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GAO

Preliminary Views

April 2000

**Government Auditing
Standards**

Independence

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GAO

Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

Accounting and Information
Management Division

April 14, 2000

TO AUDIT OFFICIALS AND OTHERS INTERESTED IN
GOVERNMENT AUDITING STANDARDS

GAO invites your comments on the accompanying preliminary views on possible revisions to *Government Auditing Standards*, commonly known as the Yellow Book, to address certain auditor independence issues. The preliminary views in this draft document present a revised second general standard, independence, and add new related standards to reporting on financial audits and performance audits to illustrate possible revisions to the standards. We want to emphasize that consideration of these matters is in the deliberative phase. The purpose of the preliminary views document is to obtain the views of users of the standards to assist us in considering possible changes to the standards and alternative approaches that would reasonably and effectively address the auditor independence issues.

To help ensure that the standards continue to meet the needs of the audit community and the public it serves, the Comptroller General of the United States appointed the Advisory Council on Government Auditing Standards to review the standards and recommend necessary changes. The Council includes experts in financial and performance auditing drawn from all levels of government, private enterprise, public accounting, and academia. Public comment is requested on all draft revisions to the standards.

The Council recommended to the Comptroller General that a preliminary views draft be issued rather than an exposure draft to reflect the fact that the Council is aware of the complexity and controversy associated with the auditor independence issues and is seeking to reach out to all users of the standards to help formulate possible solutions. This draft identifies one possible solution to the auditor independence issues, but the Council recognizes other alternative approaches may exist. Although this draft identifies issues that are known to exist concerning auditor independence, the Council acknowledges that there may be additional issues to consider and invites respondents to identify and comment on those issues to assist the Council in its deliberations. Specifically, the Council is interested in assessing the potential effects of their preliminary views and in identifying potential implementation problems. The Council is also considering holding public hearings in conjunction with the issues addressed in this draft to gain greater insight regarding the effect of adopting this proposal and to consider alternative approaches.

The revisions to *Government Auditing Standards* that the Advisory Council is considering affect the second general standard, independence, and related reporting standards for financial and performance audits. Specifically, the revisions clarify issues concerning

government auditors' organizational independence. The current standards related to organizational independence may have been misinterpreted by some audit organizations, thus indicating that clarification is needed. The proposed solution provides additional clarity to the standards by more explicitly stating the criteria for organizational independence and by providing guidance for organizations that do not meet this criteria.

Under *Government Auditing Standards*, audit organizations that do not meet certain independence standards are currently precluded from issuing opinions on financial statements in accordance with these standards. Under this preliminary views document, in situations when a statutory or regulatory requirement that has the effect of law requires a government audit organization to report on financial statements and the audit organization does not meet the organizational independence requirement, the Council has taken the position that the statutory or regulatory requirement takes precedence over auditing standards. However, the Council proposes that in order to prevent misunderstanding by users of the audit report, auditors should include information in the scope paragraph of their report regarding the audit requirement and the factors associated with the organizational independence of the government audit or evaluation organization. appendix I provides possible illustrative language for the disclosure in the auditor's report.

The Council is also considering a requirement for this explanatory language to be added to the scope section of the audit report when the audit or evaluation organization is authorized to conduct other audits or evaluations and report on this work by law or regulation that has the effect of law but the head of the organization does not meet the organizational independence standard. Because many of these documents could become public, there is a need for transparency and clarity for outside users. appendix II includes possible illustrative language for performance audit reports.

The Council acknowledges that certain federal, state, and local auditors could be impacted by the potential revision. For example, because the current standards may not be clear, certain federal inspectors general (IGs) who are appointed by the agency head may not be aware that they do not currently meet the criteria that defines organizational independence (paragraph 3.25, 1994 Revision). Accordingly, if the preliminary views are adopted, these entities would be required to include certain mandatory disclosures in their reports in order to report on mandated financial statement audits and authorized performance audits and evaluations in accordance with these standards.

