



Agenda Item 2C (1)

Issues Paper

Proposed Conforming Amendments to AU-C section 940

AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* establishes requirements and provides guidance that applies only when an auditor is engaged to perform an audit of internal control over financial reporting (ICFR) that is integrated with an audit of financial statements (integrated audit). Agenda item 2C(2) includes the proposed revisions to AU-C section 940, to conform to the reporting requirements in SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*. In developing the proposed amendments, we also considered the amendments made to PCAOB AS 2201: *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* as part of PCOAB Release AS 2017-001, *The Auditor's Report On An Audit Of Financial Statements When The Auditor Expresses An Unqualified Opinion And Related Amendments To PCAOB Standards*.

The ASB is asked to review the conforming amendments in agenda item 2C(2). The ASB is also asked to consider the following issues for consideration.

Issues for ASB Consideration

Issue 1 – Auditor’s Responsibilities

Issue 1a

Paragraph .64e.iv.(1) of extant AU-C section 940 requires the report on ICFR to include, in the “Auditor’s Responsibility” section of the ICFR report, a description of the audit by stating that an audit involves performing procedures to obtain audit evidence about whether a material weakness exists. The auditor’s responsibilities section of AU-C section 700 of SAS No. 134 focuses on the objectives of the audit and does not discuss procedures. However, the sentence from extant paragraph .64e.iv.(1) provides greater transparency to users as it helps to bridge the notion of “ineffective ICFR” with “material weakness” particularly with the addition of the discussion about “reasonable assurance.” The amendments to the auditor’s responsibilities for the audit of ICFR section of the auditor’s report include the extant requirement in paragraph .64f.ii. and is illustrated in the auditor’s reports.

The following is the auditor's responsibilities section of the report on ICFR that reflects the proposed amendments to paragraph .64 relating to the auditor's responsibilities included in agenda item 2C(2):

Auditor's Responsibilities for the Audit of Internal Control Over Financial Reporting

Our objectives are to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects, and to issue an auditor's report that includes our opinion. An audit of internal control over financial reporting involves performing procedures to obtain audit evidence about whether a material weakness exists. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit of internal control over financial reporting conducted in accordance with GAAS will always detect a material weakness when it exists.

In performing an audit of internal control over financial reporting in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Obtain an understanding of internal control over financial reporting, assess the risks that a material weakness exists, and test and evaluate the design and operating effectiveness of internal control over financial reporting based on the assessed risk.

The options considered for the placement of the content from extant paragraph .64e.iv.(1) (green highlighted sentence above) included the following:

1. Include the sentence in pararaph .64f.ii as illustrated above.
2. Replace the sentence with the following: “Internal control over financial reporting is not effective if a material weakness exists.”
3. Remove the sentence, but modify the previous sentence to align with the language in the illustrative communication “Our objectives are to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects (*that is, whether material weaknesses exist as of the date specified in management's assessment*), and to issue an auditor's report...”

Action Requested of the ASB – Issue 1a

1. Does the ASB agree with retaining the extant requirement to state that an audit of internal control over financial reporting involves performing procedures to obtain audit evidence about whether a material weakness exists.
 - 1(a). If so, does the ASB agree with the placement as illustrated above (option 1).
 - 1(b). If not, does the ASB prefer options 2, 3, or 4?

Issue 1b

The second paragraph of the auditor's responsibility for the audit of ICFR can be presented in various ways. The following illustrates one way to present this content.

Auditor's Responsibilities for the Audit of Internal Control Over Financial Reporting

Our objectives are to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects, and to issue an auditor's report that includes our opinion. An audit of internal control over financial reporting involves performing procedures to obtain audit evidence about whether a material weakness exists. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit of internal control over financial reporting conducted in accordance with GAAS will always detect a material weakness when it exists.

In performing an audit of internal control over financial reporting in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Obtain an understanding of internal control over financial reporting, assess the risks that a material weakness exists, and test and evaluate the design and operating effectiveness of internal control over financial reporting based on the assessed risk.

The options considered for the placement of this content include the following:

1. Present as illustrated above.
2. Include the entire section in paragraph form (no bullets)
3. Bullet the entire section as follows:

In performing an audit of internal control over financial reporting in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit
- Obtain an understanding of internal control over financial reporting and assess the risks that a material weakness exists
- test and evaluate the design and operating effectiveness of internal control over financial reporting based on the assessed risk.

Action Requested of the ASB

2. Does the ASB have a preference between options 1, 2, or 3 for the presentation of the auditor's responsibilities section?

