

GAO PROPOSES A CONCEPTUAL APPROACH TO INDEPENDENCE

INTRODUCTION

The Government Accountability Office (GAO) has proposed a new “conceptual” approach for evaluating independence in its revisions to the “generally accepted” *Government Auditing Standards* (also known as “GAGAS” or the “Yellow Book”). The framework embodies the approach used by the American Institute of CPAs (AICPA) and the International Federation of Accountants (IFAC) and emerged, in part, from discussions between the GAO staff and an advisory council appointed by the Acting US Comptroller General. The GAO staff, who assist auditors performing work under the Yellow Book with independence inquiries, have found the *Conceptual Framework for AICPA Independence Standards* a helpful tool for evaluating independence when specific guidance does not exist, also supported this move.

About the Author & Publisher

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When final, the 2011 Yellow Book will supersede the 2007 version and the independence guidance entitled, *Government Auditing Standards: Answers to Independence Standard Questions (GAO-02-870G)*, a series of frequently-asked-questions and answers (FAQs) on the independence implications of performing nonattest services.

This article highlights the proposed Yellow Book independence rules, focusing primarily on the rules applicable to CPAs in public practice.

What is the Conceptual Framework and When and How Should Auditors Apply it?

As proposed, the conceptual framework provides a means for auditors to assess their independence in light of unique circumstances that are not expressly prohibited by the rules. Like the AICPA’s Framework, auditors should first determine whether the rules address their situation. If not, they should apply the framework. Auditors

may need to evaluate independence *at any time* but generally will be required to do so when their firms undertake a new audit or nonaudit service, a new auditor is assigned to an engagement, or another issue surfaces while an engagement is in process.

In applying the conceptual framework, the auditor should:

- Identify threats to independence,
- Evaluate the significance of those threats, and
- Apply safeguards, as needed, to eliminate the threats or reduce them to an acceptable level.

“Auditor” is any individual who performs work (i.e., financial statement audits, attestation engagements, and performance audits) under the Yellow Book, regardless of their job title, and includes those in public practice and government.

“Acceptable level” means that threats no longer compromise an auditor’s independence.

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IN THIS TEMPLE
AS IN THE HEARTS OF THE PEOPLE
FOR WHOM HE SAVED THE UNION
THE MEMORY OF ABRAHAM LINCOLN
IS ENSHRINED FOREVER



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What Do the Proposed Changes Mean for Auditors and Others Working in Public Accounting Firms?

The proposed standards are very good news for auditors and others in firms performing audit and attest work because they are more closely aligned to the AICPA independence rules than the 2007 Yellow Book. In fact, AICPA members performing work under the Yellow Book and the AICPA *Code of Professional Conduct* (AICPA Code) will find very few differences. The standards are also simpler and more concise than before. Of course, less explicit guidance means auditors will apply more judgment when they encounter situations not prohibited by the rules. Paragraph 3.58 notes the importance of professional judgment in assessing threats to independence and the safeguards that might mitigate those threats. The proposal stresses the importance of independence in appearance (defined in para. 3.03), which is particularly important when the auditor applies the framework. According to James Dalkin, Director of Financial Management and Assurance at the GAO, "Auditors may believe that certain nonaudit services do not impair their independence, and taken service-by-service, that may be true. However, *in the aggregate*, the appearance of independence may be troubling and auditors should consider this in their analyses."

Despite the addition of a new conceptual framework for evaluating independence, proposed changes to

the Yellow Book independence standards are generally more form than substance; that is, an auditor should come to the same answer under the new standards as under the old ones. The process for getting to the answer may change and the rules may be less prescriptive than before, but the results should be similar.

Readers are encouraged to review and comment on the proposed Yellow Book provisions (comments are due November 22, 2010). The links below provide additional information.



INFORMATION

- 2010 Exposure Draft: <http://www.gao.gov/new.items/d10853g.pdf>
- GAO Exposure Draft, email: yellowbook@gao.gov
- General Updates (Yellow Book page): <http://www.gao.gov/govaud/ybk01.htm>
- AICPA Comparison between Proposed GAO Independence Rules and the AICPA and IFAC Rules:
www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/2010SeptemberComparisonofProposedGAOIndependenceStandardstoAICPAandIFAC.doc

Specific Elements of the Proposed Independence Rules

According to the proposal, an auditor's consideration of independence consists of four interrelated elements:

1. The conceptual framework
2. Guidance for auditors considering independence issues related to audit organizations that are structurally located within the governments they audit
3. Requirements for performing nonaudit services

4. Documentation guidance

Items 1, 3, and 4 apply to auditors in public practice, while all four apply to auditors working in government.

