

Guidance for Complying with Government Auditing Standards Related to Nonaudit Services

Purpose and Background

The ALGA Board is providing this guidance to assist its members in complying with generally accepted government auditing standards (GAGAS) related to independence when performing nonaudit services and to assist peer review teams in assessing members' compliance with these requirements.

The 2011 GAGAS revision removed acknowledgment that auditors in government often provide nonaudit services that by their nature pose no risk to independence. Further, the "*Requirements for Performing Nonaudit Services*" (paragraphs 3.34 to 3.44) appear to be based on an assumption that the auditor is performing the nonaudit service on behalf of management. These were significant changes affecting many of our members as local government auditors often independently perform nonaudit services to investigate fraud, reduce the risk of management override of controls, or improve governance.

This guidance provides a tool for government auditors to use in conjunction with the GAGAS conceptual framework to assess threats to independence related to nonaudit services by considering how the service deviates from the three-party relationship model of auditing. It also addresses the circumstances under which government auditors may perform nonaudit services that are "otherwise prohibited" as discussed in GAGAS paragraph 3.47, and the requirements related to mandated nonaudit services that affect independence.

Discussion and Guidance

Determining Applicability of Management Oversight Requirements

When performing nonaudit services, auditors should consider how the roles and relationships between the parties involved can affect threats to independence. When an auditor performs a nonaudit service under a three-party arrangement where the auditor acts for a principal (such as the governing body) to evaluate actions or information of an agent (i.e., management), requiring management oversight of the nonaudit service could adversely affect the auditor's ability to provide independent services to the principal.

Nonaudit services that fit the three-party relationship model generally would not pose management participation threats. A nonaudit service that conforms to the three-party relationship model usually does not set direction or accept responsibility for key processes or controls because the role of the auditor is to independently review the agent's activities on behalf of the principal. In these situations, the requirements related to management oversight of the nonaudit service are most likely not applicable. Similarly, nonaudit services that represent a two-party relationship between the auditor and the public or governing body, such as estimating the fiscal impact of proposed legislation or preparing questions for hearings, likely do not create a management participation threat to independence and the requirements related to management oversight of the nonaudit service are not applicable.

The auditor should evaluate whether the services could create a self-review threat for subsequent related audits. For example, an auditor who reviews contracts for propriety before they are executed may face a self-review threat if asked to audit contracting processes. Potential safeguards for mitigating self-review threats include: (1) limiting conclusions drawn from nonaudit services; (2) disclosing the source of the data, methods of data collection and any limitations in the data; and, (3) ensuring that the auditor who performs the service is not involved in subsequent related audits.

In all cases where nonaudit services are performed, auditors should develop policies and procedures for conducting and reporting on nonaudit services that include assessments of potential threats; applications of safeguards (if appropriate); and, documentation of the analysis, professional judgments, and conclusions. Using the GAGAS Conceptual Framework for Independence (Attachment I) and the Threat Assessment Tool for Nonaudit Services (Attachment II) can assist the auditor in assessing threats to independence from performing nonaudit services.

Prohibited Nonaudit Services

GAGAS paragraph 3.36 and paragraphs 3.45 through 3.58 lists and address various prohibited services for which the management participation threat is considered too great for safeguards to reduce it to acceptable levels. These services are integral to the financial management of the entity and auditors who perform them are not independent to conduct financial audits. According to GAGAS paragraph 3.47, however, provision of nonaudit services that are otherwise prohibited by GAGAS does not necessarily impair the auditor's independence to conduct performance audits or agreed-upon procedures, depending on the subject matter of the engagement.

Since many ALGA members do not perform financial audits or attestation engagements (other than agreed-upon-procedures), it is possible that auditors could provide nonaudit services that are otherwise prohibited without impairing independence. Auditors should, however, decline to perform a prohibited service if it seems likely that it would affect a future audit or significantly reduce the audit organization's scope of audit authority.

