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Omnibus proposal of Professional Ethics Division interpretations and rulings

American Institute of Certified Public Accountants. Professional Ethics Executive Committee

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EXPOSURE DRAFT

OMNIBUS PROPOSAL OF PROFESSIONAL ETHICS DIVISION INTERPRETATIONS AND RULINGS

□ PROPOSED REVISION OF INTERPRETATION NO. 101-5 UNDER RULE 101: Loans From Financial Institution Clients and Related Terminology □ PROPOSED REVISION OF ET SECTION 92: Definitions □ PROPOSED REVISION OF ETHICS RULING NO. 91 UNDER RULE 101: Member Leasing Property to or From a Client □ PROPOSED REVISION OF INTERPRETATION NO. 101-3 UNDER RULE 101: Performance of ~~Other~~ *Nonattest* Services □ PROPOSED DELETION OF INTERPRETATION NO. 101-13 UNDER RULE 101: Extended Audit Services □ PROPOSED DELETION OF ETHICS RULING NO. 103 UNDER RULE 101: Attest Report on Internal Controls □ PROPOSED DELETION OF ETHICS RULING NO. 104 UNDER RULE 101: Operational Auditing Services □ PROPOSED DELETION OF ETHICS RULING NO. 105 UNDER RULE 101: Frequency of Performance of Extended Audit Procedures

March 19, 2003

Prepared by the AICPA Professional Ethics Executive Committee for comments from persons interested in independence, behavioral, and technical standards matters

**Comments should be received by May 19, 2003, and addressed to
Lisa A. Snyder, Director, Professional Ethics Division,
AICPA, Harborside Financial Center, 201 Plaza Three,
Jersey City, NJ 07311-3881 or via the Internet at lsnyder@aicpa.org.**

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March 19, 2003

This exposure draft contains several important proposals for review and comment by the AICPA's membership and other interested parties regarding pronouncements for possible adoption by the Professional Ethics Executive Committee (the Committee). The accompanying text of each proposed pronouncement shows the changes being proposed by using boldface italics for the additions and strikethroughs for the deletions. Explanations of each proposed pronouncement are also included in this exposure draft.

After the exposure period is concluded and the Committee has evaluated the comments, the Committee may decide to publish one or more of the proposed pronouncements. Once published, the pronouncements become effective on the last day of the month in which they are published in the *Journal of Accountancy*, unless otherwise stated in the pronouncements.

Your comments are an important part of the standard-setting process. Please take this opportunity to comment. Responses must be received at the AICPA by May 19, 2003. All written replies to this exposure draft will become part of the public record of the AICPA and will be available for inspection at the office of the AICPA after June 19, 2003, for a period of one year.

All comments received will be considered by the Committee at an open meeting, which is scheduled for June 2 - 3, 2003, at the AICPA New York City office.

Please send comments to Lisa A. Snyder, Director, AICPA Professional Ethics Division, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881 or lsnyder@aicpa.org. Comments submitted via electronic mail are encouraged and would be appreciated.

Sincerely,

James L. Curry
Chair
AICPA Professional Ethics
Executive Committee

Lisa A. Snyder
Director
AICPA Professional
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PROPOSED REVISION OF INTERPRETATION NO. 101-5 UNDER RULE 101

[*Explanation*]

The Professional Ethics Executive Committee is proposing revisions to "Other Permitted Loans" as set forth in Interpretation 101-5, *Loans From Financial Institution Clients and Related Terminology*, (AICPA, *Professional Standards*, vol. 2, ET sec. 101.07). The proposed revision to "Other Permitted Loans" would increase the allowable outstanding balance for credit cards and cash advances that a covered member has obtained from a financial institution client from \$5,000 to \$10,000. The Committee believes that this change, which will conform the rule to that of the Securities and Exchange Commission (SEC), is reasonable and appropriate. Similar to the SEC rule, the proposed revision permits the covered member to utilize any available grace period when reducing these balances to an acceptable level. As a practical matter, the Committee recommends amending the interpretation's title since related terms have been moved to ET section 92, *Definitions*.

[*Text of Proposed Revisions of Interpretation No. 101-5*]¹

.07 101-5—Loans from financial institution clients and related terminology. Interpretation 101-1.A.4 [ET section 101.02] provides that, except as permitted in this interpretation, independence shall be considered to be impaired if a **covered member** * has any **loan** to or from a **client**, any officer or director of the client, or any individual owning ~~ten~~**10** percent or more of the client's outstanding equity securities or other ownership interests. This interpretation describes the conditions a covered member (or his or her **immediate family**) must meet in order to apply an exception for a "Grandfathered Loan" or "Other Permitted Loan."

Grandfathered Loans

Unsecured loans that are not material to the covered member's net worth, home mortgages,⁷¹¹ and other secured loans⁷¹¹ are grandfathered if:

1. they were obtained from a **financial institution** under that institution's **normal lending procedures, terms, and requirements**,
2. after becoming a covered member they are kept current as to all terms at all times and those terms do not change in any manner not provided for in the original loan agreement,⁸¹² and

¹ Strikethrough denotes proposed deletions to current text. Proposed new language is in boldface italic.

* Terms shown in boldface type upon first usage in this interpretation are defined in ET section 92, *Definitions*.

⁷¹¹ The value of the collateral securing a home mortgage or other secured loan should equal or exceed the remaining balance of the grandfathered loan during the term of the loan. If the value of the collateral is less than the remaining balance of the grandfathered loan, the portion of the loan that exceeds the value of the collateral must not be material to the covered member's net worth.

⁸¹² Changes in the terms of the loan include, but are not limited to, a new or extended maturity date, a new interest rate or formula, revised collateral, or revised or waived covenants.

3. they were:
- a) obtained from the financial institution prior to its becoming a client requiring independence; or
 - b) obtained from a financial institution for which independence was not required and were later sold to a client for which independence is required; or
 - c) obtained prior to February 5, 2001 and met the requirements of previous provisions of Interpretation 101-5 [ET section 101.07] covering grandfathered loans; or
 - d) obtained between February 5, 2001 and May 31, 2002, and the covered member was in compliance with the applicable independence requirements of the SEC during that period; or
 - e) obtained after May 31, 2002 from a financial institution client requiring independence by a borrower prior to his or her becoming a covered member with respect to that client

In determining when a loan was obtained, the date a loan commitment or line of credit is granted must be used, rather than the date a transaction closes or funds are obtained.

For purposes of applying the grandfathered loans provision when the covered member is a partner in a partnership:

- a loan to a limited partnership (or similar type of entity) or a general partnership would be ascribed to each covered member who is a partner in the partnership on the basis of their legal liability as a limited or general partner if:
 - the covered member's interest in the limited partnership, either individually or combined with the interest of one or more covered members, exceeds 50 percent of the total limited partnership interest; or
 - the covered member, either individually or together with one or more covered members, can control the general partnership.
- even if no amount of a partnership loan is ascribed to the covered member(s) identified above, independence is considered to be impaired if the partnership renegotiates the loan or enters into a new loan that is not one of the permitted loans described below.