The following table briefly summarizes the major independence provisions in the GAO's proposal and the author's commentary on what they mean for auditors (if adopted):

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PROPOSED INDEPENDENCE PROVISIONS	COMMENTS
I. Conceptual Framework	
<ul style="list-style-type: none"> Auditors should apply the conceptual framework at the audit organization, engagement, and individual auditor level (3.07). Auditors should exercise professional judgment to identify threats, assess the significance of threats, and apply safeguards, as needed. 	<p><i>A thorough understanding of when to use the framework and how will be critical. Firms and government agencies should train personnel on use of the framework, i.e. the definition of independence, threats, and safeguards, and work through examples. All personnel subject to Yellow Book independence requirements will need to gain a familiarity with these concepts and their practical application.</i></p>
<p>Threats. Threats are circumstances that could—but do not automatically—impair independence. Threats described in the framework are:</p> <ol style="list-style-type: none"> Self-interest Self-review Familiarity Undue influence Management participation Bias (political, social, etc.) Structural 	<p><i>A list (A3.02–A3.09) illustrates the types of circumstances that may cause threats to independence. The proposal stresses that unique situations can create threats, thus, the list is not all-inclusive.</i></p>
<p>Safeguards. Safeguards are controls designed to eliminate or reduce threats to independence to an acceptable level. Safeguards may:</p> <ol style="list-style-type: none"> Exist in the work environment (e.g., the CPA firm or government agency) and include such things as: policies and procedures and the use of separate personnel to perform audit and nonaudit services, etc.). Be created by the profession, legislation, or regulation. These safeguards augment those that exist in the work environment. <p>Safeguards may also exist within the audited entity; however the auditor may not rely solely on these types of safeguards.</p>	<p><i>Like threats, the list of sample safeguards is not all-inclusive. It's important to note that auditors do not need to abolish all threats to independence – threats do however need to be reduced to an “acceptable level,” meaning the threat cannot compromise the auditor’s objectivity, integrity, and professional skepticism in performing attest services.</i></p> <p><i>The Yellow Book proposes safeguards that are similar to those in the AICPA’s conceptual framework, except that the AICPA does not explicitly preclude the auditor from applying safeguards that exist only within the audited entity. Nevertheless, the AICPA framework does state that client-related safeguards “operate in combination with other safeguards,” which implies a similar application.</i></p>
II. Independence within a Governmental Structure (Government Auditors)	
<ul style="list-style-type: none"> Government employees whose employers exist within the audited entity should consider the guidelines provided in paras. 3.27 – 3.30. Factors to consider include constitutional or statutory safeguards that may sufficiently mitigate threats to independence and the level and branches of government involved. 	<p><i>This portion of the rules, which applies to government auditors, does not exist in the AICPA Code and provides numerous factors for auditors to consider in evaluating their independence. As always, if auditors encounter situations not addressed in the rules, they should apply the conceptual framework.</i></p>

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PROPOSED INDEPENDENCE PROVISIONS	COMMENTS
III. Nonaudit Services	
<p>The auditor should determine whether providing a nonaudit service to an audited entity would create a threat to independence before accepting the engagement. The general requirements (paras. 3.34 – 3.42) emphasize three things: (i) the auditor should avoid performing management responsibilities (i.e., because no safeguards can reduce the threat to an acceptable level in these cases), (ii) the auditor should ensure that the entity will perform all management responsibilities via their designee who has suitable skills, knowledge, and experience to do so, and (iii) the auditor should establish and document the understanding with the entity, especially the delineation of duties as per (i) and (ii) above.</p> <p>Six types of services that may create threats to independence are discussed:</p> <ol style="list-style-type: none"> 1. Bookkeeping/preparing accounting records 2. Preparing financial statements 3. Internal audit services 4. Internal control monitoring and assessments 5. IT systems services 6. Valuation services <p>The proposal describes aspects of each service that are prohibited because they create insurmountable threats to independence. For services not specifically prohibited, auditors should use the conceptual framework to assess independence.</p>	<p><i>These requirements mirror the AICPA's Interpretation 101-3 (Performance of Nonattest Services). Key to establishing the understanding with the audited entity, the auditor must determine whether the person who will oversee the nonaudit services is sufficiently knowledgeable to serve in that role, which will help to ensure that the auditor will not assume management responsibilities.</i></p> <p><i>The AICPA rules contain similar proscriptions on the six services in the GAO proposal. However, AICPA rules also describe certain permissible nonattest services; the GAO proposal does not.</i></p>
IV. Documentation	
<ul style="list-style-type: none"> • Documentation is required in all cases where an auditor evaluates their independence using the framework. • The auditor should document: <ul style="list-style-type: none"> - The conclusion reached, and - The substance of any discussions that support that conclusion. 	<p><i>Documentation requirements are more comprehensive under the proposed standards than in the 2007 Yellow Book. If adopted, auditors and their firms should implement policies and procedures that ensure matters are documented whenever the auditor applied the framework and:</i></p> <ul style="list-style-type: none"> • <i>Determined that the application of safeguards was unnecessary, or</i> • <i>Determined that safeguards sufficiently mitigated threats to independence, or</i> • <i>Determined that safeguards did not sufficiently mitigate threats to independence. (Note: This may occur when a government auditor is required by law to conduct an audit, in which case the auditor should also disclose the nature of the threat(s) that cannot be eliminated or reduced to an acceptable level and modify the GAGAS compliance statement accordingly.)</i>
<p>Effective Date: To be determined when the standards are issued in final form.</p>	