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2012

## 2011 Yellow Book: Independence - Nonaudit Services Documentation Practice Aid

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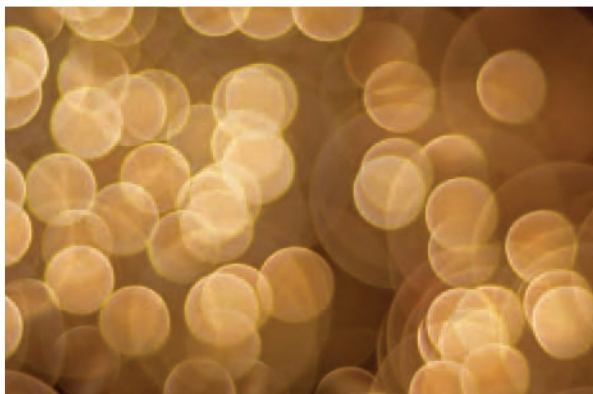
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P R A C T I C E   A I D   S E R I E S

# 2011 Yellow Book Independence - Nonaudit Services Documentation Practice Aid



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**TABLE OF CONTENTS**

Purpose of This Practice Aid ..... 6

Background..... 7

Using This Practice Aid ..... 8

Notice to Readers ..... 9

2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid..... 10

    Section I: Prohibited Nonaudit Services—Management Responsibilities..... 11

    Section II: Nonaudit Services—Evaluation of Threats to Independence and the Application of Safeguards ..... 12

    Section III: Nonaudit Services—Documentation of Skills, Knowledge, or Experience of the Individual(s) Designated by the Audited Entity to Oversee Nonaudit Services ..... 13

    Section IV: Establish and Document the Understanding With the Audited Entity Regarding Nonaudit Services ..... 14

    Section V: Conclusion..... 16

2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid Continuation Page-Section I..... 17

2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid Continuation Page-Section II ..... 18

2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid Continuation Page- Section III ..... 19

2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid Continuation Page- Section IV ..... 20

Appendix A: Detailed Instructions to This Practice Aid ..... 21

Appendix B: Nonaudit Services..... 24

    Case Analysis Illustrative Examples ..... 25

Appendix C: Prohibited Nonaudit Services..... 27

Appendix D: Threat Indicators ..... 29

The Cumulative Effect of Aggregate Threats May Increase the Significance of Threats.....	29
The Significance of Nonaudit Services to the Subject Matter of the Audit May Increase the Significance of Threats.....	29
The Degree of Assumptions and Judgments by the Auditor May Increase the Significance of Threats.....	30
Increasing the Degree of Subjectivity Related to Nonaudit Services May Increase the Significance of Threats.....	30
The Condition of the Audited Entity’s Records May Increase the Significance of Threats ....	30
The Cumulative Effect of the Indicators May Increase the Significance of Threats .....	30
Other Threats to Independence May Increase the Significance of Threats .....	30
Other Factors to Consider When Evaluating the Significance of Threats .....	31
Illustrative Examples.....	31
Appendix E: Application of Safeguards .....	34
Illustrative Examples.....	35
Appendix F: Evaluation of Skills, Knowledge, or Experience.....	39
Illustrative Examples.....	40
Appendix G: Completed Practice Aid Example .....	43
Section I: Prohibited Nonaudit Services—Management Responsibilities.....	45
Section II: Nonaudit Services—Evaluation of Threats to Independence and the Application of Safeguards .....	46
Section III: Nonaudit Services—Documentation of Skills, Knowledge, or Experience of the Individual(s) Designated by the Audited Entity to Oversee Nonaudit Services .....	47
Section IV: Establish and Document the Understanding With the Audited Entity Regarding Nonaudit Services .....	48
Section V: Conclusion.....	50
2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid Continuation Page-Section I.....	51

2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid Continuation Page-Section II .....	52
2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid Continuation Page-Section III .....	53
2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid Continuation Page-Section IV .....	54
Appendix H: Yellow Book Independence Decision Flowchart.....	55
Glossary and Resources .....	56
Glossary .....	56
Resources .....	58

## Purpose of This Practice Aid

This practice aid will assist auditors performing audits<sup>1</sup> in accordance with the 2011 revision to *Government Auditing Standards*<sup>2</sup> (the 2011 Yellow Book) issued by the Government Accountability Office (GAO) in identifying and evaluating threats to independence for nonaudit services when considering whether to provide a nonaudit service. It will also assist auditors in applying the conceptual framework for independence contained in the 2011 Yellow Book (Yellow Book Conceptual Framework) and in complying with the Yellow Book's independence documentation requirements. Users of this practice aid should consult the original material referenced in this practice aid for a complete understanding of the standards, requirements, and guidance.

This practice aid will be useful to auditors having audit engagements of all types and sizes. However, this practice aid highlights the following nonaudit services that are frequently performed for smaller entities:

- Preparing financial statements
- Preparing journal entries other than proposed audit entries
- Preparing reconciliations

An auditor could use various approaches to meet the independence evaluation and documentation requirements of the 2011 Yellow Book; therefore, use of this particular practice aid is not required. This practice aid is intended to provide an illustration of one methodology that could be used by an auditor. However, auditors using their own internal methodologies are encouraged to review this practice aid to ensure that such methodologies do not need to be enhanced or revised.

Finally, auditors are encouraged to use this practice aid in the manner that is best suited for their practice. For example, this practice aid illustrates the evaluation and documentation of all nonaudit services for an engagement in a single document. Alternatively, auditors may prefer to use this practice aid in a manner that would address each individual nonaudit service in separate documents.

For additional information and guidance on the 2011 Yellow Book, auditors can refer to the GAO's website at [www.gao.gov/yellowbook](http://www.gao.gov/yellowbook) and the AICPA Governmental Audit Quality Center website at [www.aicpa.org/GAQC](http://www.aicpa.org/GAQC).

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<sup>1</sup> The term *audit*, as used in this practice aid, refers to financial audits and attestation engagements conducted in accordance with *Government Auditing Standards* (the Yellow Book).

<sup>2</sup> The 2011 revision to the Yellow Book is effective for financial audits and attestation engagements performed for periods ending on or after December 15, 2012. However, auditors performing nonaudit services must be independent for the period covered by the financial statements. Therefore, auditors may be required to comply with the 2011 Yellow Book independence requirements for nonaudit services performed as early as January 1, 2012.

## Background

Audits performed under audit or attestation standards established by the AICPA must comply with Interpretation No. 101-3, “Performance of Nonattest Services,” under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .05), in determining independence when accepting an engagement to perform nonaudit services for audits of attest clients (hereinafter referred to as an audited entity). Audits performed under the 2011 Yellow Book have additional independence requirements.

The 2011 Yellow Book introduces the Yellow Book Conceptual Framework for Independence, which uses a threats and safeguards approach that is generally consistent with ET section 100-1, *Conceptual Framework for AICPA Independence Standards* (AICPA, *Professional Standards*).

The 2011 Yellow Book requires documentation of the evaluation of threats and the application of safeguards whenever threats are considered significant, thereby requiring the application of safeguards to eliminate or reduce the threats to an acceptable level (see paragraph 3.08 of the 2011 Yellow Book). Auditors should evaluate threats both individually and in the aggregate because threats can have a cumulative effect on an auditor’s independence. Further, if no safeguards are available to eliminate a significant threat or reduce it to an acceptable level, independence would be considered impaired (see paragraph 3.09 of the 2011 Yellow Book).

The 2011 Yellow Book contains a number of nonaudit service prohibitions that are generally consistent with Interpretation No. 101-3 (paragraph 3.36 of the 2011 Yellow Book includes a listing of those prohibited services). For nonaudit services not specifically prohibited, auditors must apply the Yellow Book Conceptual Framework and assess management’s ability to effectively oversee the nonaudit service. Although not prohibited, paragraph 3.40 of the 2011 Yellow Book states that activities such as financial statement preparation and cash-to-accrual conversions are considered to be nonaudit services and have to be evaluated using the Yellow Book Conceptual Framework.

New independence-related documentation requirements are introduced in the 2011 Yellow Book, some of which go beyond Interpretation No. 101-3. The 2011 Yellow Book documentation requirements include (a) documenting threats to independence that require the application of safeguards, along with the safeguards applied; (b) documenting management’s ability to effectively oversee nonaudit services, including whether management possesses suitable skills, knowledge, or experience (SKE); and (c) documenting the understanding established with the audited entity regarding the nonaudit services to be performed. The 2011 Yellow Book requires documentation of the evaluation of threats and the application of safeguards whenever threats are considered significant, both individually and in the aggregate, and, therefore, requires the application of safeguards to eliminate or reduce the threats to an acceptable level.

It is important for auditors to note that the 2011 Yellow Book requires documentation of the suitability of management’s SKE and the understanding established with the audited entity for all nonaudit services performed, regardless of whether threats to independence are determined to be significant.



## Using This Practice Aid

This practice aid is limited to the consideration of potential threats to independence related to the threats of management participation and self-review that arise when the auditor provides nonaudit services. However, auditors should keep in mind that circumstances can result in other threats to independence. Auditors must also consider whether other threats to independence exist and must use professional judgment to determine whether the facts and circumstances created by a threat warrant use of the Yellow Book Conceptual Framework. In such cases, additional evaluation and documentation beyond that provided in this practice aid would likely be required.

The following appendixes are provided to assist the auditor with completing this practice aid:

- Appendix A, “Detailed Instructions to This Practice Aid”
- Appendix B, “Nonaudit Services”
- Appendix C, “Prohibited Nonaudit Services”
- Appendix D, “Threat Indicators”
- Appendix E, “Application of Safeguards”
- Appendix F, “Evaluation of Skills, Knowledge, or Experience”
- Appendix G, “Completed Practice Aid Example”
- Appendix H, “Yellow Book Independence Decision Flowchart”

Finally, auditors are cautioned that circumstances often change during the performance of an audit, which may require the auditor to reevaluate conclusions reached regarding the significance of threats to independence. For example, the significance of threats in the aggregate and the necessity for the application and types of safeguards to be applied to eliminate or reduce those threats to an acceptable level may need to be reevaluated if the auditor is engaged to perform additional nonaudit services during the period of the professional engagement.

