Auditor Independence in the Public Sector

BY STEPHEN W. BLANN

State and local governments serve a variety of stakeholders. Some of these (such as creditors and regulatory agencies) are very similar to the kinds of stakeholders found in the private sector, while others (such as citizens and their elected representatives) are unique to the public sector. To meet the diverse needs of these stakeholders, governments produce and disseminate general purpose financial statements. However, by themselves, such financial statements might not prove as useful to their intended audiences as could be hoped. Questions regarding the reliability and accuracy of the information could make potential users of the financial statements hesitant to base important decisions on data that might be misstated (either intentionally or otherwise). To address those concerns, governments need an objective third party to lend credibility to their financial reporting process, through an unbiased examination of the financial statements and underlying accounting information. The independent auditor serves that role.

UNDERSTANDING GOVERNMENTAL ACCOUNTABILITY

> The very nature of state and local governments demands public accountability.

The very nature of state and local governments demands public accountability. The unique elements of the governmental environment — from the power to tax, to the restrictions on the uses of funding sources, to the role of the annual budget as a legal appropriation of public funds — all point to the need for governments to provide the public with detailed information that meets the principles of transparency and accountability. This concept has long been recognized by authoritative accounting standards, which have emphasized that "financial reporting helps fulfill government's duty to be publicly accountable,"[1] and "the independent audit of state and local government financial statements is considered an essential element of financial control and accountability."[2]

If transparency and accountability begin with financial reporting, then financial reporting begins with internal control. In its landmark report, Internal Control — *Integrated Framework*, the Committee of Sponsoring Organizations (COSO) identifies several parties with responsibility for internal control, including management, the board of directors (those charged with governance), internal auditors, and other personnel in an organization. However, the COSO report notes that while external auditors can contribute to achieving an entity's objectives, they are not actually part of an entity's internal control. Instead, external auditors bring an "independent and objective view" that provides information "useful to management and the board in carrying out their responsibilities."[3] The role of independent auditors, then, is to assist state and local governments in demonstrating their accountability, but not to be a part of the internal control structure itself.

DEFINING INDEPENDENCE

Like so many terms in the accounting world, "independence" means different things to different people. To some, it is simply an acknowledgement that someone is not under the control or influence of another party. To others, the concept of independence means being objective and free from bias or prejudice. In the context of financial statement audits, however, independence is governed by authoritative standard setters.

All financial statement audits of state and local governments are subject to generally accepted auditing standards (GAAS). These standards are promulgated by the American Institute of Certified Public Accountants (AICPA) through its Auditing Standards Board. The general standard for auditor independence is fairly simple, but it can prove somewhat complicated to put in practice: "The auditor must maintain independence in mental attitude in all matters relating to the audit."[4] These standards go on to describe that an auditor's independence requires impartiality for his findings to be dependable.

However, it is not enough to simply be independent. For the objective of an audit to be met, the auditor must also be *recognized* as independent. Since the independent audit is intended to provide users of financial statements with a degree of confidence in the reliability of the information being reported, it would be of little value for an organization to hire an auditor who is distrusted because of a perceived lack of independence. Accordingly, authoritative standards require that auditors not only be independent in fact, but that they avoid situations that might lead outsiders to doubt their independence.[5]

Auditor independence can be impaired by any number of factors, ranging from individual or organizational relationships to the types of ancillary (nonaudit) services provided to a client. The AICPA has developed a comprehensive set of rules (professional ethics) for auditors to follow in establishing and maintaining their independence.

"GOVERNMENT" AUDITING STANDARDS

The AICPA is not the only standards setter in the area of auditing rules, however. The Government Accountability Office (GAO) also issues a comprehensive set of standards for auditors to follow, titled *Government Auditing Standards*. Also referred to as generally accepted government auditing standards (GAGAS), or the "Yellow Book," *Government Auditing Standards* builds on the foundation of GAAS laid down by the AICPA and adds additional ethical principles and independence standards beyond those provided by the AICPA for performing financial audits.

Despite their name, however, generally accepted government auditing standards are not followed by all governments, nor is their application limited to governmental units. In fact, GAGAS may be followed by governments, non-profits, and even for-profit entities in certain contexts. Generally, organizations are required to follow GAGAS due to one of the following conditions:

- They are subject to a single audit conducted in accordance with OMB Circular A-133 (for expending at least $500,000 of federal awards in a single year)
- They are required to follow GAGAS by the terms of a contract or grant agreement
- They are required to follow GAGAS by state law or regulation.

Accordingly, many smaller governments are not required to follow GAGAS, or the more stringent rules for auditor independence they contain. (In these cases, the Government Finance Officers Association recommends that governments still voluntarily hold their auditors to the independence standards of GAGAS.[6])

> The role of independent auditors is to assist state and local governments in demonstrating their accountability, but not to be a part of the internal control structure itself.

GAGAS approach potential impairments to auditor independence from three distinct perspectives: personal, external, and organizational impairments.

Personal impairments result from relationships or beliefs that might cause an auditor to limit, weaken, or slant audit findings in any way. Close family members in key management positions, significant financial interests (whether direct or indirect), or responsibility for management functions could all represent personal impairments to an auditor's independence, as could preconceived ideas and biases towards individuals, groups, or organizations.