When considering whether to perform nonaudit services that are otherwise prohibited, auditors can use Attachments I and II to assess whether the nonaudit service creates threats to independence and, if so, whether safeguards can reduce the threats to an acceptable level. Auditors should document their evaluation of potential threats and safeguards applied, if any. Auditors should decline to conduct subsequent related audits and agreed-upon-procedure engagements or modify compliance statements if subsequent audits must be performed in related areas and safeguards cannot reduce threats to independence to an acceptable level.

Mandated Nonaudit Services that Affect Independence

GAGAS paragraph 3.44 recognizes that an auditor in a government entity may be required to perform a nonaudit service that could impair the auditor's independence with respect to a required audit. If the auditor cannot, as a consequence of constitutional or statutory requirements over which the auditor has no control, implement safeguards to reduce the resulting threat to an acceptable level, or decline to perform or terminate a nonaudit service that is incompatible with audit responsibilities, the auditor should:

- (1) Disclose the nature of the threat that could not be eliminated or reduced to an acceptable level.

(2) Modify the GAGAS compliance statement.

GAGAS paragraphs 2.24 and 2.25 discuss modifications to the GAGAS compliance statement.

Tools for Assessing Threats to Independence and Additional Guidance

GAGAS provides a flowchart, the *GAGAS Conceptual Framework for Independence* (Attachment I), to assist auditors in applying the conceptual framework for independence. ALGA has developed the *Threat Assessment Tool for Nonaudit Services* (Attachment II) for use in conjunction with GAGAS to assist its members with the assessment of threats to independence by considering the various relationships related to a provided service. For services that do not conform to a three-party relationship, the severity of the threat to independence and the appropriate safeguards to apply depends on who requests and receives the service, as well as the nature and scope of the service.

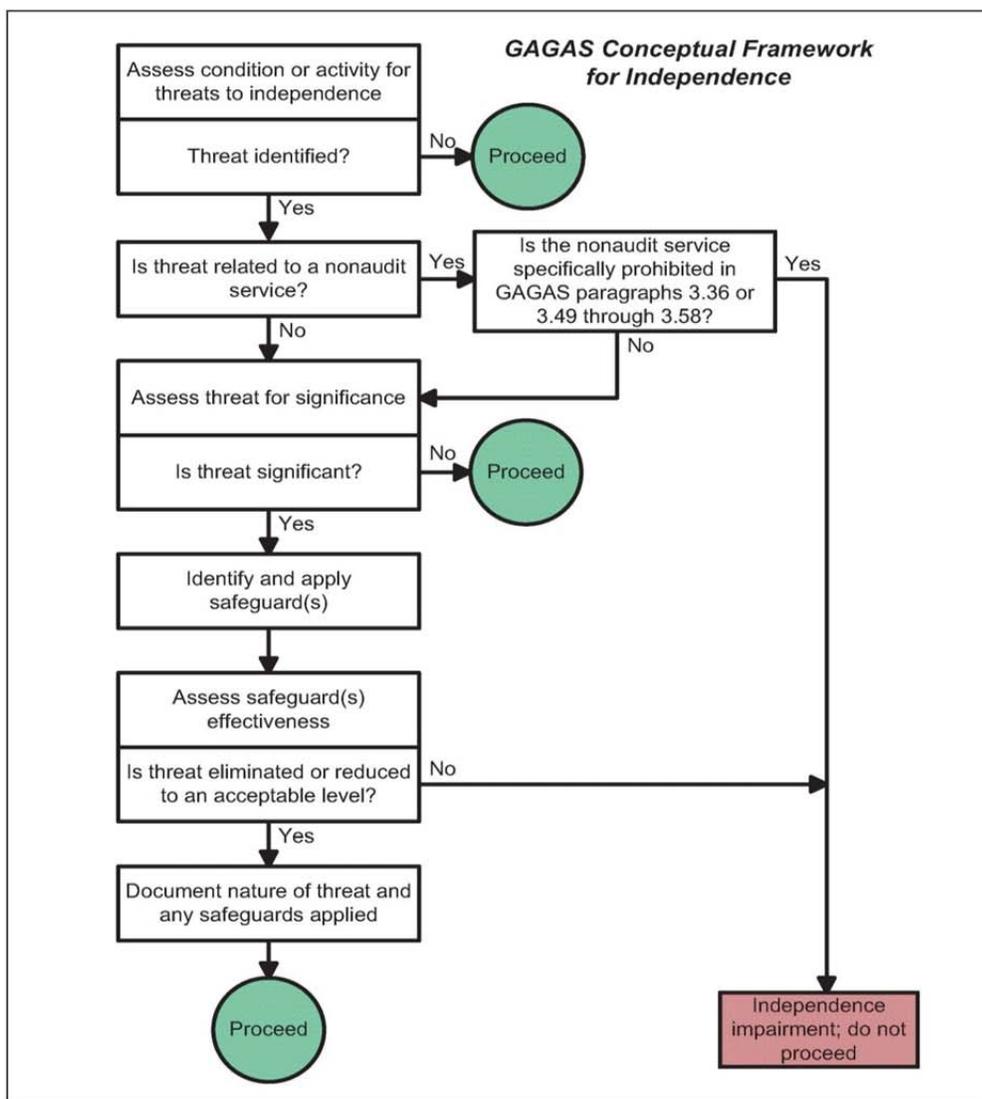
When considering the provision of nonaudit services, it is recommended that ALGA members:

