Auditor Independence Series
Spotlight on
Auditor Independence and You

Presentation to: CPAacademy.org

Jay M. Bornstein, CPA
Auditor Independence Consultant
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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.org on auditor independence matters
  - Over 6,000 attendees at multiple presentations
- The views and opinions presented are my own and not those of EY or any regulatory body or group
Spotlight on - Independence and You
  Today – November 2, 2017
Spotlight on – Auditor Independence Update
  Next Session – November 15, 2017
Spotlight on – Non-Audit Services
  Next Session – November 30, 2017

Archived sessions available at CPAacademy.org
## Time after Time

**What a difference 6 months makes**

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So much to worry about

- Personal Ethics – Firm Code of Conduct
- Conflict of Interest Policies
- Confidentiality
- Insider Trading Rules
- Privacy of Personal Tax Return Data/HIPPA

Finally, an added Bonus

Independence
Independence in “fact and appearance” – a toll charge on the audit highway

► Independence in Fact
► A series of rules designed to assist you in maintaining an independence “state of mind” – that is: “you are free of influences that could compromise your professional judgment”

► Independence in Appearance
► Does an outside user of the financial statements conclude that you are independent – that you would do the right thing if you identified an issue
  ► The “Reasonable Investor” Test
Today’s Topics – Independence and You

► How does independence impact your financial life

► What about my family

► Suppose I want to leave the firm

► Spousal and Family employment limitations
What’s new and exciting

► “Romance and Bromance” – the two SEC enforcement cases against EY
► “That’s my boy” – PCAOB enforcement case against Thomas W. Klash, CPA
► “Who’s Your Client” – new definition from the AICPA
► “Lessor of 2 Evils” – new interpretation re leases
► “Be my guest” – new rules on data hosting
► “Long time coming” – Long association with client
Both cases released September 2016
- Cited EY and Individuals at EY and/or client

Violations of Rule 2-01(b) – the reasonable investor standard

Firm had reason to know of the matter
- Contrast to insider trading case against Scott London of KPMG

Firms respond with changes to independence procedures
Use of close relative as a bookkeeper for the client

Client was a shell company – no assets, no employees

Bookkeeper was engagement quality review partner’s son

Similar to other PCAOB enforcement cases in 2015
New Definition adopted by the AICPA – effective December 31, 2017

- Separate “attest client” from “client”
  - Attest client is entity on which procedures are performed
  - “Engaging entity”, if different, is separate client

- Attest client requires independence

- Engaging entity –
  - Test for affiliate status under independence rules
  - Test for pressure points on “Integrity and Objectivity Rule” in ethics rules.
New lease accounting rules effective for financial statements years beginning
- Periods beginning after 12/15/2018 – public companies
- Periods beginning after 12/15/2019 – private companies

More reporting on the balance sheet of leases as liabilities ("right to use obligations")

Leases and loans with audit clients subject to different independence rules – loans are more limited

AICPA proposals out for public comment – effective date ties in to effective date of accounting rules
Long Association with Attest client

► New independence rules designed to converge with similar International (IESBA) rules
► AICPA proposed rules are different than IESBA
  ► No partner rotation as that is covered by SEC for issuer audit clients
  ► AICPA Rule only covers senior engagement personnel
  ► AICPA Rule on mentions “familiarity threat” and not self interest threat
► Comment period open on AICPA proposals
So many rules – so little time

- **Firm Rules**
  - Could be broader in application than actual SEC or AICPA Rules
    - This creates a safety net between violations and regulatory matters
  - Could apply differently to partners and non-partners
  - Firm Rules are supplemented by Firm’s independence procedures

- **AICPA Rules**
  - Apply to more than just audits
  - Definition of Firm or member of network
  - Definition of audit client goes beyond entity you are auditing

- **SEC and PCAOB Rules**
  - Apply to auditors of issuers and broker dealers
  - SEC Rules also apply to some non-public entities
  - Expanded definition of audit client
Sources of Independence Rules

► Independence Related Rules
  ► SEC Regulation S-X, Rule 2-01
  ► 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
  ► Your employer’s rules and your own common sense
Who has to be independent?