The Council also wishes to emphasize that certain federal, state, and local internal auditors may enhance their appearance of independence within their entity as discussed in proposed paragraphs 3.20 through 3.22. However, under the proposed preliminary views, auditors who report externally must meet the criteria for organizational independence, as proposed in paragraphs 3.18 or 3.19. As stated above, for those auditors who are not organizationally independent, the preliminary views proposes to recognize external reporting when a financial audit is mandated by law and when performance audits and evaluations are authorized by law, provided that certain disclosures are made by the auditor as proposed in paragraphs 5.28.2 and 7.42.2.

The Council is considering revising and relocating existing paragraphs 3.18 through 3.22 concerning internal auditors within Chapter 3 of *Government Auditing Standards* to avoid confusion with independence requirements for external auditors. *Government Auditing*

Standards recognize that an internal audit function can be independent from the programs and activities it audits within the parent organization. However, this concept of independence is different from the concept of independence for external auditors considered to have met the criteria for organizational independence contained in *Government Auditing Standards*.

Another preliminary view of the Advisory Council presented in this document is whether removal of the head of the government audit or evaluation organization should be added to the criteria for organizational independence in paragraph 3.25 of *Government Auditing Standards*. Currently, organizational independence as defined in paragraph 3.25 is dependent on how the head of the government audit or evaluation organization was appointed to office and the concept of reporting audit results to and the accountability to the legislative body. The Council's preliminary view is that how the organizational head can be removed from office is also an important factor in determining organizational independence. Paragraph 3.18 of this document presents the Council's preliminary view that removal should be added to the criteria for organizational independence, and that the decision for removal of the head of the audit or evaluation organization should reflect approval or oversight of parties outside the audited organization.

This draft is being sent to financial management and audit officials at all levels of government, the public accounting profession, academia, professional organizations, and public interest groups. We encourage you to send your comments, whether you wish to comment on the entire document or only a portion of it. All comments will be distributed to the entire Council and will be considered during further deliberations. Only after comments are evaluated by the Council will an exposure draft be considered for further public comment.

In the preliminary views draft, italicizing and bolding are used to identify potential added language and striking-out is used to identify potential deleted language. To facilitate review of the preliminary views, it is located on the Internet on GAO's Home Page (www.gao.gov). Additional copies of the preliminary views draft can be obtained from the U.S. General Accounting Office, Room 1100, 700 4th Street, NW, Washington, DC 20548, or by calling (202) 512-6000.

Although all comments on the preliminary views are encouraged, the Council is specifically requesting comments on several key issues to assist them on focusing on critical aspects of this proposal. Please comment specifically on the following questions and provide the rationale for your responses:

1. Do you agree with the preliminary views that proposes adding removal as a criteria of organizational independence (proposed paragraph 3.18)?
2. Do you agree with the preliminary views that for those government audit organizations that are mandated to report on financial statements but do not meet the criteria defining organizational independence that the audit organization should include in the scope paragraph of their report explanatory information (proposed paragraph 5.28.1) to prevent any misunderstandings by users of the resulting report on the financial statements?

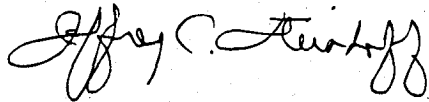
3. Do you agree with the preliminary views that proposes that the elements of the explanatory information should include the statement noting that the audit organization does not meet the organizational independence criteria but is permitted to conduct and report on the audit in accordance with *Government Auditing Standards* (proposed paragraph 5.28.2)?
4. Do you agree with the preliminary views that proposes that when government audit organizations are not considered organizationally independent and there is no statutory or regulatory requirement to perform an audit of financial statements and report on the results of the audit, that auditors should be precluded from expressing an opinion on the financial statements (proposed paragraph 5.28.3)?
5. For other than financial statement audits, do you agree with the preliminary views that proposes a requirement for explanatory language to be added to the scope section of the report when the audit or evaluation organization is authorized to conduct audits or evaluations and report on such work by law or regulation that has the effect of law but the head of the organization does not meet the organizational independence criteria (proposed paragraph 7.42.1)?
6. Do you agree with the preliminary views that distinguishes between the threshold for reporting on performance audit based on if the auditor is authorized to conduct and report on such work while the threshold for reporting on financial audit is if the auditor is required to conduct and report on the specific audit if the head of the government audit organization does not meet the organizational independence criteria (proposed paragraphs 5.28.1 and 7.42.1)?
7. Do you believe that the illustrative language included as appendixes I and II adequately captures the required elements of the explanatory paragraph? In responding to this question, the Council would appreciate any suggestions for alternative language. The Council is particularly interested in streamlining the suggested language while retaining coverage of the proposed disclosure elements.
8. As a possible alternative to the proposed explanatory language in internal audit reports, would restrictive use language that states that the reports are intended to be used only by management be sufficient disclosure for an external user of the report?
9. As a possible alternative for auditors who do not meet the organizational independence criteria in the preliminary views document (see paragraphs 3.18 or 3.19), should *Government Auditing Standards* have criteria that defines organizational independence for auditors who audit within their entity and report to management? In addition to providing a rationale for your views, please provide suggested criteria if you support having separate criteria for defining organizational independence for these auditors.
10. Are there alternative approaches to resolve the auditor independence issues that you believe the Council should consider? In addition to providing a suggested alternative approach, please provide what you believe are the advantages and the disadvantages to adopting your proposed alternative approach.

