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Helping Attest Clients Implement the New Revenue Standard Complying with the Independence Rules

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Significant changes in accounting standards present opportunities and expectations for auditors to help clients understand, implement, and transition to the new rules. As detailed in many CPEA reports, *Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers*, codified primarily in FASB *Accounting Standards Codification (FASB ASC) 606*, introduces broad and deep changes that affect all entities, whether public, private, or not-for-profit (NFP).

Independence Standards

The applicable independence rules, and the degree to which a practitioner can provide accounting and other assistance – as a “nonattest” service to its attest client – depends on the type of client involved. When providing attest services to a client under AICPA standards, a practitioner must comply with the *Independence Rule* (ET sec. 1.200.001) of the AICPA *Code of Professional Conduct* (the Code). If an attest client is a private company with no other regulatory reporting requirements, the practitioner should comply with the Code and the applicable state accountancy board rules.

Practice Note: Many, but not all, state accountancy boards adopt the AICPA independence rules and some boards adopt the AICPA rules but also have additional requirements. Other boards maintain their own independence rules. Practitioners should check their board’s web site to determine the applicable rules.

In addition, audit or attest services can be subject to additional requirements and more restrictive rules than those in the AICPA Code. For example, the Government Auditing Standards (also known as “GAGAS” or the “Yellow Book”) apply to federal, state, and local governmental bodies and other entities (such as NFP entities) that receive federal funds or are required by law or regulation to follow GAGAS. Securities and Exchange

Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) independence rules apply to audits of broker-dealers and companies that are publicly traded, SEC registrants, larger insured financial institutions, and other entities. For example, SEC independence rules apply to attest services performed under rule 206(4)-2 under the Investment Advisers Act's "custody rule."

Scope of this report

This report addresses the application of the AICPA independence rules to engagements to assist attest clients with implementation of the new revenue standard (FASB ASC 606). To the extent GAGAS carry additional requirements, this report notes them. Other independence rules, including those of the SEC and PCAOB, are not addressed.

Independence and Nonattest Services: A Primer

For decades, the Code has addressed how members¹ may provide nonattest services – whether tax or advisory – to an attest client while maintaining independence. Today, those rules appear in ET 1.295, *Nonattest Services*, of the Code; they only apply when performed for an attest client. If the client is a financial statement attest client, the rules also apply (with certain exceptions) to that client's affiliates.

Threats to Independence

ET 1.295 indicates that: "When a member performs nonattest services for an attest client, self-review, management participation, or advocacy threats to the member's compliance with the "Independence Rule" [ET 1.200.001] may exist. When significant independence threats exist during the period of the professional engagement or the period covered by the financial statements (except as provided for in paragraph .03), independence will be impaired unless the threats are reduced to an acceptable level and any requirements included in the interpretations of the "Nonattest Services" subtopic [1.295] under the "Independence Rule" have been met."

Timeframe. As noted, the relevant time frame to consider in applying ET 1.295 is the period of the professional engagement and the period covered by the financial

¹ Throughout this report, the term "member" refers to a practitioner and his or her firm applying the independence rules to an attest engagement.

Definitions

Attest Client. A person or entity with respect to which an *attest engagement* is performed.

Attest Engagement. An engagement that requires *independence*, as set forth in the AICPA Statements on Auditing Standards (SASs), Statements on Standards for Accounting and Review Services (SSARs), and Statements on Standards for Attestation Engagements (SSAEs).

Financial Statement Attest Client. An entity where *financial statements* are audited, reviewed, or compiled when the *member's* compilation report does not disclose a lack of *independence*. This term is used in the "Client Affiliates" interpretation (ET 1.224.010) and in the definition of an affiliate (ET 0.400.02)

statements. The former begins when a member signs an initial engagement letter to perform attest services or begins to perform attest services, whichever comes first. The period lasts for the entire duration of the professional relationship, which may cover many periods, and ends when the member or client terminates the relationship or the final report is issued, whichever is later. The period covered by the financial statements or other subject matter of the engagement is the specific timeframe related to the subject matter of the attest engagement.

