Auditor Independence Update
Spotlight on Non-audit Services

Presentation to: CPAacademy.org

Jay M. Bornstein, CPA
Auditor Independence Consultant
July 27, 2016
About me:

- Retired partner of Ernst & Young (June 2013)
  - 30 years in tax practice in Philadelphia
  - 10 years in National Independence Consulting Group

- Consultant and Author on Independence Matters
  - Independent consultant to review remediation plan of large firm after SEC enforcement action
  - CFO.com – November 12, 2014
  - CFO.com – April 14, 2015

- Presenter at CPAacademy.com re Auditor Independence
  - Over 4,000 attendees over 7 presentations

- The views and opinions presented are my own and not those of EY or any regulatory body or group
Independence training – the “three peat”

► Independence and You
  ► Archived version June 22, 2016
  ► Next live session August 17, 2016 – 4 p.m. EST

► Auditor Independence Update
  ► 2016 Archived version - July 14, 2016
  ► 2015 Archived versions – July 22 and September 21, 2015

► Spotlight on Non-audit services
  ► Today - July 27, 2016
  ► Archived versions – October 21 and November 16, 2015
Today’s Topics – Spotlight on non-audit services

► Hierarchy of Rules

► Who do you have to be independent of – quick overview
  ► Audit client and affiliate definition

► What services can you provide?
  ► To the entity being audited
  ► To affiliates of the entity being audited
  ► The “not subject to audit rule”

► Specific non-audit service offerings

► The way you do the things you do
Why is this important now?

► Since January 2014, 4 of the Top 10 Firms have been fined and/or censured by the SEC related to independence matters
  ► KPMG and EY matters related to non-audit services
  ► Deloitte related to business relationships
  ► Grant Thornton related to management functions

► The SEC and/or the PCAOB have recently fined over 20 broker-dealer auditors related to independence violations concerning non-audit services
  ► See, for example, PCAOB Release 105-2015-035

► There have been several high profile audit firm resignations due to independence matters
  ► PWC resignation due to proscribed consulting engagement of acquired firm

► Statements by regulators stress independence matters
Hierarchy of Rules

- **AICPA Code of Conduct**
  - New Code of Conduct Effective December 15, 2014
  - Section 1.200 – Independence
  - Section 1.295 – Non-attest services

- **SEC – Regulation S-X, Rule 2-01**
  - Rule 2-01(a) – The Four Overarching Principles
  - Rule 2-01(c)(4) – Non-audit services

- **PCAOB Rules on Tax Services and Independence**
  - Rules 3521, 3522, 3523 – Fees & Tax Services
  - Rules 3524, 3525 – Pre-approval of Certain Services
Safeguards for non-attest services:

a) Client and Management agree to:
   I. Assume all management responsibilities
   II. Oversee the service by a substantially skilled and knowledgeable individual
   III. Evaluate the adequacy and results of the services performed
   IV. Accept responsibility for the results of the services

b) Auditor does NOT assume management responsibility

c) Documentation of auditor and client understanding of engagement
   I. Must be in writing
   II. Inclusion in engagement letter is sufficient to meet requirement
SEC – Four overarching independence principles
Regulation S–X, Rule 2-01(a)

► Does a relationship or a service:
  ► Create a mutual or conflicting interest between the accountant and the audit client
  ► Place the accountant in the position of auditing his own work
  ► Result in the accountant acting as management or an employee of the audit client
  ► Place the accountant in a position of being an advocate for the audit client
An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides the following non-audit services to an audit client:

**The sometimes permitted or ‘Good Five’**
- Bookkeeping or other services related to the accounting records or financial statements of the audit client
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services

**The never permitted or ‘Bad Five’**
- Management or employee functions
- Human resources
- Broker-dealer, investment adviser, or investment banking services
- Legal services
- Expert services unrelated to the audit
Who do you have to be independent of?
Who do you have to be independent of?

- Audit client
  - Entity being audited
- Affiliates of the audit client
  - Entity in control of the audit client
  - Entity that the audit client controls
  - Entity under common control with audit client
  - Entity which has significant influence over the audit client and the audit client is material to that entity
  - Entity over which the audit client has significant influence and the entity is material to the audit client
Ownership Structure for US Public Company

Audit client is U.S. Public Company
Structure for Private Equity Company

Passive Investors

100%

Management Co.

99%

100%

Contract 1%

Private Equity Co.

