

Auditor Independence

New GAGAS Independence Standard

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GAGAS Amendment 3: Independence

In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, should be free both in fact and appearance from personal, external, and organizational impairments to independence.

David M. Walker

Comptroller General of the United States

“The focus of the changes to the auditor independence standard is to better serve the public interest and to maintain a high degree of integrity, objectivity, and independence for audits of government entities.”

Independence Standard

- Issued January 25, 2002
 - Deals with a range of auditor independence issues; most significant change relates to nonaudit, or consulting services
 - Indicated further guidance would be issued in question and answer form; many questions received from those the new standard affects
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Affect on Auditors Required to Use GAGAS

- Sometimes not appropriate to perform both audit and nonaudit services for the same client
- May need to choose which of these services an audit organization will provide

Questions Cover Broad Areas

- Implementation and transition matters
 - Underlying concepts
 - Applying the standard in specific nonaudit circumstances
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Extending the Effective Date

Original effective date:

- Applicable to all audits for periods beginning on or after ***October 1, 2002***

Extended effective date:

- Applicable to all audits for periods beginning on or after ***January 1, 2003***
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Grandfathering

In cases where nonaudit services would not have violated pre-existing professional standards, exemptions are allowed for:

- Nonaudit services performed before January 25, 2002
 - Contracts for nonaudit services signed prior to January 25, 2002, if the nonaudit work is completed no later than June 30, 2003
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Addressing Other Pertinent Implementation Matters

- For exempted contracts, extensions and change orders are considered new contracts and the overarching principles and safeguards apply
- The passage of time may or may not have an impact on relieving an impairment

Questions Concerning Underlying Concepts

- Overarching principles and safeguards
 - Significance/materiality
 - Audit and nonaudit services
 - Subject matter of the audit
 - Routine advice
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Overarching Principles

- Auditors should not perform management functions or make management decisions
 - Auditors should not audit their own work or provide nonaudit services in situations where the amounts or services involved are significant/material to the subject matter of the audit
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Supplemental Safeguards

- Personnel who perform certain nonaudit services would be precluded from performing related audit work
 - The auditor's work could not be reduced beyond the level that would be appropriate if the nonaudit work was performed by another unrelated party
 - Certain documentation and quality assurance requirements must be met
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Substance Over Form Doctrine

- Use reasonable judgment and consider:
 - The nature of the nonaudit service
 - The significance/materiality to the subject matter of the audit
 - The totality of services provided to the audited entity
 - Cannot “unbundle” services to circumvent an independence impairment
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Deminimis Criteria

- Personnel providing nonaudit services can perform related audit work if the nonaudit services total
 - **40 hours** or fewer for government audit organizations, or
 - fees of **\$5,000** or less for nongovernment audit organizations
- The overarching principles must be complied with and the other safeguards would apply

Taking a Holistic Approach

- Nonaudit services provided by one office or unit of an audit organization affects the entire audit organization's independence as it relates to the audited entity
 - Nonaudit services provided to one agency do not affect independence for audits of other agencies
 - Except when the subject matter of the audit involves an area where one of the agencies performs work for, or provides a service to the other
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Determining Significance/Materiality

These terms are used synonymously

- ***Performance audits:*** Measure significance against the program or activity under review
 - ***Financial statement audits:*** Consider materiality based on the financial statements taken as a whole
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Distinguishing Audit and Nonaudit Services

Audit Services

- Financial audits, attestation engagements, and performance audits

Nonaudit Services

- Requested by management and directly supports entity operations
 - Generally performed for the sole use and benefit of the requesting entity
 - Data provided without verification, analysis, conclusions, recommendations, or opinions
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Meaning of “Subject Matter of the Audit”

Financial audits:

- The financial statements as a whole

Performance audits:

- Defined by the audit objectives and is generally limited to the program or activity under review

Routine Activities Based on Technical Expertise and Knowledge

Paragraph 3.23 allows certain routine activities without an independence impairment or applying safeguards

- Providing routine advice to assist in activities such as establishing internal controls or implementing audit recommendations
- Answering technical questions
- Providing training
- Participating on committees in an advisory capacity or as an observer or ex-officio member (non-voting)

Routine Activities (cont'd.)

