



## Agenda Item 6

### Discussion Memo AU-C 800

#### Objective for the October 2018 ASB Meeting

To update the ASB on reactions to the proposal to introduce the concept of a compliance framework and eliminate the dual opinion in AU-C 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*.

#### Background

The ASB's Auditor Reporting Task Force (task force) is revising AU-C 800 to (1) reflect changes to the auditor's report included in the November 2017 exposure draft *Auditor Reporting*, and (2) introduce the concept of a compliance framework, which is included in ISA 800 (Revised) *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*.

The term *compliance framework* in ISA 800 is used to refer to a financial reporting framework that requires compliance with the requirements of the framework but does not require additional disclosures that are not required by the framework. The regulatory and contractual bases of accounting have been deemed similar to the ISA concept of a compliance framework because financial statements prepared under those frameworks are generally designed primarily for a specific purpose (or specific users) and may not require all the relevant disclosures required by GAAP.

AU-C 800 currently assumes that all special purpose frameworks (cash, tax, regulatory, contractual and other bases) are fair presentation frameworks. The presumption in a fair presentation framework is that in certain circumstances it may be necessary for management to provide disclosures in addition to those required by the applicable financial reporting framework. Paragraph .17 of AU-C 800 identifies the auditor's responsibility for evaluating disclosures in financial statements prepared in accordance with such fair presentation special purpose frameworks:

.17 Section 700 requires the auditor to evaluate whether the financial statements achieve fair presentation.<sup>7</sup> In an audit of special purpose financial statements when the special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, the auditor should evaluate whether the financial statements include informative disclosures similar to those required by GAAP. The auditor should also evaluate whether additional disclosures, beyond those specifically required by the framework, related to matters that are not specifically identified on the face

of the financial statements or other disclosures are necessary for the financial statements to achieve fair presentation.

At its January 2018 meeting, the ASB concluded that AU-C 800 should recognize and incorporate the concept of a compliance framework. Based on that conclusion, the task force is proposing that paragraph .17 of AU-C 800 only apply to fair presentation frameworks, such as the cash and tax basis of accounting and not to compliance frameworks, such as regulatory or contractual bases of accounting.

Another issue being considered relates to the second opinion in the auditor's report when financial statements are prepared using a regulatory framework (or presumably a contractual framework) and those financial statements are used and widely distributed as the entity's primary financial statements.

Paragraph .19 of extant AU-C 800 requires that an auditor's report on financial statements prepared in accordance with a special purpose framework include an emphasis-of-matter paragraph that

- indicates that the financial statements are prepared in accordance with a special purpose framework,
- refers to the note to the financial statements that describes that framework, and
- states that the special purpose framework is a basis of accounting other than GAAP.

Paragraph .20 of extant AU-C 800 requires an other matter paragraph that restricts the use of the auditor's report for financial statements prepared in accordance with a regulatory or contractual basis of accounting.

Auditor's reports on financial statements prepared in accordance with a regulatory basis of accounting are exempt from the requirements in paragraphs .19 and .20 if the financial statements, together with the auditor's report, are intended for general use. In those circumstances, paragraph .21 of extant AU-C 800 requires the auditor to express an opinion on whether the financial statements are

1. presented fairly, in all material respects, in accordance with GAAP and
2. prepared in accordance with the special purpose framework (a dual opinion),

The task force has proposed eliminating the dual opinion and allowing the auditor to report only on the regulatory basis of accounting even when the financial statements would be widely distributed as the entity's primary financial statements.

All special purpose framework reports would contain an emphasis-of-matter paragraph (consistent with extant paragraph .19) indicating that the financial statements are prepared in accordance with a special purpose framework that is a basis of accounting other than GAAP.

A primary difference between reporting on a special purpose framework that is intended to be a fair presentation framework versus reporting on a special purpose framework that is intended to be a compliance framework would be how the opinion is phrased. For example, when the framework is a fair presentation framework, the opinion would be phrased “In our opinion, the financial statements referred to above present fairly, in all material respects, ....” When the framework is a compliance framework, the opinion would be phrased “In our opinion, the financial statements referred to above are prepared, in all material respects, in accordance with [describe the compliance framework] ....”

Additional issues that the task force is still deliberating include:

- in what circumstances should reports on special purpose financial statements prepared in accordance with a compliance framework include restricted use language or wording indicating that the financial statements may not be suitable for another purpose, in addition to the required emphasis-of-matter wording, and
- whether management can convert a compliance framework (e.g., a regulatory framework) to a fair presentation framework by subjecting the framework to additional GAAP-like disclosures, or whether there are other characteristics that differentiate a compliance framework from a fair presentation framework.

### **Input From Affected Parties**

The ASB asked the task force to obtain input from parties that would be affected by this proposal, for example, insurance entities, state insurance regulators, and CPAs who audit and report on the financial statements of insurance entities. In conversations with the staff and chair of the AICPA NAIC<sup>1</sup> Task Force, representatives of CPA firms and insurance entities had a positive reaction to the proposal to move away from the dual opinion to a single compliance-type opinion. The NAIC Task Force is waiting to obtain additional input from insurance regulators until after the ASB has decided on the direction it will take with regard to dual opinions.

At the September 7, 2018 GASB-AITF liaison meeting, the ASB Audit Issues Task Force discussed eliminating the dual opinion. Concerns were expressed by certain GASB participants about whether eliminating the dual opinion would “incentivize” state or local governments to create regulatory frameworks to achieve a specific financial statement outcome. An example is a state government that establishes a special purpose framework that is the same as GAAP but omits the requirement to record a liability for other postemployment benefits, thereby enabling the governmental entity to avoid a deficiency in revenue over expenditures. Separately, in a recent meeting with the AICPA State and Local Government Expert Panel, the GASB chairman and lead staff again emphasized their concerns on this topic.

In a recent letter to Chuck Landes, Scott Woelfle of the Office of the Washington State Auditor, expressed support for the ASB’s tentative conclusions to converge with ISA 800 and eliminate the dual opinion for regulatory basis financial statements intended for general use. His office believes the dual opinion creates confusion for management, legislative bodies, citizens and other report users. In a follow up communication, Mr. Woelfle and others said they would

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<sup>1</sup> National Association of Insurance Commissioners.

welcome the opportunity to meet with the task force and to further discuss situations in which the regulatory basis of accounting is used. He also suggested that getting input from other members of the National Association of State Auditors, Comptrollers, and Treasurers would be beneficial.

The task force will continue to obtain input from affected parties but wishes to make the ASB aware of these views so that they can be considered as part of the ASB's deliberations.