



Governmental Audit Quality Center

# Considering and Documenting Nonaudit Services under the 2018 Yellow Book

March 4, 2020

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Today's speakers



Nancy Miller,  
CPA  
KPMG



Brian  
Schebler, CPA  
RSM

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What we will cover

- An overview of the independence rules in the 2018 edition of *Government Auditing Standards* (the 2018 Yellow Book)
- Reinforcement of important concepts using a case study
- Best practices and tips
- An understanding of where things can go wrong



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Terminology and abbreviations

AICPA	American Institute of CPAs	Government Auditing Standards	Generally Accepted Government Auditing Standards or Yellow Book or GAGAS
AJE	Adjusting Journal Entry	GAO	Government Accountability Office
AICPA Code or ET section reference	AICPA Code of Professional Conduct	GAQC	Governmental Audit Quality Center
BTA	Business Type Activities	IT	Information Technology
CPE	Continuing professional education	NFP	Not for profit organization
EQCR	Engagement Quality Control Review	SKE	Skills, Knowledge, and Experience
FASB ASC	Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC)	TCWG	Those Charged With Governance
F/S	Financial Statements	YB	Yellow Book

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Panel discussion – Why is today's topic important for those performing governmental audits to understand?



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Overview of 2018  
Yellow Book  
Independence Rules

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### 2018 Yellow Book

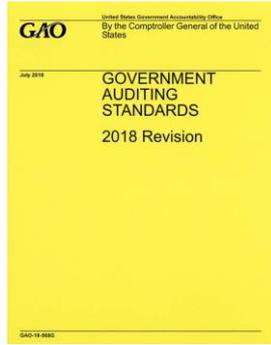
Standards issued in July 2018

Supersedes the 2011 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




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### 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.

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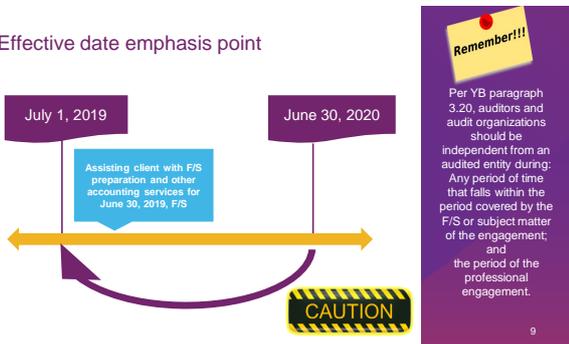
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### Effective date emphasis point




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Key changes in independence section of 2018 YB

- Structure – new format and organization
- Nonaudit services (most significant changes in preparation of accounting records and F/S and SKE clarifications)
- Clarification of entity(ies) requiring independence – “responsible party”
- Requirement to re-evaluate threats

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**Key Change: Structure – new format and organization**

- Presented in a “clarified” format
- Requirements appear in boxes
- Application guidance included after each boxed requirement

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**Key Change: Nonaudit services**

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 30)

Changes made primarily relate to the following:

- Preparing accounting records and F/S
- SKE clarifications

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

Paragraph 3.24 of 2018 YB

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

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**Key Change: Requirement to re-evaluate threats**

2018 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.

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**Key Differences Between 2018 YB and AICPA Code**

-  Conceptual framework approach
-  Permitted nonaudit services
-  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

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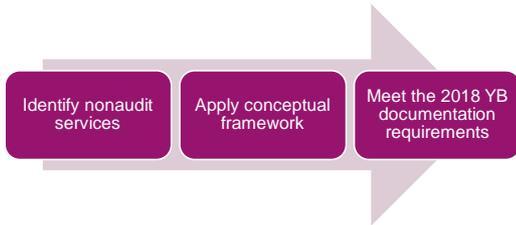
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Steps to consider and document nonaudit services



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Before we dig in.....where are the pitfalls in YB independence considerations?

- Failure to identify nonaudit services
- Failure to identify a nonaudit service as being related to preparing accounting records and F/S
- Failure to recognize lack of SKE at audited entity
- Failure to recognize when assistance with the implementation of a new standard crosses the line of assuming management responsibilities
- Failure to consider relevant factors impacting threat significance such as:
  - Materiality of the subject matter on the audit
  - Degree of subjectivity involved
  - Extent of audited entity's involvement in determining significant matters of judgment
- Failure to put into place effective safeguards
- Failure to appropriately document



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Identify nonaudit services

Examples of nonaudit services

- Preparing accounting records and F/S
- Internal audit assistance
- Internal control monitoring
- IT systems services
- Valuation services
- Other services that are not part of conducting the audit or obtaining audit evidence



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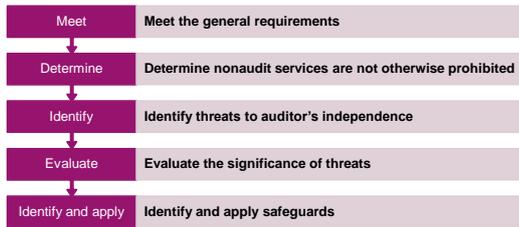
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Applying the conceptual framework



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1 Meet the general requirements

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).