Routine Services. Certain ancillary activities are considered a normal, routine part of performing an attest service (e.g., annual audit) and, therefore, do not require the member to apply ET 1.295. Examples cited in the Code include the member's discussions with the client's management about:

- Management's selection and application of accounting standards or policies and financial statement disclosure requirements
- The appropriateness of methods used in determining accounting and financial reporting
- Adjusting journal entries that the member has prepared or proposed for management's consideration
- The form or content of the financial statements

Routine assistance should be a natural extension of the attest relationship. Otherwise, the member should treat the service as a separate, nonattest engagement. Such would clearly be the case when a member assists an attest client with planning and executing the implementation of a significant new accounting standard, like the new revenue standard (FASB ASC 606).

General Requirements. Before performing nonattest services for an attest client, a member must comply with the general requirements, which appear in ET 1.295.040, *General Requirements for Performing Nonattest Services* (general requirements). Several safeguards applied in advance of performing the services serve as prerequisites. Specifically, the member should be satisfied that the client understands the scope and objectives of the nonattest services and will be able to do all the following:

- Evaluate the adequacy and results of the services
- Accept responsibility for, and make informed judgments on, the results of the services
- Accept responsibility for making all significant judgments and decisions related to the services

The client must designate a person, preferably in senior management, with suitable skills, knowledge, and/or experience (SKE) to oversee the services, which means that he or she would understand the nature, objective, and scope of the nonattest services and:

- Make all significant judgments
- Evaluate the adequacy and results of the service
- Accept responsibility for the service results
- Ensure that the resulting work product meets the agreed-upon specifications

Factors to consider in evaluating a designee's SKE are:

- Knowledge of the client's operations
- Industry knowledge and experience
- General business knowledge
- Position in the organization
- Level of education

The nature of the service is an important consideration and not all these factors are determinative; for example, lack of formal education would not necessarily mean that a designee lacks suitable SKE if other criteria are met. Also, the individual would not be expected to supervise the member's services or possess expertise equivalent to the member.

Clear lines of responsibility – what the client's designee is responsible for and what the firm is responsible for – must be established. Once the understanding with the client has been established, the member should document it in the engagement letter or another document.

Management Responsibilities. A critical, overarching requirement for independence is the avoidance of management responsibilities. Though members are closely involved with their client's financial statements by virtue of performing audits, reviews, and compilations, the ultimate responsibility for financial reporting, including the underlying books and records, rests with management. The Code describes management responsibilities as leading and directing an entity, including making significant decisions regarding the acquisition, deployment, and control of human, financial, physical, and intangible resources. ET 1.295.030 identifies the following types of activities (among others) as management responsibilities:

- Setting policy or strategic direction for the attest client
- Exercising authority on behalf of an attest client
- Preparing source documents that evidence a transaction's occurrence
- Deciding which recommendations management should implement or prioritize

- Reporting to those charged with governance on behalf of management
- Accepting responsibility for managing the client's project
- Accepting responsibility for the preparation and fair presentation of the attest client's financial statements
- Accepting responsibility for designing, implementing, or maintaining internal control

Interpretations - nonattest services. Several interpretations of the independence rule address specific types of nonattest services, such as bookkeeping and payroll assistance, valuations, tax compliance, and forensic services. Each interpretation explains the types of threats to independence that may arise, whether self-review, management participation, and/or advocacy threats, and the types of activities that would create unacceptable threats to independence versus those that would not. See the sidebar for a brief description of each threat.

Conceptual Framework. A member should avoid threats that impair independence by applying the general requirements and the specific provisions in ET 1.295. If the provisions do not address the services to be performed, the member must apply the *Conceptual Framework for Independence* (Conceptual Framework) to determine whether a significant threat to the member's independence exists. When a significant threat exists, the member should apply safeguards (e.g., use separate teams for attest and nonattest services or obtain an additional review of the work) to eliminate or reduce the threat(s) to an acceptable level and document the evaluation. If the member cannot apply safeguards that effectively reduce or eliminate the threats, independence would be impaired.

