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AUDIT CONDUCT NEWS

Complying with Relevant Ethical Requirements in Firm Mergers & Acquisitions

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Accounting firms have experienced a momentous and prolonged period of merger and acquisition (M&A) activity, which shows no sign of abating. According to Accounting Today's "Year Ahead" Surveys, 29% of large firms expect to be involved in M&A activity in 2019, seeking more growth. In a recent speech at the Accountants Club of America in New York, American Institute of CPAs (AICPA) president and CEO Barry Melancon remarked that increasingly, CPA firms are merging with non-CPA firms. "When you look at the top 400 firms, there are record numbers of mergers and acquisition activity of non-CPA firms," he said. About a third of the mergers and acquisitions occurring in 2018 were non-CPA firm acquisitions by CPA firms, according to Melancon.

Melding cultures, people and protocols is challenging enough, but keeping pace with regulatory and professional obligations, including ethics and independence, can be particularly taxing.

This issue of Audit Conduct NEWS discusses relevant ethical requirements for firms contemplating mergers or acquisitions and the types of issues firms should consider as they grow.

Applicable Code Provisions

Firms contemplating a merger or acquisition should be familiar with the following AICPA Code provisions:

Firm Mergers and Acquisitions
(1.220.040)

This independence interpretation states that, in an M&A situation, certain relationships or services one firm (or its professionals) had with, or provided to, the other firm's attest client may create threats to independence. An important consideration may be which firm is the "acquiring" firm and the Code directs members to the FASB Accounting Standards Codification (ASC) 805-10-55 paragraphs 11–18 and other sources.

A few case studies illustrate the application of this interpretation:

Partner of one firm serves on board of directors of other firm's attest client

Firm A and Firm B are preparing

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to merge when they learn that Pam, a partner in Firm A, sits on the board of ABC (Firm B's audit client), which creates a management participation threat to independence. The firms agree to apply several safeguards pre-merger to maintain the merged firm's independence. Specifically, Pam will:

1) resign from the board prior to the closing date of the acquisition;

2) not participate in the ABC audit;

3) avoid any position that would allow her to influence the ABC audit engagement for any periods she served on the board; and

4) disassociate from ABC prior to the closing date of the acquisition (e.g., dispose of any stock holdings in or loans with ABC).

Before issuing ABC's audit report, Antonio, a partner in the merged firm's Quality Control group, will evaluate Pam's prior relationship with ABC and her position in the new firm, to determine if threats are at an acceptable level. If he determines that threats are not at an acceptable level, the firm should apply additional safeguards to eliminate or reduce them to an acceptable level. Assume Pam was a member of the client's board of directors for two years but will not serve in an executive capacity in the new firm or otherwise be able to influence ABC's audit. These circumstances may lead Antonio to conclude that management participation threats are at an acceptable level. Caron, ABC's audit partner, should discuss the nature of the relationship and the safeguards applied with ABC's audit committee or a similar body charged with governance. The Code encourages documentation of the substance of that discussion.

> **"Melding cultures, people and protocols is challenging enough, but keeping pace with regulatory and professional obligations, including ethics and independence, can be particularly taxing."**

Acquiring firm provided prohibited services to acquired firm's attest client

AronBaker, PLLC (AB) plans to acquire TKR, LLP in May 2019. In reviewing contractual agreements, the firms learn that AB provided prohibited valuation services to TKR's audit client from August to October 2018 (covering both the period of the professional engagement and the period covered by the financial statements). Here, the Code concludes that threats to independence would not be at an acceptable level and that safeguards would not reduce them to an acceptable level. AB's independenc e is impaired with respect to the audit client for the periods in question because as the acquiring/surviving firm, TKR's audit client will become AB's audit client when the transaction closes. And there's no "cure" for a lack of independence in a continuing audit engagement.

Acquired firm provided prohibited services to acquiring firm's attest client

Haberman, LLC plans to acquire Evermore, LLC, a non-CPA firm,

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in June 2019. Evermore provided prohibited information system managed services to Haberman's audit client from March to December 2018, which precedes the financial statement period covered by the next audit report (January 1 – December 31, 2019). In this case, there's no self-review or management participation threat to Haberman's independence because the prohibited services predated the financial statement period that the new firm will audit.

What if Evermore provided prohibited services during the period covered by the financial statements? Haberman's independence would be impaired unless the firms take the following steps:

1. Evermore terminates the services (or modifies the scope of the services so they are permissible) prior to the closing date of the acquisition (June 10, 2019).

2. Professionals who provided prohibited services do not serve on the audit and may not be in a position to influence the audit engagement related to the January 1 – December 31, 2019 financial statement period.

3. To evaluate the threats, the firms consider whether the prohibited services should be attributed to Haberman or Evermore (in other words, which firm will be liable and/or accountable for the services?):

a. If Haberman will assume responsibility for the results of the services, the firms should evaluate threats during the entire financial statement period (January 1 – December 31, 2019).

b. If Evermore will assume responsibility for the results of the services, the firm can limit its evaluation of threats to the time the acquisition was pending, that is, from commencement of negotiations (March 11, 2019) through the transaction's closing date (June 10, 2019).

4. The Code provides several other considerations for evaluating threats, including whether work performed will be subject to audit procedures and how significant the results of the prohibited services are to the client's financial statements.

5. If threats are not at an acceptable level, the firm should apply safeguards to eliminate or reduce the threats to an acceptable level. The interpretation provides sample safeguards– see Sidebar. If the firm is unable to apply adequate safeguards, independence is impaired.

