Understanding the Changes to Yellow Book Independence

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Today’s speakers

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What we will cover

- Independence requirements under the AICPA Code of Professional Conduct and the 2018 edition of Government Auditing Standards (the 2018 Yellow Book)
- The impact of the 2018 Yellow Book on independence with a focus on nonaudit services
- Other recent AICPA Ethics changes impacting governmental audits
- GAO and AICPA resources
Panel discussion – Why is today’s topic important for those performing governmental audits to understand?

Yellow Book revision process

Exposure draft was issued for public comment in April 2017

GAO received over 1,700 individual comments

Final standards issued in July 2018

Consultation with Advisory Council on Government Auditing Standards both at exposure draft stage and in developing final standards

Access 2018 Yellow Book
Effective date

For financial audits, attestation engagements, and reviews of financial statements for periods ending on or after June 30, 2020

For performance audits beginning on or after July 1, 2019

2018 YB supersedes:
- 2011 YB
- 2005 GAO CPE guidance
- 2014 GAO peer review ratings guidance

Early implementation is not permitted!

Summary of key change areas from 2011 YB

New format and organization

Independence requirements related to nonaudit services

CPE

Peer review requirements

Finding guidance

Waste and abuse

Standards for reviews of financial statements

Performance audits

Other

Our focus today is on independence changes!

Want to know more about other 2018 Yellow Book changes?

GAQC has made available a no-CPE archive of a previously held Web event, The 2018 Yellow Book: What You Need to Know

Covers:

- Key changes that will result from the 2018 Yellow Book
- Other 2018 Yellow Book emphasis areas

Access archived GAQC Web events
Setting the Stage

The independence “sweet spot”

A threat to independence is not acceptable if:

- An auditor’s professional judgment is compromised, or
- A reasonable and informed third party would conclude that the integrity, objectivity, or professional skepticism of the audit organization, or a member of the audit team, is compromised

Effective date emphasis point

Per YB paragraph 3.20, auditors and audit organizations should be independent from an auditor entity during:

- Any period of time that falls within the period covered by the F/S (or subject matter of the engagement);
- The period of the professional engagement.

Remember:

Assisting client with F/S preparation and other accounting services for June 30, 2019, financial statements
Key Differences Between 2018 YB and AICPA Code

Conceptual framework approach
• YB requires all circumstances/relationships that may result in threats to undergo threats/safeguards analysis
• AICPA only requires threats/safeguards analysis if circumstance/relationship not specifically addressed in Code

Permitted nonaudit services
• YB requires all permitted nonaudit services to undergo threats/safeguards analysis which may result in need for safeguards
• If nonaudit service is permitted under AICPA ET 1.295, additional safeguards are generally not required unless the member becomes aware of significant threats.

Documentation of management’s SKE

Preparing F/S in entirety always a significant threat

Documentation of evaluation of significance of threats for preparing accounting records and F/S

Key 2018 Yellow Book independence rule changes

2018 Yellow Book independence guidance for government audit organizations

- Recognizes that audit organizations in government entities frequently provide services that differ from the traditional professional services a firm provides
- These types of services are often provided: in response to a statutory requirement; at the discretion of the authority of the audit organization or to an engaging party.
- Generally do not create a threat to independence.
2018 Yellow Book independence guidance for government audit organizations

Examples of the types of services that generally would not create a threat to independence for audit organizations in government entities:

- Providing information or data to a requesting party without auditor evaluation or verification of the information or data
- Providing assistance and technical expertise to legislative bodies
- Providing assistance in reviewing budget submissions
- Providing audit, investigative, and oversight-related services that do not involve a GAGAS engagement

See 2018 Yellow Book paragraph 3.72 for the full list of examples.