11. Are there any other issues that you believe the Council should consider with respect to auditor independence in the context of this preliminary views document?

To facilitate analysis of your comments, it would be helpful if you sent them both in writing and on diskette (in Word or ASCII format). To ensure that your comments are considered by the Council in their deliberations, please submit them by June 30, 2000, to:

Government Auditing Standards Comment
Independence Preliminary Views
U.S. General Accounting Office
Room 5089 (AIMD)
441 G Street, NW
Washington, DC 20548

Also, please indicate if you wish to testify at a public hearing and provide a telephone number and/or e-mail address where you can be reached. If you need additional information, please call Marcia B. Buchanan, Assistant Director, Corporate Audits and Standards, at (202) 512-9321.



Jeffrey C. Steinhoff
Acting Assistant Comptroller General

1. The first part of the document is a letter from the author to the editor of the journal. The letter discusses the author's interest in the topic and the reasons for writing the paper.

2. The second part of the document is the abstract of the paper. It provides a brief summary of the main findings and conclusions of the study.

3. The third part of the document is the introduction. It sets the context for the study and outlines the objectives and scope of the research.

4. The fourth part of the document is the literature review. It discusses the existing research on the topic and identifies the gaps that the current study aims to address.

5. The fifth part of the document is the conclusion. It summarizes the main findings of the study and discusses their implications for future research.

INDEPENDENCE

3.11 The second general standard is:

In all matters relating to the audit and evaluation work, the audit and evaluation organization and the individual auditors and evaluators, whether government or public, should be free from personal and external impairments to independence, should be organizationally independent, and should maintain an independent attitude and appearance.

3.12 This standard places responsibility on each auditor *and evaluator* and the audit *and evaluation* organization to maintain independence so that opinions, conclusions, judgments, and recommendations will be impartial and will be viewed as impartial by knowledgeable third parties.

3.13 Auditors *and evaluators* should consider not only whether they are independent and their attitudes and beliefs permit them to be independent but also whether there is ~~anything about~~ *an appearance associated with* their situations that might lead others to question their independence. ~~All situations deserve consideration because it is essential not only that a~~ Auditors *and evaluators need to be* ~~are,~~ in fact, independent and impartial. ~~but~~ *They also need to be recognized as independent by* ~~also that~~ knowledgeable third parties. ~~Consider them so.~~

3.14 Government auditors *and evaluators*, including ~~hired consultants and internal experts and specialists~~, need to consider three general classes of impairments to independence—personal, external, and organizational. If one or more of these impairments affects an auditor's *or an evaluator's* ability to do the work and report findings *results* impartially, that auditor *or evaluator* should either decline to perform the audit *work except as follows. Statutory or regulatory requirements that have the effect of law may exist by which government auditors and evaluators are required to conduct financial statement audits or are authorized to conduct performance audits and evaluations and report the results but the government audit organization does not meet the criteria listed in paragraphs 3.18 or 3.19 that define organizational independence. When these requirements and conditions exist, or in those situations where that auditor cannot decline to perform the audit, the impairment(s) government auditors or evaluators should be include information in the scope section of their report as required by paragraphs 5.28.1 through 5.28.3 for financial statement audits and as required by paragraphs 7.42.1 and 7.42.2 for performance audits and evaluations. Also, when auditors are employees of the audited entity, that fact should be reflected in the scope section of the auditor's or evaluator's report.*

