2-24-2003

Technical Bulletins: The New Governmental Auditor Independence Requirements: What Cities Need to Know

Dick Phebus
Municipal Technical Advisory Service

Follow this and additional works at: https://trace.tennessee.edu/utk_mtastech

Part of the Public Administration Commons

The MTAS publications provided on this website are archival documents intended for informational purposes only and should not be considered as authoritative. The content contained in these publications may be outdated, and the laws referenced therein may have changed or may not be applicable to your city or circumstances.

For current information, please visit the MTAS website at: mtas.tennessee.edu.

Recommended Citation


This Bulletin is brought to you for free and open access by the Municipal Technical Advisory Service (MTAS) at Trace: Tennessee Research and Creative Exchange. It has been accepted for inclusion in MTAS Publications: Technical Bulletins by an authorized administrator of Trace: Tennessee Research and Creative Exchange. For more information, please contact trace@utk.edu.
THE NEW GOVERNMENTAL AUDITOR INDEPENDENCE REQUIREMENTS: WHAT CITIES NEED TO KNOW

By Dick Phebus
Finance and Accounting Consultant

What do January 25, 2002, and your municipality’s external auditor have in common? Don’t know? Well, what you don’t know may impact the relationship you now enjoy with the audit firm you’ve engaged to prepare your financial statement audit. The impact you see may vary in relation to the size and expertise of the city’s accounting and finance office staff as well as the size and experience of the audit firm’s staff conducting the audit.

Introduction of the New Independence Standard

On January 25, 2002, David M. Walker, Comptroller General of the United States and head of the U.S. General Accounting Office (GAO), announced significant changes to the auditor independence requirements in Government Auditing Standards. These standards, first published in 1972 and commonly referred to as “Yellow Book” auditing standards, apply to the audits of federal agencies and local governments that receive federal funds. Many states, including Tennessee, have adopted these standards as guidance for auditors who conduct audits of a governmental entity.

Why This Impacts Municipalities

As noted above, Tennessee has adopted the “Yellow Book” as guidance for auditors in conducting audits of local governments. Every municipality is required to have an audit performed annually by an independent auditor. Prior to commencing the audit, a Contract to Audit Accounts must be filed with the State of Tennessee, Comptroller of the Treasury, Division of Municipal Audit. Section 2 of the contract reads, in part, “The auditor shall conduct the audit in accordance with generally accepted government auditing standards and requirements prescribed by the Comptroller of the Treasury…”
Further, section 7 of the contract reads, in part, “Instances of noncompliance which are not related to federal funds...should be reported in accordance with Government Auditing Standards,” i.e., “Yellow Book” standards. Finally, section 14 of the contract reads “In addition, as the auditor I also affirm that all auditors in the engagement are independent under the requirements of the AICPA and Government Auditing Standards” (emphasis added).

If you still are not persuaded that auditors must adhere to the new standards, look at the most recent audit report for your city. On the opinion page (where there really is some useful information), the first sentence of the second paragraph usually reads “We conducted our audit in accordance with auditing standards generally accepted in the United States of America and with Government Auditing Standards, issued by the Comptroller General of the United States.”

It should be clear from the above analysis that the audit firm you select to perform the municipality’s financial statement audit is asserting in the independent auditor’s report (opinion letter) that it has conducted the audit in accordance with Government Auditing Standards. These standards are the same ones the firm agreed to in the audit contract approved by the Division of Municipal Audit. Further, these standards, as amended, are the same ones required and mentioned in the announcement by the GAO on January 25, 2002. Now that there is no doubt the “Yellow Book” standards apply to your city, let’s take a look at the requirements of the new independence standard.

**The New Independence Standard**

The new standard deals with a range of auditor independence issues, most of which relate to the rules governing the nonaudit, or consulting, services offered by audit firms in addition to audit services and how these services may impair the firm’s independence. Auditors have the capability of performing a wide range of services for their clients. Examples include bookkeeping, payroll, tax filing, consultation on data processing equipment and information technology, and personnel recruitment to name just a few. However, in accordance with the new standard, in some circumstances it is not appropriate for the auditor to perform both audit and certain nonaudit services for the same client. Recent financial news from the corporate world has been rife with examples of misconduct on the part of audit firms and their corporate clients. While not in direct response to these unfortunate events (GAO had been considering the changes in independent standards for several years), the new standard addresses many potential problems associated with audit firms providing both audit and nonaudit services to the same client. Many professionals, both in and out of government, feel that the GAO went too far with these new rules. Whether it did or not, the rules are now in effect, and audit firms and their clients must adhere to them.

**The Two Overarching Principles and Seven Safeguards**

The new GAO independence standard is based on two overarching principles that must always be considered, along with seven safeguards to consider if the two principles are met. The two principles are:

1. Audit organizations should not provide nonaudit services that involve performing management functions or making management decisions (emphasis added); and
2. Audit organizations should not audit their own work or provide nonaudit services in situations where the nonaudit services are significant or material to the subject matter of the audit.

