



## Agenda Item 3C (2)

### **Proposed Conforming Amendments to AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements***

#### **AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS**

~~The following table provides a comparison of the relevant requirements from AU-C section 700 and how they have been addressed as proposed revisions to AU-C section 940.~~

#### **Amendments to Section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* in SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as Amended**

~~(*Boldface italics* denote new language. Deleted text is in strikethrough.)~~

~~1. The amendment is effective for audits of financial statements for periods ending on or after December 15, 2022.~~

~~[No proposed amendments to paragraphs .01-.63] of AU-C section 940.~~

#### **~~Proposed Revisions to AU-C section 940~~**

~~.64~~ The auditor's report on the audit of ICFR should be in writing and should include the following elements:

- ~~a.~~ *Title.* ~~The auditor's report should have A~~ a title that includes the word *independent* to clearly indicate ~~indicates~~ that it is the report of an independent auditor.
- ~~b.~~ *Addressee.* ~~An addressee as required by the~~ *The auditor's report should be addressed, as appropriate, based on the* circumstances of the engagement.

- c. ***Auditor's Opinion on ICFR.*** ~~An introductory paragraph that includes the following:~~ ***The first section of the auditor's report should include the auditor's opinion on ICFR and should have the heading "Opinion on Internal Control Over Financial Reporting." The "Opinion on Internal Control Over Financial Reporting" of the auditor's report should also do the following:***
- i. ~~Identification of~~ ***Identify*** the entity whose ICFR has been audited
  - ii. ~~A statement~~ ***State*** that the entity's ICFR has been audited
  - iii. ~~Identification of~~ ***Identify*** the as of date
  - iv. ~~Identification of~~ ***Identify*** the criteria against which ICFR is measured
  - v. ***Include the auditor's opinion on whether the entity maintained, in all material respects, effective ICFR as of the specified date, based on the criteria***
- d. ***Basis for Opinion.*** ***The auditor's report should include a section, directly following the "Opinion on Internal Control Over Financial Reporting" section, with the heading "Basis for Opinion," that does the following:***
- i. ***States that the audit was conducted in accordance with generally accepted auditing standards and identifies the United States of America as the country of origin of those standards (Ref: par. .A113)***
  - ii. ***Refers to the section of the auditor's report that describes the auditor's responsibilities under GAAS***
  - iii. ***Includes a statement that the auditor is required to be independent of the entity and to meet the auditor's other ethical responsibilities, in accordance with the relevant ethical requirements relating to the audit<sup>7</sup>***
- <sup>7</sup> See paragraphs .A38–.A39 of section 700, *Forming an Opinion and Reporting on Financial Statements*.
- [subsequent footnotes renumbered]
- iv. ***States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion***
- ed. ***Responsibilities of Management.*** ***The auditor's report should include a*** ~~A~~ ***section with the heading "Responsibilities of Management's Responsibility for Internal Control Over Financial Reporting". This section of the auditor's report should do that includes the following:***

- i. ~~A statement~~ ***State*** that management is responsible for designing, implementing, and maintaining effective ICFR
- ii. ~~A statement~~ ***State*** that management is responsible for its assessment about the effectiveness of ICFR
- iii. ~~A~~ ***Include a*** reference to management's report on ICFR

***fe. Auditor's Responsibilities. The auditor's report should include a*** ~~A~~ section with the heading "Auditor's ***Responsibilities for the Audit of Internal Control Over Financial Reporting Responsibility***" ***This section of the auditor's report should do*** that includes the following:

- i. ***State that the objectives of the auditor are to***
  - a. ***obtain reasonable assurance about whether effective ICFR was maintained in all material respects***
  - ib. ~~A statement that the~~ ***issue an*** auditor's ***report*** responsibility is to express an ~~an~~ ***that includes the auditor's*** opinion on the entity's ICFR based on the audit
- ii. ~~A statement that the audit was conducted in accordance with auditing standards generally accepted in the United States of America (Ref: par. A113)~~
- iii. ~~A statement that such standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective ICFR was maintained in all material respects~~
- ii. ***State that internal control over financial reporting is not effective if a an audit of ICFR involves performing procedures to obtain audit evidence about whether a material weakness exists***

***Staff Note:*** At the July 2019 ASB meeting the ASB supported option 2 in issue 1a of agenda item 2C (1). This option supported replacing the statement in the auditor's report that "an audit of ICFR involves performing procedures to obtain audit evidence about whether a material weakness exists" with a statement that "internal control over financial reporting is not effective if a material weakness exists."