3.15 Nongovernment auditors *and evaluators* need to consider those personal and external impairments that might affect their ability*ies* to do their work and report their findings *results* impartially. If their ability*ies* ~~is~~ *are* adversely affected, they should decline to perform the audit. *Certified public accountants and Ppublic*

accountants should also follow the American Institute of Certified Public Accountants (AICPA) code of professional conduct, the code of professional conduct *and the regulations* of the state board with jurisdiction over the practice of the public accountant and the audit organization, and the guidance on personal and external impairments in these standards.

3.15.1 *In using the work of specialists¹ auditors and evaluators need to evaluate whether any of the three general classes of impairments to independence affect these individuals' ability to do the work and report results impartially. If the specialists may have an impairment to independence, auditors and evaluators need to consider the need to use the work of other specialists who do not have an impairment. If auditors and evaluators decide to continue working with specialists whose independence may be impaired, auditors and evaluators should perform additional procedures with respect to some or all of the specialists' assumptions and methods to determine that the results are not unreasonable or engage another specialist for this purpose.*

Personal Impairments

~~3.16 There are circumstances under which auditors may not be impartial, or may not be perceived as impartial. The audit and evaluation organization is responsible for having policies and procedures in place to help determine if auditors and~~

¹Specialists to whom this section applies include, but are not limited to, actuaries, appraisers, attorneys, engineers, environmental consultants, medical professionals, and geologists.

evaluators have any personal impairments *to independence*. Managers and supervisors need to be alert for personal impairments *to independence* of their staff members. Auditors *and evaluators* are responsible for notifying the appropriate official within their audit *and evaluation* organization if they have any personal impairments *to independence*. These impairments apply to individual auditors *and evaluators*, but they may also apply to the audit *and evaluation* organization. Personal impairments may include, but are not limited to, the following:

- a. official, professional, personal, or financial relationships that might cause an auditor *or evaluator* to limit the extent of the inquiry, to limit disclosure, or to weaken or slant audit *or evaluation findings results* in any way;
- b. preconceived ideas toward individuals, groups, organizations, or objectives of a particular program that could bias the audit *or evaluation*;
- c. previous responsibility for decision-making or managing an entity that would affect current operations of the entity or program being audited *or evaluated*;
- d. biases, including those induced by political or social convictions, that result from employment in, or loyalty to, a particular group, organization, or level of government;

- e. subsequent performance of an audit *or evaluation* by the same individual who, for example, had previously approved invoices, payrolls, claims, and other proposed payments of the entity or program being audited *or evaluated*;
- f. concurrent or subsequent performance of an audit by the same individual who maintained the official accounting records;² *and*
- g. financial interest that is direct, or is substantial though indirect, in the audited *or evaluated* entity or program.

External Impairments

3.17 Factors external to the audit *or evaluation* organization may restrict the audit *or evaluation* or interfere with an auditor's *or evaluator's* ability to form independent and objective opinions and conclusions. For example, under the following conditions, ~~an audit may be adversely affected and~~ an auditor *or evaluator* may not have complete freedom to make an independent and objective judgment:

² For example, an individual performs a substantial part of the accounting process or cycle, such as analyzing, journalizing, posting, preparing, adjusting and closing entries, and preparing the financial statements, and later the same individual performs an audit. In stances in which the auditor acts as the main processor for transactions initiated by the audited entity, but the audited entity acknowledges responsibility for the financial records and financial statements, the independence of the auditor is not necessarily impaired. For further explanation of this potential impairment, auditors should refer to the AICPA Code of Professional Conduct related to Accounting services (ET 101.05).

