



Agenda Item 3C (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 3C (2) includes the proposed revisions to AU-C section 940, to conform to the reporting requirements in Statement on Auditing Standards (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 PCAOB 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*.

ASB Discussion from July 2019 ASB Meeting

At the July 2019 ASB meeting, the ASB discussed proposed conforming amendments to AU-C section 940, including three issues as outlined in Agenda Item 2C (1) to the July 2019 ASB meeting. The ASB provided the following views:

- Issue 1a (*Auditor's Responsibilities*; Paragraph 64e.iv.(1)). The ASB supported option 2 from Agenda Item 2C (1) to the July 2019 ASB meeting. Option 2 includes the sentence "Internal control over financial reporting is not effective if a material weakness exists" in the first paragraph of the auditor's responsibilities section of the auditor's report in place of "An audit of internal control over financial reporting involves performing procedures to obtain audit evidence about whether a material weakness exists."
- Issue 1b (*Auditor's Responsibilities*; second paragraph of the auditor's responsibility for the audit of ICFR) – The ASB supported option 1 from Agenda Item 2C (1) to the July 2019 ASB meeting that would present the second paragraph of the auditor's responsibility for the audit of ICFR section of the auditor's report as shown in that agenda item.
- Issue 2 (*Adverse Opinion on ICFR*) – The ASB agreed with the proposed amendments to paragraph .71 of AU-C section 940 as proposed in Agenda Item 2C (1) to the July 2019 ASB meeting. The proposed amendment requires a separate paragraph, to be placed within

the opinion section of the report on ICFR, that discloses whether the auditor's opinion on the financial statements was affected by the material weakness.

- 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. See the Issue in this issue paper for further discussion of this topic.

Subsequent to the July 2019 ASB Meeting

Subsequent to the July 2019 ASB meeting, staff has revised the proposed SAS to address the ASB's views from the July 2019 ASB meeting. Agenda Item 3(C) 2 to the October 2019 ASB meeting contains the proposed amendments from the July 2019 ASB meeting marked to reflect proposed changes resulting from the ASB discussions at the July 2019 ASB meeting. The proposed amendments have been reformatted to reflect AICPA style for proposed amendments (this includes only those paragraphs of the SAS affected by the changes with new text in ***bold italics*** and deleted text in ~~strikethrough~~).

Action requested of the ASB

1. The ASB is asked to review the conforming amendments in agenda item 3C (2).

Issues for ASB Consideration

Issue – 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 and the related auditor's report. *Additional information* is information in addition to the elements that are subject to the auditor's evaluation in paragraph .55 of AU-C section 940, for example management's statement regarding cost-benefit or remediation actions taken subsequent to the period of evaluation. The content in paragraph .80 of AU-C section 940 was originally based on certain concepts in AU-C section 720A, *Other Information in Documents Containing Audited Financial Statements*, and referred the auditor to requirements and guidance in that standard. Specifically, AU-C section 940 requires the auditor to (emphasis added):

- a. disclaim an opinion, in an other-matter paragraph, on the additional information when such information is included in management's report
- 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 apply the requirements in AU-C section 720A, adapted as necessary, to the audit of ICFR.

July 2019 ASB Discussion

In July 2019 the ASB issued SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*. SAS No. 137 supersedes SAS No. 118, *Other Information in Documents Containing Audited Financial Statements*, as amended (AICPA, *Professional Standards*, AU-C sec. 720A). The changes adopted in SAS No. 137 relating to the definitions and auditor responsibilities extend beyond the typical circumstances related to additional information found in reporting on ICFR in private company reporting situations. Accordingly, at the July 2019 ASB meeting the ASB agreed that the reference to AU-C section 720 as superseded by SAS No. 137 would not be appropriate because the additional information as addressed in AU-C section 940 would not be considered an annual report and therefore is not within the scope of SAS No. 137. The ASB asked staff to consider expanding paragraph .80 of AU-C section 940 to include guidance for reporting on the additional information when reporting on an audit of ICFR rather than include a reference to AU-C section 720.

