

Evaluation of a Firm's Compliance with 2011 Yellow Book Independence Requirements Related to Nonaudit Services

Question and Answer for Peer Reviewers

Note to Reviewer: The following are key differences in applying AICPA Ethics Interpretation 101-3 and the 2011 Yellow Book that peer reviewers need to be aware:

- *The 2011 Yellow Book requires documentation of the assessment of management's ability to oversee the nonaudit services, including whether management has suitable skills, knowledge, or experience (SKE); AICPA Ethics Interpretation 101-3 requires the same assessment, but does not require documentation of the assessment. However, the conclusion as to management's ability to oversee the nonaudit services should be the same under both standards.*
- *The 2011 Yellow Book requires consideration of threats in the aggregate with other nonaudit services provided. This concept is not currently included in AICPA Ethics Interpretation 101-3.*
- *The 2011 Yellow Book requires that any and all nonaudit services that are not prohibited, regardless of significance, be assessed using the Yellow Book Conceptual Framework. Therefore, all nonaudit services must be evaluated for threats and safeguards must be applied when threats are deemed to be significant. However, under AICPA Ethics Interpretation 101-3 for nonattest services listed as permitted, as long as the auditor complies with the general requirements for performing nonattest services, no further assessments of threats or application of safeguards are required.*
- *The 2011 Yellow Book specifically defines preparation of financial statements and cash to accrual entries as nonaudit services subject to 2011 Yellow Book independence evaluation and documentation requirements. Under a nonauthoritative Frequently Asked Questions to AICPA Ethics Interpretation 101-3, those services are defined as routine services and only require that auditors not assume management responsibilities when performing such services. Recently adopted revisions to Ethics Interpretation 101-3 specifically identify activities such as financial statement preparation, cash-to-accrual conversions, and reconciliations as nonattest services effective for engagements covering periods beginning on or after December 15, 2014.*
- *To see the current comparison of AICPA versus GAO Independence Rules, refer to www.aicpa.org/interestareas/professionalethics/resources/tools/downloadabledocuments/2012mayaicpagaocomparision.pdf. Please note that there is currently an exposure draft (dated August 31, 2012) that would revise AICPA Ethics Interpretation 101-3 to require evaluation of threats in the aggregate. See www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/Pages/ExposureDrafts.aspx for the current status of the exposure draft.*

1. What engagements does the 2011 Yellow Book apply to?

The 2011 Yellow Book applies to financial audits and attestation engagements conducted in accordance with *Government Auditing Standards* performed for periods ending on or after December 15, 2012. However, auditors performing nonaudit services must be independent for the period covered by the financial statements. Therefore, auditors may be required to comply with the 2011 Yellow Book independence requirements for nonaudit services performed as early as January 1, 2012. The 2011 Yellow Book also applies to performance audits conducted in accordance with *Government Auditing Standards* for audits beginning on or after December 15, 2011.

2. Is a firm required to complete the AICPA 2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid or other third party standardized forms in order to evidence the firm's independence in the performance of nonaudit services performed for an auditee under the December 2011 revision to *Government Auditing Standards* (the 2011 Yellow Book)?

