INTRODUCTION

In August 2010, the Government Accountability Office (GAO) proposed a new “conceptual” approach for evaluating independence in its revisions to the “generally accepted” Government Auditing Standards (also known as “GAGAS” or the “Yellow Book”). The framework—very much consistent with the approach used by the Ethics Codes of the American Institute of CPAs (AICPA) and the International Federation of Accountants (IFAC)—emerged, in part, from discussions between the GAO staff and an advisory council appointed by the Acting US Comptroller General. In August 2011, the GAO published an “Internet” version of the new Yellow Book, which serves as an interim issuance of the standards until they are finalized after the AICPA has completed the clarity revisions.

The 2011 Yellow Book supersedes the 2007 version and the independence guidance entitled, Government Auditing Standards: Answers to Independence Standard Questions (GAO-02-870G), a series of frequently-asked-questions and answers (FAQs) on the independence implications of performing nonattest services.

This article highlights the new Yellow Book independence rules, focusing exclusively on the impact of the new rules on CPAs in public practice. The article also discusses the primary differences between the AICPAs Interpretation 101-3, Performance of Nonattest Services, and the new GAO standards.

The Conceptual Framework

The biggest change in the Yellow Book independence standards is incorporation of the Conceptual Framework (“the Framework”). Auditors should evaluate their independence using the Framework whenever they encounter unique issues or circumstances that the rules do not expressly prohibit. Auditors may need to evaluate independence at any time but generally will be required to do so when their firms undertake a new audit or nonaudit service, a new individual is assigned to an engagement, or an issue surfaces during an engagement.

In applying the Framework, the auditor should:
- Identify threats to independence,
- Evaluate the significance of those threats, and
- Apply safeguards, as needed, to eliminate the threats or reduce them to an acceptable level.

“Auditor” is any individual who performs work (i.e., financial statement audits, attestation engagements, and performance audits) under the Yellow Book, regardless of their job title.

“Acceptable level” means that threats no longer compromise an auditor’s independence.

Alignment with AICPA Independence Rules

The new standards provide good news for the profession because they are more closely aligned with the AICPA independence rules than the 2007 Yellow Book. In fact, AICPA members performing work under the Yellow Book and the AICPA Code of Professional Conduct (AICPA Code) will find few differences (described later in this article). The standards are also simpler and more concise than before. Of course, less explicit guidance means auditors will apply more judgment when they encounter situations not prohibited by the rules. In fact, the Yellow Book emphasizes the importance of applying professional judgment in assessing threats to independence and the safeguards that might mitigate those threats.

Independence in appearance is also stressed, especially when assessing the significance of threats in the aggregate.

The Rules

The following table briefly summarizes the major GAO independence provisions.
### Conceptual Framework
- Auditors should apply the Conceptual Framework (the “Framework”) at the audit organization (“CPA firm”), engagement, and individual auditor level.
- Auditors should exercise professional judgment to identify threats, assess the significance of threats, and apply safeguards, as needed.

### Threats
Threats are circumstances that could—but do not automatically—impair independence. Threats described in the framework are:
1. Self-interest
2. Self-review
3. Familiarity
4. Undue influence
5. Management participation
6. Bias (political, social, etc.)

### Safeguards
Safeguards are controls designed to eliminate or reduce threats to independence to an acceptable level. Safeguards may:
1. Exist in the work environment and include such things as: policies and procedures and the use of separate personnel to perform audit and nonaudit services, etc.
2. Be created by the profession, legislation, or regulation. These safeguards augment those in the work environment. Safeguards may also exist within the audited entity (the “client”); however the auditor may not rely solely on these types of safeguards.

### Nonaudit Services - Understanding with Client
The auditor should determine whether providing a nonaudit service to a client would create a threat to independence before accepting the engagement. Three things are emphasized: (i) the auditor should avoid performing management responsibilities (i.e., because no safeguards can reduce the threat to an acceptable level in these cases), (ii) the auditor should ensure that the client will perform all management responsibilities via their designee who has suitable skills, knowledge, and experience to do so, and (iii) the auditor should establish and document the understanding with the client, especially the delineation of duties in (i) and (ii) above.

### Specific Nonaudit Services
Certain aspects of nonaudit services may create threats to independence. Some examples follow:
- **Bookkeeping/preparing accounting records.** Prohibited activities include: determining or changing journal entries without obtaining management’s approval.
- **IT systems services.** Prohibited activities include: designing a financial 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 the audit.
- **Benefit plan administration.** Prohibited activities include: making policy decisions on behalf of management. Note that these prohibited activities are consistent with AICPA Interpretation 101-3.

### Documentation
- Understanding with the client regarding the provision of nonaudit services (should be formed prior to performing the work for the client).
- Evaluations of independence under the framework when the auditor was required to apply safeguards.
- When performing nonaudit services, the basis for concluding that the client’s designee who will oversee the services had suitable skill, knowledge and experience to do so.
Comparison to AICPA Independence Rules
It appears that the primary differences between the AICPA and the new Yellow Book independence rules are as follows:

First, the GAO requires documentation of the assessment of the client designee’s skill, knowledge and/or experience. The AICPA does not require documentation of the assessment—although AICPA requires the member assess the designee’s skill, knowledge and/or experience and conclude that the client has met this requirement. Second, the AICPA Conceptual Framework applies only when there is no specific independence guidance addressing an issue; auditors should apply the Yellow Book’s Framework to evaluate any nonattest services that are not expressly prohibited under the rules. Also, under the AICPA’s Interpretation 101-3, preparing the financial statements or converting the statements from the cash to the accrual basis when done as part of the audit is exempt from Interpretation 101-3. Under the Yellow Book, these activities are considered to be nonaudit services subject to, among other things, use of the Yellow Book’s Framework and the documentation requirements.

Effective Date
The effective date for financial audits and other attestation engagements is for periods ending on or after December 15, 2012. The effective date for performance audits is for audits beginning on or after December 15, 2011. Early implementation is not permitted.

Important Note about Nonaudit Services
With certain exceptions, auditors should be independent of their clients during the period of the professional engagement and the period covered by the financial statements (or the subject matter of the audit). For example, firms performing nonaudit services occurring during the period covered by the financial statements should comply with the new Yellow Book independence standards, including implementation of the conceptual framework approach and the new documentation requirements.

About the Author & Publisher
Cathy Allen, CPA, of Audit Conduct, LLC (www.auditconduct.com) provides compliance and advisory services to CPA and other professional firms, including customized training and communications; quality controls advice and practice tools; independence compliance support; and litigation support and expert witness. She was formerly a senior staff member of the AICPA Professional Ethics Division and Director of Independence for two of the “big four” accounting firms.

FOR MORE INFORMATION
2011 Internet Version of Yellow Book:

General updates (Yellow Book page):
http://www.gao.gov/yellowbook

AICPA Interpretation 101-3:
www.aicpa.org/Research/Standards/CodeofConduct/Pages/et_101.aspx#et_101.05