Other Permitted Loans

This interpretation permits only the following new loans *and leases* to be obtained from a financial institution client for which independence is required. These loans *and leases* must be obtained under the institution's normal lending procedures, terms, and requirements and must, at all times, be kept current as to all terms.

1. Automobile loans and leases collateralized by the automobile.
2. Loans fully collateralized by the cash surrender value of an insurance policy.
3. Loans fully collateralized by cash deposits at the same financial institution (e.g., "passbook loans").

4. ***Aggregate outstanding*** ~~credit cards and cash advances where the aggregate outstanding balances on the current statement is~~ ***that are*** reduced to \$105,000 or less ***on a current basis taking into consideration*** by the payment due date ***and any available grace period.***

Related prohibitions that may be more restrictive are prescribed by certain state and federal agencies having regulatory authority over such financial institutions. Broker-dealers, for example, are subject to regulation by the Securities and Exchange Commission.

PROPOSED REVISION OF ET SECTION 92, *DEFINITIONS*

[*Explanation*]

The Professional Ethics Executive Committee is proposing revisions to the definition of a “financial institution” to make it clear that it includes entities that lease automobiles to the general public. The Committee believes this clarification is necessary to recognize that automobile leases can be entered into with leasing entities that may not be considered traditional financial institutions (for example, banks, savings and loan associations) because they do not make *loans* to the general public in a manner similar to a traditional lender. Since automobile leases are (and have been since the early 1990s) permitted under this interpretation, the Committee believes it would be useful to clarify the definition of “financial institution” to make it clear that an entity that leases automobiles to the general public would be considered a financial institution for purposes of Interpretation 101-5, *Loans From Financial Institution Clients* [ET section 101.07].

[*Text of Proposed Revision of ET Section 92, Definitions*]¹

08 Financial Institution. A financial institution is considered to be an entity that, as part of its normal business operations, makes loans to the general public. *In addition, for automobile leases addressed under Interpretation 101-5, Loans From Financial Institution Clients [ET section 101.07], an entity would be considered a financial institution if it leases automobiles to the general public.*

¹ Proposed new language is in boldface italic.

PROPOSED REVISION OF ETHICS RULING NO. 91 UNDER RULE 101

[*Explanation*]

The Professional Ethics Executive Committee is proposing a revision to Ethics Ruling No. 91, “Member Leasing Property to or From a Client,” of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity*, which addresses when independence would be considered impaired when property is leased to or from a client. The Committee believes that regardless of whether a lease is classified as an operating lease or a capital lease, independence should be considered impaired if a covered member leased personal or business property to or from a client, unless the lease was immaterial to the lessee and lessor, and certain other criteria are met. Accordingly, as proposed, immaterial capital leases would no longer be deemed to impair independence.

Since this proposal is more restrictive than the existing guidance for operating leases, the committee proposes to grandfather existing operating leases provided the lessee remains current as to all lease terms, and the terms of the lease do not change in any manner not provided for in the original lease agreement. The proposal would not apply to automobile leases which are covered under Interpretation 101-5, *Loans From Financial Institution Clients* [ET section 101.07].

[*Text of Proposed Revision of Ethics Ruling No. 91*]¹

Member Leasing Property to or From a Client

.182 Question—Would independence be considered to be impaired if a covered member leased ***personal or business property, other than automobiles (which would be covered by Interpretation 101-5 [ET section 101.07])***, to or from a client?

.183 Answer—Independence would not be considered to be impaired if ***all of the following criteria are met:***

- a. ***The annual lease payments are immaterial to the lessee and lessor.***
- b. ***The leased property is leased under the lessor’s normal terms, procedures, and requirements.***
- c. ***Payments are kept current at all times. lease meets the criteria of an operating lease (as described in Generally Accepted Accounting Principles), the terms and conditions set forth***

¹ Strikethrough denotes proposed deletions to current text. Proposed new language is in boldface italic.

in the lease agreement are comparable with other leases of a similar nature, and all amounts are paid in accordance with the terms of the lease.

Independence would be considered to be impaired if a *covered* member had a lease that meets the criteria of a capital lease (as described in Generally Accepted Accounting Principles) unless the lease is in compliance with interpretations 101-1.A.4 [ET section 101.02] and 101-5 [ET section 101.07], because the lease would be considered to be a loan to or from the client.

Grandfathered Operating Leases

Independence would not be considered to be impaired for operating leases that existed prior to [the effective date of the revision], provided they met the conditions outlined in the guidance in effect at the inception of the lease, the lessee remains current as to all lease terms, and the terms of the lease do not change in any manner not provided for in the original lease agreement.

PROPOSED REVISION OF INTERPRETATION 101-3 AND PROPOSED DELETION OF INTERPRETATION 101-13 AND RELATED ETHICS RULINGS UNDER RULE 101

[Explanation]

INTRODUCTION AND BACKGROUND

One of the primary responsibilities of the Professional Ethics Executive Committee is to interpret the AICPA *Code of Professional Conduct* (the “Code”) and amend it when necessary to ensure its continued effectiveness in protecting the public interest by promoting the independence of AICPA members. Pursuant to that responsibility, the Committee added a project to its three-year agenda in late 2001 to reexamine Interpretation 101-3, *Performance of Other Services* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05), and Interpretation 101-13, *Extended Audit Services* (AICPA, *Professional Standards*, vol. 2, ET sec.101.15), to ensure the standards’ continued effectiveness in promoting independence when a member renders nonattest services to an attest client. Subsequently, in May 2002, the Texas State Board of Public Accountancy asked the Committee to expedite its review of the AICPA’s nonattest services independence rules. During this time, the International Federation of Accountants (IFAC), an organization of which the AICPA is a member, adopted revisions to its rules on independence, which included new restrictions for certain nonattest services. In light of these events, in May 2002 the Committee agreed to advance its evaluation of the aforementioned interpretations to determine whether revisions to these rules were needed.

During the succeeding months, the Committee conducted its review, focusing initially on certain nonattest services. Recognizing that many entities are subject to independence rules of other authoritative bodies such as the Securities and Exchange Commission (SEC) and the General Accounting Office (GAO), the Committee considered the various proposed and existing rules and regulations of those bodies. Special emphasis was placed on analyzing the conceptual underpinnings of the current AICPA nonattest services independence rules to determine whether they should continue to serve as the foundation for the rules. Throughout the process, the Committee was especially mindful of the AICPA nonattest services rules’ widespread application—from attest engagements performed for private, family-owned businesses to those performed for companies regulated by other authoritative bodies. Consistent with its primary standard-setting objective, the Committee sought to ensure that the nonattest services independence rules will continue to protect the public interest and will continue to be relevant in the current environment. Since independence as defined by AICPA rules is a prerequisite for performing audits and other attestation engagements under the profession’s standards, the nonattest services independence rules should also be universal in breadth, and facilitate application by a varied population of practitioners.

The Committee is conducting its review in phases. During this first phase, the Committee focused on three of the services that are specifically addressed in Interpretation 101-3 and on the services that are specifically addressed in Interpretation 101-13.

- Bookkeeping services
- Appraisal, valuation, and actuarial services
- Financial information systems—design, installation, or integration services
- Internal audit assistance (currently referred to as *extended audit services* in the Code)

Professionals with relevant technical expertise assisted the Committee in conducting its review along with representatives of various state boards of accountancy and the National Association of State Boards of Accountancy (NASBA).

