

**Auditor Independence:
Why It Is Important to You**

David R. Nance, CPA, Deputy Director
North Carolina State Board of CPA Examiners

1



21 NCAC 08B .0508 Requests for Informal Opinions
Requests to Board employees or legal counsel, or requests to Board members not in accordance with Rule .0501 of this Section, for opinions concerning the application of the Board's rules or any statutes are discouraged. If ever an opinion is given, it shall not be binding on the Board. Applicants, licensees, and any other persons who act in reliance on such opinions do so at their own risk.

2

Why Important?

Independence practices should be part of the ongoing operations of the audit firm – both preventive controls as well as detection controls.

Independence violations can be embarrassing to the firm and could lead to the loss of the client. These types of issues can also have an impact on the global perspective of the profession.

3

Why Important?

The independence of CPAs is an integral part of the framework of the profession – requirements relate to everything a CPA does – business and employment relationships as well as the services delivered to clients.

Independence in fact and appearance relates to the integrity and objectivity of the auditor.

4

Independence in Fact

- Guided by the various rules that exist that provide direction to the auditor in performing both attest and non-attest services
- Audit Standards require the independent auditor to maintain independence in mental attitude in all matters related to the audit
- Must remain free of any influences that could compromise the auditor's professional judgment

5

Independence in Appearance

- **Eyes of the Beholder Test** – There is a lot of subjectivity inherent to assessments of the “appearance of independence”
- AICPA Definition – The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team has been compromised.



6

Lots of Subjectivity

- Reasonable? Informed? Knowledge of all relevant information? Safeguards? Reasonably conclude?
- Lots of interpretive areas = Lots of wiggle room
- Assessing independence depends on the interpretations made by the assessor

7

Lots of Subjectivity

- Persons with differing experiences more than likely also reach different conclusions – one auditor’s judgment may be different from another auditor
- Decisions must be made at the beginning or during the decision-making process versus having the advantage of hindsight with all of the facts

8



Perception is reality!

9

Knowledgeable But Skeptical

- Overall concern related to the appearance of independence occurs when the *auditor becomes too close or too involved with the activities of the client*
- **Balancing Act** - Audit goes more smoothly when you have prior experiences and knowledge of the client; yet, if you are close enough to be influenced by the client then questions can be raised about the professional skepticism employed during the process



10

Various sources of independence rules & requirements—all have very similar themes



11

AICPA Code of Professional Conduct

1.200.001 Independence Rule - A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council.

Easily said, but tougher to figure out – Must evaluate against the Conceptual Framework for Independence

12

Just the Facts Please

The conceptual framework approach entails identifying threats and evaluating the threat that the member would not be independent or would be perceived by a reasonable and informed third party who is aware of the relevant information as not being independent. The member must eliminate or reduce that threat to an acceptable level to conclude that the member is independent. Threats are at an acceptable level either because of the types of threats and their potential effect or because safeguards have eliminated or reduced the threat, so that a reasonable and informed third party who is aware of the relevant information would perceive that the member's professional judgment is not compromised.

13

Documentation

- When the member applies safeguards to eliminate or reduce significant threats to an acceptable level, the *member should document the identified threats and safeguards applied.*
- *Failure to prepare the required documentation would be considered a violation of the "Compliance with Standards Rule" rather than the "Independence Rule" if the member can demonstrate that safeguards were applied that eliminated or reduced significant threats to an acceptable level.*



14

US Government Accountability Office (GAO)

- The GAO also uses a conceptual framework for independence. Principles-based approach to allow auditors to assess situations where performing services that not expressly prohibited.
- Continues themes of "Independence of Mind" and "Independence in Appearance." Paragraph (3.21)
- Effective Now – Periods Ending 6/30/2020



15

Key Changes to the Yellow Book

- Guidance to determine if the responsible management official has the skills, knowledge, and experience (SKE) to oversee the services being provided
- The independence standard is expanded to state that preparing financial statements from a client-provided trial balance or underlying accounting records generally creates significant threats to auditors' independence, and auditors should document the threats and safeguards applied to eliminate and reduce threats to an acceptable level or decline to perform the service
- Auditors should re-evaluate threats to independence whenever the auditors become aware of changes in circumstances that could impact safeguards applied or identified threats

16

Conceptual Framework Applies

- See that the client meets the general management responsibility requirements
- If performing nonaudit services, determine that they are not prohibited
- Identify threats to the auditor's independence
- Determine the significance of those threats and if they can be overcome
- Determine safeguards that can be applied