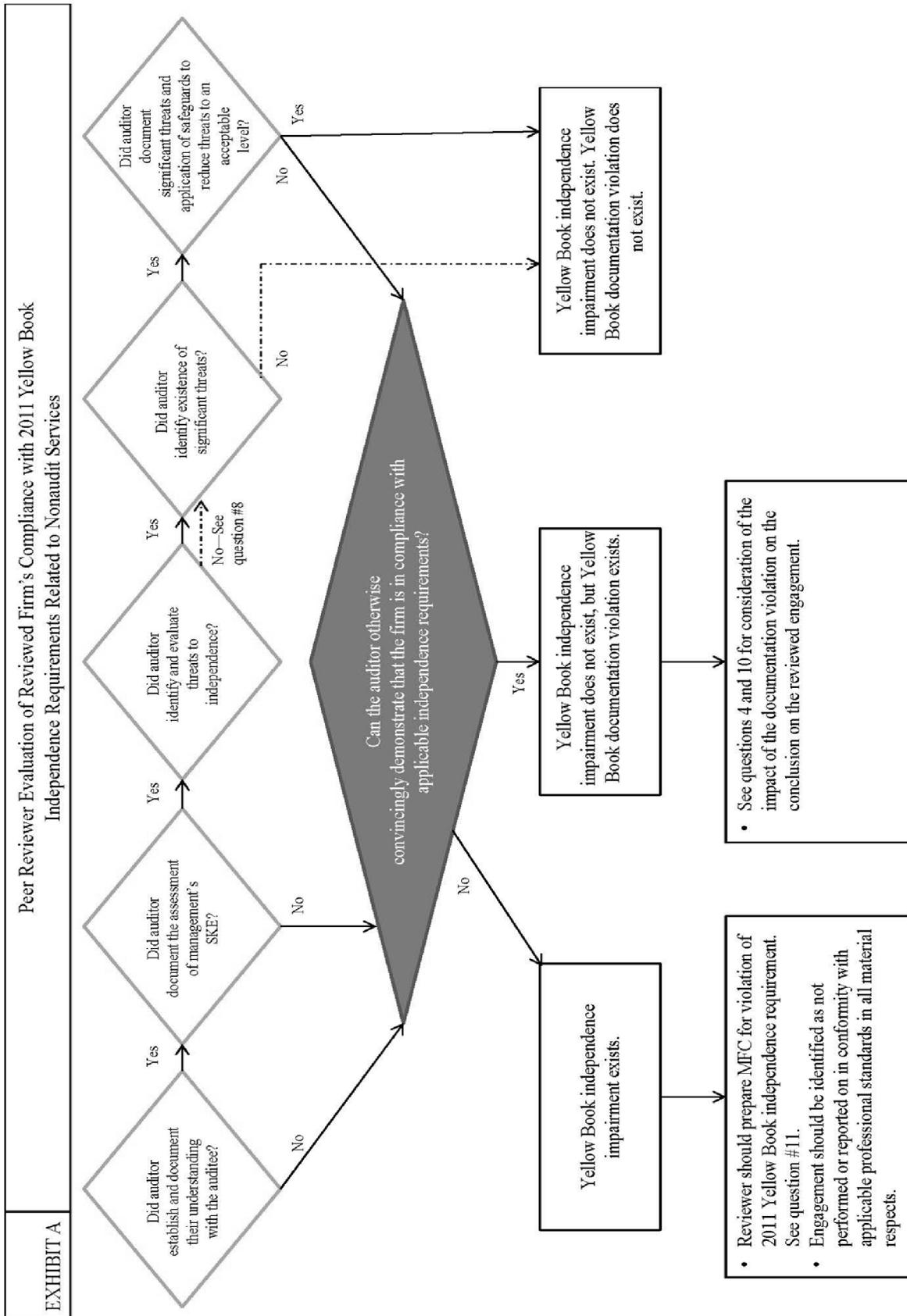
No. The *2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid* was developed to assist auditors in meeting the requirements in the 2011 Yellow Book for identifying and evaluating threats to independence when considering whether to provide a nonaudit service. An auditor could use various approaches to meet the independence evaluation and documentation requirements of the 2011 Yellow Book; therefore, use of the AICPA practice aid or any other third party provided practice aid is not required by professional standards. Peer reviewers should obtain an understanding of the firm's internal quality control policies and procedures to meet the applicable professional

requirements. The peer reviewer should evaluate whether the firm's methodology for meeting the requirements is appropriate.

Peer reviewers should note that the documentation requirement for assessment of the skills, knowledge, and experience of the individual at the auditee designated to oversee a nonaudit service will not be compliant simply through management representations or other actions performed solely by the audited entity. This requirement is applicable for any and all permitted nonaudit services, regardless of significance. Auditors are expected to document an assessment under the standards, therefore completion of a checklist that does not provide for documentation of the actual evaluation will be unlikely to comply with the standards.

3. Is there a tool that peer reviewers can utilize to evaluate a firm's compliance with the 2011 Yellow Book independence requirement related to nonaudit services?

Yes. This Q&A document provides guidance to assist peer reviewers in evaluating a firm's compliance with the 2011 Yellow Book independence requirement related to nonaudit services. The following chart in exhibit A should be used in conjunction with the interpretive guidance for peer reviews.



4. Is a failure to comply with the documentation requirements regarding independence in the 2011 Yellow Book considered a departure from professional standards?

Yes. The 2011 Yellow Book emphasizes that documentation is required for the evaluation of each of the elements of independence, which consists of management's ability to oversee the nonaudit services, including whether management has SKE, significant threats that require the application of safeguards along with the safeguards applied, and the understanding established with the audited entity regarding the nonaudit services to be performed. Failure to document one or more of these elements is considered a departure from professional standards.