## **Notice to Readers**

This publication is designed to provide illustrative information with respect to the subject matter covered. It does not establish standards or preferred practices. The material was prepared by the AICPA staff and has not been considered or acted upon by senior technical committees or the AICPA board of directors and does not represent an official opinion or position of the AICPA. It is provided with the understanding that the staff and publisher are not engaged in rendering legal, accounting, or other professional service. All such information is provided without warranty of any kind.

The use of this publication requires the exercise of individual professional judgment. It is not a substitute for the original authoritative accounting and auditing guidance. Users are urged to refer directly to applicable authoritative pronouncements, when appropriate. As an additional resource, users may call the AICPA Professional Ethics Hotline at 888-777-7077 (option 6, option 2).

## 2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid



Audited entity: \_\_\_\_\_

Period end: \_\_\_\_\_

Completion of this practice aid will assist the auditor in evaluating and documenting threats, both individually and in the aggregate, to independence resulting from the performance of nonaudit services; determining safeguards to be applied when threats are significant; and otherwise documenting the evaluation of the audited entity’s skills, knowledge, or experience (SKE) and the understanding established with the audited entity regarding the nonaudit service(s) to be provided. See appendix A, “Detailed Instructions to This Practice Aid,” for detailed instructions for completing this practice aid. Certain responses may indicate that independence impairments exist, at which point the auditor should stop the evaluation and either not perform the nonaudit service or not perform the audit. Items in **RED** are indications that independence will be impaired.

**Section I: Prohibited Nonaudit Services—Management Responsibilities**

(1)	(1a)	(2)	(3)
<i>Nonaudit services to be provided</i>	<i>Detailed description of the nature and extent of nonaudit services to be provided</i>	<i>Is there a specific prohibition against any of the nonaudit services (appendix C, “Prohibited Nonaudit Services,” includes a summary of prohibited nonaudit services)? If “Yes,” STOP; independence will be impaired. If “No,” proceed to column (3).</i>	<i>Will the nonaudit service involve assuming management responsibilities (see appendix C)? If “Yes,” STOP; independence will be impaired. If “No,” proceed to section II.</i>
Preparing financial statements			
Preparing journal entries other than proposed audit entries			
Preparing reconciliations			
Other			
Other			
Other			
Other			

**Section II: Nonaudit Services—Evaluation of Threats to Independence and the Application of Safeguards**

(1)	(4)	(5)	(6)
<i>Nonaudit services to be provided (repeat summary description from section I)</i>	<i>Are threats significant (see appendix D, “Threat Indicators,” for threat indicators)? If “Yes,” identify significant threats below and proceed to column (5). If “No,” indicate “N/A” in columns (5)–(6) and proceed to section III for the documentation required for all nonaudit services to be provided.</i>	<i>Can safeguards be applied when threats are significant? If “No,” STOP; independence will be impaired. If “Yes,” document below the safeguards to be applied and proceed to column (6). (See appendix E, “Application of Safeguards,” for examples of safeguards.)</i>	<i>Will the application of the safeguards eliminate or reduce the significant threat(s) to an acceptable level? If “No,” STOP; independence will be impaired. If “Yes,” proceed to section III for the documentation required for all nonaudit services to be provided.</i>
Preparing financial statements			
Preparing journal entries other than proposed audit entries			
Preparing reconciliations			
Other			
Other			
Other			
Other			

**Section III: Nonaudit Services—Documentation of Skills, Knowledge, or Experience of the Individual(s) Designated by the Audited Entity to Oversee Nonaudit Services**

**Note:** This section must be completed for ALL nonaudit services to be provided, regardless of whether a significant threat to independence is identified.

(1)	(7)	(8)
<i>Nonaudit services to be provided (repeat summary description from section I)</i>	<i>Identify the individual(s) designated by the audited entity to oversee nonaudit services.</i>	<i>Document SKE of the designated individual(s), or provide a working paper reference to separate documentation (see appendix F, “Evaluation of Skills, Knowledge, or Experience,” for more information on evaluating SKE). If the individual at the audited entity has suitable SKE, proceed to section IV for the documentation required for all nonaudit services to be provided. If no individual at the audited entity has suitable SKE to oversee the nonaudit service(s), indicate below and <b>STOP; independence will be impaired.</b></i>
Preparing financial statements		
Preparing journal entries other than proposed audit entries		
Preparing reconciliations		
Other		
Other		
Other		
Other		

## Section IV: Establish and Document the Understanding With the Audited Entity Regarding Nonaudit Services

**Note:** This section is required for ALL nonaudit services to be provided, regardless of whether a significant threat to independence is identified.

(1)	(9)	(10)	(11)	(12)
<p><i>Nonaudit services to be provided (repeat summary description from section I)</i></p>	<p><i>Document that the audited entity agrees to each of the management responsibilities described below in (a)–(c), or provide a working paper reference to where such an agreement is documented (for example, a reference to an engagement letter). <b>If management is unwilling to accept any of the following responsibilities, STOP; independence will be impaired:</b></i></p> <ul style="list-style-type: none"> <li><i>a. The audited entity agrees to assume all management responsibilities.</i></li> <li><i>b. The audited entity agrees to evaluate the adequacy and results of the nonaudit services performed.</i></li> <li><i>c. The audited entity agrees to accept responsibility for the results of the nonaudit services.</i></li> </ul>	<p><i>Document the understanding established with the audited entity regarding the objectives of the nonaudit services, or provide a working paper reference to where such is documented.</i></p>	<p><i>Document the understanding established with the audited entity regarding the auditor’s responsibilities, or provide a working paper reference to where such is documented.</i></p>	<p><i>Document the understanding established with the audited entity regarding the limitations, if any, on the nonaudit services to be provided, or provide a working paper reference to where such is documented.</i></p>
<p>Preparing financial statements</p>				
<p>Preparing journal entries other than proposed audit entries</p>				
<p>Preparing reconciliations</p>				

(1)	(9)	(10)	(11)	(12)
<p><i>Nonaudit services to be provided (repeat summary description from section I)</i></p>	<p><i>Document that the audited entity agrees to each of the management responsibilities described below in (a)–(c), or provide a working paper reference to where such an agreement is documented (for example, a reference to an engagement letter). <b>If management is unwilling to accept any of the following responsibilities, STOP; independence will be impaired:</b></i></p> <ul style="list-style-type: none"> <li><i>d. The audited entity agrees to assume all management responsibilities.</i></li> <li><i>e. The audited entity agrees to evaluate the adequacy and results of the nonaudit services performed.</i></li> <li><i>f. The audited entity agrees to accept responsibility for the results of the nonaudit services.</i></li> </ul>	<p><i>Document the understanding established with the audited entity regarding the objectives of the nonaudit services, or provide a working paper reference to where such is documented.</i></p>	<p><i>Document the understanding established with the audited entity regarding the auditor’s responsibilities, or provide a working paper reference to where such is documented.</i></p>	<p><i>Document the understanding established with the audited entity regarding the limitations, if any, on the nonaudit services to be provided, or provide a working paper reference to where such is documented.</i></p>
Other				
Other				
Other				
Other				



**Section V: Conclusion**

We have evaluated the nonaudit services to be provided to the audited entity, both individually and in the aggregate. We have determined that none of the nonaudit services are prohibited services or involve undertaking management responsibilities, as described in *Government Auditing Standards*. We evaluated and documented all significant threats and applied safeguards to eliminate or reduce any significant threats to an acceptable level. We have also evaluated the SKE of the individual(s) designated by the audited entity to oversee the nonaudit service(s) and determined that they are suitable in the circumstances. These evaluations are documented in this working paper. Based on the foregoing, we may provide the nonaudit services described herein and remain independent with respect to the audited entity.

