In providing human resource advisory services, did the firm conduct an executive search or a recruiting program for the client? [GAS 3, par. 18(f); Q+A Nos. 91-92] Yes No

Part II: Follow-Up Considerations

Please review the following categories carefully for any *yes* response you provided in the Questionnaire and for any questions that you were unable to answer. An illustration of a documented independence matter appears in Appendix D. Please also refer to Part II, “Resolution of Potential Independence Issues,” in the AICPA Compliance Tool for general guidance on factors to gather and consider in assessing independence.

Category 1: Personal Impairments

Auditors are responsible for notifying the appropriate officials within their firms if they have any personal impairment to independence:

- Once a firm identifies a personal impairment to independence, the impairment needs to be resolved in a timely manner.
- In situations in which the personal impairment is applicable only to an individual auditor on a particular assignment, the firm may be able to mitigate the personal impairment by:
 - Requiring the auditor to eliminate the personal impairment, e.g., the auditor could move a prohibited loan to a financial institution that does not cause independence issues, or
 - Removing the individual from the audit (or other attest) engagement team.
- If a personal impairment cannot be mitigated through these means, the only other option is for the firm to withdraw from or decline to perform the audit or other attest engagement.

Category 2: Nonaudit Services

Auditors have the capability of performing a range of services for their clients. However, in a number of circumstances, it is not appropriate for them to perform both audit and certain nonaudit services for the same client. In these circumstances, the auditor and/or the client will have to make a choice as to which of these services will be provided.

Making decisions involving possible independence impairment related to audit and nonaudit services for the same client requires firms to apply reasonable judgment. In each case, the decision on whether independence is impaired is likely to rest on different factors, considering the nature of the nonaudit service and its significance or materiality to the subject matter of the audit. In other words, the facts and circumstances of the nonaudit service will drive the judgment.

In addition, the audit firm should consider the totality of services provided to the client in making reasonable judgments on independence. Overall, an audit firm should use a “substance over form” approach in applying the principles and safeguards. For example, if, in substance, the audit firm is effectively maintaining the official accounting records, the firm has violated the overarching independence principles as stated in GAS 3, paragraph 13, and the express prohibition in GAS 3, paragraph 18a.

APPENDIX A: AICPA INDEPENDENCE TERMS

Attest engagement. An attest engagement is an engagement that requires independence as defined in *AICPA Professional Standards*.

Attest engagement team. The attest engagement team consists of individuals participating in the attest engagement, including those who perform concurring and second-partner reviews. The attest engagement team includes all employees and contractors retained by the firm who participate in the attest engagement, irrespective of their functional classification (for example, audit, tax, or management consulting services). The attest engagement team excludes specialists as discussed in AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), and individuals who perform only routine clerical functions, such as word processing and photocopying.

Client. A client is any person or entity, other than the member's employer, that engages a member or a member's firm to perform professional services, or that engages a person or entity with respect to which professional services are performed. For purposes of this paragraph, the term *employer* does not include:

1. Entities engaged in the practice of public accounting; or
2. Federal, state, and local governments or component units thereof, provided the member performing professional services with respect to those entities:
 - a. Is directly elected by voters of the government or component unit thereof with respect to the professional services that are performed; or
 - b. Is an individual who is (1) appointed by a legislative body and (2) subject to removal by a legislative body; or
 - c. Is appointed by someone other than the legislative body, so long as the appointment is confirmed by the legislative body and removal is subject to oversight or approval by the legislative body.

Close relative. A close relative is a parent, sibling, or nondependent child.

Commission. A commission is any compensation for recommending or referring a product or service to a third party. The term *commission* excludes a referral fee paid for the services of a CPA to any person.

Contingent Fee. A contingent fee is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service.

Covered member. A covered member is:

1. An individual on the attest engagement team;
2. An individual in a position to influence the attest engagement;
3. A partner or manager who provides nonattest services to the attest client beginning once he or she provides 10 hours of nonattest services to the client within any fiscal year and ending on the later of the date (a) the firm signs the report on the financial statements for the fiscal year during which those services were provided or (b) he or she no longer expects to provide 10 or more hours of nonattest services to the attest client on a recurring basis;
4. A partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement;
5. The firm, including the firm's employee benefit plans; or
6. An entity whose operating, financial, or accounting policies can be controlled (as defined by generally accepted accounting principles [GAAP] for consolidation purposes) by any of the individuals or entities described in items 1 through 6 or by two or more such individuals or entities if they act together.

