

The 2018 Yellow Book

Common Independence Questions

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Q1: Were the independence rules updated with the issuance of the new (2018) Yellow Book? If so, how?

A1: Yes, there were updates to the independence rules. One update is in paragraph 3.88, which clarifies that when preparing a client's financial statements in their entirety from the client's trial balance or underlying accounting records, an auditor should conclude that *significant threats* to independence exist.

Q2: Is this a change from the 2011 Yellow Book?

A2: The 2011 Yellow Book did not specifically identify the preparation of financial statements as a significant threat. Auditors were required to apply the conceptual framework. Preparing financial statements and then auditing those statements creates a self-review threat. A self-review threat is the threat that an auditor or an audit organization will not appropriately evaluate the judgments made in preparing the financial statements. If auditors prepared the financial statements in their entirety and then audited those same financial statements, the self-review threat would not be at an acceptable level unless the auditor applied effective safeguards.

Q3: If the threat is significant, what should I do?

A3: When encountering significant threats to independence, you should apply safeguards to eliminate or reduce the threat(s) to an acceptable level.

Q4: Does the Yellow Book provide any examples of safeguards?

A4: Paragraph 3.69 in the new Yellow Book provides examples of possible safeguards you could apply that may be effective in reducing or eliminating threats to independence. They include:

- Using separate personnel from the audit team to provide the nonaudit services.
- Engaging another auditor (from inside or outside the auditor's firm) to perform a second review of the preparation of accounting records and financial statement work.

There could also be other safeguards that may reduce threats or eliminate threats to independence. Safeguards vary depending on the facts and circumstances of an audit and in some cases, multiple safeguards may be necessary to address a threat.

Q5: How should I determine whether threats are reduced to an acceptable level?

A5: Threats are at an acceptable level when a reasonable and informed third party would likely conclude that you could perform the audit without compromising your integrity, objectivity, or

professional skepticism. You should apply professional judgment when evaluating threats, for example, by considering both qualitative and quantitative factors.

Q6: I applied safeguards to reduce threats to independence to an acceptable level. What else should I do?

A6: When you apply effective safeguards to reduce or eliminate threats to independence, you should document your evaluation of threats to independence, describe the safeguards applied and the rationale for your conclusions.

Q7: What should I do if I am unable to apply effective safeguards?

A7: If you are unable to apply appropriate safeguards to reduce threats to an acceptable level, you should not perform the nonaudit services creating the threats during the period covered by the financial statements and the period of professional engagement, *or* you should cease performing the audit or other attest services.

Q8: Were any other updates made to the independence rules in the new Yellow Book?

A8: Yes, paragraph 3.89 of the new Yellow Book states that auditors should identify any services related to preparing accounting records and financial statements as threats to independence, including:

- a. recording transactions for which management has determined or approved the appropriate account classification, or posting coded transactions to a client's general ledger;
- b. preparing certain line items or sections of the financial statements based on information in the trial balance;
- c. posting entries that a client's management has approved to the client's trial balance; and
- d. preparing account reconciliations that identify reconciling items for client management's evaluation.

Note: Paragraph 3.87 describes services that are always prohibited (e.g., determining or changing journal entries without management approval).

As noted in A1 above, when preparing a client's financial statements in their entirety, per paragraph 3.88, the auditor should conclude that significant threats exist, which would require the auditor to apply safeguards.

In addition, auditors should evaluate the significance of threats to independence created by providing any of the above services (a-d), document the evaluation of the significance of such threats and the firm's conclusion. If safeguards are applied, the auditor should describe those and the rationale for concluding that safeguards eliminated or reduced significant threats to an acceptable level.

Q9: How should I evaluate whether a threat is significant?

A9: You may consider the following factors in determining whether threats are significant, including the:

- a. Extent to which the outcome of the service could have a material effect on the financial statements;
- b. Degree of subjectivity involved in determining the appropriate amounts or treatment for those matters reflected in the financial statements; and
- c. Extent of management's involvement in determining significant matters of judgment.

Q10: What would be an example of a threat that is NOT significant?

A10: Some factors may lend themselves to concluding that a threat to independence was not significant. Perhaps you will only perform straightforward calculations requiring little to no professional judgment and the results of your work would not be material to the financial statements.

Q11: If I conclude a threat was not significant, is there anything else I need to do?

A11: If you conclude a threat related to preparing accounting records and financial statements is not significant, you should still document your evaluation, including the rationale for your conclusion. This is a change from the 2011 Yellow Book. The 2011 Yellow Book required auditors to document these threats when they concluded that the threats were significant. To comply with the 2018 Yellow Book, you should document threats created by these services even if you conclude they are not significant.