As a result of completing the first phase of its review, the Committee proposes the following revisions to the AICPA rule:

- Incorporation by reference into the AICPA’s nonattest services rules the nonattest services rules of certain authoritative bodies, where applicable;
- Strengthening of the general requirements for performing nonattest services;
- A new requirement to document the member’s arrangement with the client prior to performing the nonattest services engagement;
- Clarification of certain nonattest service provisions such as bookkeeping and internal audit assistance; and
- New restrictions for valuation, appraisal, and actuarial services, and financial information systems-related services.

PROPOSED REVISIONS

Incorporation by Reference: Nonattest Services Rules of Certain Other Authoritative Bodies

One of the key changes being proposed is that when more restrictive independence rules of an authoritative body apply to a member rendering a nonattest service to an attest client, a violation of those rules would be deemed to be a violation of the AICPA’s independence rules. To achieve this, an explicit statement has been added to Interpretation 101-3 that in addition to meeting the requirements of Interpretation 101-3, members must comply with the independence rules of bodies such as the SEC, GAO, Department of Labor, and state boards of accountancy whenever those rules apply to the member’s engagement. This requirement will also apply to the internal audit assistance rule, which has been moved from Interpretation 101-13 to Interpretation 101-3 so that all of the AICPA’s nonattest services independence rules will be contained in one independence rule.

Currently, members who are found in violation of such organizations’ regulations are deemed to violate AICPA Rule 501, *Acts Discreditable* (AICPA, *Professional Standards*, vol. 2, ET section 501). The proposed revision would more appropriately enable the Committee to find members in violation of the AICPA’s independence rule (that is, rule 101). This change is significant because independence under rule 101 is a prerequisite for performing a financial statement audit under

Generally Accepted Auditing Standards¹ (or a financial statement review or other attestation services under other applicable AICPA literature).² As part of its sanctioning process, members who have violated rule 101 are referred by the Committee to the auditing or other relevant literature to determine the appropriate measures to be taken, such as withdrawing their audit or other attest report. No such action occurs for a violation of rule 501. The Committee recognizes that increasing the potential for a member to have to withdraw his or her attest report or be precluded from issuing it under AICPA independence rules can have potentially serious ramifications. The Committee believes, however, that those ramifications will serve as an inducement to members to ensure their compliance with all of the independence rules that apply to their engagements.

General Requirements—or Prerequisites—for Performing Nonattest Services

The proposal emphasizes the Committee's longstanding position that a member may not perform management functions or make management decisions on the attest client's behalf under any circumstances. Rather, the client must be solely responsible for performing all management functions—including all significant decision-making—in connection with a nonattest services engagement. This basic prerequisite is the critical conceptual underpinning of the AICPA's nonattest services independence rules. Compliance with it effectively mitigates the self-review threat that can arise when a member audits financial statements that reflect the results of significant judgments he or she made when rendering nonattest services. Accordingly, the member and the attest client must agree to follow certain parameters for the nonattest services engagement regarding their respective roles and responsibilities at the outset of the engagement. This is to ensure that in conducting the engagement the member does not act in a capacity equivalent to that of client management (for example, make decisions on the client's behalf, such as which adjusting journal entries to record, approving invoices, monitoring business processes, or supervising client employees). With the appropriate division of duties, the member's subsequent audit procedures will be applied solely to transactions and other matters that reflect the client's decisions, not the member's, thus enabling the member to carry out those procedures with objectivity and an appropriate level of professional skepticism.

For example, a member may be asked to perform bookkeeping services for a client, including preparing journal entries and preparing the client's financial statements. In order for the member to provide such services, the member and the client must first agree on the responsibilities that each will need to undertake in connection with the engagement to ensure that the member will not undertake responsibilities that are those of client management. Further, in connection with the service the client must designate a competent person within its organization to oversee the engagement; make all management decisions (for example, determining or approving account classifications, adjusting journal entries, and changes to source documents); establish and maintain internal controls, including monitoring ongoing activities related to the services; evaluate the

1 Statement on Auditing Standards (SAS) No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 220, "Independence").

2 See Statement on Standards for Accounting and Review Services No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR secs. 100.19 and 100.39), and Statement on Standards for Attestation Engagements No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101.35).

adequacy of the services; and take responsibility for the books, records, and related financial statements. Under these guidelines the member is prohibited from, among other things, creating source documents upon which evidence of an accounting transaction would be initially recorded, classifying or coding transactions to be entered into the client's books, or changing the client's pre-coded source documents (for example, an invoice) or any information in the source documents without the client's approval. These parameters enable the member to provide the bookkeeping services without assuming responsibility for functions that are the responsibility of client management. Accordingly, because the member would neither make significant judgments nor exercise discretion in providing the bookkeeping services, his or her independence would be preserved and he or she would be able to challenge the amounts recorded in the financial statements without concern that doing so would call into question his or her own judgments.

The Committee proposes to revise Interpretation 101-3 (under the section "General Requirements for Performing Nonattest Services") to amplify this important prerequisite for performing nonattest services for an attest client (see pages 18-19). To ensure that the member and client management maintain their respective roles and relationships, the revised interpretation would preclude the member from being engaged to provide a nonattest service to an attest client unless the member assesses the competency of the client individual designated to oversee the nonattest service and is satisfied that based on the weight of available evidence the individual is someone who understands the nature of the service and can and will oversee its performance, evaluate its adequacy, and accept responsibility for the results.

This should be viewed as a rebuttable presumption. That is, it is presumed that the client does not have the necessary level of sophistication, skill, and expertise regarding the subject matter of the nonattest service to be able to assume those responsibilities or, if it does, that it chooses not to do so by retaining the member to be responsible for the task instead. That presumption can be overcome only if the member is satisfied, based on a careful assessment of the nature of the assignment and weight of available evidence, that the client individual does in fact possess the level of sophistication, skill, and expertise needed to be able to carry out his or her responsibilities under this interpretation and will in fact do so. Members assess the competency of individuals when complying with Statement on Auditing Standards (SAS) No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336). The assessment called for by this proposal to determine whether the presumption can be overcome may be similar to a SAS No. 73 assessment, depending on the facts and circumstances. If the client is unable or unwilling to make all management decisions and perform all management functions, the member will be unable to overcome the presumption and will be precluded from performing the nonattest service for the client while he or she is required to be independent of the client.

For some nonattest services, however, the Committee believes it is not reasonable for a member to conclude that the rebuttable presumption can be overcome, regardless of the weight of any evidence that may appear to exist. This would be the case where the level of sophistication, skill, and expertise required to understand the subject matter of the service are such that individuals who lack the requisite training and ongoing experience could not reasonably be expected to possess them regardless of their aptitude and willingness to develop the needed expertise as the service is being rendered. It also would be the case where the requirements of the service would clearly place the

member in a position where he or she would be functioning as client management (for example, serving as the client's chief financial officer), or the results of the service would, in the view of the Committee, pose an unacceptable risk of self-review because the member would subsequently be attesting to work that results from the member's judgments rather than the client's (for example, by installing a financial reporting system that the member designed for the client). Interpretation 101-3 identifies a number of individual services that are prohibited for these reasons. The proposed revisions contain increased prohibitions for certain appraisal, valuation, and actuarial services and certain financial information system design and implementation services; they also clarify the prohibitions that apply when providing internal audit assistance.

