VEDDER PRICE

Accounting Law Bulletin

A bulletin prepared by the Accountants Professional Services Group at Vedder Price designed to keep accountants and accounting firms informed of major developments in the accounting industry

January 2005

NON-ATTEST SERVICES—NEW RULES AND PROPOSALS

Engagement Letters Required

Under the matrix of Federal and state regulations applicable to the accounting profession, accountants are now confronted with making material adjustments in the ways they conduct their business. Non-attest services generate significant revenues for accountants, but they also raise significant potential professional risks. While Interpretation 101-3 under the AICPA Code of Professional Conduct, by its terms, applies only to the provision of non-attest services for attest clients, its substantive provisions will most likely be considered a "best practice" for all accountants who provide non-attest services for any client.

The performance of non-attest services for an SEC audit client of an accounting firm is strictly limited by Federal securities laws. Item 2-01(c) of Regulation S-X lists the non-attest services which, if performed for an issuer by the issuer's audit firm, will impair the audit firm's independence under the securities laws. Furthermore, any non-audit services must be pre-approved by the public issuer's audit committee, and must be documented by a written agreement between the issuer and the accountant.

This article will not focus specifically on permissible non-attest services for SEC audit clients under applicable Federal securities laws, but will, instead, focus on the broader applicability of Interpretation 101-3. Under the AICPA Code of Conduct and applicable state laws and regulations, the performance of non-attest services for any attest client has the potential to impair the independence of the auditor in its attest engagement. Compliance with Interpretation 101-3 creates at least a plausible defense, if not a safe harbor, against an attack on independence resulting from the performance of non-attest services.

General Requirements for Non-Attest Services

Accountants are required to comply with the most restrictive rules on independence to which they are subject. The general principle is that the auditor should not be performing management functions or making management decisions for the attest client. The accountant may, however, provide advice, research materials, and give recommendations to assist the client's management in performing its functions and making management decisions.

Effective January 1, 2005, under the revised AICPA Interpretation 101-3, an accountant or accounting firm engaged to perform permitted non-attest services for an attest client must document such assignment with a written engagement letter. The Interpretation requires

IN THIS ISSUE

only that the engagement be documented in writing, and does not specify a form to be followed.

Client Responsibilities. In accepting an engagement to perform non-attest services, the accounting firm must assure itself that the potential client is aware of, and has accepted, its responsibilities. The accounting firm, in its capacity as consultant or appraiser or the like, may not perform the following functions for an attest client, and the client is required to undertake these functions:

- Determination of all management decisions
- Designation of a competent senior employee of the client to oversee the non-attest services
- Evaluation of the adequacy and results of the services performed
- Acceptance of responsibility for the results of the services
- Establishment and maintenance of internal controls, including monitoring ongoing activities

The accountant must be in a position to make a reasonably informed judgment that the client is capable of performing these functions. If the accountant does not believe that the client has a senior employee who is sufficiently competent to oversee the non-attest services being provided, the non-attest services could impair the accountant's independence with respect to the audit function, where independence is required. The written engagement letter, required by Interpretation 101-3, assists the accountant in completing its due diligence that the client can, and is willing to, accept these responsibilities.

Documentation of Non-Attest Services. To the extent that an accounting firm or a separate practice unit is permitted by law to perform non-attest services for an attest client, AICPA Interpretation 101-3 requires that, effective January 1, 2005, the accounting firm must have a specific written engagement letter with the client for such non-attest services. While there is not one prescribed form of letter, Interpretation 101-3 does provide that an engagement letter for permissible non-attest services must contain the following elements:

- objectives of the engagement
- description of services to be performed
- designation of client responsibilities and client's acceptance of such responsibilities
- accountant's responsibilities
- limitations on the engagement

The failure to address at least these elements in an engagement letter for non-attest services for an attest client could lead to an impairment of the accounting firm's independence with respect to its auditing function. The engagement letter requirement does not apply to routine technical questions in the normal course of a client relationship, non-attest services performed prior to January 1, 2005, and non-attest services performed prior to a client's becoming an attest client.

An engagement letter is mandated for all non-attest services to be performed by an accountant for an attest client. Though this requirement does not expressly apply where a client is not also an attest client, it is certainly advisable to follow the material portions of this procedure for all clients. The written engagement letter will provide clarity and certainty in the client-accountant relationship, and will, in all cases, foster improved client relationships and efficiency in providing services.

The actual form of the engagement letter is not delineated by Interpretation 101-3. In addition to the formal letter, acceptable methods include: a memorandum to audit files copied to the client, and a memorandum of understanding in billing or correspondence, or as part of

the report to the client. However, the formal engagement letter with a signed acknowledgment by the client will constitute the best evidence that the accountant has completed its due diligence, and that the client is prepared to accept its responsibilities with respect to the non-audit services.