The new standard allows an audit firm to perform nonaudit services that do not violate the two principles only if the audit organization and the audit client comply with seven safeguards written into the standard. If, after the audit organization makes the determination that the nonaudit service does not violate the two overarching principles, it may provide the services only if all of the following seven safeguards are met:
1. The audit firm documents its consideration of the nonaudit service provided, including documentation for its rationale that providing the service does not violate either of the two overarching principles;
2. Before providing nonaudit services, the audit firm establishes and documents an understanding with the client regarding the objectives, scope of work and product of the nonaudit services;
3. The audit firm precludes personnel who provide the nonaudit services from planning, conducting, or reviewing audit work related to the nonaudit services;
4. The audit firm cannot reduce the scope and extent of audit work beyond the level that would be appropriate if the nonaudit work was performed by another unrelated party;
5. The audit firm’s quality control system includes policies and procedures that ensure consideration of the effect of performing nonaudit services on ongoing, planned, and future audits. This understanding should be communicated to management and can be included in the engagement letter;
6. If performing a nonaudit service impairs its ability to meet either of the overarching principles, the audit firm must inform the client that it will be unable to perform subsequent audit work related to the subject matter of the nonaudit service; and
7. For audits selected during peer review, the audit firm makes available to its peer reviewer all related nonaudit service documentation. (Author’s note: audit firms generally are required to have a peer review every three years.)

Sorting Through the Accountant-Speak

Sorting through the language of the new independence standard can be a challenge. Because of some perceived ambiguous provisions of the standard, the GAO issued further guidance in June 2002 in the form of a series of questions and answers aimed at clarifying the new provisions and facilitating compliance. As a result of both the new standard and the accompanying Q&A, auditors and municipal officials should have a better understanding of its provisions and how the auditor/city relationship may change in the future.

You can download a copy of the new independence standard from the GAO Web site at www.gao.gov/govaud/agagas3.pdf. You also can download the GAO’s Q&A on the new standard at www.gao.gov/govaud/d02870g.pdf.

As an aid to municipal officials in determining what services are allowed, the following table lists examples of nonaudit services under the GAO independence standard. This list is taken from both the original release of the new standard and the subsequent Q&A regarding the new standard.
<table>
<thead>
<tr>
<th>Nonaudit Service</th>
<th>Permitted Activities (Independence Not Impaired)</th>
<th>Prohibited Activities (Independence Impaired)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic bookkeeping and accounting services</td>
<td>Preparing draft financial statements based on management’s chart of accounts. Preparing trial balance and adjusting/correcting entries that management has approved. Maintaining depreciation schedules as long as management has determined the method of depreciation, rate of depreciation and salvage value. Proposing adjusting and correcting entries identified during the audit as long as management agrees to accept these entries. Converting cash-basis financial statements to accrual as long as management can make informed judgments and take responsibility for the conversion.</td>
<td>Maintaining or preparing the basic accounting records of the audit client. Posting transactions to the client’s financial statements that result in data used to audit the client (whether coded or not coded by management).</td>
</tr>
<tr>
<td>Payroll services</td>
<td>Computing pay amounts for the client’s employees based on time records, pay rates and deductions. Generating unsigned payroll checks.</td>
<td>Processing an entire payroll where payroll is significant or material to the subject matter of the audit.</td>
</tr>
<tr>
<td>Payroll and other tax services</td>
<td>Preparing routine tax filings such as federal forms 941, W-2 and 1099. Preparing State of Tennessee unemployment premium reports.</td>
<td>Most tax services are considered routine in nature and, therefore, independence would not be impaired when auditors perform these services.</td>
</tr>
<tr>
<td>Design and operation of data processing and other information technology services</td>
<td>Advising clients on system design, installation, and security if management takes responsibility for the system’s implementation and operation. Conducting training for off-the-shelf accounting software packages.</td>
<td>Operating client’s system. Installing off-the-shelf accounting packages. Selling client software developed by the audit firm. Making major modifications to existing client software.</td>
</tr>
</tbody>
</table>

continued
<table>
<thead>
<tr>
<th>Nonaudit Service</th>
<th>Permitted Activities (Independence Not Impaired)</th>
<th>Prohibited Activities (Independence Impaired)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personnel services</td>
<td>- Evaluating potential candidates for position openings to assist management.</td>
<td>- Recommending a single individual for a specific position.</td>
</tr>
<tr>
<td></td>
<td>- Interviewing candidates to advise management on qualifications.</td>
<td>- Conducting a recruiting program or executive search for the audit client.</td>
</tr>
<tr>
<td>Internal audit services</td>
<td>None</td>
<td>Internal audit services are considered a function of management. Any service of this nature would impair independence.</td>
</tr>
<tr>
<td>Services related to the implementation of GASB statement 34</td>
<td>- Providing routine advice, explaining technical requirements, and providing training.</td>
<td>- Performing extensive valuation services related to client’s infrastructure assets.</td>
</tr>
<tr>
<td></td>
<td>- Converting governmental fund information to government wide financial statements provided management understands the conversion and takes responsibility for the results.</td>
<td>- Preparing the client’s Management’s Discussion and Analysis (MD&amp;A).</td>
</tr>
</tbody>
</table>