Fund 1

A

100%

B

100%

C

40%

Fund 2

D

70%

E

10%

F

30%

Fund 3

G

100%

H

50%

I

30%

Audit client is Company D (SEC issuer)

- Affiliate

- Affiliate if material
► Greater emphasis on materiality

► Materiality measured using 10% - not 5%

► Aggregation of entities used for calculations

► Watch for further developments concerning engaging party
What services can you provide?
An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides the following non-audit services to an audit client:

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- Bookkeeping or other services related to the accounting records or financial statements of the audit client
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services

**The never permitted or ‘Bad Five’**
- Management or employee functions
- Human resources
- Broker-dealer, investment adviser, or investment banking services
- Legal services
- Expert services unrelated to the audit
SEC – Certain prohibited services permitted if:

“"It is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit clients financial statements”

Materiality is not a criteria nor is exclusion from audit scope

Generally not available for downstream affiliates whether consolidated or not

Services must comply with all other general independence standards
The “Not subject to audit” exception

Passive Investors

Private Equity Co.

Management Co.

Fund 1

Fund 2

Fund 3

A

B

C

D

E

F

G

H

I

100%

99%

100%

100%

100%

70%

100%

100%

Audit client is Company D (SEC issuer)

- Affiliate

- Affiliate if material

- Contract 1%

- Contract 1%

- Contract 1%

- 100%

- 70%

- 10%

- 30%

- 30%

- 50%
Specific non-audit service offerings
Bookkeeping, Payroll, and Disbursements
AICPA Rule – Section 1.295.120

**Permitted***

- Record or post transactions to ledger
- Prepare financial statements based on general ledger
- Propose and post journal entries
- Prepare unsigned checks and process payroll
- Prepare reconciliations

**Prohibited**

- Determine postings or entries without client’s approval
- Preparing source documents
- Signs or co-signs checks for an attest client
- Maintains client bank account or has custody or client assets

*Subject to compliance with general independence requirements of Section 1.295.040
Bookkeeping and financial statement preparation

Prohibited Activities - SEC Rule – 2-01(c)(4)(i)

► Maintaining or preparing the Audit client’s accounting records

► Preparing the Audit client’s financial statements that are filed with the Commission

► PCAOB Release 105-2015-035 – Disciplinary Release concerning *Olivia, Goddard, and Wright – Certified Public Accountants*
  ► Maintained fixed asset ledger
  ► Prepared journal entries for tax provision
  ► Prepared accounts payable accrual
  ► Computed depreciation / reconciled fixed assets
  ► Prepared financial statements and notes
  ► Converted FOCUS Reports to financial statements

► These were all permitted activities under AICPA Rules
Financial Information Systems design and implementation - AICPA Rule – Section 1.295.145

**Permitted***

- Install or integrate “off the shelf” software
- Install systems unrelated to the financial statements or accounting records
- Perform software maintenance on systems

**Prohibited**

- Design financial software systems
- Supervise client personnel operating financial systems
- Operate a client’s network

*Subject to compliance with general independence requirements of Section 1.295.040*
Financial Information Systems design and implementation – SEC Rule 2-01(c)(4)(ii)

Permitted

► Evaluating client systems under development and recommending improvements on internal control matters
► Audit related testing on Client systems
► Design or implementation of non-financial systems
  ▶ See SEC FAQ on Tax Compliance Software

Prohibited

► Operating, directly or indirectly, client’s information system or local area network
► Designing or implementing a hardware or software system that aggregates source data or generates information that is significant to the financial statements
► Tax compliance software that has tax provision modules
AICPA Rule – 1.295.110

**Permitted**
- Valuations of immaterial items
- Valuations of non-subjective matters, such as pension liabilities or post-employment benefits
- Non-financial statement related valuations

**Prohibited**
- Valuations involving subjectivity related to material items on financial statements

SEC Rule – 2-01(c)(4)(iii)

**Permitted**
- Tax Related Valuations
  - Transfer Pricing
  - Cost Segregation
- Audit Support
  - Impairment testing
  - Purchase price allocation reviews

**Prohibited**
- Financial Statement Valuations
- Fairness Opinions
- Contribution-in-kind reports

*Subject to compliance with general independence requirements of Section 1.295.040*
AICPA Rule – 1.295.110

Permitted*

► See comments regarding Appraisals and Valuations – Actuarial computations are assumed not to be subjective and are therefore permitted

*Subject to compliance with general requirements of Section 1.295.040

SEC Rule 2-01(c)(4)(iv)

Permitted

► Advice on appropriate actuarial methods and assumptions
► Audit related support