6. Assuming the new firm can move forward with the audit, the firm should communicate the nature of the services that were subject to the firm's evaluation and the application of any safeguards to the client's governance body as soon as practicable, but before the audit report is issued. Firms are encouraged to document the substance of the discussion.

Other Interests and Relationships

Firms should take whatever (pre-merger or acquisition) actions are necessary to comply with the Code when other interests or relationships threaten independence. For example, if a principal in Firm X held stock in Firm Y's audit client, or the principal's

Examples of Safeguards

a. **An individual not associated with the nonattest engagement reviews the nonattest services work performed.**

b. **Another firm performs an attest engagement on the subject matter of the nonattest service.**

c. **Another firm re-performs the nonattest service to the extent necessary for it to take responsibility for that service.**

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spouse was the Controller of Firm Y's audit client, she and the firm should take appropriate and timely action(s) to address the threat(s) to independence.

If the firm identifies threats to independence in fact or appearance that the Code does not address, the firm must evaluate them and if significant, apply safeguards that eliminate or reduce the threats to an acceptable level. A firm that is unable to demonstrate these actions would be considered in violation of the Independence Rule.

Other Code Provisions

Other Code provisions that apply when a firm acquires all or part of another firm come under the Acts Discreditable (1.400) and Confidential Client Information (1.700) rules, which are described next:

Transfer of Files and Return of Client Records in Sale, Transfer, Discontinuance or Acquisition of a Practice (1.400.205)

Sale of firm or portion of firm

This interpretation applies when the owner(s) of a firm selling some or all of a practice to another firm will have no equity interest in the successor (acquiring) firm. The owner(s) should send a written request to each client subject to the sale requesting the client's consent to transfer its files to the acquiring firm. Unless prohibited by law (including state accountancy board regulations), the owner(s) should notify the client that its consent may be presumed if it does not respond to the firm's request within 90 days. The firm's owner(s) should not transfer any client files to the acquiring firm until the client's consent is obtained, or 90 days has passed, and is encouraged to retain evidence of consent.

Acquisition of firm or portion of firm

Owners of the acquiring firm should be satisfied that the selling firm has fulfilled its ethical obligation to send a written request to each client subject to the sale, seeking consent to transfer the records, and that consent has been obtained or the requisite period has lapsed, as previously described.

Disclosing Client Information in Connection with a Review or Acquisition of the Member's Practice (1.700.050)

The Confidential Client Information Rule indicates that review of a professional practice includes one performed in conjunction with a prospective purchase, sale, or merger of all or part of a firm. It's important to take appropriate precautions to help ensure that a prospective purchaser does not disclose any confidential client information obtained during the review. For example, the seller may execute a written confidentiality agreement with the prospective purchaser or take other measures to protect the information. Firms that obtain client files via an acquisition should not disclose any confidential client information contained in the files.

Considerations for Growing Firms

Firms that experience significant growth through M&A activity, particularly if it's rapid, will quickly learn that compliance with relevant

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ethical requirements can become more complex. Independence is especially challenging given the many ways threats can arise, and the different approaches firms may have for complying with independence. For example, smaller firms generally use a highly centralized structure and employ a simpler, more direct and personalized approach to compliance because they have fewer people, offices and attest clients. Larger firms tend to be decentralized, operate from several offices and require technological tools to track independence compliance. The larger the firm, the more complicated the issues tend to be as clients are generally larger, more complex structurally and may be subject to multiple professional and regulatory requirements. The acquisition of other firms comprised largely or even entirely of non-CPAs can present additional challenges.

Blending Cultures

Firms tend to look for a good cultural fit when scoping out possible acquisition targets, but there always will be periods of adjustment whenever two firms join – even when both are CPA firms. For example, one CPA firm may take a more conservative approach to complying with independence or other ethical requirements, which should be reconciled to the other firm's approach. Professionals acquired in a transaction need training on the new firm's policies and procedures as soon as possible to help ensure ongoing compliance with relevant ethical requirements. Firms should provide specialized training to acclimate non-CPAs to the audit firm environment and help them understand theirs and the firm's obligation to maintain independence and comply with ethical standards.

> "To minimize conflicts, firms should discuss these situations before the merger or acquisition and proactively agree to a fair and formal process for making decisions about whether to provide attest or nonattest services to clients when independence or other ethical constraints apply.

Blending attest and nonattest

A formal process for vetting and approving nonattest services engagements before they are accepted is a critical component of independence compliance and will help prevent inadvertent violations. Sometimes, but not always, the scope of nonattest work may be scaled back to allow the firm to provide both services. However, in some cases, firms will need to decide whether to retain attest or nonattest work when the latter creates insurmountable threats to independence. Conflicts between newly-merged practices can occur if nonattest services create independence issues for attest clients. To minimize conflicts, firms should discuss these situations before the merger or acquisition and proactively agree to a fair and formal process for making decisions about whether to provide attest or nonattest services to clients when independence or other ethical constraints apply.

Additional articles on this subject include:

The Importance of Independence — Considerations for Growing Firms, Cathy Allen, *The CPA Journal*, March 2018.

Ethics for CPA firm mergers and acquisitions, Ken Tysiac, *Journal of Accountancy*, July 2018.

How to comply with the new AICPA ethics standards for M&A, April Sherman, *Journal of Accountancy*, August 2017.

About The Author & Publisher

Cathy Allen, *founder of* **Audit Conduct, LLC**, *develops numerous courses on professional ethics, independence, and related topics, provides specialized training and expert services, consults on critical independence matters, and advises firms on improving their quality controls.*