Prepared by: \_\_\_\_\_ Date: \_\_\_\_\_

Reviewed by: \_\_\_\_\_ Date: \_\_\_\_\_

Optional Space for Any Additional Conclusion Considerations

**2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid Continuation Page-Section I**



Audited entity: \_\_\_\_\_

Period end: \_\_\_\_\_

**2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid Continuation Page-Section II**



Audited entity: \_\_\_\_\_

Period end: \_\_\_\_\_

**2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid Continuation Page- Section III**



Audited entity: \_\_\_\_\_

Period end: \_\_\_\_\_

**2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid Continuation Page- Section IV**



Audited entity: \_\_\_\_\_

Period end: \_\_\_\_\_

## Appendix A: Detailed Instructions to This Practice Aid

<i>Instructions to Complete This Practice Aid (Outline Number Refers to Column Number in the Practice Aid)</i>	<i>References and Additional Resources</i>
<p>1. The auditor should list and provide a detailed description of all nonaudit services to be provided to the audited entity during the period of professional engagement and the period covered by the financial statements or subject matter of the audit. This evaluation should be made before the nonaudit services are performed<sup>1</sup> and whenever relevant new information about a threat to independence comes to the attention of the auditor during the audit.</p> <p>Repeat or copy the descriptions of the nonaudit services in column 1 in sections II–IV, as necessary.</p>	<ul style="list-style-type: none"> <li>• Paragraph 3.05 of <i>Government Auditing Standards</i> (the 2011 Yellow Book)</li> <li>• Appendix B, “Nonaudit Services”</li> <li>• Appendix C, “Prohibited Nonaudit Services”</li> <li>• “Glossary and Resources” (for the period of professional engagement)</li> </ul>
<p>2. Determine whether the 2011 Yellow Book specifically prohibits the nonaudit services being considered. If prohibited, the auditor should decline to provide the nonaudit service or withdraw from the audit engagement.</p>	<ul style="list-style-type: none"> <li>• Paragraphs 3.50–.58 of the 2011 Yellow Book</li> <li>• Appendix C</li> </ul>
<p>3. Determine whether performance of the nonaudit services would require the auditor to take on management responsibilities.</p> <p><b>Note:</b> Management responsibilities involve leading and directing an entity, including making decisions regarding the acquisition, deployment, and control of human, financial, physical, and intangible resources. If an auditor were to assume management responsibilities for an audited entity, the management participation threats created would be so significant that no safeguards could eliminate or reduce such threats to an acceptable level.</p>	<ul style="list-style-type: none"> <li>• Paragraphs 3.35–.36 of the 2011 Yellow Book</li> <li>• Appendix C</li> </ul>
<p>4. Determine whether there are significant threats to independence and document all such threats. Auditors should evaluate threats both individually and in the aggregate because threats can have a cumulative effect on an auditor’s independence. Document all threats identified as significant in column 4.</p> <p><b>Note:</b> Management participation and self-review threats generally exist whenever nonaudit services are performed. Although the auditor is not required to document the rationale why threats are not considered significant, the auditor should be prepared to justify his or her professional judgment regarding threats not deemed to be significant.</p>	<ul style="list-style-type: none"> <li>• Appendix D, “Threat Indicators”</li> </ul>
<p>5. Document safeguards applied to mitigate identified significant threats to independence. <i>Safeguards</i> are controls designed to eliminate or reduce threats to independence to an acceptable level.</p> <p><b>Note:</b> It is not possible to rely solely on safeguards that the audited entity has implemented to eliminate threats or reduce them to an acceptable level when significant threats have been identified.</p>	<ul style="list-style-type: none"> <li>• Paragraphs 3.16 and 3.19 of the 2011 Yellow Book</li> <li>• Appendix E, “Application of Safeguards”</li> </ul>
<p>6. Determine whether the application of safeguards eliminates or reduces the threats to an acceptable level. Threats to independence</p>	<ul style="list-style-type: none"> <li>• Paragraph 3.22 of the 2011 Yellow Book</li> </ul>

<sup>1</sup> For nonaudit services performed during the period covered by the financial statements but prior to the period of professional engagement, the auditor should consult paragraph 3.48 of *Government Auditing Standards*.

<b>Instructions to Complete This Practice Aid (Outline Number Refers to Column Number in the Practice Aid)</b>	<b>References and Additional Resources</b>
<p>are not at an acceptable level if they either (a) could affect the auditor’s ability to perform an audit without being affected by influences that compromise professional judgment or (b) could expose the audit organization to circumstances that would cause a reasonable and informed third party to conclude that the integrity, objectivity, or professional skepticism of the audit organization or a member of the audit team had been compromised.</p> <p><b>Note:</b> In making the determination that safeguards are both available and have been applied, the auditor should use professional judgment and should take into account whether both independence of mind and independence in appearance are maintained. Both qualitative and quantitative factors should be considered.</p>	
<p>7. Identify the individual(s) designated by the audited entity to oversee the nonaudit services(s) to be provided by the auditor. In some cases, there may be one individual overseeing all nonaudit services. In other cases, there may be different individuals designated to oversee different nonaudit service(s).</p>	<ul style="list-style-type: none"> <li>• Appendix F, “Evaluation of Skills, Knowledge, or Experience”</li> </ul>
<p>8. Document the skills, knowledge, or experience (SKE) of the individual(s) designated by the audited entity to oversee the nonaudit service(s).</p> <p><b>Note:</b> The auditor is required to evaluate the suitability of SKE of the individual(s) designated by the audited entity to oversee the nonaudit service(s). Representations by management alone would not be sufficient to perform or document this evaluation. If the auditor is unable to reach a conclusion that the individual(s) possesses suitable SKE to oversee the service, then the auditor is assuming management responsibilities, and independence would be impaired. Evaluation of SKE should be performed for each nonaudit service. The 2011 Yellow Book does not require the individual(s) to possess the expertise to perform or reperform the nonaudit service(s).</p>	<ul style="list-style-type: none"> <li>• Paragraphs 3.34, 3.38, and 3.59 of the 2011 Yellow Book</li> <li>• Appendix F</li> </ul>
<p>9. Document that the audited entity’s management has agreed to each of the management responsibilities described subsequently in (a)–(c) in connection with the nonaudit service(s). If management does not agree to assume all these functions, independence would be impaired if the nonaudit service(s) is provided to the audited entity. The auditor should document the agreement by either indicating that management has agreed to assume each of the management responsibilities in the column provided or by indicating a working paper reference to where such management agreement is documented (such as an engagement letter).</p>	<ul style="list-style-type: none"> <li>• Paragraphs 3.37–.38 of the 2011 Yellow Book</li> </ul>
<p>a. Assume all management responsibilities</p>	
<p>b. Evaluate the adequacy and results of the service(s) performed</p>	
<p>c. Accept responsibility for the results of the service(s)</p>	
<p>10. Document the understanding established with the audited entity regarding the objectives of the nonaudit service(s). Alternatively, provide a working paper reference to where such documentation is located (such as an engagement letter).</p>	<ul style="list-style-type: none"> <li>• Paragraph 3.39 of the 2011 Yellow Book</li> </ul>
<p>11. Document the understanding established with the audited entity regarding the auditor’s responsibilities for the nonaudit service(s).</p>	<ul style="list-style-type: none"> <li>• Paragraph 3.39 of the 2011 Yellow Book</li> </ul>

<b><i>Instructions to Complete This Practice Aid (Outline Number Refers to Column Number in the Practice Aid)</i></b>	<b><i>References and Additional Resources</i></b>
Alternatively, provide a working paper reference to where such documentation is located (such as an engagement letter).	
12. Document the understanding established with the audited entity regarding the limitations, if any, for the nonaudit service(s). Alternatively, provide a working paper reference to where such documentation is located (such as an engagement letter).	<ul style="list-style-type: none"> <li>• Paragraph 3.39 of the 2011 Yellow Book</li> </ul>
<p>13. Conclusion: Document the date and signature of the preparer and supervisory reviewer.</p> <p>If, subsequent to reaching a conclusion, relevant new facts and circumstances come to the attention of the auditor regarding threats to independence, the auditor should evaluate the significance of the threats, in accordance with the Yellow Book Conceptual Framework, and update the practice aid documentation and conclusion as necessary.</p>	<ul style="list-style-type: none"> <li>• Paragraphs 3.21 and 6.79–.83 of the 2011 Yellow Book</li> </ul>



## Appendix B: Nonaudit Services

*Government Auditing Standards* (the 2011 Yellow Book) defines *nonaudit services* as professional services other than audits or attestation engagements (paragraph 2.12 of the 2011 Yellow Book). The 2011 Yellow Book differentiates nonaudit services from *routine audit services*, which are defined as routine activities performed by auditors that relate directly to the performance of an audit, such as providing advice and responding to questions as part of an audit. Routine activities generally involve providing advice or assistance to the audited entity on an informal basis as part of an audit. Routine activities typically are insignificant in terms of time incurred or resources expended and generally do not result in a specific project or engagement or in the auditors producing a formal report or other formal work product (paragraph 3.40 of the 2011 Yellow Book). Auditors should consider that any services provided that do not meet the definition of routine audit services (and are not audit or attestation services) may be nonaudit services.

In all cases, the auditor needs to first determine if the nonaudit service is a prohibited service (paragraphs 3.36 and 3.50–.58 of the 2011 Yellow Book). If so, then no safeguards are sufficient to eliminate or reduce threats to an acceptable level, and the auditor’s performance of such services would impair independence. Furthermore, the auditor cannot take on management responsibilities. Performing management responsibilities creates a threat to independence for which no safeguards would be sufficient to overcome. See appendix C, “Prohibited Nonaudit Services,” for a discussion of prohibited services.

Examples of nonaudit services are provided subsequently. This list is not all-inclusive but is illustrative to assist the auditor in identifying nonaudit services that may create threats to independence:

- 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 financial statements
- Posting entries that have been approved by an audited entity’s management to the entity’s trial balance
- Proposing entries affecting the financial statements
- Preparing cash-to-accrual entries
- Preparing Governmental Accounting Standards Board Statement No 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, conversion entries
- Preparing depreciation schedules
- Preparing account reconciliations
- Separate evaluations of internal control
- Internal audit assistance services

- Corporate finance services
- Investment advisory services
- Business risk consulting
- Benefit plan administration
- IT systems services
- Preparing tax returns, such as IRS Form 990
- Preparing a cost allocation plan
- Valuation services
- Executive or employee search services
- Preparing utility and other enterprise operations cost of services

The 2011 Yellow Book considers financial statement preparation by the auditor to be a nonaudit service. Preparation of a trial balance by the auditor to assist with the preparation of the financial statements should be considered by the auditor when evaluating threats associated with preparing the financial statements. If the auditor is not preparing financial statements but prepares a trial balance from the audited entity's general ledger solely for use in the performance of the audit, the preparation of the trial balance would likely be considered a routine part of the audit and would not require consideration of threats to independence.

### **Case Analysis Illustrative Examples**

#### ***Case 1***

The auditor has been requested to prepare financial statements for the audited entity. Under paragraph 3.40 of the 2011 Yellow Book, this is considered to be a nonaudit service; therefore, the auditor would need to meet the requirements for performing nonaudit services under paragraph 3.39 of the 2011 Yellow Book, including documentation of compliance with those requirements. The auditor would also need to (a) apply the Yellow Book Conceptual Framework and, if the threats to independence were considered to be significant, apply safeguards to eliminate or reduce the threats to an acceptable level and (b) document the significant threats and safeguards applied.

#### ***Case 2***

The auditor has been requested to perform ongoing monitoring procedures for the audited entity. The auditor has determined that this is a prohibited service under paragraph 3.54 of the 2011 Yellow Book. Therefore, the auditor would have to decline the engagement to provide the nonaudit service. Alternatively, the auditor could provide the nonaudit service, and the audited entity could engage another firm to perform the audit.

#### ***Case 3***

The auditor has been requested to prepare the annual IRS Form 990 for the audited entity. The

auditor has determined that this is a nonaudit service; therefore, the auditor would need to meet the requirements for performing nonaudit services under paragraph 3.39 of the 2011 Yellow Book, including documentation of compliance with those requirements. The auditor would also need to (a) apply the Yellow Book Conceptual Framework and, if the threats to independence were considered significant, apply safeguards to eliminate or reduce the threats to an acceptable level and (b) document the significant threats and safeguards applied.