GAGAS incorporates a conceptual framework that members must apply in all cases. In addition, the 2018 Yellow Book requires members who perform any accounting, bookkeeping, or financial statement preparation services to evaluate threats to independence to determine the significance of the threats and document the evaluation (regardless of the outcome). If the member helps prepare the financial statements in total, a significant threat to independence exists and the member must apply safeguards to mitigate the threat. See paragraphs 3.26-.63 of GAGAS for further information about the

Relevant Threats

Self-Review Threat: Threat that a member will not appropriately evaluate the results of a previous judgment made or service the member (or colleague) performed or supervised, which the member will rely on when forming a judgment as part of an attest engagement.

Management Participation Threat: Threat that a member will assume the role of attest client management or perform management responsibilities for an attest client.

Advocacy Threat: Threat that a member will promote an attest client's interests or position to the point that his or her independence is compromised.

conceptual framework and pars. 3.88-.89 for information about preparing accounting records and financial statements.

Cumulative Effect. Performing multiple nonattest services can increase the significance of threats to independence, which a member should evaluate using the Conceptual Framework. That is, before agreeing to perform multiple nonattest services for an attest client, the member should evaluate whether performing those services -- in the aggregate -- pose significant threats to independence. If threats are not at an acceptable level, the member should apply safeguards to eliminate the threats or reduce them to an acceptable level. Otherwise, independence would be impaired.

Assisting a Client in Implementing FASB ASC 606

To describe and illustrate the independence requirements that apply when helping a client plan for, implement, and transition to FASB ASC 606, we present a fictional case study below. While we chose to use an NFP client in the case study, the principles and guidance can be applied to private companies and other organizations.

BrightWater, CPAs (BW) performs annual audits of Bird-Save, a national NFP membership organization that operates programs to protect and preserve wild birds. Bird-Save receives federal funding and, therefore, its audit is subject to both AICPA and GAGAS requirements. Bird-Save needs help implementing FASB ASC 606; the assistance being requested goes beyond routine services the auditor normally would provide.

Donna leads BW's Accounting Services practice. She is working with Horace, the client's audit partner, to discuss whether independence rules will allow the firm to provide the requested services. Donna and Horace meet with Nancy, the client's CEO and explain that she will need to designate a management-level person with appropriate skills and knowledge to oversee the service and work with the team. Nancy agrees to designate Juan, the CFO, to serve in this role. Juan, a credentialed accountant, has many years of experience in the organization and the nonprofit environment. Donna and Horace consider him to be quite competent and capable; a hands-on leader with excellent technical skills and a questioning mind.

After the meeting, Donna and Horace discuss each requested service to determine the permissible scope. Later, they will meet with the client to discuss the draft engagement

letter, which will serve as the firm's understanding of the scope of the services and the parties' respective responsibilities. Both AICPA standards and GAGAS require written documentation of the understanding (see sidebar). GAGAS also requires the firm to document how it concluded that Juan, the client's designee to accept responsibility for the services and make any required management decisions, has suitable SKE to oversee the services (GAGAS, 3.73-.74).

Project Management Versus Assistance

Client Ask

The client will assemble a project team from the accounting, finance, sales, and legal departments and would like BW to lead the project.

Firm Response

Donna and Horace know they must avoid performing management responsibilities and, therefore, cannot lead the client's project team. They will request that Juan perform that role. BW may assist Juan and the project team by performing research and providing feedback, advice, and recommendations on priorities and other considerations. However, Juan must make all the decisions related to the team's activities and the project's direction.

Impact Assessment

Client Ask

Assess how FASB ASC 606 will impact Bird-Save's income streams and business (e.g., budgeting, operations, cash management, and debt covenants). Perform an analysis to identify gaps between the current state and the requirements of FASB ASC 606 (gap analysis). Present all findings to the board of directors.

Firm Response

BW may perform a gap analysis. For example, the firm could identify current process flows for revenue recognition and perform sample contract reviews to discuss with the client. They would work with Juan and others to pull the information together, including the client's existing accounting policies, processes, disclosures, data, and systems requirements and internal control over financial reporting. BW may present the results of its work to the board of directors.

