



## Evaluation of a Firm's Compliance with 2018 Yellow Book Independence Requirements Related to Nonaudit Services

### Notice to Readers

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.

### Question and Answers for Peer Reviewers

The following are key differences in applying the [AICPA Code of Professional Conduct](#) (the AICPA Code) independence provisions in ET Section 1.200 and the [2018 revision of Government Auditing Standards](#), also referred to as GAGAS or the 2018 Yellow Book:

- The 2018 Yellow Book requires documentation of the assessment of management's ability to oversee the nonaudit services, including whether management has suitable skill, knowledge, or experience (SKE); the AICPA Code 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 2018 Yellow Book requires that all nonaudit services that are not prohibited, regardless of significance, be assessed using the Yellow Book conceptual framework approach to independence. Therefore, all nonaudit services must be evaluated for threats and safeguards must be applied when threats are deemed to be significant. However, the AICPA Conceptual Framework should be used when making decisions on independence matters that are not explicitly addressed by the AICPA Code.
- The 2018 Yellow Book requires auditors to conclude that preparing financial records in their entirety from a client-provided trial balance or underlying accounting records creates significant threats to auditors' independence and should document the threats and safeguards applied to eliminate and reduce threats to an acceptable level or decline to provide the services (GAS paragraph 3.88). The AICPA Code generally considers preparing accounting records and financial statements permissible without the application of additional safeguards provided the firm complies with ET Section 1.295.
- The 2018 Yellow Book requires auditors to evaluate the significance of threats created by preparing accounting records and financial statements (other than those defined as impairments to independence and significant threats) as

nonaudit services (GAS paragraphs 3.89 – 3.90) and document the evaluation of such threats. The AICPA Code does not conclude that the preparation of accounting records and financial statements create threats or significant threats to independence requiring analysis and documentation.

### **1. What engagements does the 2018 Yellow Book apply to?**

The effective date for financial audits, attestation engagements, and reviews of financial statements is for periods ending on or after June 30, 2020. The effective date for performance audits is for performance audits beginning on or after July 1, 2019. However, firms 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. Therefore, firms may be required to comply with the 2018 Yellow Book independence requirements for nonaudit services performed as early as July 1, 2019.

### **2. Is a firm required to complete third-party standardized forms to evidence the firm's independence in the performance of nonaudit services for a client under the 2018 Yellow Book?**

No. A firm could use various approaches to meet the independence evaluation and documentation requirements of the 2018 Yellow Book; therefore, use of third-party practice aids is not required by professional standards. Peer reviewers would need to obtain an understanding of the firm's quality control policies and procedures to meet the applicable professional requirements. The peer reviewer would evaluate whether the firm's methodology for meeting the requirements is appropriate.

The documentation requirement for assessment of the SKE of the individual at the client designated to oversee a nonaudit service will not be compliant simply through management representations or other actions performed solely by the client. This requirement is applicable for all permitted nonaudit services, regardless of significance. Firms are expected to document an assessment under the standards, therefore completion of a checklist that does not provide for documentation of the actual evaluation of the SKE of the individual at the client designated to oversee nonaudit services will be unlikely to comply with the standards.

### **3. Are there tools that peer reviewers can utilize to evaluate a firm's compliance with the 2018 Yellow Book independence requirements related to nonaudit services?**

Yes. Two flowcharts at the end of chapter 3 of the 2018 Yellow Book further illustrate the independence requirements and enhance understanding. Figure 1 is titled, "Generally Accepted Government Auditing Standards Conceptual Framework for Independence," and Figure 2 is titled, "Independence Considerations for Preparing Accounting Records and Financial Statements."

Additionally, this Questions and Answers document for peer reviewers provides guidance to assist peer reviewers in evaluating a firm's compliance with the 2018 Yellow

Book independence requirements related to nonaudit services. The flowchart in [Exhibit A](#) may be used in conjunction with this Questions and Answers document.

**4. Is a lack of compliance with the documentation requirements regarding independence in the 2018 Yellow Book considered a departure from professional standards?**

Yes. The 2018 Yellow Book (GAS paragraph 3.107) emphasizes that documentation is required for each of the elements of independence, where applicable, consisting of:

- a. Consideration of audited entity management's ability to effectively oversee the nonaudit services, including whether management has SKE,
- b. Threats that require the application of safeguards along with the safeguards applied,
- c. The understanding established with the audited entity regarding the nonaudit services to be provided, and
- d. Evaluation of the significance of the threats created by providing any of the services discussed in GAS paragraph 3.89.

