

Understanding the New Independence Rules Related to Financial Statement Preparation

by Brittney Williams, CPA, CGFM, Audit Partner

Posted on October 6, 2020

(originally published on April 15, 2020)



Have you heard of the new Yellow Book or *Government Auditing Standards* issued by the [Governmental Accountability Office](#)? If not, that's OK – this article aims to provide you with some critical information to be aware of for the upcoming audit year. The 2018 edition of the Yellow Book is effective for audits ending on or after June 30, 2020. There were many improvements and changes made to the new Yellow Book. One of the most notable changes, and the one discussed in this article, is related to the Independence Requirements when an auditor provides nonattest services to the client by assisting with the preparation of the financial statements.

This has always been an area that received a lot of attention in the audit community and it is important to fully understand the concepts and rules that govern this topic.

When an auditor contracts with a client to provide assistance with the preparation of the financial statements, there is a series of steps an auditor must take to ensure independence is maintained.

- Management must meet the general requirements
- Determine the nonaudit services are not otherwise prohibited
- Identify threats to the auditor's independence
- Evaluate the significance of threats
- Identify and apply safeguards

The general requirements for management include: assuming all management responsibilities, assigning an individual with skills, knowledge and experience to oversee

the nonaudit services, evaluate the adequacy and results of services performed and accept responsibility for the services. These general requirements are outlined and agreed to by management in the Engagement Letter. Management is not required to possess the expertise to re-perform the services, rather, the person designated with skills, knowledge and experience should be able to detect a material error, omission, or misstatement when reviewing the financial statements. As an auditee, a key point to being successful in this area is to utilize a financial statement checklist and other documents provided by your auditor in reviewing the financial statements and allocate sufficient time for a thorough review.

Under the new Yellow Book, preparation of the financial statements is always considered a significant threat. However, the identification of a significant threat doesn't prohibit an auditor from performing the nonaudit services. Rather, the auditor is required to identify and document the safeguards applied to reduce the threat to an acceptable level. The threats with this type of service are typically referred to as Self-Review Threat and Management Participation Threat. Self-review Threat is the threat that an auditor who has provided the nonaudit services will not appropriately evaluate the results of previous judgements made or services performed. Management Participation Threat is the threat that results from an auditor taking on the role of management or otherwise performing management functions on behalf of the audited entity and thus not being able to be objective.

To ensure that the auditor remains independent with regards to these threats, the auditor will analyze and document which safeguards are in place to be able to proceed with the nonaudit services.

Some of the common safeguards that are utilized and deemed to be effective include:

- Separate nonaudit service and audit engagement teams
- Engagement quality control reviews or cold reviews
- Communication with the Board or Council regarding Independence
- Educating the clients on independence and services provided
- Review of deliverables by the audit team prior to providing to the client
- Enhanced documentation of client review and approvals
- Including disclaimers on deliverables
- Status updates with the audit team
- Firm Training and communication

While this list is not meant to be all-inclusive, it is evident of many of the steps taken by auditors to document the safeguards in place to reduce the significant threat to an acceptable level in order to continue to provide the nonaudit service of assisting with the preparation of the financial statements.

To do your part as an auditee, ensure that you have identified the appropriate individual within your organization who has the skills, knowledge and experience to review the financial statements and will allocate the appropriate amount of time once the auditor has

provided the draft copies. Utilize the financial statement checklist and conversion journal entries provided by the auditors to perform a thorough review of the financial statements ensuring they are free of material misstatements. Lastly, schedule a time to review the financial statement draft with your auditor to ensure that any questions are resolved prior to finalizing your report.

For more helpful tips, refer to the video [“The Do’s and Dont’s of Reviewing School District Financial Statements”](#) by Sara Kirk of HeinfeldMeech.

The content of these pages is for general information purposes only and does not constitute advice. Heinfeld, Meech & Co., P.C. tries to provide content that is true and accurate as of the date of writing; however, we give no assurance or warranty regarding the accuracy, timeliness, or applicability of any of the contents.