External impairments to independence arise when auditors are deterred from acting objectively and exercising professional skepticism by management or employees of the audited organization. External interference with an audit, including unreasonable restrictions on access to information or the ability to override or influence auditor judgment, would constitute an external impairment.

Organizational impairments arise from the relationship between an audit organization and the entity being audited, either through the legal structure of the audit organization (e.g., a state audit organization that is administratively subject to an agency it is supposed to audit) or through the provision of non-audit services that might blur the line between independent external auditors and management.

NON-AUDIT SERVICES

Both GAAS and GAGAS place limitations on the types of non-audit services an audit organization can perform while still maintaining its independence. Historically, the AICPA has taken a slightly more permissive stance on these services than the GAO, which holds auditors to a higher standard of independence. GAGAS provides two overarching principles for auditor independence:

- Audit organizations must not provide non-audit services that involve performing management functions or making management decisions.
- Audit organizations must not audit their own work or provide non-audit services in situations in which the non-audit services are significant or material to the subject matter of the audits.[7]

Any non-audit service that violates either of these overarching principles would impair an auditor's independence and disqualify him or her from performing an audit in accordance with GAGAS. Non-audit services can generally be divided into three broad categories:

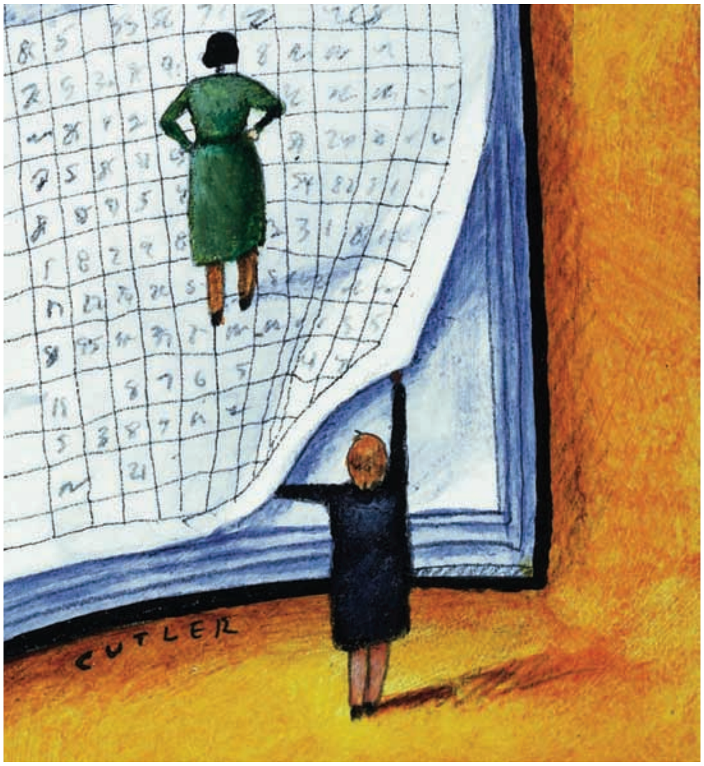
- Non-audit services that do not impair the audit organization's independence.
- Non-audit services that would not impair the audit organization's independence so long as the audit organization complies with certain supplemental safeguards.
- Non-audit services that always impair the audit organization's independence.

Non-audit services that do not impair an audit organization's independence are generally limited to providing routine technical advice, or operating in a strictly advisory capacity. Conversely, the types of non-audit services that will always impair an audit organization's independence generally involve auditors performing management functions or auditing their own work (i.e., violating the two overarching principles). Examples include maintaining a client's basic accounting records, making management decisions, or serving as a voting member of the governing body.

In between these two extremes lies a wide array of non-audit services that are permitted, so long as the two overarching principles are met, and certain supplemental safeguards are put in place. These safeguards include:

- Documenting the auditor's consideration of the non-audit services.
- Establishing a written understanding with the client regarding management's responsibility for the subject matter of the non-audit service and any decision making.
- Precluding personnel who provide significant non-audit services from planning, conducting, or reviewing the related audit procedures.
- Not reducing the scope or extent of audit procedures below the level that would be appropriate had the non-audit service been performed by an unrelated party.[8]

GAGAS emphasize the need for auditors to apply professional judgment in assessing their independence with respect to non-audit services.[9] While these supplemental safeguards can provide auditors with a fair amount of latitude, auditors are reminded that their primary duty is to serve the public interest and honor the public trust.

