



National Association of State Boards of Accountancy

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Professional Ethics Executive Committee
American Institute of Certified Public Accountants
1345 Avenue of the Americas
New York, NY 10105

Via e-mail: ethics-exposedraft@aicpa.org

Re: Discussion Memorandum: Potential revisions to the AICPA Code of Professional Conduct and guidance related to independence in alternative practice structures

Dear Members and Staff of the AICPA Professional Ethics Executive Committee (PEEC):

The National Association of State Boards of Accountancy (NASBA) appreciates the opportunity to comment on the above-referenced Discussion Memorandum, *Potential revisions to the AICPA Code of Professional Conduct and guidance related to the independence in alternative practice structures* (the Discussion Memorandum). NASBA's mission is to enhance the effectiveness and advance the common interests of State Boards of Accountancy (State Boards) that regulate all Certified Public Accountants (CPAs) and their firms in the United States and its territories, which includes all audit, attest and other services provided by CPAs. State Boards are charged by law with protecting the public.

In furtherance of that objective, NASBA offers the following comments.

General Comments

As noted in the Discussion Memorandum, accounting firms have been part of alternative practice structures (APS) for more than two decades. The Discussion Memorandum focuses on depicting the basic structure of an APS with a public or private investor that involves dividing the accounting firm into an attest firm and nonattest entity. NASBA believes that this is a reasonable depiction as it would not be feasible to address every nuance of every APS.

This Discussion Memorandum covers a range of transaction types involving the use of APS. In other words, it is not solely focused on APS structures arising as a result of private equity transactions. Given the recent surge in private equity investments in accounting firms, NASBA encourages PEEC to act with urgency to issue authoritative and nonauthoritative guidance for independence considerations as well as the other principles of the AICPA Code of Professional Conduct (Code) as it relates to APSs. We suggest that one way in which this project could be

expedited is by carving out and prioritizing the private equity subtopic. The remainder could be covered in a later project.

Private equity investments are rapidly transforming the accounting profession. Without established guidance, concerns are growing from regulators, accountants and the public over potential conflicts of interest arising from these transactions and the potential impact to audit quality. State Boards are particularly concerned about their lack of jurisdiction and enforcement powers over private equity firms that invest in accounting firms. A balance of authoritative and nonauthoritative guidance will be most effective and drive more consistent application for the benefit of all – the public, State Boards, CPAs, private equity firms and other investors in accounting firms.

NASBA has prepared responses later in this letter to the specific questions detailed in the Discussion Memorandum related to the process for independence considerations for APS. NASBA offers the following comments related to macro issues of APSs that potentially have considerations beyond the independence principle of the Code.

Terms of the private equity agreement: NASBA is concerned that the terms of the private equity agreement may put undue pressure on the attest firm in ways that can impair independence, objectivity, and/or quality management. Historically, the focus of private equity firms and their investees is to maximize profits and prioritize a return on investment. This focus could result in cost-cutting measures that negatively impact audit quality. Control by non-CPAs may mean less familiarity with the requirements for rigorous assessment and implementation contained in accountancy laws, rules and other standards including the Code.

Terms of the shared services agreement: NASBA is concerned that the terms of the administrative/shared services agreement may put undue pressure on the attest firm in ways that can impair independence, objectivity, and/or quality management. For example, it is not clear how having an attest firm that has no employees or resources but “leases” partners, employees and resources from the nonattest entity under the administrative/shared services agreement allows the attest firm to be truly independent. This concern is elevated when one considers that those personnel are compensated by the nonattest entity based on the nonattest entity’s determination of compensation levels. In these agreements, it appears that the decision-making is occurring at the nonattest entity so it becomes unclear how reliance can be placed on the assertion in paragraph 14 of the Discussion Memorandum that states “it is the attest *firm*’s responsibility to ensure that this contract provides resources sufficient for the attest *firm* to comply with applicable professional standards, including *independence* and quality management standards.”