- a. external interference or influence that improperly or imprudently limits or modifies the scope of an audit *or evaluation*;
- b. external interference with the selection or application of audit *and evaluation* procedures or in the selection of transactions to be examined;
- c. unreasonable restrictions on the time allowed to complete an audit *or evaluation*;
- d. interference external to the audit *and evaluation* organization in the assignment, appointment, and promotion of audit *and evaluation* personnel;
- e. restrictions on funds or other resources provided to the audit *and evaluation* organization that would adversely affect the audit *and evaluation* organization's ability to carry out its responsibilities;
- f. authority to overrule or to influence the auditor's *or evaluator's* judgment as to the appropriate content of an audit *the* report; and
- g. influences that jeopardize the auditor's *or evaluator's* continued employment for reasons other than competency or the need for audit *or evaluation* services.

Organizational Independence

~~3.18 Government auditors' independence can be affected by their place within the structure of the government entity to which they are assigned and also by whether they are auditing internally or auditing other entities.~~

External Auditors

~~3.23 Government auditors employed by audit organizations whose heads are elected and legislative auditors auditing executive entities may be considered free of organizational impairments when auditing outside the government entity to which they are assigned.~~

3.25.18 A *g*Government auditors *or evaluation organization* may also be presumed to be independent *of the audited entity*, assuming no personal or external impairments exist, if the audit *or evaluation* organization's head is

- a. *directly* elected by the citizens *voters* of their jurisdiction *the government or component unit thereof with respect to which professional services are performed and, if subject to removal, the process is transparent to establish reasonable safeguards over external factors that could adversely affect the organization's independence, or*

- b. ~~elected or appointed by a *legislative body*, of the level of government to which they are assigned and~~ *subject to removal by a legislative body, and* reports the results of audits to and ~~are~~ *is* accountable to ~~the~~ *a* legislative body, or
- c. appointed by the chief executive but *someone other than a legislative body, so long as the appointment is confirmed by a legislative body and removal from the position is subject to oversight or approval by a legislative body,*³ *and* reports the results of audits to and ~~are~~ *is* accountable to a legislative body. ~~of the level of government to which they are assigned.~~

3-24.19 Government auditors *and evaluation organizations* may also be presumed to be independent of the audited *or evaluated* entity, assuming no personal or external impairments exist, if the entity is

- a. a level of government other than the one to which they are assigned (federal, state, or local) or
- b. a different branch of government within the level of government to which they are assigned (legislative, executive, or judicial).

³ *Legislative bodies may exercise their confirmation powers through a variety of means as long as they are involved in the approval of the individual to head the audit or evaluation office. This involvement can be demonstrated by approving the individual after the appointment or by initially selecting or nominating an individual or individuals for appointment by the appropriate authority.*

3.1920 *Certain* A federal, state, or local government audit *and evaluation* organizations, or an audit *and evaluation* organizations within other government entities, such as a public college, university, or hospital, *may not meet the organizational independence criteria in paragraphs 3.18 or 3.19. Auditors who do not meet the criteria in paragraphs 3.18 or 3.19 can strengthen their organizational status if the head of the audit organization is accountable to and* ~~reporting~~ the results of their ~~audits~~ *work to the head or deputy head of the government entity and being* ~~accountable to the head or deputy head of the government entity, and~~ ~~be organizationally located~~ *who is located organizationally* outside the staff or line management function of the unit under audit *or evaluation, and* ~~The audit organization's independence is enhanced when it also reports regularly to the entity's independent audit committee and/or the appropriate government oversight body. may be subject to administrative direction from persons involved in the government management process. To help achieve organization independence, audit organizations should.~~

3.2021 Auditors *and evaluators, as discussed in paragraph 3.20,* should also be sufficiently removed from political pressures to ensure that they can conduct their audits objectively and can report their findings, opinions, and conclusions objectively without fear of political repercussion. Whenever feasible, they should be under a personnel system in which compensation, training, job tenure, and advancement are based on merit.