## Appendix C: Prohibited Nonaudit Services

The auditor needs to determine whether the nonaudit service is a prohibited service (paragraphs 3.36, 3.50, and 3.53–.58 of *Government Auditing Standards* (the 2011 Yellow Book). If prohibited, no safeguards are sufficient to mitigate the threats to an acceptable level, and the auditor’s performance of such services would impair independence.

If an auditor were to assume management responsibilities for an audited entity, the management participation threat created would be so significant that no safeguards could eliminate or reduce such threat to an acceptable level. Management responsibilities involve leading and directing an entity, including making decisions regarding the acquisition, deployment, and control of human, financial, physical, and intangible resources (paragraph 3.35 of the 2011 Yellow Book).

<i>Prohibited Services (Paragraphs 3.36, 3.50, and 3.53–.58 of the 2011 Yellow Book or as Otherwise Indicated Subsequently)</i>	
<i>Specific Type of Service</i>	<i>Detailed Description</i>
Assuming management responsibilities—Always prohibited under paragraph 3.36 of the 2011 Yellow Book	Setting policies and the strategic direction for the audited entity
	Directing and accepting responsibility for the actions of the audited entity’s employees in the performance of their routine, recurring activities
	Having custody of an audited entity’s assets
	Reporting to those charged with governance on behalf of management
	Deciding which of the auditor’s or outside third party’s recommendations to implement
	Accepting responsibility for designing, implementing, or maintaining internal control
	Providing services that are intended to be used as management’s primary basis for making decisions that are significant to the subject matter of the audit
	Developing an audited entity’s performance measurement system when that system is material or significant to the subject matter of the audit
	Serving as a voting member of an audited entity’s management committee or board of directors
Preparing accounting records and financial statements*	Determining or changing journal entries, account codes, or classifications for transactions or other accounting records for the entity without obtaining management’s approval (paragraph 3.50[a] of the 2011 Yellow Book)
	Authorizing or approving the entity’s transactions (paragraph 3.50[b] of the 2011 Yellow Book)
	Preparing or making changes to source documents without management approval (paragraph 3.50[c] of the 2011 Yellow Book)
Internal audit assistance*	Setting internal audit policies or the strategic direction of internal audit activities (paragraph 3.53[a] of the 2011 Yellow Book)
	Performing procedures that form part of the internal control (paragraph 3.53[b] of the 2011 Yellow Book)
	Determining the scope of the internal audit function and resulting work (paragraph 3.53[c] of the 2011 Yellow Book)
Internal control monitoring*	Ongoing monitoring procedures performed on behalf of management (paragraph 3.54 of the 2011 Yellow Book)
Nontax disbursement*	Accepting responsibility to authorize payment of audited entity funds
	Accepting responsibility for signing or cosigning checks
	Maintaining an audited entity’s bank account or otherwise having custody of funds or making credit or banking decisions for the audited entity
	Approving vendor invoices for payment
Benefit plan administration*	Making policy decisions
	Interpreting plan documents when dealing with participants; making

<i>Prohibited Services (Paragraphs 3.36, 3.50, and 3.53–.58 of the 2011 Yellow Book or as Otherwise Indicated Subsequently)</i>	
<i>Specific Type of Service</i>	<i>Detailed Description</i>
	disbursements on behalf of the plan
	Having custody of plan assets or serving as a <i>plan fiduciary</i> , as defined by the Employee Retirement Income Security Act of 1974
Investment—Advisory or management*	Making investment decisions or otherwise having discretionary authority over an audited entity’s investments
	Executing a buy or sell transaction
	Having custody of assets, such as taking temporary possession of securities purchased by an audited entity
Corporate finance—Consulting or advisory*	Maintaining custody of an audited entity’s securities
	Acting as a promoter, an underwriter, a broker-dealer, and so on
	Committing the audited entity to the terms of a transaction or consummating a transaction
Executive or employee personnel matters*	Committing the audited entity to employee compensation or benefit arrangements
	Hiring or terminating employees
Business risk consulting*	Making or approving business risk decisions
	Presenting business risk considerations to those charged with governance or others on behalf of management
IT services*	Designing or developing a financial or other IT system that will play a significant role in the management of an area of operations that is, or will be, the subject matter of an audit (paragraph 3.56[a] of the 2011 Yellow Book)
	Providing services that entail making other than insignificant modifications to the source code underlying a financial or other IT system (paragraph 3.56[b] of the 2011 Yellow Book)
	Operating or supervising the operation of an IT system (paragraph 3.56[c] of the 2011 Yellow Book)
Valuation services*	Valuation services to an audited entity when the valuation would have a material effect, separately or in the aggregate, on the financial statements or other information on which the auditor is reporting, and the valuation involves a significant degree of subjectivity (paragraph 3.57 of the 2011 Yellow Book)

\*Not all activities under this specific type of service are prohibited by the 2011 Yellow Book. Examples of those that are specifically prohibited under the 2011 Yellow Book are provided under the “Detailed Description” column.

## **Appendix D: Threat Indicators**

Threats to independence are circumstances that could impair independence. Whether independence is impaired depends on the nature of the threat, whether the threat is of such significance that it would compromise an auditor's professional judgment or create the appearance that the auditor's professional judgment may be compromised, and the specific safeguards applied to eliminate the threat or reduce it to an acceptable level (paragraph 3.13 of *Government Auditing Standards* [the 2011 Yellow Book]).

Auditors should determine whether identified threats to independence are at an acceptable level or have been eliminated or reduced to an acceptable level by the application of safeguards. Threats to independence are not acceptable if they either (a) could affect the auditor's ability to perform an audit without being affected by influences that compromise professional judgment or (b) could expose the auditor or audit organization to circumstances that would cause a reasonable and informed third party to conclude that the integrity, objectivity, or professional skepticism of the audit organization or a member of the audit team had been compromised.

When assessing the significance of the threats related to the performance of nonaudit services, the following indicators may assist the auditor in the evaluation process.

### **The Cumulative Effect of Aggregate Threats May Increase the Significance of Threats**

Threats can have a cumulative effect on independence when performing multiple nonaudit services, such as financial statement preparation, numerous reconciliations, and cash-to-accrual entries. The significance of the threats may increase as additional nonaudit services are provided to the same audited entity. Additional nonaudit services may mean more types of services or a greater extent of the same type of service. For example, providing multiple nonaudit services, such as preparing the financial statements, preparing the bank reconciliations, and preparing conversion entries for full accrual statements, for an audited entity may increase the significance of threats to independence. Also, providing multiple reconciliations (such as reconciliations for cash, accounts receivables, accounts payable, and accrued expenses) may indicate an increased threat as compared with just providing one type of reconciliation.

### **The Significance of Nonaudit Services to the Subject Matter of the Audit May Increase the Significance of Threats**

The performance of nonaudit services that are significant to the subject matter of the audit may increase the significance of threats to independence. For example, preparing depreciation schedules for an audited entity for which capital assets are not material may represent a less significant threat than preparing depreciation schedules for an audited entity for which capital assets are material. Preparing financial statements would likely be considered a significant threat in most circumstances due to the significance of the nonaudit service to the subject matter of the audit. Similarly, preparing cash-to-accrual or other conversion entries that are material to the subject matter of the audit would likely represent significant threats.

### **The Degree of Assumptions and Judgments by the Auditor May Increase the Significance of Threats**

The performance of nonaudit services with significant assumptions and judgments made by the auditor may increase the significance of threats to independence. For example, preparing a mechanical calculation of depreciation for an audited entity for which all assumptions and determinations have been provided by management may represent less significant threats than preparing a depreciation schedule in which the auditor, with management's approval, assisted with determinations of capitalizable assets, useful lives, and depreciation methods.

### **Increasing the Degree of Subjectivity Related to Nonaudit Services May Increase the Significance of Threats**

The performance of nonaudit services with a high degree of subjectivity may increase the significance of threats to independence. For example, performing a valuation service for an audited entity that does not have a material effect on the financial statements but that involves a significant degree of subjectivity would likely represent a more significant threat than assisting with a reconciliation of a bank account.

### **The Condition of the Audited Entity's Records May Increase the Significance of Threats**

Incomplete or inaccurate books and records may increase the significance of threats to independence. Conversely, when the audited entity's books and records are substantially complete, current, and accurate, the threats may be less significant. Significant proposed entries by the auditor expected or found during the performance of an engagement would be an indication that threats may be more significant. However, the auditor may not determine that such threats exist until the audit is in progress and may be required to reevaluate his or her assessment of the significance of the threats during the audit. In addition, such circumstances may also indicate that the individual(s) designated by the audited entity to oversee the nonaudit services may not have suitable skills, knowledge, or experience (SKE) to oversee the nonaudit services.

### **The Cumulative Effect of the Indicators May Increase the Significance of Threats**

Multiple indicators of significant threats may cumulatively increase the significance of threats to independence. For example, a nonaudit service that is highly subjective, requiring significant inputs from the auditor, for an audited entity whose books and records are incomplete and inaccurate may increase the significance of threats.

### **Other Threats to Independence May Increase the Significance of Threats**

Other threats to independence that exist may cumulatively increase the significance of threats to independence. For example, performing nonaudit services for an audited entity for which a familiarity threat also exists may cumulatively increase the significance of threats to independence for both the threats inherent for nonaudit services of self-review and management participation and the additional familiarity threat.

## Other Factors to Consider When Evaluating the Significance of Threats

Auditors should evaluate threats both individually and in the aggregate because threats can have a cumulative effect on an auditor's independence (paragraph 3.20 of the 2011 Yellow Book).

Whenever relevant new information about a threat to independence comes to the attention of the auditor during the audit, the auditor should evaluate the significance of the threat in accordance with the Yellow Book Conceptual Framework (paragraph 3.21 of the 2011 Yellow Book).