17

Management Responsibilities (3.73-3.78)

Auditor should obtain agreement that client management:

- Assumes all management responsibilities
- Will oversee the services by someone within or designated by management that has SKE
- Can evaluate the adequacy and results of the services provided
- Accepts responsibility for the services performed

18

Management SKE (3.79)

- A critical component of determining whether a threat to independence exists is consideration of management's ability to effectively oversee the nonaudit service to be provided. Although the responsible individual in management is required to have sufficient expertise to oversee the nonaudit services, management is not required to possess the expertise to perform or re-perform the services. However, indicators of management's ability to effectively oversee the nonaudit service include management's ability to determine the reasonableness of the results of the nonaudit services provided and to recognize a material error, omission, or misstatement in the results of the nonaudit services provided.

19

Management Have SKE?

- Auditor is preparing significant number of journal entries to the underlying accounting records
- Auditor is preparing adjusting journal entries of a material nature
- Client provided copy of statements to review and initials and dates them without any substantial review
- Management does not have sufficient time to discuss audit processes or understand the reasoning for the discussions

20

Document Nonaudit Services to be Performed (3.77)

Auditors should establish agreement with management as part of engagement letter:

- objectives of the nonaudit service
- services to be provided
- audited entity's acceptance of its responsibilities
- the auditors' responsibilities, and
- any limitations on the provision of nonaudit services

21

Independence Impaired

- In cases where the audited entity is unable or unwilling to assume these responsibilities (for example, the audited entity does not have an individual with suitable skill, knowledge, or experience to oversee the non-audit services provided, or is unwilling to perform such functions due to lack of time or desire), the auditor's provision of these services would impair independence.

22

The Big Change (3.88)

- Auditors should conclude that preparing financial statements in their entirety from a client-provided trial balance or underlying accounting records creates significant threats to auditors' independence, and should **document** the threats and safeguards applied to eliminate and reduce threats to an acceptable level decline to provide the services
- Auditors should evaluate the significance of threats to independence created by providing any services discussed in paragraph 3.89 and should **document** the evaluation of the significance of such threats

23

Change in Focus

Yellow Book 2011 (3.52)

- 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 based on information in the trial balance;
- posting entries that have been approved by an audited entity's management to the entity's trial balance;

Yellow Book 2018 (3.89)

- recording transactions for which management has determined or approved the appropriate account classification, or posting coded transactions to an audited entity's general ledger;
- preparing certain line items or sections of the financial statements based on information in the trial balance;
- posting entries that an audited entity's management has approved to the entity's trial balance; and

24

Change in Focus

Yellow Book 2011

- preparing account reconciliations that identify reconciling items for the audited entity management's evaluation; and
- proposing standard, adjusting, or correcting journal entries or other changes affecting the financial statements to an audited entity's management provided management reviews and accepts the entries and the auditor is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.

Yellow Book 2018

- preparing account reconciliations that identify reconciling items for the audited entity management's evaluation
- There is no and above and the bullet to the left is now gone
- More emphasis on management SKE and less reliance on management sign-off on documents as acceptance and understanding of the financial statements

25

Evaluate the Significance of the Threat

Determining whether services are significant threats and require safeguards is a matter of professional judgment

- Consider nonaudit services individually and in aggregate
- How important is the service to the overall audit?
- Would the auditor's professional skepticism be compromised or the appearance of independence be compromised by performance of the service?
- Document this consideration

26

Evaluate the Significance of the Threat

Factors that are relevant in evaluating the significance of any threats created by providing services include:

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

27

Documentation



Documentation of independence considerations provides evidence of the auditor's judgments in forming conclusions regarding compliance with independence requirements. GAGAS contains specific requirements for documentation related to independence which may be in addition to the documentation that auditors have previously maintained. While insufficient documentation of an auditor's compliance with the independence standard does not impair independence, appropriate documentation is required under the GAGAS quality control and assurance requirements.

28

Documentation



- The thought process is that if it is not documented, then it's difficult to show that it was performed
- OSA quality workpaper reviews over the past several years have consistently identified issues related to CPAs documentation of the independence considerations

29

Identified Potential Safeguards (3.69)

The following are examples of actions that in certain circumstances could be safeguards in addressing threats to independence related to nonaudit services:

- not including individuals who provided the nonaudit service as engagement team members;
- having another auditor, not associated with the engagement, review the engagement and nonaudit work as appropriate;
- engaging another audit organization to evaluate the results of the nonaudit service; or
- having another audit organization re-perform the nonaudit service to the extent necessary to enable that other audit organization to take responsibility for the service.

