

Yellow Book /
Independence

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HUD / Single Audit

**Generally Accepted Government
Auditing Standards**

Generally Accepted Auditing Standards

- All audit work must be independent and remain objective and impartial.
- Except under limited circumstances, auditors should be independent from an audited entity during:
 - ◆ Any period of time covered by the financial statements or subject matter of the engagement
 - ◆ Period of professional engagement
- Independence is comprised of:
 - ◆ Independence of Mind
 - ◆ Independence of Appearance





- GAGAS's consideration of independence consists of 4 related sections, providing
 - ◆ A conceptual framework for making determinations unique to specific environments; requirements
 - ◆ Guidance on independence for organizations structurally located within the entities; requirements
 - ◆ Guidance on independence for auditors providing non-audit services; and requirements
 - ◆ Guidance on documentation necessary to support adequate consideration of independence

- GAGAS's conceptual framework helps auditors identify, evaluate, and apply safeguards to address threats to independence.
- Auditors should reevaluate threats to independence, including safeguards, whenever new information rises or changes.
- If the work of specialists are used, their independence should be assessed.
- Auditors should conclude that independence is impaired if the safeguards are not effective.
- If impaired, auditors should decline engagement.



- At a minimum, auditors should identify, assess, and evaluate the following broad categories of threats to independence:
 - ◆ Self-interest threat
 - ◆ Self-review threat
 - ◆ Bias threat
 - ◆ Familiarity threat
 - ◆ Undue influence threat
 - ◆ Management participation threat
 - ◆ Structural threat (not applicable to CPA firms)



- Safeguards are controls designed to eliminate or reduce to an acceptable level threats to independence.
- Under the conceptual framework, the auditor applies safeguards that address the specific facts and circumstances under which threats to independence exist.
- The Yellow Book lists two safeguard categories:
 - ◆ Safeguards in the work environment
 - ◆ Safeguards created by the profession, legislation, or regulation



Examples of Circumstance Threats



Self –Interest Threats	Self-Review Threats	Bias Threats	Familiarity Threats
Audit organization having undue dependence on income from a particular audited entity.	Audit organization issuing a report on the effectiveness of the operation of the systems after design or implement.	Member of the engagement team having preconceptions about the objectives of a program under audit that are strong enough to affect the auditor’s objectivity.	Member of engagement team having a close/immediate family member who is a principal or senior manager of the audited entity.
Member of audit team entering employing negotiations with audited entity.	Audit organization having prepared data used to generate records that are the subject of the engagement.		Member of engagement team having close/immediate family who’s employed by the entity in a position of significant influence.
Significant error found when evaluating results of previous service provided by auditor’s audit organization.	Audit organization providing service or audited entity directly affecting the subject matter of the engagement.	Member of the engagement team having biases associated with political, ideological, or social convictions that result from membership or employment in, or loyalty to, a particular type of policy, group, entity, or level of government that could affect the auditor’s objectivity.	Principal/employee of audited entity recently served on the engagement team.
Member of the audit team has direct financial interest in the audited entity.	A member of the engagement team being/recently been, employed by audited entity in a position to significantly influence the subject matter of the engagement.		Auditor accepting gifts or preferential treatment from an audited entity.
			Senior audit personnel having a long association with the entity.

Examples of Circumstance Threats, continued



Undue Influence Threats	Management Participation Threats
Influence that could improperly limit/modify the scope of an engagement or threaten to do so, including pressure to reduce the extent of work performed to reduce costs/fees.	Member of the engagement team being, have been, a principal or senior manager of the audited entity.
External interference with selection/application of audit procedures or the selection of transactions examined.	Audit organization principal or employee serving as a voting member, making policy decisions affecting future direction of the program.
Unreasonable restrictions on time allotted to complete an engagement or issue the report.	Audit organization principal/employee recommending a single individual for a specific position key to the entity or program under audit.
External interference over assignment, appointment, compensation, and promotion of audit personnel.	Auditor preparing management's corrective action plan to deal with deficiencies detected in the engagement.
Restrictions on funds or resources provided to the audit organizations adversely affecting the ability to fulfill responsibilities.	Structural Threats
Authority to overrule/inappropriately influence auditors' judgment as to the appropriate content of the report.	External/internal auditor organizations, structural placement of the audit function within the reporting line of the areas under audit.
Threat of replacing the auditors over audit report disagreement, conclusions, or application of accounting principle or other criteria.	For internal audit organizations, administrative direction from the audited entity's management.
Influences that jeopardize the auditors' employment for reasons other than incompetence, misconduct, or the audited entity's need for GAGAS engagement.	