Further, NASBA believes that a critical assumption was made in the drafting of the Discussion Memorandum. That assumption was not explicitly stated in the document. The assumption is that the terms and operational aspects of the shared services agreement are such that the attest firm is able to act independently regarding decisions associated with regulatory compliance. If such independence does not truly exist it is our view that the resulting structure would not constitute an APS and the attest firm and the nonattest firm would be subject to the same independence rules. In

subsequent standards setting, guidance should be provided to cover both situations in which the attest entity has necessary independence and those in which it does not have such independence.

Regulatory challenges in monitoring complex ownership structures: The diverse and intricate ownership arrangements resulting from private equity investments pose challenges for regulators in maintaining oversight. A particular concern is the firm name and branding of the attest firm and nonattest entity. When the attest firm name and the nonattest entity name are essentially the same, branding and advertising is similar and the same website is used for attest and nonattest services, there can be confusion for the public as well as the regulators in understanding how services are being delivered.

The private equity investment in accounting firms has enabled many firms to expand services and acquire smaller firms, leading to rapid growth, multi-state activities and consolidation within the industry. This poses regulatory oversight and firm mobility challenges as there is need to consider and understand jurisdictional laws and regulations regarding firm ownership composition.

Private equity transactions that have occurred with large accounting firms often describe robust processes and resources that existed prior to the transaction or were expanded post-transaction to monitor relationships and track restricted entities for independence. More recent private equity transactions involving smaller firms pose concerns as to whether the appropriate processes and resources are in place not only to track and report independence matters but also successfully integrate firms and maintain audit quality.

Stability and continuity: The private equity investment may include high leverage and debt financing, posing risks to the attest firm's long-term financial stability. Upon exit, the attest firm could be left with a high debt load, which could result in disruption to client service and fiduciary responsibilities may be jeopardized.

Data privacy: Private equity owned firms have access to sensitive attest firm client financial data. This data must be appropriately protected and managed carefully particularly in the event of the private equity firm's exit.

Quality management and peer review: We understand that quality management and peer review standards do not fall within the purview of PEEC. We believe that the Auditing Standards Board should closely monitor the activities of this initiative with the goal of developing and issuing standards that ensure that attest firms implement appropriate processes and controls related to this topic over quality management. In addition, the peer review standards will need to be updated to include the monitoring of compliance by the attest firms with such standards.

Comments on Specific Questions from the Discussion Memorandum

Subject to the concerns expressed above, NASBA provides the following responses to the specific questions enumerated in the Discussion Memorandum:

1. Does the diagram present a clear and understandable representation of an APS? Are you familiar with any other forms of APS?

NASBA believes the diagram presents a clear and understandable basic representation of an APS. The diagram depicts the fundamental elements most common in an APS in the current environment.

2. Are the APS characteristics we described broad enough to allow application across various forms of an APS?

NASBA believes that the APS characteristics are broad enough to allow application across various forms of an APS.

3. Are there any APS characteristics we failed to address that should be included?

NASBA has no suggestions or comments.

4. Are the new terms and their definitions clear? Are they broad enough to allow application across various forms of an APS? If not, please explain.

NASBA believes the new terms and their definitions are clear and broad enough to allow application across various forms of an APS.

5. Are there other terms that should be defined in any resulting guidance?

NASBA is not aware of any other terms that should be defined in any resulting guidance.

6. Do you agree with the preliminary conclusions the task force has reached regarding network firms in an APS (paragraphs 27-31)? If not, please explain.

NASBA agrees with the preliminary conclusions the task force has reached regarding *network firms* in an APS. However, it is not clear in paragraph 37 why there is a different standard for *financial statement* audit and review *clients* versus other *attest clients*. All attest engagements should be treated the same and should comply with the independence requirements.

7. Do you agree with the task force's preliminary conclusions regarding covered members in an APS (paragraphs 32-35)? If not, please explain.

NASBA agrees with the preliminary conclusions the task force has reached regarding *covered members* in an APS; however, NASBA has concerns with certain statements included in paragraph 34. The first bullet states that the chief executive or equivalent of the nonattest entity is a *covered member* because this individual directly supervises or manages the *partners* of the attest *firm*. NASBA does not believe that situation can exist for attest engagements. In other words, how could the nonattest CEO who is most likely not a CPA directly supervise attest partners?

