

## AICPA – GAO INDEPENDENCE RULES COMPARISON: NONAUDIT SERVICES

COMMENTS	AICPA	GAO
<p><b><u>Overarching Principle(s)</u></b></p> <p>With respect to nonaudit services, the GAO rule is generally more restrictive than the AICPA rule as a result of a proscription from providing nonaudit services (except for routine advice/activities) in situations where those services are significant / material to the subject matter of the audit. In cases where the nonaudit service is not material/significant to the subject matter of the audit, specific safeguards, including a requirement for a separate engagement team to perform the service, are required in most cases. (Note: Under AICPA rules Appraisal, Valuation and Actuarial services, where the results are material to the financial statements would be prohibited if the service <i>also</i> involves a significant degree of subjectivity.)</p> <p>For reasons of efficiency and practicality, GAO rules provides that if the firm provides 40 hours or less of nonaudit services in relation to a specific audit engagement, the safeguard associated with precluding personnel who provided the nonaudit service from performing related audit work would not be required.</p> <p>AICPA rules do <i>not</i> require that the person designated by the client to oversee the service be an <i>employee</i> of the client. The individual could be the owner of the company or an individual outside the company such as an outsourced bookkeeper or controller, provided he or she possesses the necessary skill, knowledge and/or experience, functions in a capacity equivalent to that of a client employee, and has the authority to make decisions</p>	<p>The rule contains one overarching principle:</p> <p>(1) A member may not perform management functions or make management decisions for the attest client. But the member may provide advice, research materials, and recommendations to assist the client’s management in performing its functions and making decisions.</p> <p>In all situations, the client must agree to perform the following functions in connection with the engagement to perform nonattest services:</p> <ol style="list-style-type: none"> <li>a. Make all management decisions and perform all management functions;</li> <li>b. Designate an individual who possesses suitable skill, knowledge, and/or experience, preferably within senior management, to oversee the services;</li> <li>c. Evaluate the adequacy and results of the services performed;</li> <li>d. Accept responsibility for the results of the services; and</li> <li>e. Establish and maintain internal controls, including monitoring ongoing activities.</li> </ol> <p>The member should be satisfied that the client will be able to meet all of these criteria and make an informed judgment on the results of the member's nonattest services. In assessing whether the designated individual possesses suitable skill, knowledge, and/or experience, the member should be satisfied that such individual understands the services to be performed sufficiently to oversee them. However, the individual is not required to possess the expertise to perform or re-perform the</p>	<p>The rule contains two overarching principles:</p> <p>(1) audit organizations should not provide nonaudit services that involve performing management functions or making management decisions<sup>3</sup>; and</p> <p>(2) audit organizations should not audit their own work or provide nonaudit services in situations where the nonaudit services are significant/material to the subject matter of audits.</p> <p>If the nonaudit service meets both principles, the audit organization must first comply with a list of safeguards in order to perform the nonaudit service. The safeguards are:</p> <ul style="list-style-type: none"> <li>• The audit organization should preclude personnel who provided the nonaudit services from planning, conducting, or reviewing audit work related to the nonaudit service under the overarching principle that auditors cannot audit their own work<sup>4</sup>. (also, see “Comments”)</li> <li>• The audit organization should document its consideration of the nonaudit services including documentation for its rationale that providing the nonaudit services does not violate the two overarching principles.</li> <li>• 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</li> </ul>

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<p>on behalf of the client.</p>	<p>services. In cases where the client is unable or unwilling to assume these responsibilities (for example, the client does not have an individual with suitable skill, knowledge, and/or experience to oversee the nonattest services provided, or is unwilling to perform such functions due to lack of time or desire), the member's provision of these services would impair independence.</p> <p>Before performing nonattest services, the member should establish and <i>document in writing</i><sup>1</sup> his or her understanding with the client (board of directors, audit committee, or management, as appropriate in the circumstances) regarding the following:</p> <ol style="list-style-type: none"> <li>a. Objectives of the engagement</li> <li>b. Services to be performed</li> <li>c. Client's acceptance of its responsibilities</li> <li>d. Member's responsibilities</li> <li>e. Any limitations of the engagement</li> </ol> <p>The documentation requirement does not apply to:</p> <ul style="list-style-type: none"> <li>• Nonattest services performed prior to January 1, 2005.</li> <li>• Nonattest services performed prior to the client becoming an attest client.<sup>2</sup></li> </ul> <p>General requirements 2 and 3 above do not apply to certain routine activities performed by the member such as providing advice and responding to the client's questions as part of the normal client-member relationship.</p>	<p>organization should also establish and document an understanding with management that management is responsible for the substantive outcomes of the work and, therefore, has a responsibility to be in a position in fact and appearance to make an informed judgment on the results of the nonaudit service and That the audited entity complies with the following:</p> <ol style="list-style-type: none"> <li>1. Designates a management-level individual to be responsible and accountable for overseeing the nonaudit service.</li> <li>2. Establishes and monitors the performance of the nonaudit service to ensure that it meets management's objectives.</li> <li>3. Makes any decisions that involve management functions related to the nonaudit service and accepts full responsibility for such decisions.</li> <li>4. Evaluates the adequacy of the services performed and any findings that result.</li> </ol> <ul style="list-style-type: none"> <li>• 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.</li> <li>• 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</li> </ul>