Documentation Requirement

The current rule encourages (but does not require) members to establish in writing their understanding with the client concerning the (1) objectives of the nonattest services engagement and any applicable limitations, (2) nature of the services, and (3) member's and the client's respective responsibilities. The proposed rule would *require* the member to document such understanding with the client, provided the requirements in the "General Requirements for Performing Nonattest Services" section are met (for example, the client is willing and able to carry out management functions, accept responsibility for the services, and so on). Under the proposal, if the weight of available evidence enables the member to conclude that the rebuttable presumption can be overcome, the member must document the understanding established with the client concerning the objectives of the engagement and its limitations, the nature of the service, and the responsibilities of the member and client, respectively. The form of documentation would be left to the member's discretion. However, it would be an integral part of overcoming the rebuttable presumption and therefore should articulate those items in a clear and convincing manner.

Revisions to Rules on Specific Services

Bookkeeping Services

The proposal clarifies one of the examples of a specific permitted bookkeeping service to properly reflect the responsibilities of the client and the member in connection with the service, that is, the client needs to understand the nature of the journal entries or other changes proposed by the member that affect the financial statements. The Committee also proposes that an item indicating that a member may provide data processing services to the client be deleted, as widespread use of computer systems by even the smallest businesses has rendered this specific provision obsolete (where such services are requested, the member may do so if he or she complies with the rule's general requirements). In addition, the phrase "originate data" is proposed for deletion since the Committee considers it redundant, that is, it is synonymous with "preparing source documents."

Internal Audit Assistance Services

The guidance in Interpretation 101-13, *Extended Audit Services*, has been moved into Interpretation 101-3. In addition, related guidance under Ethics Ruling No. 103, *Attest Report on Internal Controls* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.206-.207), and Ethics Ruling No. 104, *Operational Auditing Services* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.208-.209), under ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity*, has been incorporated into Interpretation 101-3. Ethics Ruling No. 105, *Frequency of Performance of Extended Audit Procedures* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.210-.211), was determined to be no

longer necessary and is being proposed for deletion. With these changes, all of the AICPA's interpretive guidance on internal audit assistance services will be addressed in Interpretation 101-3.

Changes to the provisions of Interpretation 101-13 include the new documentation requirement and the obligation to assess the ability and willingness of client management to oversee the nonattest services engagement. In addition, other authoritative bodies' rules, which have been incorporated into the proposed rule by reference, would apply where appropriate. (These new requirements would apply to *all* nonattest services provided by members to their attest clients.) The Committee also proposes important revisions to clarify the guidance on internal audit assistance services. Interpretation 101-13 has always precluded members from providing such services when the client delegates or "outsources" responsibility and accountability for managing part or all of its internal audit function to the member because this would result in the member acting in a capacity equivalent to that of client management, which is prohibited. To emphasize this, a statement has been added to the rule stating, "any outsourcing of the internal audit function to the member whereby the member in effect manages the internal audit activities of the client would impair independence."

To avoid redundancies when incorporating internal audit assistance rules into Interpretation 101-3, the Committee deleted references to prohibited activities in Interpretation 101-13 that were already reflected in Interpretation 101-3.

The Committee also clarified that procedures considered to be extensions of the member's audit scope (that is, applied in the audit of the client's financial statements) and engagements performed under attestation engagements are not considered to be internal audit assistance for purposes of Interpretation 101-3 (that is, they are not considered nonattest services subject to this rule).

Appraisal, Valuation, and Actuarial Services

The proposal introduces significant new restrictions for appraisal, valuation, and actuarial services. In addition to the general requirements of the interpretation, the proposed rule would prohibit the performance of such services if the results of the service would be material to the financial statements *and* the service involves a significant degree of subjectivity. A significant degree of subjectivity would generally be evident when there are multiple methodologies from which to choose in performing the calculations that can produce a broad range of outcomes, or when applying a single methodology would be expected to result in a broad range of outcomes because of the nature of the assumptions required by the methodology. In those situations, the results of the service are affected in large part by judgments required in selecting the methodology or in selecting the assumptions necessary to apply a methodology.

The Committee believes that in most cases involving appraisal, valuation, and actuarial services it is not reasonable to expect the client individual to have the requisite competence or technical skills to be able to meet the prerequisites that would allow the member to perform these types of nonattest services. However, even if the individual did have a sufficient level of competence to meet the prerequisites, the Committee concluded that the extent of the member's judgments that are necessitated by the availability of multiple appraisal, valuation, or actuarial methodologies, the application of the member's unique skills, training, and expertise in performing the appraisal, valuation, or actuarial service, and the potentially wide variability of results, make it difficult for the

member to be dispassionate with respect to the resulting amounts when the member provides this service, thus creating a self-review risk. Accordingly, even if those judgments and assumptions were made by the client, the Committee concluded that when significant subjectivity is required to develop the appraisal, valuation, or actuarial amounts and the results would be material to the financial statements, the member should not rely upon a designated client individual to meet the prerequisites of the rule. In those cases, the Committee believes that the self-review risk would be unacceptable and the service should be precluded. Therefore, the Committee proposes that where the appraisal, valuation, or actuarial service is highly subjective—allowing a wide array of possible outcomes—and the results of the service are material to the client’s financial statements, independence would be considered to be impaired.

The proposal distinguishes actuarial services performed in connection with a client’s pension or other postemployment benefit plan liabilities from other appraisals and valuations because they generally do not entail a significant degree of subjectivity. In addition to the client making all of the significant assumptions and other judgments required in performing the calculation, such calculations are based on a single prescribed methodology that uses a single set of reasonably objective criteria and therefore would be expected to produce generally the same or a relatively narrow range of amounts no matter who performs the calculation. In those situations, the risk of self-review is sufficiently mitigated because those amounts would be generally the same whether the member’s actuary or another actuary performed the calculation. Thus, members can be dispassionate with respect to the amounts and therefore would be free to challenge the client’s reported pension or other postemployment benefit liabilities. Accordingly, the proposal notes that actuarial valuations of a client’s pension or other postemployment benefit liabilities would not impair independence, even if the amounts are material, provided the rule’s other requirements are met.

Appraisal, valuation, and actuarial services that are performed for tax planning or tax compliance, estate or gift taxation, or divorce proceedings, and other such services performed solely for nonfinancial reporting purposes would not be subject to materiality and subjectivity provisions of the proposed rule because the results of such services do not directly affect the client’s financial statements. However, the prerequisites still apply to these types of services, as the member is always prohibited from performing management functions, whether nonattest services affect the client’s financial statements or not.

The proposed appraisal and valuation services rule is consistent with newly-adopted IFAC independence rules. Specifically, the IFAC Code (section 8.173) states:

If the valuation service involves the valuation of matters material to the financial statements and the valuation involves a significant degree of subjectivity, the self-review threat created could not be reduced to an acceptable level by the application of any safeguard. Accordingly, such valuation services should not be provided or, alternatively, the only course of action would be to withdraw from the audit engagement.