If a firm does not document one or more of the elements of the independence evaluation required by the 2018 Yellow Book, ordinarily the engagement would be identified as not performed or reported on in accordance with the requirements of applicable professional standards in all material respects (nonconforming).

The peer reviewer should exercise professional judgment when there is marginal documentation of a particular element required by professional standards when determining the degree of noncompliance on the engagement. Consider if the firm can otherwise demonstrate its compliance with all requirements, including documentation, or whether there is a lack of understanding. Peer reviewers would need to thoroughly document all relevant considerations within the peer review working papers to reduce questions during technical review and Report Acceptance Body (RAB) acceptance.

**Example 4.1**

The firm fully prepares the financial statements for the client and this was the only nonaudit service performed. The firm:

- Documented significant threats to independence and applied and documented appropriate safeguards, and
- Documented management's SKE to oversee the nonaudit services, and
- Obtained a representation letter where the client accepted responsibility for nonaudit services (after the service was performed).

The firm did not document the understanding with the client of nonaudit services to be provided. In this circumstance, the engagement would likely be considered nonconforming for the firm not documenting all the four of the items in GAS paragraph 3.107. Each item should be evaluated independently and must be satisfied to conform to the relevant professional standards.

#### Example 4.2

The firm prepares the client's financial statements in their entirety and this was the only nonaudit service performed. The engagement documentation identified:

- The understanding with the client for nonaudit service of preparing the financial statements,
- Management's ability to oversee the nonaudit service, including the SKE of the designated individual responsible for overseeing the nonaudit service, and
- Obtained a representation letter where the client accepted responsibility for nonaudit services (after the service was performed).

Since the auditor was involved in preparing the financial statements in their entirety, it appears that significant threats to independence exist; however, the engagement working papers did not document that the threats were significant, nor explicitly identify which safeguards were applied to reduce such threats to an acceptable level. There is evidence in the working papers that an engagement quality control review (EQCR) was performed on the engagement in accordance with the firm's quality control policy applicable to all Yellow Book audits. Upon inquiry by the peer reviewer, the firm indicates that the firm EQCR was the safeguard applied to reduce the significant threat to an acceptable level. In this circumstance, the engagement would likely be considered nonconforming for not documenting identification of a significant threat.

In addition, the reviewer would need to consider whether the documentation of the safeguard applied was marginal by evaluating the evidence. If documentation of safeguards applied is less than marginal, this departure may also contribute to a nonconforming engagement. GAS paragraph 3.49 indicates safeguards are actions or other measures, individually or in combination, that auditors and audit organizations take that effectively eliminate threats to independence or reduce them to an acceptable level and vary depending on the facts and circumstances.

#### Example 4.3

Assume the same circumstances as Example 4.2 except the firm identified and documented significant threats to independence; however, the firm did not document in the engagement working papers the related safeguard applied to reduce the significant threat to an acceptable level. Upon inquiry by the peer reviewer, the firm indicated an independent qualified individual performed the EQCR as the safeguard in accordance with the firm's quality control policy. In this circumstance, the engagement would likely be considered nonconforming because the performance of the procedure was not documented to be in relation to the assessment of the threat nor directly consider the

circumstances of the client or engagement. GAS paragraph 3.49 indicates safeguards are actions or other measures, individually or in combination, that auditors and audit organizations take that effectively eliminate threats to independence or reduce them to an acceptable level and vary depending on the facts and circumstances.

**5. Is it necessary for a firm to document their consideration of an independence threat even if the threat is not significant?**

Yes. Peer reviewers should consider if the firm's documentation of independence considerations are in accordance with [AU-C Section 230, Audit Documentation](#). AU-C Section 230.08-.09 indicates,

“.08 The auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

- a. The nature, timing, and extent of the audit procedures performed to comply with GAAS and applicable legal and regulatory requirements;
- b. The results of the audit procedures performed, and the audit evidence obtained; and
- c. Significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions”.