Auditors should avoid situations that could lead reasonable and informed third parties to conclude that the auditors are not independent and, thus, are not capable of exercising objective and impartial judgment on all issues associated with conducting the audit and reporting on the work (paragraph 3.04 of the 2011 Yellow Book).

### Illustrative Examples

The following examples are for illustrative purposes only to demonstrate how an auditor, using professional judgment, might reach conclusions about the situations described. They are not intended to be authoritative examples. Subtle changes in facts and circumstances could lead an auditor to reach different conclusions.

#### *Example 1*

The auditor has been requested to prepare the financial statements for an audited entity for which the requirements for performing nonaudit services have been met under paragraphs 3.37 and 3.39 of the 2011 Yellow Book. The auditor considered the following in evaluating whether a significant threat to independence existed:

- a. The audited entity's books and records are substantially complete and accurate. Few, if any, correcting entries are expected to be proposed.
- b. The individual designated by the audited entity who oversees the preparation of the financial statements possesses SKE sufficient to reperform the service, not just oversee the service. The designated individual, in order to make better use of his or her time, has asked the auditor to prepare the financial statements. The designated individual will also review the draft financial statements using a comprehensive disclosure checklist.
- c. This is the only nonaudit service that the auditor has been requested to perform.

**Conclusion:** Based on the foregoing; the auditor reached the conclusion that preparation of the financial statements would not result in a significant threat to independence; therefore, it is not necessary to apply safeguards.

**Caution:** In this example, the designated individual of the audited entity is fully capable of preparing the financial statements without assistance from the auditor (that is, the auditor is preparing the financial statements for the sake of convenience). In addition, the audited entity's books and records are substantially complete and accurate, and this is the only nonaudit service performed by the auditor. Based on this narrow set of facts, it is reasonable to conclude that preparing the financial statements would not result in a significant threat. However, in the



following example 2, a slightly different fact pattern results in a significant threat (that is, the auditor prepares financial statements for the audited entity because the designated individual is not able to prepare them). The Government Accountability Office has indicated that, in its view, other than in very limited circumstances, such as the fact pattern in this example, preparing financial statements would generally result in a significant threat.

### ***Example 2***

The auditor has been requested to prepare the financial statements for an audited entity for which the requirements for performing nonaudit services have been met under paragraphs 3.37 and 3.39 of the 2011 Yellow Book. The auditor considered the following in evaluating whether a significant threat to independence existed:

- a. The audited entity's books and records are substantially complete and accurate. Few, if any, correcting entries are expected to be proposed.
- b. The individual designated by the audited entity who oversees the preparation of the financial statements possesses SKE sufficient to oversee the service but is not capable of reperformance.
- c. This is the only nonaudit service that the auditor has been requested to perform.

***Conclusion:*** Based on the foregoing; the auditor reached the conclusion that preparation of the financial statements would result in a significant threat to independence; therefore, it would be necessary to apply safeguards.

### ***Example 3***

The auditor has been requested to prepare the financial statements, cash-to-accrual conversion entries, bank reconciliations, and depreciation schedules for an audited entity. The requirements for performing nonaudit services have been met under paragraphs 3.37 and 3.39 of the 2011 Yellow Book. The auditor considered the following in evaluating whether a significant threat to independence existed:

- a. A significant number of correcting journal entries are expected to be proposed to the financial statements in order to make the books and records complete and accurate.
- b. The individual designated by the audited entity who oversees the preparation of the financial statements and the other nonaudit services possesses SKE sufficient to oversee the service but is not capable of reperformance.

***Conclusion:*** Based on the foregoing; the auditor reached the conclusion that the nonaudit services performed would result in a significant threat to independence; therefore, it would be necessary to apply safeguards. The auditor would likely determine that the safeguards to be applied in this situation would need to be inherently stronger, or more safeguards would need to be applied, than those in the preceding example 2 in order to sufficiently eliminate or reduce threats to an acceptable level.

#### ***Example 4***

The auditor has been requested to prepare the annual IRS Form 990 for its audited entity, which is the only nonaudit service performed by the auditor for this audited entity. The requirements for performing nonaudit services have been met under paragraphs 3.37 and 3.39 of the 2011 Yellow Book. The auditor considered the following in evaluating whether a significant threat to independence existed:

- a. The audited entity's books and records are substantially complete and accurate.
- b. The individual designated by the audited entity who oversees the preparation of Form 990 possesses SKE sufficient to oversee the service but is not capable of reperformance.

***Conclusion:*** Based on the foregoing; the auditor reached the conclusion that preparation of the annual IRS Form 990 did not result in a significant threat to independence; therefore, it was not necessary to apply safeguards. Because Form 990 generally is not significant to the subject matter of the audit, it is likely that preparation of Form 990 would not, by itself, create significant threats to independence.

## Appendix E: Application of Safeguards

*Government Auditing Standards* (the 2011 Yellow Book) requires that safeguards be applied whenever threats are significant in order to eliminate or reduce such threats to an acceptable level. Depending on the nature of the audit, an auditor may also be able to place limited reliance on safeguards that the audited entity has implemented (paragraph 3.18 of the 2011 Yellow Book). However, the auditor may not rely solely on safeguards within the audited entity's systems and procedures (paragraph 3.18 of the 2011 Yellow Book).

Examples of safeguards that may eliminate or reduce significant threats to an acceptable level include the following. This list is not authoritative, nor exclusive; not all safeguards listed would be appropriate for all significant threats identified and, often, may require combinations of more than one safeguard:

- Consulting a professional organization or regulatory authority.
- Consulting another auditor.
- Discussing independence issues with those charged with governance of the entity.
- Disclosing to those charged with governance the nature of the audit and the nonaudit services provided. The 2011 Yellow Book requires that this be done for all nonaudit services as part of establishing and documenting the understanding of the nonaudit services to be performed prior to the performance of those services (paragraph 3.39 of the 2011 Yellow Book)
- Assigning separate engagement personnel for the audit and nonaudit service.
- Obtaining secondary reviews of the nonaudit services by professional personnel who were not involved in planning or supervising the audit engagement.
- Obtaining secondary reviews of the nonaudit services by professional personnel who were not members of the audit engagement team.
- Obtaining secondary reviews of audit areas affected by the nonaudit services by professional personnel who were not members of the audit engagement team.
- Discussing the significance of the threats to management participation or self-review with the engagement team and emphasizing the risks associated with such threats
- Educating management on the nonaudit services performed by reviewing and explaining the reason and basis for all significant transactions, as well as authoritative standards, so that management is in a position to determine or approve all assumptions and judgments and take responsibility for the nonaudit services.
- When financial statement preparation is the nonaudit service being performed, determining that there has been review of the financial statements and successful completion of a disclosure checklist by the audited entity.<sup>1</sup>

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<sup>1</sup> This is a safeguard within the audited entity's systems and procedures. *Government Auditing Standards* (the 2011 Yellow Book) indicates that an auditor should not rely solely on safeguards that the audited entity has

- For recurring audits, having another independent audit organization perform an audit of the areas affected by the nonaudit service (a “cleansing” audit; see paragraph 3.43 of the 2011 Yellow Book).
- Including the audit engagement as a required engagement quality control review (EQCR) under the audit firm’s system of quality control.

When determining the type and number of safeguards to be applied, the auditor should consider the significance of the threat(s), both individually and in the aggregate. Some safeguards have a higher level of mitigation of threats than others. Safeguards that involve personnel who are independent of the audit process are generally more effective than those who are not independent. Safeguards that rely more on external factors are generally more effective than those that rely on factors internal to the audited entity. For example, discussing the significance of threats with the engagement team is likely not adequate on its own and should be combined with other safeguards. Determining which safeguards to apply involves professional judgment and is dependent on the facts and circumstances of each specific situation.

### **Illustrative Examples**

The following examples are for illustrative purposes only to demonstrate how an auditor, using professional judgment, might reach conclusions about the situations described. They are not intended to be authoritative examples. Subtle changes in facts and circumstances could lead an auditor to reach different conclusions.

#### ***Example 1***

The auditor has been requested to prepare the financial statements for an entity for which the requirements for performing nonaudit services have been met under paragraphs 3.37 and 3.39 of the 2011 Yellow Book. The auditor has determined that the preparation of such financial statements represents a significant threat to independence for which safeguard(s) must be applied. Upon evaluation of the threat, the auditor determined that the following safeguard would be applied: have someone not involved in planning or supervising the audit engagement review the financial statements before releasing the statements.

The audited entity must always accept responsibility for the financial statements and must approve them or else the general requirements under Interpretation No. 101-3, “Performance of Nonattest Services,” under Rule 101, *Independence (AICPA, Professional Standards*, ET sec. 101 par. .05), and paragraph 3.37 of the 2011 Yellow Book will not be met.

The auditor may have considered the following alternative safeguards:

- a. Educate management on the nonaudit services performed by reviewing and explaining the basis for preparing the financial statements, so that management is in a position to determine or approve all assumptions and judgments and take responsibility for the financial statements.

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implemented to eliminate threats or reduce them to an acceptable level (paragraph 3.18 of the 2011 Yellow Book).

- b. Request that the audited entity complete a disclosure checklist as part of the overall review of the financial statements.

### ***Example 2***

The auditor has been requested to prepare the financial statements for an entity for which the requirements for performing nonaudit services have been met under paragraphs 3.37 and 3.39 of the 2011 Yellow Book. The auditor has determined that the preparation of such financial statements represents a significant threat to independence for which safeguard(s) must be applied. As part of that evaluation, the auditor concluded that, although the audited entity did possess suitable skills, knowledge, or experience (SKE), the poor condition of the books and records was such that, in evaluating the threat, the auditor determined that the following safeguard would be applied: have a manager or partner not involved with the audit engagement team review the financial statements before releasing the statements.

In this case, the auditor increased the strength of the safeguard by requiring that the review of the financial statements be performed by someone not involved in the audit engagement.

The audited entity must always accept responsibility for the financial statements and must approve them or else the general requirements under Interpretation No. 101-3 and paragraph 3.37 of the 2011 Yellow Book will not be met.