As a member body of IFAC, the AICPA is prohibited from having independence standards that are less stringent than those of the IFAC Code and is therefore obligated to comply with the international standard by adopting a rule that is at least as strict as the IFAC rule. The Committee

believes that the IFAC standard is a reasonable standard that is supportable by the basic concepts underlying the AICPA nonattest services rules.

Financial Information Systems Design and Implementation

The Committee is also proposing more stringent rules for financial information systems design, installation, or integration services. As proposed, a member would be precluded from installing or integrating a client's financial information system that the member (or the member's firm) designed or significantly modified for the client. The member also would be prohibited from making anything other than insignificant modifications to the client's existing financial information system. The Committee has concluded that these services require specialized expertise and extensive judgments on the part of the member. Accordingly, even if a designated client individual possesses sufficient expertise to meet the prerequisites described earlier, the Committee has determined that these services should be prohibited for reasons similar to those that support prohibition of certain appraisal, valuation, and actuarial services.

In addition, the Committee clarified two services that members could perform, provided that all other rule requirements were met. They are assisting a client in setting up a chart of accounts and financial statement format for its financial information system, and designing, developing, installing, or integrating an information system that is unrelated to the client's financial statements or accounting records.

Finally, a member would no longer be able to operate a client's local area network (LAN) under any circumstances, even where the client has designated a member of senior management to be responsible for the LAN. The Committee believes that members should not assume responsibility for operating any client systems or processes, and that having such a responsibility would put the member in a position of acting as client management even if the client designated an individual within its organization to have ultimate responsibility for the system or process.

INVITATION TO PROVIDE VIEWS TO THE COMMITTEE

The Professional Ethics Executive Committee invites comments on the proposed rule revisions. A series of specific questions follows the revised rule (see pages 32–33). The Committee would find it particularly helpful if respondents would provide comprehensive replies to these questions regarding, for example, the appropriateness of the revisions (for example, whether greater or lesser restrictions should be considered) and whether the rules are sufficiently clear.

To facilitate review of the proposal, a clean (that is, unmarked) version of the proposed rule may be accessed at www.aicpa.org/members/div/ethics/march03ed.asp.

~~.05 101-3—Performance of other nonattest services. A member or his or her firm ("member") who performs an attest engagement for a client may also perform other nonattest services ("other services") for that client. Before a member or his or her firm ("member") performs other nonattest services for an attest client, the member he or she must evaluate the effect of such services on his or her independence determine that the requirements described in this interpretation have been satisfactorily met. In particular, care should be taken not to perform management functions or make management decisions for the attest client, the responsibility for which remains with the client's board of directors and management. In cases where the requirements have not been met, the member's independence would be considered impaired.~~

Engagements Subject to Independence Rules of Certain Regulatory Bodies

This interpretation requires compliance with independence regulations of authoritative regulatory bodies (such as the Securities and Exchange Commission (SEC), the General Accounting Office (GAO), the Department of Labor (DOL), and state boards of accountancy) where a member performs nonattest services for a client and is required to be independent of the client under the regulations of the applicable regulatory body. Accordingly, failure to comply with the nonattest services provisions contained in the independence rules of the applicable regulatory body that are more restrictive than the provisions of this interpretation would constitute a violation of this interpretation.

~~Before performing other services, the member should establish an understanding with the client regarding the objectives of the engagement, the services to be performed, management's responsibilities, the member's responsibilities, and the limitations of the engagement. It is preferable that this understanding be documented in an engagement letter. In addition, the member should be satisfied that the client is in a position to have an informed judgment on the results of the other services and that the client understands its responsibility to—~~

- ~~1. — Designate a management level individual or individuals to be responsible for overseeing the services being provided.~~
- ~~2. — Evaluate the adequacy of the services performed and any findings that result.~~
- ~~3. — Make management decisions, including accepting responsibility for the results of the other services.~~
- ~~4. — Establish and maintain internal controls, including monitoring ongoing activities.~~

General Requirements for Performing Nonattest Services

- 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 functions and making decisions.***

¹ Strikethrough denotes proposed deletions to current text. Proposed new language is in boldface italic.

2. *The client must agree to carry out the following functions in connection with the engagement to perform nonattest services:*

- a. *Make all management decisions and perform all management functions;*
- b. *Designate a competent employee, preferably within senior management, to oversee the services;*
- c. *Evaluate the adequacy and results of the services performed;*
- d. *Accept responsibility for the results of the services; and*
- e. *Establish and maintain internal controls, including monitoring ongoing activities.*

The member should be satisfied that the client will be able to meet all of the above criteria and make an informed judgment on the results of the member's nonattest services. In cases where the client is unable or unwilling to assume these responsibilities (for example, the client does not have an individual with the necessary competence to evaluate the results of the nonattest services provided, or is unwilling to perform such functions due to lack of time or desire), the member's provision of these services would be considered to impair independence.

3. *The member should establish and document in writing⁴ 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 responsibilities;*
- d. *Member's responsibilities; and*
- e. *Any limitations of the engagement.*

General Activities

The following are some general activities that would be considered to impair a member's independence:

- Authorizing, executing, or consummating a transaction, or otherwise exercising authority on behalf of a client, or having the authority to do so
- Preparing source documents⁴⁵ or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders)
- Having custody of client assets
- Supervising client employees in the performance of their normal recurring activities

4 An isolated and inadvertent failure to prepare the required documentation would not impair independence, provided that the member did establish the understanding with the client, documents the understanding promptly upon discovery of the failure to do so, and all other provisions of the interpretation are met.

4.5 The Source documents are the documents upon which evidence of an accounting transaction are initially recorded. Source documents are often followed by the creation of many additional records and reports, which do not, however, qualify as initial recordings. Examples of source documents are purchase orders, payroll time cards, and customer orders.

- Determining which recommendations of the member should be implemented
- Reporting to the board of directors on behalf of management
- Serving as a client's stock transfer or escrow agent, registrar, general counsel, or its equivalent

Specific Examples of Nonattest Services

The examples in the following table identify the effect that performance of ~~other~~***certain nonattest*** services for an attest client can have on a member's independence. These examples are not intended to be all-inclusive of the types of ~~other~~***nonattest*** services performed by members.

Impact on Independence of Performance of ~~Other~~Nonattest Services

Type of OtherNonattest Service	Independence Would Not Be Impaired	Independence Would Be Impaired
Bookkeeping	<ul style="list-style-type: none"> • Record transactions for which management has determined or approved the appropriate account classification, or post coded transactions to a client's general ledger. • Prepare financial statements based on information in the trial balance. • Post client-approved entries to a client's trial balance. • Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client <i>provided the client reviews the entries and the member is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.</i> • Provide data processing services. 	<ul style="list-style-type: none"> • Determine or change journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval. • Authorize or approve transactions. • Prepare source documents or <i>originate data.</i> • Make changes to source documents without client approval.