30

Considerations

- Perform audit of County and also nonaudit service of preparing financial statements from trial balance/ Finance officer has SKE – May have been considered not significant under prior YB, but now mandatory significant threat to be evaluated and safeguards applied – Documented
- Perform audit of County and also nonaudit service of preparing sections of the financial statements/ Finance officer has SKE – Evaluate the sections and significance to the FS as a whole – Could require safeguards - Documented

31

Considerations

- Perform audit of Town and also nonaudit service of preparing financial statements from trial balance/ Small firm with two partners (Tax/ Audit) and small staff – Safeguards to apply? Probably have to go outside of firm to properly establish safeguards – Documented
- Perform audit of Town and also nonaudit service of preparing financial statements from trial balance/ Sole proprietor /Safeguards to apply not involving going outside of firm? May be a situation that cannot be overcome by safeguards and require someone else to prepare the FS - Documented

32

Considerations

- Perform audit of Town and also nonaudit service of preparing financial statements because there is no one on the Town's staff that understands the accounting standards or how to begin putting together a set of financial statements – Speaks to Management SKE/Probably have to go with outside assistance to perform the necessary role – Documented
- Perform audit of Town and also nonaudit service of preparing financial statements from trial balance/ Town cannot prepare financial statements without assistance/ Reportable internal control condition? Management SKE? Independence Issue? - Documented

33

**North Carolina State Board
of CPA Examiners**

21 NCAC 08N .0201 *Integrity*

The reliance of the public and the business community on sound financial reporting and advice on business affairs imposes on the accounting profession an obligation to maintain high standards of technical competence, morality, and integrity. A CPA shall at all times maintain independence of thought and action, hold the affairs of clients in strict confidence, strive continuously to improve professional skills, observe generally accepted accounting principles and standards, promote sound and informative financial reporting, uphold the dignity and honor of the accounting profession, and maintain high standards of personal conduct.

Again, that's a lot of stuff!

34

21 NCAC 08N .0402 *Independence*

a) A CPA, or the CPA's firm, who is performing an engagement in which the CPA, or the CPA's firm, will issue a report on financial statements of any client (other than a report in which lack of independence is disclosed) **shall be independent with respect to the client in fact and appearance.**

35

Board Actions/Discussions

- Board has a strategic objective to improve audit quality and is a part of governmental audit process in NC
- Failures to document the auditor's assessment of independence
- Identification of management persons as not qualified (audit findings) yet no discussion as to ramifications to auditor independence
- Discussion as to the Implications of AU-C 265 - *Communicating Internal Control Related Matters Identified in an Audit*

36

Independence Compromised

Threats to independence are not at an acceptable level if:

- CPA's professional judgment is compromised
- A reasonable third-party would consider the actions of a CPA to compromise their integrity, objectivity, or professional skepticism

Document your decision-making processes

If you are using the same documentation for 2020 that you used in 2019, you may not be addressing the standards

37

North Carolina State Board of CPA Examiners

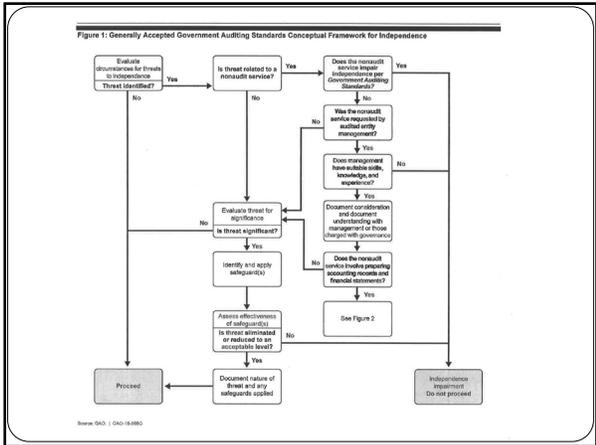
Professional Standards
Frank X. Trainor, Esq.
Staff Attorney
ftrainor@nccpaboard.gov

Executive Staff
Robert N. Brooks
Executive Director
rbrooks@nccpaboard.gov

David R. Nance, CPA
Deputy Director
dnance@nccpaboard.gov

 fb.com/NCCPABoard
 @NCCPABoard
 nccpaboard.gov

38



39