The requirement has been revised to reflect this change. The illustrative reports have been revised accordingly.

- iii. *State that reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material weakness when it exists.*
- iv. ~~A description of~~ *Describe* the audit by stating that, *in performing an audit of ICFR in accordance with GAAS, the auditor's responsibilities are to:*
  - (1) Exercise professional judgment and maintain professional skepticism throughout the audit.*
  - ~~(1) an audit of ICFR involves performing procedures to obtain audit evidence about whether a material weakness exists~~
  - ~~(2) the procedures selected depend on the auditor's judgment, including the assessment of the risks that a material weakness exists~~
  - (2) (3) an audit includes obtaining Obtain an understanding of ICFR, assess the risks that a material weakness exists, and test and evaluate and testing and evaluating the design and operating effectiveness of ICFR based on the assessed risk*

*Staff Note:* At the July 2019 ASB meeting the ASB was asked whether they had a preference to how .64f.iv. should be presented (see Issue 1b of agenda item 2C (1)). The ASB did not have a preference and supported retaining the format as presented above.

- ~~v. A statement about whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the audit opinion~~

### *Definition and Inherent Limitations of Internal Control Over Financial Reporting*

*g. ~~¶~~The auditor's report should include* a section with the heading "Definition and Inherent Limitations of Internal Control Over Financial Reporting" or other appropriate heading that includes the following:

- i. A definition of ICFR (the auditor should use the same description of the entity's ICFR as management uses in its report)
- ii. A paragraph stating that because of inherent limitations, ICFR may not prevent, or detect and correct, misstatements and that projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate

~~g. A section with the heading "Opinion" that includes the auditor's opinion on whether the entity maintained, in all material respects, effective ICFR as of the specified date, based on the criteria~~

*h. Signature of the Auditor.* The ~~manual or printed signature of the auditor's firm~~ **auditor's report should include the manual or printed signature of the auditor's firm.**

*i. Auditor's Address.* The **auditor's report should name the** city and state where the ~~auditor practices~~ **auditor's report is issued.**

*j. Date of the Auditor's Report.* The ~~date of the auditor's report~~ **should be dated, as required by paragraph .66.**

### **Separate Report on ICFR**

**.65** If the auditor issues a separate report on ICFR, the auditor should add the following paragraph, ~~in an other matter paragraph with an appropriate heading, in accordance with section 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report~~ **following the opinion paragraph within the "Opinion" section**, to the auditor's report on the financial statements:

We also have audited, in accordance with auditing standards generally accepted in the United States of America, [entity name]'s internal control over financial reporting as of December 31, 20X8, based on [identify criteria] and our report dated [date of report, which should be the same as the date of the report on the financial statements] expressed [include nature of opinion].

The auditor also should add the following ~~other matter paragraph~~ **paragraph, following the opinion paragraph within the "Opinion on Internal Control Over Financial Reporting" section**, to the report on ICFR:

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of [entity name] and our report dated [date of report, which should be the same as the date of the report on ICFR] expressed [include nature of opinion]. (Ref: par. .A114–.A116)

### **Report Date**

**.66** The auditor should date the report on ICFR no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence **on which** to ~~support~~ **base** the auditor's opinion; ~~including evidence that the audit documentation has been reviewed..~~ Because the audit of ICFR is integrated with the audit of the financial statements, when issuing separate reports on the entity's financial statements and on ICFR, the dates of the reports should be the same. (**Ref: par. .A116**)