Payroll and
other
disbursement

- Using payroll time records provided and approved by the client, generate unsigned checks, or process client's payroll.
- Transmit client-approved payroll or other disbursement information to a financial institution provided the client has authorized the member to make the transmission and has made arrangements for the financial institution to limit the corresponding individual payments as to amount and payee. In addition, once transmitted, the client must authorize the financial institution to process the information.
- Make electronic payroll tax payments in accordance with U.S. Treasury Department *or comparable* guidelines provided the client has made arrangements for its financial institution to limit such payments to a named payee.⁵⁶
- Accept responsibility to authorize payment of client funds, electronically or otherwise, except as specifically provided for with respect to electronic payroll tax payments.
- Accept responsibility to sign or cosign client checks, even if only in emergency situations.
- Maintain a client's bank account or otherwise have custody of a client's funds or make credit or banking decisions for the client.
- Sign payroll tax return on behalf of client management.
- Approve vendor invoices for payment.

⁵⁶ Although this type of transaction may be considered by some to be similar to signing checks or disbursing funds, the Professional Ethics Executive Committee concluded that making electronic payroll tax payments under the specified criteria would not impair a member's independence.

Benefit plan administration⁶⁻⁷

- Communicate summary plan data to plan trustee.
- Advise client management regarding the application or impact of provisions of the plan document.
- Process transactions (e.g., investment/benefit elections or increase/decrease contributions to the plan; data entry; participant confirmations; and processing of distributions and loans) initiated by plan participants through the member's electronic medium, such as an interactive voice response system or Internet connection or other media.
- Prepare account valuations for plan participants using data collected through the member's electronic or other media.
- Prepare and transmit participant statements to plan participants based on data collected through the member's electronic or other medium.

Investment—
advisory or
management

- Recommend the allocation of funds that a client should invest in various asset classes, depending upon the client's desired rate of return, risk tolerance, etc.
- Perform recordkeeping and reporting of client's portfolio balances including providing a comparative analysis of the client's investments to third-party benchmarks.
- Make policy decisions on behalf of client management.
- When dealing with plan participants, interpret the plan document on behalf of management without first obtaining management's concurrence.
- Make disbursements on behalf of the plan.
- Have custody of assets of a plan.
- Serve a plan as a fiduciary as defined by ERISA.
- Make investment decisions on behalf of client management or otherwise have discretionary authority over a client's investments.
- Execute a transaction to buy or sell a client's investment.
- Have custody of client assets, such as taking temporary possession of securities purchased by a client.

⁶⁻⁷ When auditing plans subject to the Employee Retirement Income Security Act (ERISA), Department of Labor (DOL) regulations, which may be more restrictive, must be followed.

Corporate
finance—
consulting or
advisory

- Review the manner in which a client's portfolio is being managed by investment account managers, including determining whether the managers are (1) following the guidelines of the client's investment policy statement; (2) meeting the client's investment objectives; and (3) conforming to the client's stated investment styles.
- Transmit a client's investment selection to a broker-dealer or equivalent provided the client has authorized the broker-dealer or equivalent to execute the transaction.
- Assist in developing corporate strategies.
- Assist in identifying or introducing the client to possible sources of capital that meet the client's specifications or criteria.
- Assist in analyzing the effects of proposed transactions including providing advice to a client during negotiations with potential buyers, sellers, or capital sources.
- Assist in drafting an offering document or memorandum.
- Participate in transaction negotiations in an advisory capacity.
- Be named as a financial adviser in a client's private placement memoranda or offering documents.
- Commit the client to the terms of a transaction or consummate a transaction on behalf of the client.
- Act as a promoter, underwriter, broker-dealer, or guarantor of client securities, or distributor of private placement memoranda or offering documents.
- Maintain custody of client securities.

Appraisal,
valuation or
actuarial

- ~~Test the reasonableness of the value placed on an asset or liability included in a client's financial statements by preparing a separate valuation of that asset or liability.~~
- ~~Perform a valuation of a client's business when all significant matters of judgment are determined or approved by the client and the client is in a position to have an informed judgment on the results of the valuation.~~
- Prepare a valuation of an employer's securities contained in an employee stock ownership plan (ESOP) to support transactions with participants, plan contributions, and allocations within the ESOP, when the client is not in a position to have an informed judgment on the results of this valuation.
- ~~Prepare an appraisal, valuation, or actuarial report using assumptions determined by the member and not approved by the client.~~

Executive or
employee
search

- Recommend a position description or candidate specifications.
- Solicit and perform screening of candidates and recommend qualified candidates to a client based on the client-approved criteria (e.g., required skills and experience).
- Participate in employee hiring or compensation discussions in an advisory capacity.
- Commit the client to employee compensation or benefit arrangements.
- Hire or terminate client employees.

Business risk
consulting

- Provide assistance in assessing the client's business risks and control processes.
- Recommend a plan for making improvements to a client's control processes and assist in implementing these improvements.
- Make or approve business risk decisions.
- Present business risk considerations to the board or others on behalf of management.

Information systems— design, installation, or integration

- Design, ~~install or integrate a client's *financial* information system provided the client makes all management decisions~~ *that was not designed or developed by the member provided such activities do not entail making other than insignificant modifications to the financial information system.*
- *Assist in setting up the client's chart of accounts and financial statement format with respect to the client's financial information system.*
- *Design, develop, install, or integrate a client's information system that is unrelated to the client's financial statements or accounting records.*
- ~~Customize a prepackaged accounting or information system, provided the client makes all management decisions.~~
- ~~Provide the initial training and instruction to client employees on a newly implemented information and control system.~~
- *Install or integrate a client's financial information system that was designed or developed by the member.*
- *Make other than insignificant modifications to a client's existing financial information system.*
- Supervise client personnel in the daily operation of a client's information system.
- Operate a client's local area network (LAN) system ~~when the client has not designated a competent individual, preferably within senior management, to be responsible for the LAN.~~

Appraisal, Valuation, and Actuarial Services

Independence would be impaired if a member performs an appraisal, valuation, or actuarial service where the results of the service, individually or in the aggregate, would be material to the financial statements and the appraisal, valuation, or actuarial service involves a significant degree of subjectivity.

Preparing an actuarial valuation of a client's pension or postemployment benefit plan liabilities generally does not require a significant degree of subjectivity because this service is based on a single prescribed methodology that produces reasonably consistent results. Therefore, such services would not impair independence provided all significant assumptions and matters of

judgment are determined or approved by the client and the client is in a position to have an informed judgment on, and accepts responsibility for, the results of the service.

Valuations performed in connection with, for example, business combinations or appraisals of assets generally are not based on a single methodology and, therefore, the results can vary widely. Accordingly, if these services produce results that are material to the financial statements, independence would be impaired.

Appraisal, valuation, and actuarial services performed for nonfinancial statement purposes would not impair independence.⁸

Internal Audit Assistance Services

Internal audit services involve assisting the client in the performance of its internal audit activities, sometimes referred to as "internal audit outsourcing." In evaluating whether independence would be impaired, the nature of the service needs to be considered.

Assisting the client in performing financial and operational⁹ internal audit activities would impair independence unless the member takes appropriate steps to ensure that the client understands its responsibility for establishing and maintaining the internal control system¹⁰ and directing the internal audit function, including the management thereof. Accordingly, any outsourcing of the internal audit function to the member whereby the member in effect manages the internal audit activities of the client would impair independence.