Overview of key independence changes in 2018 Yellow Book

- Structure
- Nonaudit services (most significant changes in preparation of accounting records and F-5 and SKE clarifications)
- Clarification of entity(ies) requiring independence - "responsible party"
- Requirement to re-evaluate threats

Key Change: Structure – new format and organization

Presented in a “clarified” format

Requirements appear in boxes

Application guidance included after each boxed requirement

Chapters are reorganized and realigned

Certain topic areas that had previously been combined are now separated out resulting in 9 chapters

Supplemental guidance in Appendices from the 2011 YB is either removed or incorporated into 2018 YB
Steps in conceptual framework generally remain the same (see later slides)

- GAO did add new flowchart to walk auditors through independence considerations for preparing accounting records and F/S (see slide 32)

Changes made primarily relate to the following:

- Preparing accounting records and F/S
- SKE clarifications

Key Change: Nonaudit services

YB paragraph 3.24

Engaging party may differ from party responsible for subject matter of engagement

Independence would be required of the responsible party (same as under AICPA)

Independence is not required of the engaging party when different than the responsible party

Key Change: Clarification of entity(ies) requiring independence - "responsible party"

YB paragraph 3.24

Engaging party may differ from party responsible for subject matter of engagement

Independence would be required of the responsible party (same as under AICPA)

Independence is not required of the engaging party when different than the responsible party

Key Change: Requirement to re-evaluate threats

YB paragraph 3.28 states:

Auditors should re-evaluate threats to independence, including any safeguards applied, whenever the audit organization or the auditors become aware of new information or changes in facts and circumstances that could affect whether a threat has been eliminated or reduced to an acceptable level.
Applying the conceptual framework

1. Meet the general requirements
2. Determine nonaudit services are not otherwise prohibited
3. Identify threats to auditor’s independence
4. Evaluate the significance of threats
5. Identify and apply safeguards

Management must:

• Assume all management responsibilities
• Assign an individual with SKE to oversee performance of nonaudit service(s)
• Evaluate the adequacy and results of the nonaudit services performed
• Accept responsibility for the results of the nonaudit service(s)

The 2018 YB adds additional application guidance to determine whether an individual designated by management has SKE (see next slide).

New SKE application guidance – 2018 YB 3.79

Management not required to possess expertise needed to perform or re-perform the nonaudit services.

Indicators of management’s ability to effectively oversee the nonaudit service include management’s ability to:

• determine the reasonableness of the results of the nonaudit service provided
• recognize a material error, omission, or misstatement in the results of the nonaudit services provided.

YB 3.73: Auditors should determine that the audited entity has designated an individual who possesses suitable SKE and who understands the nonaudit services to be provided sufficiently to oversee them.
Red flags that management has not taken responsibility or does not have SKE

- Auditor prepares a significant number of journal entries to adjust or correct records
- Auditor gives the client a disclosure checklist to complete and they bring in back in 30 minutes
- You give the client the F/S to review which are 60 pages (including note disclosures) and their review is completed in 30 minutes; they ask no questions

Steps to ensure management accepts responsibility and oversees nonaudit services

- Have a clearly defined scope of work
- Ensure evidence of reviews and approvals by management of work
- Consider placing disclaimers on deliverables that communicate management's responsibility for the work
- Avoid providing deliverables that allow for a rubber stamp by management

Determine the nonaudit services are not otherwise prohibited – assuming management responsibilities (YB 3.31)
Determine the nonaudit services are not otherwise prohibited – prohibited nonaudit services

- Determining or changing journal entries, account codes or classifications for transactions, or other accounting records for the entity without obtaining management’s approval; authorizing or approving the entity’s transactions; and preparing or making changes to source documents (YB 3.87)
- Certain internal audit services (YB 3.96)
- Providing or supervising ongoing monitoring procedures over an entity’s system of internal control (YB 3.97)
- Certain IT services (YB 3.102)
- Appraisal, valuation, and actuarial services (YB 3.104)
- Certain other nonaudit services (YB 3.106)

See 2018 YB discussion in paragraphs 3.85 - 3.106 for considerations of specific nonaudit services that impair independence.

