United States General Accounting Office

GAO

By the Comptroller General of the United States

July 2002

GOVERNMENT AUDITING STANDARDS

Answers to Independence Standard Questions

G A O

Accountability * Integrity * Reliability

GAO-02-870G

Contents

Questions Relating to Independence Standard Implementation and Transition		6
Questions Concerning Certain Independence Standard Underlying Concepts		11
	Audit and Nonaudit Services	11
	Overarching Principles and Safeguards	15
	Significance/Materiality	26
	Management Functions	26
	Subject Matter of the Audit	28
	Personal Impairments	28
Questions about Applying the Independence Standard in Specific Nonaudit Circumstances		35
	Bookkeeping Services	35
	Financial Statement Review and Basic Accounting Assistance	47
	Internal Audit Services	54
	Information Technology Services	55
	Work of Specialists	59
	Tax Services	62
	Budget Work	64
	Human Resource Services	67

GAO
Accountability * Integrity * Reliability

Comptroller General
of the United States

United States General Accounting Office
Washington, D.C. 20548

On January 25, 2002, we issued an amendment to *Government Auditing Standards* (1994 revision), Amendment No. 3, *Independence*, which substantially changed the previous standard to better serve the public interest and to maintain a high degree of integrity, objectivity, and independence for audits of government entities. While the new amendment deals with a range of auditor independence issues, the most significant change relates to the standards associated with nonaudit, or consulting services.

Understandably, we have received many inquiries about the new independence standard due to its significant effect on auditors in connection with audits of federal entities and funds and on those who have adopted or are otherwise required to use *Government Auditing Standards*. Indeed, when we issued the new standard, we indicated that we planned to subsequently provide further guidance in the form of questions and answers to assist in its implementation. Accordingly, this document responds to questions related to the independence standard's implementation time frame, underlying concepts, and application in specific nonaudit circumstances.

In making judgments on independence under *Government Auditing Standards* and applying the independence standard's principles and safeguards, audit organizations should take a "substance over form" approach and consider the nature and significance of the services provided to the audited entity—the facts and circumstances. Before an audit organization agrees to perform nonaudit services, it should carefully consider the need to 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. It is imperative that auditors always be viewed as independent in fact and appearance.

Importantly, when the independence standard was issued, we called for its provisions to be applicable to all audits for periods beginning on or after October 1, 2002. Because of the breadth of changes in the amendment and to allow additional time for the new independence standard's effective implementation, we are extending its effective date to be applicable to all audits for periods beginning on or after January 1, 2003.

Also, when we issued the new independence standard on January 25, 2002, we intended for audit organizations to begin their transition at that time. We have since found that some audit organizations affected by the new independence standard, particularly smaller audit organizations and those in remote locations, may not have become immediately aware of its issuance and that many audit organizations have raised implementation questions. Accordingly, we are providing the following guidance to audit organizations to use in transitioning to the new independence standard.

Nonaudit services that were completed prior to January 25, 2002, are exempt, or grandfathered, from the new independence standard's provisions. Also exempt are nonaudit services that were performed under a binding contract entered into, or that were initiated by a government audit organization, by June 30, 2002, provided the work is completed before June 30, 2003.

Also with the next update of *Government Auditing Standards* and based on the information this document provides, we plan several modifications to the independence standard. We will

- expand paragraph 3.13, footnote 1, to fully recognize that auditors who are required to follow the new independence standard in conducting their audit work must also be aware of and comply with any applicable government ethics laws and regulations

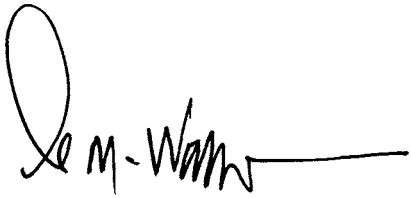
and any other ethics requirements (such as those of state boards of accountancy) associated with their activities;

- clarify paragraph 3.14, footnote 2, to specify that the independence standard's provisions related to using the work of specialists applies to external consultants and firms performing work for the audit organization; and

- establish a requirement, in a new footnote to paragraph 3.26a, that an audit organization should obtain from an audited entity's management an acknowledgement in its management representation letter, which is required by *Government Auditing Standards*, of the role of an audit organization in drafting financial statements and notes and in converting cash-based financial statements to accrual-based financial statements, as well as management's review, approval, and responsibility for the financial statements, related notes, and accrual adjustments.

This question and answer document was provided in draft for input to the Comptroller General's Advisory Council on Government Auditing Standards, and the major concepts were discussed with other interested parties. The council includes 21 experts in financial and performance auditing and reporting drawn from all levels of government, academia, private enterprise, and public accounting.

An electronic version of this document can be accessed at (*http://www.gao.gov/govaud/ybk01.htm*). If you have any questions regarding this document or the independence standard, please contact Jeffrey C. Steinhoff, Managing Director, Financial Management and Assurance, at (202) 512-2600, or Marcia B. Buchanan, Assistant Director, Financial Management and Assurance, at (202) 512-9321.



David M. Walker
Comptroller General
of the United States

Questions Relating to Independence Standard Implementation and Transition

On January 25, 2002, we issued an amendment to *Government Auditing Standards* (1994 revision), Amendment No. 3, *Independence*. As provided in this amendment, the *Government Auditing Standards'* second general standard is as follows:

> **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.**

Regarding this standard, GAO recognizes that audit organizations have the capability of performing a range of services for their clients. However, for audits that are required to be conducted under *Government Auditing Standards*, in certain circumstances it is not appropriate for an audit organization to perform both audit and selected nonaudit services for the same client. In these circumstances, an audit organization and/or an audited entity will have to make a choice as to which of these services an audit organization will provide.

When issued, the new independence standard provided for audit organizations to implement its provisions for all audits for periods beginning on or after October 1, 2002. Because of the breadth of changes related to the independence standard, this time frame is being extended. The independence standard's provisions are applicable to all audits for periods beginning on or after January 1, 2003.

Also, when we issued the new independence standard on January 25, 2002, we intended for audit organizations to begin their transition at that time. We have since found that some audit organizations affected by the new independence standard, particularly smaller audit organizations and those in remote locations, may not

have become immediately aware of its issuance and that many audit organizations have raised implementation questions. Accordingly, we are providing the following guidance to audit organizations to use in transitioning to the new independence standard.

Nonaudit services that were completed prior to January 25, 2002, are exempt, or grandfathered, from the new independence standard's provisions. Also exempt are nonaudit services that were performed under a binding contract entered into, or that were initiated by a government audit organization, by June 30, 2002, provided the work is completed by June 30, 2003.

These matters are discussed in response to the following questions.

1. **The new independence standard supersedes preexisting professional standards under which an audit organization could have performed certain nonaudit services, such as certain accounting entry and payroll processing activities, without impairing audit organization independence. Would performing such nonaudit services prior to the new standard's release on January 25, 2002, impair an audit organization's independence?**

   No. If such services were performed prior to the new standard's release and they were in compliance with the then existing professional standards, an audit organization's independence would not be impaired. Nonaudit services performed before January 25, 2002, are exempt, or grandfathered, from the application of the new standard.

2. On the date the independence standard was issued some audit organizations may have been under contract to provide both audit and nonaudit services. In that case, how should an audit organization make the transition to the new standard?

Contracts for nonaudit services that were signed prior to January 25, 2002, (the date that the new standard was issued) will also be exempt, or grandfathered, provided the nonaudit work is completed by June 30, 2003, and would not have violated preexisting professional standards. This transition period for already established contracts will provide an audit organization and an audited entity time to make other arrangements for conducting either the nonaudit services or the audit, if necessary.

3. How would this exemption apply to binding contracts for nonaudit services that may have been signed on or after January 25, 2002?

Originally, our intent was that any nonaudit service contract awarded on or after January 25, 2002, would not be exempt, or grandfathered. However, some audit organizations may not have understood this or were not aware of the standard when it was issued on January 25, 2002. To be fair to these audit organizations, we will exempt, or grandfather, all nonaudit services that were initiated, agreed to, or performed by June 30, 2002, provided the work is completed by June 30, 2003.

4. **Would a nonaudit service performed or initiated by a government audit organization on or after January 25, 2002, but by June 30, 2002, be similarly exempt, or grandfathered?**

   Yes, if the work is completed by June 30, 2003.

5. **What about nonaudit services related to contracts that may be signed, or initiated by a government audit organization, from July 1, 2002, through January 1, 2003?**

   The new independence standard's provisions would apply to these nonaudit service engagements.