Subsequent Considerations

Subsequent to the July 2019 ASB meeting, staff considered revisions to paragraph .80 to address situations when (a) additional information is included in management's report, and (b) when the additional information is included outside management's report in a document containing management's report and the related auditor's report. Staff also considered which requirements should be included to address the auditor's responsibilities when a material inconsistency or material misstatement of fact between the additional information and management's report has been identified by the auditor.

Additional Information Included in Management's Report

Staff noted that the extant requirements do not require the auditor to read the additional information for material inconsistencies or misstatements of fact when the additional information is included in management's report. Rather, the auditor is required to disclaim an opinion on the additional information. Paragraph .55 of extant AU-C section 940 requires the auditor to evaluate management's report to ensure it contains certain required elements but does not include specific procedures or guidance relating to additional information included in management's report. The auditor is required to read the additional information to identify material inconsistencies only when the additional information is included outside management's report. This raised the question about whether the auditor should read the additional information to identify material inconsistencies and material misstatements of fact between the additional information and the information in management's report in addition to disclaiming an opinion on the additional information when the information is included in management's report.

In developing the proposed amendments, staff considered the following requirements and guidance:

- Paragraph .80 of extant AU-C section 940
- Paragraphs .C12-.C14 of PCAOB AS 2201

See the Table in the Appendix A to this Issues paper for a side-by-side comparison of the above listed sections.

Additonal Information Included Outside Management's Report In A Document Containing Mangement's Report And The Related Auditor's Report

As discussed previously, paragraph .80 of AU-C section 940 requires the auditor to 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 is required to apply the requirements in AU-C section 720, adapted as necessary, to the audit of ICFR.

As discussed at the July 2019 ASB meeting, staff considered the following guidance in developing proposed requirements to include procedures within AU-C section 940 rather than to reference to AU-C 720.

- Paragraphs 20-21 of SAS No. 137
- Paragraph 53 of SAS No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*

See Appendix B to this Issues paper for excerpts of the above listed sections.

Options for ASB Consideration

The following are two options for the ASB's consideration relating to the auditor's responsibilities for additonal information included either in management's report or located outside management's report. The table in Appendix A to this issues paper includes a side-by-side comparison of these two options to the requirements in extant AU-C section 940 and PCAOB AS 2201.

Option 1 – Additional Information [Requires the Auditor to Read the Information for Material Inconsitencies and Material Misstatements of Fact Regardless of Whether the Additional Information is Located in Management's Report or Outside Management's Report]

The proposed amendments to paragraph .80 of AU-C section 940 in Option 1 would change extant to require the auditor to read the additional information to identify material inconsistencies and material misstatements of fact between the additional information and management's report regardless of whether the additional information is included within mangement's report or outside management's report. This option would still require the auditor to also disclaim an opinion on the additional information when it is included in management's report. This option provides guidance for the auditor when a material inconsonistency or material misstatement of fact is identified based on SAS No. 137.

The marked changes reflect changes made to paragraph .80 of extant AU-C section 940. [New text in ***bold italics*** and deleted text in ~~strikethrough~~]

Additional Information

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

- a. **when such information is included in management's report, read the additional information to identify material inconsistencies with management's report and to become aware of material misstatements of fact. If no material inconsistencies or material misstatements of fact are identified**, disclaim an opinion, in an other-matter paragraph, on the additional information ~~when such information is included in management's report~~. **If, upon reading the additional information the auditor identifies a material inconsistency or becomes aware of a material misstatement of fact, request management to correct the information. If management agrees to make the correction, determine that the correction has been made. If management refuses to make the correction, communicate the matter to those charged with governance and request that the correction be made. If the correction is not made after communicating with those charged with governance, the auditor should do one of the following:** (Ref: par. .A129)
 - i. **disclaim an opinion in an other-matter paragraph on the additional information**
 - ii. **withhold the auditor's report**
 - iii. **withdraw from the engagement, when withdrawal is possible under the applicable law or regulation**
- b. **when such information is included outside management's report and the related auditor's report**, 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 **identifies a** ~~becomes aware of an apparent~~ material inconsistency or **becomes aware of a material** misstatement of fact, ~~the auditor should~~ **request management to correct the information. If management agrees to make the correction, determine that the correction has been made. If management refuses to make the correction, communicate the matter to those charged with governance and request that the correction be made. If the correction is not made after communicating with those charged with governance, the auditor should do the following:** ~~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)