### **Report Modifications**

[No proposed amendments to paragraph .67]

### **Adverse Opinions**

[No proposed amendments to paragraph .68]

.69 When ICFR is not effective because one or more material weaknesses exist, the auditor's report should include ***the following in the “Basis for Adverse Opinion on Internal Control Over Financial Reporting” section***

- a. the definition of a material weakness and
- b. a statement that one or more material weaknesses have been identified and an identification of the material weaknesses described in management’s assessment about ICFR. (Ref: par. .A120)

[No proposed amendments to paragraph .70 of AU-C 940.]

.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)

***Staff Note:*** At the July 2019 ASB meeting the ASB was asked whether they 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 (issue 2 in agenda item 2C (1)).

The ASB supported requiring the placement of this information to be within the Opinion section.

[No **proposed** amendments to paragraph .72.]

### ***Scope Limitations***

[No **proposed** amendments to paragraphs .73-.74]

.75 When disclaiming an opinion because of a scope limitation, the auditor should state that the auditor does not express an opinion on the effectiveness of ICFR ~~and~~ ***within the “Disclaimer of Opinion on Internal Control Over Financial Reporting” section and state*** the substantive reasons for the disclaimer: ***within the “Basis for Disclaimer of Opinion on Internal Control Over Financial Reporting” section***. The auditor ***should amend the basis of opinion and auditor’s responsibilities sections and*** should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of ICFR, as described in paragraph .64d(i), ***paragraph .64de(ii), paragraph .64de(iv) and paragraph .64f***; to do so might overshadow the disclaimer. (Ref: par. .A123-.A124)

.76 When the auditor disclaims an opinion but has concluded that one or more material weaknesses exist, the auditor’s report also should include ***the following in the “Basis for Disclaimer of Opinion on Internal Control Over Financial Reporting” section***

- a. the definition of a material weakness

*b. a statement that one or more material weaknesses have been identified and an identification of the material weaknesses described in management's assessment about ICFR and*

~~b.c.~~ a description of ~~any~~*the* material weaknesses identified in the entity's ICFR. This description ~~should address the requirements in paragraph .69 and~~ should provide the users of the report with specific information about the nature of any material weakness and its actual and potential effect on the presentation of the entity's financial statements issued during the existence of the weakness.

The auditor also should apply the requirements in ~~paragraph~~*paragraphs .70 and .71*. (Ref: par. .A125)

~~*The following section contains proposed amendments to the remaining sections of AU-C section 940 that have not been addressed in the previous table.*~~

[No proposed amendments to paragraphs ~~.778~~*.79*]

### **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 revise the information. If management agrees to make the correction, determine that the correction has been made. If management refuses to make the correction revision, the auditor should communicate the this 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: 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)
- 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
- [See Issue 3 in Agenda item 2C(1).]

**TF Note:** At the July 2019 ASB meeting the ASB was asked whether references to AU-C section 720 (SAS 137) should be removed and instead include appropriate requirements within AU-C section 940.

The ASB agreed that a reference to SAS No. 137 would not be appropriate in these circumstances because the additional information is not an annual report. The ASB supported including applicable information in the proposed SAS to address these situations. The ASB recommended that staff look at SAS No. 137 and the considerations relating to the Form 5500 in SAS No. 136 to help develop appropriate guidance for AU-C section 940.

The above proposed changes reflect Option 1 from the Issue "Additional Information" in Agenda Item 3C(1). See agenda item 3C(1) for further discussion and alternative requirements to the one presented here for ASB consideration.

## SPECIAL TOPICS

### Entities With Multiple Components

[No proposed amendments to paragraphs .81-.83.]

#### *Special Situations*

[No proposed amendments to paragraphs .84-.85.]