Dependent. Generally, a dependent is an individual who receives more than half of his or her financial support from the covered member.

Direct financial interest. A direct financial interest is:

- Owned directly by an individual or entity (including those managed on a discretionary basis by others); or
- Under the control⁸ of an individual or entity (including those managed on a discretionary basis by others); or
- Beneficially owned through an investment vehicle, estate, trust, or other intermediary when the beneficiary:
 - Controls the intermediary; or
 - Has the authority to supervise or participate in the intermediary's investment decisions.

A financial interest is beneficially owned if an individual or entity is not the record owner of the interest but has a right to some or all of the underlying benefits of ownership. These benefits include the authority to direct the voting or the disposition of the interest or to receive the economic benefits of the ownership of the interest.

⁸ For purposes of this definition, the term *control* includes situations in which the covered member, individually or acting together with his or her firm or with other partners or professional employees of his or her firm, has the ability to exercise such control.

Diversified Mutual Fund. A diversified mutual fund is a mutual fund that meets the requirements of Section 5(b)(1) of the Investment Company Act of 1940 (the Act). In addition, a mutual fund's prospectus will indicate if a fund is *not* diversified and may be used to determine whether a mutual fund is a diversified mutual fund meeting the Act's criteria.

Financial institution. A financial institution is considered to be an entity that, as part of its normal business operations, makes loans or extends credit to the general public. In addition, for automobile leases addressed under AICPA Interpretation 101-5, *Loans From Financial Institution Clients* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.07), an entity would be considered a financial institution if it leases automobiles to the general public.

Financial Interest. A financial interest is an ownership interest in an equity or a debt security issued by an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest.

Firm. A firm is a form of organization permitted by law or regulation whose characteristics conform to resolutions of the Council of the American Institute of Certified Public Accountants that is engaged in the practice of public accounting. Except for purposes of applying AICPA Rule 101: *Independence* [AICPA, *Professional Standards*, vol. 2, ET sec. 101.01], the firm includes the individual partners thereof.

Grandfathered Loan. Grandfathered loans are unsecured loans that are not material to the covered member's net worth. Home mortgages and other secured loans are grandfathered if:

1. They were obtained from a financial institution under that institution's normal lending procedures, terms, and requirements,
2. After the borrower becomes 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, and
3. They were obtained from a financial institution:
 - a. Prior to its becoming a client requiring independence; or
 - b. For which independence was not required and were later sold to a client for which independence is required; and
4. They complied with the applicable independence requirements in place at the time the loan was obtained.

Immediate family. Immediate family is a spouse, spousal equivalent, or dependent (whether or not related).

Indirect financial interest. An indirect financial interest is a financial interest beneficially owned through an investment vehicle, estate, trust, or other intermediary, such that the

beneficiary neither controls the intermediary nor has the authority to supervise or participate in the intermediary's investment decisions.

A financial interest is **beneficially owned** if an individual or entity is not the record owner of the interest but has a right to some or all of the underlying benefits of ownership. These benefits include the authority to direct the voting or the disposition of the interest or to receive the economic benefits of the ownership of the interest.

Individual in a position to influence the attest engagement. An individual in a position to influence the attest engagement is one who:

1. Evaluates the performance or recommends the compensation of the attest engagement partner;
2. Directly supervises or manages the attest engagement partner, including all successively senior levels above that individual through the firm's chief executive;
3. Consults with the attest engagement team regarding technical or industry-related issues specific to the attest engagement; or
4. Participates in or oversees, at all successively senior levels, quality control activities, including internal monitoring, with respect to the specific attest engagement.

Joint closely held investment. A joint closely held investment is an investment in an entity or property by the member and the client (or the client's officers or directors, or any owner who has the ability to exercise significant influence over the client) that enables them to control (as defined by GAAP for consolidation purposes) the entity or property.

Key position. A key position is a position in which an individual:

1. Has primary responsibility for significant accounting functions that support material components of the financial statements;
2. Has primary responsibility for the preparation of the financial statements; or
3. Has the ability to exercise influence over the contents of the financial statements, including when the individual is a member of the board of directors or similar governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

For purposes of attest engagements not involving a client's financial statements, a key position is one in which an individual is primarily responsible for or able to influence the subject matter of the attest engagement, as described above.

