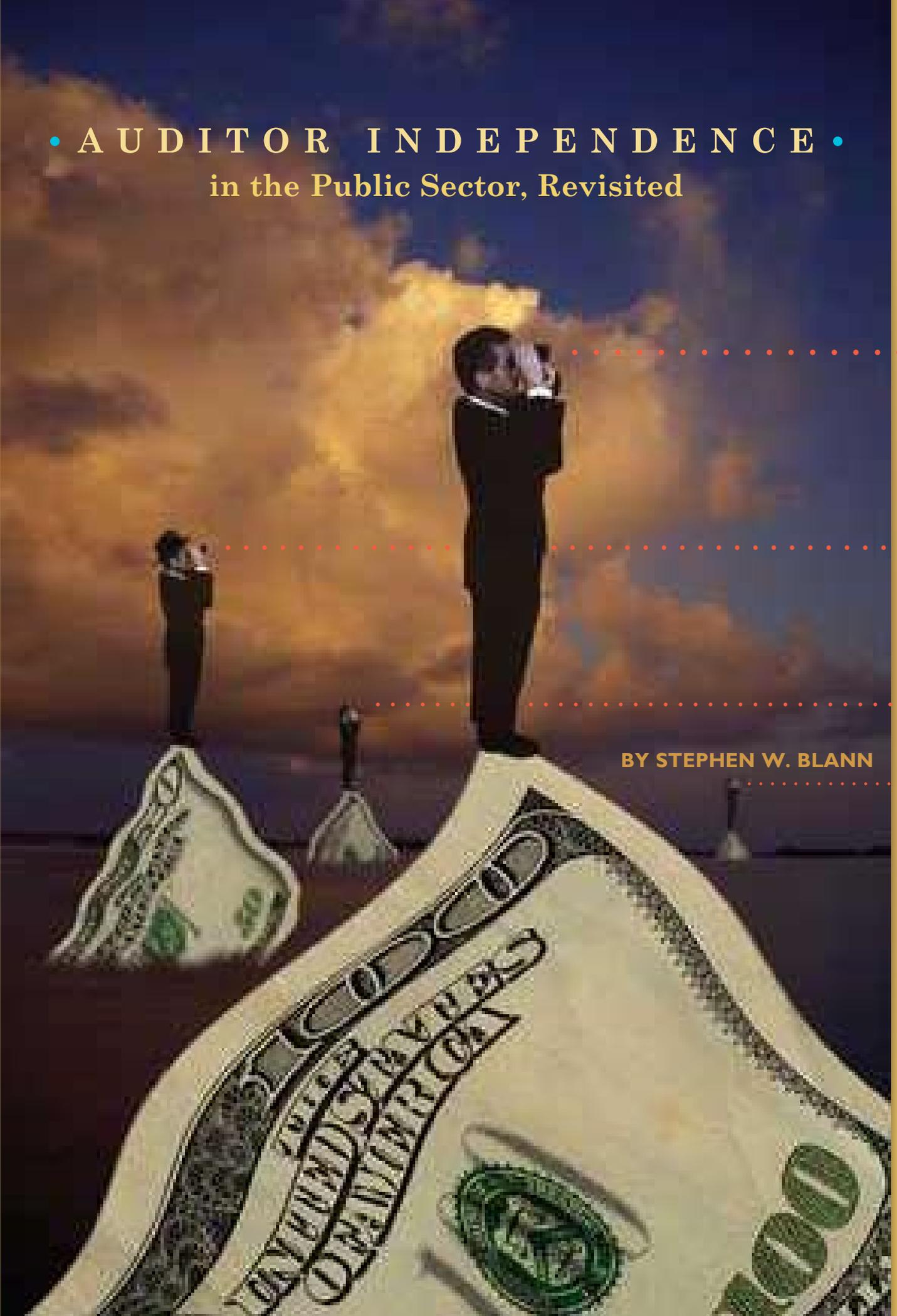


• AUDITOR INDEPENDENCE •  
in the Public Sector, Revisited

BY STEPHEN W. BLANN



The external audit lends credibility to the financial reporting process of state and local governments, and an essential element of that process is the independence of the external auditors from the governments they are auditing. Otherwise, those who use governmental financial statements cannot rely on the integrity and objectivity of the auditors' report.