.86 In situations in which management elects to limit its assessment by excluding certain entities, the auditor should evaluate whether it is appropriate, in the auditor's judgment, to do so. If the auditor concludes that it is appropriate, ***in applying the requirement in paragraph .64d,*** the auditor should include ~~in the introductory paragraph of the report~~ a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment about ICFR and the auditor's audit of ICFR. Additionally, the auditor should evaluate the appropriateness of management's disclosure related to such a limitation. (Ref: par. .A136)

[No proposed amendments to paragraphs .87-.A113. Paragraph .A113, .A115-.A116 included for contextual purposes. Paragraphs .A115 and .A116 renumbered to .A114 and .A115.]

## APPLICATION MATERIAL AND OTHER EXPLANATORY MATERIAL

...

### REPORTING ON ICFR (REF: PAR. .64-.65)

#### Considerations Specific to Governmental Entities

.A113 When the audit is also conducted in accordance with *Government Auditing Standards* (also known as the Yellow Book), the auditor may state that the audit was conducted in accordance with the auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. If significant deficiencies in ICFR are identified in such an audit and the auditor's report refers to *Government Auditing Standards*, those standards require the auditor to report such deficiencies. The following is an illustration of that communication through the addition of other-matter paragraphs to the auditor's report:

In accordance with *Government Auditing Standards*, we are required to report findings of significant deficiencies. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies

in ABC Company's internal control described below [*or in the accompanying schedule of findings*] to be significant deficiencies.

ABC Company's response to the findings identified in our audit is described below [*or in the accompanying schedule of findings*]. We did not audit ABC Company's response and, accordingly, we express no opinion on the response.

~~.A114 When an other matter paragraph relating to ICFR is included in a financial statement audit report, the auditor may include a heading above the other matter paragraph such as "Report on Internal Control Over Financial Reporting." When an other matter paragraph relating to the financial statement audit is included in an ICFR report, the auditor may include a heading above the other matter paragraph such as "Report on the Financial Statements."~~

~~.A114-A115~~ The auditor may choose to issue a combined report (that is, one report containing both an opinion on the financial statements and an opinion on ICFR) or separate reports on the entity's financial statements and on ICFR.

~~.A115-A116~~ If the auditor issues a separate report on ICFR and expresses an adverse opinion on ICFR, the disclosure required by paragraph .71 related to the effect of the adverse opinion on ICFR on the auditor's opinion on the financial statements may be combined with the report language described in paragraph .65.

**.A116** *AU-C section 220, Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards, requires that, on or before the date of the auditor's report, the engagement partner, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.<sup>25</sup> When an engagement quality control review is performed, AU-C section 220 requires that the auditor's report not be released prior to the completion of the engagement quality control review.<sup>26</sup>*

<sup>25</sup> See paragraph .19 of AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, for further discussion.

<sup>26</sup> Paragraph .21 of AU-C section 220.

[subsequent footnotes renumbered]

[No proposed amendments to paragraphs ~~.A117-A153~~ (~~see table above for proposed new paragraph A116A.~~)]

## EXHIBIT A — ILLUSTRATIVE REPORTS

**.A154** The following illustrate the report elements described in this section. The illustrations assume that the audit of internal control over financial reporting (ICFR) and the audit of the financial statements were performed by the same auditor. Report modifications are discussed beginning in paragraph .67 of this section.

Illustration 1 — Unmodified Opinion on ICFR

Illustration 2 — Adverse Opinion on ICFR

Illustration 3 — Disclaimer of Opinion on ICFR

Illustration 4 — Unmodified Opinion on ICFR Making Reference to a Component Auditor

Illustration 5 — Combined Report Expressing an Unmodified Opinion on ICFR and an Unmodified Opinion on the Financial Statements

### **Illustration 1 — Unmodified Opinion on ICFR**

The following is an illustrative report expressing an unmodified opinion on ICFR.

#### **Independent Auditor's Report**

[*Appropriate Addressee*]

#### **Report on Internal Control Over Financial Reporting<sup>1</sup>**

##### ***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*].<sup>2</sup> ***In our opinion, ABC Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].***

##### **~~*Management's Responsibility for Internal Control Over Financial Reporting*~~**

<sup>1</sup> 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.