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		<p>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 and can be included in the engagement letter.</p> <ul style="list-style-type: none"> <li>• For individual audits selected in the peer review, all related nonaudit services should be identified to the audit organization’s peer reviewer and the required audit documentation be made available for inclusion in the audit organization’s peer review.</li> <li>• In cases where certain nonaudit services by their nature impair the audit organizations 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.</li> </ul>
<p><b><u>Bookkeeping Services</u></b></p> <p>GAO rules are generally more restrictive than those of the AICPA. While both organizations prohibit the performance of management functions, the AICPA would not consider maintaining or preparing the client’s general ledger or posting coded transactions to the general ledger to be a management function (assumes compliance with the general requirements as outlined in the interpretation), rather they are ministerial in nature.</p>	<p>Independence <i>would not</i> be considered to be impaired if the member(s)–</p> <ul style="list-style-type: none"> <li>• Record transactions for which management has determined or approved the appropriate account classification, or post coded transactions to a client’s general ledger;</li> <li>• Prepare financial statements based on information in the trial balance.</li> <li>• Post client-approved entries to a client’s trial balance.</li> </ul>	<p>Independence <b>would not</b> be considered to be impaired if the audit organization provided basic accounting assistance <i>provided that such services were deemed not to be significant/material to the subject matter of the audit</i> and are limited to services such as—</p> <ul style="list-style-type: none"> <li>• 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;</li> </ul>

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<p>GAO has clarified that preparation of a trial balance based on management’s chart of accounts and draft financial statements and note disclosures which the audited entity’s management reviews and approves, are considered to be technical assistance and part of the audit. Accordingly, the engagement team that prepared the trial balance and draft financial statements and notes could also perform the financial statement audit provided all other services comply with the overarching principles as previously discussed as well as the safeguards as addressed in Section 3.17 of the June 2003 revision to the GAO Governmental Auditing Standards.</p> <p>Similarly, the engagement team that converted the audited entity’s cash-based financial statements to the accrual basis, could also perform the financial statement audit since this service is in substance the same as proposing adjusting or correcting entries. In all cases, management’s representation letter should acknowledge the audit organization’s role in providing these services and management’s review, approval, and responsibility for the services.</p>	<ul style="list-style-type: none"> <li>• Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client provided the client reviews the entries and the member is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.</li> </ul> <p>Such services are <i>not</i> considered management functions that would violate the overarching principle.</p> <p>However, independence <i>would be</i> considered to be impaired if the member(s) –</p> <ul style="list-style-type: none"> <li>• Determine or change journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval.</li> <li>• Authorize or approve transactions.</li> <li>• Prepare source documents.</li> <li>• Make changes to source documents without client approval.</li> </ul> <p>Such services are considered management functions that violate the overarching principle.</p>	<ul style="list-style-type: none"> <li>• Preparing draft notes to the financial statements based on information determined and approved by management;</li> <li>• Preparing a trial balance based on management’s chart of accounts;</li> <li>• Maintaining depreciation schedules for which management has determined the method of depreciation, rate of depreciation, and salvage value of the asset;</li> <li>• Proposing adjusting and correcting entries that are identified during the audit as long as management makes the decisions on accepting these entries.</li> <li>• Converting cash-based financial statements to accrual-based financial statements, as long as management is in the position to make informed judgments to review, approve, and take responsibility for the appropriateness of the conversion.</li> </ul> <p>Independence <b>would be</b> considered to be impaired under all circumstance if the audit organization—</p> <ul style="list-style-type: none"> <li>• Maintains or prepares the audited entity’s basic accounting records or maintain or take responsibility for basic financial or other records that the audit organization will audit;</li> <li>• Posts transactions (whether coded or not coded) to the entity’s financial records or to other records that subsequently provide data to the entity’s financial records.</li> </ul>