The examples provided are intended to assist the peer reviewer in determining whether there is a departure from professional standards and the impact of that departure on the engagement. However, examples cannot contemplate every circumstance a peer reviewer might face and are not a substitute for professional judgment. The peer reviewer is likely to encounter situations where the engagement is somewhere on a continuum of compliance with standards. If there is a failure to document one or more of the elements of the independence evaluation required by the 2011 Yellow Book, ordinarily the engagement should be considered as not performed in conformity with applicable professional standards in all material respects. If there is marginal documentation of a particular element required by professional standards, the peer reviewer should use judgment to determine the degree of noncompliance on the conclusion of the engagement.

5. If a peer reviewer is reviewing an engagement and determines that independence is not documented in accordance with paragraph 3.59 of the 2011 Yellow Book, should the reviewer automatically conclude that there are independence impairments?

No. A documentation failure does not automatically indicate independence impairment. In a situation in which an independence documentation deficiency exists, the peer reviewer will need to perform additional inquiries of the firm to determine whether independence was impaired. In this case, an MFC will be required to document the peer reviewer and firm's assessment of the noncompliance, whether or not it rises to the level of independence impairment. If the conclusion is reached that there is either a documentation failure or independence is impaired, the reviewer should refer to questions 10 and 11.

6. How can a reviewer evaluate whether noncompliance with the documentation requirements of the 2011 Yellow Book indicates that independence is impaired?

If the firm failed to document all of the components required by *Government Auditing Standards* (that is, management's ability to oversee the nonaudit services, including whether management has SKE, significant threats that require the application of safeguards, and the understanding established with the audited entity regarding the nonaudit services to be performed), the reviewer should presume that independence was impaired. However, the audit firm may be able to provide convincing evidence that the lack of documentation does not indicate independence impairments.

Reviewers should make the initial inquiries of the firm verbally and timely. This will help the reviewer determine the underlying cause of the failure and genuineness of the firm's response. The firm can subsequently provide a written response to support the oral claims. However, if the audit firm indicates the auditee did not have anyone with sufficient SKE to oversee the nonaudit services performed, then a significant threat existed for which no safeguards to overcome the threat were available and conclusive proof exists that independence was impaired.

7. Can the firm otherwise demonstrate that it is independent although management's ability to oversee the nonaudit services, including whether they have SKE, is not properly documented?

Yes. However, the burden of proof required of the firm to evidence such compliance is high and the firm will need to provide the reviewer with persuasive evidence that independence was not impaired.

Example 7.1

The auditor established and documented the understanding with the auditee regarding the nonaudit services in accordance with paragraph 3.39 of the 2011 Yellow Book, but failed to document consideration of management's SKE. Upon inquiry by the reviewer, the auditor was able to demonstrate that the SKE of the CFO responsible for oversight of the nonaudit service was common knowledge to the auditor because of extensive history and experience with the auditee and the CFO. The reviewer should evaluate the evidence based on the totality of the situation to determine whether the firm met the burden of proof to support its claims that it had appropriately considered and complied with

the independence requirements. In this case, the reviewer might reach the conclusion that the firm failed to conform with the 2011 Yellow Book by failing to document the considerations required, but that the firm's independence was not impaired. This engagement would be considered, not performed or reported on, in conformity with applicable professional standards in all material respects for failing to comply with the documentation requirements of the 2011 Yellow Book (see question 10 for additional information).

Example 7.2

The auditor established and documented the understanding with the auditee regarding the nonaudit services in accordance with paragraph 3.39 of the 2011 Yellow Book, but failed to document consideration of management's SKE. Upon inquiry by the reviewer, the auditor was unable to provide persuasive evidence that the individual at the auditee responsible for overseeing the nonaudit service had SKE. In this case, the reviewer would likely reach the conclusion that the firm failed to conform with professional standards because the firm failed to document the considerations required and the firm was not independent because an individual with sufficient SKE did not oversee the performance of the nonaudit service. This engagement would be considered, not performed or reported on, in conformity with applicable professional standards in all material respects for failing to comply with the independence requirements of the 2011 Yellow Book (see question 11 for additional information).

8. Under what circumstances should the peer reviewer question the audit firm's evaluation of threats and documentation (or lack thereof) of safeguards to reduce threats to an acceptable level?