<sup>2</sup> 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)."

~~Management is responsible for designing, implementing, and maintaining effective internal control over financial reporting, and for its assessment about the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report].~~

### ***Auditor's Responsibility***

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

### **Basis for Opinion**

We conducted our audit in accordance with auditing standards generally accepted in the United States of America (GAAS). ***Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of Internal Control Over Financial Reporting section of our report. We are required to be independent of ABC Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audit. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.***

### **Responsibilities of Management for Internal Control Over Financial Reporting**

***Management is responsible for designing, implementing, and maintaining effective internal control over financial reporting, and for its assessment about the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report].***

~~Those standards require that we plan and perform the audit~~

### **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 Internal control over financial reporting is not effective if involves performing procedures to obtain audit evidence about whether a material weakness exists. The procedures selected depend on the auditor's *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, ~~including the assessment of the risks that a material weakness exists. An audit includes obtaining~~ ***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 ~~testing—test~~ and ~~evaluating—evaluate~~ the design and operating effectiveness of internal control over financial reporting based on the assessed risk.

~~We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.~~

### ***Definition and Inherent Limitations of Internal Control Over Financial Reporting***

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements. Also, projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

### ***Report on Other Legal and Regulatory Requirements***

***[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]***

### ***Opinion***

~~In our opinion, ABC Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].~~

***Report on Financial Statements***

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

***Report on Other Legal and Regulatory Requirements***

~~[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]~~

~~[Auditor's signature]~~ **[Signature of auditor's firm]**

~~[Auditor's City and state where the auditor's report is issued]~~

~~[Date of the auditor's report]~~

## **Illustration 2 — Adverse Opinion on ICFR**

The following is an illustrative report expressing an adverse opinion on ICFR. In this example, the opinion on the financial statements is not affected by the adverse opinion on ICFR.

### **Independent Auditor's Report**

[Appropriate Addressee]

#### **Report on Internal Control Over Financial Reporting<sup>1</sup>**

##### **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].<sup>2</sup> *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 [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.*

##### **Basis for Adverse Opinion**

*A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. The following material weakness has been identified and included in the accompanying [title of management's report].*

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<sup>1</sup> 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.

<sup>2</sup> 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)."

*[Identify the material weakness described in management’s report.]<sup>3</sup>*

*We conducted our audit in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor’s Responsibilities for the Audit of Internal Control Over Financial Reporting section of our report. We are required to be independent of ABC Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audit. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.*

*Responsibilities of Management ~~Management’s Responsibility for Internal Control Over Financial Reporting~~*

Management is responsible for designing, implementing, and maintaining effective internal control over financial reporting, and for its assessment about the effectiveness of internal control over financial reporting, included in the accompanying *[title of management’s report]*.

*Auditor’s ~~Responsibility~~ Responsibilities for the Audit of Internal Control Over Financial Reporting*

*Our objectives are to* responsibility is to express an opinion on the entity’s internal control over financial reporting based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit 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 **Internal** control over financial reporting **is not effective if** 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* The procedures selected depend on the auditor’s judgment, including the assessment of the risks that a material weakness exists. An audit includes obtaining an

<sup>3</sup> See paragraphs .68–.71 of this section for specific reporting requirements. The auditor’s report need only refer to the material weaknesses described in management’s report and need not include a description of each material weakness, provided each material weakness is included and fairly presented in all material respects in management’s report.

understanding of internal control over financial reporting, *assess the risks that a material weakness exists*, and ~~test testing~~ and ~~evaluate evaluating~~ the design and operating effectiveness of internal control over financial reporting based on the assessed risk.