The auditor may have considered the following alternative safeguard: include the audit engagement as a required EQCR under the audit firm's system of quality control.

### ***Example 3***

The auditor has been requested to prepare a depreciation schedule for an entity for which the requirements for performing nonaudit services have been met under paragraphs 3.37 and 3.39 of the Yellow Book. Capital assets are material to the entity. The audited entity has provided the auditor with assets to be capitalized but has not provided estimated useful lives and methods. The auditor has determined that the preparation of such a depreciation schedule represents a significant threat to independence for which safeguard(s) must be applied. Upon evaluation of the threat, the auditor determined that the following safeguards would be applied:

- a. Educate management on the nonaudit service performed by reviewing and explaining the basis for preparing the depreciation schedules, so that management is in a position to determine or approve all assumptions and judgments (for example, useful lives, depreciation method, and so on) and accept responsibility for the depreciation schedule.
- b. Have someone not involved in planning or supervising the audit engagement review the depreciation schedule.

In this case, the auditor determined that minimal safeguards were required to mitigate the threats, even though the threats were significant.

The audited entity must always accept responsibility for the depreciation schedule and must approve it or else the general requirements under Interpretation No. 101-3 and paragraph 3.37 of the 2011 Yellow Book will not be met.

#### ***Example 4***

The auditor has been requested to prepare a depreciation schedule for an entity for which the requirements for performing nonaudit services have been met under paragraphs 3.37 and 3.39 of the 2011 Yellow Book. Capital assets are material to the entity. In addition, the auditor will be responsible for making initial determinations of the assets to be capitalized, estimated useful lives, and methods. Audited entity approvals will be obtained. The auditor has determined that preparation of such a depreciation schedule represents a significant threat to independence for which safeguard(s) must be applied. Upon evaluation of the threat, the auditor determined that the following safeguards would be applied:

- a. Have someone not involved in the audit engagement prepare the depreciation schedules.
- b. Educate management on the nonaudit service performed by reviewing and explaining the basis for preparing the depreciation schedules, so that management is in a position to determine or approve all assumptions and judgments (for example, useful lives, depreciation method, and so on) and accept responsibility for the depreciation schedule.

In this case, the auditor determined that stronger safeguards were needed to mitigate the threats than in the preceding example 3.

The audited entity must always accept responsibility for the depreciation schedule and must approve it or else the general requirements under Interpretation No. 101-3 and paragraph 3.37 of the 2011 Yellow Book will not be met.

#### ***Example 5***

The auditor has been requested to prepare the financial statements, cash-to-accrual conversion entries, bank reconciliations, and depreciation schedules for an entity for which the requirements for performing nonaudit services have been met under paragraphs 3.37 and 3.39 of the 2011 Yellow Book. The auditor has determined that the nonaudit services, in the aggregate, represent a significant threat to independence for which safeguards must be applied. As part of that evaluation, the auditor concluded that, although the audited entity did possess suitable SKE, the poor condition of the books and records was such that, in evaluating the threat, the auditor determined that the following safeguards would be applied:

- a. Educate management on the nonaudit services performed by reviewing and explaining the basis for preparing the financial statements, cash-to-accrual conversions, bank reconciliations, and depreciation schedules, so that management is in a position to determine or approve all assumptions and judgments and take responsibility for the nonaudit services.
- b. Request that the audited entity complete a disclosure checklist as part of the overall review of the financial statements.
- c. Have a manager or partner not involved with the audit engagement team review the financial statements, conversion entries, bank reconciliations, and depreciation schedules.

The audited entity must always accept responsibility for the results of the nonaudit services or else the general requirements under Interpretation No. 101-3 and paragraph 3.37 of the 2011

Yellow Book will not be met.

The auditor may have considered the following alternative safeguard in lieu of the preceding safeguard (c): include the audit engagement as a required EQCR under the audit firm's system of quality control.

## **Appendix F: Evaluation of Skills, Knowledge, or Experience**

*Government Auditing Standards* (the 2011 Yellow Book) requires that the suitability of the skills, knowledge, or experience (SKE) of the individual(s) overseeing the nonaudit service be evaluated and that such evaluation be documented (paragraph 3.34 of the 2011 Yellow Book). If no one at the audited entity is willing and able to oversee the nonaudit service, then independence would be considered impaired, and no safeguards would be sufficient to overcome the impairment (paragraph 3.38 of the 2011 Yellow Book).

The evaluation requires an action on the part of the auditor to reach a conclusion that the individual designated by the audited entity has suitable SKE to oversee the nonaudit service. Such evaluation is also required under Interpretation No. 101-3, “Performance of Nonattest Services,” under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .05); however, Interpretation No. 101-3 does not require documentation of the evaluation. Neither the 2011 Yellow Book nor the AICPA require that the individual(s) overseeing the nonaudit service be able to perform the service but only that the individual(s) be able to oversee the performance of the service.

The documentation requirement would not be met simply by obtaining management representations or other actions performed solely by the audited entity. The documentation must include a critical assessment of the SKE of the designated individual to oversee the nonaudit service.

The nature of the nonaudit service will affect the weight and applicability of factors to consider when determining suitable SKE. Nonaudit services that are more technical and complex would likely require someone possessing stronger SKE than services that are less complex.

The level of the SKE of the designated individual may also affect the strength of safeguards necessary to be applied. Although SKE is not a safeguard, it may be a mitigating factor in determining the strength of the safeguards to be applied to eliminate or reduce significant threats to an acceptable level.

Auditors are expected to utilize their professional judgment and experience to recognize which individuals are able and willing to fulfill the management responsibilities that are set forth in the 2011 Yellow Book. Through interaction with the audited entity’s management, experienced auditors should be able to assess whether the designated individual possesses the SKE to effectively oversee the nonaudit service.

In assessing whether the individual designated to oversee the nonaudit service possesses suitable SKE, the auditor should consider the following factors that pertain to the designated individual:

- Understanding of the nature of the service
- Knowledge of the audited entity’s business
- Knowledge of the audited entity’s industry
- General business knowledge
- Education, licenses, accreditations, and membership in professional organizations



- Position at the audited entity

Some factors may be given more weight than others, depending on the nature of the nonaudit service. For example, although the level of education attained by the individual can be one indicator of his or her skills or knowledge, or both, it is not necessarily true that the more formal education that the individual possesses, the more able he or she would be to oversee the nonaudit service. If the individual understands the nature of the service and possesses sufficient knowledge of the audited entity's business and industry, he or she may have the SKE to oversee the nonaudit service, regardless of the level of education that he or she possesses.

The individual(s) designated by the audited entity will likely depend on the nature of the audited entity's organization and the nature of the nonaudit service. In a small organization, it will often be a key executive or even a board member, but depending on the nature of the nonaudit service(s) and the qualifications (that is, SKE) of other employees or individuals, it also could be the finance director, bookkeeper, or another employee. In larger organizations or for more complex services, the audited entity is more likely to designate a senior official to oversee the service(s). The employee or individual responsible for overseeing the nonaudit service(s) needs to understand the service(s) sufficiently to oversee it but does not need to possess the technical qualifications to perform or reperform the service(s).

### **Illustrative Examples**

The following examples are for illustrative purposes only to demonstrate how an auditor, using professional judgment, might reach conclusions about the situations described. They are not intended to be authoritative examples. Subtle changes in facts and circumstances could lead an auditor to reach different conclusions.

#### ***Example 1***

Most small nonprofit executive directors understand their organization's operations and financial position better than anyone, and they understand the services that they need from the auditor and what those services are intended to accomplish. Because they are the key executive of the organization, they regularly carry out important decisions about all matters affecting their organization. Accordingly, an auditor might conclude that those individuals would possess the necessary SKE to understand the nonaudit service(s) being performed, make any management decisions, and determine whether the results of the services meet the agreed-upon specifications.

#### ***Example 2***

Many small nonprofit organization boards of directors have a CPA on the board who can assist the non-CPA executive director or bookkeeper. Accordingly, an auditor might conclude that the executive director, with the assistance of the board member, would possess the necessary SKE to understand the nonaudit service(s) being performed, make any management decisions, and determine whether the results of the services meet the agreed-upon specifications.

#### ***Example 3***

The auditor has been asked to prepare depreciation schedules that include recommendations

about the estimated useful lives and depreciation methods based on the audited entity's capitalization policy. The executive director, who serves as the audited entity's designee, has knowledge of and understands the entity's capitalization policy. For purposes of this nonaudit service, the auditor may conclude that the executive director possesses the SKE to oversee the service.

#### ***Example 4***

The auditor is asked to install an off-the-shelf accounting package and set up the chart of accounts and financial statement format for a small local government. The finance director of the town is traveling on business and designates the office manager to oversee the installation. The office manager primarily performs routine clerical and receptionist functions for the finance office; has a limited understanding of the finance department's operations; and has never used accounting or financial software, such as the application being installed by the auditor. In addition, because the town hires a part-time bookkeeper to maintain its general ledger and subsidiary records, the office manager has no understanding of the town's books or records and financial statements. For purposes of this nonaudit service, it appears unlikely that the office manager would be in a position to sufficiently understand the nonaudit service(s) being performed to oversee them and accept responsibility for the resulting accounting system.

#### ***Example 5***

When proposing journal entries, the designated individual should understand the reason why the journal entries are being proposed and the effect that they have on the financial statements. For recurring or standard journal entries (for example, depreciation), the designated individual may require no explanation regarding the reason for the entry (for example, when the auditor has previously discussed these entries with the audited entity), whereas for more complex journal entries (for example, conversion to full accrual statements for state and local governments), the auditor may need to explain to the audited entity the reason and basis for the entry and its impact on the financial statements. In any case, the designated individual should have the ability to understand the reasons for the journal entries, be in a position to approve the proposed journal entries, and accept responsibility for the entity's financial statements.

#### ***Example 6***

For tax return preparation engagements, the individual designated by the audited entity need not have an understanding of the applicable tax laws; however, the auditor should have the designated individual review the tax return, with an emphasis on the key tax positions taken. The designated individual should understand the entity's tax situation, have a general understanding of how the amounts on the tax return were determined, and have an understanding of significant tax positions taken in the return.