“.09 In documenting the nature, timing, and extent of audit procedures performed, the auditor should record:

- a. The identifying characteristics of the specific items or matters tested;
- b. Who performed the audit work and the date such work was completed; and
- c. Who reviewed the audit work performed and the date and extent of such review”.

A reviewer with no connection to the audit is presumed to have no access to anything except what is in the working papers. Therefore, the working papers need sufficient detail for the reviewer to understand what was done and significant conclusions being reached, for example, a firm evaluating all nonaudit services and considering if any of them are a threat. The working papers should stand on their own to support the procedures performed by the firm and include sufficient detail to support those procedures.

**Example 5.1**

The firm performs services for the client involving assistance with the preparation of the pension footnote and the results of the firm's work would not be material to the client. The client will prepare the financial statements and all remaining footnotes. Additionally, client management is fully engaged in overseeing the services and has designated an individual with appropriate SKE to oversee the service. This was the only nonaudit

service performed. If the firm concludes the self-review threat is not significant, it would still document its evaluation, including the rationale for its conclusion. If the threats to independence are considered significant, and safeguards will be applied that effectively reduce threats to an acceptable level, then the documentation would include the significant threats and a description of the safeguards applied.

**6. Should a firm separately identify preparation of the financial statements and preparation of the Schedule of Expenditures of Federal Awards (SEFA) in the documentation of the evaluation of threats to independence and the application of safeguards?**

The auditee is responsible for preparing the SEFA. The auditor's responsibility is to determine and report on whether the SEFA is presented fairly in all material respects in relation to the auditee's financial statements as a whole. If the firm is preparing the SEFA, the firm should document performance of the service as a nonaudit service. If the firm is assisting management in the preparation of financial statements, including the SEFA, the firm should document preparation of the SEFA as a nonaudit service. While not explicitly required by the 2018 Yellow Book to document separately, it should be clear from the documentation that preparation of the SEFA was considered. The firm must meet the requirements for performing nonaudit services under paragraph 3.77 of the 2018 Yellow Book, including documentation of compliance with those requirements. The firm should also apply the 2018 Yellow Book's conceptual framework (GAS paragraphs 3.26 – 3.83) for independence considerations and documentation thereof.

Peer reviewers are reminded that GAS paragraph 3.68 states that nonaudit services provided by auditors can affect independence in mind and in appearance in periods after the period in which the nonaudit service was provided. If a firm does not properly assess the impact of nonaudit services on current and future work and does not adequately respond to identified threats to independence, independence impairments could result in both current and subsequent periods.

**7. If a firm is preparing accounting records and financial statements from information provided by the client who has the SKE to prepare the financial statements themselves, how does the management participation threat apply?**

Under the 2018 Yellow Book, management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework, even if the auditor assisted in drafting those financial statements (GAS paragraph 3.91). Management participation threats occur during the performance of nonaudit services when a firm takes on the role of management. A firm that acts on behalf of management (e.g., takes responsibility for the service, performs a management function, makes decisions on behalf of the client) is no longer independent to objectively assess and report on management's actions. Whether those threats exist depends on the facts and circumstances of the nonaudit service.

**Example 7.1**

A firm performs the audit for the client and has been engaged to assist with the determination of conversion entries for the full accrual financial statements for which the

requirements for performing nonaudit services have been met under paragraphs 3.76 and 3.77 of the 2018 Yellow Book. This is the only nonaudit service that the firm has been requested to perform. The firm concluded the individual designated by the client who oversees the nonaudit service possess SKE sufficient to effectively oversee the service and takes responsibility for the service. If the firm is making determinations on what those conversion entries should be without appropriate oversight, input, and approval from the client, a higher management participation threat may exist. It is important that the client make an informed judgement on the results of the firm's performance of nonaudit services and understands its responsibility for the outcomes. In this situation, the firm should document the evaluation of the threats to determine significance. If significant, the documentation should include a description of the safeguards applied to reduce any significant threats to an acceptable level.

Peer reviewers are reminded to carefully consider the documentation required by GAS paragraphs 3.74 and 3.107 and that the management-level individual who oversees the nonaudit services possesses SKE sufficient to effectively oversee the services.