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SKE application guidance – 2018 YB 3.79

Management is 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.

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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. Client returns it with significant portions incomplete and with many errors.
- 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



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Panel discussion

1. Can you discuss the common misconception that client SKE is an effective safeguard?
2. Can we do F/S preparation nonaudit services when our client does not have SKE by identifying the service as a significant threat and then implement effective safeguards to address the threats?



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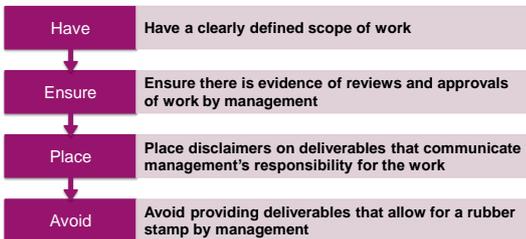
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Steps to ensure management accepts responsibility and oversees nonaudit services



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2 Determine the nonaudit services are not otherwise prohibited – assuming management responsibilities (YB 3.81)



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2 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.

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3 Identify threats to auditor's independence

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



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



**1**  
Independence impaired!

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



**2**  
Significant threats

Preparing F/S in their entirety



**3**  
Create threats – evaluate and document

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

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Required documentation – preparing F/S (not in entirety) and accounting records

Any other nonaudit services related to preparing accounting records and F/S (not in entirety) 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

See 2018 YB paragraph 3.89



**Bucket #3**

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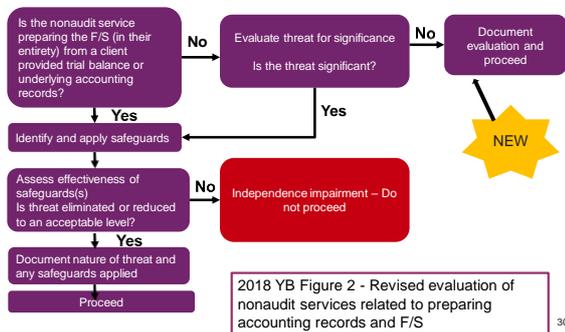
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4 Evaluate the significance of threats – factors in evaluating significance of preparing accounting records and F/S

Extent outcome could have material effect on F/S

Degree of subjectivity in determining amounts or treatment

Extent of entity's involvement in determining significant matters of judgment

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.

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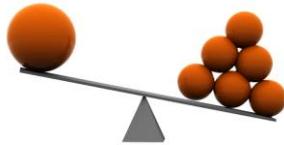
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Significant threats – tipping point?

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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5 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.



There may be circumstances where safeguards will not be sufficient to mitigate the threat to an acceptable level. In those circumstances, the auditor cannot perform the nonaudit service(s) and remain independent.

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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  
 Client SKE is not a safeguard!




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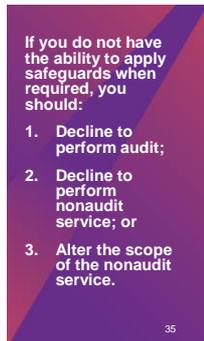
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Example safeguards related to nonaudit services

-  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




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Potential safeguards specific to certain threats	Self- review	Management participation
Separate nonaudit service and audit engagement teams	X	
Engagement quality control reviews or cold reviews	X	
Communication with TCWG related to independence		X
Educate client on independence/nonaudit services	X	X
Review of deliverables by audit team prior to providing to the client	X	X
Enhanced documentation of client review/approvals		X
Including disclaimers on deliverables		X
Status updates with audit team	X	X
Firm training and communications	X	X

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.