Documentation Requirement

Before performing nonattest services the member establishes and documents in writing his or her understanding with the attest client (board of directors, audit committee, or management, as appropriate in the circumstances) regarding the:

- Objectives of the engagement
- Services to be performed
- Attest client's acceptance of its responsibilities
- Member's responsibilities
- Any limitations of the engagement

Plan Development

Client Ask

Based on the gap analysis, develop a plan for implementing FASB ASC 606. Present the plan to the board of directors.

Firm Response

As noted previously, Juan, not the firm, should lead this project. BW must avoid performing management responsibilities so Horace and Donna should ensure that the client understands that Juan is responsible for developing the plan. BW can provide advice and recommendations for Juan and the project team to consider, but all final decisions rest with management, not the firm. Also, BW should not report the proposed plan to the board on management's behalf, although the firm can act in a support role (e.g., help Juan prepare information for the meeting, attend the meeting, and be available to answer questions about the firm's gap analysis and impact assessment).

Plan Implementation

Client Ask

Help implement FASB ASC 606 based on the project plan:

- Fill in gaps and bridge to the new revenue standard
- Revise processes, internal controls, and accounting policies to capture the necessary information and meet the new requirements
- If required, re-design software to allow for the capture of necessary inputs or develop manual workarounds
- Help the client identify and evaluate customer contracts, group contracts, and implement a portfolio approach
- Identify performance obligations and assist with other unit of account issues
- Draft initial journal entries and note disclosures

Firm Response

The firm can provide some assistance to the client during the implementation process. However, not all services are permissible from an independence standpoint and several potential pitfalls must be navigated. In addition, BW will need to consider the cumulative effect of these and all other nonaudit services being provided to the client. (Currently, the firm is not providing any other nonaudit services to the client.) Horace and Donna agree to consider the totality of these services once they've reviewed all the components.

Horace and Donna also acknowledge that some of the requested activities clearly impair independence, while others may be performed if carried out in accordance with the Code. Certain activities may raise self-review and management participation threats to independence that require close evaluation. If threats are significant, the firm must apply safeguards to sufficiently reduce the threat(s). If that is not possible, they should not perform the activity.

BW believes it can help Juan and others think through alternatives, make suggestions, and provide examples of ways that similar NFPs have addressed the issues. Here, the importance of having competent management fully engaged in the firm's services cannot be overstated. Capable management can act on the firm's advice, weighing alternatives and considering pros and cons so the firm is not placed in a position where it must make these decisions for the client, which impairs independence.

BW will inform the client that it cannot accept responsibility for performing the following activities because they raise significant management participation and self-review threats that impair independence:

- Develop new accounting policies or procedures
- Design new internal controls over financial reporting (ICFR) or revise existing controls
- Design or develop financial information system enhancements

BW may provide guidance, advice, and recommendations that help management or another service provider design or develop the above policies, procedures, controls or systems. However, BW and management should have a clear understanding about the applicable limitations on the scope of these services before the services are performed. See ET 1.295.030, *Management Responsibilities* and ET 1.295.145, *Information Systems Design, Implementation, or Integration*, for additional information.

Beware of Scope Creep When Assisting Clients with FASB ASC 606

Scope creep is an issue firms should avoid as this can lead to violations of independence. Donna and Horace should ensure the BW team clearly understands the services to be provided in terms of permissibility and should ensure the client understands its responsibilities, and that requests for additional work (beyond that described in the engagement letter) require partner review.

Horace and Donna also acknowledge that management will need to make more estimates and use more judgment under FASB ASC 606. The BW team may educate, coach, and advise Juan and others on techniques and factors to consider. Education likely will be

significant during this phase of the engagement and should be priced into the services since it is integral to the process. For example, BW can help Juan determine:

- The estimates related to variable consideration
- Whether goods and services are distinct
- Whether material customer rights are present in a contract
- Whether the entity is acting as a principal or agent

As a membership organization implementing FASB ASC 606, Bird-Save will need to revisit how and when it recognizes revenue. They may need help allocating the transaction price to various performance obligations in its contracts and determining transition adjustments and entries. Making judgments will require an understanding of the standard and the relevant factors. BW can guide Juan in this process by explaining how similar NFPs have accounted for transactions and work with him so he can take full responsibility for the judgments and estimates underlying the financial statements.