The 2011 Yellow Book does not require documentation of the evaluation of threats unless the threats are deemed significant enough to require the application of safeguards. If there is contradictory evidence that would appear to refute the auditor's claim that a threat is not significant, the reviewer should consider whether the audit firm's evaluation of the threat was appropriate through inquiries of the firm. If the threats are deemed to be significant, the reviewer will need to determine whether safeguards had been applied that reduced the threats to an acceptable level. If the reviewer determined that significant threats existed and safeguards were applied that reduced the threats to an acceptable level, but the firm failed to document the consideration of the threats and the application of safeguards, the reviewer may reach a conclusion that the firm was independent but failed to comply with professional standards by not documenting its independence considerations. If the reviewer determines that significant threats existed and safeguards were not applied, this would indicate independence impairment.

Factors to consider that may indicate significant threats exist include the following:

- Performance of multiple nonaudit services
- Nonaudit services that are significant to the subject matter of the audit
- Significant assumptions and judgments made by the auditor
- Significant degree of subjectivity related to the nonaudit service
- Poor condition of the audited entity's books and records

Threats must be evaluated in the aggregate as well as individually when assessing the significance of the threats.

The Government Accountability Office has indicated that, in its view, other than in very limited circumstances, preparing financial statements for an auditee would result in a significant threat for which safeguards should be applied and documented.

Example 8.1

The auditor prepared the financial statements for the auditee and this was the only nonaudit service performed. The auditor had documented the requirements under paragraphs 3.37 and 3.39 of the 2011 Yellow Book, including evaluation that the individual designated by the audited entity who oversees the preparation of the financial statements possessed SKE sufficient to oversee the service. The auditor did not identify any significant threats to independence and thus did not document that any safeguards had been applied to reduce significant threats to an acceptable level. In this circumstance, the reviewer may want to make additional inquiries of the firm as to whether they considered financial statement preparation to be a significant threat requiring the application of safeguards. The reviewer should evaluate whether the firm considered threats in relation to the nonaudit service performed, whether safeguards were applied but

not documented, and whether the firm reached an appropriate conclusion as to the significance of the threats. In this situation, the reviewer might reach one of the following conclusions:

1. The firm reached an appropriate conclusion that threats were not significant (however, see the paragraph regarding GAO's position on significance of threats for nonaudit services related to preparation of financial statements).
2. The firm did not reach an appropriate conclusion that threats were not significant and therefore did not document its assessment of threats or application of safeguards. However, the firm appropriately applied safeguards sufficient to reduce the threat(s) to an acceptable level which would result in noncompliance with professional standards but not independence impairment.
3. The firm did not reach an appropriate conclusion that threats were not significant and failed to apply safeguards to reduce significant threats to an acceptable level. Therefore, independence would be considered impaired.

Example 8.2

The auditor prepares the financial statements for the auditee and this was the only nonaudit service performed. The auditor had documented the requirements under paragraphs 3.37 and 3.39 of the 2011 Yellow Book, including evaluation that the individual designated by the audited entity who oversees the preparation of the financial statements possessed SKE sufficient to oversee the service. The auditor did not identify any significant threats to independence and thus did not document that any safeguards had been applied to reduce significant threats to an acceptable level. The reviewer noted that the auditor also proposed a significant number of material correcting journal entries in order to make the books and records complete and accurate. In this circumstance, the reviewer may reach a conclusion that threats were significant, considering that the nonaudit service is significant to the subject matter of the audit and that the books and records appear to be in a poor condition. In this circumstance, the reviewer would need to determine if appropriate safeguards were applied to reduce threats to an acceptable level in determining whether this noncompliance with professional standards rises to the level of independence impairment.

9. How should the reviewer evaluate other evidence in the workpapers that may contradict conclusions that the auditor has reached regarding independence evaluations?

Evaluation of independence is a process that must be continuously evaluated during the entire period of the audit. Circumstances can arise that would cause a firm to re-evaluate its independence considerations, and reviewers need to be alert to evidence in the workpapers that may have required a firm to perform such reconsideration.

Example 9.1

The auditor had documented its evaluation that there was sufficient SKE at the auditee to oversee the nonaudit service(s) performed. The reviewer noted that there were a significant number of material audit adjustments proposed during the audit. In addition, the auditor had to correct a number of reconciliations prepared by the auditee. The adjustments and the reconciliations related to the job responsibilities of the individual who was designated to oversee the nonaudit service(s) performed. In this circumstance, the reviewer should make additional inquiries of the firm to determine if the auditor had considered the need to re-evaluate the SKE of the designated individual as a result of these adjustments and corrections.