Examples of Specific Language for Engagement Letters

Objective. The engagement letter should include, at the beginning, a brief statement of the overall objective of the non-attest services to be performed. This will place in context the more detailed descriptions of tasks to be undertaken by the accountant. The following are examples of such objectives:

> We will assist you in developing a business plan.
>
> We will advise you with respect to the start-up of your [ ] business.
>
> We will provide your company with bookkeeping and other business management services.
>
> We will perform a valuation of your equity interest in [ ].
>
> We are pleased to assist you in determining whether to lease or purchase your new [equipment].

While the possibilities are endless, the short initial statement of the objective of the engagement will frame the context of all of the services to be performed and the allocation of responsibilities between accountant and client.

Specific Description of Services. The specific description of the non-attest services should set forth what the accountant will do and what the accountant will not be doing in pursuit of the stated objective. The breadth and limitation are equally important elements of the description. The description should be sufficiently detailed to show the major components of the non-attest services, and should define the boundaries of the scope of the services.

There is no "right" or "wrong" description, and each situation is unique. The following are merely examples of descriptions of a range of non-attest services:

> (1) We will assist you in developing, implementing and maintaining your financial plan to achieve your stated financial goals. We will collect and organize the facts of your current and desired financial status, and will discuss with you the results of our preliminary analysis. We will draft initial recommendations of steps to achieve your goals, and will include projections based on specific assumptions. We will finalize the plan, including its assumptions, after our discussion with you. We will not, as part of these services, be providing you with any specific investment advice or recommendations.
>
> (2) We will conduct a review of your office lease to determine compliance by the landlord of the terms thereof. We shall perform the following procedures: (i) review the lease and all amendments to determine the basis for all rental charges; (ii) inspect the books and records of the landlord for expenditures that affect rental charges, (iii) compute the escalation charges, based on the foregoing information, (iv) review amounts you have paid to the landlord, and determine whether there is a deficiency owed to or refund due from the landlord. It is understood and agreed that our services will not constitute an audit in accordance

with generally accepted auditing standards. Furthermore, we will not undertake to determine whether the landlord has adequate supporting documentation for journal or ledger entries. However, if suspicious circumstances come to our attention, we will notify you and extend our procedures as you may further instruct in writing.

(3) You have requested that we assist you in your negotiations with the [ ] bank for the purpose of modifying the financial covenants contained in your existing credit agreement. We will prepare a financial analysis of your compliance with existing financial covenants. We will prepare projections of your compliance, based on information furnished to us by management. Using such analyses, we will assist you in developing negotiating strategies to obtain amendments to the financial covenants that are realistic for the next [five] years. You understand that our services do not constitute a financial audit, and we are not undertaking to review any records provided to us by management.

(4) You have asked us to compare the costs and benefits of purchasing or leasing [equipment]. We will base our analysis on data and assumptions to be provided to us by management, and we will not undertake to verify the accuracy of such underlying data or the reasonableness of such assumptions.

(5) We look forward to assisting you in obtaining new financing. Initially, we will perform a study of your current financing sources and your projected financing needs. Based on that study, we will advise you on the types and sources of financing that is appropriate for your needs. We will also assist you in preparing presentations to the potential sources of financing and in evaluating the available alternatives. Our role is one of assisting, evaluating and advising, and we are not providing you with any assurance that any such financing will be available to you on terms you find acceptable.

Responsibilities of the Client. The engagement letter should be very precise in stating that the ultimate decision-making responsibility lies with the client. For attest clients, this element is necessary to preserve the accountant's independence on the audit side; for non-attest clients, this is a clear allocation of the respective responsibilities of accountant and client so as to avoid subsequent misunderstandings and miscommunications.

Again, there is no exact required formulation of this language, but here are a few examples:

(1) You will be responsible for making all management decisions and performing all management functions in connection with our performance of the services described in this letter. You will also provide us with the information necessary to enable us to perform our services in a timely fashion. Prior to, or simultaneously with, the commencement of our engagement, you agree to designate to us in writing, an employee from among your senior managers who is capable of overseeing our services and with whom we will have our primary contact. Such person should be able to evaluate the adequacy of the results of our services.

(2) You will have all responsibility for [financial planning] decisions. We will assist you in suggesting alternative approaches and in evaluating the likely success of such approaches. Investment recommendations should be made by a registered investment advisor whom you select and engage. We are not responsible for the success or failure of any specific investment recommendation by such advisor.