In addition to the general requirements of this interpretation, the member should ensure that client management:

- *Designates a competent individual or individuals, preferably within senior management, to be responsible for the internal audit function;*
- *Determines the scope, risk, and frequency of internal audit activities, including those to be performed by the member providing internal audit assistance services;*
- *Evaluates the findings and results arising from the internal audit activities, including those performed by the member providing internal audit assistance services; and*

⁸ *Examples of such services may include appraisal, valuation, and actuarial services performed for tax planning or tax compliance, estate and gift taxation, and divorce proceedings.*

⁹ *For example, a member may assess whether performance is in compliance with management's policies and procedures, to identify opportunities for improvement, and to develop recommendations for improvement or further action for management consideration and decision making.*

¹⁰ *As part of its responsibility to establish and maintain internal control, management monitors internal control to assess the quality of its performance over time. Monitoring can be accomplished through ongoing activities, separate evaluations, or a combination of both. Ongoing monitoring activities are the procedures designed to assess the quality of internal control performance over time and that are built into the normal recurring activities of an entity and include regular management and supervisory activities, comparisons, reconciliations, and other routine actions. Separate evaluations focus on the continued effectiveness of a client's internal control. A member's independence would not be impaired by the performance of separate evaluations of the effectiveness of a client's internal control, including separate evaluations of the client's ongoing monitoring activities.*

- *Evaluates the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining reports from the member.*

The member should also be satisfied that the client's board of directors, audit committee, or other governing body is informed about the member's and management's respective roles and responsibilities in connection with the engagement. Such information should provide the client's governing body a basis for developing guidelines for management and the member to follow in carrying out these responsibilities and monitoring how well the respective responsibilities have been met.

The member is responsible for performing the internal audit procedures in accordance with the terms of the engagement and reporting thereon. The performance of such procedures should be directed, reviewed, and supervised by the member. The report should include information that allows the individual responsible for the internal audit function to evaluate the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures. This report may include recommendations for improvements in systems, processes, and procedures. The member may assist the individual responsible for the internal audit function in performing preliminary audit risk assessments, preparing audit plans, and recommending audit priorities. However, the member should not undertake any responsibilities that are required, as described above, to be performed by the individual responsible for the internal audit function.

The following are examples of activities (in addition to those listed in the "General Activities" section of this interpretation) that, if performed as part of an internal audit assistance engagement, would be considered to impair independence:

- *Performing ongoing monitoring activities or control activities (for example, reviewing loan originations as part of the client's approval process or reviewing customer credit information as part of the customer's sales authorization process) that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both, and performing routine activities in connection with the client's operating or production processes that are equivalent to those of an ongoing compliance or quality control function*
- *Determining which, if any, recommendations for improving the internal control system should be implemented*
- *Reporting to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function*
- *Approving or being responsible for the overall internal audit work plan including the determination of the internal audit risk and scope, project priorities, and frequency of performance of audit procedures*
- *Being connected with the client as an employee or in any capacity equivalent to a member of client management (for example, being listed as an employee in client directories or other client publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the client's internal audit function, or using the client's letterhead or internal correspondence forms in communications)*

The foregoing list is not intended to be all-inclusive.

Subsequent to performing internal audit assistance services for a client, a member may be asked to perform an attestation engagement to report on the client's assertion regarding the effectiveness of its internal control over financial reporting. Under such circumstances, independence would not be considered to be impaired with respect to the issuance of such a report provided (1) management has assumed responsibility to establish and maintain internal accounting controls; (2) the member is in compliance with the requirements of this interpretation; and (3) the client does not rely on the member's work as the primary basis for its assertion.

Services involving an extension of the procedures that are generally of the type considered to be extensions of the member's audit scope applied in the audit of the client's financial statements, such as confirming of accounts receivable and analyzing fluctuations in account balances, are not considered internal audit assistance services, and would not impair independence even if the extent of such testing exceeds that required by generally accepted auditing standards. In addition, engagements performed under the attestation standards would not be considered internal audit assistance services and therefore would not impair independence.

[Text of Proposed Deletion of Interpretation 101-13]¹

~~.15 101-13 Extended audit services. A member or his or her firm ("member") may be asked by a client, for which the member performs an attest engagement, to perform extended audit services. These services may include assistance in the performance of the client's internal audit activities and/or an extension of the member's audit service beyond the requirements of generally accepted auditing standards (hereinafter referred to as "extended audit services"). A member's performance of extended audit services would not be considered to impair independence with respect to a client for which the member also performs an attest engagement, provided that the member or his or her firm is not an employee of the client or does not act or appear to act in a capacity equivalent to a member of client management.~~

~~The responsibilities of the client, including its board of directors, audit committee, and management, and the responsibilities of the member, as described below, should be understood by both the member and the client. It is preferable that this understanding be documented in an engagement letter that indicates that the member may not perform management functions or make management decisions.~~

~~A member should be satisfied that the client understands its responsibility for establishing and maintaining internal control and directing the internal audit function, if any. As part of its responsibility to establish and maintain internal control, management monitors internal control to assess the quality of its performance over time. Monitoring can be accomplished through ongoing activities, separate evaluations or a combination of both.~~

¹ Strikethrough denotes proposed deletions to current text.

~~Ongoing monitoring activities are the procedures designed to assess the quality of internal control performance over time and that are built into the normal recurring activities of an entity and include regular management and supervisory activities, comparisons, reconciliations and other routine actions. Separate evaluations focus on the continued effectiveness of a client's internal control. A member's independence would not be impaired by the performance of separate evaluations of the effectiveness of a client's internal control, including separate evaluations of the client's ongoing monitoring activities.~~

~~The member should understand that, with respect to the internal audit function, the client is responsible for—~~

- ~~• Designating a competent individual or individuals, preferably within senior management, to be responsible for the internal audit function~~
- ~~• Determining the scope, risk and frequency of internal audit activities, including those to be performed by the member providing extended audit services~~
- ~~• Evaluating the findings and results arising from the internal audit activities, including those performed by the member providing extended audit services~~
- ~~• Evaluating the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining reports from the member~~

~~The member should be satisfied that the board of directors and/or audit committee is informed of roles and responsibilities of both client management and the member with respect to the engagement to provide extended audit services as a basis for the board of directors and/or audit committee to establish guidelines for both management and the member to follow in carrying out these responsibilities and monitoring how well the respective responsibilities have been met.~~

~~The member should be responsible for performing the audit procedures in accordance with the terms of the engagement and reporting thereon. The day to day performance of the audit procedures should be directed, reviewed, and supervised by the member. The report should include information that allows the individual responsible for the internal audit function to evaluate the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures. This report may include recommendations for improvements in systems, processes, and procedures. The member may assist the individual responsible for the internal audit function in performing preliminary audit risk assessments, preparing audit plans, and recommending audit priorities. However, the member should not undertake any responsibilities that are required, as described above, to be performed by the individual responsible for the internal audit function.~~

~~Performing procedures that are generally of the type considered to be extensions of the member's audit scope applied in the audit of the client's financial statements, such as confirming of accounts receivable and analyzing fluctuations in account balances, would not impair the independence even if the extent of such testing exceeds that required by generally accepted auditing standards.~~