- i. *consider the implications for the auditor's report and communicate to those charged with governance about how the auditor plans to address the material inconsistency or material misstatement of fact in the auditor's report*
- ii. *withhold the auditor's report*
- iii. *withdraw from the engagement, when withdrawal is possible under the applicable law or regulation*

Option 2 — Additional Information — [Requires the Auditor to Disclaim an Opinion on the Additional Information When that Information is Located Within Management's Report and Read the Additional Information for Material Inconsistencies and Material Misstatements of Fact When the Additional Information is Located Outside Management's Report]

Option 2 would retain extant requirements to disclaim an opinion on the additional information when such information is included in management's report and does not contain an explicit requirement for the auditor to read the additional information for material inconsistencies or material misstatements of fact unless the additional information is included outside management's report. This option would continue to require the auditor to read the additional information for material inconsistencies and material misstatements of fact when the additional information is included outside management's report in a document containing management's report and the related auditor's report. This option provides guidance for the auditor when a material inconsistency or material misstatement of fact is identified based on SAS No. 137.

The marked changes reflect changes made to paragraph .80 of extant AU-C section 940. [New text in *bold italics* and deleted text in ~~strikethrough~~]

Additional Information

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

- 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)
- b. *when such information is included outside management's report and the related auditor's report*, 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 *identifies a* ~~becomes aware of an apparent~~ material inconsistency or *becomes aware of a material* misstatement of fact, the

~~auditor should~~ ***request management to correct the information. If management agrees to make the correction, determine that the correction has been made. If management refuses to make the correction, communicate the matter to those charged with governance and request that the correction be made. If the correction is not made after communicating with those charged with governance, the auditor should do the following:*** 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)

- i. consider the implications for the auditor's report and communicate to those charged with governance about how the auditor plans to address the material inconsistency or material misstatement of fact in the auditor's report*
- ii. withhold the auditor's report*
- iii. withdraw from the engagement, when withdrawal is possible under the applicable law or regulation*

Action requested of the ASB

2. Does the ASB have a preference for Option 1 or Option 2?
3. If option 1 is preferred, does the ASB believe that paragraph .80 should be amended to require the auditor to read the additional information for material inconsistencies and material misstatements of fact when that information is located in management's report, while still disclaiming an opinion on the additional information?
4. For both options, does the ASB agree with including the requirements, as illustrated above, within AU-C section 940?

Appendix A

The following table provides a comparison of the requirements in paragraph .80 of extant AU-C section 940 with similar requirements in PCAOB AS 2201, and the options proposed in this issue paper.

Table A-1 — Side-by-side Comparison of AU-C 940, PCAOB AS 2101 and Options 1 and 2

<i>Location of Additional Information</i>	<i>Extant AU-C 940 Paragraph .80</i>	<i>PCAOB AS 2101 Paragraphs .C12-.C14</i>	<i>Option 1</i>	<i>Option 2</i>
Included in Management’s Report	Disclaim an Opinion in an OM paragraph	<p>Disclaim an opinion if report could be reasonably viewed by users as including such information</p> <p>If auditor believes the additional information contains an MMF, discuss with management.</p> <p>If after discussing the matters the MMF remains notify management and the audit committee, in writing, of the auditor’s views</p>	<p>Read the additional information to identify MIs and MMFs</p> <p>If none are identified disclaim an opinion on the additional information</p> <p>If MIs or MMFs are identified</p> <ul style="list-style-type: none"> - discuss with management - if corrected, make sure corrections are made - If mgmt refuses to correct, communicate the matter to TCWG - If no changes are made after discussing with TCWG <ul style="list-style-type: none"> - Disclaim an opinion - Withhold the auditor’s report, or - Withdraw when possible 	Disclaim an Opinion in an OM paragraph