1. Develop policies and procedures for conducting and reporting on nonaudit services and for mitigating management participation and self-review threats for subsequent related audits.
2. Consider threats to independence, particularly threats related to self-review (paragraph 3.14 b) or management participation (paragraph 3.14 f), using Attachments I and II.
3. Assess whether safeguards can eliminate or reduce a threat to an acceptable level, if a threat is identified, and apply the required safeguards (GAGAS paragraphs 3.37-3.38) for management participation threats.
4. Determine whether the nonaudit service is a prohibited service and, if so, whether the circumstances (i.e., the auditor does not conduct financial audits) would otherwise allow for providing the service.
5. Modify compliance statements for audits related to mandated services that the auditor is required to perform for which safeguards cannot reduce threats to independence to an acceptable level.
6. Document the application of the *GAGAS Conceptual Framework for Independence* and resulting safeguards, if any, for each service provided.

Peer Reviews

When assessing whether auditors considered the potential effect on auditor independence, peer review teams should review the auditor's policies and procedures for performing nonaudit services and its documentation of the application of the *GAGAS Conceptual Framework for Independence* (Attachment I) for each nonaudit service performed. If the team has questions about whether the auditor's performance of nonaudit services complies with GAGAS, the team leader should address those questions to the peer review coordinator to ensure consistency in how peer review teams assess that compliance.

GAGAS Conceptual Framework for Independence



Source: GAO.

THREAT ASSESSMENT TOOL FOR NONAUDIT SERVICES

GAGAS 3.13 identifies seven threats that could impair an auditor’s independence. Two of those threats are more likely to exist when an auditor performs a nonaudit service:

- **Management participation** threats occur when the performance of nonaudit services merges the auditor’s role with that of management. An auditor acting on behalf of management is no longer independent to assess management’s actions and report objectively to principals, as the auditor effectively becomes an agent of the manager.
- **Self-review** threats occur when the auditor is unable, or is perceived as unable, to provide an objective assessment significant to an audit when a subject matter is related to a previous nonaudit service.

Whether these threats exist depends on the relationship the auditor has with other parties (i.e., management and those charged with governance) involved in the nonaudit service. The following diagrams illustrate how independence may be threatened within a relationship. Refer to the *Guidance for Complying with Government Auditing Standards Related to Nonaudit Services* for how to comply with GAGAS under each of these situations.