#### ***Example 7***

For financial statement preparation, the individual designated by the audited entity need not have the understanding and ability to prepare financial statements and disclosures based on generally accepted accounting principles. The auditor may assist the designated individual in obtaining the necessary understanding, so that he or she is in a position to review and accept responsibility for

the financial statements and related disclosures. For example, the auditor may explain certain accounting principles and disclosure requirements that were applied in preparing the financial statements, so that the individual has the necessary SKE to oversee the preparation of the financial statements and accept responsibility for them. In any case, the designated individual should be able to review the financial statements, with an emphasis on significant issues and disclosures.

## Appendix G: Completed Practice Aid Example

**Note:** This completed example assumes the facts described in the following paragraph. The audit firm of ABC Firm is performing the audit of Small Town USA. ABC Firm has audited Small Town USA for the last three years.

Small Town USA is governed by a 10-member town council that meets monthly. The town has 3 employees in the finance department who are involved in the audit. Brandon, the town manager, has worked for the town for 15 years. Dave, the finance director, has worked for Small Town USA for 5 years but previously worked for another small town in a similar role. Shelly, the accounting clerk, has worked for Small Town USA for 15 years. The finance department provides a trial balance to ABC Firm but does not make any year-end adjusting entries. Small Town USA also provides a listing of fixed asset additions and deletions, and ABC Firm prepares the depreciation schedule. ABC Firm prepares Small Town USA's financial statements, including the cash-to-accrual conversion (including Governmental Accounting Standards Board [GASB] Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, conversion entries). The finance director reviews and approves all adjusting entries. The capital assets for the December 31, 2012, year-end are not material to Small Town USA's financial statements. The town manager and town council assume all management responsibilities related to the nonaudit services.

**Note:** The following example is for illustrative purposes only to demonstrate how an auditor, using professional judgment, might reach conclusions about the situations described. It is not intended to be an authoritative example. Subtle changes in facts and circumstances could lead an auditor to reach different conclusions.



Audited entity: \_\_Small Town USA\_\_\_\_\_

Period end: \_\_December 31, 2012\_\_\_\_\_

Completion of this practice aid will assist the auditor in evaluating and documenting threats, both individually and in the aggregate, to independence resulting from the performance of nonaudit service(s); determining safeguards to be applied when threats are significant; and otherwise documenting the evaluation of the audited entity's skills, knowledge, or experience (SKE) and the understanding established with the audited entity regarding the nonaudit service(s) to be provided. See appendix A, "Detailed Instructions to This Practice Aid," for detailed instructions for completing this practice aid. Certain responses may indicate that independence impairments exist, at which point the auditor should stop the evaluation and either not perform the nonaudit service or not perform the audit. Items in **RED** are indications that independence will be impaired.

**Section I: Prohibited Nonaudit Services—Management Responsibilities**

(1)	(1a)	(2)	(3)
<i>Nonaudit services to be provided</i>	<i>Detailed description of the nature and extent of nonaudit services provided</i>	<i>Is there a specific prohibition against any of the nonaudit services (appendix C, “Prohibited Nonaudit Services,” includes a summary of prohibited nonaudit services)? If “Yes,” STOP; independence will be impaired. If “No,” proceed to column (3).</i>	<i>Will the nonaudit service involve assuming management responsibilities (see appendix C)? If “Yes,” STOP; independence will be impaired. If “No,” proceed to section II.</i>
Preparing financial statements	We will prepare the financial statements, including note disclosures and GASB Statement No. 34 conversion entries. Small Town USA will provide a trial balance to be used in the preparation of the financial statements.	No	No
Preparing journal entries other than proposed audit entries	We will propose and prepare year-end adjusting entries for Small Town USA. Small Town USA’s management will review and approve all journal entries.	No	No
Preparing reconciliations	We will prepare the property tax roll reconciliation for Small Town USA. Small Town USA’s management will review and approve the reconciliation.	No	No
Other—preparing depreciation schedule	We will prepare the depreciation schedule for Small Town USA. Small Town USA will make all decisions on useful lives and the depreciation methods used.	No	No
Other			
Other			
Other			

**Section II: Nonaudit Services—Evaluation of Threats to Independence and the Application of Safeguards**

(1)	(4)	(5)	(6)
<i>Nonaudit services to be provided (repeat summary description from section I)</i>	<i>Are threats significant (see Appendix D, “Threat Indicators,” for threat indicators)? If “Yes,” identify significant threats below and proceed to column (5). If “No,” indicate “N/A” in columns (5)–(6) and proceed to section III for the documentation required for all nonaudit services to be provided.</i>	<i>Can safeguards be applied when threats are significant? If “No,” STOP; independence will be impaired. If “Yes,” document below the safeguards to be applied and proceed to column (6). (See appendix E, “Application of Safeguards,” for examples of safeguards.)</i>	<i>Will the application of the safeguards eliminate or reduce the significant threat(s) to an acceptable level? If “No,” STOP; independence will be impaired. If “Yes,” proceed to section III for the documentation required for all nonaudit services to be provided.</i>
Preparing financial statements	Yes, management participation and self-review threats	We will have Nancy, an auditor not assigned to this engagement, review the financial statements and will discuss with the chair of the audit committee of Small Town USA the extent and nature of entries and adjustments. The finance director will review the financial statements and complete a disclosure checklist.	Yes
Preparing journal entries other than proposed audit entries	Yes, same as the above.	To the extent applicable, we will employ the same safeguards as those previously described for preparing the financial statements.	Yes
Preparing reconciliations	Yes, same as the above.	To the extent applicable, we will employ the same safeguards as those previously described for preparing financial statements.	Yes
Other—preparing depreciation schedule	No	N/A	N/A
Other			
Other			
Other			

**Section III: Nonaudit Services—Documentation of Skills, Knowledge, or Experience of the Individual(s) Designated by the Audited Entity to Oversee Nonaudit Services**

**Note:** This section must be completed for ALL nonaudit services to be provided, regardless of whether a significant threat to independence is identified.

(1)	(7)	(8)
<i>Nonaudit services to be provided (repeat summary description from section I)</i>	<i>Identify the individual(s) designated by the audited entity to oversee nonaudit services.</i>	<i>Document SKE of the designated individual(s), or provide a working paper reference to separate documentation. (See Appendix F, “Evaluation of Skills, Knowledge, or Experience,” for more information on evaluating SKE.) If the individual at the audited entity has suitable SKE, proceed to section IV for the documentation required for all nonaudit services to be provided. If no individual at the audited entity has suitable SKE to oversee the nonaudit service(s), indicate below and <b>STOP; independence will be impaired.</b></i>
Preparing financial statements	Dave, finance director	Dave has a B.A. in accounting; 10 years’ experience in government finance, including 5 years with Small Town USA; and obtains adequate continuing professional education in governmental accounting. In addition, we have observed his ability to oversee the preparation of financial statements in prior years.
Preparing journal entries other than proposed audit entries	Dave, finance director	See the preceding. Additionally, we have observed Dave’s ability to review and approve journal entries in prior years.
Preparing reconciliations	Shelly, accounting clerk	Shelly has worked for Small Town USA as an accounting clerk for 15 years. Her responsibilities have always included maintaining the property tax rolls for the town. We have observed her ability to review and approve the property tax reconciliation in prior years.
Other—preparing depreciation schedule	Shelly, accounting clerk	Shelly has worked for Small Town USA as an accounting clerk for 15 years. Her responsibilities have always included preparing and maintaining a listing of fixed assets added and deleted during the year. We observed her ability to provide reasonable estimated useful lives and proper methodology in prior years.
Other		
Other		
Other		



## Section IV: Establish and Document the Understanding With the Audited Entity Regarding Nonaudit Services

**Note:** This section is required for ALL nonaudit services to be provided, regardless of whether there is a significant threat to independence is identified.

(1)	(9)	(10)	(11)	(12)
<p><i>Nonaudit services to be provided (repeat summary description from section I)</i></p>	<p><i>Document that the audited entity agrees to each of the management responsibilities described below in (a)–(c), or provide a working paper reference to where such an agreement is documented (for example, a reference to an engagement letter). <b>If management is unwilling to accept any of the following responsibilities, STOP; independence will be impaired:</b></i></p> <ul style="list-style-type: none"> <li><i>a. The audited entity agrees to assume all management responsibilities.</i></li> <li><i>b. The audited entity agrees to evaluate the adequacy and results of the nonaudit services performed.</i></li> <li><i>c. The audited entity agrees to accept responsibility for the results of the nonaudit services.</i></li> </ul>	<p><i>Document the understanding established with the audited entity regarding the objectives of the nonaudit services, or provide a working paper reference to where such is documented.</i></p>	<p><i>Document the understanding established with the audited entity regarding the auditor’s responsibilities, or provide a working paper reference to where such is documented.</i></p>	<p><i>Document the understanding established with the audited entity regarding the limitations, if any, on the nonaudit services to be provided, or provide a working paper reference to where such is documented.</i></p>
<p>Preparing financial statements</p>	<p>See working paper (WP) A-2.<sup>1</sup></p>	<p>See WP A-2.</p>	<p>See WP A-2.</p>	<p>See item 1 on continuation page-section IV</p>
<p>Preparing journal entries other than proposed audit entries</p>	<p>See WP A-2.</p>	<p>See WP A-2.</p>	<p>See WP A-2.</p>	<p>See above.</p>
<p>Preparing reconciliations</p>	<p>See WP A-2.</p>	<p>See WP A-2.</p>	<p>See WP A-2.</p>	<p>See above.</p>

<sup>1</sup> The reference to working paper A-2 refers to the engagement letter.