- A threat to independence is not an acceptable level if it either:
 - ◆ Could affect the auditors' ability to conduct an engagement without being affected by influences compromising judgment or
 - ◆ Could expose the auditors/audit organization to circumstances that would cause a third party to conclude the organization has been compromised.
- Auditors may place limited reliance on client safeguards but they should not rely solely on them to eliminate or reduce threats.



Requirements: Identifying Prohibited Non-audit Services

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- Before providing non-audit service to an audited entity, auditors should determine if the service provided is a threat to independence and if the entity has an individual that can assume the responsibilities.
- If the entity is unable/unwilling to assume these responsibilities, auditors should conclude that these services are an impairment to independence.
- Auditors should conclude that management responsibilities are impairments to independence.



Application: Identifying Prohibited Non-audit Services

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- Auditors, while having a range of nonaudit services consistent with their skills/expertise, may create threats to independence.
- Effectively overseeing the service provided is a critical component of determining independence.
- The individual responsible for overseeing the management is required to have sufficient expertise, however, the management is not required to possess a specific skill to re-perform the service





- Management responsibilities include:
 - ◆ Setting policies and strategic direction for the audited entity;
 - ◆ Directing and accepting responsibility for the actions of the audited entity's employees in the performance of their routine, recurring activities;
 - ◆ Having custody of an audited entity's assets;
 - ◆ Reporting to those charged with governance on behalf of management;
 - ◆ Deciding which of the audit organization's or outside third party's recommendations to implement;
 - ◆ Accepting responsibility for designing, implementing, or maintaining internal control;
 - ◆ Providing services intended for use as management's primary basis for making decisions significant to the engagement;
 - ◆ Developing an audited entity's performance measurement system when significant to the engagement; and
 - ◆ Serving as a voting member of an audited entity's management committee or board of directors



- Routine activities typically are insignificant in terms of time incurred or resources expended and generally do not result in a specific project/engagement or formal report.
- Routine activities include:
 - ◆ Providing advice to the audited entity on accounting matters
 - ◆ Providing advice on routine business matters
 - ◆ Educating the audited entity on matters within technical expertise
 - ◆ Providing information to the entity that is readily available to the auditors



- For recurring engagements, having another independent audit organization audit areas affected by the non audit service may provide a safeguard to mitigate a threat to independence.
- A non-audit service otherwise prohibited by GAGAS during the period covered by financial statements may not threaten auditors' independence provided that the following exist:
 - ◆ Non-audit service was provided before the period of professional engagement;
 - ◆ Non-audit service related only to period prior to the time covered by the financial statements; and
 - ◆ The financial statements for the period to which the non-audit service relates were audited by other auditors

Non-Audit Services, continued

Auditors providing services for entities conducting GAGAS engagements need assurance that the following functions are performed in connection with non-audit services:	In connection with non-audit services, auditors should establish & document their understanding of the management regarding:
Assumes all management responsibilities	Objectives of the non-audit service
Oversees services, designating an individual, with suitable experience	Services provided
Evaluate the adequacy and results of the services provided	Entity's acceptance of responsibilities
Accept responsibilities for the results of the services	Auditors' responsibilities
	Limitations on the provision of non-audit services



- Some non-audit services directly support an entity's operation, and may threaten the auditor's ability to maintain independence.
- Auditors may provide non-audit services without impairing independence: (1) services are not prohibited by GAGAS, (2) specific requirements are met, and (3) significant threats have been eliminated/reduced to an acceptable level.



Preparing Accounting Records and Financial Statements

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- The following services involving preparation of accounting records impair independence:
 - ◆ Determining or changing any records without approval; authorizing/approving the entities transactions; and preparing or making changes to source documents without approval
- Apart from those defined as impairments, related services create significant threats and should be documented to eliminate/reduce. These include:
 - ◆ Recording transactions or posting coded transactions; preparing financial statements based on trial balance; posting entries approved to the entity's trial balance; and **preparing account reconciliations that identify reconciling items for evaluation.**
- Management is responsible for the preparation and fair presentation of financial statements.
- Consequently, an auditor's acceptance of responsibility would impair the auditor's independence.





- The following internal audit assistance activities impair independence:
 - ◆ Setting internal audit policies/strategic direction of activities; performing procedures that form part of the internal control; and determining the scope of the internal audit function and resulting work.
- Providing/supervising ongoing monitoring procedures impairs independence because of the management participation threat is significant.
- Some non-audit services are provided by individuals not directly involved in the operation, making possible for the auditor to provide an objective analysis.



- IT services impair independence if they include:
 - ◆ Designing/developing an entity's financial information or IT system that will play a significant role in the management;
 - ◆ Making significant modifications to source code;
 - ◆ Supervising audited entity personnel in the daily operation; or
 - ◆ Operating an audited entity's network, financial information system, or other IT system
- IT services may aggregate data, form part of internal control, or generate information affecting the subject matter of the engagement.