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



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# Case Study

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Case study information – City of Palms (the City)

<p>For the last 5 years, Jane Doe has been the Director of Finance for the City. Prior to working at the City, Jane was a bank teller.</p>	<p>Jane reports to the City Manager, Mark Smith.</p>	<p>There is a five-member elected City Council. None of the Council members have financial or accounting expertise.</p>	<p>The City has multiple funds including a water utility fund, a debt service fund, a capital projects fund, and multiple special revenue funds.</p>	<p>The City has debt related to the water utility fund, as well as General Obligation debt.</p>
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Services to be performed/prepared by Superior CPA firm (auditor of City of Palms)

- Preparation of all F/S including:
  - Conversion entries to convert from modified to full accrual and prepare the government-wide financial statements
  - Preparing the notes to the F/S
- Reconciliation of utility receivables
- Assisting with the identification of accounts payable for all funds

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Identify nonaudit services

Johnny Lane, audit manager for Superior CPAs identifies the following nonaudit services based on the services to be provided (see prior slide):

- Preparing financial statements in their entirety
- Reconciliation of utility receivables
- Assisting with the identification of accounts payable

Let's walk through Johnny's consideration of these nonaudit services

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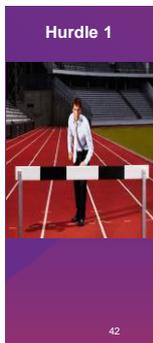
Management responsibilities and prohibited services?

Johnny determines that none of the nonaudit services that Superior CPAs will perform will involve assuming management responsibilities (see paragraphs 3.73 – 3.82 of the 2018 YB)

Johnny then reviews paragraphs 3.85 - 3.106 of the 2018 YB and determines that none of the nonaudit services to be performed by Superior CPAs are prohibited

Johnny documents both of the above conclusions

If Johnny's determinations had been that Superior CPAs would have been assuming management responsibilities OR that one of the nonaudit services was a prohibited service, Superior CPAs' independence would have been impaired!



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SKE evaluation

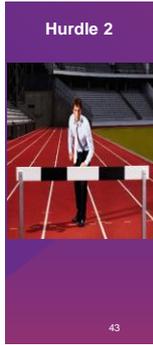
The next question Johnny needs to answer is:

- Has City of Palms designated an individual possessing suitable SKE and, if so, does that person understand the services to be provided sufficiently to oversee them?

Based on Johnny's experience in working with Jane, and upon further review of her background, Johnny concludes that Jane meets this hurdle test.

He rolls his sleeves up and begins to prepare his documentation to support this conclusion (next slide).

**If the answer to this question had been no, Superior CPAs' independence would have been impaired!**




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Documenting SKE

Johnny now documents the SKE of Jane Doe and the evaluation of his consideration of her ability to effectively oversee the nonaudit services

Here is his first stab at it. Do you think this is sufficient documentation of Jane's SKE?

Title of entity personnel overseeing the nonaudit service	Assessment/documentation
Director of Finance	Jane has been the director for five years.

**Not Johnny's first attempt. Not Johnny's second attempt. Not Johnny's third attempt. Not Johnny's fourth attempt. Not Johnny's fifth attempt. Not Johnny's sixth attempt. Not Johnny's seventh attempt. Not Johnny's eighth attempt. Not Johnny's ninth attempt. Not Johnny's tenth attempt. Not Johnny's eleventh attempt. Not Johnny's twelfth attempt. Not Johnny's thirteenth attempt. Not Johnny's fourteenth attempt. Not Johnny's fifteenth attempt. Not Johnny's sixteenth attempt. Not Johnny's seventeenth attempt. Not Johnny's eighteenth attempt. Not Johnny's nineteenth attempt. Not Johnny's twentieth attempt. Not Johnny's twenty-first attempt. Not Johnny's twenty-second attempt. Not Johnny's twenty-third attempt. Not Johnny's twenty-fourth attempt. Not Johnny's twenty-fifth attempt. Not Johnny's twenty-sixth attempt. Not Johnny's twenty-seventh attempt. Not Johnny's twenty-eighth attempt. Not Johnny's twenty-ninth attempt. Not Johnny's thirtieth attempt.**

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Johnny's second attempt – much better!

Nonaudit service	Identify the individual(s) designated by the entity to oversee the nonaudit service	Assessment of SKE
Preparing the F/S in their entirety; reconciling utility receivables; and assisting with identification of accounts payable	Jane Doe, Finance Director	Jane has a B.A. in accounting. She has 5 years experience in government finance at the City of Palms and obtains adequate CPE in governmental accounting each year. In addition, she regularly displays her knowledge on day-to-day activities, and we have observed her ability to effectively oversee the preparation of the F/S in prior years.