6. **Regarding a contract for nonaudit services that is exempt, or grandfathered, would an audit organization's independence be affected if the contract was extended after June 30, 2002?**

   Yes. On these contracts, extensions and change orders would be considered new contracts and viewed in light of the two overarching principles and safeguards.

7. **On June 25, 2002, an audit organization was engaged to design and implement a financial system for an entity and the work is completed by June 30, 2003. Would this impair the independence of an audit organization to conduct the entity's financial statement audit for periods beginning after January 1, 2003?**

   No. An audit organization's independence would not be impaired for nonaudit services that began, or were agreed to, by June 30, 2002, and are completed on or before June 30, 2003. However, as audit organizations enter into new contracts, or accept requests for additional nonaudit services, they

should consider the overarching principles and the safeguards.

8. On June 25, 2002, an audit organization was engaged to design and implement an entity's accounting system, and the work is completed in November 2003. When would an audit organization be considered independent to perform the entity's financial statement audit?

In this case, an audit organization completed the nonaudit service engagement in November 2003, or after the transition period ended on June 30, 2003. Therefore, an audit organization's independence to perform the entity's financial statement audits is impaired for as long as the entity uses the accounting system. The passage of time has no impact on the impairment unless the system is subsequently upgraded or redesigned to such an extent that it would be considered a new system. If that were to occur, the new standard's overarching principles would not be violated because an audit organization would not be auditing its own work.

9. In the above situation, would an audit organization's independence be impaired if it were engaged to perform the nonaudit service after June 30, 2002, but before January 1, 2003, and the nonaudit services were completed by June 30, 2003?

An audit organization's independence would be impaired. For a nonaudit service to be exempt, or grandfathered, an audit organization must have been engaged to perform the nonaudit service by June 30, 2002, and the related nonaudit work must be completed by June 30, 2003.

Questions Concerning Certain Independence Standard Underlying Concepts

Before an audit organization agrees to perform nonaudit services, it should consider the need to 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. The standard for nonaudit services is based on two 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.

For nonaudit services that do not violate the above principles, certain supplemental safeguards would have to be met. For example, (1) personnel who perform nonaudit services would be precluded from performing any related audit work, (2) an audit organization's work could not be reduced beyond the level that would be appropriate if the nonaudit work was performed by another unrelated party, and (3) certain documentation and quality assurance requirements must be met.

We have received inquiries related to some of the concepts underlying the two overarching principles and the safeguards. We have been asked, for example, for further guidance regarding what constitutes a management function, significance/materiality, and the subject matter of the audit. This section provides information on a range of areas such as these.

Audit and Nonaudit Services

10. Because of the significant and differing effects audit and nonaudit services can have on audit organization independence, how can an audit organization distinguish between them?

GAGAS define audit services as financial audits, attestation engagements, and performance audits. In nonaudit services, audit organizations perform tasks requested by management that directly support the entity's operations. Nonaudit services (1) are generally performed for the sole use and benefit of the entity requesting the work or (2) provide information or data to a requesting party without providing verification, analysis, or evaluation of the information or data and, therefore, the work does not usually provide a basis for conclusions, recommendations, or opinions on the information or data. The nature and scope of a nonaudit service is generally determined by agreement between an audit organization and an audited entity or by the requesting party. In contrast, the nature and scope of an audit is determined by an audit organization in order to satisfy the audit objectives.

11. The independence standard, paragraph 3.26, gives examples of nonaudit services that typically would not create an impairment to an audit organization's independence. Is the provision of these services a safe harbor?

No. The examples in paragraph 3.26 are illustrative in nature. The facts and circumstances of each nonaudit service always need to be considered in light of the two overarching principles and the substance over form doctrine. If either of the principles would be violated, an audit organization and/or the audited entity need to decide whether an

audit organization will provide the nonaudit service or perform the audit.

12. May staff members of an audit organization who provide nonaudit services convey to the audit organization's audit engagement team information based on the knowledge gained about an audited entity and its operations?

Yes. The independence standard permits such knowledge sharing. The nonaudit service team may have specific understanding of an audited entity's internal controls that, for example, could be useful to the audit engagement team in planning the audit. Since the audit engagement team is required to obtain a sufficient understanding of internal controls to plan the audit and to determine the nature, timing, and extent of tests to be performed, the understanding that the nonaudit assignment team may have of an audited entity's operations can significantly assist in fulfilling this requirement. This information can be conveyed to the audit engagement team and documentation from the nonaudit team can be transferred for use by the audit engagement team; but the nonaudit service team cannot otherwise participate in the audit. However, the audit engagement team should be mindful that knowledge shared by the nonaudit service team cannot be used to reduce the audit work beyond the level that would be appropriate if the nonaudit work was performed by another unrelated party.

13. What circumstances can give rise to personal impairments to independence and how can an audit organization detect and prevent them?

The independence standard, in paragraph 3.15, presents examples of personal impairments to

independence, including factors such as having a direct or a significant/material indirect financial interest in an audited entity or program. An audit organization and its staff members, including internal experts and specialists, need to be alert to possible impairments to staff member independence. To assist in this regard, an audit organization should have an internal quality control system (see paragraph 3.15) to help determine if its auditors and internal experts and specialists have any personal impairment to independence that could affect their impartiality or the appearance of impartiality on a given assignment.

14. If an audit organization is asked to evaluate a program's efficiency, can it perform this work as a performance audit (instead of as a consulting engagement) without impairing its independence to do further audits for the requesting entity?

This work could be done as either a performance audit or as a consulting engagement. If the work is performed in accordance with the GAGAS performance auditing standards, including the general, fieldwork, and reporting standards, the provisions of the independence standard in paragraphs 3.18 through 3.26 do not apply, and an audit organization's independence would not be impaired. If performed as a consulting service, this work would be considered a nonaudit service. In that case, the independence standard's overarching principles must not be violated and the safeguards must be applied.

Overarching Principles and Safeguards

15. As indicated previously, the new independence standard is principles-based. Is there a practical, impartial way for audit organizations to apply the overarching principles without the new standard being construed as rules-based?

Yes. Making decisions involving possible independence impairment related to audit and nonaudit services for the same audited entity will require reasonable judgment by audit organizations and auditors. In each case, the decision on whether independence is impaired is likely to rest on different factors, considering the nature of the nonaudit service and its significance/materiality to the subject matter of the audit. In other words, the facts and circumstances of the nonaudit service drive the judgment.

In addition, the audit organization should consider the totality of services provided to the audited entity in making reasonable judgments on independence. Overall, an audit organization should use a "substance over form" approach in applying the principles and safeguards. For example, if in substance, the audit organization is effectively maintaining the official accounting records, the audit organization has violated the overarching principles and the express prohibition in paragraph 3.26a.

16. What is the potential impact on an audit organization's independence if it provides nonaudit services?

Audit organizations that provide nonaudit services should consider whether providing these services creates an impairment, either in fact or appearance, that adversely affects its independence for conducting audits. If an audit organization provides

a nonaudit service that would cause it to violate one or both of the overarching principles, an audit organization would not be considered independent in performing any related audit services to an audited entity. When a potential independence impairment may arise in subsequent audit work, an audit organization and/or an audited entity must decide which of the services (either audit or nonaudit) the audit organization will provide. It becomes a matter of choice.

17. If one office or unit of an audit organization performs a nonaudit service that would violate either of the two overarching principles for a particular audited entity with respect to subsequent audit work, could another of the audit organization's offices or units perform the subsequent audit without being impaired?

No. When any one office or unit of an audit organization performs nonaudit services for an audited entity, it affects the entire audit organization's independence as it relates to that entity.

We consider an audit organization to be (1) a federal, state, or local government organization that performs financial, attestation, and performance audits or (2) a form of organization permitted by state law or regulation that is engaged in the practice of public accounting. One office or unit of an audit organization is not differentiated from another. Consequently, each office or unit is considered to be part of the same audit organization rather than separate audit organizations. Therefore, it is of utmost importance for an audit organization to always be aware of nonaudit services performed across its offices or units.

18. An audit organization has put a firewall between its consulting and auditing units. Could the work of the consulting unit affect the audit organization's independence to perform audits?

Yes. In this case, both units are still part of the same organization. Therefore, the independence standard's overarching principles and safeguards would apply.

19. If an audit organization sells its consulting unit to another firm or the consulting unit was spun off as an independent entity, what would be the affect on the audit organization's independence to perform audits?