► Firm
► Covered Persons in the Firm
► Immediate and Close Family members
Who - Firm

- Accounting Firm
  - Departments, Parents, Subsidiaries or divisions
  - Pension, Investment, employee benefit or similar plans
  - Associated Entities

- See: SEC Release 75028 – In the matter of Mayer Hoffman McCann P.C. – May 21, 2015 re alternative practice structures

- See PCAOB Release 105-2015-034 – In the matter of David Aronson CPA – October 2, 2015 re using son’s accounting firm as bookkeeper for clients
Who – Covered Persons in the Firm

► Category 1 – Attest engagement team

► Category 2 – Chain of Command – person in a position to influence the attest engagement

► Category 3 – Manager level or higher ranking employee or partner who provides more than 10 hours of non-attest service to attest client within a fiscal year

► Category 4 – Other partners of the Firm in the same office as lead engagement partner on attest engagement (regardless of location of client)
Immediate Family Members include
- Spouse
- Spousal Equivalent
- Dependents

Close Family Members include
- All the above plus
- Parents
- Non-dependent children
- Siblings

Note – “In law” relationships are excluded
Financial Relationships

- Stocks, bonds, notes and options
  - Size of investment or length of holding period not relevant
  - Short sales and put and call options included
  - 5% of attest client’s security rule
- Loans – subject to certain exceptions
- Savings and checking accounts
- Brokerage accounts
  - Margin accounts subject to the loan rules
- Credit cards
- Insurance Products
Direct versus Indirect Financial Interests

- Direct Financial Interest – no materiality
  - Owned directly even if managed by others
  - Under control even if managed by others
  - Owned through an intermediary when the intermediary is controlled or you are involved in its investment decisions

- Indirect Financial Interest – consider materiality
  - Owned through an intermediary where you do not control it or participate in its investment decisions
Mutual Funds

▸ Diversified Mutual Funds –
  ▸ Owning less than 5% means underlying investments are considered immaterial indirect investments
  ▸ Owning more than 5% requires materiality testing

▸ Non-Diversified Mutual or other Funds –
  ▸ Materiality testing re underlying investments
  ▸ Fund can’t own 20% of a single audit client

▸ Funds can become non-diversified at any time – in particular entities such as activist hedge funds
Pass-through Entities

- Ownership of an LLC interest or a partnership interest is a direct financial interest in that entity.
- General partners or LLC Managing members have direct financial interests in the entity’s financial interests.
- Limited partners or non-managing LLC members have indirect financial interests in the entity’s financial interests.
- Investment clubs are partnerships – materiality is not a factor in assessing investments.
Permitted Loans

- Normal course of business loans – from lending institutions
  - Auto loans and leases with autos as collateral
  - Loans fully collateralized by cash surrender value of life insurance
  - Loans fully collateralized by cash deposits at the same financial institution
  - Mortgage loans on primary residences obtained prior to becoming covered person
  - Credit cards and overdrafts lines under $10,000
- Under AICPA Rules all loans prior to becoming a covered person are grandfathered but must remain current
  - SEC rules only grandfather primary residence mortgage
Financial interest exceptions

- Gifts and inheritances provided they are disposed of within 30 days
- New audit client – disposal of stock prior to commencing audit procedures or signing an initial engagement letter
- Compensation and benefit plans of family members employed by audit client
  - Unavoidable by virtue of participation in compensation or benefits plan
  - Disposals of financial interests as soon as practical
Alternate practice structures create a public entity deemed to be part of accounting firm

Your audit client invests in that public entity

Common personal independence violations

► Spousal/spousal equivalent and dependents’ investments (including retirement plans)

► Financial interests received as gifts and inheritances

► Financial interests in trusts where you are a trustee or where you have power of attorney over another person’s financial interests

► Financial interests managed on a discretionary basis by a third party

► Ignoring changes to your investment portfolio due to mergers, acquisitions, spin-offs, etc.
Simultaneously being the auditor and an employee in any form impairs independence
- Includes all professional employees of firm – not just covered persons
- Discussing potential employment with audit client requires withdrawal from audit engagement team
- The CPA firm should consider need for additional audit procedures on your work
Your exit strategy - issues

- Any amounts due to you from the firm including unfunded retirement benefits, payments for capital, etc. must be immaterial to the firm.
- Amounts due you must remain fixed in amount or by formula or reside in a funded retirement plan.
- You have no ongoing association with the firm.
- The firm evaluates it’s audit procedures to assess your familiarity with them and your level of influence over engagement team.
If you are in an accounting role or a financial reporting oversight role – no unfunded payments can be due to you – regardless of materiality
► Unfunded pensions must be set aside in a Rabbi Trust
► Consultant versus employee issues