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<p><b><u>Payroll Services</u></b></p> <p>GAO rules are generally more restrictive than those of the AICPA. Specifically, any permitted payroll services under the GAO rule must not be significant /material to the subject matter of the audit and must be performed by engagement personnel not involved in the audit, while AICPA rules contain no such provision.</p>	<p>Independence <i>would not</i> be considered to be impaired if the member(s)—</p> <ul style="list-style-type: none"> <li>• Using payroll time records provided and approved by the client, generate unsigned checks, or process client’s payroll.</li> <li>• Transmit client-approved payroll or other disbursement information to a financial institution provided the client has authorized the member to make the transmission and has made arrangements for the financial institution to limit the corresponding individual payments as to amount and payee. In addition, once transmitted, the client must authorize the financial institution to process the information.</li> <li>• Make electronic payroll tax payments in accordance with U.S. Treasury Department or comparable guidelines provided the client has made arrangements for its financial institution to limit such payments to a named payee.</li> </ul> <p>Such services are <i>not</i> considered management functions that would violate the overarching principle.</p> <p>Independence <i>would be</i> considered to be impaired if the member(s) –</p> <ul style="list-style-type: none"> <li>• Accepting responsibility to authorize payments of client funds, electronically or otherwise, (except as permitted with respect to electronic payroll tax payments); or to sign or cosign client checks, even if only done in emergency</li> </ul>	<p>Independence <i>would not</i> be considered to be impaired if the audit organization provided payroll services <i>provided that such services were deemed not to be significant / material to the subject matter of the audit</i> and are limited to services such as—</p> <ul style="list-style-type: none"> <li>• Computing pay amounts for the entity’s employees based on entity maintained and approved time records, salaries or pay rates, and deductions from pay;</li> <li>• Generating unsigned payroll checks;</li> <li>• 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.</li> </ul>

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	<p>situations.</p> <ul style="list-style-type: none"> <li>• Having custody of client funds; making credit or banking decisions for the client; maintaining a client’s bank account.</li> <li>• Signing payroll tax returns on behalf of client management.</li> <li>• Approve vendor invoices for payment.</li> </ul> <p>Such services are considered management functions that violate the overarching principle.</p>	
<p><b><u>Appraisal and Valuation Services</u></b></p> <p>GAO rules are generally more restrictive than those of the AICPA, as the GAO limits appraisal and valuation services to <i>reviewing</i> the work of the entity or a specialist employed by the entity. In addition, any permitted appraisal or valuation service under the GAO rule (e.g., valuing an entity’s pension plan) must not be significant /material to the subject matter of the audit and must be performed by engagement personnel not involved in the audit. AICPA guidance also restricts valuation engagements to those in which the results are <i>not</i> material (either individually or in the aggregate) to the financial statements, <i>and</i> do not involve a significant degree of subjectivity.</p>	<p>Independence <i>would be</i> impaired if a member(s) performs an appraisal, valuation, or actuarial service for an attest client where the results of the service, individually or in the aggregate, would be material to the financial statements and the appraisal, valuation, or actuarial service involves a significant degree of subjectivity.</p> <p>Valuations performed in connection with, for example, employee stock ownership plans, business combinations, or appraisals of assets or liabilities generally involve a significant degree of subjectivity and therefore would impair Independence if material to the financial statements.</p> <p>An actuarial valuation of a client’s pension or postemployment benefit liabilities generally does not require a significant degree of subjectivity and therefore, would not impair independence. In addition, appraisal, valuation, and actuarial services performed for nonfinancial statement purposes such as those performed for tax planning or tax compliance, estate and gift taxation and divorce proceedings would not impair independence.</p>	<p>Independence <i>would not</i> be considered to be impaired if the audit organization provided appraisal or valuation services <i>provided that such services were deemed not to be significant/material to the subject matter of the audit</i> and are limited to services such as—</p> <ul style="list-style-type: none"> <li>• Reviewing the work of the entity or a 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;</li> <li>• 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 and the expense or liability is not material to the financial statements.</li> </ul>

