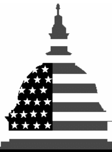

GAO
Accountability * Integrity * Reliability

Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

April 30, 2007

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International Ethics Standards Board for Accountants
International Federation of Accountants
545 Fifth Avenue, 14th Floor
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Subject: International Ethics Standards Board for Accountants' (IESBA) December 2006 Exposure Draft: *Section 290 of the Code of Ethics: Independence—Audit and Review Engagements*, and *Section 291 of the Code of Ethics: Independence—Other Assurance Engagements*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the IESBA's proposed revisions to the independence provisions of its Code of Ethics. We support the efforts of the IESBA to enhance the independence of professional accountants who perform assurance engagements. We view auditor independence as the crucial element for gaining and maintaining public trust. Auditors and audit organizations must maintain independence so that their opinions, findings, conclusions, judgments, and recommendations will be impartial and viewed as impartial by objective third parties with knowledge of the relevant information.[1]

We do, though, have significant concerns about the manner in which certain of the IESBA's proposed revisions would be extended to government audit organizations and audit firms that conduct audits of government entities. Accordingly, our comments focus on aspects of the proposed revisions that would affect public sector audit organizations and audit firms that conduct audits of government entities and programs.

Our comments address (1) the process for determining auditor independence provisions for public sector entities and (2) enhanced safeguards for auditors of public sector entities.

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[1] U.S. Government Accountability Office, *Government Auditing Standards*, *January 2007 Revision*, GAO-07-162G (Washington, D.C.: January 2007), paragraph 3.03.

Process for determining auditor independence provisions for public sector entities

The IESBA has proposed extending the listed-entity independence provisions to auditors of entities of "significant public interest." The proposed standard states, "Entities of significant public interest will **always** include listed entities, and will **normally** include regulated financial institutions such as banks and insurance companies, and **may** include pension funds, government agencies, government-controlled entities, and not-for-profit entities." (emphasis added) The proposed changes would allow some flexibility for IFAC member bodies to determine, based on the facts and circumstances, which entities should be considered of significant public interest within their respective jurisdictions. In the United States, the American Institute of Certified Public Accountants (AICPA) serves as the IFAC member body.

The proposal sets forth the following hierarchy for determining whether entities are of "significant public interest" and, therefore, whether these entities are subject to the same enhanced auditor independence safeguards as listed entities. Where law or regulation defines the entities that are to be considered of significant public interest for independence purposes, the IESBA concluded that IFAC member bodies should use those definitions for applying the independence standards of Section 290. In the absence of such a legislative or regulatory definition, the proposed standard states that the appropriate IFAC member body should determine which entities in addition to listed entities will be treated as entities of significant public interest. Table 1 illustrates the IESBA proposal.

Table 1: IESBA Proposal for Determining Entities of Significant Public Interest

	Listed entities	**Regulated financial institutions**	**Pension funds, government agencies, government-controlled entities, not-for-profit entities**
Is the entity of significant public interest?	Always	Normally	May be of significant public interest
IFAC proposed process for determining whether the entity is of significant public interest	Always	1. Law or regulation 2. IFAC member bodies/national auditing standards setters make determination if no applicable law or regulation makes the determination.	

Our concern is that IFAC member bodies that are national auditing standard setters are generally not the appropriate parties for determining independence requirements for auditors of regulated financial institutions, pension funds, government agencies, government-controlled entities, and not-for-profit entities. In addition, the conclusions reached under the proposed hierarchy and the resulting implementation of the standard likely would be inconsistent, depending on the context and the facts and circumstances. For example, a municipal water treatment plant likely would be considered of significant public interest within the context of the municipal

environment. However, that same water authority would not be considered of significant public interest within a state or national context. Auditors in the first instance would be required to apply enhanced independence safeguards, while auditors in the second instance would not.

We agree with the Board's conclusion that it is impracticable to develop a single definition of an entity of significant public interest that would have global application and be suitable in all jurisdictions. We also agree that in jurisdictions where law or regulation defines entities that are of significant public interest for auditor independence purposes, IFAC member bodies should use those same laws or regulations in determining the appropriate auditor independence standards.

However, in the absence of such a law or regulation, an appropriate government entity, such as the national or state audit office, and not IFAC member bodies that are national auditing standard setters, should determine applicable enhanced independence safeguards for auditors of government agencies, government-controlled entities, and certain government-funded not-for-profit organizations. For regulated financial institutions and pension funds, the agency that regulates these institutions should make the decision. We also believe that in both of these situations the party making the decision should coordinate with the appropriate IFAC member body. Our proposed model is illustrated in table 2.