Similarly, the second bullet states that there can be situations where a nonattest board member has the “authority to approve the compensation of the attest *firm partners* at the individual level.” Such control over compensation for attest partners would not be consistent with professional standards. We refer to Code section 0.400 (Definitions) subparagraph .25 which states that an “individual in a position to influence the attest engagement” is “one who evaluates the performance or recommends the compensation of the attest engagement partner”.

NASBA believes that careful consideration should be given to the other individuals associated with the APS identified in paragraph 35 as to whether they meet the definition of a *covered member*. The nonattest entity board members are likely not independent board members but a related party to the private equity firm in some manner.

While not directly associated with this question, NASBA would like to express one other concern regarding partner compensation. In traditional private equity structures, there are frequently “clawback” provisions. If distributions are made to limited partners and performance of the entity subsequently turns negative, the general partner has the right to claw back the excess distributions. While we understand that there are accounting firm private equity transactions with clawback provisions, we are not aware of how extensive they are at this time. We are concerned that “clawback” arrangements will result in further control over the attest firm partners’ compensation by the nonattest entity. In addition, these arrangements could place undue performance pressure on the attest firm partners and result in short-cutting quality management to meet goals. NASBA suggests that consideration of this potential area of risk be further studied.

8. Do you agree with the task force’s preliminary conclusion in paragraph 38? If not, please explain.

NASBA agrees with the task force’s preliminary conclusion in paragraph 38 on those identified relationships with other individuals and entities associated with the APS beyond the scope of *covered members* and *network firms* that may create *threats to independence*. NASBA has concerns regarding aspects of the administrative/shared services agreement between the attest and nonattest entities that could impair independence. For example, if the agreement requires the attest firm to use personnel and partners from the nonattest entity there would appear to be an enhanced level of risk of independence impairment. As previously discussed, the nonattest entity board setting individual compensation for the attest firm personnel including partners raises questions regarding the independence of the attest firm. Appropriate guidance or guardrails may be needed within the administrative/shared services agreement so that the attest firm is less dependent on the goodwill of the nonattest entity. Independence should be in substance as well as form.

9. Do you agree with the task force’s preliminary conclusion in paragraph 39, including the individuals and entities listed? If not, please explain.

NASBA agrees with the task force’s preliminary conclusion in paragraph 39, including the individuals and entities listed. NASBA recommends an indication that the listed individuals and

entities are not intended to be all-inclusive and other relationships/entities will need to be considered.

10. Do you agree with the task force’s preliminary conclusion in paragraph 40? If not, please explain.

NASBA agrees with the task force’s preliminary conclusion in paragraph 40.

11. Should the threshold for determining whether the attest firm can provide a financial statement attest service to an entity (for example, an LP) that invests in the investor be based on:

a. whether the entity (for example, an LP) has significant influence over the investor (such as a PE fund or public company) and the investment is material to the entity (that is, as proposed in paragraph 40); or

b. whether the entity (for example, an LP or shareholder) has significant influence over the investor (such as a PE fund or public company) or the investment is material to the entity?

NASBA believes the threshold for determining whether the attest firm can provide a financial statement attest service to an entity that it invests in the investor be based on whether the entity has significant influence or the investment is material to the entity.

12. Do you agree with the task force’s preliminary conclusion in paragraph 41? If not, please explain.

NASBA agrees with the task force’s preliminary conclusion in paragraph 41.

13. Do you agree with the task force’s preliminary conclusion that the relationships and circumstances described in paragraph 43 should be evaluated under the “Conceptual Framework for Independence”? If not, please explain.

NASBA agrees with the task force’s preliminary conclusions that the relationships and circumstances described in paragraph 43 should be evaluated under the “Conceptual Framework for Independence”. NASBA recommends that the language in the second and third bullet to paragraph 43 state “knows or has reason to believe *after reasonable inquiry*.”

14. Are there any circumstances and relationships that would create threats to independence that the task force has not addressed but should?