(3) The purpose of our engagement is to assist you in designing a [ ] system. Your management will be responsible for implementing the recommendations set forth in our study. It is important to recognize that this will be your system to be administered by Company personnel. Our role will be limited to providing advice and training, and we will have no responsibility for any costs, planned or unplanned, resulting from the operation of such system.

(4) This engagement is limited to the [ ] services described in this letter. We reserve the right to decline to take any action or perform any procedure which, in our sole professional judgment, could be interpreted as our participation in the management of the Company.

Conclusion

While the provisions of the revised Interpretation 101-3 expressly apply only to the provision of non-attest services for attest clients, the substance of such provisions should eventually be recognized as a "best practice" in all situations where non-attest services are being performed. A written agreement will allocate responsibilities between accountant and client, and will improve the efficiency of the overall client services.

PCAOB Proposed Rules—Restrictions on Providing Tax Services to Attest Clients

On December 14, 2004, the PCAOB announced proposed rules to safeguard independence of public accounting firms that audit and review financial statements of public companies. The thrust of these proposed rules addresses threats to the auditor's independence in two areas: the provision of advice on tax positions that may be abusive, and tax planning services for senior officers of the public company client (those officers who have a financial oversight role). While these rules are subject to comment through February 14, 2005, the scope of the proposals and the accompanying discussion will have a significant impact on the accounting profession irrespective of the final form of those rules. The PCAOB proposals introduce a new subpart (Part 5 — Ethics) of Section 3 (Professional Standards) of the PCAOB rules, and can be summarized as follows:

- A registered public accounting firm will not be independent of an audit client if the firm, or an affiliate of the firm, provides any service or product to an audit client for a contingent fee or a commission, or receives from an audit client, directly or indirectly, a contingent fee or a commission.

- A registered public accounting firm will not be independent of an audit client if the firm, or an affiliate of the firm, provides assistance to the audit client or to certain senior officers of the audit client, in planning, or providing tax advice on, certain types of potentially abusive tax transactions.

- The registered public accounting firm will have to provide information to the audit committee in connection with seeking pre-approval of non-prohibited tax services, including the engagement letter and the compensation arrangements (including referral fee or fee-sharing arrangements between the accounting firm and any other person.

- The registered public accounting firm must be independent of its audit client throughout the entire audit and professional engagement period, which commences with the signing of the initial engagement letter, and ends when

the audit client notifies the SEC that the client is no longer that accounting firm's audit client.

The PCAOB proposed these new rules on the basis of a series of public roundtable discussions and the Board's review of non-audit services being provided by registered public accounting firms. The PCAOB considered a wide range of tax services, including routine tax return preparation, tax planning, executive tax services, international assignment tax services and tax shelter strategies and products. The PCAOB chose to focus on two areas that it saw as creating potential ethical issues for the firms: the provision of advice on tax positions that may be abusive, and tax compliance and planning services for certain senior executives of the audit client. To the extent that other tax services provided by the auditor are consistent with the existing restrictions on tax services, and are subject to the pre-approval by the audit committee of the public client, such tax services would not be prohibited by the new rules.

The theory underlying rules on auditor independence, whether from the SEC, the PCAOB or the AICPA, is that an accountant should not perform services for an audit client if, as a result of the performance of such services, the accountant would not be, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues within the accountant's engagement. Proposed Rule 3520 sets forth the fundamental ethical obligation of a public accounting firm's independence, but does not create a new independence requirement. The firm must be independent of its audit client throughout the audit and professional engagement period. The Rule also specifically requires that the accounting firm comply with all applicable rules regarding independence, whether of the SEC, the GAO, the state accounting boards or other authorities with applicable jurisdiction.

Proposed Rule 3521 is adapted from the SEC's rule on contingent fees, and would treat a registered public accounting firm as not independent if it enters into a contingent fee arrangement with an audit client. The Proposed Rule extends to affiliates of the public accounting firm: the firm's parents; subsidiaries; pension, retirement, investment or similar plans; and any associated entities of the firm (as determined by the SEC). Like the SEC, the PCAOB has not defined "associated entity," and instead relies on the SEC's interpretations of "associated entity." In order to avoid running afoul of the evolving interpretations of these terms, an accounting firm with a services agreement connecting it to a separate non-attest practice structure should avoid having such separate non-attest practice have a contingent fee arrangement with the attest firm.

The PCAOB Proposed Rule differs from the SEC prohibition in Rule 2-01(f)(1) of Regulation S-X on contingent fees in several ways. The PCAOB Rule eliminates the SEC exception for fees "in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies." Also, the PCAOB rule prohibits contingent fees received "directly or indirectly," and therefore, includes the payment of a contingent fee from any person, even if such person is not related to the audit client in any way. This is intended to prohibit accounting firms from recommending tax shelters or other products to their clients, and receiving payment from the promoter of such tax shelters if the audit client participates in such product.

