

Understanding Interpretation 101-3 – Independence and Non-attest Services

Since December 2003, when revisions to the profession's Code of Professional Conduct applying to nonattest services for attest clients became effective, the AICPA's Professional Ethics Executive Committee (PEEC) has published a number of informal guidance documents to assist members in implementing Interpretation 101-3's provisions. In addition, in January 2005, editorial revisions to the Interpretation were made which further address members' concerns with respect to the "client competency" and "documentation" requirements.

Some have accused the AICPA of "cascading" Sarbanes-Oxley independence rules to private company audits. That is not the case. The process that led to changes in Interpretation 101-3 started in 1999 when PEEC decided to modernize the Code in several phases. Phase 1 dealt with financial interest and family relationships and resulted in an engagement team approach to independence. Phase 2 dealt with scope of services issues.

The underlying principles of Interpretation 101-3 remain unchanged from what has been a longstanding position of the AICPA as follows:

The auditor may not undertake the role of client management, cannot perform management functions or make management decisions on the client's behalf and cannot audit his or her own work.

The Interpretation makes clear that the client has the responsibility to make all management decisions, including significant matters of judgment. The client must also establish and maintain internal controls, evaluate adequacy of services, accept responsibility for the results of the service, and designate an individual with *suitable skills, knowledge and/or experience to oversee the nonattest service.*

Member concerns over level of client "competence"

The revised Interpretation clarified certain general requirements of the rule. One of the revisions mandated that the client designate a *competent* employee to oversee the nonattest services.

Prior to the revision, the requirement stated that management *make an informed judgment on the results of the member's nonattest services.* PEEC always interpreted this to mean that management had to possess a requisite degree of skill, knowledge and/or experience to make such an informed judgment.

However, some members, particularly those affiliated with smaller firms, expressed concerns regarding the practical application of the revised Interpretation's competency requirement.

Of particular concern was whether the level of competence that the designated client employee needed to possess in order to effectively oversee the nonattest service should be *equivalent* to that of the member.

This equivalency was never the intention. In using the term “competent”, PEEC never intended the rule to require that the client employee possess a level of technical expertise commensurate with that of the member.

Therefore, In order to clarify the PEEC’s intent, the Committee agreed, at its January 2005 meeting, to replace the term “competence” with the words “suitable skill, knowledge and/or experience” throughout the Interpretation.

In addition, the Committee agreed to replace the term client *employee* with *individual* to clarify that the person designated by the client to oversee the service could be the owner of the company or an individual outside the company, such as an outsourced bookkeeper or controller.

So the essence of this particular requirement is that the individual designated by the client should possess the skill, knowledge and/or experience to understand the key issues involved, make any required management decisions and evaluate the adequacy of the resulting work product.

By ensuring that the client has designated an individual as described above, the threats to independence are sufficiently mitigated because the member's attest (e.g., audit) procedures would be applied solely to transactions and other matters that reflect the client's decisions, not the member's. This enables the member to carry out those procedures with objectivity and an appropriate level of professional skepticism.

More detailed guidance on the application of the requirement is available at http://www.aicpa.org/download/ethics/101-3_Competency_Guidance.pdf .

Documentation of client understanding

The revised Interpretation 101-3 also includes a requirement that the member’s understanding with the client regarding the performance of nonattest services be documented.

The requirement states that prior to performing nonattest services, the member should establish and document the following in writing:

- The objectives of the engagement;
- The services to be performed;
- The client's acceptance of its responsibilities;
- The member's responsibilities; and
- Any limitations of the engagement.

The form of documentation is left to the member’s discretion. For example, if the member performs a consulting engagement for an audit client, the member may

decide to document the required elements with respect to the consulting engagement in the audit engagement letter. However, the understanding could also be documented, for example, in a separate engagement letter specific to the consulting service engagement, in a memo to the audit files, or in a checklist that the member completes as part of the audit. Other methods of documentation such as a memo of understanding maintained in the member's billing or correspondence files would also satisfy this requirement. In order to provide members with additional time to update firm policies and procedures and further educate their staff, this documentation requirement was deferred until December 31, 2004.

In January 2005, the Interpretation was revised to reflect that a failure to document the understanding with the client would *not* be considered an impairment of a member's *independence* provided such understanding had been established with the client. Such failure to document is considered a failure to comply with an ethics standard under Rule 202 – *Compliance With Standards*.

The Committee also agreed that it was no longer necessary to provide for an exception where the failure to document the understanding was *isolated and inadvertent*, so this "exception" was deleted.

More detailed guidance on the application of the *documentation* requirement is available at http://www.aicpa.org/download/ethics/Int. 101-3_documentation_guidance.pdf.

Other Provisions of Revised Interpretation 101-3

The revised Interpretation 101-3 also clarifies some provisions regarding bookkeeping and internal audit services and imposes more restrictive rules on providing certain services to attest clients, such as valuations, appraisals, actuarial work and information systems design and implementation.

The revised Interpretation also incorporates an explicit requirement under Rule 101– *Independence*, that members must comply with more restrictive independence rules of other bodies - such as the state accountancy boards, the SEC, and the GAO - where applicable.

Previously, failures to comply with the independence requirements of these bodies had not been enforced under Rule 101, but rather were enforced under Rule 501 – *Acts Discreditable* of the Code.

Further guidance and clarification

The AICPA has dedicated an entire section of its Web site to providing background information and additional guidance on Interpretation 101-3. You can access this special section at: http://www.aicpa.org/members/div/ethics/intr_101-3.htm .