Table 2: GAO's Proposed Model for Determining Entities of Significant Public Interest

	Regulated financial institutions and pension funds	**Government agencies, government-controlled entities, not-for-profit entities**
Process for determining the applicability of enhanced independence safeguards	1. Law or regulation 2. Regulators make determination if no applicable law or regulation makes the determination	1. Law or regulation 2. Appropriate government entities, such as the national and state audit offices, make determination if no applicable law or regulation makes the determination
	3. Regulators and appropriate government entities coordinate with IFAC member bodies/national auditing standards setters.	

In the United States, U.S. *Government Auditing Standards* [2] provide the model for how the national audit office should determine independence requirements for government agencies, government-controlled entities, and certain not-for-profit organizations that receive government funding. In the United States, auditors of government entities and entities that receive government awards are required to follow U.S. *Government Auditing Standards*. These standards include independence requirements that differ from national standards in that they are more stringent in a number of respects and are tailored to address the unique aspects and risks of government audits. U.S. *Government Auditing Standards* emphasize the importance

[2] U.S. *Government Auditing Standards* may be accessed at http://www.gao.gov/govaud/ybk01.htm. The independence standards are in paragraphs 3.02-3.30.

of independence for both auditors and audit organizations in audits of government entities and entities that receive government awards. In establishing and promoting adherence to these standards, GAO regularly coordinates and communicates with the AICPA; federal, state, and local government auditors; CPA firms that audit government entities and government-funded programs; and other stakeholders.

Enhanced safeguards for auditors of public sector entities

The enhanced auditor independence requirements for audits of government entities that are included in U.S. *Government Auditing Standards* were developed following extensive due process, including deliberations by the Comptroller General's Advisory Council on U.S. *Government Auditing Standards* and public exposure and comment. Based on U.S. *Government Auditing Standards*, we agree that auditors of government-agencies, government controlled entities, and not-for-profit entities should apply enhanced safeguards in certain circumstances in order to maintain their independence both in fact and in appearance. For example, U.S. *Government Auditing Standards* includes safeguards similar to those proposed by the IESBA to protect against threats to independence when auditors provide nonassurance services to audit clients. However, some of IESBA's proposed enhanced safeguards are not appropriate and necessary for auditors of government agencies, government-controlled entities, and not-for-profit entities.

Specifically, the enhanced safeguards related to an audit team member joining an audit client are not appropriate and necessary in audits of public sector entities. Because of different motivations, circumstances, and issues in government entities, the self-interest, familiarity, and intimidation threats created by such employment would be much less for auditors of public entities than for auditors of listed entities.

Partner rotation offers another example of how government entities, such as national audit offices, can best determine the applicable enhanced independence safeguards that are most appropriate based on the relevant facts, circumstances, and regulatory context for auditors of government agencies, government-controlled entities, and certain not-for-profit organizations. The proposed provisions related to the threats that may arise from using the same senior audit personnel on an engagement over a long period of time are inappropriate and unnecessary for public entity auditors. In audits of entities of significant public interest, the IESBA's provisions state that "an individual should not be a key audit partner for more than seven years. After such a time, the individual should not return to the engagement team or be a key audit partner for the client for two years. During that period the individual should not participate in the audit of the entity."

After passage of the Sarbanes-Oxley Act of 2002 (the Act) in the United States, GAO analyzed whether the partner rotation requirements of the Act would be appropriate in the government audit environment. The Act makes it unlawful for a firm to provide audit services to a publicly traded company if the lead audit partner having primary responsibility for the audit or the audit partner responsible for reviewing the audit has performed audit services for the entity in each of the five previous fiscal years.

We concluded that these requirements are not necessary in the government environment, although some audit organizations may choose to follow them. For many government audit organizations, law mandates the performance of an audit by the individual who holds a specified office, such as the auditor general or the comptroller general. For instance, in the United States in order to preserve independence and to protect the office from political pressure, the Comptroller General serves a 15-year term, cannot be reappointed, and is subject to removal only by a joint resolution of the U.S. Congress for specified causes.

Other safeguards ordinarily found in U.S. public sector audit offices include formal mandates establishing the audit offices' powers and duties; public availability of most government audit reports; the enhanced accountability of most government audit offices; and the required use of U.S. *Government Auditing Standards*, established specifically to address the unique aspects of government audits, for audits of U.S. federal government entities and for audits of other entities that receive federal funding. In addition, some government entities are required to regularly re-bid their audit contracts. We believe that these safeguards in place in the U.S. government audit arena are sufficient to help audit offices and firms mitigate the self review and self interest threats.

We thank you for considering our comments on these important issues.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

cc: The Honorable Christopher Cox, Chairman
Securities and Exchange Commission

The Honorable Mark W. Olson, Chairman
Public Company Accounting Oversight Board

Mr. Henrik Otbo, Auditor General, Denmark
Chair, INTOSAI Professional Standards Committee

Mr. Harold Monk, Chair
Auditing Standards Board

Mr. James M. Sylph, Technical Director
International Auditing and Assurance Standards Board