Prohibited

► Performing actuarial computations
► Performing actuarial related advisory services involved in determining amounts recorded in the financial statements
**AICPA Rule 1.295.150**

*Permitted*

- Assistance with performance of financial and operational internal audit activities
- Assistance of internal audit functions and recommendations for improvement
- Assistance with audit risk assessments and recommending audit plans and priorities

*Prohibited*

- Providing outsourced internal audit functions to the attest client
- Performing ongoing evaluations or controls activities
- Performing ongoing compliance or quality control functions

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**SEC Rule 2-01(c)(4)(v)**

*Permitted*

- Non-recurring evaluations of discrete items including “agreed upon procedures” engagements
- Operational internal audits unrelated to the internal controls, financial systems, or financial statements
- Recommendations and improvements on internal controls

*Prohibited*

- Internal audit outsourcing services related to internal accounting controls, financial systems, or financial statements

*Subject to compliance with general independence requirements of Section 1.295.040*
Tax Services – Overview of SEC Views

► Tax services expressly permitted by Sarbanes-Oxley Act of 2002, unless prohibited by specific non-audit services limitations

► “Labeling a service a tax service will not necessarily eliminate its potential to impair independence.”

► Prohibitions:
  ► Representation in Tax Court or similar forum
  ► Tax services involving making management decisions, directing third parties, or having custody of client assets
  ► Tax services that are business relationships such as subcontracting relationships
  ► Loaned staff in tax engagements
  ► Recurring functions that are equivalent to employee functions

► Stay aware of new technologies and their impact on service delivery

► Shared work portals may eliminate potential for management review
PCAOB Independence Rules related to Tax Services

- Rule 3521 – Contingent Fees Prohibited
  - Similar to SEC Rule
  - More restrictive than AICPA Rule

- Rule 3522 – Confidential and Aggressive Tax Position Transactions

- Rule 3523 – Tax Services to Persons in a Financial Reporting Oversight Role
  - Issuer only rule

- Rule 3524 – Audit Committee Pre-approval of tax services
  - Issuer only rule
The way you do the things you do

► Tax Services as Loaned Staff Engagement

► Tax Services as business relationships
  ► Subcontracting with an audit client
  ► Tax and financial planning services offered jointly with broker-dealer audit client
  ► Exclusive recommendation arrangements

► Tax Services as Acting as management
  ► Supervising third parties in joint projects
  ► Technology limiting management’s review of work
  ► Frequency of services – routine transaction involvement
  ► Advocacy
Management or employee functions
AICPA Rules compared to SEC Rules

AICPA Rules 1.295.030 and 1.295.105 (advisory services)

Permitted*
► Providing advice, etc., to assist management
► Attend Board meetings as a non-voting advisor

Prohibited
► Being simultaneously associated with client as a director, officer, or employee
► Refer to the listing of activities considered management activities at 1.295.030

SEC Rule 2-01(c)(vi)

Permitted
► Assessment of internal accounting and risk management controls
► Providing recommendations for improvements to clients on third party service providers

Prohibited
► Acting temporarily or permanently as director, officer, or employee of an audit client
► Supervising client employees
► Having decision making authority
► Loaned staff engagements including tax

*Subject to compliance with general independence requirements of Section 1.295.040
AICPA Rule 1.295.135

Permitted*
► Recommendations concerning job descriptions or candidate specifications
► Solicit or screen candidates based on client approved criteria
► Make hiring recommendations to the attest client
► Participate in hiring discussions in an advisory category

Prohibited
► Committing the client to compensation and benefit arrangements
► Hiring or firing attest client’s employees

SEC Rule 2-01(c)(4)(vii)

Permitted
► Advice on organizational matters
► Assistance with design and development of compensation plans, in particular, assistance in tax and accounting aspects

Prohibited
► Perform searches for managerial or executive positions
► Negotiations with candidates on an audit client’s behalf
► Undertake reference checks or provide testing or evaluations

*Subject to compliance with general independence requirements of Section 1.295.040
Broker-dealer Services
AICPA Rules - Section 1.295.130 – Corporate Finance Consulting & Section 1.295.155 Investment Advisory and Management

Permitted*

► Assistance in development of corporate strategies
► Introductions to possible sources of capital
► Assistance in drafting offering documents
► Participate in transaction negotiations
► Be named as a Financial Advisor in documents
► Recommend investment allocation strategies
► Evaluate third party investment managers