Refer to GAS paragraph 3.43 for illustrative examples of circumstances that create management participation threats for a firm.

**8. Would a lack of documentation of the consideration of the cumulative effect of providing multiple nonaudit services be considered a departure from professional standards?**

Yes. The AICPA Code of Professional Conduct ET 1.200 provides a conceptual framework for independence and general requirements for performing nonattest services, including consideration of the aggregate effect of providing multiple nonattest services on threats to independence. The 2018 Yellow Book builds on top of those requirements, especially related to documentation. GAS paragraph 3.64 states that each nonaudit service should be evaluated considering other nonaudit services before a firm agrees to provide a nonaudit service to a client. When considered in isolation, each nonaudit service may not be deemed significant; but when considered cumulatively, they could have grown to a point where the firm would need to either not perform the additional nonaudit service or implement safeguards to reduce the threats to an acceptable level. Documentation of independence considerations provides evidence of the auditor's judgements in forming conclusions regarding compliance with independence requirements (GAS paragraph 3.108). While insufficient documentation of an auditor's compliance with the independence standard does not impair independence, appropriate documentation is required under the 2018 Yellow Book quality control and assurance requirements.

Peer reviewers are reminded that before a firm can provide a nonaudit service, a firm should ensure that the client will designate an individual with suitable SKE to oversee the nonaudit service to be provided and document the assessment of the client management's ability to effectively oversee the nonaudit service provided. The evaluation and documentation are required for all nonaudit services regardless of the significance of the threats. The designated individual must be willing and able to oversee the nonaudit service(s) (GAS paragraphs 3.73 – 3.74, and 3.107c).

If a firm does not conform with the 2018 Yellow Book by not documenting the considerations required, the engagement would ordinarily be considered nonconforming for not complying with the documentation requirements of the 2018 Yellow Book (see questions 4 and 16 for additional information).

#### Example 8.1

The auditor prepared multiple reconciliations for the auditee, including cash, accounts receivable, accounts payable, and accrued expenses. No other nonaudit services were performed. The auditor had documented the requirements under 3.76 and 3.77 of the 2018 Yellow Book, including evaluation that there was sufficient SKE at the auditee to oversee the nonaudit services performed. 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 peer reviewer may want to make additional inquiries of the firm as to whether it considered that multiple reconciliations may indicate an increased threat compared with just providing one reconciliation. The peer reviewer should assess the firm's documentation of the evaluation of threats to independence (GAS paragraphs 3.89 – 3.90), whether the firm reached an appropriate conclusion as to the significance of the threats, and whether safeguards were applied but not documented. If the peer reviewer determines the firm did not reach an appropriate conclusion about the significance of the threats, but the firm appropriately applied safeguards sufficient to reduce the threats to an acceptable level, then the peer reviewer would likely conclude noncompliance with professional standards but not independence impairment. However, if the peer reviewer determines the firm did not reach an appropriate conclusion about the significance of the threats and did not apply safeguards to reduce significant threats to an acceptable level, then the reviewer would likely conclude that independence was impaired as no sufficient safeguards were present.

#### Example 8.2

The auditor prepared the financial statements, cash-to-accrual conversion entries, bank reconciliations, and depreciation schedules. No other nonaudit services were identified as nonaudit services expected to be performed. The auditor had documented the requirements under 3.76 and 3.77 of the 2018 Yellow Book, including evaluation that there was sufficient SKE at the auditee to oversee the nonaudit services performed. The auditor identified significant threats to independence and documented safeguards had been applied to reduce significant threats to an acceptable level. The peer reviewer noted that the auditor proposed a significant number of material audit adjustments to make the books and records complete and accurate. In addition, the firm had to correct several reconciliations prepared by the client. In this circumstance, the peer reviewer would likely need to assess 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. If management does not have SKE to oversee the nonaudit services, then the firm is assuming management responsibilities and independence would be impaired.



**9. If a peer reviewer is reviewing an engagement and determines that independence is not documented in accordance with paragraph 3.107 of the 2018 Yellow Book, should the peer reviewer automatically conclude that there are independence impairments?**

No. Documentation noncompliance does not automatically indicate independence impairment. In a situation in which independence documentation noncompliance exists, the peer reviewer would need to perform additional inquiries of the firm to determine whether independence was impaired. In this case, a matter for further consideration (MFC) form will be required to document the peer reviewer and firm's assessment of the noncompliance, and whether it rises to the level of independence impairment. If the conclusion is reached that there is either documentation noncompliance or independence is impaired, refer to questions 16 and 17.