Loan. A loan is a financial transaction, the characteristics of which generally include but are not limited to an agreement that provides repayment terms and a rate of interest. A loan

includes but is not limited to a guarantee of a loan, a letter of credit, a line of credit, or a loan commitment.

Manager. A manager is a professional employee of the firm who has either of the following responsibilities:

1. Continuing responsibility for the overall planning and supervision of engagements for specified clients.
2. Authority to determine that an engagement is complete subject to final partner approval if required.

Member. A member, associate member, or international associate of the American Institute of Certified Public Accountants.

Normal Lending Procedures, Terms, and Requirements. *Normal lending procedures, terms, and requirements* relating to a covered member's loan from a financial institution are defined as lending procedures, terms, and requirements that are reasonably comparable with those relating to loans of a similar character committed to other borrowers during the period the loan to the covered member is committed. Accordingly, in making such comparison and in evaluating whether a loan was made under “normal lending procedures, terms, and requirements,” the covered member should consider all the circumstances under which the loan was granted, including:

1. The amount of the loan in relation to the value of the collateral pledged as security and the credit standing of the covered member
2. Repayment terms
3. Interest rate, including “points”
4. Closing costs
5. General availability of such loans to the public

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 (SEC).

Office. An office is a reasonably distinct subgroup within a firm, whether constituted by formal organization or informal practice, in which personnel who make up the subgroup generally serve the same group of clients or work on the same categories of matters. Substance should govern the office classification. For example, the expected regular personnel interactions and assigned reporting channels of an individual may well be more important than an individual's physical location.

Partner. A partner is a proprietor, shareholder, or equity or nonequity partner of the firm, or is any individual who assumes the risks and benefits of firm ownership or who is otherwise held out by the firm to be the equivalent of any of the aforementioned.

Period of the professional engagement. The period of the professional engagement begins if a member either signs an initial engagement letter or other agreement to perform attest services, or begins to perform an attest engagement for a client, whichever is earlier. The period lasts for the entire duration of the professional relationship (which could cover many periods) and ends with the formal or informal notification by either the member or the client of the termination of the professional relationship or by the issuance of a report, whichever is later. Accordingly, the period does not end with the issuance of a report and recommence with the beginning of the following year's attest engagement.

Permitted Loan. Permitted loans are the following new loans and leases, obtained from a financial institution client. These loans and leases 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, such as the following:

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., "pass-book loans").
4. Aggregate outstanding balances from credit cards and overdraft reserve accounts that are reduced to \$10,000 or less on a current basis taking into consideration the payment due date and any available grace period.

Significant influence. The term *significant influence* is as defined in Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, and its interpretations.

Source Document. Source documents are the documents upon which the evidence of an accounting transaction is initially recorded. Source documents are often followed by the creation of many additional records and reports, which do not, however, qualify as initial recordings. Examples of source documents are purchase orders, payroll timecards, and customer orders.

Spousal Equivalent. A spousal equivalent designation should be made on a case-by-case basis considering factors such as the nature of the relationship, living and financial arrangements, and whether a common law marriage exists. However, it should be noted that the lack of a common law marriage under state law (or the lack of such law recognizing common law marriages in an individual's state of residence) does not mean that an individual is not a spousal equivalent if other factors lead to that conclusion.

APPENDIX B: GAO INDEPENDENCE TERMS

Audit engagement team. The audit engagement team consists of individuals participating in the audit engagement, including those who perform concurring and second partner reviews. The audit engagement team includes all employees and contractors retained by the firm who participate in the audit engagement, irrespective of their functional classification (for example, audit, tax, or management consulting services). In addition, if the work of a specialist is used, auditors need to consider the specialist as a member of the audit team.

Audit Services. Audit services are financial audits, attestation engagements, and performance audits.

De Minimus Amount of Time. Generally, if a nonaudit service involves a total of 40 or fewer hours as it relates to a specific audit engagement, the safeguard associated with precluding personnel who provided the nonaudit service from performing related audit work would not be required. The other safeguards in GAO 3, paragraph 17, though, would apply. Audit firms should consider related services that may have been performed under separate contracts or separate engagements in applying the de minimus criteria. Related nonaudit services should be considered together in determining the overall time involved in performing the services. In applying the safeguards, firms should be able to articulate why the nonaudit service should be considered as a separate, unrelated service to other nonaudit services being provided.