Identify threats to auditor’s independence

Self-interest threat
Self-review threat
Bias threat
Familiarity threat
Undue influence threat
Management participation threat
Structural threat

Independence considerations for preparing accounting records and financial statements – 3 buckets

- Determining or changing accounting records
- Authorizing or approving the entity’s transactions; and
- Preparing or making changes to source documents without management approval

Preparing F/S in their entirety

Create threats – evaluate and document

Other nonaudit services described in YB 3.89 related to preparing accounting records and F/S (see next slide)
Required documentation - preparing accounting records and F/S

Any other nonaudit services related to preparing accounting records and F/S create a threat whose evaluation for significance should be documented

- Recording transactions for which management has determined or approved the appropriate account classification, or posting coded transactions to an audited entity’s general ledger;
- Preparing certain line items or sections of the F/S based on information in the trial balance
- Posting entries that an audited entity’s management has approved to the entity’s trial balance; and
- Preparing account reconciliations that identify reconciling items for the audited entity management’s evaluation.

DON’T FORGET! Under the 2018 YB, you are required to document your evaluation of the significance of a threat created by preparing accounting records and F/S.
Significant threats – tipping point?

Consider nonaudit services individually and in the aggregate

Significance of nonaudit service to subject matter of audit

Is the threat of such significance that it would compromise an auditor's professional judgment or create the appearance that the auditor's integrity, objectivity, or professional skepticism may be compromised?

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Identify and apply safeguards

What is a safeguard?

Safeguards are actions or other measures, individually or in combination, that auditors take that effectively eliminate threats to independence or reduce them to an acceptable level.

Safeguard emphasis point

Safeguards vary depending on facts and circumstances

Not enough to just select safeguard(s) to apply

Need to ensure safeguard(s) are effective against the threat and are implemented
Example safeguards related to nonaudit services

- Not including individuals who provided the nonaudit service on the audit engagement (i.e., separate engagement teams);
- Having another auditor, not associated with the engagement, perform a concurring review of the audit engagement; or
- Having another audit organization re-perform the nonaudit service to the extent necessary to enable that other audit organization to take responsibility for the service.

Impact
Firms that do not have the ability to apply safeguards when required will either need to scale back nonaudit services or independence will be impaired.

Potential safeguards specific to certain threats

<table>
<thead>
<tr>
<th>Potential safeguards</th>
<th>Self-review</th>
<th>Management participation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Separate nonaudit service and audit engagement teams</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Engagement quality control reviews or cold reviews</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Communication with TCWG related to independence</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Educate client on independence/services</td>
<td>X</td>
<td>X</td>
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<tr>
<td>Review of deliverables by audit team prior to providing to the client</td>
<td>X</td>
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<tr>
<td>Enhanced documentation of client review/approvals</td>
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<tr>
<td>Including disclaimers on deliverables</td>
<td>X</td>
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<tr>
<td>Status updates with audit team</td>
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<td>X</td>
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<td>Firm training and communications</td>
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Note: The above example safeguards are not meant to be exclusive and these may not be appropriate depending on the facts and circumstances. In applying the conceptual framework, auditors assess the effectiveness of safeguards by determining whether threats are eliminated or reduced to an acceptable level.
Warning!
The next series of slides contains examples and scenarios that we will look at in isolation.

Remember! When considering the significance of threats to independence that the auditor should evaluate the significance of the threats identified, both individually and in the aggregate.

Our examples assume these are the only nonaudit services provided.

Many of our examples assume the auditor, using judgment, did not evaluate the nonaudit service as being significant under the 2011 Yellow Book; we are using that premise to illustrate the differences between the 2011 and 2018 Yellow Book and not because we necessarily agree with the premise.

Auditors should also re-evaluate independence when facts and circumstances change.

Panel discussion – F/S preparation
You audit Miller Town in Virginia. You also have been engaged to prepare the F/S in their entirety (i.e., F/S and related disclosures) based on the trial balance.
The director of finance has sufficient SKE to oversee this nonaudit service and takes responsibility for the service.
You previously evaluated threats in providing this nonaudit service as “not significant” and therefore did not apply safeguards.
This evaluation has not previously been documented because, in your view, the 2011 Yellow Book did not require documentation of the evaluation of threats unless threats were significant and required safeguards.

Example 1 – What impact will the 2018 Yellow Book have on this nonaudit service?
See slide 40 for related assumptions and warnings!