For issuers, if you were on the audit engagement team, a cooling off period would apply for financial reporting oversight role employment.
► Could be as long as 23 months after employment with CPA Firm
► Could apply retroactively in the event of an IPO
It’s a family affair - investments

- Family financial interest limitations – immediate family members
  - Direct financial interests are prohibited
  - Indirect financial interests are measured by materiality
    - Materiality is calculated using you and family member’s assets
  - Exceptions for employment based financial interests

- Close family member’s material investment in your audit client is a potential issue
Immediate family of any covered person cannot be employed in a key position at an attest client.

Close family member of most covered persons (not Category 3) cannot be employed in a key position at an attest client.

Key position is assessed with reference to financial statements being audited – therefore doesn’t include all affiliates.
Employment related financial interests

► Applicable to immediate family members
  ► Participation in employee benefit plans is permitted under AICPA rules – some limits under SEC rules

► Participation in share based compensation plans
  ► Exception doesn’t apply to your audit client
  ► When shares can be disposed – they are immediately disposed
  ► If shares are subject to option – options are exercised as soon as practical and shares are disposed
Oops – Sh*t happens
What now

- Read Section 1.298 – AICPA Code of Conduct re: Breaches in independence
- Evaluate your objectivity, integrity and freedom from bias
- Conclude and communicate with client
- Have client reach their own conclusion
- Resources -
  - AICPA Ethics Division and Hotline
  - SEC Office of The Chief Accountant
► More details on some rules

► Free time reading suggestions

► Sign up for Cathy Allen’s newsletter at Auditconduct.com

► Check AICPA Ethics and Independence Activities at PEEC section of AICPA website
Thanks for listening!

Questions / comments

Jay.Bornstein@cpa.com
215-915-7370
Linkedin.com/in/jaybornstein
AICPA Independence Hierarchy

- Threats – Relationships or circumstances that could impair independence
- Safeguards – Actions or other measures that may eliminate or reduce a threat to an acceptable level
- Acceptable Level – a level where a reasonable informed third party would be expected to conclude independence is not impaired
- Impaired – the lack of independence
Familiarity Threat – family member in key position at attest client

Management Participation Threat – a member serves as an officer or director of attest client

Self Interest Threat – a member has a direct or material indirect financial interest in the attest client
Savings and checking accounts

- Permitted subject to limits of FDIC Insurance
  - For SEC Rules one day over limit is a violation – even if checks are outstanding
  - For AIPCA Rules amounts over limit must be immaterial or “cured” to immaterial amount within 30 days
- Accounting Firms are not subject to FDIC limit rule unless bank financial difficulty is not remote
- Overdraft protection lines of credit are loans – not offsets to deposit accounts
Loans – complex rules apply

► Covers all debtor-creditor relationships including guarantees – loans to and from attest clients are both considered

► SEC rules include loans from all 10% shareholders – including banks – while AICPA Rules only include individuals that are 10% shareholders

► Applies to loans from the audit client and its officers and directors
Loans – things to watch

► Accounts payable – when does a permitted accounts payable become a prohibited loan
  ► Also need to monitor business relationship rules
► Banks that lend to your client and then take possession of the stock upon default or via equity kickers
► Capital leases are loans – not leases – watch new accounting rules
► Credit cards – who are you borrowing from
Group policies are permitted – only individual policies are covered by the rules

For SEC rules policies obtained prior to being a covered person are grandfathered
  - Renewals are permitted – significant changes are not renewals

For AICPA Rules policies obtained under normal terms, etc. are permitted

Solvency of insurance company must be monitored

Policies with investment options – the underlying investments are direct financial interests

Demutualization creates disposal requirement
Steps of an independence evaluation

- Who is the client
- Whose independence is impacted by the situation
- What rules (AICPA, SEC, IFAC) apply to the situation
- What is the relationship or service being evaluated
- What other Firm rules (QC, conflicts, etc) need to be considered
Great free-time reading

▶ AICPA Plain English Guide to Independence – March 1, 2016

▶ SEC and PCAOB Alerts re Independence for non-issuer audit engagements – primarily broker-dealers