**Effective Date of the New Standard**

The new independence standard was scheduled originally to apply to all audits for periods beginning on or after October 1, 2002. Due to the breadth of changes in the standard and to allow additional time for its implementation, the GAO extended the effective date to all audits for periods beginning on or after January 1, 2003. There is one caveat that will affect audit periods that end June 30, 2003. The GAO’s original intent was that any nonaudit service contract awarded on or before January 25, 2002 (the date the new standard was released) would be exempt or grandfathered. The GAO has extended that date to exempt all nonaudit services that were initiated, agreed to, or performed by June 30, 2002, provided the work is completed by June 30, 2003. While this may be somewhat confusing to the reader, the bottom line is that unless you had an agreement with your audit firm to perform nonaudit services that would otherwise be considered an impairment to the auditor’s independence prior to June 30, 2002, those nonaudit services cannot be performed by the auditor in regard to fiscal year 2003 and future audits.

**Action Required by Municipal Officials**

Audit firms that perform governmental audits should, by now, be well acquainted with the new GAO independence standard. However, there still may be some gray areas that firms are dealing with. As one seasoned governmental auditor said, “Many audit firms provide a host of nonaudit services to their governmental clients, especially the smaller clients. They have been performing many management functions for so long it has become accepted procedure for both the firm and the client. The result is that firms may not even realize these nonaudit services violate the new independence standard.”
The Municipal Technical Advisory Service (MTAS) is a statewide agency of The University of Tennessee Institute for Public Service. MTAS operates in cooperation with the Tennessee Municipal League to provide technical assistance services to officials of Tennessee’s incorporated municipalities. Assistance is offered in areas such as accounting, administration, finance, public works, ordinance codification, and wastewater management.

MTAS Technical Bulletins are information briefs that provide a timely review of topics of interest to Tennessee municipal officials. MTAS provides one copy free of charge to each Tennessee municipality, county, and department of state and federal government. There is a $2 charge for additional copies and those for the private sector.

MTAS OFFICES

Knoxville (Headquarters)
Phone: (865) 974-0411
Fax: (865) 974-0423

Johnson City
Phone: (423) 854-9882
Fax: (423) 854-9223

Nashville
Phone: (615) 532-6827
Fax (615) 532-4963

Jackson
Phone: (731) 423-3710
Fax: (731) 425-4771

Martin
Phone: (731) 587-7055
Fax: (731) 587-7059

For More Information

You can find additional information regarding the new standard on the GAO Web site at [www.gao.gov/govaud/ybk01.htm](http://www.gao.gov/govaud/ybk01.htm). Also, a link to this site is on the MTAS Web site at [www.mtas.utk.edu/Content/federal%20links.htm](http://www.mtas.utk.edu/Content/federal%20links.htm). Please call your MTAS Management or Finance Consultant for further information regarding this subject.

If you have questions about whether your independent audit firm will be able to continue to provide services it has provided in the past, you should consult a representative of the firm prior to the end of your June 30, 2003, fiscal year. If it is determined that your auditor will not be able to provide certain services it has provided previously, you should take the necessary steps to complete these services. This includes making arrangements with other professionals prior to year end to perform such services or employing qualified staff who are able to do so. Either way, this new independence standard may result in increased costs to local government.

Or, call the MTAS Answer Line to receive quick answers to short questions: (888) 667-MTAS (6827).

The University of Tennessee does not discriminate on the basis of race, sex, color, religion, national origin, age, disability, or veteran status in provision of educational programs and services or employment opportunities and benefits. This policy extends to both employment by and admission to The University.

The University does not discriminate on the basis of race, sex, or disability in its education programs and activities pursuant to the requirements of Title VI of the Civil Rights Act of 1964, Title IX of the Education Amendments of 1972, Section 504 of the Rehabilitation Act of 1973, and the Americans with Disabilities Act (ADA) of 1990.

Inquiries and charges of violation concerning Title VI, Title IX, Section 504, ADA, or the Age Discrimination in Employment Act (ADEA) or any of the other above referenced policies should be directed to the Office of Diversity Resources (DRES), 2110 Terrace Avenue, Knoxville, Tennessee 37996-3560, telephone (865) 974-2498 (V/TTY available) or (865) 974-2440. Requests for accommodation of a disability should be directed to the ADA Coordinator at the Office of Human Resources, 600 Henley Street, Knoxville, Tennessee 37996-4125.