In addressing independence matters under the new independence standard, an audit organization cannot do indirectly what it cannot do directly. If an audit organization has totally divested itself of the consulting unit—that is, it does not have any direct financial interest in the consulting unit and/or control over its work—an audit organization's independence to perform audits would not be impaired by subsequent nonaudit services provided by its former consulting unit.

However, if the audit organization retains any direct financial interest in its former consulting unit, the audit organization's independence would be impaired by any work done by the consulting unit that would violate an overarching principle had the audit organization done the nonaudit service itself. Likewise, if an audit organization has a direct financial interest in any other entity that provides consulting services, an audit organization's independence would be impaired by work done by this other entity in the same manner as it would be

for a consulting unit that it sold or spun off. These situations exemplify the application of the substance over form doctrine and why it is always important for an audit organization to think of its work in that context.

20. In the above circumstance, what about the audit organization's independence with regard to nonaudit services its former consulting unit performed before it was sold or spun off?

For these prior services, unless the nonaudit service provided by the audit organization's former consulting unit was exempt, or grandfathered, from the independence standard, the audit organization's independence would be affected in the same way it would have been affected if the consulting unit were still under the ownership and control of the audit organization.

21. Is an audit organization's independence affected by an affiliation with a team, consortium, or partnering arrangement with other organizations?

Affiliations such as these would not, in and of themselves, cause an impairment to independence. Any impairment to the audit organization's independence would depend on the specific facts and circumstances of its involvement as they relate to the overarching principles. Specifically, an audit organization would need to consider its specific work, role, and financial interest in order to assure that it does not impair its independence by violating the overarching principles and it complies with the safeguards, as applicable.

22. The senior leadership or partners of an audit organization establish a new entity, separate and apart from the audit organization that provides nonaudit or consulting services. The senior leadership or partners of the audit organization own and/or control the new entity. Since the audit organization itself does not have a direct financial interest in or control of the new entity, what would be the effect on the audit organization's independence to perform audits?

As stated previously, under the new independence standards, an audit organization cannot do indirectly what it cannot do directly. Under the arrangement described in the question, applying the substance over form doctrine, the audit organization would be impaired by any work done by this new entity that would have violated an overarching principle had the audit organization done the work itself.

In this case, the senior leadership or partners of the audit organization would clearly have a substantial vested interest in the work of the new entity and its success. In substance, the audit organization would be attempting to do through the new entity what it could not do itself and still maintain its audit independence. An audit organization must always be careful to ensure that it is independent both in fact and appearance. A reasonable third party would most certainly question this relationship as being one of form over substance to the extent the new entity was doing work that would impair audit independence if done by an audit organization.

23. If an audit organization performs a nonaudit service that results in an impairment to its independence at one federal agency, would this impairment extend to other federal agencies as well?

No. However, there is a caveat. Generally, if an audit organization has an impairment to independence related to one particular governmental agency—whether at the federal, state, or local level—an audit organization's independence is not impaired with respect to other governmental agencies, as long as the two agencies are separate entities.

At the federal level, for example, the Department of Health and Human Services (HHS) and the Social Security Administration (SSA) are separate entities. Therefore, if an audit organization provides HHS nonaudit services, it would not affect an audit organization's independence as it related to audits at SSA.

An exception to this example would be created if the subject matter of the audit involved any areas where the work of HHS and SSA may overlap or where one of these organizations may be providing services to the other. These situations could result in the nonaudit service being material to the audit objectives and an audit organization auditing its own work, which would violate an overarching principle. Accordingly, the audit organization needs to be alert for such situations and, applying the substance over form doctrine, ensure that it does not violate the overarching principles and applies the safeguards.

24. If an audit organization does consulting work involving the valuation of a material line item for the financial statements of a particular bureau within a major department, is the audit organization independent to conduct the bureau's financial statement audit?

No. The audit organization would not be independent to conduct the bureau's financial statement audit because the nonaudit service would be significant/material to the subject matter of audit, which would violate the overarching principle that audit organizations should not audit their own work.

25. In the above situation, would the audit organization be independent to conduct the department's financial statement audit?

It would depend on the materiality of the bureau-level line item at the department level. If the valuation were significant/material to the department's financial statements, the audit organization's independence would be impaired in connection with the department as well. On the other hand, if the valuation is not material/significant to the department's financial statements, the audit organization's independence is not impaired and it could perform the audit of the department, provided it complies with the safeguards.

26. How would an audit organization's independence be affected if it provides nonaudit services to an entity that provides a central service, such as payroll processing, to support each of a department's entities and other departments as well?

An audit organization would apply the independence standard's overarching principles and safeguards as discussed in the previous response. In the example cited in this question, the audit organization's independence could be impaired to perform audits for the department and its components, as well as other federal agencies, when personnel costs or payroll operations are significant/material to the subject matter of the audit. At the federal level, for example, the Department of Agriculture's (USDA) National Finance Center provides payroll services for USDA's components and for many other departments and agencies.

27. What routine activities can an audit organization provide without impairing its independence and requiring it to apply the safeguards?

The independence standard, paragraph 3.23, lists several routine activities that are always viewed as not significant/material to the subject matter of the audit and that an audit organization can provide without impairing independence provided the audit organization does not make management decisions or perform management functions. For example, an audit organization can provide routine advice to an audited entity and its management to assist in activities such as establishing internal controls or implementing audit recommendations, can answer technical questions, and/or provide training. Other

examples of activities that the audit organization can be involved with that are considered routine include providing tools and methodologies, such as best practice guides, benchmarking studies, and internal control assessment methodologies; collaborating with others to strengthen professional standards; developing audit methodologies; and providing legal/accounting opinions or other assistance to a legislative body. The decision to follow the audit organization's advice remains with management of the audited entity.

28. A federal government office of inspector general has as its mission both audit and investigative functions and is required to follow *Government Auditing Standards* for audits. When a federal inspector general undertakes an investigation, is it considered an audit or a nonaudit service for purposes of applying the independence standard?

When a federal office of inspector general undertakes an investigation, it is considered to be neither an audit nor a nonaudit service and GAGAS does not apply.

29. Would the previous answer apply if the federal inspector general performed an inspection using the President's Council on Integrity and Efficiency standards?

Yes.

30. Would the safeguards apply if an audit organization provides a nonaudit service that may not be a routine activity, but involves only a de minimis amount of time to perform?

An audit organization always must ensure that the nonaudit service does not violate the overarching principles. If the overarching principles are not violated, then the safeguards must be considered.

In applying the safeguards and for reasons of efficiency and practicality, if the nonaudit service involves a *total of 40 hours or fewer as it relates to a specific audit engagement*, the safeguard associated with precluding personnel who provided the nonaudit service from performing related audit work would not be required. The other safeguards in paragraph 3.25, though, would apply.

Auditors and audit organizations need to consider related services that may have been performed under separate contracts or separate engagements in applying the de minimis criteria, and they should not inadvertently or purposely perform related services under separate contracts or engagements in a manner that would circumvent the safeguards. Related nonaudit services need to be considered together in determining the overall time involved in performing the services.

In applying the safeguards, audit organizations need to be able to articulate why the nonaudit service should be considered as a separate, unrelated service to other nonaudit services being provided. Substance over form is paramount, and "unbundling" of services should not be used as a means to circumvent an impairment to independence. This situation would be considered a serious violation of the GAGAS independence

standard and could cast doubt on the integrity of the audit organization.

31. If an audit organization provides a nonaudit service that has no relationship whatsoever to any ongoing or planned future audit work, would all of the safeguards apply?

No. If the nonaudit service has no relationship whatsoever to either ongoing or planned audits under GAGAS, then the safeguards concerned with (1) precluding personnel who provided the nonaudit service from performing related audit work (paragraph 3.25c), and (2) reducing the scope of related audit work (paragraph 3.25d) would not be applicable.

At the same time, in deciding whether to provide a nonaudit service, government audit organizations should consider their broad audit responsibilities and any legislative or other requirements that would limit their ability to decline to provide future audit work, as discussed in paragraph 3.24. While a nonaudit service may have no relationship to current or planned audits, it could affect the independence of the audit organization to perform future audit work. For this reason, the other safeguards in paragraph 3.25 would apply. While a nongovernment audit organization also should consider its future commitments for audit services, as discussed in paragraph 3.24, it may be in a better position to decline to perform a future audit than a government audit organization.

