ETHICS

Doing the right thing: the conceptual approach to evaluating independence

By VICTORIA L. PITKIN, CPA, CGMA

In March 2018, the AICPA Professional Ethics Executive Committee (PEEC) released two FAQs addressing threats to a member's independence resulting from the long association of senior personnel with a client. Since the NYSSCPA adopted the AICPA's code as its own code of conduct in May 2013, all Society members are subject to it. The gist of both FAQs, considered together, was that a threat to a member's independence might exist as a result of his or her having worked with a client for a long period of time, and if such a threat is determined to be significant, appropriate safeguards need to be implemented in order to eliminate the threat or reduce it to an acceptable level.

The threat that the PEEC is concerned with is the familiarity threat to the member's independence, which is addressed in the Conceptual Framework for Independence (the "Conceptual Framework") in ET section 1.210.010. The Conceptual Framework provides an overall approach to identifying and addressing potential threats to independence, other than those that are specifically covered by the independence interpretations in the AICPA Code of Professional Conduct (the "Code").

Before the introduction of the Conceptual Framework, a practitioner might conclude that if there was no interpretation that specifically addressed a potential independence issue, there was no independence impairment. Once the Conceptual Framework was introduced, however, a new threats-and-safeguards approach was introduced into the Code. In the absence of a specific interpretation, the member must now consider the guidance in the Conceptual Framework in order to determine if there is a threat to his or her independence. Because this approach requires a significant amount of professional judgment, the member should evaluate the facts and circumstances through the "eyes" of a reasonable and informed third party who is aware of the relevant information.

The approach, outlined in the Conceptual Framework, starts with identifying potential threats to independence. Threats are broadly classified into seven categories: adverse interest threats, advocacy threats, familiarity threats, management participation threats, self-interest threats, self-review threats and undue influence threats. Each of these categories is defined and illustrated within the Conceptual Framework. It is important to note that a member may be faced with more than one threat to his or her independence, depending on the facts and circumstances of the member's relationship with the client.

Consider the situation in which a partner in a CPA firm has worked continuously on an engagement for 20 years. For some partners, this amount of time might be their entire professional careers; for others, 20 years might represent the length of time since they were promoted to partner. Considering just these facts, a reasonable and informed third party would probably conclude that a familiarity threat exists.

Once a threat to independence has been identified, the member has to determine if the threat is a significant threat. If so, the member should put adequate safeguards in place to eliminate the threat or reduce it to an acceptable level.

Continuing the scenario above, a significant threat might exist if client management and accounting personnel had remained the same over the 20 years, if the partner on the engagement golfs with the client's CEO or CFO once a week, or if the client's current CFO was a former partner of the firm and mentor to the current engagement partner. However, the practitioner might conclude there is no significant threat to independence if management of the client company transferred to the next generation of the family—with whom the member has no previous relationship—or if the company was purchased by a larger entity that retained the member's firm in order to perform attest services on the company as a subsidiary of a larger entity. In determining whether a significant threat exists, all of the relevant facts and circumstances need to be considered.

If the member concludes that a significant threat exists, he or she must implement safeguards to eliminate the threat or reduce the threat to an acceptable level. The Conceptual Framework provides examples of such safeguards. In the case of a member having a long association with a client, the member might seek an engagement quality control review or might shift the engagement to another partner within the firm. The Securities and Exchange Commission's independence rules require partner rotation every five years for issuer clients. When a threat is identified, the member should document the professional judgments that he or she made in determining whether the threat is significant, and the effect of the implemented safeguards on the threat.

The example discussed above addresses the familiarity threat arising from a senior engagement professional's long association with a client. There are other threats to a member's independence that are not specifically addressed in the independence interpretations. Therefore, it is important for every member to be aware of these possible threats to his or her independence.

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At Society's poker evening, a focus on business skills and strategy

On Aug., 23, the NYSSCPA hosted an event presented by Poker Divas, offering members insights on leadership and negotiation.