# GAO Auditor Independence Standard
# Fact Sheet

**What is the GAO Auditor Independence Standard all about?**

The U.S. General Accounting Office issued a final audit standard on January 25, 2002 establishing significant changes to the auditor independence requirements under Government Auditing Standards (also known as the "Yellow Book."). It applies to all Yellow Book audits for periods beginning on or after October 1, 2002. GAO encourages early implementation. The new GAO Independence Standard is available on GAO's web site at http://www.gao.gov/govaud/ybk01.htm.

**Who is affected and how?**

The GAO Independence Standard establishes independence standards for CPAs, non-CPAs, government financial auditors, and performance auditors. It deals with a range of auditor independence issues, including restrictions on nonaudit services. It affects a significant number of audits, applying to auditors of federal, state and local governments as well as not-for-profit and for profit recipients of federal (and some state) grant and loan assistance (for example, colleges, universities, trade schools, hospitals, charitable organizations, cities, counties, school and utility districts, small businesses with SBA loans, HUD projects and lenders, public housing authorities, and many state-administered programs and contracts).

**What are the new standards?**

The GAO Independence Standard adopts an **engagement-team-focused approach** to independence for matters such as financial interests of an individual auditor, not unlike the AICPA's Code of Conduct. It also employs a **principles-based approach** to independence **supplemented with certain safeguards** for matters such as the performance of non-audit services.

The standard for nonaudit services employs two *overarching principles*:

1. *Audit organizations should not provide nonaudit services that involve performing management functions or making management decisions; and*

2. *Audit organizations should not audit their own work or provide nonaudit services in situations where the nonaudit services are significant/material*[1] *to the subject matter of the audits.*

Audit organizations may perform nonaudit services that do not violate the above principles only if all of the following *seven safeguards* are followed:

1. The audit organization should preclude personnel who provided the nonaudit services from planning, conducting, or reviewing audit work related to the nonaudit service.
2. The audit organization is precluded from reducing the scope and extent of the audit work beyond the level that would be appropriate if the nonaudit work was performed by another unrelated party.

[1] Government Auditing Standards discusses the auditor's consideration of materiality. Paragraphs 4.8 and 4.9 of *Government Auditing Standards* (1994 Revision) states the following: "Auditors' consideration of materiality is a matter of professional judgment and is influenced by their perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. In an audit of financial statements of a government entity or an entity that receives government assistance, auditors may set lower materiality levels than in audits in the private sector because of the public accountability of the auditee, the various legal and regulatory requirements, and the visibility and sensitivity of government programs." Further, the GAO discusses matters the auditor should consider " significant" in planning, performing, and reporting on performance audits in paragraphs 6.7and 6.8 of *Government Auditing Standards.*

3. The audit organization should document its consideration of the nonaudit service, and document its rationale that providing the nonaudit service does not violate the two overarching principles.
4. Before performing nonaudit services, the audit organization should establish and document an understanding with the audited entity regarding the objectives, scope of work, and product or deliverables of the nonaudit service. The audit organization should also establish and document an understanding with management that management is responsible for the substantive outcomes of the work.
5. The audit organization's quality control systems for compliance with independence requirements should include policies and procedures to assure consideration of the effect on the ongoing, planned, and future audits when deciding whether to provide nonaudit services and a requirement to have the understanding with management of the audited entity documented. The understanding should be communicated to management in writing. Documentation must specify management's responsibility for the nonaudit service, management's qualifications to conduct the required oversight, and that management's responsibilities were performed.
6. In cases where certain nonaudit services by their nature impair the audit organization's ability to meet either or both of the overarching principles for certain types of audit work, the audit organization should communicate to management of the audited entity, before performing the nonaudit service, that the audit organization would not be able to perform subsequent audit work related to the subject matter of the nonaudit service.
7. For audits selected in the peer review, all related nonaudit services should be identified to the audit organization's peer reviewer and the audit documentation made available for peer review.

**What non-audit services may be performed and which are expressly prohibited?**

The GAO Independence Standard *permits* auditors to participate on committees or task forces in a purely advisory capacity to advise entity management on issues related to the knowledge and skills of the auditors without impairing their independence. Auditors can also provide routine advice to the audited entity and management to assist them in activities such as establishing internal controls or implementing audit recommendations, can answer technical questions, and/or provide training. An auditor may also provide tools and methodologies, such as best practice guides, benchmarking studies, and internal control assessment methodologies that can be used by management. These are routine activities would not require the audit organization to apply the safeguards described above.