Significance/ Materiality

32. The independence standard uses the terms "significant" and "material." Are these terms synonymous?

Yes. *Government Auditing Standards* cover financial statement audits, where "material" is typically used, and performance audits, where the term "significant" is typically used. Importantly, both terms involve the consideration of both quantitative and qualitative elements.

33. In determining significance/materiality, should an audit organization consider the cumulative nature of related nonaudit services?

Yes. Each nonaudit service should be considered in light of other previous or current nonaudit services. When considered in isolation, each nonaudit service may not be deemed significant/material; but when such services are considered cumulatively, they could be deemed significant/material and, therefore, impair auditor independence. This is one reason why it is important for an audit organization to document its nonaudit services and have the ability to track these services.

Management Functions

34. As related to nonaudit services, what would constitute a management function?

This question can best be responded to by illustrating several types of situations that would typically constitute management functions. These include

- serving as a member of an entity's management decision-making committee or on its board of directors (although participating as an observer

or nonvoting ex-officio member is permitted under paragraph 3.23),

- making policy decisions affecting the direction and operations of entity programs,
- supervising entity employees,
- developing entity programmatic policies,
- authorizing entity transactions, or
- maintaining custody of entity assets (unless the assets are in the custody of an investigative unit and, under its statutory authority, are being held as evidence in a investigation).

It would be important that audit organizations ensure that the audited entity understands its responsibility for the substantive outcomes of, and is in a position to make an informed judgment on, the results of an audit organization's nonaudit service. Audit organizations should carefully consider the evidence required by paragraph 3.25e that, in fact, the management-level individual designated to oversee the nonaudit service has the necessary qualifications to conduct the oversight needed.

35. If an individual auditor has a management responsibility related to an audited entity or is responsible for making decisions that could affect the audited entity's operations or its programs, can the audit organization retain its independence to audit the entity?

No. Making management decisions or having responsibility for managing the entity would violate one of the overarching principles. Were an

individual auditor to perform management functions or make a management decision, the independence of the entire audit organization would be impaired.

Subject Matter of the Audit

36. For a performance audit, what does the phrase "subject matter of the audit" mean? What does this phrase mean for a financial statement audit?

For performance audits, the subject matter of the audit is defined by the audit objectives, and it is generally limited to the program, activity, or operation under review. For financial statement audits, the subject matter of the audit is determined by the audit objectives as well, and can vary among audits. If the financial statement audit objective is to express an opinion on the financial statements taken as a whole, then the subject matter of the audit is the financial statements taken as a whole. If the financial statement audit objective is to express an opinion on each material unit within a state and local government, the subject matter of the audit is each material unit.

Personal Impairments

Paragraph 3.13 states that auditors need to consider three general classes of impairments to independence—personal, external, and organizational—and provides a footnote indicating the need to also follow other codes of professional conduct. With the next *Government Auditing Standards* update, we will expand footnote 1 as follows:

> *Auditors who are required to follow the new independence standard in conducting their audit work must also be aware of and comply with any applicable government ethics laws and regulations and any other ethics requirements (such as those*

of state boards of accountancy) associated with their activities. For example, federal auditors need to be aware of and comply with the requirements associated with the Office of Government Ethics. Also, government and nongovernment auditors who are certified public accountants should follow the code of professional conduct of the state board with jurisdiction over the practice of the public accountant and the audit organization, as applicable, and if a member of the American Institute of Certified Public Accountants (AICPA), the AICPA code of professional conduct.

37. Paragraph 3.13, footnote 1, covers the need for nongovernment auditors to also follow certain codes of professional conduct. What about government auditors?

As noted above, we plan to expand paragraph 3.13, footnote 1, to cover government auditors as well. Also, we reiterate that all auditors who are required to follow the new independence standard in conducting their audit work must also be aware of and comply with any applicable government ethics laws and regulations and other requirements (such as those of state boards of accountancy) associated with their activities.

38. Under paragraph 3.25c of the independence standard, an audit organization's personnel who provide nonaudit services are precluded from planning, conducting, or reviewing audit work related to the nonaudit service. What work is covered in planning, conducting, and reviewing audit work?

As discussed in GAGAS:

- *Planning* includes determining audit objectives, scope, and methodology; establishing criteria to evaluate matters subject to audit; and coordinating the work of other audit organizations. This excludes individuals whose roles are limited to gathering information used in planning the audit. (In this regard and as previously discussed, a nonaudit service team can convey knowledge to an audit engagement team.)

- *Conducting* includes performing audit tests and procedures necessary to accomplish the audit objectives in accordance with GAGAS.

- *Reviewing* includes examining the audit work and/or the report contents and substance to determine whether the audit objectives have been accomplished and the evidence supports the report's technical content and substance prior to issuance.

39. If an individual audit staff member's involvement in the nonaudit service, in fact and appearance, was insignificant, would paragraph 3.25c preclude the audit staff from planning, conducting, or reviewing the audit work related to the nonaudit service?

No. In applying the substance over form doctrine to the facts and circumstances presented, the audit staff member's independence would not be impaired.

40. If a staff member of an audit organization participated in an audited entity's policy-making responsibilities through previous employment with an audited entity, can they work on audits of the entity?

It would depend on the subject matter of the audit and time that has lapsed since the staff member participated in the policy-making. If the situation described involves policies—such as those covering an audited entity's financial reporting—that directly relate and are significant/material to the subject matter of the audit—such as a financial statement audit—it would constitute a personal impairment to the individual staff member's independence. The auditor needs to be free from this personal impairment for "a cooling-off" period before being allowed to work on audits involving this subject matter. Footnote 5 (at paragraph 3.15c) states that the auditor needs to be free from this impairment for the period covered by the activity under audit, including any financial statements being audited, and for the period in which the audit is being performed and reported. In most cases, this means that individual staff members should recluse themselves of involvement with the audit for 2 years. However, this situation would not impair an

audit organization's independence to perform a financial statement audit for an audited entity.

41. Does the engagement-team concept apply to all financial, business, and employment relationships of an audit organization?

Yes. The independence standard, in footnote 7 to paragraph 3.17, provides that "auditors participating in the audit assignment, including those who perform review of the report, and all others within an audit organization who can directly influence the outcome of the audit, need to be free from personal impairments." Although this footnote specifically applies to paragraph 3.17, the engagement-team concept applies to all financial, business, and employment relationships discussed in paragraph 3.15.

42. As set out in paragraph 3.15g, personal impairment includes "seeking employment with an audited organization during the conduct of the audit." Can this personal impairment be mitigated through removing the individual from the engagement?

Yes. See paragraph 3.17.

43. What elements are needed in an internal quality control system over audit organization independence? If an audit organization is small, does the internal quality control system need to be as elaborate as that described in paragraph 3.16?

As discussed in paragraph 3.32 of *Government Auditing Standards*, the nature and extent of an audit organization's internal quality control system depends on a number of factors, such as the audit

organization's size, the degree of operating autonomy allowed its personnel and its audit office, the nature of its work, its organizational structure, and appropriate cost-benefit considerations. Thus, the systems established by individual organizations will vary as will the need for, and the extent of, their documentation of the systems. However, each audit organization should prepare appropriate documentation to demonstrate compliance with policies and procedures to identify personal impairments to independence. For a small audit organization, this need not be elaborate. The substance over form doctrine is paramount in applying all key elements of this independence standard.

44. If the head of, or other individual employed by a government audit organization is included by statute as a member of an oversight board, such as one that is responsible for administering a governmental entity's pension system, can the audit organization still audit the program?

In paragraph 3.13, the standard states that in situations in which a government auditor, because of a legislative requirement or for other reasons, cannot decline to perform the work, the auditor can still perform and report on the audit. However, the impairment should be reported in the scope section of the audit report. In the disclosure, auditors can consider addressing the following issues: (1) the cause of the impairment, (2) the mandate to do the audit, and (3) any compensating actions taken to minimize the impairment.

45. Would the previous answer be different if a government auditor were required by statute to provide any nonaudit services that might otherwise violate the overarching principles?

No. The answer would be the same, as paragraph 3.13 covers all situations of this nature. In instances where a government audit organization is required by law to perform a nonaudit service and cannot decline to perform the work, it must ensure that the related audit report clearly makes the necessary disclosures, to ensure the situation is transparent to the reader of the audit report. However, if the statutorily required nonaudit service is a routine activity, as delineated in paragraph 3.23, that would not violate an overarching principle, applying the substance over form concept, disclosure in the audit report would not be necessary.

