



GAO

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Comptroller General
of the United States

United States General Accounting Office
Washington, DC 20548

May 20, 2003

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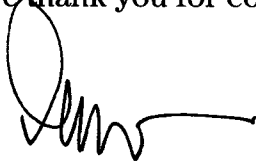
Subject: *Exposure Draft: Omnibus Proposal of Professional Ethics Division
Interpretations and Rulings*

We congratulate the Professional Ethics Executive Committee on its efforts to strengthen AICPA independence rules related to performing nonattest services. We are particularly pleased that the proposed rules include the following changes:

- Incorporating by reference the nonattest services rules of other authoritative bodies, including those of the U.S. General Accounting Office, where a member is required to be independent under the applicable rules.
- Strengthening the general requirements for members performing nonattest services for attest clients or entities, as well as strengthening the specific requirements for certain nonattest services.
- Requiring members to evaluate the client's ability to make an informed judgment on the results of the nonattest services.

GAO has specific recommendations for improving the AICPA's proposed revisions to the ethics rules as described in the enclosure. Our recommendations would explicitly state that auditors should not audit their own work where the subject matter of the nonattest services is material to the subject matter of the audit. We are also recommending that the client's understanding and acceptance of the responsibilities of a nonattest engagement be documented. Finally, we believe that an external auditor's independence for performing audits and attestation engagements for an entity is impaired if the auditor provides outsourced internal audit services for that same entity, and we are recommending changes accordingly.

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

A handwritten signature in black ink, appearing to read 'D. Walker', with a large loop at the beginning and a horizontal line extending to the right.

David M. Walker
Comptroller General
of the United States

Enclosure

cc: International Auditing and Assurance Standards Board of the International
Federation of Accountants
Auditing Standards Committee of the International Organization of Supreme
Audit Agencies
Public Company Accounting Oversight Board

Exposure Draft: Omnibus Proposal of Professional Ethics Division Interpretations and Rulings

GAO Proposed Change #1:

The General Requirements for Performing Nonattest Services should preclude members from auditing their own work, in addition to the requirement that auditors should not perform management functions or make management decisions for the attest client. This would prevent members from planning, conducting, or reviewing audit work related to nonattest services that they performed, and it should preclude members from reducing the level of audit testing based on nonattest services that the members performed for the same client.

Rationale for and Benefits of Proposed Change #1:

This change will more clearly delineate attest from nonattest services, which will strengthen auditor independence. This proposed change is consistent with the conceptual underpinnings of the AICPA nonattest services independence rules and provides explicit guidance to prevent the “self-review” threat that arises when a member audits financial statements that use the auditor’s own nonattest work when that work is material to the audit subject matter.

Suggested Wording of Proposed Change #1:

Interpretation No. 101-3 Under Rule 101

General Requirements for Performing Nonattest Services

Paragraph 1. The member should not perform management functions or make management decisions for the attest client. However, the member may provide advice, research materials, and recommendations to assist the client’s management in performing its function and making decisions.

In addition, the member should not audit his or her own work or provide nonattest services where the nonattest services are material to the audit subject matter. In considering whether the nonattest service can have a material effect on the audit subject matter, the member should take into account:

- (1) ongoing audits,**
- (2) planned audits, and**
- (3) expected future audits.**

GAO Proposed Change #2:

Enhance the new requirement to evaluate management's ability to make informed judgments on the nonattest services by requiring documentation that management understands and accepts these responsibilities.

Rationale for and Benefits of Proposed Change #2:

The proposed change will make the documentation requirements more consistent with the "rebuttable presumption" principle explained in the introduction and background to the standard and included in paragraph 2.

Suggested Wording of Proposed Change #2:

Interpretation No. 101-3 Under Rule 101

General Requirements for Performing Nonattest Services

Paragraph 3. The member should establish and document in writing his or her understanding with the client (board of directors, audit committee, or management, as appropriate in the circumstances), regarding the:

- a. Objectives of the engagement;
- b. Services to be performed;
- c. Client's **understanding and acceptance of its** responsibilities, including its responsibilities to make informed judgments;
- d. Member's responsibilities; and
- e. Any limitations of the engagement.

GAO Proposed Change #3:

The proposed rules for internal audit assistance services should state that providing internal audit services for a client would impair the independence of an external auditor to perform audit and attestation engagements for the same client.

Rationale for and Benefits of Proposed Change #3:

Internal auditors have a unique position within an organization to provide independent analyses, evaluations, assurances, recommendations, and other information to the entity's management and board of directors or to others with equivalent authority and responsibility. The Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing* (Internal Audit Standards) defines internal auditing as an independent appraisal function within an entity and requires internal auditors to be independent of the activities they audit. However, internal auditors are not independent from the **entity** they audit. This concept of independence is different from the

independence the external auditor maintains under the AICPA Code of Professional Conduct.¹

Even when an internal audit function is performed under the Internal Audit Standards for independence, that work is being done for entity management. Therefore, when an external auditor performs internal audit activities as a contractor or consultant (outsourcing), this would violate the AICPA proposed general requirement for performing nonattest services: “The member should not perform management functions or make management decisions for the attest client.”

Suggested Wording of Proposed Change #3:

Delete entire section under the heading Internal Audit Assistance Services on pages 25 - 27 and replace with:

Internal audit services are considered a management function and, for external audit organizations, would impair the independence of an external auditor for performing audits and attestation engagements.²

¹ Excerpted from *Codification of Statements on Auditing Standards*, AU Section 322.02 – 322.03.

² Excerpted from *Government Auditing Standards, Answers to Independence Standard Questions* (GAO-02-870G) pg. 54.