NASBA is not aware of any circumstances and relationships that the task force has not addressed; however, NASBA recommends that the guidance be framed as illustrative (i.e., including, but not limited to).

15. Are there additional factors and possible safeguards that should be included in table 2?

NASBA is not aware of additional factors that should be included in table 2; however, NASBA recommends that the guidance be framed as illustrative (i.e., including, but not limited to).

16. Do you agree with the task force's preliminary conclusions related to other individuals and entities associated with the APS who would generally not create threats to independence (paragraphs 45-48)? If not, please explain.

NASBA agrees with the task force's preliminary conclusions related to other individuals and entities associated with the APS who would generally not create *threats to independence*.

17. Should other individuals or entities associated with the APS be included in this category?

NASBA is not aware of other individuals or entities associated with the APS that should be included in this category.

18. Do you agree with the three-step process for identifying, evaluating, and, where possible, mitigating threats to independence in an APS described in paragraph 52? If not, please explain.

NASBA agrees with the three-step process for identifying, evaluating, and, where possible, mitigating *threats to independence* in an APS described in paragraph 52.

19. In general, based on paragraphs 51-55, and appendixes 1 and 2, do you prefer option 1 or option 2?

a. If you prefer option 1 (appendix 1):

- i. Are there elements of the draft interpretation that you do not believe can be operationalized? If yes, please explain which elements.***
- ii. Are there elements of the interpretation that you believe would be more appropriately presented in nonauthoritative guidance?***
- iii. Should the APS example diagram presented after paragraph .07 in appendix 1 remain in the interpretation or be moved to nonauthoritative guidance as presented in appendix 2?***
- iv. Should the information presented in table 1 of appendix 1 be presented as a table or in paragraph form, as in paragraphs .09 - .12 of the example interpretation in appendix 2?***
- v. Should the information presented in the conceptual framework table (table 2) be in the interpretation in appendix 1 or should it be nonauthoritative guidance as presented in appendix 2?***
- vi. Are there any other aspects of option 1 you would like to address?***

b. If you prefer option 2 (appendix 2):

- i. Are there any aspects of the nonauthoritative examples that you believe should be included in the interpretation?***
- ii. Should the network firms conclusions be presented as nonauthoritative guidance as in appendix 2, or included in authoritative guidance as in appendix 1, paragraphs .09 - .12?***
- iii. Are the covered member conclusions better presented as nonauthoritative guidance as in appendix 2, or included in authoritative guidance as in appendix 1, paragraphs .13 - .15?***
- iv. If you believe the information in table 2 should be presented as nonauthoritative guidance, do you agree with listing the circumstances necessitating the application of the conceptual framework as they are presented in the draft interpretation in appendix 2, paragraph .13?***
- v. Are there any other aspects of option 2 you would like to address?***

NASBA recommends using option 1. A State Board can most readily enforce clearly defined authoritative rules. While potentially enforceable, guidance labeled as nonauthoritative would present greater challenges for regulators in their enforcement efforts. Authoritative, bright-line guidance offers more specific, objective rules with more predictable results and consistent application in many cases as compared to general guidance, recognizing that bright-line rules may lack flexibility and fail to account for individual nuances or variations from the models presented.

- i. NASBA is not aware of any elements of option 1 that cannot be operationalized.
- ii. NASBA is not aware of any elements of the interpretation that would be more appropriately presented in nonauthoritative guidance.
- iii. NASBA believes that the APS example diagram should remain in the interpretation.
- iv. NASBA recommends that the information be presented in both paragraph form and in a table.
- v. NASBA recommends the information presented in the conceptual framework table (table 2) be presented in the interpretation in appendix 1.
- vi. NASBA supports option 1 but would like to include the nonauthoritative guidance in option 2 that is not covered in option 1 such as the guidance for APS structures other than private equity.

20. Is there an approach other than option 1 or option 2 that would be more appropriate for providing independence guidance on APSs? If so, please describe the approach.

NASBA has no other recommendation.

We appreciate the opportunity to comment on the Discussion Memorandum.

Very truly yours,

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