Questions about Applying the Independence Standard in Specific Nonaudit Circumstances

The independence standard recognizes that audit organizations may encounter many different circumstances or combinations of circumstances that could result in an impairment to independence. At the same time, the standard in paragraph 3.23 recognizes that audit organizations can provide routine advice and answer technical questions without violating the two overarching principles or having to comply with the supplemental safeguards. The standard also provides examples of how certain nonaudit services are to be treated in determining audit independence.

The answers to the following questions provide further guidance to assist in implementing the independence standard in certain specific nonaudit circumstances.

Bookkeeping Services

Several questions have been raised regarding an audit organization's development of draft financial statements and notes and other bookkeeping services. Before responding to those questions, in the next *Government Auditing Standards* update, we plan to add the following requirement as a footnote after the first sentence in paragraph 3.26a.

> *If an audit organization has prepared draft financial statements and notes and performed the financial statement audit, it should obtain from the audited entity's management an acknowledgement in its management representation letter, required by Government Auditing Standards, the audit organization's role in this regard and entity management's review, approval, and responsibility for the financial statements and related notes. Likewise, if the audit organization converts cash-based financial statements to accrual-based financial statements, it should obtain from the audited entity's management an acknowledgement in its*

management representation letter the audit organization's role in reflecting accruals and entity management's review, approval, and responsibility for the accrual adjustments.

46. Can an audit organization be involved in preparing a trial balance and draft financial statements and notes without impairing its independence to audit the financial statements? Can audit engagement team members perform these activities?

Maintaining the audited entity's books and records is the responsibility of its management. Accordingly, management is responsible for ensuring that these books and records adequately support the preparation of financial statements in accordance with generally accepted accounting principles and that records are current and in balance.

If an audit organization were asked to prepare a trial balance, the audit organization would not impair its audit independence if the preparation of the trial balance was purely technical in nature. The trial balance should be based on management's chart of accounts, and the audited entity's management must take responsibility for the trial balance. In other words, the preparation of the trial balance is a matter of formatting the chart of accounts into a trial balance. Work involving more than the technical formatting of the trial balance would impair independence because the audit organization would be performing a management function, which would violate an overarching principle.

The audit organization's preparation of draft financial statements and note disclosures from a trial balance provided by entity management (or

prepared by the audit organization as described above), which the management of the audited entity then reviews and approves, would not impair the auditor's independence (see paragraphs 3.26 and 3.26a). This work is considered technical assistance and as part of the audit. The audit organization must be careful not to make management decisions, and management of the audited entity must have the knowledge to evaluate and approve the draft financial statements and notes and take responsibility for them.

Further, the audit engagement team that prepared the trial balance and draft financial statements and notes could also perform the financial statement audit. The audit organization must comply with all other safeguards in paragraph 3.25. Also, the management representation letter, required by auditing standards, should acknowledge the audit organization's role in preparing the trial balance and draft financial statements and related notes, and management's review, approval, and responsibility for the financial statements and related notes.

Likewise, auditors can convert cash-based financial statements to accrual-based financial statements, as long as management is in the position to make informed judgments to review, approve, and take responsibility for the appropriateness of the conversion. In providing this service, the audit team that proposed the accruals could also perform the financial statement audit since this service is in substance the same as proposing adjusting or correcting entries as long as management makes the decision on accepting the entries. Similarly, as stated above, the management representation letter should also acknowledge the audit organization's role in reflecting accruals and management's review, approval, and responsibility for the accrual adjustments.

It is important to reiterate that the answer to this question is conditioned on the audit organization starting with appropriate books and records that balance and the audited entity having knowledgeable management. Where this is not the case, the audit organization must be careful not to cross the line of making management's decisions or performing management functions and find itself in a position where reasonable third parties with knowledge of the relevant facts and circumstances could conclude that the auditor has, in effect, maintained the audited entity's books or records and, therefore, has impaired its independence to conduct the financial statement audit.

47. The AICPA defines the compilation of financial statements as presenting in the form of financial statements information that is the representation of management without undertaking to express any assurance on the statements. This definition acknowledges that the audit organization might find it necessary to perform other accounting services to compile the financial statements, such as adjusting the books of accounts or consulting on accounting matters. Can an audit organization provide a compilation service without impairing independence to audit subsequent period financial statements?

Yes. Compilations are generally performed to periodically supply financial information in an understandable format, such as quarterly financial statements. Similar in substance to drafting financial statements and notes, the compilation of financial information would not impair the audit organization's independence as long as it does not make management decisions and management of the audited entity has the knowledge to evaluate and approve the compilation and to take responsibility

for it. Also, the team that performed the compilation could perform the financial statement audit as long as the audit organization complies with the other safeguards in paragraph 3.25.

Similar to our answer to the previous question regarding the preparation of draft financial statements and notes, we reiterate that our answer is conditioned on the audit organization starting with appropriate books and records and the audited entity having knowledgeable management. Therefore, the audit organization was able to perform the compilation without having to reconstruct the books and records, and the audited entity's management was in a position to take responsibility for the compilation.

48. Paragraph 3.26a of the independence standard states that independence is impaired if the audit organization maintains or prepares an audited entity's basic accounting records or maintains or takes responsibility for basic financial or other records that an audit organization will audit. What is considered to be an entity's basic accounting records and basic financial or other records?

Basic accounting and financial records are considered to be source documents or originating data evidencing transactions have occurred (for example, purchase orders, payroll time records, and customer orders). Such records would also include an audited entity's general ledger and subsidiary records, or equivalent. Supporting schedules are not considered to be basic accounting or financial records, as long as management has made all the decisions in key areas regarding these supporting schedules. An example of a supporting schedule is a

depreciation schedule, which the next question discusses further.

49. Can an audit organization assist an audited entity's management in preparing depreciation schedules without impairing its independence to perform the financial statement audit?

Yes, as long as the audited entity's management has determined such key factors as the method and rate of depreciation and the salvage value of the assets. If the audit organization makes these decisions, it has violated an overarching principle. To not impair its independence, the audit organization's service must be limited to calculating the depreciation, and the audited entity's management must take responsibility for the depreciation schedules. The audit organization must take care that the extent of its work does not cross the line and place it in a position where reasonable third parties with knowledge of the relevant facts and circumstances could conclude that the auditor's independence is impaired. Also, given the nature of this nonaudit service, the audit organization would not have to apply the safeguard precluding personnel who provided the nonaudit services from auditing their own work. However, the remaining safeguards in paragraph 3.25 would apply.

50. If the audit organization posts transactions coded by the audited entity's management, would the audit organization's independence be impaired to perform the financial statement audit?

Yes. Paragraph 3.26a specifically addresses the posting of transactions, whether coded by management or not, to an entity's financial records or to other records that subsequently provide data

to an entity's financial records. An audit organization cannot provide this service without impairing its independence to perform the financial statement audit.

51. An audit organization arrives at an audited entity for the first day of fieldwork and finds that the last quarter's cash receipts and disbursements and other transactions have not been recorded. To assist the audited entity in updating its financial records, the audit organization agrees to prepare and post all transactions to the general ledger based on the audit organization's professional judgment. Would the audit organization's independence be impaired to perform the financial statement audit?

Yes. The audit organization would be posting transactions to the audited entity's general ledger, which impairs its independence as discussed in paragraph 3.26a.

52. An audited entity provides an audit organization with a record of all cash receipts and cash disbursements made during the period. The audit organization (1) determines the appropriate classification of each transaction based on the available information (such as payee and description), (2) posts current-year transactions to the prior-year adjusted balance sheet and then determines necessary adjustments to convert the financial information to the accrual basis of accounting, and (3) uses this adjusted information to draft financial statements, which are reviewed with and approved by an audited entity. In this case, would an audit organization's independence be considered impaired to perform the financial statement audit?

Yes. Determining the appropriate classification of receipts and disbursements, in substance, would be the same as maintaining/preparing an audited entity's basic accounting records. Likewise, posting current year transactions to the prior year's balance sheet has the same affect as posting transactions to the audited entity's financial records. As discussed in paragraph 3.26a, activities such as these would impair an audit organization's independence to perform the financial statement audit.

53. An audited entity provides its cash receipts and disbursements journals to the audit organization, which, as part of its financial statement audit, proposes adjusting entries to convert from a cash basis to an accrual basis of accounting. The audited entity's management, which has requested the conversion, reviews, approves, and posts the entries and has sufficient knowledge and ability to take responsibility for them. Would the audit organization's independence be considered impaired for the financial statement audit?