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<i>Location of Additional Information</i>	<i>Extant AU-C 940 Paragraph .80</i>	<i>PCAOB AS 2101 Paragraphs .C12-.C14</i>	<i>Option 1</i>	<i>Option 2</i>
<p>Included outside management’s report in a document containing management’s report and the related auditor’s report</p>	<p>Read the additional information to identify material inconsistencies (MIs) and material misstatements of fact (MMFs)</p> <p>If MIs or MMFs are identified apply AU-C 720 adapted as necessary to the audit of ICFR</p> <p>[Note: AU-C 720A.12 requires:</p> <ul style="list-style-type: none"> - If mgmt refuses to correct, communicate the matter to TCWG - Include an OM paragraph describing the MI - Withhold the auditor’s report, or - Withdraw when possible] 	<p>If auditor believes the additional information contains an MMF, discuss with mangement.</p> <p>If after discussing the matters the MMF remains notify management and the audit committee, in writing, of the auditor’s views</p>	<p>Read the additional information to identify MIs and MMFs</p> <p>If MIs or MMFs are identified:</p> <ul style="list-style-type: none"> - discuss with management - if correced, make sure corrections are made - If mgmt refuses to correct, communicate the matter to TCWG - If no chagnes made after discussing with TCWG: <ul style="list-style-type: none"> o Consider the implications for the auditor’s report and communicate to TCWG about how the auditor plans to address the MI or MMF in the auditor’s report o Withhold the auditor’s report, or o Withdraw when possible 	<p>Read the additional information to identify MIs and MMFs</p> <p>If MIs or MMFs are identified:</p> <ul style="list-style-type: none"> - discuss with management - if correced, make sure corrections are made - If mgmt refuses to correct, communicate the matter to TCWG - If no chagnes made after discussin with TCWG: <ul style="list-style-type: none"> o Consider the implications for the auditor’s report and communicate to TCWG about how the auditor plans to address the MI or MMF in the auditor’s report o Withhold the auditor’s report, or o Withdraw when possible

Appendix B

This appendix contains excerpts of SAS No. 137 and SAS No. 136 to aid in the ASB's consideration of this topic.

Excerpt from SAS No. 137

The following is an excerpt of paragraphs 20-21 of SAS No. 137 (SAS No. 137 explains that a material misstatement may be an inconsistency, a misstatement of fact, or information that is otherwise misleading)

Responding When the Auditor Concludes That a Material Misstatement of the Other Information Exists

- 20.** If the auditor concludes that a material misstatement of the other information exists, the auditor should request management to correct the other information and
- a. if management agrees to make the correction, determine that the correction has been made.
 - b. if management refuses to make the correction, communicate the matter to those charged with governance and request that the correction be made.
- 21.** If the auditor concludes that a material misstatement exists in other information obtained prior to the date of the auditor's report, and the other information is not corrected after communicating with those charged with governance, the auditor should (Ref: par. A48)
- a. consider the implications for the auditor's report and communicate to those charged with governance about how the auditor plans to address the material misstatement in the auditor's report (see paragraph 24cii); (Ref: par. A49)
 - b. withhold the auditor's report; or (Ref: par. A51)
 - c. withdraw from the engagement, when withdrawal is possible under applicable law or regulation. (Ref: par. A50–A51)

Excerpt from SAS No. 136

Staff also considered the guidance in paragraph 53 of SAS No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*. The following is an excerpt of paragraph .53 of SAS No. 136 as it relates to considerations for the Form 5500:

- 53.** When the auditor identifies a material inconsistency prior to the report release date that requires revision of the information in the draft Form 5500, and management refuses to make the revision, the auditor should communicate this matter to those charged with governance and (Ref: par. A81)
- a. include in the auditor's report an other-matter paragraph describing the material inconsistency, in accordance with AU-C section 706,
 - b. withhold the auditor's report, or
 - c. when withdrawal is possible under applicable law or regulation, withdraw from the engagement.