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	<p>In performing such services, all significant assumptions and matters of judgment should be determined or approved by the client and the client should be in a position to have an informed judgment on, and accept responsibility for, the results of the service.</p>	
<p><b><u>Information Technology Services</u></b></p> <p>GAO rules are more restrictive than those of the AICPA. Specifically, any permitted information technology services under the GAO rule must not be significant /material to the subject matter of the audit and must be performed by engagement personnel not involved in the audit. AICPA and GAO both prohibit the member/audit organization from operating or supervising the operation of the client’s information technology system (including LAN operation) and from designing or developing the financial information system.</p>	<p>Independence <i>would not</i> be considered to be impaired if the member(s)—</p> <ul style="list-style-type: none"> <li>• Install or integrate a client’s financial information system that was not designed or developed by the member (e.g., an off-the-shelf accounting package).</li> <li>• Assist in setting up the client's chart of accounts and financial statement format with respect to the client's financial information system.</li> <li>• Design, develop, install, or integrate a client's information system that is unrelated to the client's financial statements or accounting records.</li> <li>• Provide training and instruction to client employees on an information and control system.</li> </ul> <p>Such services are <i>not</i> considered management functions that would violate the overarching principle.</p> <p>A member would however, be prohibited from designing or developing a client’s financial information system, making other than insignificant modifications to the source coding underlying a client’s existing financial information system, supervising client personnel in the daily operation</p>	<p>Independence <i>would not</i> be considered to be impaired if the audit organization provided advisory services on information technology <i>provided that such services were deemed not to be significant/material to the subject matter of the audit</i> and are limited to services such as—</p> <p><i>Advising</i> 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 –</p> <ol style="list-style-type: none"> <li>(1) whether to implement a new system,</li> <li>(2) the adequacy of the new system design,</li> <li>(3) the adequacy of major design changes to an existing system, and</li> <li>(4) the adequacy of the system to comply with regulatory or other requirements.</li> </ol> <p>The audit organization would be prohibited from performing the actual design, development, or installation of the audited entity’s accounting or other financial system. In addition, operating or supervising the operation of the entity’s information technology system is prohibited.</p>

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	<p>of a client's information system, and operating a client's local area network (LAN). Operating a client's LAN is prohibited even when the client has designated someone with suitable skill, knowledge and or experience to be responsible for the LAN.</p> <p>Such services are considered management functions that violate the overarching principle.</p>	
<p><b>Human Resources Services</b></p> <p>GAO rules are more restrictive than those of the AICPA. Specifically, the GAO prohibits the audit organization from performing executive search and recruiting activities for the client. AICPA independence rules would permit such activities provided the client makes all decisions.</p> <p>In addition, any permitted human resource services under the GAO rule must not be significant /material to the subject matter of the audit and must be performed by engagement personnel not involved in the audit, while AICPA rules contain no such provision.</p>	<p>Independence <i>would not</i> be considered to be impaired if the member(s)—</p> <ul style="list-style-type: none"> <li>• Recommends a position description or candidate specifications;</li> <li>• Solicits and performs screening of candidates and recommend qualified candidates to a client based on the client-approved criteria (e.g., required skills and experience);</li> <li>• Participates in employee hiring or compensation discussions in an advisory capacity.</li> </ul> <p>Such services are <i>not</i> considered management functions that would violate the overarching principle.</p> <p>However, independence <i>would be</i> considered to be impaired if the member(s)—</p> <ul style="list-style-type: none"> <li>• Commits the client to employee compensation or benefits;</li> <li>• Hires or terminates client employees</li> </ul> <p>Such services are considered management functions that violate the overarching principle.</p>	<p>Independence <i>would not</i> be considered to be impaired if the audit organization provided human resources services <i>provided that such services were deemed not to be significant/material to the subject matter of the audit</i> and are limited to services such as—</p> <ul style="list-style-type: none"> <li>• Assisting management in its evaluation of potential candidates that are limited to activities such as— <ul style="list-style-type: none"> <li>➢ Serving on an evaluation panel to review applications;</li> <li>➢ interviewing candidates to provide input to management in arriving at a listing of best qualified applicants to be provided to management.</li> </ul> </li> </ul> <p>Independence <i>would be</i> considered to be impaired under all circumstance if the audit organization—</p> <ul style="list-style-type: none"> <li>• Recommends a single individual for a specific Position;</li> <li>• Conducts an executive search or a recruiting program for the audited entity.</li> </ul>