No. An audit organization could perform these activities as part of a financial statement audit without impairing its independence, provided management of the audited entity is in a position to evaluate and take responsibility for results of the conversion. As with the answers to the earlier question related to converting financial statements from a cash to an accrual basis, this answer assumes that the cash receipts and disbursements journals only have to be converted and do not have to be reconstructed to such an extent that the audit organization, in substance, would be maintaining or preparing the audit entity's basic accounting records. Also, similarly to previous answers, the management representation letter should acknowledge the audit organization's role in the conversion and management's review, approval, and responsibility for the conversion.

54. A small audited entity's sole accountant suddenly leaves due to an emergency situation, and it asks an audit organization to provide a temporary staff person until a new accountant is hired. If the staff person that the audit organization assigns to provide this assistance is not part of the audit engagement team and the audit organization complies with all of the required safeguards, would its independence be considered impaired on a financial statement audit?

First, an emergency situation should be a rare and cataclysmic event that is unexpected and has a severe adverse impact on the audited entity. Second, the audit organization would have to document that, under the circumstances, the audited entity had no other viable option to address the emergency, such as hiring temporary help to carry them over. The audit organization should ensure that the audited entity understands the need to exhaust all other viable options and that the audit organization should be viewed as the last resort.

Considering the caveats included in the question and assuming that this represents the rare case where there is no other viable option, an audit organization could provide this emergency service for a short time (no longer than 1 month) without impairing its independence, as long as it included in its audit report the circumstances related to the emergency situation and makes clear its role and the safeguards taken.

55. An audited entity asks an audit organization to assist with implementing GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. Would an audit organization's independence be impaired?

It would depend on the nature of the assistance provided. GASB Statement No. 34 significantly changed the state and local governmental financial reporting model by redefining the general-purpose external financial statements and by requiring a new section on Management's Discussion and Analysis and that all capital assets, including infrastructure assets, be reported in the financial statements. An audit organization could provide the type of services covered under the independence standard in paragraph 3.23—such as providing routine advice, explaining technical requirements, and providing training—without impairing its independence. Generally, such assistance relating to an audit organization's knowledge and skills would be considered routine and not impair audit independence.

However, if an audit organization is asked to perform work that goes beyond routine advice, this work needs to be considered in light of the overarching principles and the safeguards. This would be the case, for example, if an audit organization were asked to perform extensive valuation services (such as may be related to an audited entity's infrastructure assets or to prepare an audited entity's Management's Discussion and Analysis.

56. If an audit organization arrives at an audited entity to perform a financial statement audit and finds that bank account reconciliations were not performed during the year, can the audit organization perform this service without impairing independence?

It would depend on the facts and circumstances. Reconciling cash balances to bank statements or related records is an internal control that is the responsibility of entity management. In deciding whether to provide this nonaudit service, the audit organization must consider the overarching principles and the safeguards, applying the substance over form doctrine. If the extent of an audit organization's efforts in assisting the audited entity is extensive, which would seem to be the case in this situation, an audit organization needs to consider whether its efforts, in fact, constitute performing a management function. Also, the audit organization needs to consider the materiality of cash to the financial statements and whether management has the knowledge to evaluate and approve the auditor's work.

57. Over the last few years, the U.S. Department of Housing and Urban Development (HUD) has introduced a number of electronic filing requirements for financial information for public housing authorities and multifamily housing projects. HUD will soon introduce new electronic filing requirements for the lender community. Would independence be considered impaired if an audit organization assists an entity in making the electronic submission? What if the transmitted amount was material to the financial statements?

No. This would be considered a routine byproduct of the audit and is permissible irrespective of the materiality of the transmitted amount and without applying the safeguards.

Financial Statement Review and Basic Accounting Assistance

58. Can an audit organization perform review services without impairing its independence to audit the financial statements?

The AICPA defines review of financial statements as performing inquiry and analytical procedures that provide the auditor with a reasonable basis for expressing limited assurance that there are not material modifications that should be made to the financial statements for them to be in conformity with the generally accepted accounting principles (GAAP) or, if applicable, with an other comprehensive basis of accounting. In performing a review, the auditor performs limited audit procedures to provide a basis for providing negative assurance on the presentation of financial statements in accordance with GAAP.

The AICPA has separate standards for review services and does not consider them audit services.

Consistent with the AICPA standards, the GAGAS independence standard does not consider review services as an audit. However, under GAGAS, a review does have characteristics similar to a limited scope audit; for example, (1) the auditor exercises professional judgment in determining the specific procedures to apply in order to provide negative assurance on the presentation of the financial statements in accordance with GAAP, (2) the results of the review are for parties in addition to management of the audited entity, and (3) management is responsible for the basic financial records and the financial statements that the audit organization will review.

Considering the above similarities and applying the substance over form doctrine, a review will be treated as if it is an audit for the purpose of determining audit independence. Therefore, the audit organization could conduct both a review of the entity's financial statements for a given period, such as a calendar quarter, and then subsequently audit the entity's year-end financial statements, without having an impairment to its independence as long as the audit organization ensures that the review services do not involve a level of work so extensive that it gives an appearance that the audit organization, in substance, is maintaining an entity's books. In other words, the audited entity must have adequately maintained books and records to support its financial statements and management that has the knowledge to evaluate and approve any adjustments or corrections that the auditor proposes in order to provide the limited assurance on the financial statements.

Conversely, if the audit organization encounters a situation where the entity does not have adequately maintained books and records, and the audit organization is expected to, in effect, reconstruct

the existing books and records and develop financial statements to review, the independence of the audit organization would be impaired to conduct the year-end financial statement audit. In substance, it would be auditing its own work, which violates an overarching principle. Further, it could be viewed that the audit organization was performing a management function or making management decision in order to produce the financial statements which would violate an overarching principle as well.

59. What if an audited entity's records are in disarray and require hundreds of correcting/adjusting entries? Would an audit organization be impaired at a certain point if it proposes so many correcting/adjusting entities that it is taking heroic efforts to be able to express an opinion?

Footnote 11 in paragraph 3.26a does not place a limit on the number or dollar value of adjusting or correcting entries that an audit organization can propose as a result of its audit as long as management makes the decision on accepting these entries. Nonetheless, this question demonstrates a situation where applying sound judgment and the substance over form doctrine are critical. If the extent of an audit organization's efforts in proposing correcting/adjusting entries is extraordinary, an audit organization needs to consider whether its efforts, in fact, constitute substantially maintaining the records that are being audited. It is important for the audit organization to avoid any situation that could lead reasonable third parties with knowledge of the relevant facts and circumstances to conclude that the auditor is substantially maintaining or reconstructing the records to be audited.

Audit organizations and audited entities have several options to consider when they encounter a situation in which the magnitude of adjustments and corrections that need to be made, in substance, constitute maintaining the records to be audited. The audit organization can suggest the audited entity engage a different audit organization, a bookkeeping service, or temporary assistance to clean up the accounting records before the audit begins or the audit organization could elect to clean up the entity's records and decline to do the audit.

60. Regarding footnote 11 in paragraph 3.26a, are other nonaudit services, such as drafting disclosures for bond offering statements, considered to be routine byproducts resulting from the performance of the audit and, thus, covered by the footnote?

No. Footnote 11 does not extend to any services beyond proposing adjusting and correcting entities. Other nonaudit services need to be considered in light of the overarching principles and the safeguards.

61. Is an audit organization's independence to perform a financial statement audit impaired if it assists a client in converting its financial statements to address new accounting principles?

It would depend on the nature of the assistance. An audit organization's independence to perform financial statement audits for the entity would not be impaired, if it provided routine advice as described in paragraph 3.23. However, beyond routine advice, an audit organization would need to consider the two overarching principles and the

safeguards before agreeing to perform this nonaudit service.

62. Following up on the previous question, to what extent can an audit organization assist the client in redesigning its financial accounting system to implement new accounting principles?

The answer is the same as above. Again, routine advice, as described in paragraph 3.23, would not impair the audit organization's independence. However, beyond routine advice, which would probably be the case in this situation, the organization would need to consider the overarching principles and the safeguards, applying the substance over form doctrine.

For example, if the nonaudit service is to redesign an accounting system, independence would be impaired if the changes were material to the financial statements. If the changes would not be material, an audit organization must comply with the safeguards and the additional requirements in paragraph 3.26e concerning information technology advisory services.