(1)	(9)	(10)	(11)	(12)
<p><i>Nonaudit services to be provided (repeat summary description from section I)</i></p>	<p><i>Document that the audited entity agrees to each of the management responsibilities described below in (a)–(c), or provide a working paper reference to where such an agreement is documented (for example, a reference to an engagement letter). <b>If management is unwilling to accept any of the following responsibilities, STOP; independence will be impaired:</b></i></p> <ul style="list-style-type: none"> <li><i>a. The audited entity agrees to assume all management responsibilities.</i></li> <li><i>b. The audited entity agrees to evaluate the adequacy and results of the nonaudit services performed.</i></li> <li><i>c. The audited entity agrees to accept responsibility for the results of the nonaudit services.</i></li> </ul>	<p><i>Document the understanding established with the audited entity regarding the objectives of the nonaudit services, or provide a working paper reference to where such is documented.</i></p>	<p><i>Document the understanding established with the audited entity regarding the auditor’s responsibilities, or provide a working paper reference to where such is documented.</i></p>	<p><i>Document the understanding established with the audited entity regarding the limitations, if any, on the nonaudit services to be provided, or provide a working paper reference to where such is documented.</i></p>
<p>Other—preparing depreciation schedule</p>	<p>See WP A-2.</p>	<p>See WP A-2.</p>	<p>See WP-A2.</p>	<p>See above.</p>
<p>Other</p>				
<p>Other</p>				
<p>Other</p>				

## Section V: Conclusion

We have evaluated the nonaudit services to be provided to the audited entity, both individually and in the aggregate. We have determined that none of the nonaudit services are prohibited services or involve undertaking management responsibilities, as described in *Government Auditing Standards*. We evaluated and documented all significant threats and applied safeguards to eliminate or reduce any significant threats to an acceptable level. We have also evaluated the SKE of the individual(s) designated by the audited entity to oversee the nonaudit service(s) and determined that they are suitable in the circumstances. These evaluations are documented in this working paper. Based on the foregoing, we may provide the nonaudit services described herein and remain independent with respect to the audited entity.

Prepared by: Jane Doe

Date: February 14, 2013

Reviewed by: John Smythe

Date: February 15, 2013

**2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid Continuation Page-Section I**



Audited entity: \_\_\_\_\_

Period end: \_\_\_\_\_

**2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid Continuation Page-Section II**



Audited entity: \_\_\_\_\_

Period end: \_\_\_\_\_

**2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid Continuation Page-Section III**



Audited entity: \_\_\_\_\_

Period end: \_\_\_\_\_

**2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid Continuation Page-Section IV**

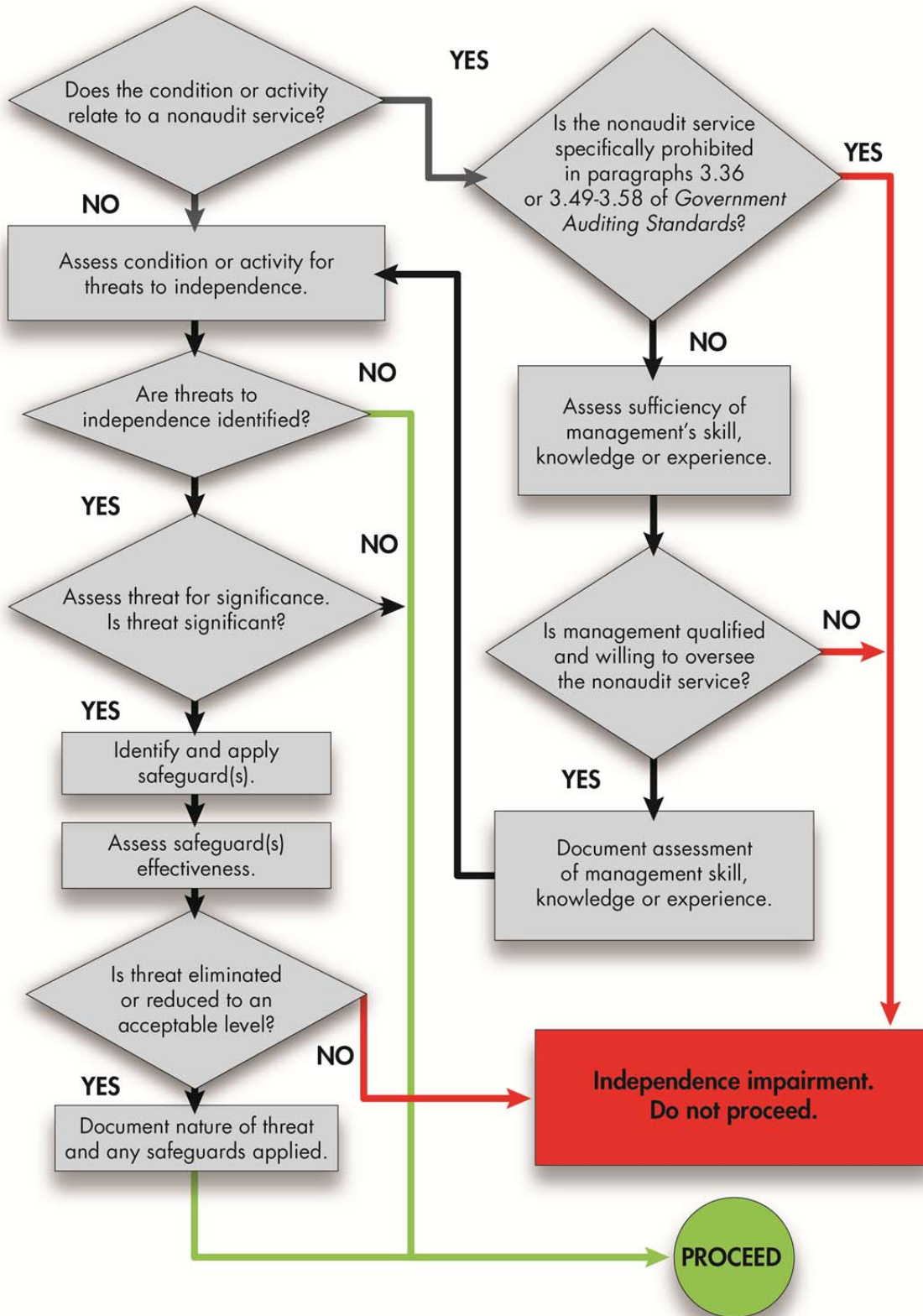


Audited entity: Small Town USA \_\_\_\_\_

Period end: December 31, 2012

1. On February 14, 2013, I discussed with Brandon that this engagement is limited to the financial statement preparation, preparation of journal entries, reconciliation of property tax rolls, and preparation of depreciation schedules, as previously outlined. I also indicated to Brandon that our firm, in its sole professional judgment, reserves the right to refuse to do any procedure or take any action that could be construed as making management decisions or performing management functions, including determining account codings and approving journal entries. Brandon indicated he understood the limitations of the engagement.

## Appendix H: Yellow Book Independence Decision Flowchart





## Glossary and Resources

### Glossary

**Independence in appearance.** The absence of circumstances that would cause a reasonable and informed third party, having knowledge of the relevant information, to reasonably conclude that the integrity, objectivity, or professional skepticism of an audit organization or member of the audit team had been compromised (paragraph 3.03[b] of *Government Auditing Standards* [the 2011 Yellow Book]).

**Independence of mind.** The state of mind that permits the performance of an audit without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism (paragraph 3.03[a] of the 2011 Yellow Book).

**Interpretation No. 101-3.** An ethics interpretation of the AICPA Code of Professional Conduct—Interpretation No. 101-3, “Performance of Nonattest Services,” under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .05).

**Management participation threat.** The threat that results from an auditor taking on the role of management or otherwise performing management functions on behalf of the entity undergoing an audit (paragraph 3.14[f] of the 2011 Yellow Book).

**Nonaudit services.** Professional services other than audits or attestation engagements (paragraph 2.12 of the 2011 Yellow Book).

**Period of the professional engagement.** The period of the professional engagement begins when the auditor either signs an initial engagement letter or other agreement to perform an audit or begins to perform an audit, whichever is earlier. The period lasts for the entire duration of the professional relationship (which, for recurring audits, could cover many periods) and ends with the formal or informal notification, either by the auditor or the audited entity, of the termination of the professional relationship or by the issuance of a report, whichever is later. Accordingly, the period of professional engagement does not necessarily end with the issuance of a report and recommence with the beginning of the following year’s audit or a subsequent audit with a similar objective (paragraph 3.05 of the 2011 Yellow Book).

**Routine audit services or routine activities.** Activities performed by auditors that directly relate to the performance of an audit, such as providing advice and responding to questions as part of an audit. Such services are not considered nonaudit services under paragraph 3.40 of the 2011 Yellow Book. Such routine activities generally involve providing advice or assistance to the entity on an informal basis as part of an audit. Routine activities typically are insignificant in terms of time incurred or resources expended and generally do not result in a specific project or engagement or in the auditors producing a formal report or other formal work product. Activities such as financial statement preparation, cash-to-accrual conversions, and reconciliations are considered nonaudit services under the 2011 Yellow Book, not routine activities related to the performance of an audit, and are evaluated using

the Yellow Book Conceptual Framework (paragraph 3.46 of the 2011 Yellow Book).

**SKE.** Acronym for skills, knowledge or experience.

**Self-review threat.** The threat that an auditor or audit organization that has provided nonaudit services will not appropriately evaluate the results of previous judgments made or services performed as part of the nonaudit services when forming a judgment significant to an audit (paragraph 3.14[b] of the 2011 Yellow Book).

**Yellow Book.** Common term used to refer to *Government Auditing Standards*.

## **Resources**

**AICPA Code of Professional Conduct**—[www.aicpa.org/Research/Standards/CodeofConduct/Pages/default.aspx](http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/default.aspx)

**AICPA Ethics Hotline**—[ethics@aicpa.org](mailto:ethics@aicpa.org) or 888-777-7077 (option 6, option 2)

**AICPA Governmental Audit Quality Center**—[www.aicpa.org/GAQC](http://www.aicpa.org/GAQC)

**GAO technical hotline**—[yellowbook@gao.gov](mailto:yellowbook@gao.gov)

***Government Auditing Standards (Yellow Book)***—[www.gao.gov/yellowbook](http://www.gao.gov/yellowbook)