**10. How can a peer reviewer evaluate whether noncompliance with the documentation requirements of the 2018 Yellow Book indicates that independence is impaired?**

If the firm did not document all the components required by 2018 Yellow Book (refer to question 4), the peer reviewer may presume that independence was impaired. However, the firm may be able to provide convincing evidence that the lack of documentation does not indicate independence impairments.

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

**11. 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 would need to provide the peer reviewer with persuasive evidence that independence was not impaired.

**Example 11.1**

The firm established and documented the understanding with the client regarding the nonaudit services in accordance with paragraph 3.77 of the 2018 Yellow Book but did not document consideration of management's SKE. Upon inquiry by the peer reviewer, the firm was able to demonstrate that the SKE of the Chief Financial Officer (CFO) responsible for oversight of the nonaudit service was common knowledge to the firm because of extensive history and experience with the client and the CFO. The peer reviewer would need to evaluate the evidence to determine whether the firm appropriately considered and complied with the independence requirements. In this

case, the peer reviewer might reach the conclusion that the firm did not conform with the 2018 Yellow Book by not documenting the considerations required, but that the firm's independence was not impaired. This engagement would also be considered nonconforming for not complying with the documentation requirements of the 2018 Yellow Book (see question 16 for additional information).

#### Example 11.2

The firm established and documented the understanding with the client regarding the nonaudit services in accordance with paragraph 3.77 of the 2018 Yellow Book but did not document consideration of management's SKE. Upon inquiry by the peer reviewer, the firm was unable to provide persuasive evidence that the individual at the client responsible for overseeing the nonaudit service had SKE. In this case, the peer reviewer would likely reach the conclusion that the firm did not conform with professional standards because the firm did not 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 also be considered nonconforming for not complying with the independence requirements of the 2018 Yellow Book (see question 17 for additional information).

### **12. What safeguards are required when significant threats to independence are identified?**

GAS paragraph 3.69 provides examples of safeguards that may be effective, either individually or in combination, under certain circumstances. While the list does not provide safeguards for all circumstances, it provides a starting point for firms who have identified significant threats to independence and are considering what safeguards could eliminate those threats or reduce them to an acceptable level. Safeguards vary depending on the facts and circumstances of an audit and in some cases multiple safeguards may be necessary to address a threat.

Peer reviewers are reminded that it is not possible to rely solely on the safeguards that the audited entity has implemented to eliminate significant threats or reduce them to an acceptable level (GAS paragraph 3.49). Furthermore, client SKE should not be viewed as a safeguard, but a mandatory condition before performing any nonaudit services (GAS paragraph 3.73).

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

Under the 2018 Yellow Book, if the auditor is preparing the financial statements in their entirety (from a client-provided trial balance or underlying accounting records), it is a significant threat for which sufficient safeguards must be applied to reduce the threat to an acceptable level and this should be documented. Anything less than financial statement preparation in their entirety, the threat must be evaluated for significance, and documented (and safeguards applied if necessary, and documented). (GAS paragraphs 3.89 – 3.90, and 3.107 – 3.108)

If there is contradictory evidence that would appear to refute the firm's claim that a threat is not significant, the peer reviewer would need to consider whether the firm's evaluation of the threat was appropriate through inquiries of the firm. If the threats are deemed to be significant, the peer reviewer would determine whether safeguards had been applied that reduced the threats to an acceptable level. If the peer reviewer determined that significant threats existed and safeguards were applied that reduced the threats to an acceptable level, but the firm did not document the consideration of the threats and the application of safeguards, the peer reviewer may reach a conclusion that the firm was independent but did not comply with the documentation requirements of the professional standards. If the peer reviewer determines that significant threats existed and safeguards were not applied, this would indicate independence impairment.