~~3.2122~~ If the above conditions *of paragraphs 3.20 and 3.21* are met, and no personal or external impairments exist, ~~the audit staff~~ *these auditors and evaluators are in a better position to improve the operations of an organization by bringing a more objective and disciplined approach to evaluate and improve the effectiveness and efficiency of the organization's operations and the soundness of its risk management, internal control, and governance processes.* ~~should be considered organizationally independent to audit internally and free to report objectives to top management.~~

~~3.2223~~ When ~~organizationally independent internal~~ *these auditors and evaluators* conduct audits external to the government entity to which they are directly assigned, *such as auditing contractors or outside party agreements, and no personal or external impairments exist,* they may be considered independent of the audited entity and free to report objectively to the head or deputy head of the government entity to which they are assigned.

[Paragraphs 3.24 and 3.25 not used.]

Reporting When Government Auditors Do

Not Meet Organizational Independence Criteria

5.28.1 The fourth additional reporting standard for financial statement audits is:

If a government audit organization does not meet the criteria for organizational independence, and when statutory or regulatory requirements with the effect of law require the organization to report on financial statements, it should include summary information regarding the legal requirement and disclose the factors associated with the organizational independence of the government audit organization in the auditors' report.

5.28.2 When statutory or regulatory requirements that have the effect of law require the government audit organization to report on financial statements, GAGAS recognizes that such statutory or regulatory authority has precedence over the standards. To prevent misunderstandings by users of the resulting report, the auditors should include in the scope paragraph of their report summary information regarding the legal requirement to audit the financial statements and to report thereon and the factors associated with the organizational independence of the government audit organization. The auditors' report should exclude the word "independent" from the title of the report and include the following language:

- a. *a summary statement citing the law or regulation that requires the audit organization to audit and report on the financial statements,*
- b. *a statement noting that the audit organization does not meet the organizational independence criteria in paragraphs 3.18 and 3.19, and*
- c. *a statement noting that while the head of the audit organization does not meet the organizational independence criteria, Government Auditing Standards recognize the mandated audit requirement and allow the audit organization to conduct and report on the audit in accordance with these standards.*

5.28.3 *When a government audit organization does not meet the criteria for organizational independence described in these standards and there is no statutory or regulatory requirement to perform an audit of financial statements and report on the results of the audit, auditors would be precluded from expressing an opinion on the financial statements. Accordingly, in these circumstances under these standards, auditors are required to disclaim an opinion with respect to the financial statements and to state specifically that they are not independent.*

Reporting When Government Auditors and Evaluators

Do Not Meet Organizational Independence Criteria

7.42.1 If a government audit and evaluation organization does not meet the criteria for organizational independence, and when that organization is required or authorized by statutory or regulatory requirements that have the effect of law to conduct performance audits and evaluations and to report the results, it should include information regarding the legal requirement authority and disclose the factors associated with its organizational independence in the scope section of the report as required by 7.42.2.

7.42.2 When circumstances described in 7.42.1 exist, the report should include the following language in the scope section:

- a. a summary statement citing the law or regulation that requires or authorizes the audit organization to audit and report on performance audits and evaluations,**
- b. a statement noting that the audit organization does not meet the organizational independence criteria in paragraphs 3.18 and 3.19, and**
- c. a statement noting that while the head of the audit organization does not meet the organizational independence criteria, Government Auditing**

Standards recognize that the authority to audit allows the audit organization to conduct and report on the audit in accordance with these standards.

Possible Illustrative Language for Disclosure
in Auditor's Report on Financial Statements

[Name of specific law or regulation that has the impact of law] mandates that [name of audit organization] conduct and report on the audit of [name of agency] in accordance with *Government Auditing Standards* that contain standards for auditor independence. These standards include for the head of the government audit organization to meet certain appointment criteria. While [title of head of the audit organization] does not meet the specified organizational independence criteria, *Government Auditing Standards* recognize the mandated audit requirement and allow us to conduct and report on this audit in accordance with these standards.

Possible Illustrative Language for Disclosure
in Performance Audit Reports

[Name of specific law or regulation that has the impact of law] authorizes [name of audit organization] to conduct and report on the audit of [name of agency] in accordance with *Government Auditing Standards* that contain standards for auditor independence. These standards include for the head of the government audit organization to meet certain appointment criteria. While [title of head of the audit organization] does not meet the specified organizational independence criteria, *Government Auditing Standards* recognize the authority to audit allows us to conduct and report on this audit in accordance with these standards.

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