Panel discussion – preparing conversion entries
You audit Schebler County in Washington State. You have also been engaged to assist with the determination of conversion entries for the full accrual F/S.
The director of finance has sufficient SKE to oversee this nonaudit service and takes responsibility for the service.
You previously evaluated threats in providing this nonaudit service as “not significant” and therefore did not apply safeguards.
This evaluation has not been previously documented because, in your view, the 2011 Yellow Book did not require documentation of the evaluation of threats unless threats were significant and required safeguards.

Example 2 – What impact will the 2018 Yellow Book have on this nonaudit service?
See slide 40 for related assumptions and warnings!
Panel discussion - preparing certain sections of the financial statements

You audit Small County in Virginia. You have also been engaged to prepare the government-wide F/S based on the trial balance and several note disclosures. The county will prepare the remaining fund F/S and notes.

The director of finance has sufficient SKE to oversee this nonaudit service and takes responsibility for the service.

You previously evaluated threats in providing this nonaudit service as "not significant" and therefore did not apply safeguards.

This evaluation has not previously been documented because, in your view, the 2011 Yellow Book did not require documentation of the evaluation of threats unless threats were significant and required safeguards.

See slide 40 for related assumptions and warnings!

Panel discussion - preparing financial statements except for the long-term debt note

You audit ABC nonprofit. You have also been engaged to prepare the F/S based on the trial balance and all note disclosures except for the long-term debt note disclosure (which ABC nonprofit will prepare).

The controller has sufficient SKE to oversee this nonaudit service and takes responsibility for the service.

You previously evaluated threats in providing this nonaudit service as "not significant" and therefore did not apply safeguards.

This evaluation has not previously been documented because, in your view, the 2011 Yellow Book did not require documentation of the evaluation of threats unless threats were significant and required safeguards.

See slide 40 for related assumptions and warnings!

Panel discussion – preparing certain footnotes

You audit Bordeaux township in North Carolina. You have also been engaged to prepare the pension and OPEB notes. The township will prepare all F/S and remaining notes.

The director of accounting has sufficient SKE to oversee this nonaudit service and takes responsibility for the service.

You previously evaluated threats in providing this nonaudit service as "not significant" and therefore did not apply safeguards.

This evaluation has not previously been documented because, in your view, the 2011 Yellow Book did not require documentation of the evaluation of threats unless threats were significant and required safeguards.

See slide 40 for related assumptions and warnings!
Panel discussion – typing, printing, and binding

You audit EFG nonprofit. You have also been engaged to type, print and bind EFG’s F/S. You have not been engaged to perform any other F/S preparation services.

The controller has sufficient SKE to oversee this nonaudit service and takes responsibility for the service.

You previously evaluated threats in providing this nonaudit service as “not significant” and therefore did not apply safeguards.

This evaluation has not previously been documented because, in your view, the 2011 Yellow Book did not require documentation of the evaluation of threats unless threats were significant and required safeguards.

See slide 40 for related assumptions and warnings!

Panel discussion – Preparing the SEFA and DCF

You perform the F/S audit and single audit for RST nonprofit. You have been engaged to prepare the SEFA and DCF. RST nonprofit will prepare all other F/S and notes.

The finance director has sufficient SKE to oversee this nonaudit service and takes responsibility for the service.

You previously evaluated threats in providing this nonaudit service as “not significant” and therefore did not apply safeguards.

This evaluation has not previously been documented because, in your view, the 2011 Yellow Book did not require documentation of the evaluation of threats unless threats were significant and required safeguards.

See slide 40 for related assumptions and warnings!

Other common questions on F/S preparation

My audit client provides us with the F/S in QuickBooks. We use that information to create the F/S we audit. Would this be considered a significant threat?

How would you define “preparing the financial statements in their entirety”?

My audit client has us prepare the F/S in their entirety purely as a matter of convenience. Should this be considered a significant threat?
Other common questions on F/S preparation

My audit client prepares the balance sheet, income statement, and provides all information for the footnotes, but engages us to assist only with the preparation of the cash flows statement. Would you consider this a significant threat?

Help! We are a small 2 partner firm with 5 staff. I serve as the audit partner and we also have a tax partner. We prepare the F/S for our audit clients. What safeguards can I implement to eliminate or reduce the threats to an acceptable level? Would an EQCR be sufficient? What else?