<p>Figure 1 Auditor as part of a three-party relationship</p>	<p>Figure 2 Auditor providing nonaudit services as part of a two-party relationship with management</p>	<p>Figure 3 Auditor providing nonaudit services as part of a two-party relationship with the principal</p>
	<ul style="list-style-type: none"> • Providing advice and technical expertise • Providing training • Reconciling accounts • Reviewing system design • Preparing routine tax filings • Preparing an indirect cost proposal 	<ul style="list-style-type: none"> • Providing information without verification • Developing questions for use at a hearing • Developing surveys and collecting responses • Assessing fiscal impact of proposed legislation

<p align="center">Figure 1 Auditor as part of a three-party relationship</p>	<p align="center">Figure 2 Auditor providing nonaudit services as part of a two-party relationship with management</p>	<p align="center">Figure 3 Auditor providing nonaudit services as part of a two-party relationship with the principal</p>
<p>A three-party relationship is between the principal (those charged with governance), an agent (management) to whom the principal has given responsibility for resources and authority, and an independent auditor who reports to the principal on the agent’s activities. In local government, either the elected legislative body delegates resources to city/county managers, or the voters delegate resources to a chief executives, such as an elected mayor. In the case of internal auditors who are independent to report internally under GAGAS 3.31, the principal is a senior executive, elected or appointed, and the agents are the managers who report to the executive. Figure 1, adapted from <i>The Role of Auditing in Public Sector Governance</i>, illustrates these relationships.¹</p> <p>Audits and attestation engagements represent a three-party relationship because the agent has more information than the principal about the use of the resources, and the principal relies on an independent auditor to provide assurance that the agent’s representations are accurate or that the agent’s activities are effective.</p> <p>Nonaudit services that fit the three-party relationship model are those in which the auditor independently examines activities of the agent and reports to the principal. These nonaudit services would generally not pose a threat to independence, even when related to the broad areas identified in GAGAS as management responsibilities.</p>	<p>Nonaudit services that represent a two-party relationship between the auditor and the agent, illustrated in figure 2, often pose both management participation and self-review threats. The severity of the threats depends on the scope and nature of the work.</p> <p>GAGAS 3.40 and 3.41 list examples of routine nonaudit services to management that generally do not impair an auditor’s independence because the nature of the service is limited in scope, and decisions about how to use the information clearly rest with management.</p> <p>GAGAS 3.36 and 3.45-3.58 list a number of prohibited nonaudit services for which the management participation threat is too great for safeguards to reduce it to acceptable levels. These services are integral to the financial management of the entity and auditors who perform them are not independent to conduct financial audits. However, according to GAGAS 3.47, provision of these services does not necessarily impair the auditor’s independence to conduct performance audits or agreed-upon procedures, depending on the subject matter of the engagement.</p> <p>For other allowable nonaudit services conducted for management, safeguards required in GAGAS 3.37-3.39 would most likely apply.</p>	<p>Nonaudit services that represent a two-party relationship between the auditor and the principal, illustrated in figure 3, likely do not create a management participation threat, but could create a self-review threat for subsequent related audits. For example, an auditor who reviews contracts for propriety before they are executed may face a self-review threat if asked to audit contracting processes.</p> <p>Situations could arise in which a principal loses confidence in management and requests the auditor to take over management functions. These situations would pose a management participation threat. If the services are prohibited under GAGAS, providing the service even in emergency circumstances would impair the auditor’s independence to conduct financial audits.</p> <p>Similarly, a constitutional or statutory provision could require a government auditor to perform a nonaudit service for which a management participation threat exists. GAGAS 3.44 applies in these cases and the auditor should disclose the nature of the threat that could not be eliminated or reduced to an acceptable level and modify the GAGAS compliance statement accordingly.</p>

¹ *The Role of Auditing in Public Sector Governance*, The Institute of Internal Auditors, 2006, p. 10.