The concept of auditor independence is governed by a number of professional standards setters, including the American Institute of Certified Public Accountants (AICPA) through its generally accepted auditing standards (GAAS). In addition, state and local governments, along with many not-for-profit entities they contract with, are frequently subject to government auditing standards, which are issued by the Government Accountability Office (GAO). *Government Auditing Standards*, also referred to as generally accepted government auditing standards (GAGAS), or the "Yellow Book," builds on the foundation of GAAS laid down by the AICPA and adds additional ethical principles and independence standards for performing financial audits, beyond those provided by the AICPA.

In December 2011, the GAO released an updated version of the Yellow Book that is effective for financial audits of periods ending on or after December 15, 2012.

Among the more significant changes in the 2011 revision of *Government Auditing Standards* was the introduction of a new conceptual framework for auditor independence, which completely replaced the former "overarching principles" and "supplemental safeguards" of the previous Yellow Book. While similar in spirit to earlier guidance, this new framework represents a significant shift from a more rules-based approach to auditor independence to a more principles-based approach. (The GAO had previously issued a 70-page Q&A guide on auditor independence, in addition to the guidance actually contained in the Yellow Book.)

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## BASIC PRINCIPLES

The GAO's basic rule for auditor independence is fairly simple: "In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be independent."<sup>1</sup> The GAO goes on to indicate that the concept of independence comprises two elements: *independence of mind*, and *independence in appearance*.

*Independence of mind* is the mental state that allows an auditor to perform his or her duties with integrity and objectivity, without being influenced by factors that could compromise his or her professional judgment. This concept is sometimes referred as "independence in fact,"

but there is an important distinction here — the GAO isn't concerned about whether the auditor is "factually" independent of his or her client, but rather whether the auditor is actually able to undertake the audit with the appropriate mental attitude.

*Independence in appearance* speaks to the concept of public perception and is defined as "the absence of circumstances" that would cause a third party to conclude that an auditor's integrity, objectivity, or professional judgment had been compromised. Given that one of the primary objectives of an audit is to allow

users of financial statements to be confident of their reliability, it would be counterproductive to argue that an auditor should be permitted to conduct an audit when the users of the financial statements might reasonably question his or her independence. Of course, if not appropriately limited, this rule could easily be abused. Accordingly, the standard refers to a "reasonable and informed third party, having knowledge of the relevant information."<sup>2</sup>

These basic principles are equally applicable to each audit engagement, audit organization, and the individual auditors participating in an audit.

## GAGAS CONCEPTUAL FRAMEWORK

The new conceptual framework laid out in the Yellow Book is essentially a risk-based approach to independence. First, the auditor identifies any potential *threats* to his or her independence. Next, the auditor evaluates the *significance* of those threats (both individually and in the aggregate). Finally, the auditor applies one or more *safeguards* to either eliminate the threats to independence or to reduce them to an acceptable level.

A *threat* to independence is any circumstance that could impair an auditor's professional judgment. Think of a threat as an identified risk. It may or may not be significant, and may or may not actually impair an auditor's independence. However, any threat that is identified should be evaluated using the conceptual framework. The GAO has identified seven categories for categorizing risk:

- **Self-Interest Threat.** The risk that an auditor's judgment will be impacted by a "what's in it for me" attitude.
- **Self-Review Threat.** The risk that an auditor will not apply the same standard of care or will not report problems found when reviewing his or her own work (typically caused when the auditor was first engaged to assist with some non-audit service that is later subject to the audit).
- **Bias Threat.** The risk that an auditor's prejudices (whether positive or negative) will affect his or her objectivity.
- **Familiarity Threat.** The risk that an auditor will become too close to a client (socially or through long-standing relationship) to be objective.
- **Undue Influence Threat.** The risk that outside pressures or influence will affect an auditor's ability to make objective judgments.
- **Management Participation Threat.** The risk that comes from an auditor assuming the role of manage-

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ment, rather than being independent of it.

- **Structural Threat.** The risk that an audit organization's placement within a government will affect its ability to perform work objectively (e.g., an Office of Audits that is subordinate to the department it has been charged to audit).