63. A local government contacts an audit organization to perform an agreed-upon procedures engagement involving a golf course's revenues, of which the local government receives 25 percent under a revenue sharing arrangement. Can the audit organization perform this engagement without impairing its independence to perform financial statement audits of the golf course and of the local government?

Yes. This engagement can be performed without impairing an audit organization's independence to perform financial statement audits, or any other audits, of either the golf course or the local government because, under GAGAS, an agreed-upon procedures engagement is an audit.

64. Regarding indirect cost proposals or cost allocation plans, how the new independence standard compare to provisions of U.S. Office of Management and Budget (OMB) Circular A-133, *Audits of State, Local Governments and Non-Profit Organizations*?

The underlying concepts are different. OMB sets a specific dollar threshold above which an audit organization would be precluded from performing the financial statement audit, while the new independence standard applies a principles-based approach to establishing audit organization independence to perform the audit.

OMB Circular A-133, section 305(b), prohibits an audit organization that prepares an indirect cost proposal or a cost allocation plan from being selected to perform the audit that is required when the indirect costs recovered by the auditee during the prior year exceeded $1 million. Under OMB

Circular A-133, this prohibition applies to the base-year used in preparing indirect cost proposals or cost allocation plans and any subsequent years in which the resulting indirect cost agreements or cost allocation plans are used to recover costs. The $1 million threshold applies regardless of materiality.

The new auditor independence standard addresses audit organization independence to prepare indirect cost proposals or cost allocation plans in terms of the two overarching principles: Is this work material to the financial statements and is the audit organization performing a management function or making a management decision?

65. Following up on the prior question, what if an amount over $1 million was not significant/material to the subject matter of the audit?

Preparing indirect cost proposals over $1 million that are not material to the financial statements and for which the audit organization is not performing a management function or making a management decision would not impair the audit organization's independence to perform the financial statement audit under GAGAS. OMB Circular A-133 would though, prohibit the audit organization from doing so. Conversely, if an indirect cost proposal of $1 million or less is material to the financial statements, the audit organization's independence would be impaired under GAGAS because it would be in violation of an overarching principle.

Internal Audit Services

66. If an audited entity does not have an internal audit operation and engages an audit organization to perform internal audit services, would the audit organization's independence be impaired to also serve as the external auditor?

Yes. Internal audit is considered a management function and, for external audit organizations, would impair independence by violating an overarching principle. This would impair the independence of external audit organizations to perform not only the entity's financial statement audit but also performance audits.

67. Why, then, are an entity's internal audit organization and internal audit function not considered to have an impairment to independence?

Under paragraphs 3.30.5 and 3.30.6, internal audit organizations and the internal audit function can be presumed to be free from organizational impairments to independence when reporting internally to management if the head of the internal audit organization is (1) accountable to the head or deputy head of the entity, (2) required to report the results of an audit organization's work to the head or deputy head of the entity, and (3) located organizationally outside the staff or line management function of the unit under audit. If an internal audit organization meets these criteria and care is taken to avoid personal or external impairments to independence, it is independent under GAGAS to report objectively to the entity's management.

Information Technology Services

68. An audited entity purchases a commercial accounting package and asks an audit organization to provide advice on setting up the chart of accounts and the financial statement format. Would the audit organization's independence be considered impaired?

No. Under paragraph 3.23, advice related to an audit organization's knowledge and skills would generally be considered routine and is permitted. However, the decision to follow an audit organization's advice must remain with an audited entity's management. Likewise, an audit organization needs to limit its involvement to providing advice. If an audit organization becomes responsible for the design, development, or installation of the accounting system, or for its operation, an audit organization's independence would be impaired for any subsequent financial statement audit or any other audit where the accounting system would be significant/material to the audit objectives. This level of involvement would clearly violate the overarching principles that audit organizations should not audit their own work and should not provide nonaudit services that involve performing management functions or making management decisions.

69. A not-for-profit audited entity purchases software for a nonaccounting membership database, which it asks an audit organization to install. The audit organization is also asked to provide assistance in customizing the membership reports the system generates and to conduct initial training. Would the audit organization's independence be considered impaired?

The impact on an audit organization's independence depends on an audited entity's use of the database and the audit organization's audit objectives. For example, if the membership database is used to bill members for dues and dues revenue is material to the entity's financial statements, the audit organization's independence would be impaired. Also, if the audit objectives focused on the adequacy of membership information, or on the related system, independence would be impaired since this nonaudit service would be significant/material to the audit objectives.

In contrast, independence would not be impaired for a financial statement audit if, in this example, the membership system is used only for purposes that are not relevant or material to the preparation of the financial statements and assuming the audit organization has not performed any management functions or had not made any management decisions. Also, the safeguard on precluding personnel who provided the nonaudit service from performing related audit work (paragraph 3.25c) would not apply in this case because the nonaudit service would have no relationship to the objectives of the financial statement audit.

Under provisions of paragraph 3.23, an audit organization could provide the training associated

with the new system without impairing its independence to perform either audit or imposing the safeguards. However, if asked to do a performance audit to evaluate the adequacy of the training, the audit organization's independence would be impaired.

70. If an audit organization does all the work associated with installing an off-the-shelf accounting system except for "pushing the button," is the audit organization's independence impaired for the financial statement audit?

Yes. An audit organization's independence would be impaired in connection with a financial statement audit. Because the accounting system is significant/material to the subject matter of the audit, applying the substance over form doctrine, this service would violate the overarching principle that an audit organization should not audit its own work.

71. To follow up on the previous question, what if an audit organization was auditing the effectiveness of a particular program as a performance audit?

In that case, the audit organization's independence would not be impaired if data from the accounting system were not significant/material to the objectives of the performance audit. However, the audit organization should comply with the safeguard to document its rationale that the overarching principles have not been violated.

If the data from the accounting system were significant to the subject matter of a performance audit, which might well be the case for financial

information, independence would be impaired for the performance audit as well.

72. A firm provides training on certain off-the-shelf accounting packages. Does installing include training?

No. As defined by paragraph 3.23, training is a separate category and will not impair audit organization independence. Paragraph 3.23 permits an audit organization to provide training without impairing its independence or triggering application of the safeguards.

73. If an audit organization develops or designs accounting or other financial systems software, can the audit organization sell the software to audit clients without impairing the audit organization's independence to audit the client's financial statements? What if an audit organization significantly modifies computer software that the audit client has purchased from another firm or off the shelf?

In both cases, the answer would be no. Since the financial systems described in these questions are significant/material to the subject matter of the audit, an audit organization would not be independent to perform the financial statement audit because it would violate the principle of auditing its own work.

74. An audit organization has been asked by an entity for advice on a particular n accounting software package. Would providing such advice impair the audit organization's independence to audit the entity's financial statements?

No. If an audit organization is asked to provide advice regarding particular software packages, this is considered routine advice under paragraph 3.23. An audit organization may provide the audited entity its opinion on various software packages based on its experience with and knowledge of the effectiveness of these packages at other organizations and based on its knowledge of the audited entity's needs.

Further, if the audit organization is asked to recommend a package based on its knowledge of the audited entity's needs, it should attempt to point out two or more packages that could be used. Recommending only one package could create the appearance of an independence impairment. Finally, if the audit organization is asked to analyze a particular accounting software package, as long as the work is performed as a performance audit under GAGAS, the audit organization's independence would not be impaired to audit the financial statements.

Work of Specialists

Paragraph 3.14 of the new independence standard presents requirements related to using the work of specialists and footnote 2 elaborates on the types of specialists and organizations to which the requirements apply. Several questions have been raised regarding this footnote information. With the next *Government Auditing Standards* update, we will clarify footnote 2 as follows:

This section applies to external consultants and firms performing work for the audit organization and includes, but is not limited to, actuaries, appraisers, attorneys, engineers, environmental consultants, medical professionals, statisticians, and geologists.

75. Would paragraph 3.14 apply when using the work of specialists who perform work under a contract with the audited entity?

No, because the specialists are under contract to the audited entity and not to the audit organization. While paragraph 3.14 would not directly apply to these specialists, if the audit organization used this work, it generally would need to assess the specialists' capability to perform the work and the reliability of their data. In doing so, an audit organization would need to assure itself of the qualifications and independence of the firm under contract with the audited entity and then whether the specialists who actually performed the work are qualified and independent. An audit organization would consider any professional standards the specialists followed in conducting their work, especially whether they followed standards requiring independence.

76. What if the specialists are employed by the audited entity?

In this case, paragraph 3.14 would not directly apply to these specialists. The work of these specialists would be considered in the same way as information gathered from an audited entity's management.