Prohibited

► Committing clients to transactions
► Acting as a promoter, etc., of an attest client’s securities
► Maintain custody of a client’s securities or assets
► Execute investment transactions for client

*Subject to compliance with general independence requirements of Section 1.295.040
Broker-dealer Services
SEC Rule - 2-01(c)(4)(viii)

**Permitted**
- Transactional support and advisory services not in the nature of broker-dealer services

**Prohibited**
- Serving as a registered or unregistered broker-dealer
- Serving as a promoter or underwriter of client securities
- Selling or recommending an audit client’s securities
- Providing advice and recommendations on investments
- Drafting investment memorandum
- Use caution re personal tax services and PCAOB Rule 3523 when doing personal financial planning work
Legal Services
AICPA Rules compared to SEC Rules

**AICPA Rule – 1.295.140**

**Permitted**
- Serving as a non-deciding mediator in a dispute involving an audit client
- Providing advice about the facts, issues, or strategy pertaining to a legal matter
- Providing services as a fact witness

**Prohibited**
- Unauthorized practice of law
- Serving as a trier of fact, a special master or arbitrator
- Representing a client in court in a tax matter
- Serving as an expert witness

**SEC Rule – 2-01(c)(4)(ix)**

**Permitted**
- Providing services which are only provided by a lawyer in a foreign jurisdiction, if a non-lawyer can provide the services in the U.S.
- Having lawyers participate in the delivery of advisory services where they do not provide legal advice

**Prohibited**
- Acting as a lawyer in the performance of services
- Representing oneself as a lawyer in the performance of services for a client
- Providing services that only a lawyer can provide
- Representing a client in a court even if a CPA is permitted to represent clients there (e.g., U.S. Tax Court)

*Subject to compliance with general independence requirements of Section 1.295.040
AICPA Rule – Section 1.295.140
Forensic Accounting

Permitted*
► Providing investigation services that do not involve actual or threatened litigation
► Expert services to a group subject to the 20% rule
► Fact witness testimony
► Providing litigation consulting advisory services

Prohibited
► Providing expert witness services

SEC Rule – 2-01(c)(4)(x)

Permitted
► Performing internal investigations or other fact finding engagements
► Providing the result of work to a client’s legal counsel
► Serving as a fact witness
► Assisting the audit committee in fulfilling its responsibilities to conduct investigations

Prohibited
► Providing forensic or expert type services after a legal proceeding has commenced
► Providing expert witness testimony
► Assisting client’s legal counsel in connection with defense in litigation, regulatory, or administrative matters
► Being an advocate for the audit client

*Subject to compliance with general independence requirements of Section 1.295.040
Jay M. Bornstein CPA
Auditor independence consultant

Jay.Bornstein@CPA.com
215-915-7370
https://www.linkedin.com/in/jaybornstein
Appendix and supplemental information
Auditor Independence Update
Spotlight on
Non Audit Services
Sources of Independence Rules

- **Independence Related Rules**
  - SEC Regulation S-X, Rule 2-01
    - More detailed explanation at SEC Release #33-8183
  - PCAOB Rules 3600 to 3626
  - AICPA Code of Professional Conduct – Section 1.200
  - IFAC Code of Ethics for Professional Accountants
  - Government Accounting Office and Department of Labor Rules

- **Other operative rules for CPA’s**
  - IRS Circular 230
  - State Board of Accountancy Rules
What is independence

- Independence in Fact – a rules based system
  - Rule 2-01 of Regulation S-X of the SEC Rules concerning financial statements
  - Rules 3600 to 3626 of the PCAOB
  - AICPA Code of Professional Conduct Section 1.200
  - IFAC Code of Ethics for Professional Accountants

- Independence in Appearance
  - The “reasonable investor” test
  - The “Wall Street Journal” test

“Auditors play a crucial role in the financial reporting process by serving as the “public watchdog”

U.S. vs. Arthur Young & Co. 465 U.S. 805
Why independence?