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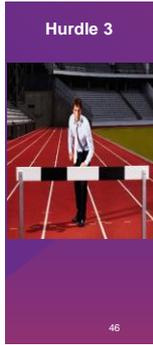
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Gaining understanding with management and documenting the understanding

Johnny meets with Jane Doe and Mark Smith to discuss the nonaudit services to ensure there is an appropriate understanding about the following:

- The objectives of the nonaudit services
- A description of the services to be provided
- Any limitations on the provision of nonaudit services including, among other things, that Superior CPAs will not make management decisions and the City will provide access to all books, records and related individuals




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Gaining understanding with management and documenting the understanding (continued)

Hurdle 3

During Johnny's discussion with Jane and Mark, he confirms that the City agrees to the following responsibilities:

- City will assume all management responsibilities
- City will have Jane oversee the nonaudit services (as noted previously, she has appropriate SKE to take on this duty)
- City will evaluate the adequacy and results of the nonaudit services
- City will accept responsibility for the results of the nonaudit services

Johnny documents these items and those on the previous slide

**If the City would not agree to accept any of these responsibilities, Superior CPAs' independence would have been impaired!**

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Identifying and evaluating threats

From reading the 2018 YB, Johnny understands that preparing the F/S in their entirety always results in a significant threat

Johnny also proceeds to identify the threats for the other two nonaudit services the firm will be performing (relating to preparing F/S and accounting records) and to document the significance of those threats

Johnny also prepares documentation evidencing this identification and evaluation process (see next two slides for Johnny's documentation)

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Example documentation for threat identification

Nonaudit service	Identify the nature of the threat
Preparing F/S in their entirety (including conversion entries from modified accrual to accrual to prepare the government-wide F/S and preparation of all footnotes)	An auditor from the engagement team will prepare the F/S from the City's trial balance using Superior CPAs' trial balance and report generator software. Due to the risk of the firm potentially making management decisions and preparing information that we will audit, performing this service creates <b>management participation and self-review threats</b> .
Reconciling utility receivables	An auditor from the engagement team will prepare a reconciliation of the utility receivables creating <b>management participation and self-review threats (same reasons as above)</b> .
Assisting with identification of accounts payable	An auditor from the engagement team will assist by identifying accounts payables creating <b>management participation and self-review threats (same reasons as above)</b> .

Identify the nature of the threats to Superior CPAs' independence

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Threat evaluation documentation

Nonaudit service	Nature of the threat	Document the evaluation of the significance of threats.
Preparing F/S in their entirety	Management participation and self-review threats	Because the firm is preparing the F/S in their entirety, threats are automatically considered <b>significant</b> per paragraph 3.88 of the 2018 YB.
Reconciling utility receivables	Same as above	The utility fund receivables represent 15% of the net assets of the City's BTAs. Due to the materiality of the subject matter, the complexity of related receivable calculations (e.g., based on meter size, residential vs. commercial, etc.), and the cumulative threat when combined with the other nonaudit services, the management participation and self review threats are deemed to be <b>significant</b> .
Assisting with identification of accounts payable	Same as above	The accounts payable for all funds represent 5% of the liabilities of the City. This fact, combined with the complexities surrounding determining certain payables (e.g., construction-in-progress and retainages payable) and the cumulative threat when combined with the other nonaudit services, the management participation and self review threats are deemed to be <b>significant</b> .

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Safeguard identification and evaluation documentation

Nonaudit service	Nature of the threat	Identify the safeguards(s) to be applied and document how the application effectively eliminates or reduces the threat(s) to an acceptable level
Preparing F/S in their entirety	Management participation and self-review threats	<p>To address the self-review threat, Nancy Clancy, an audit manager with Superior CPAs that is not assigned to the City's audit engagement will review the F/S. Nancy is experienced in governmental accounting and auditing. Having another person, outside of the engagement team, participate in this manner will effectively mitigate the self-review threat.</p> <p>To address the management participation threat, Johnny will provide a draft of the F/S to Jane for her review and approval. Jane has asked for 1-week to review the F/S. Johnny will meet with Jane after that review is complete to verify that Jane performed a thorough review (e.g., by reviewing any checklists used by Jane, discussing questions and comments that Jane has on the F/S and related disclosures, etc.). Having this management involvement will effectively mitigate the management participation threat. Johnny will have Jane evidence her review and approval in writing (email or otherwise) and will retain documentation to support her review procedures and her approval.</p>

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Safeguard identification and evaluation documentation

Nonaudit service	Nature of the threat	Identify the safeguards(s) to be applied and document how the application effectively eliminates or reduces the threat(s) to an acceptable level
Reconciling utility receivables  Assisting in identifying accounts payable	Management participation and self-review threats	

*If no safeguards are available to be applied or the safeguards do not mitigate the threat(s), Superior CPAs' independence will be impaired!*

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Panel discussion – If the nonaudit services we provide for our client do not relate to preparing accounting records and financial statements, what are our documentation requirements related to the evaluation of the significance of threats and the application of safeguards?