77. What if the specialists are under contract with the audit organization?

The requirements of paragraph 3.14 apply to these specialists. An audit organization must determine that the firm under contract is independent of the audited entity and then assess the specialists' capability to perform the work and report results impartially. In conducting this assessment, an audit organization should provide the specialists with the GAGAS independence requirements and obtain representations from the specialists regarding their independence from the activity or program under audit. Further, an audit organization would need to assure itself of the validity of these specialists' work, as presented above.

78. What if the specialists are employed by the audit organization?

Audit organizations employ specialists, such as attorneys, actuaries, and statisticians, to assist on individual engagements. The independence requirements for specialists are the same as for auditors. Specialists employed by the audit organization are required to consider the three general classes of impairments to independence—personal, external, and organizational—as would any audit staff member. They are also required to consider the independence standard's principles and safeguards as an auditor would in performing any nonaudit service.

As described in paragraph 3.16, an audit organization should have internal quality control system requirements to identify personal impairments and determine compliance with GAGAS independence requirements. These

requirements should extend to the specialists it employs.

79. If pension expense or liability is material to an audited entity's financial statements, can an audit organization perform the valuation of the plan and be independent to audit the entity's financial statements?

No. An audit organization would be auditing its own work, which is also material to the subject matter of the audit, and thus, would violate an overarching principle.

80. Following up on the previous question, can an audit organization provide advice to an audited entity on methodologies it can use in developing the valuation of the plan without impairing its independence?

Yes. This would be allowed under paragraph 3.23.

Tax Services

81. An entity asks an audit organization to prepare tax returns or for advice on deposits due to a taxing authority. Would these types of tax services impair an audit organization's independence to perform the entity's financial statement audits?

No. These types of tax services generally would be considered routine advice under paragraph 3.23. The overarching principles would not be violated, and an audit organization would not be required to apply the safeguards.

82. Would tax structuring also be considered to be routine advice under paragraph 3.23?

No. An audit organization would have to ensure that providing these tax services would not impair its independence by violating one of the overarching principles and must apply the safeguards, as applicable.

83. Can an audit organization assist its clients in preparing Internal Revenue Service (IRS) form 990, "Return of Organization Exempt From Income Tax," without impairing its independence to audit the entities? Can audit engagement team members perform this activity?

Yes. This type of activity would be considered routine advice under paragraph 3.23. The overarching principles would not be violated, and an audit organization would not be required to apply the safeguards. This means that the audit engagement team could prepare such tax forms for the audited entity.

84. Under 5 U.S.C. 500, certified public accountants (CPA) have a statutory right to represent taxpayers before IRS as long as the CPAs meet certain conduct standards. Would an audit organization's independence for performing financial statement audits be considered impaired if it represents an audited entity in IRS matters, such as in an IRS audit or in obtaining IRS rulings or other agreements?

No. These services, which are prescribed in law, would not impair independence for a financial statement audit. However, if an audit organization

were engaged to perform a performance audit of tax compliance, its work to represent the audited entity before IRS would impair the audit organization's independence since it would be auditing its own work.

Budget Work

85. An audit organization provides assistance to a small municipal government that is preparing its annual operating budget by analyzing budget proposals or to a legislative body by analyzing budget requests submitted to it in the budget process. Would an audit organization's independence be considered impaired?

No, as long as the work is done under the performance audit standards in GAGAS. If these services are limited to analyzing budget proposals, this work could be considered a type of performance audit consistent with paragraph 2.7 of GAGAS.

86. If an audit organization were asked to assist an audited entity in preparing its annual budget, would the independence standard be violated? The audited entity's board has the power to accept or reject the budget.

It would depend on the type or nature and degree of assistance an audit organization is asked to provide and the nature of any subsequent audit work it is asked to perform. Preparing an annual budget is a management function and involves making management decisions, which an audit organization must avoid to remain independent. However, if the assistance involves assessing the budget execution as a baseline for preparing the current budget, this work would qualify as a performance audit under

GAGAS as long as the work is done in accordance with the performance audit standards.

87. An audit organization is engaged to assist a governmental entity in assessing program or policy alternatives, such as forecasting program outcomes under various assumptions or analyzing various opportunities for privatizing certain of its functions. Would an audit organization's independence be considered impaired?

No. As long as the work is done under the performance audit standards, the audit organization's independence would not be impaired. In performing engagements of this nature, an audit organization would always need to exercise caution that it does not perform any management functions or make any management decisions. If these services are limited to assessing program or policy alternatives, it could be considered a performance audit consistent with paragraph 2.7 of GAGAS. Under a performance audit, an audit organization can make recommendations, but management has the responsibility for determining action to be taken based on an audit organization's work.

88. What if the audit organization wishes to perform the work described in the previous questions under the AICPA's consulting standards and to not follow the performance audit standards in GAGAS?

The audit organization would have to apply the overarching principles and safeguards since it has elected to do this work as a nonaudit service. This is not a matter of form over substance, since the performance audit standards in GAGAS are for a different purpose and are considerably more

rigorous than the AICPA's consulting standards. Performing audit services under GAGAS would not impair an audit organization's independence, whereas performing nonaudit services can impair independence if either of the overarching principles is violated or if the safeguards are not adhered to.

89. An audit organization is engaged to identify ways that an audited entity can improve services and cut costs. The audit organization studies the entity, interviews personnel from various departments, and ultimately makes recommendations for management to consider. Would the audit organization's independence be considered impaired?

Under GAGAS, such work would qualify as a performance audit. If done under the performance audit standards, this service would not impair independence. However, if such services were performed as a nonaudit service (for example, as a consulting service that does not follow GAGAS), the services would be subject to the overarching principles and required safeguards.

90. Can audit organizations assist clients with strategic planning without impairing audit organization independence?

It would depend on the nature of the assistance. An audit organization may provide routine advice under paragraph 3.23 in assisting the audited entity's management in using strategic planning tools and methodologies, providing training, and answering technical questions without impairing audit independence.

However, preparing an audited entity's strategic plan would normally involve performing a

management function that requires making management decisions. Thus, if an audit organization were to prepare or substantially prepare the strategic plan, it would violate the overarching principles and impair its independence to perform audits of the audited entity.

Human Resource Services

91. Is auditor independence impaired if an audit organization is asked for its opinion on the qualifications of a specific individual for a particular key position at an audited entity?

No. This would qualify as routine advice under paragraph 3.23. If an audited entity asks about the qualifications of a particular individual for a specific position, an audit organization can respond without impairing its independence or having to apply the safeguards.

92. What if the audit organization instead is asked to recommend individuals for a particular position?

The audit organization can suggest individuals for the audited entity to contact for consideration without impairing the audit organization's independence as long as it provides more than one name for a particular position. However, as discussed in paragraph 3.26f, if an audit organization recommends a single individual for a specific key position or conducts an executive search or recruiting program for an audited entity, the audit organization's independence would be impaired.

Therefore, audit organizations should advise their clients to also consider other sources of information about potential candidates for financial management executive positions or accounting and

other positions that may have a key role or substantially influence matters that may be the subject matter of an audit. In this regard, audit organizations should be aware of the potential for future independence impairments arising from human resource services they may provide to audited entities.

GAO's Mission

The General Accounting Office, the investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through the Internet. GAO's Web site (www.gao.gov) contains abstracts and full-text files of current reports and testimony and an expanding archive of older products. The Web site features a search engine to help you locate documents using key words and phrases. You can print these documents in their entirety, including charts and other graphics.

Each day, GAO issues a list of newly released reports, testimony, and correspondence. GAO posts this list, known as "Today's Reports," on its Web site daily. The list contains links to the full-text document files. To have GAO e-mail this list to you every afternoon, go to www.gao.gov and select "Subscribe to daily E-mail alert for newly released products" under the GAO Reports heading.

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. General Accounting Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone:	Voice:	(202) 512-6000
	TDD:	(202) 512-2537
	Fax:	(202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:
Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Public Affairs

Jeff Nelligan, managing director, NelliganJ@gao.gov (202) 512-4800
U.S. General Accounting Office, 441 G Street NW, Room 7149
Washington, D.C. 20548

PRINTED ON RECYCLED PAPER

United States
General Accounting Office
Washington, D.C. 20548-0001

Official Business
Penalty for Private Use $300

Address Service Requested

Presorted Standard
Postage & Fees Paid
GAO
Permit No. GI00