These categories may be helpful for identifying the types of issues that can threaten auditor independence,

but under the conceptual framework, all threats are treated essentially the same way. Accordingly, there is little value in dwelling on which category an identified threat belongs to. Any condition that has the potential to adversely affect an auditor's objectivity or professional judgment should be considered a threat and moved on to the evaluation stage.

Evaluating the *significance* of a threat to independence is a matter of professional judgment. Certain threats may exist but be clearly insignificant. In that case, all that is required is to document the consideration of the threat and the conclusion that it is not significant. Other threats may be significant enough to require one or more safeguards to eliminate or reduce them to an acceptable level. Still other threats may be so significant that no amount of safeguards would be sufficient to eliminate them or reduce them to an acceptable level.

*Safeguards* are controls designed to eliminate threats to independence, or reduce them to an acceptable level. Auditors may select one or more appropriate safeguards, based on the specific facts and circumstances that gave rise to the threats in the first place. There is no exhaustive list of safeguards that an auditor can choose from. As a starting point, however, GAGAS do provide several examples:

- Consulting with an independent third party.
- Involving another audit organization to perform (or re-perform) a portion of the audit.
- Having another staff member who was not part of the audit team review the work performed.

- Having an appropriate member of management review and approve any non-audit services performed by the auditor.

Once one or more safeguards have been applied, the auditor should reassess the threats to determine whether they have been eliminated or reduced to an acceptable level. A threat to independence is not acceptable if it could affect either the auditor's independence of mind or independence in appearance. If the threats have been eliminated or reduced to an acceptable level, the auditor should document both the threats identified and the safeguards applied. If not, the auditor should decline to perform the audit (or terminate the audit, if already in progress).

## NON-AUDIT SERVICES

One of the most common (and potentially most significant) threats to auditor independence comes in the form of non-audit services. Despite using the term some 85 times, GAGAS do not contain an official definition of non-audit services, though from context we can safely infer that any service not considered to be an integral part the audit is considered non-audit by default. Under the conceptual framework, non-audit services may represent both a self-review threat and a management participation threat. Essentially, the risk is that an auditor will either 1) cross the line from external auditor to internal extension of management, or 2) be in a position to essentially audit his or her own work.

GAGAS specifically identify certain "routine activities" that directly relate to an audit and are not considered non-audit services. These activities typically require an insignificant investment of time and do not result in a formal work product.<sup>3</sup> They include providing advice on accounting or routine business matters, providing training, or sharing best practices information. Similarly, GAGAS specifically identify certain non-audit services that are expressly forbidden (i.e., the threat to independence is simply too great to be overcome through the use of safeguards). However, in most cases, the auditor must apply professional



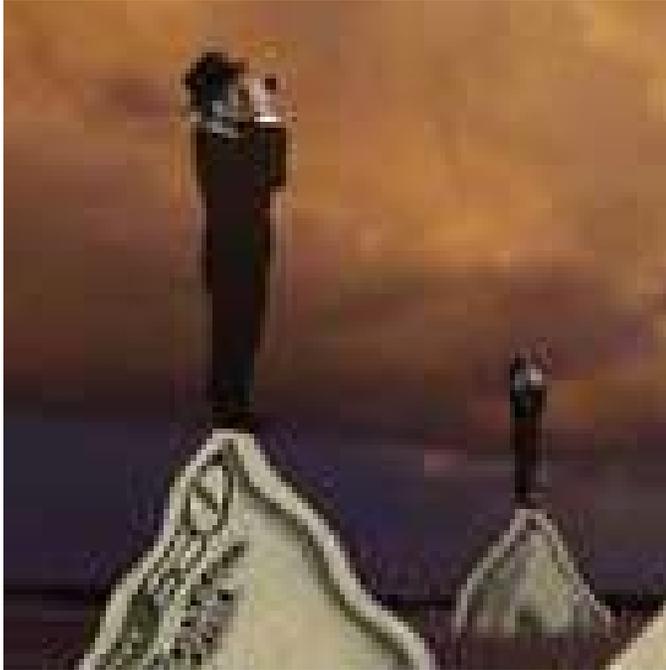
judgment and use the conceptual framework to evaluate whether the threat posed by a non-audit service can be eliminated or reduced to an acceptable level. A critical factor in this evaluation is management's ability to oversee the non-audit service to be performed.