Management Functions. Management functions include the following activities, though not all-inclusively:

- Serving as a member of an entity's management decision-making committee or on its board of directors (although participating as an observer or nonvoting ex-officio member is permitted under GAS 3, par. 15),
- Making policy decisions affecting the direction and operations of entity programs,
- Supervising entity employees,
- Developing entity program policies,
- Authorizing entity transactions, or
- Maintaining custody of entity assets (unless the assets are in the custody of an investigative unit and, under its statutory authority, are being held as evidence in an investigation).

Material. See *Government Auditing Standards* on financial audits, Chapter 4.04.

Nonaudit Services. Nonaudit services involve performing tasks requested by management and directly supporting the entity's operations. Nonaudit services (1) are generally performed for the sole use and benefit of the entity requesting the work or (2) provide information or data to a requesting party without providing verification, analysis, or evaluation of the information or data and, therefore, the work does not usually provide a basis for conclusions, recommendations, or opinions on the information or data. The nature and scope of a nonaudit service is generally determined by agreement between an audit firm and a client, or by the requesting party. In contrast, the nature and scope of an audit is determined by an audit firm in order to satisfy the audit objectives.

Prohibited Bookkeeping Services. Prohibited bookkeeping services include the following:

1. Maintaining the official accounting records if such services involve preparing source documents or originating data in electronic or other form;
2. Posting transactions (whether coded by management or not);
3. Authorizing, executing, or consummating transactions (for example, approving invoices, payrolls, claims, or other payments of the entity or program being audited);
4. Maintaining an entity's bank account or otherwise having custody of the audited entity's funds; or
5. Otherwise exercising authority on behalf of the entity, or having authority to do so.

Routine Activities. Routine activities generally include routine advice to a client and its management to assist in activities such as establishing internal controls or implementing audit recommendations, answering technical questions, and/or providing training. In addition, routine activities include providing tools and methodologies, such as best practice guides, benchmarking studies, and internal control assessment methodologies; collaborating with others to strengthen professional standards; developing audit methodologies; and providing legal and accounting opinions or other assistance to a legislative body.

Significant. See *Government Auditing Standards*, Chapter 7.08, "Performance Audits."

Subject Matter of the Audit. For performance audits, the subject matter of the audit is defined by the audit objectives, and it is generally limited to the program, activity, or operation under review. For financial statement audits, the subject matter of the audit is determined by the audit objectives, and can vary among audits. If the financial statement audit objective is to express an opinion on the financial statements taken as a whole, then the subject matter of the audit is the financial statements taken as a whole. If the financial statement audit objective is to express an opinion on each material unit within a state and local government, the subject matter of the audit is each material unit.

APPENDIX C: SOURCES OF GUIDANCE

Readers may refer to www.aicpa.org/members/div/ethics/index.htm for comprehensive, helpful information about the AICPA and the independence rules of other standard setters and regulators.

Sources of AICPA guidance are as follows:

- The AICPA *Code of Professional Conduct* is available at <http://www.aicpa.org/about/code/index.html> (See ET Section 100 for independence, integrity and objectivity, ET Section 300 for contingent fees, and ET Section 500 for commissions.)
- For resources related to understanding and applying the provisions of Interpretation 101-3, “Performance of Nonattest Services,” under Rule 101, *Independence (AICPA, Professional Standards*, vol. 2, ET sec. 101.05), see: http://www.aicpa.org/members/div/ethics/intr_101-3.htm.
- For independence inquiries by phone, call (888) 777-7077. Send e-mail inquiries to ethics@aicpa.org.
- The AICPA *Independence and Ethics Alert* is published annually and is available at www.cpa2biz.com or by calling 1-888-777-7077.
- The AICPA interactive CD-ROM course on independence, entitled *Independence*, provides information on the AICPA’s and SEC’s independence rules and qualifies for eight hours of continuing professional education (CPE) credits. See https://www.cpa2biz.com/CS2000/Products/CPA2BIZ/CPE+Self-Study/Sub+1/Independence.htm?cs_catalog=CPA2Biz.