Threats must be evaluated individually and, in the aggregate, when assessing the significance of the threats. Factors to consider that may indicate significant threats exist include, but are not limited to, the following: (GAS paragraph 3.94)

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

#### Example 13.1

The firm prepares the financial statements for the client, including all footnote disclosures, and this was the only nonaudit service performed by the firm. The firm documented the requirements under paragraph 3.77 of the 2018 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 firm 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, when preparing a client's financial statements in their entirety, the peer reviewer should conclude that significant threats exist, which would require the firm to apply safeguards (GAS paragraph 3.88). In this circumstance, the peer 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.

#### Example 13.2

The firm performs services for the client involving preparation of accounting records that includes straightforward calculations requiring little to no professional judgement and the results of the firm's work would not be material to the financial statements. Additionally, client management is fully engaged in overseeing the services and has designated an individual with appropriate SKE to oversee the service. This was the only nonaudit service performed. The firm documented the requirements under paragraphs 3.76 and

3.77 of the 2018 Yellow Book, including evaluation that the individual designated by the audited entity who oversees nonaudit service 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 were applied to reduce significant threats to an acceptable level. The peer reviewer would need to evaluate whether the firm considered the significance of threats to independence in relation to the nonaudit service performed and documented the evaluation and the firm's conclusion, 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 peer reviewer might reach one of the following conclusions:

1. The firm reached an appropriate conclusion that threats were not significant.
2. The firm did not reach an appropriate conclusion that threats were not significant and therefore did not document its application of safeguards. However, the firm appropriately applied safeguards sufficient to reduce the threats to an acceptable level which would result in noncompliance with the documentation requirements of professional standards but not independence impairment.
3. The firm did not reach an appropriate conclusion that threats were not significant and did not apply safeguards to reduce significant threats to an acceptable level. Therefore, independence would be considered impaired.

#### **14. How should the peer reviewer evaluate other evidence in the working papers that may contradict conclusions that the firm 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 reevaluate its independence considerations, and peer reviewers need to be alert to evidence in the working papers that may have required a firm to perform such reconsideration. For example, a change in the scope of the engagement, changes in client personnel, or changes to threats to independence. GAS paragraph 3.28 indicates:

Auditors should reevaluate 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.

##### **Example 14.1**

The firm documented the evaluation that there was sufficient SKE at the client to oversee the nonaudit services performed. The peer reviewer noted that there were a significant number of material audit adjustments proposed during the audit. In addition, the firm had to correct several reconciliations prepared by the client. The adjustments and the reconciliations related to the job responsibilities of the individual who was designated to oversee the nonaudit services performed. In this circumstance, the peer reviewer would need to make additional inquiries of the firm to determine if the firm had

considered the need to re-evaluate the SKE of the designated individual because of these adjustments and corrections.

#### Example 14.2

The firm documented the evaluation that there was sufficient SKE at the client to oversee the firm's preparation of the financial statements as a nonaudit service. The peer reviewer noted that the firm identified a material weakness in internal control over the client's inability to prepare GAAP-based financial statements. In this circumstance, the peer reviewer may choose to make additional inquiries of the firm to determine if it had considered the need to re-evaluate the SKE of the designated individual because of the material weakness. The peer reviewer would need to assess whether the identified material weakness in internal controls results from the client's inability to re-perform the service as opposed to its inability to effectively oversee the performance of the service.

For purposes of complying with the independence requirements, the 2018 Yellow Book does not require SKE sufficient to re-perform the service (GAS paragraph 3.79). If the peer reviewer determines that the material weakness relates to the client's inability to prepare the GAAP-based financial statements, but the client is capable of overseeing the service, then no further action is necessary. However, if the peer reviewer determines that the material weakness is an indicator that the client did not designate someone with sufficient SKE to oversee the nonaudit service, then the peer reviewer would 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.

### **15. Can a sole practitioner overcome a significant self-review threat over preparation of financial statements without bringing in a third party?**

The application of appropriate safeguards vary depending on the facts and circumstances and should be responsive to the applicable threats (e.g., self-review, management participation, familiarity). Firms use professional judgement in applying the Yellow Book conceptual framework to determine independence in each situation, which includes identifying and evaluating any threats to the auditor's independence, threats to the appearance of independence, and related safeguards that may mitigate the identified threats.