## IT ALL COMES DOWN TO SKE

Auditors are charged with determining whether management has designated an individual who possesses suitable skills, knowledge, or experience (SKE), and that the individual understands the non-audit services to be performed sufficiently to oversee them.<sup>4</sup> An important distinction here is that this individual is *not* required to possess the expertise to perform or re-perform the services, so long as he or she can effectively oversee them.

The concept of SKE can be confusing, as it bears a striking resemblance to the wording from Statement on Auditing Standards (SAS) No. 115, *Communicating Internal Control Related Matters Identified in an Audit*. SAS Statement

The new conceptual framework laid out in the Yellow Book is essentially a risk-based approach to independence.



No. 115 requires auditors to report as a “material weakness in internal control over financial reporting” any condition that results in at least a “reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis.”<sup>5</sup> This would include a situation in which employees or management lack the qualifications and training to fulfill their assigned functions, such as when the person responsible for the accounting and reporting function “lacks the skills and knowledge to apply GAAP in recording the entity’s financial transactions or preparing its financial statements.”<sup>6</sup>

At what point, then, does using the external auditor to assist with non-audit services represent acceptable practice? When does it represent a control deficiency, and when does it threaten (and ultimately impair) independence? As stated previously, there is a significant element of professional judgment to be applied here, but the following guidance may be helpful.

First, determine *why* the auditor is performing the non-audit service. Is it because management is incapable of doing so, or because management has determined that it is more cost-effective to outsource the task, even

Evaluating the significance of a threat to independence is a matter of professional judgment.

though it is fully capable of doing it in-house? Sometimes, management asks the external auditors to complete a non-audit service because of time or staffing constraints, or because the audit organization is equipped to perform the service more efficiently than the government is. In this case, there is likely neither a control deficiency nor an insurmountable threat to independence. As long as management possesses the requisite SKE and is willing to carefully review and accept responsibility for the work of the independent auditors, there should be no significant problem.

If management is incapable of performing the non-audit service without outside assistance, however, a different consideration is required. Assuming the non-audit service is essential to the government’s compliance with GAAP (e.g., drafting the financial statements and related footnotes, or determining a material account balance), then some form of control deficiency (either a material weakness or a significant deficiency) likely exists. Governments are responsible for developing *internal controls* over financial reporting. When an independent *external* auditor is engaged to assist in this process, the auditor cannot, by definition, be considered part of the government’s *internal controls*.

Finally, the auditor needs to determine whether management possesses sufficient SKE to take responsibility for the non-audit service, even if management lacked the expertise to perform the service in the first place. If management has skills, knowledge, or experience sufficient to oversee the service, and accepts responsibility for the results, then the auditor’s independence is not impaired. If, however, the auditor believes that management lacks the requisite SKE, then the auditor would no longer be independent and would have to resign from the audit engagement.

To apply this concept in a different context, someone might be “reasonably handy” around the house for basic repair and maintenance jobs. This person is able to handle most common power tools, fix children’s toys, and even tackle minor electrical projects, but for whatever reason, she has had consistently miserable luck when attempt-

ing anything plumbing-related. If she so much as holds a pipe wrench within a foot of a sink, water begins spraying everywhere. When it is time to replace the garbage disposal, then, this person would hire a professional plumber to remove the old unit and install the new one she had picked out. She could explain which water shut-off valves needed to be closed for the project, which connectors and pipes needed to attach where, and, generally, how everything should look when the project was complete, but she wouldn't feel comfortable doing the service herself and would therefore outsource it. When the plumber finished, she would inspect his work, turn on the water, and test the garbage disposal. If everything looked and worked as expected and nothing was leaking, she would accept the plumber's work. This person would have the SKE to oversee this service, even if she lacked the expertise to perform it herself.

In all cases regarding non-audit services, it is essential that the auditor and government document their understanding of the services to be performed, acknowledge management's responsibility to oversee and accept responsibility for the non-audit services, and identify someone with appropriate SKE to serve in that role.