Sources of GAO guidance are as follows:

- Government Accountability Office (GAO, formerly the U. S. Government Accounting Office) Yellow Book requirements are available at: www.gao.gov/govaud/yb2003.pdf
- The answers to frequently-asked independence questions can be obtained at <http://www.gao.gov/govaud/d02870g.pdf>.
- Direct inquiries to Marcia Buchanan, Asst. Director—Financial Management and Assurance at (202) 512-9321 or e-mail buchananm@gao.gov.

Sources of other guidance are as follows:

- Department of Labor (DOL)
 - DOL Regulation 2509.75-9, Interpretive Bulletin Relating to Guidelines on Independence of Accountant Retained by Employee Benefit Plan

- Direct inquiries to the DOL at 1-866-4-USA-DOL
- Federal Deposit Insurance Corporation (FDIC), The Annual *Independent Audits and Reporting Requirements*, can be obtained at www.fdic.gov/regulations/laws/rules/2000-8500.html#2000part363
- State Boards of Accountancy Information, www.aicpa.org/states/info/index.htm

APPENDIX D: DOCUMENTING INDEPENDENCE MATTERS

Firms should ensure that they adequately document matters involving independence considerations—other than clearly insignificant matters—in the audit working papers.

An illustration of a fictional firm’s documentation of an independence matter appears below.

Date: June 11, 2006

Name of Engagement: Salem, Inc. Annual Audit

Responsible Partner: B. Brown

Description of the Facts:

1. T. M., a partner in the Long Island, NY office of CPA Firm, LLP, has a daughter who has plans to accept an employment offer from Salem Company, a Long Island based electronics firm.
2. Salem, Co. is a privately held company (not subject to GAO or other independence rules).
3. CPA Firm has performed the annual audit of Salem’s financial statements since 1999.
4. The lead engagement partner for this engagement is B. Brown, a Long Island office partner and the engagement is conducted by the Long Island office.
5. The daughter would work in Salem’s internal audit department as an Internal Audit Director with overall responsibility for Salem’s financial and operational internal audit function including:
 - a. Setting project objectives, methodology, timeline and deliverables,
 - b. Identifying areas to be examined,
 - c. Documenting process flows,
 - d. Performing interviews,
 - e. Supervising staff,
 - f. Evaluating the adequacy of internal controls associated with business processes and adherence to controls and processes,
 - g. Analyzing data and forming recommendations, and
 - h. Communicating findings and recommendations to management.

(A copy of the job description and reporting lines are included as an attachment.)

6. CPA Firm has determined that the position being considered is a “key position” in that it would allow the daughter to exercise influence over the contents of the financial statements.
7. The daughter meets the definition of a close relative, since she is not a dependent of the partner.
8. The AICPA rules (Interpretation 101-1, *Application of Independence Rules to Close Relatives*) says that a covered member (i.e., a partner in the office of the lead partner) whose close relative has a key position with the client impairs the firm’s independence.
9. The firm and the partner have agreed that TM should relocate to a separate office of the firm located in NYC prior to his daughter’s employment with Salem. By doing so, TM will no longer be considered a covered person whose close relative’s position impairs the firm’s independence.

APPENDIX E:

MODIFIED AICPA INDEPENDENCE REQUIREMENTS FOR CERTAIN SSAE ENGAGEMENTS

AICPA Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 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 specified covered members, and their immediate families, are required to be independent with respect to the responsible party in accordance with AICPA Rule 101. These covered members are individuals:

- Participating on the attest engagement team;
- Who directly supervise or manage the attest engagement partner; and
- 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 AICPA Interpretation 101-1.A (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02) with the responsible party that was material to the firm.

In cases in which the firm provides nonattest services to the responsible party that are proscribed under AICPA Interpretation 101-3 (AICPA, *Professional Standards*, vol. 2, ET sec. 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 in which 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 AICPA Interpretation 102-2 (AICPA, *Professional Standards*, vol. 2, ET sec. 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 (SAS) or Statements on Standards for Accounting and Review Services (SSARS), or to an examination or review engagement performed under the Statements on Standards for Attestation Engagements (SSAE).

Source: AICPA Interpretation 101-11 [AICPA, *Professional Standards*, vol. 2, ET sec. 101.13] of the AICPA Code of Professional Conduct.

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