- Developing best practices guides
- Developing internal control assessment methodologies
- Performing investigative services
- Developing professional standards
- Undertaking benchmarking studies
- Developing audit methodologies
- Providing legal/accounting opinions to legislative bodies
- Developing questions for hearings and draft legislation
- Preparing routine tax filings (discussed later)

Questions About Applying the Standard in Specific Circumstances

- Basic accounting services
- Internal audit services
- Tax services
- Information technology services
- Work of specialists
- Budget work
- Human resource services

Providing Basic Accounting Services

An audit organization's independence to perform audits is impaired if it:

- maintains or prepares the audited entity's basic accounting records,
- maintains or takes responsibility for basic financial or other records that the audit organization will audit, or
- posts transactions to the entity's financial records or to other records that subsequently provide data to the entity's financial records.

Developing Draft Financial Statements and Notes

- Viewed as technical assistance and part of the audit
- Auditor must be careful not to be, in essence, constructing the records
- Must be based on a trial balance:
 - provided by management using appropriate books and records that balance, or
 - prepared by auditors when their work to prepare the trial balance is technical formatting in nature and uses management's chart of accounts.

Developing Draft Financial Statements and Notes (cont'd.)

- Must be reviewed and approved by audited entity management, who must have adequate knowledge to evaluate and take responsibility for the result
- Management representation letter should acknowledge auditor's role and management's review, approval, and responsibility for the financial statements and notes
- Independence would not be impaired if the auditor does not make management decisions. Must comply with other safeguards except that which precludes the same personnel from providing the service and the audit

Providing Accounting Assistance in Emergency Situations

- An emergency situation is a rare and potentially cataclysmic event on the audited entity (e.g., its sole accountant suddenly dies, or contracts a serious illness)
- Under the independence standard, an audit organization could provide accounting assistance for a short duration of time (no more than 1 month) but the safeguards apply
- Audit organization must advise the audited entity to exhaust all other viable options, document the situation, and disclose in its audit report

Performing Internal Audit Services

- External audit organizations would violate the overarching principles if they provide internal audit services because such services are considered a management function
- Section 3.30.5 covers independent internal audits

Providing Tax Services

- Some tax services are routine under paragraph 3.23
 - Preparing tax returns or assisting with preparing tax deposits, for example, would be routine advice and not violate the overarching principles
 - Audit organizations may represent audited entities in IRS matters (under 5USC500) without independence impairment for financial statement audits
 - An impairment could arise for a performance audit of tax compliance
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Providing Information Technology Services

- Limit to advice on system design, system installation, and system security
 - Apply the safeguards and have management acknowledge responsibility
 - Should not operate or supervise the operation of the entity's information technology system
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Applying the Independence Standard to Specialists

Using the work of specialists ***contracted by the audited entity***:

- Paragraph 3.14 applies
- Determine professional standards the specialist may be required to follow
- Obtain an understanding of the methodologies and significant assumptions the specialist used
- Obtain from the specialist a representation that they are independent of the audited entity

Applying the Independence Standard to Specialists (cont'd.)

Using the work of specialists *employed by the audited entity*:

- Paragraph 3.14 would not apply
- Audit organization would have to assure itself as to the specialist's qualifications
- Specialist's work would be considered the same as information gathered from the entity's management
- Determine the validity and reliability through direct tests of the data

Applying the Independence Standard to Specialists (cont'd.)

Using the work of specialists ***employed by the audit organization:***

- Paragraph 3.14 per se would not apply
- Independence requirement is the same as for auditors
- An audit organization's internal quality control systems requirements to identify personal impairments and compliance with GAGAS should extend to employees who are specialists

For specialists ***contracted by an audit organization,*** paragraph 3.14 would apply (see footnote 2)

Assisting With Budget Work

- Certain budget work could be performed under GAGAS performance audit standards:
 - Analyzing budget proposals or budget requests
 - Assessing program or policy alternatives
 - Identifying ways to improve services or cut costs
- Depending on the nature of the assistance, independence would be impaired for:
 - Preparing annual budgets
 - Preparing strategic plans

Providing Human Resource Services

- Limit to activities such as:
 - Serving on an evaluation panel to review applications to provide input to management in arriving at a listing of best qualified applicants
- Auditor independence would be impaired by:
 - Recommending a single individual for a significant position
 - Conducting an executive search or a recruiting program for a significant position

Stopping Short of the Line

- Avoid situations that could lead reasonable third parties with knowledge of the relevant facts and circumstances to conclude that the auditor is not able to maintain independence in conducting audits
 - **Remember:** The independence standard is ***principles-based*** and should be applied using a ***substance over form*** approach
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Looking Ahead

- Input is being provided by the Comptroller General's Auditing Standards Advisory Council
 - Major concepts discussed with other interested parties
 - This presentation is being made available through GAO's website at www.gao.gov
 - AGA/NASACT national teleseminar -- May 28th
 - Issuance of independence standard Q&As is planned for mid to late June 2002
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