PCAOB Proposed Rule 3522 effectively prohibits auditors from providing services relating to planning or opining on the tax consequences of transactions that are listed or confidential transactions under U.S. Department of Treasury regulations, or transactions that promote an interpretation of applicable tax laws for which there is inadequate support. These tax-motivated transactions are deemed to pose an unacceptable risk of impairing the auditor's independence with respect to its audit client. Because the IRS or a governmental agency might challenge the tax implications of such products, the interests of the client and the auditor converge, and the auditor is consequently less independent than it should be.

Under Proposed Rule 3523, a registered public accounting firm would be deemed to have lost its independence from an audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any tax service to an officer in a financial reporting oversight role at the audit client. Again, performing such tax services would appear to create a mutuality of interest between the auditor and such senior financial officers. Those individuals covered by this Rule would be only those who have direct responsibility for oversight over those who prepare the financial statements and related information. A director whose only role at the issuer is serving on the board would not be covered by Proposed Rule 3523. The prohibitions of Proposed Rule 3523 apply whether the tax services are paid for by the audit client or by the executive officer directly.

Sarbanes-Oxley requires that all non-audit services must be approved by the audit committee of the issuer. Proposed Rule 3524 increases the auditor's responsibility in seeking audit committee pre-approval by requiring the accounting firm to provide the audit committee with detailed documentation of the scope and nature of the proposed tax services; to discuss with the audit committee the potential effects on the audit firm's independence; and to document the audit firm's discussions with the audit committee. The PCAOB Proposed Rule is intended to supplement the SEC rules on pre-approval.

The PCAOB's new Rules are proposed to become effective on the later of October 20, 2005, or 10 days after the SEC approves the Rules. All transactions completed before such date will be permitted. The October 20, 2005 date is intended to allow tax services in connection with 2004 to be completed, after allowing for all extensions. In the meantime, the PCAOB is accepting comments on the Proposed Rules until February 14, 2005.

Accounting Law Bulletin is a periodic publication of Vedder, Price, Kaufman & Kammholz, P.C. and should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult your lawyer concerning your specific situation and any legal questions you may have.

If you have any questions regarding material in this issue of the *Accounting Law Bulletin* or suggestions for a specific topic you would like addressed in a future issue, please contact Dan L. Goldwasser 212/407-7710 or at dgoldwasser@vedderprice.com, John H. Eickemeyer 212/407-7760 or at jeickemeyer@vedderprice.com, or Steven R. Berger 212/407-7714 or at sberger@vedderprice.com.

Contributing Author: **Steven R. Berger**

About Vedder Price

Vedder, Price, Kaufman & Kammholz, P.C. is a national full-service law firm with more than 210 attorneys in Chicago, New York City, and in Roseland, New Jersey. The attorneys in the firm's Accountants Professional Services Group focus on the sophisticated advice necessary for accountants and accounting firms to preserve, develop and enhance their accounting practices.

The Accountants Professional Services Group at Vedder Price advises accountants in managing their domestic and international business and in complying with the rapidly changing laws and regulations governing professional competence, independence, integrity and structure, including:

- defense of professional liability claims, including audit deficiencies, improper application of accounting principles, failure to detect management fraud, embezzlements, securities law violations and tax advice
- implementation of measures for reducing professional liability exposure and addressing professional liability insurance issues
- representation of accountants in disciplinary and enforcement proceedings brought by the SEC, PCAOB, state licensing authorities and professional accounting associations
- organization and structuring of accounting firms, and the acquisition of accounting practices
- compliance with Sarbanes-Oxley and other securities laws requirements, PCAOB rules and regulations, state laws and regulations and professional codes of ethics

Members of the Accountants Professional Services Group

Steven R. Berger	212/407-7714	John C. Grosz	212/407-7770
John H. Eickemeyer	212/407-7760	Susan Haskel	212/407-7765
Dan L. Goldwasser	212/407-7710	Daniel S. Holman	212/407-7764
Daniel Green	212/407-7735	Jonathan A. Wexler	212/407-7732

Chicago
222 North LaSalle Street
Chicago, Illinois 60601
312/609-7500
Fax: 312/609-5005
Contact: Robert J. Stucker

New York
805 Third Avenue
New York, New York 10022
212/407-7700
Fax: 212/407-7799
Contact: Neal I. Korval

New Jersey
Five Becker Farm Road
Roseland , New Jersey 07068
973/597-1100
Fax: 973/597-9607
Contact: John E. Bradley

www.vedderprice.com