Q12: Are there any visual aids available to help me understand these rules better?

A12: Yes, Figure 2 of Chapter 3 in the Yellow Book provides a visual aid titled "Independence Considerations for Preparing Accounting Records and Financial Statements" that you may find helpful (provided at the end of this document).

Q13: Is there anything else I should be aware of?

A13: Before providing nonaudit services, you should ensure that the client will designate an individual with appropriate skills, knowledge, and experience to oversee your services. This is not a change from the 2011 Yellow Book.

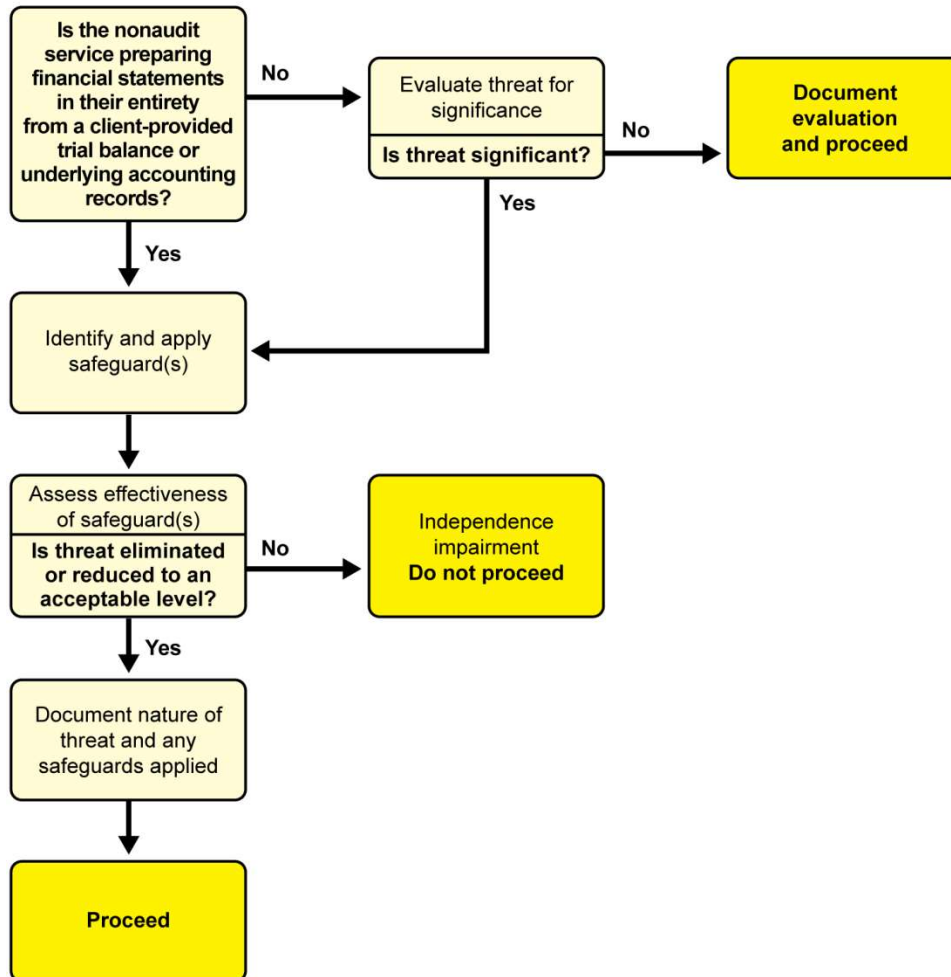
Q14: How do I know if the client has sufficient skills, knowledge, and experience?

A14: The Yellow Book provides new application guidance on evaluating whether a client has sufficient skills, knowledge, and experience to oversee a nonaudit service. Paragraph 3.79 states indicators of management's ability to oversee a nonaudit service include the ability to recognize a material error, omission, or misstatement in the results, and to determine the reasonableness of the results, of a nonaudit service.

Q15: When is the revised Yellow Book effective?

A15: The new Yellow Book is effective for financial audits, attestation engagements, and reviews of financial statements for periods ending on or after June 30, 2020, and for performance audits beginning on or after July 1, 2019. Auditors need to evaluate independence with respect to the provision of nonaudit services during the period of professional engagement, which includes the period covered by the financial statements.

Figure 2: Independence Considerations for Preparing Accounting Records and Financial Statements



Source: GAO. | GAO-18-568G

For additional information, see <https://www.gao.gov/yellowbook/overview>.