

PPC Whitepaper

Complying with the Recently Revised Requirements of AICPA Ethics Interpretation 101-3, *Performance of Nonattest Services*

In September 2003, the AICPA's Professional Ethics Executive Committee (PEEC) issued a revision to Ethics Interpretation 101-3, *Performance of Nonattest Services*. The purpose of the revision was to modify the practitioner's responsibilities for maintaining independence when providing nonattest services to attest clients. Since nonattest services include services such as bookkeeping services, payroll services, and tax services, many practitioners will be affected by this new Interpretation.

As a service to our customers, PPC is providing this document to assist you in understanding and applying the requirements of the revised Interpretation. This document provides an overview of the revised Interpretation, plus it includes answers to a series of questions that are likely to arise as practitioners begin to apply the requirements of the revised Interpretation. In addition, this document contains instructions on how to download a sample engagement letter for engagements in which several attest and nonattest services are provided for a client.

Overview

The revised Interpretation is effective as of December 31, 2003, and it contains new requirements that practitioners will, in some situations, need to consider for their December 31, 2003 engagements. The primary changes in the revised Interpretation are as follows:

- The client must agree to perform certain specific functions in connection with the nonattest services.
- Practitioners now must document in writing their understanding with the client regarding the nonattest services and the client's responsibilities.
- Certain nonattest service activities that were previously allowed, such as designing a client's financial information system or performing a valuation of a client's business for financial statement purposes, are now an impairment of independence.

Client Must Agree to Perform Certain Functions

Under the revised Interpretation, independence is considered to be impaired if a practitioner (or his or her firm) performs management functions or makes management decisions for an attest client. However, the practitioner may assist management in those functions or decisions. For the practitioner to remain independent, the client must agree to perform all of the following functions in connection with the engagement to perform nonattest services:

- Make all management decisions and perform all management functions.
- Designate a competent employee to oversee the services.
- Evaluate the adequacy and results of the services performed.
- Accept responsibility for the results of the services.
- Establish and maintain internal controls, including monitoring ongoing activities.

In addition, the practitioner should be satisfied that the client will be able to meet all of these criteria and make an informed judgment on the results of the nonattest services. In cases where the client is unable or unwilling to assume all of these responsibilities, the practitioner's performance of the nonattest services would impair independence.

Written Documentation Is Required

One of the most significant changes made in this Interpretation is that, to maintain independence, the practitioner must document in writing his or her understanding with the client regarding the following:

- Objectives of the engagement (i.e., the nonattest services).
- Services to be performed.
- Client's acceptance of its responsibilities.
- Member's responsibilities.
- Any limitations of the engagement.

The revised Interpretation does not specify how the written understanding is to be documented, so the practitioner has flexibility. For example, the understanding might be documented in a separate engagement letter, in the workpapers, or in an internal memo, or it might be included in an engagement letter obtained in conjunction with an attest engagement. A sample engagement letter designed for engagements in which several attest and nonattest services are provided for a client is available from PPC. The letter can be obtained by downloading the file from the PPC website at <http://www.ppcnet.com/IntranetFiles/42689/engletter101-3.rtf>.

Activities that May or May Not Impair Independence

Certain activities performed as part of a nonattest service are considered to be management functions and, therefore, impair independence. The Interpretation lists common nonattest service activities and notes whether they are or are *not* considered to impair independence. For example, preparing financial statements based on information in the trial balance is considered a nonattest service that does not impair independence. In addition, proposing standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client is considered a nonattest service that does not impair independence, provided the client reviews the entries and the practitioner is satisfied that management understands the nature of the changes and their impact on the financial statements. On the other hand, authorizing and approving transactions is a nonattest bookkeeping service activity that is considered to impair independence. Many of the activities listed in the revised Interpretation were listed in the Interpretation prior to the revision, with most of the changes relating to the performance of appraisal, valuation, or actuarial services and information systems design, installation, or integration.

Effective Date

The revised Interpretation, with the exception of the documentation requirement, is effective for nonattest services provided to attest clients after December 31, 2003, unless the practitioner had an existing agreement for the nonattest services on December 31, 2003, completes the nonattest services by December 31, 2004, and complies with the Interpretation as it existed prior to the revisions. The documentation requirement is effective for all nonattest services performed for an attest client after December 31, 2004.

Questions and Responses

The following are questions that are likely to arise as practitioners begin to apply the requirements of the revised Interpretation. The responses reflect the authors' views on such matters and should not be considered authoritative. They are provided as a tool to assist our customers in understanding the requirements of the revised Interpretation.

1. Definition of Attest Services.

Question^{3/4}How do the AICPA's Ethics rules define attest services?