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## COMMON NON-AUDIT SERVICES

Even with the shift away from a rules-based list to a conceptual framework, the Yellow Book still contains guidance on several specific non-audit services. Here are a few of the services most commonly encountered in practice:

■ **Financial Statement Preparation, Including Cash to Accrual Adjustments.** Even though it might be tempting to categorize this as a "routine activity," GAGAS identify it as a non-audit service subject to the conceptual framework. In general, so long as management has the SKE to oversee the auditor's work and take responsibility for the financial statements, this should be acceptable.

■ **Accounting Records Preparation.** Auditors can propose adjustments but not post them on management's behalf. There is a fine line between proposing a few routine adjustments and essentially maintaining a government's books and records, which is a management function. Professional judgment is essential in making this determination.

■ **Internal Audit Services.** By definition, internal audit services are a part of internal controls, and therefore always prohibited. Even when structured as an assurance service (such as an agreed-upon procedures engagement), if the work is considered integral to a government's internal control, then it impairs an auditor's independence.

■ **Information Technology (IT) Services.** Designing or implementing an IT system used to house accounting records will impair an auditor's independence for as long as the system is in place.

■ **Valuation Services.** If the valuation is material to the subject matter of the audit, the auditor's independence would be impaired.

■ **Investment Services.** Having custody of a government's assets or making buy-sell decisions on its behalf would impair independence.

## CONCLUSIONS

As with any change in professional standards, the auditing profession will likely need a little time to adjust to the new guidance and to develop some uniformity in practice. In some respects, the GAO's new conceptual framework for independence is not so different from the previous approach. However, the concept of SKE might cause some auditors to determine that non-audit services previously performed under GAGAS will no longer be acceptable. In those cases, it will likely be necessary to involve other outside assistance (e.g., another CPA firm or suitable expert) to perform the non-audit services, which could lead to increased

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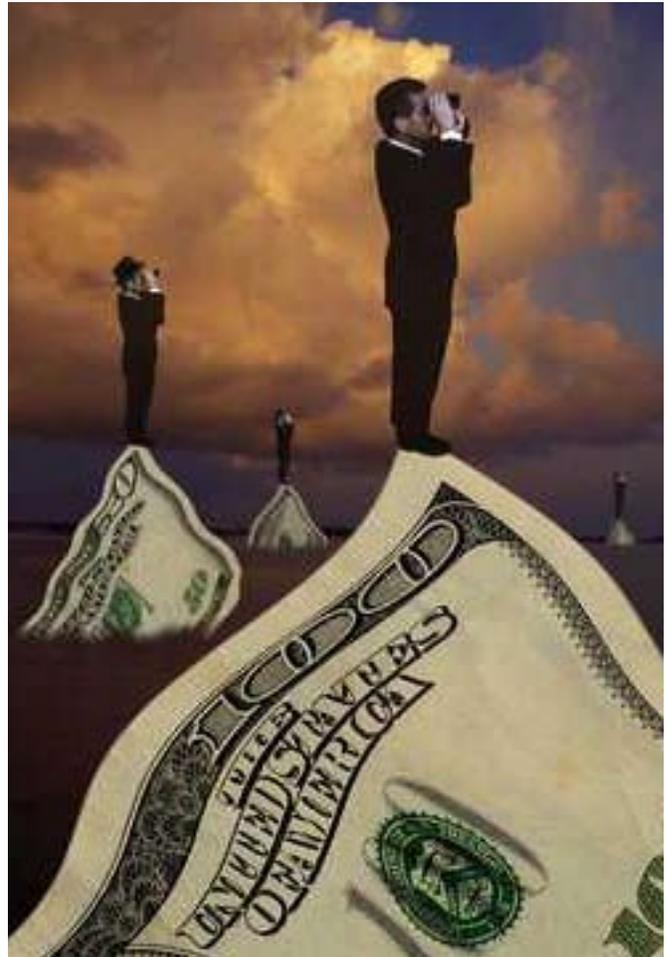
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#### Notes

1. *Government Auditing Standards*, paragraph 3.02.
2. *Government Auditing Standards*, paragraph 3.03.
3. *Government Auditing Standards*, paragraph 3.40.
4. *Government Auditing Standards*, paragraph 3.34.
5. Statement on Auditing Standards No. 115, paragraph 6.
6. Statement on Auditing Standards No. 115, Exhibit B.

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