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Other common questions on this topic

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F/S preparation questions

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?

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

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?



Seven horizontal lines for writing answers.

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F/S preparation questions

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?

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?



Seven horizontal lines for writing answers.

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Typing, printing, and binding

I am doing the F/S audit for my NFP client. We are not preparing the F/S, but have been engaged to type, print and bind our client's F/S. How is this handled under the 2018 YB?



Seven horizontal lines for writing answers.

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Common safeguard question

We are a small 2 partner firm (1 audit partner and 1 tax partner) with 5 staff. We prepare the F/S for our audit clients.

What safeguards can we implement to eliminate or reduce the threats to an acceptable level?

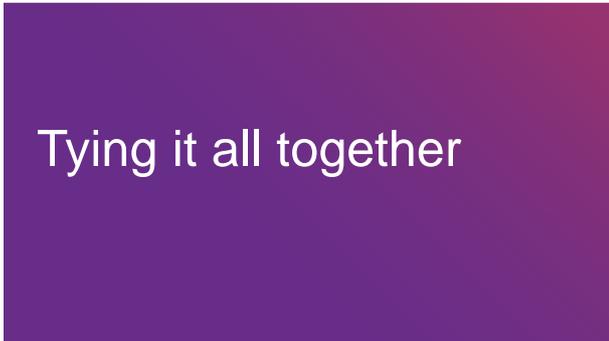
Would an EQCR be sufficient?

What else? *If no safeguards are available to be applied or the safeguards are not effective and do not mitigate the threat(s), independence will be impaired!*



Seven horizontal lines for writing notes.

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Seven horizontal lines for writing notes.

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Before we end....let's re-review where are the pitfalls in YB independence considerations

- Failure to identify nonaudit services
- Failure to identify a nonaudit service as being related to preparing accounting records and F/S
- Failure to recognize lack of SKE at audited entity
- Failure to recognize when assistance with the implementation of a new standard crosses the line of assuming management responsibilities
- Failure to consider relevant factors impacting threat significance such as:
  - Materiality of the subject matter on the audit
  - Degree of subjectivity involved
  - Extent of audited entity's involvement in determining significant matters of judgment
- Failure to put into place effective safeguards
- Failure to appropriately document



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Seven horizontal lines for writing notes.

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Key takeaways

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




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Key takeaways

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!




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Key takeaways

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!




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# Independence resources

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### GAO Resources

The [GAO Yellow Book Web page](#) includes:

- The 2018 Yellow Book
- Podcast on the 2018 Yellow Book
- The 2011 Yellow Book
- GAO contact information

GAO YB Technical Assistance Hotline

- Call (202) 512-9535; or
- E-mail [yellowbook@gao.gov](mailto:yellowbook@gao.gov).



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### 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)

Video Podcast: [Independence considerations when implementing FASB ASC 606](#) (Topic 606, *Revenue from Customers*)



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Future Resources

GAQC is developing a documentation template to assist auditors in documenting nonaudit services under the 2018 YB  
Anticipate releasing it in late Spring 2020



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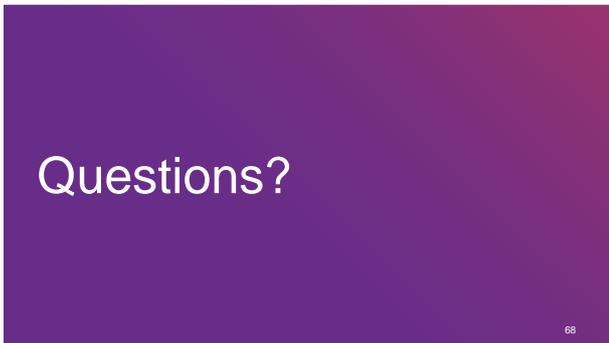
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Panel discussion – If participants take away one or two key things from this event, what would they be?



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### 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](mailto:service@aicpa.org).



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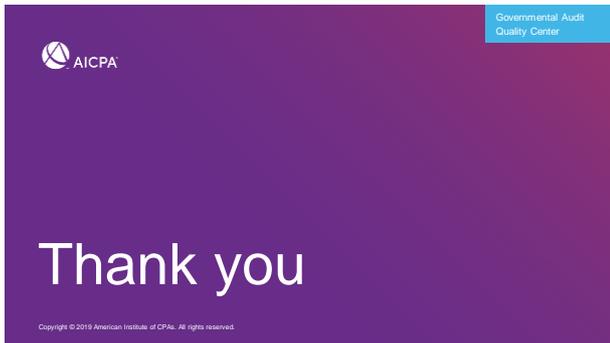
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