Example 9.2

The auditor documented his or her evaluation that there was sufficient SKE at the auditee to oversee the auditor's preparation of the financial statements as a nonaudit service. The reviewer noted that the auditor had identified a material weakness in internal control over the auditee's inability to prepare GAAP-based financial statements. In this circumstance, the reviewer may choose to make additional inquiries of the firm to determine if they had considered the need to re-evaluate the SKE of the designated individual as a result of the material weakness. The reviewer should assess whether the identified material weakness in internal controls results from the auditee's inability to reperform the service as opposed to its inability to effectively oversee the performance of the service. For purposes of complying with the independence requirements, the 2011 Yellow Book does not require SKE sufficient to reperform the service. If the reviewer determines that the material weakness relates to the auditee's inability to prepare the GAAP-based financial statements, but the auditee is capable of overseeing the service, then no further action is necessary. However, if the reviewer determines that the material weakness is an indicator that the auditee did not designate someone with

sufficient SKE to oversee the nonaudit service, then the reviewer should conclude that independence was impaired as no sufficient safeguards were present to overcome the significant threats that existed at the time the nonaudit service was performed.

10. If the peer reviewer determines that there is a failure to comply with the documentation requirements of the 2011 Yellow Book, what is the impact on the peer review and what are the responsibilities of the reviewed firm?

The peer reviewer should make inquiries of the audit firm in such a way as to (a) make an initial determination about whether the auditor understood, had awareness of, and considered all independence requirements of the 2011 Yellow Book and, if so, (b) reach a conclusion as to whether the documentation failure rises to the level of independence impairment. The reviewer's inquiries should be such that the reviewer can identify the cause of the documentation failure.

If the peer reviewer concludes that there is a documentation failure, the peer reviewer should remind the firm of its responsibilities under AU-C section 585, *Consideration of Omitted Procedures After the Report Release Date* (AICPA, *Professional Standards*) (previously AU section 390). The peer reviewer should further ascertain if independence was impaired and expect a prompt response to support the auditor's assertion that independence was not impaired. If the reviewer subsequently concludes that the audit firm has sufficiently demonstrated compliance with applicable independence elements (auditee had sufficient SKE, significant threats were mitigated by suitable safeguards, and an understanding was established with the audited entity regarding the nonaudit services to be performed), the audit firm should also take appropriate action to revise documentation in accordance with AU-C section 230, *Audit Documentation* (AICPA, *Professional Standards*) (previously SAS 103 and AU section 339), in order to comply with the 2011 Yellow Book independence requirements.

Due to a firm's failure to materially comply with the documentation requirements of the 2011 Yellow Book, the reviewed engagement would be considered not performed or reported on in conformity with applicable professional standards in all material respects. Accordingly, the peer reviewer should ordinarily prepare a MFC Form to which the reviewed firm must respond. (Refer to Interpretation 67-1, "Concluding on the Review of an Engagement.") The reviewed firm should include the actions taken or planned regarding the engagement on the MFC form. The reviewer should indicate whether the reviewer concurs with the firm's response, actions, or planned actions within section IV of the Summary Review Memorandum.

11. If the reviewer and the firm reach a conclusion that independence is impaired, what is the impact on the peer review and what are the responsibilities of the reviewed firm?

If the firm cannot provide sufficient evidence to demonstrate that the firm was independent, then the engagement is not performed or reported on in conformity with the 2011 Yellow Book in all material respects. Lack of independence on an audit engagement requires the auditor to take all appropriate steps under professional standards which may include preventing further reliance on the auditors' report, or revising and reissuing the auditors' report. The peer reviewer should remind the firm of its responsibilities under AU-C section 585, *Consideration of Omitted Procedures After the Report Date* (previously AU section 390), and AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*) (previously AU 561), regarding potential retraction of the engagement.

Additionally, as stated in paragraph 3.26 of the 2011 Yellow Book:

[i]f a threat to independence is initially identified after the auditors' report is issued, the auditor should evaluate the threat's impact on the audit and on GAGAS compliance. If the auditors determine that the newly identified threat had an impact on the audit that would have resulted in the auditors' report being different from the report issued had the auditors been aware of it, they should communicate in the same manner as that used to originally distribute the report to those charged with governance, the appropriate officials of the audited entity, the appropriate officials of the organizations requiring or arranging for the audits, and other known users, so that they do not continue to rely on findings or conclusions that were impacted by the threat to independence. If the report was previously posted to the auditors' publicly accessible website, the auditors should remove the report and post a public notification that the report was removed. The auditors should then determine whether to conduct additional audit work necessary to reissue the report, including any revised findings or conclusions or repost the original report if the additional audit work does not result in a change in findings or conclusions.