As noted, a significant part of the deliverables to the client in this type of engagement will be educating and advising management on technical accounting requirements and options as FASB ASC 606 implementation takes place. Thus, BW knows it will need to spend time with the client's management to bring them up-to-speed with the new requirements and enable them to make the important decisions.

BW may help Juan and the project team:

- Identify and evaluate customer contracts
- Group contracts and implement a portfolio approach
- Identify performance obligations and assist with other unit of account issues

The team may serve in a support role but should not perform these activities on the client's behalf as these activities will provide the foundation upon which the FASB ASC 606-related changes to the financial statements will be based.

Juan should draft the initial journal entries and note disclosures to implement the new revenue standard although BW can work with him and provide advice and assistance during the process.

Evaluating threats to independence

Once Horace and Donna review all the services and determine the scope of their permissible services, they should consider the services in the aggregate, using the Code's Conceptual Framework as a guideline. They also should be mindful of the Yellow Book requirements, including the new standard for preparing accounting records and financial statements (paragraphs 3.87- 3.95).

Given the significance of FASB ASC 606 to the client's financial statements, Donna and Horace conclude that significant self-review and management participation threats to independence require BW to apply safeguards. They agree to implement the following:

- No audit team members will provide nonattest services to the client on this engagement
- A partner from a different office in the firm, not associated with this client in any capacity, will review samples of the nonaudit team's work product
- Pre-engagement, the firm will discuss their independence review and the safeguards they have agreed to implement with the client's board of directors

AICPA standards and GAGAS require Horace and Donna to document their evaluation of the significance of threats to independence and the safeguards they applied.

Practice Note: GAGAS requires the auditor to document the evaluation of threats to independence even if the auditor concludes that threats were not significant.

A Critical Factor

It's important to note that an engagement of this nature and scope would not be possible if the client was unable or unwilling to designate an individual with appropriate SKE to work with the firm and assume all management responsibilities. For example, assume Juan was not a highly-experienced CFO with several years' experience but, rather, a relative novice to the industry and the profession. He would need more than assistance – that is, he would be incapable of leveraging the firm's knowledge and experience and would need BW to perform all the work and make all the judgments and decisions related to adopting FASB ASC 606. Clearly, it would impair the firm's independence to accept the engagement under those conditions.

Additional Consideration for Private Companies Planning to Go Public

Auditors of private companies should consider the possibility that their client may plan to become a public company via an initial public offering (IPO). Auditors of companies filing an IPO are required to be independent under the more restrictive SEC and PCAOB independence rules for all years covered by the financial statements included in the filing even though at the time the services were provided, the company was not subject to those rules.²

² See Question 2, Employment Relationships of the Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence
Frequently Asked Question <https://www.sec.gov/info/accountants/ocafagaudind080607.htm>

Summary

The key to maintaining independence while providing FASB ASC 606 implementation assistance to attest clients is avoiding management participation and self-review threats to independence as addressed in the Code. Among other considerations, practitioners should comply with the general requirements and specific interpretations of ET 1.295 of the Code and, when applicable, Chapter 3 of GAGAS (2018 edition) to achieve this. Practitioners also should consider other applicable rules, including those of the SEC, PCAOB, state accountancy boards, banking and state insurance regulators, Department of Labor, among others, where independence requirements may and often will lead to different outcomes.

References and Additional Resources

The CPEA does not answer independence and ethics questions. The AICPA already has a dedicated team to respond to such matters. The Professional Ethics hotline number is 1-888-777-7077 (select option 2, then option 3). Or, email your questions to ethics@aicpa.org.

Additional resources related to this topic can be found at the following links:

[AICPA Code of Professional Conduct, ET sec. 1.295, *Nonattest Services*](#)
[AICPA Frequently Asked Questions: Nonattest Services Questions](#)
[AICPA Conceptual Framework for Independence Toolkit](#)
[Government Auditing Standards, 2018](#)

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