In the instance of a sole practitioner with no other independent qualified staff, performing the audit and preparing the financial statement in their entirety is a significant threat that is difficult to overcome without an outside party. However, it may be possible to apply multiple safeguards to comply with professional standards.

#### Example 15.1

The sole practitioner prepared the financial statements for the client, and this was the only nonaudit service performed. The engagement documentation identified

- the understanding with the client for the nonaudit service of preparing the financial statement, and

- management's ability to oversee the nonaudit service, including SKE of the designated individual responsible for overseeing the nonaudit service.

The sole practitioner identified significant threats to independence and documented his or her own CPE and cold review as safeguards to reduce significant threats to an acceptable level with no further explanation or consideration in the audit working papers. In this circumstance, the peer reviewer may consider making additional inquiries of the firm about how the facts and circumstances support the use of the safeguard actions employed and its effectiveness. For example, how much time elapsed between financial statement preparation and cold review and why the practitioner believed it was sufficient to address all applicable threats. The peer reviewer would need to 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 compiled with independence requirements. Without sufficient explanation and documentation, the practitioner would also need to be able to explain or demonstrate that independence is not actually impaired.

#### Example 15.2

The sole practitioner prepared the financial statements for the client, and this was the only nonaudit service performed. The engagement documentation identified

- the understanding with the client for the nonaudit service of preparing the financial statement, and
- management's ability to oversee the nonaudit service, including SKE of the designated individual responsible for overseeing the nonaudit service.

The sole practitioner identified significant threats to independence and documented a second review by a manager, not involved with the engagement in any way, as the safeguard to reduce significant threats to an acceptable level. Upon inquiry by the peer reviewer, the sole practitioner was able to demonstrate that the manager had the necessary competence to support the use of the safeguard action employed and its effectiveness. In this case, the peer reviewer might reach the conclusion that the firm appropriately applied safeguards sufficient to reduce the threats to an acceptable level.

#### **16. If the peer reviewer determines that the auditor did not comply with the documentation requirements of the 2018 Yellow Book, what is the impact on the peer review and what are the responsibilities of the firm?**

The peer reviewer would need to make inquiries of the firm in such a way as to

- make an initial determination about whether the auditor understood, had awareness of, and considered all independence requirements of the 2018 Yellow Book and, if so,

- reach a conclusion as to whether the documentation noncompliance rises to the level of independence impairment.

The peer reviewer's inquiries would be focused on identifying the cause of the documentation issue. If the peer reviewer concludes that there is documentation noncompliance, the peer reviewer should remind the firm of its responsibilities under AU-C section 585, *Consideration of Omitted Procedures After the Report Release Date* (Refer to paragraph .39 of PR-C section 210). The peer reviewer would need to further ascertain if independence was impaired and expect a prompt response to support the auditor's assertion that independence was not impaired. If the peer reviewer concludes that the firm has sufficiently demonstrated compliance with applicable independence elements (client 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 peer reviewer would need to remind the firm of its responsibilities under AU-C section 230, *Audit Documentation*.

When a firm does not materially comply with the documentation requirements of the 2018 Yellow Book, the reviewed engagement would likely be considered nonconforming. Accordingly, the peer reviewer would prepare a MFC form to which the firm must respond (Refer to paragraph .39 of PR-C section 210). The MFC form would include the firm's actions taken or planned regarding the engagement. The peer reviewer would then indicate whether the peer reviewer concurs with the firm's response, actions, or planned actions within the "Findings and Conclusions" section of the Summary Review Memorandum (SRM).

**17. If the peer 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 firm?**

If the firm cannot provide sufficient evidence to demonstrate that the firm was independent, then the engagement is ordinarily nonconforming. Lack of independence on an audit engagement requires the firm 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 Release Date*, and AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*, regarding potential retraction of the engagement (Refer to paragraph .39 of PR-C section 210).