The GAO Independence Standard includes specific examples of non-audit services that are *permitted as long as the auditor complies with the two overarching principles and with the seven safeguards* (e.g., the service must be immaterial/insignificant to the subject matter of the audit and must be performed by a separate engagement team). The GAO Independence Standard also *expressly prohibits* certain nonaudit services. Such examples are summarized in the following table.

**Summary of nonaudit services permitted and prohibited under GAO Independence Standard**

| **Nonaudit Service** | **Permitted** ***(Provided the service meets the two overarching principles and the audit organization complies with the seven safeguards)*** | **Prohibited** |
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| Basic accounting assistance, including bookkeeping and record-keeping services | Providing basic accounting assistance limited to services such as:<br>• preparing draft financial statements that are based on management's chart of accounts and trial balance and any adjusting, correcting, and closing entries that have been approved by management;<br>• preparing draft notes to the financial | The audit organization *cannot:*<br>• maintain or prepare the audited entity's basic accounting records;<br>• take responsibility for basic financial or other records that the audit organization will audit;<br>• post transactions (whether coded or not coded) to the entity's |

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| | statements based on information determined and approved by management;<br>• preparing a trial balance based on management's chart of accounts;<br>• maintaining depreciation schedules for which management has determined the method of depreciation, rate of depreciation, and salvage value of the asset;<br>• proposing adjusting and correcting entries that are identified during the audit so long as management makes the decision on accepting these entries. | financial records or to other records that subsequently provide data to the entity's financial records. |
| Payroll services | Providing payroll services limited to services such as:<br>• computing pay amounts for the entity's employees based on entity maintained and approved time records, salaries or pay rates, and deductions from pay;<br>• generating unsigned payroll checks;<br>• transmitting client approved payroll to a financial institution provided management has approved the transmission and limited the financial institution to make payments only to previously approved individuals. | |
| Tax services | Preparing routine tax filings in accordance with federal tax laws and rules and regulations of the Internal Revenue Service and state and local tax authorities and any applicable laws. | |
| Human resource services | Providing human resource services to assist management in its evaluation of potential candidates that are limited to activities such as:<br>• serving on an evaluation panel to review applications;<br>• interviewing candidates to provide input to management in arriving at a listing of best qualified applicants to be provided to management. | The audit organization *cannot*<br>• recommend a single individual for a specific position;<br>• conduct an executive search or a recruiting program for the audited entity. |
| Information technology services | Providing information technology services limited to services such as:<br>• advising on system design, system installation, and system security if management acknowledges responsibility for the design, installation, and internal control over the entity's system and does not rely on the auditor's work as the primary basis for determining<br>(1) whether to implement a new system,<br>(2) the adequacy of the new system design,<br>(3) the adequacy of major design changes to an existing system, and<br>(4) the adequacy of the system to comply with regulatory or other requirements. | The audit organization *cannot* operate or supervise the operation of the entity's information technology system. |
| Appraisal or valuation services | Providing appraisal or valuation services limited to services such as:<br>• reviewing the work of the entity or a | |

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| | specialist employed by the entity where the entity or specialist provides the primary support for the balances recorded in financial statements or other information that will be audited;<br>• valuing an entity's pension, other post-employment benefit, or similar liabilities provided management has determined and taken responsibility for all significant assumptions and data. | |
| Indirect cost proposal or cost allocation plan | Preparing an entity's indirect cost proposal or cost allocation plan provided management has taken responsibility for all significant assumptions and data. | In accordance with Office of Management and Budget policy, auditors who prepare the entity's indirect cost proposal are prohibited from conducting the required audit when indirect costs recovered by the entity during the prior year exceeded $1 million |
| Legislative and administrative decision-making | Gathering and reporting unverified external or third-party data to aid legislative and administrative decision-making. | |
| Internal control self-assessments | Advising an entity regarding its performance of internal control self-assessments. | |
| Assisting legislative bodies | Assisting a legislative body by developing questions for use at a hearing | |