Issue 2 – Adverse Opinion on ICFR

AU-C section 940 requires the auditor to issue an adverse opinion on ICFR if there are deficiencies that result in one or more material weaknesses. Paragraph .71 of extant AU-C section 940 requires the auditor to disclose whether the auditor's opinion on the financial statements was affected by the material weakness, in an other-matter (OM) paragraph or as part of the paragraph that identifies the material weakness.

The following proposed amendment to paragraph .71 requires the disclosure about whether the auditor's opinion on the financial statements was affected by the material weakness to be placed in a separate paragraph within the opinion section of the report on ICFR, rather than as an OM paragraph or as part of the paragraph that identifies the material weakness. Also included below is an example of the auditor's opinion section from illustration 2 in agenda item 2C(2) that illustrates such placement.

.71 The auditor should determine the effect an adverse opinion on ICFR has on the auditor's opinion on the financial statements. Additionally, the auditor should disclose, as a separate paragraph within the Opinion section to the report on ICFR, in an other-matter paragraph or as part of the paragraph that identifies the material weakness, whether the auditor's opinion on the financial statements was affected by the material weakness. (Ref: par. .A121)

Excerpt from Illustration 2 of Agenda item 2C(2):

Report on Internal Control Over Financial Reporting¹

Adverse Opinion on Internal Control Over Financial Reporting

We have audited ABC Company's internal control over financial reporting as of December 31, 20XX, based on [identify criteria].² In our opinion, because of the effect of the material weakness described in the Basis for Adverse Opinion section on the achievement of the objectives of [identify criteria], ABC Company has not maintained effective internal control over financial reporting as of December 31, 20XX, based on [identify criteria].

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of ABC Company, and our report dated

¹ The subtitle "Report on Internal Control Over Financial Reporting" is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

² For example, the following may be used to identify the criteria: "criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

[date of report, which should be the same as the date of the report on the audit of ICFR]
expressed [include nature of opinion].

We considered the material weakness described in the Basis for Adverse Opinion paragraph in determining the nature, timing, and extent of audit procedures applied in our audit of the 20XX financial statements, and this report does not affect such report on the financial statements.

Action Requested of the ASB

3. Does the ASB agree with the changes to paragraph .71 as proposed above to require the placement of the information about whether the auditor's opinion on the financial statements was affected by the material weakness to be within the Opinion section of the report on ICFR?
4. If not, should a different location in the report be specified or should the location not be specified (for example in an other-matter paragraph)?

Issue 3 – Additional Information

Paragraph .80 of AU-C section 940 addresses how to report when additional information is included either within management's report or in a document containing management's report. The content in paragraph .80 of AU-C section 940 was originally based on certain concepts in AU-C section 720, *Other Information in Documents Containing Audited Financial Statements*, and referred the auditor to requirements and guidance in that standard.

The additional information in AU-C section 940 is not considered an annual report and therefore is not within the scope of SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*. Additionally, the changes adopted in SAS No. 137 to the auditor responsibilities and definitions extend beyond the typical circumstances related to additional information found in reporting on ICFR in private company reporting situations. Accordingly, Staff recommends that the extant requirements in paragraph .80 be retained and the auditor's response to apparent material inconsistencies or misstatement of fact would be determined by the auditor based on the circumstances.

Additional Information

.80 When management includes, either within management's report or in a document containing management's report, information in addition to the elements that are subject to the auditor's evaluation as described in paragraph .55, the auditor should

- a. disclaim an opinion, in an other-matter paragraph, on the additional information when such information is included in management's report. (Ref: par. .A129)

Discussion Memorandum: Conforming Amendments – AU-C section 940
ASB Meeting, July 22-25, 2019

- b. read the additional information to identify material inconsistencies with management's report and material misstatements of fact when such information is included outside management's report in a document containing management's report and the related auditor's report. If, upon reading the additional information, the auditor becomes aware of an apparent material inconsistency or misstatement of fact, the auditor should request management to revise the information. If management refuses to make the revision, the auditor should communicate this matter to those charged with governance and take appropriate action which may include withholding the auditor's report. ~~apply the requirements in section 720, Other Information in Documents Containing Audited Financial Statements, adapted as necessary, to the audit of ICFR.~~ (Ref: par. .A130)

Action Requested of the ASB

5. Does the ASB agree with removing references to AU-C section 720 (SAS 137) and including appropriate requirements within AU-C section 940?
6. Should AU-C 940 include additional guidance relating to when material inconsistencies or misstatements of fact are identified subsequent to the report release date?