Response^{3/4}ET Section 92.01 defines an attest engagement as "an engagement that requires independence as defined in AICPA professional standards." Consequently, attest services include audits, examinations, reviews, compilations, and agreed-upon procedures services. (However, as noted in question 4, if independence is impaired, you may still issue a compilation report as long as you modify the compilation report to indicate the lack of independence.)

2. Definition of Nonattest Services.

Question^{3/4}How do the AICPA's Ethics rules define nonattest services?

Response^{3/4}They do not define nonattest services. By defining attest as noted in question 1, all other services, including tax services, are nonattest.

3. Impact on Audit and Review Services.

Question^{3/4}How does revised Interpretation 101-3 impact my audit and review services?

Response^{3/4}You may not provide audit or review services if you are not independent. If you perform nonattest services for an audit or review client, independence will be considered to be impaired if any of the following occurs:

- a. You perform management functions or make management decisions.
- b. The client is unwilling or unable to assume all of the responsibilities for: management decisions and functions; designating a competent employee to oversee any bookkeeping services, payroll services, tax services, profit-sharing plan services, or other services provided; evaluating the adequacy and results of, and accepting responsibility for the services provided; and establishing and maintaining internal controls, including monitoring ongoing activities.
- c. You do not document in writing your understanding with the client regarding: the objectives of the engagement, the services to be performed, the client's acceptance of its responsibilities, your responsibilities, and any limitations of the nonattest engagement. (See question 8.)

Question 6 provides example engagement letter wording that practitioners may use in their audit or review engagement letters.

4. Impact on Compilation Services.

Question^{3/4}How does revised Interpretation 101-3 impact my compilation services?

Response^{3/4}If you perform nonattest services for a compilation client, independence will be considered to be impaired if any of the following occurs:

- a. You perform management functions or make management decisions.
- b. The client is unwilling or unable to assume all of the responsibilities for: management decisions and functions; designating a competent employee to oversee any bookkeeping services, payroll services, tax services, profit-sharing plan services, or other services provided; evaluating the adequacy and results of, and accepting responsibility for, the services provided; and establishing and maintaining internal controls, including monitoring ongoing activities.

- c. You do not document in writing your understanding with the client regarding: the objectives of the engagement, the services to be performed, the client's acceptance of its responsibilities, your responsibilities, and any limitations of the nonattest engagement. (See question 8.)

If independence is impaired, you may still issue a compilation report as long as you modify the compilation report to indicate the lack of independence. In a compilation engagement in which the financial statements are intended for management-use-only, the engagement letter would need to be modified, in lieu of the report, to indicate the lack of independence. The following sentence should be added to either the report or the engagement letter, as applicable, to indicate the lack of independence:

I am (We are) not independent with respect to XYZ Company.

5. Impact on Tax Services.

Question ¾ Does the revised Interpretation apply to tax services?

Response ¾ If you are performing tax services for an attest client, the Interpretation applies, and to maintain your independence, you must not perform services that are considered management functions, your understanding with the client will need to be documented in writing, and management must agree to assume certain responsibilities. However, if the client is not an attest client, the Interpretation will not impact the tax services you perform.

6. Assisting in the Preparation of Financial Statements and Proposing Adjustments as Part of an Audit or Review Engagement.

Question ¾ In my audit and review engagements, I typically assist my clients in preparing the financial statements based on their trial balance. I also often propose adjustments to the client's financial statements as a result of these engagements. Are these considered to be nonattest services, and if so, what do I need to do in these situations to comply with this revised Interpretation?

Response ¾ Yes, preparation of the financial statements based on the client's trial balance is considered a nonattest service that does not impair your independence. Also, proposing standard, adjusting, or correcting journal entries or other changes affecting the financial statements to a client is a nonattest service that does not impair your independence, provided the client reviews the entries and you are satisfied that the client's management understands the nature of the proposed entries and the impact the entries have on the financial statements. To ensure that you are in compliance with the requirements of the revised Interpretation, management must agree to assume certain responsibilities. In addition, you are required to document in writing your understanding regarding the objectives of the engagement, services to be performed, the client's acceptance of its responsibilities, your responsibilities, and any limitations of the engagement. This understanding can be separately documented or included in the engagement letter for your audit or review engagement. The following is example wording that you can include in your audit engagement letter to comply with the revised interpretation:

We will advise you about appropriate accounting principles and their application and will assist in the preparation of your financial statements, but the responsibility for the financial statements remains with you. This responsibility includes the establishment and maintenance of adequate records and effective internal controls over financial reporting, the selection and application of accounting principles, and the safeguarding of assets. You are responsible for adjusting the financial statements to correct material misstatements and for confirming to us in the management representation letter that the effects of any uncorrected misstatements aggregated by us during the current

engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. (The wording in this paragraph is already included in most PPC sample audit engagement letters.)