Additionally, as stated in paragraph 3.34 of the 2018 Yellow Book:

If auditors initially identify a threat to independence after the audit report is issued, auditors should evaluate the threat's effect on the engagement and on GAGAS compliance. If the auditors determine that the newly identified threat's effect on the engagement would have resulted in the audit 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

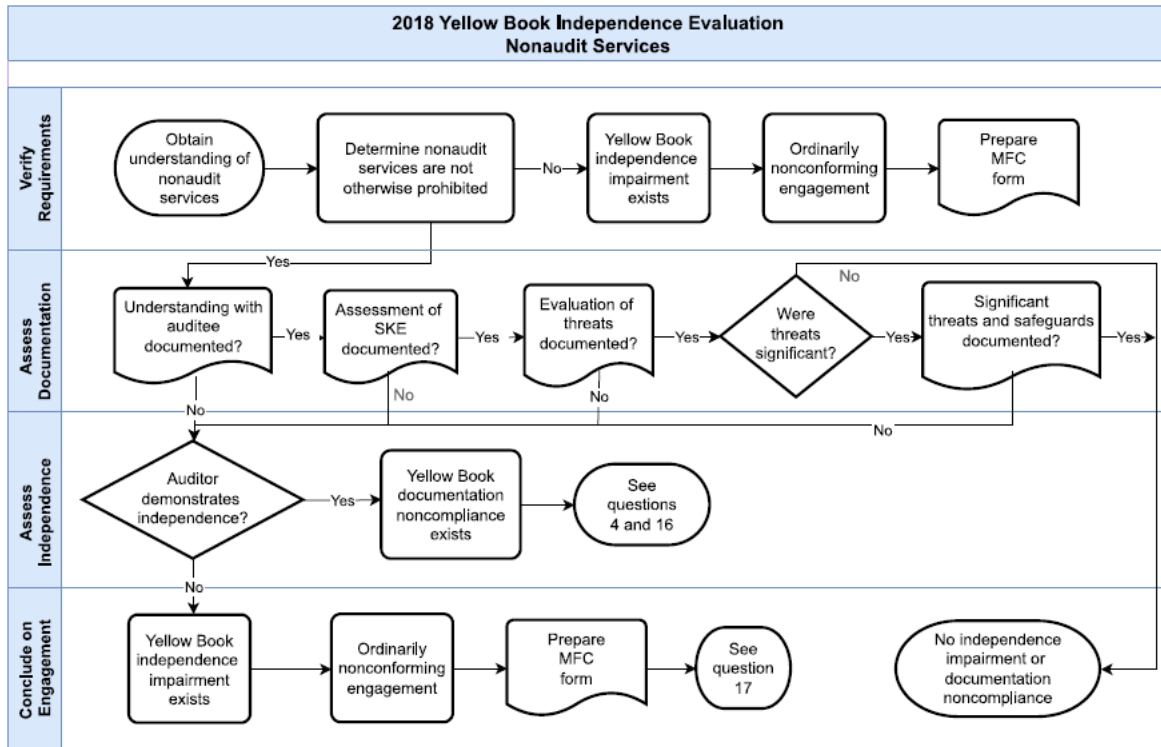
engagements, and other known users, so that they do not continue to rely on findings or conclusions that were affected by the threat to independence. If auditors previously posted the report to their publicly accessible website, they should remove the report and post a public notification that the report was removed. The auditors should then determine whether to perform the additional engagement work necessary to reissue the report, including any revised findings or conclusions, or to repost the original report if the additional engagement 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 firm should take appropriate steps under professional standards to prevent further reliance on the audit report. Due to a firm not materially complying with the independence requirements of the 2018 Yellow Book, the reviewed engagement would likely be considered nonconforming. Accordingly, the peer reviewer would then prepare a MFC form to which the firm would respond. The firm would include the actions taken or planned regarding the engagement on the MFC form. The peer reviewer would then indicate whether the peer reviewer concurs with the firm's response, actions, or planned actions within the "Findings and Conclusions" section of the SRM.



## Exhibit A

### 2018 Yellow Book Evaluation Flowchart



**Emphasis Points:**

1. Preparation of a client's financial statements in their entirety (from a client's trial balance or underlying accounting record(s)) creates significant threats to independence requiring the application of safeguards that reduce the threat(s) to an acceptable level (GAS par. 3.88).
2. A firm providing other preparation of accounting records and financial statement services should document its evaluation of threats to independence (even if the firm concludes that the threats are not significant) for the activities in GAS par. 3.89.
3. Regardless of whether there are "No" answers in the "Assess Documentation" steps, the reviewer should continue the assessment to comprehensively evaluate the full scope of the departure from professional standards.