I am a sole-proprietor. Do you think I can overcome the self-review threat without having an outside firm review the nonaudit service(s)?

There may be circumstances where safeguards will not be sufficient to mitigate the threat to an acceptable level. In those circumstances, we cannot perform the nonaudit service(s) and remain independent.
Other common questions on F/S preparation

Our audit client engages us to prepare the F/S because it is too complex for them to do. They have no one on staff that understands the accounting standards in any great depth. If we do not do this nonaudit service for them, they will be overwhelmed.

Can we do the F/S preparation nonaudit service if we consider it a significant threat and implement safeguards?

We regularly get into this circular argument in our practice and are hoping you can help.

If our clients cannot prepare the F/S without our assistance, does a reportable internal control deficiency exist (i.e., either a significant deficiency or material weakness)?

How do I distinguish the difference between normal AJEs that are discovered during the audit versus preparing entries such that we cross over into the realm of performing a nonaudit service?
A summary of key considerations in the evaluation of threats and safeguards

Make sure staff and others within the practice understand threats and are encouraged to bring those to your attention before they perform any nonaudit services.

Evaluate the materiality of the nonaudit service to the F/S.

Evaluate the degree of subjectivity involved in the nonaudit service.

Evaluate the extent of management’s involvement in determining significant matters of judgment.

Ensure that management has taken responsibility for the nonaudit service.

Ensure that safeguards are appropriate and effectively eliminate or reduce threats to acceptable level.

Remember that safeguards need to be specific to the nonaudit service(s) – not a one size fits all.

Your initial evaluation of safeguards may need to be revisited as the audit engagement evolves.

Remember….SKE is not a safeguard.

Threats to independence are not at an acceptable level if:

a. Compromises auditor’s professional judgment

b. Third party could conclude that auditor’s integrity, objectivity, or professional skepticism has been compromised

Documentation, documentation, documentation!

When in doubt….take the conservative route!
AICPA Ethics changes impacting governmental audits

Latest AICPA independence developments

Hosting - AICPA ET 1.295
Effective date delayed – 7/1/19

Long association FAQ issued March, 2018

Interpretations issued - Leases (ET 1.200.040)
- Client affiliates (ET 1.224.010)
- On the Horizon – IT Design

Exposure drafts - SLG affiliates
- Staff augmentation

AICPA – IT hosting

Hosting
- Be the sole host of attest client's financial or nonfinancial system
- Custody or storage of attest client’s data or records
- Electronic security or back-up services for attest client’s data or records

Exceptions
- Temporary as part of a service
  - Must provide all data at end of engagement
  - Licensing software
  - Attest client is responsible for maintaining output
  - Otherwise permissible service

Hosting is taking on a responsibility for a client's internal control system and therefore prohibited for an audit client.

AICPA ET 1.295.143
Independence resources

Accessing the 2018 Yellow Book

The 2018 Yellow Book can be accessed on the GAO Yellow Book Web page; or you can access the PDF file directly.

Paper editions are available for sale via the Government Publishing Office; order information.

- Printed version is a larger size book than previous versions

GAO Resources

The GAO Yellow Book Web page includes:

- Podcast on the 2018 Yellow Book
- 2011 version of the Yellow Book
- GAO contact information

GAO YB Technical Assistance Hotline

- Call (202) 512-9535; or
- E-mail yellowbook@gao.gov.
AICPA Resources

GAQC archived web event, *The 2018 Yellow Book: What You Need to Know*

AICPA Professional Ethics Division Web Page (includes link to AICPA Code)

Coming Soon! Update to GAQC Practice Aid, Yellow Book Independence – Nonaudit Services Documentation Practice Aid

Coming Soon! AICPA/GAO Independence Requirement Comparison Tool

Questions?

Panel discussion – What are the most important takeaways from today’s presentation?
How do I get my CPE certificate?

Access your CPE certificate by clicking the blue "CPE" icon.

- If at the end of this presentation you are eligible for but unable to print your CPE certificate, please log back in to this webcast in 24 hours and click the blue "CPE" button. Your certificate will still be available.

- If you need assistance with locating your certificate, please contact the AICPA Service Center at 888.777.7077 or service@aicpa.org.

Thank you