If the threat to independence cannot be reduced to an acceptable level, even if additional procedures are performed, the auditor should take appropriate steps under professional standards to prevent further reliance on the auditors' report. Due to a firm's failure to materially comply with the independence requirements of the 2011 Yellow Book, the reviewed engagement would be considered, not performed or reported on, in conformity with applicable professional standards in all material respects. Accordingly, the peer reviewer should ordinarily prepare a MFC Form to which the reviewed firm must respond. The reviewed firm should include the actions taken or planned regarding the engagement on the MFC form. The reviewer should indicate whether the reviewer concurs with the firm's response, actions, or planned actions within section IV of the Summary Review Memorandum.

Responding to Engagements Not Performed or Reported on in Conformity With Applicable Professional Standards in all Material Respects

Interpretation 67-1 indicates that the reviewed firm (firm) should make appropriate considerations to address engagements that are identified during the peer review that are not performed or reported on in conformity with applicable professional standards in all material respects. The primary responsibility is on the firm to follow professional standards to address these types of engagements. Auditing and accounting standards provide guidance for firms when this information comes to the attention of the firm subsequent to the report release date, such as information identified as a result of a peer review. The relevant professional standards include AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*, or SSARS No. 19, *Framework for Performing and Reporting on Compilation and Review Engagements* (AICPA, *Professional Standards*, AR secs. 60, 80, and 90), as applicable, or, if the firm's work does not support the report issued, as addressed in AU-C section 585, *Consideration of Omitted Procedures After the Report Date* (AICPA, *Professional Standards*). Interpretation 67-1 indicates that the reviewer should remind the firm of its responsibilities to follow the relevant professional standards to address these situations.

The firm should make and document comprehensive assessments about whether it is necessary to perform omitted procedures, or whether a material reporting error necessitates reissuance of an accounting or auditing report, revision to the financial statements, or remediation of the subsequent engagement. The firm should thoroughly consider the continued reliance by third party users on reports issued and procedures performed. Particularly, the firm should consider the expectations of regulatory bodies that the firm will perform the omitted procedures or correct reports in a timely manner.

The firm is expected to follow applicable professional standards regarding documentation of the omitted procedures, if performed, document performance or reissuance considerations, and provide a response to the peer reviewer. The firm's initial assessment should be timely and generally take place during the peer review to enable the peer reviewer to reach a proper conclusion about the engagement and evaluate the firm's response to the situation. Ordinarily, the firm's response should be documented on the MFC form that appropriately describes the most significant matters indicating the engagement is not performed or reported on in conformity with applicable professional standards in all material respects. The response may include referring to a memo subsequently added to the engagement documentation. The reviewed firm's response should indicate the conclusion and decision reached about whether or how to remediate each such engagement.

The peer reviewer should evaluate the firm's actions planned or taken or its reasons for concluding that no action is required for each engagement not performed or reported on in conformity with applicable professional standards in all material respects. The reviewer should thoroughly document these situations in the Summary Review Memorandum for System Reviews and Review Captain's Checklist for Engagement Reviews, including whether they believe the firm's considerations support its decision and whether a monitoring action is suggested to follow up on the remediation of the specific engagement. These peer review documents should be submitted for consideration during the peer review acceptance process. If all the preceding is documented appropriately, the RAB should not typically challenge the reviewed firm's considerations, actions, or conclusions. A reviewed firm's appropriately documented considerations in response to such an engagement and documentation of the reviewer's assessment of the reviewed firm's response are conditions of acceptance by the peer review committee. If the firm and reviewer considerations are not properly performed or documented, the RAB may defer acceptance of the peer review subject to appropriate considerations or peer review documentation.

Reviewers or administering entities should not require or instruct reviewed firms to perform omitted procedures, reissue accounting or auditing reports, or to have previously issued financial statements revised and reissued because those are decisions for the firm and its client to make. It is not expected that omitted procedures be performed, or all notifications made to those relying on the reports, or financial statements revised or reissued prior to the reviewer's conclusion on the engagement or conclusion on the peer review.