As part of our engagement we may propose standard, adjusting, or correcting journal entries to your financial statements. You are responsible for reviewing the entries and understanding the nature of any proposed entries and the impact they have on the financial statements. Further, you are responsible for designating a qualified management-level individual to be responsible and accountable for overseeing these services.

The following is example wording that you can include in your review engagement letter to comply with the revised Interpretation:

We will advise you about appropriate accounting principles and their application and will assist in the preparation of your financial statements, but the responsibility for the financial statements remains with you. This responsibility includes the establishment and maintenance of adequate records and effective internal controls over financial reporting, the selection and application of accounting principles, and the safeguarding of assets. As part of preparing the financial statements we may propose standard, adjusting, or correcting journal entries to your financial statements. You are responsible for reviewing the entries and understanding the nature of any proposed entries and the impact they have on the financial statements. Further, you are responsible for designating a qualified management-level individual to be responsible and accountable for overseeing these services.

7. Proposing and Recording Journal Entries.

Question^{3/4} As part of my bookkeeping or write-up services, I often propose and record journal entries. What do I need to do in this situation to comply with this revised Interpretation?

Response^{3/4} Proposing standard, adjusting, or correcting journal entries or other changes affecting the financial statements to a client does not impair your independence provided the client reviews the entries, you are satisfied that the client's management understands the nature of the proposed entries and the impact the entries have on the financial statements, and the documentation requirements of Interpretation 101-3 are met. Recording journal entries is also allowed, provided the journal entries are approved by the client.

8. Documentation Requirements.

Question^{3/4} I have numerous recurring clients for which I've been providing attest services. When is written documentation of the understanding regarding the nonattest services required?

Response^{3/4} Although the PEEC encourages immediate implementation of the documentation requirement, written documentation of the understanding regarding the nonattest services is not required for services performed on or before December 31, 2004. The documentation requirement is effective for all nonattest services performed for an attest client after December 31, 2004.

9. Providing Routine Advice to Clients.

*Question*¾ If a client calls and asks technical questions, is this considered a nonattest service for which ET Interpretation 101-3 would apply?

*Response*¾ No. Routine activities performed by the practitioner, such as providing advice and responding to the client's technical questions as part of the normal client-accountant relationship, are not considered nonattest services for which ET Interpretation 101-3 would apply.

10. Inadvertent Noncompliance.

*Question*¾ What if I inadvertently fail to comply with the revised Interpretation's requirement to obtain a written understanding regarding my client's responsibilities?

*Response*¾ The revised Interpretation states that an isolated and inadvertent failure to prepare the required documentation would not impair independence, provided that the practitioner did establish the understanding promptly upon discovery of the failure to do so, and all other provisions of the Interpretation are met.

11. Client Is Unwilling or Unable to Assume Responsibilities.

*Question*¾ What if my client is unwilling or unable to assume all of the responsibilities required by the revised Interpretation (such as designating a competent employee to oversee my bookkeeping, payroll, tax, or other services provided)?

*Response*¾ Independence is considered to be impaired. If you are performing a compilation service for this client, you can modify the compilation report to indicate a lack of independence. (In a management-use-only compilation engagement, the engagement letter would need to be modified, in lieu of the report, to indicate the lack of independence.) Other attest services cannot be provided to this client if you are not independent.

12. Independence Rules of Other Regulatory Bodies.

*Question*¾ If I perform attest services for my client and the work is subject to oversight by other regulatory bodies (e.g., General Accounting Office, Department of Labor, Securities and Exchange Commission), how does the revised Interpretation apply?

*Response*¾ The requirements of the revised Interpretation must be met, along with any independence rules of the applicable regulatory body that are more restrictive than the requirements of the revised Interpretation. Failure to comply with independence rules of the regulatory body relating to nonattest services would constitute a violation of the revised AICPA Interpretation.

13. Assessing a Client Employee's Competency.

*Question*¾ How do I assess a client's designated employee's competency as required by the revised Interpretation?

*Response*¾ Assessing the competency of the client's designated employee is a matter of professional judgment, which is determined based on the individual circumstances and the nature of the nonattest service engagement. Practitioners may find that some clients are unsophisticated in their understanding of accounting services and, thus, are not competent as defined in ET Interpretation 101-3. In those cases, the practitioners will no longer be independent of those clients. In other cases, practitioners may be able to educate their clients as necessary to allow the clients to assume the responsibilities outlined in the Interpretation.

14. Installing Pre-Packaged Accounting Software.

*Question*¾Is my independence impaired if I install pre-packaged accounting software, such as *QuickBooks*, for my client and set up the chart of accounts and financial statement format defaults?

*Response*¾In its *Background and Basis for Conclusions*, the Professional Ethics Executive Committee states that independence is not considered impaired, as this type of service does not constitute “designing” a system, provided that you do not create or change the source code(s) underlying the pre-packaged software.

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