- Independence is a cornerstone of the accounting profession.
- Clients, regulators, and others require auditors to be independent.
  - The Federal Securities Acts from 1933 require financial statements to be audited by an independent auditor.
  - Sarbanes-Oxley creates PCAOB to regulate auditors of companies which are issuers.
  - Dodd-Frank Act puts auditors of Broker-Dealers under PCAOB regulatory regime and expands registration of investment advisors.
- Consequences of independence failures can be significant to accounting firms and their clients.
  - Fines or lack of ability to access public markets for capital.
Independence overview

- Independence is a shared responsibility between auditor and client.
- Independence, in fact and appearance, relates to the integrity and objectivity of the auditor.
- Independence programs and practices should be embedded into the ongoing operations of both the audit client and the auditor.
- The primary objectives of the independence policies and programs employed by both the audit client and auditor are to maintain independence in fact and appearance and prevent independence violations from occurring.
  - Prevent controls
  - Detect controls
- Independence violations are expensive to fix; embarrassing to the firm, its people and the client; and can result in loss of the client.
  - New AICPA guidance regarding assessing independence violations – Section 1.298.010
  - Firm and individual sanctions can apply
  - Companies can be denied access to the capital markets.
Regulators have indicated that auditor independence is a shared responsibility of the company, its management, its audit committee and the audit firm.

If a company files with the SEC and the auditor is not independent, the company has failed to comply with SEC regulations.

Important to proactively manage the relationship to ensure there is communication among parties and expectations are established, understood and met.
“With this in mind, let me reinforce why maintaining independence is a shared responsibility… If you have not done so recently, I’d suggest reflecting on whether improvements to policies and procedures are appropriate…”

December 9, 2013 – Brian Croteau – Deputy Chief Accountant SEC

“I believe this reminder deserves repeating”

December 8, 2014 – Brian Croteau

SEC Solicits public comments on audit committee disclosure – July 1, 2015

Auditor Independence is the CFO’s responsibility too

Jay Bornstein and Steve Blowers – November 12, 2014 – CFO.com
“We have, in recent weeks, seen publicly reported examples of resurgence of audit firms into consulting to bolster revenue… Of what consequence are these developments for the audit functions? What are the implications for independence of the audit functions?…”

December 9, 2013  James Doty – Chairman PCAOB

“Capturing that demand requires attending to the public’s desire for confidence that the audit function is the watchdog the public expects it to be. The public needs to hear auditors bark when there’s a problem.”

December 8, 2014  James Doty – Chairman PCAOB

Independence, as a high priority for our enforcement program is – I believe – particularly necessary now as audit firms business models continue to evolve…”

December 10, 2014  Claudius Modesti – PCAOB Director of Enforcement

The Rise of Advisory Services in Audit Firms – speech to PLI Annual Directors’ Institute

November 24, 2014  Steven B. Harris – PCAOB Board Member
What rules apply to the situation

► All attest clients – AICPA Rules
► Issuers of debt or securities – SEC and PCAOB
► Broker-dealers – SEC and PCAOB
► Registered investment advisors – SEC
► Pooled Investment Funds – SEC assuming advisor registered with the SEC
► Venture Capital Funds and Family Offices – AICPA only unless advisor registered with SEC

► Note: The rules that apply are based on the entity you are auditing, but other rules could apply based on special situations.
## SEC/PCAOB Rules – Issuers versus Non-issuers

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<td>Regulation S-X, Rule 2-01 (c)</td>
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<td>1) Financial relationships</td>
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<td>2) Employment relationships (general rule)</td>
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<td>2(B)) Employment relationships (cooling off rule)</td>
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<td>3) Business relationships</td>
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<td>4) Non-audit services</td>
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<td>5) Contingent Fees</td>
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<td>6) Partner rotation</td>
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3522, 3523
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## SEC/PCAOB Rules – Issuers versus Non-issuers

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<td>7) Audit Committee Administration Of Engagement</td>
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<td>Additional Rules</td>
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<td>8) Audit Partner Compensation</td>
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<td>3524, 3525 Additional pre-approval requirements</td>
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**Notes:**
- ✓: Required
- X: Optional
- –: Not applicable

**Issuer**
- Broker Dealer

**Non-issuer**
- Issuer
For additional information

► Article by Matthew P. Bosher of Hunton & Williams, “Recent Auditor Independence Cases Suggest SEC’s “Operation Broken Gate” is in Full Swing”, published by Bloomberg BNA in the Securities Law and Regulation Report dated December 22, 2014

► SEC enforcement cases and associated press releases re independence enforcement cases (SEC Website under enforcement):
   ► KPMG LLP – January 24, 2014 re non-audit services, affiliate identification and new audit client evaluations
   ► Ernst & Young LLP – July 14, 2014 re advocacy services
   ► Grant Thornton India LLP – October 1, 2015 re acting as management

► PCAOB enforcement cases against various broker-dealer auditor firms (see PCAOB Website for links)

► AICPA FAQ’s concerning non-audit services and plain language guide to independence rules