~~The following are examples of activities that, if performed as part of an extended audit service, would be considered to impair independence:~~

- ~~• Performing ongoing monitoring activities or control activities (for example, reviewing loan originations as part of the client's approval process or reviewing customer credit information as part of the customer's sales authorization process) that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both, and performing routine activities in connection with the client's operating or production processes that are equivalent to those of an ongoing compliance or quality control function~~
- ~~• Determining which, if any, recommendations for improving the internal control system should be implemented~~
- ~~• Reporting to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function~~
- ~~• Authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client~~
- ~~• Preparing source documents on transactions~~
- ~~• Having custody of assets~~
- ~~• Approving or being responsible for the overall internal audit work plan including the determination of the internal audit risk and scope, project priorities and frequency of performance of audit procedures~~
- ~~• Being connected with the client as an employee or in any capacity equivalent to a member of client management (for example, being listed as an employee in client directories or other client publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the client's internal audit function, or using the client's letterhead or internal correspondence forms in communications)~~

~~The foregoing list is not intended to be all inclusive.~~

[Text of Proposed Deletion of Ethics Rulings No. 103, 104 and 105]¹

~~103.—Attest Report on Internal Controls~~

~~.206—Question—If a member or his or her firm provides extended audit services for a client in compliance with interpretation 101-13 [ET section 101.15], would the firm be considered to be independent in the performance of an attestation engagement to report on the client's assertion regarding the effectiveness of its internal control over financial reporting?~~

~~.207—Answer—Independence would not be considered to be impaired with respect to the issuance of such a report if both of the following conditions are met:~~

- ~~1.—Management has assumed responsibility to establish and maintain internal control.~~
- ~~2.—Management does not rely on the firm's work as the primary basis for its assertion and accordingly has (a) evaluated the results of its ongoing monitoring procedures built into the normal recurring activities of the entity (including regular management and supervisory activities) and (b) evaluated the findings and results of the firm's work and other separate evaluations of controls, if any.~~

~~104.—Operational Auditing Services~~

~~.208—Question—As part of an extended audit engagement, a member or his or her firm reviews certain of the client's business processes, as selected by the client, for how well they function, their efficiency, or their effectiveness. For example, a member (or the firm) may assess whether performance is in compliance with management's policies and procedures, to identify opportunities for improvement, and to develop recommendations for improvement or further action for management consideration and decision making. Would independence be considered to be impaired in performing such services?~~

~~.209—Answer—Independence would not be considered to be impaired provided that during the course of the review the member (and other members of his or her firm) is not employed by the client and does not act or appear to act in any capacity equivalent to that of a member of client management. The decision as to whether any of the member's (or the firm's) recommendations will be implemented must rest entirely with management.~~

~~105.—Frequency of Performance of Extended Audit Procedures~~

~~.210—Question—In providing extended audit services, would the frequency with which a member or his or her firm performs an audit procedure impair independence?~~

~~.211—Answer—Independence would not be considered to be impaired provided that the member's (or the firm's) activities have been limited in a manner consistent with interpretation 101-13 [ET section 101.15] and the procedures performed constituted separate evaluations of the effectiveness of the ongoing control and monitoring activities/procedures that are built into the client's normal recurring activities.~~

¹ Strikethrough denotes proposed deletions to current text.

[Questions]

**QUESTIONS PERTAINING TO PROPOSED REVISIONS TO INTERPRETATION 101-3,
PERFORMANCE OF NONATTEST SERVICES**

Incorporation by Reference into the AICPA's Nonattest Services Rules the Nonattest Services Rules of Certain Authoritative Bodies

1. Do you believe that proposed Interpretation 101-3 ("the proposed rule") should incorporate the nonattest services rules of certain authoritative bodies by reference (see page 18)? Please explain your rationale.
2. If you believe that the proposed rule *should* refer to other bodies' rules, do you believe that the Professional Ethics Executive Committee has identified the relevant regulators? If not, please indicate which regulators you would include or exclude.

Strengthening the General Requirements for Performing Nonattest Services

3. Do you believe that the proposed rule adequately clarifies the general or "prerequisite" requirements for providing nonattest services to attest clients (see pages 18-19)? If not, please specify which provision(s) require further edification.
4. Are there other specific prerequisites that you believe the rule should incorporate? Please explain.

New Documentation Requirement

5. Do you believe that the proposed rule should require a member to document in writing the understanding reached between the member and the attest client prior to performing nonattest services (see page 19)? Why or why not?
6. If you believe that a documentation requirement is appropriate, do you believe the proposed rule properly identifies which items should be documented (that is, the objectives of the engagement and any applicable limitations, nature of the services, and member's and client's respective responsibilities)? If not, please indicate which items you believe should be documented.
7. Do you believe that members should be required to document their assessment of client management's competence to perform duties associated with the nonattest services engagement? Please explain your rationale.
8. If you agree that an assessment of client management's competence should be documented, do you believe that the notion of a "rebuttable presumption" (see pages 13-14) is an appropriate approach that should be incorporated into the rule? Please explain.

Clarification of the Rules on Internal Audit Assistance Services

9. Do you believe the proposed rule adequately clarifies the rules on internal audit assistance services (see pages 26-28), which were previously addressed in Interpretation 101-13? If not, please specify which provision(s) require further edification.

New Restrictions for Valuation, Appraisal, and Actuarial Services

10. Do you believe that the proposed rule introduces appropriate restrictions for appraisal, valuation, and actuarial services (see pages 25-26)? If not, please describe your rationale.
11. Do you agree with the proposal to permit actuarial services related to a client's pension or postemployment benefit plan liabilities, provided that the rule's general requirements are met (see pages 25-26)? Please provide your rationale.
12. Are you aware of other appraisal, valuation, or actuarial services that generally do *not* require a significant degree of subjectivity (that is, because the service is based on a single prescribed methodology that produces reasonably consistent results)? If so, please describe these other services.
13. Do you agree with the proposal to permit tax-related and other valuation and similar services that have no financial statement impact (see page 26), provided the rule's general requirements are met? Please provide your rationale.
14. Do you believe that the proposed rules on appraisal, valuation, and actuarial services are sufficiently clear? If not, please indicate where further clarification is needed.

New Restrictions for Financial Information Systems-Related Services

15. Do you believe that the proposed rule introduces appropriate restrictions for information technology-related services (see page 25)? If not, please specify how the proposal should be modified and describe your rationale.
16. Do you believe that the proposed rules for information technology-related services are sufficiently clear? If not, please indicate which provision(s) require further edification.

General Questions

17. Where the proposed rules are more restrictive than current rules, do you believe that transitional provisions should be included to allow members to implement them over a certain period of time (for example, to complete contract commitments, revise firm policies, educate personnel)? Why or why not?
18. If you believe transitional provisions are needed, please specify an appropriate length of time that should be allotted for implementation of the new rules. Also, please indicate the specific portions of the rule to which you believe such transitional provisions should apply.
19. Do you have other comments or concerns regarding *any* aspect of the proposed revision to Interpretation 101-3 or deletion of Interpretation 101-13 and the related ethics rulings? If so, please explain fully.