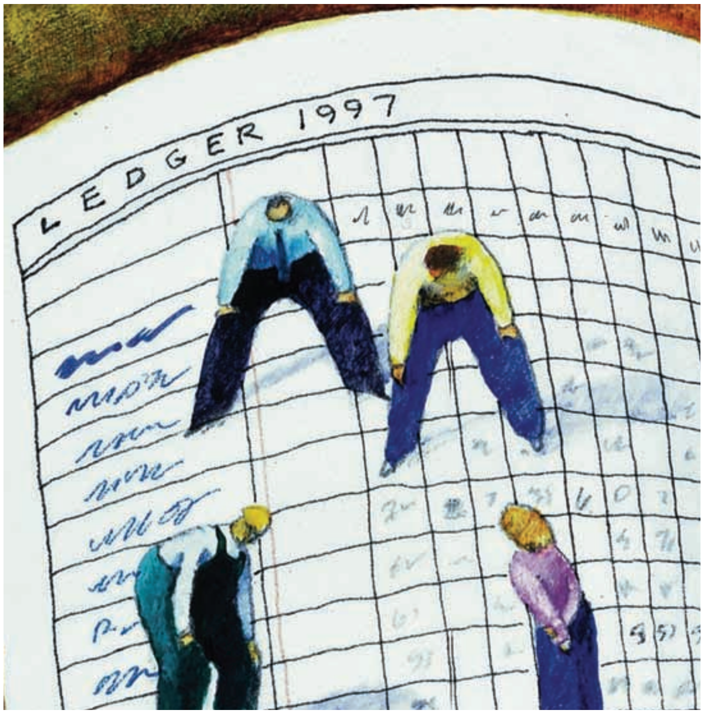


ENHANCING AUDITOR INDEPENDENCE

As stated previously, auditor independence is as much an issue of appearance as one of fact. Accordingly, there are several simple steps governments can take to improve the perceived independence of their external audits.

Establish an Audit Committee. Auditors work *with* management, but they work *for* the board. Establishing a direct link between the auditors and the governing board is one way to enhance both the real and perceived independence of the auditors. An effective audit committee provides a forum separate from management in which auditors and other interested parties can candidly discuss concerns, and it provides independent review and oversight of a government's financial reporting processes, internal controls, and independent auditors.[10]

Periodically Bid Out the Audit. Ideally, auditor independence would be enhanced by a policy requiring that the independent auditor be replaced at the end of the audit contract, as is often the case in the private sector (either by changing firms or rotating engagement personnel). Unfortunately, the frequent lack of competition among audit firms fully qualified to perform public-sector audits could make a policy of mandatory auditor rotation counterproductive. In such cases, it is recommended



that a governmental entity actively seek the participation of all qualified firms, including the current auditors, assuming that the past performance of the current auditors has proven satisfactory. [11]

Don't Use the Audit as a Bookkeeping Service. Sometimes, governments rely inappropriately on the annual external audit as the primary mechanism for getting their books properly stated in accordance with generally accepting accounting principles (GAAP). Rather than taking responsibility for their internal accounting records, these governments instead view the process of closing the books as the auditor's responsibility. While auditors can certainly provide assistance in the preparation of a government's external financial statements, a government's internal controls should be sufficient to maintain its books and records accurately throughout the year, without auditor assistance — especially since financial data is used by the governing board year round, not just at year's end. The GFOA recommends that governments establish and document a system of financial reporting that is sufficient to provide reasonable assurance that management is able to prepare financial statements in conformity with GAAP, both to enhance auditor independence and to minimize the likelihood of control deficiencies being reported in connection with the annual audit. [12]

Auditors work *with* management, but they work *for* the board. Establishing a direct link between the auditors and the governing board is one way to enhance both the real and perceived independence of the auditors.

CONCLUSION

Auditor independence can be a complex and occasionally murky issue. At its core, however, having an independent external audit is a key element in governments, demonstrating their accountability to the public and upholding the public trust. By maintaining their status as objective outsiders, auditors lend a degree of credibility to the work of government finance managers that would otherwise be difficult to obtain. Together, governments and their independent auditors can do what neither can accomplish alone — assure the public that the financial information provided by their government is both accurate and reliable.

Notes

1. GASB Concepts Statement 1, paragraph 3.
2. NCGAS 1, paragraph 168.
3. COSO *Internal Control — Integrated Framework*, 2002.
4. AICPA *Codification of Statement on Auditing Standards*, Section 220.01.
5. AICPA *Codification of Statement on Auditing Standards*, Section 220.03.
6. GFOA Best Practice, *Audit Procurement* (2002).
7. *Government Auditing Standards*, paragraph 3.22 (Washington, D.C.: Government Accountability Office, 2007).
8. *Government Auditing Standards*, paragraph 3.30.
9. The GAO has developed a comprehensive Q&A guide related to independence issues for auditors, which is available at http://www.gao.gov/govaud/ybk01.htm. While the GAO has announced that the 2007 edition of the Yellow Book will be updated in 2010/2011 with a more principles-based approach to auditor independence that will eliminate this specific guidance, the new principles are expected to be consistent with the spirit of the current rules.
10. GFOA Best Practice, *Audit Committees* (2008).
11. GFOA Best Practice, *Audit Procurement* (2002).
12. GFOA Best Practice, *Mitigating the Negative Effects of Statement on Auditing Standards No. 112* (2007).

STEPHEN W. BLANN, CPA, CGFM, is a principal with Rehmann, a regional CPA firm specializing in governmental and non-profit auditing. Mr. Blann is the firm's director of governmental audit quality and an advisor to the GFOA's Committee on Accounting, Auditing, and Financial Reporting. He can be contacted at stephen.blann@rehmann.com.