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<p><b>Internal Audit Assistance Services</b></p> <p>GAO rules are more restrictive than those of the AICPA. Specifically, the GAO prohibits the audit organization from performing internal audit services as they are considered to be a management function. AICPA independence rules would permit such activities provided the internal audit function is not outsourced to the member whereby the member in effect manages the internal audit activities of the client and certain safeguards are implemented by both the member and client.</p>	<p>Independence <i>would not</i> be considered to be impaired if the member(s) assist the client in performing financial and operational internal audit activities provided the member takes appropriate steps to ensure that the client understands its responsibility for establishing and maintaining the internal control system and directing the internal audit function, including the management thereof.</p> <p>For example, the member should ensure that client management:</p> <ul style="list-style-type: none"> <li>• Designates an individual or individuals, who possess suitable skill, knowledge, and/or experience, preferably within senior management, to be responsible for the internal audit function;</li> <li>• Determines the scope, risk, and frequency of internal audit activities, including those to be performed by the member providing internal audit assistance services;</li> <li>• Evaluates the findings and results arising from the internal audit activities, including those performed by the member providing internal audit assistance services; and</li> <li>• Evaluates the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining reports from the member.</li> </ul> <p>Independence <i>would be</i> considered to be impaired if the member(s) –</p> <ul style="list-style-type: none"> <li>• In effect, manages the internal audit activities of the client;</li> <li>• Performs ongoing monitoring activities or control activities (for example, reviewing loan originations as part of the client's</li> </ul>	<p>Independence <i>would not</i> be considered to be impaired if the audit organization provided routine activities, such as –</p> <ul style="list-style-type: none"> <li>• Providing routine advice to the audited entity and management to assist them in activities such as establishing internal controls or implementing audit recommendations;</li> <li>• Providing tools and methodologies, such as internal control assessment methodologies that can be used by management.</li> </ul> <p>Independence <i>would</i> be considered to be impaired if the audit organization performed internal audit services for an audited entity that does not have an internal audit operation.</p>

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	<p>approval process or reviewing customer credit information as part of the customer's sales authorization process) that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both, and performing routine activities in connection with the client's operating or production processes that are equivalent to those of an ongoing compliance or quality control function;</p> <ul style="list-style-type: none"> <li>• Determines which, if any, recommendations for improving the internal control system should be implemented;</li> <li>• Reports to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function;</li> <li>• Approves or is responsible for the overall internal audit work plan including the determination of the internal audit risk and scope, project priorities, and frequency of performance of audit procedures;</li> <li>• Is connected with the client as an employee or in any capacity equivalent to a member of client management (for example, being listed as an employee in client directories or other client publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the client's internal audit function, or using the client's letterhead or internal correspondence forms in communications)</li> </ul>	

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### **Endnotes:**

<sup>1</sup> A failure to prepare the required documentation would not impair independence, *but would be considered a violation of Rule 202 – Compliance with Standards*, provided that the member did establish the understanding with the client. [Footnote added effective December 31, 2003, by the Professional Ethics Executive Committee. Footnote subsequently revised January 27, 2005.] Additionally, the Professional Ethics Executive Committee (PEEC) deferred until December 31, 2004 the effective date of the new requirement to *document in writing* the understanding established with the client in accordance with General Requirement No. 3 under Interpretation 101-3 – *Nonattest Services*. The documentation requirement will apply to all nonattest services (e.g., bookkeeping, tax, consulting, internal audit services, etc.) performed for an attest client after December 31, 2004, (i.e., nonattest engagements in process at or commencing after December 31, 2004). All other requirements of Interpretation 101-3 remain effective December 31, 2003 subject to the transition provisions as provided for in the Interpretation.

<sup>2</sup> However, upon the acceptance of an attest engagement, the member should prepare written documentation demonstrating his or her compliance with the other general requirements during the period covered by the financial statements, including the requirement to establish an understanding with the client.

<sup>3</sup> Auditors can 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 that would not require the audit organization to apply the safeguards.

<sup>4</sup> Personnel who provided the nonaudit service are permitted to convey the knowledge gained of the audited entity and its operations to the audit assignment team. Also, certain exceptions to this safeguard exist for specific bookkeeping services. See “Comments” under the bookkeeping services section below.