- Auditors should conclude independence is impaired (if services involve significant subjectivity, or when combined with other services are material to the financial statements) if activities include:
 - ◆ Advisory service
 - ◆ Benefit plan administration
 - ◆ Business risk consulting
 - ◆ Executive or employee recruiting
 - ◆ Investment advisory or management



DOCUMENTATION





- While insufficient documentation does not impair independence, auditors should prepare appropriate documentation under GAGAS requirements. Independence standard includes:
 - ◆ Document threats to independence requiring safeguards;
 - ◆ Document specific safeguards if an audit organization is located within a government entity and considered independent of said safeguards;
 - ◆ Document consideration of management's ability to effectively oversee the service; and
 - ◆ Document the auditor's understanding with an audited entity for which the auditor provides non-audit service

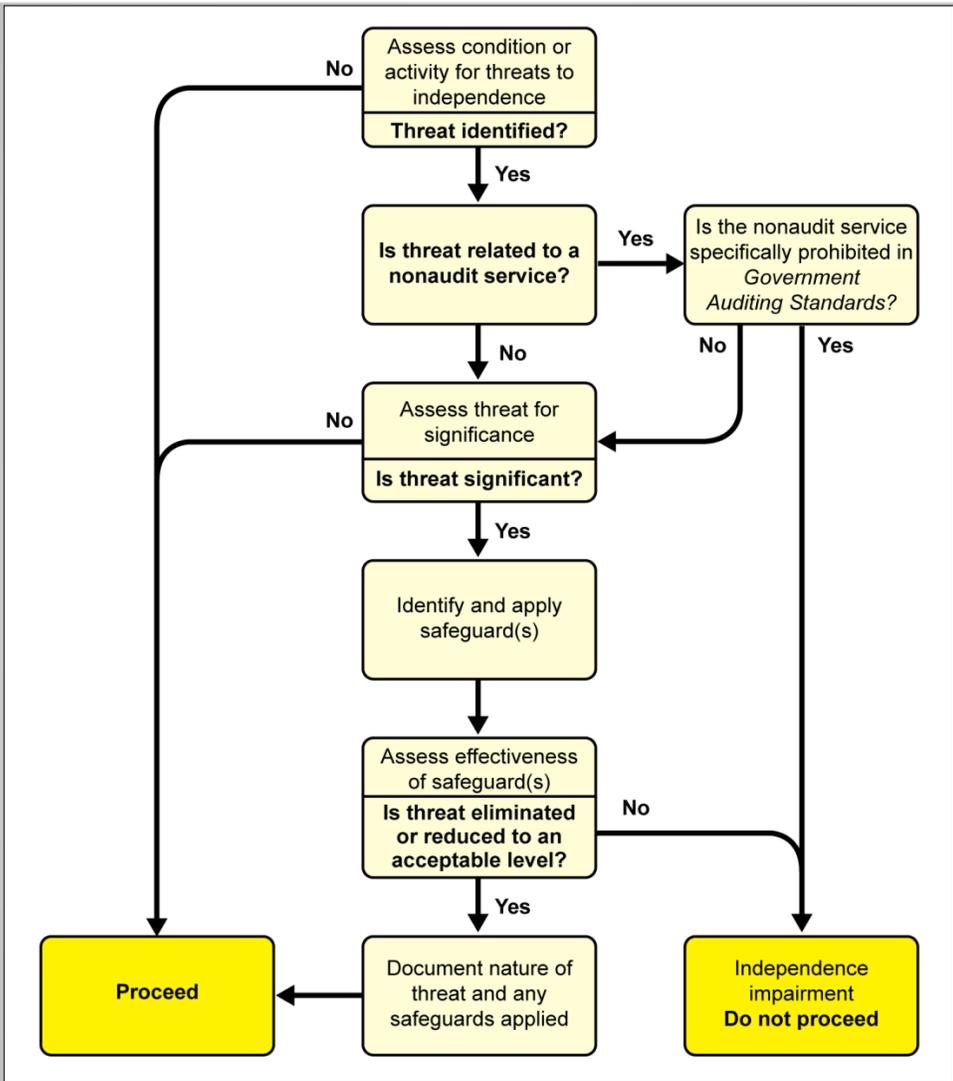
PROFESSIONAL JUDGEMENT





- Professional judgment includes exercising reasonable care and professional skepticism.
- Professional judgment represents the application of all involved individuals.
- Professional judgment is important in:
 - ◆ Carrying out all professional responsibilities
 - ◆ Applying the conceptual frame work to determine independence
 - ◆ Determining the necessary level of understanding of the subject matter and circumstances
- Professional judgment does not mean eliminating all limitations/weaknesses, but rather identifying, assessing, mitigating, and concluding on them.

GAGAS Conceptual Framework for Independence



Source: GAO.