~~We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse audit opinion.~~

### ***Definition and Inherent Limitations of Internal Control Over Financial Reporting***

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction, of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements. Also, projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

### ***Report on Other Legal and Regulatory Requirements***

*[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]*

### ***Adverse Opinion***

~~In our opinion, because of the effect of the material weakness described in the Basis for Adverse Opinion paragraph 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*].~~

### ***Report on Financial Statements***

~~We considered the material weakness identified above 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.~~

~~[Auditor's signature]~~

~~[Auditor's **Signature of auditor's firm**]~~

~~[City and state **where the auditor's report is issued**]~~

~~[Date of the auditor's report]~~

### **Illustration 3 — Disclaimer of Opinion on ICFR**

The following is an illustrative report expressing a disclaimer of opinion on ICFR. In this example, the auditor is applying paragraph .76 of this section because a material weakness was identified during the limited procedures performed by the auditor.

#### **Independent Auditor's Report**

[Appropriate Addressee]

#### **Report on Internal Control Over Financial Reporting<sup>1</sup>**

##### ***Disclaimer of Opinion on Internal Control Over Financial Reporting***

We were engaged to audit ABC Company's internal control over financial reporting as of December 31, 20XX, based on [identify criteria].<sup>2</sup> ***Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the effectiveness of ABC Company's internal control over financial reporting.***

***We 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 [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.***

##### ***Basis for Disclaimer of Opinion***

**[Provide description of the matter giving rise to the disclaimer of opinion]**

***A material weakness has been identified. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented,***

<sup>1</sup> 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.

<sup>2</sup> 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)."

*or detected and corrected, on a timely basis. If one or more material weaknesses exist, an entity's internal control over financial reporting cannot be considered effective. The following material weakness has been included in the accompanying [title of management's report].*

*[Identify the material weakness described in management's report and include a description of the material weakness, including its nature and its actual and potential effect on the presentation of the entity's financial statements issued during the existence of the material weakness.]*

### ***Responsibilities of Management ~~Management's Responsibility~~ for Internal Control Over Financial Reporting***

Management is responsible for designing, implementing, and maintaining effective internal control over financial reporting and for its assessment about the effectiveness of internal control over financial reporting included in the accompanying *[title of management's report]*.

### ***Auditor's ~~Responsibility~~ Responsibilities for the Audit of Internal Control Over Financial Reporting***

Our responsibility is to ***conduct an audit of*** ~~express an opinion on~~ ABC Company's internal control over financial reporting ~~based on conducting the audit~~ in accordance with auditing standards generally accepted in the United States of America. ***However, because*** ~~Because~~ of the matter described in the Basis for Disclaimer of Opinion ~~section paragraph~~, ~~however~~, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

***We are required to be independent of ABC Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audit.***

### ***Definition and Inherent Limitations of Internal Control Over Financial Reporting***

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with *[applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]*. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with *[applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]*, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and

correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements. Also, projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

***Basis for Disclaimer of Opinion***

*[Provide a description of the matter giving rise to the disclaimer of opinion.]*

***Material Weakness***

~~Because of the matter described above, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. However, A material weakness has been identified. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. If one or more material weaknesses exist, an entity's internal control over financial reporting cannot be considered effective. The following material weakness has been included in the accompanying [title of management's report].~~

*[Identify the material weakness described in management's report and include a description of the material weakness, including its nature and its actual and potential effect on the presentation of the entity's financial statements issued during the existence of the material weakness.]*

***Disclaimer of Opinion***

~~Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the effectiveness of ABC Company's internal control over financial reporting.~~

***Report on Financial Statements***

~~We 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 [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 identified above 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.~~

### **Report on Other Legal and Regulatory Requirements**

*[The form ~~Form~~ and content of this section of the auditor's report **would** ~~will~~ vary depending on the nature of the auditor's other reporting responsibilities.]*

*[Signature of the auditor's firm ~~Auditor's signature~~]*

*[~~Auditor's city~~ City and state **where the auditor's report is issued**]*

*[Date of the auditor's report]*

#### **Illustration 4 — Unmodified Opinion on ICFR Making Reference to a Component Auditor**

The following is an illustrative report expressing an unmodified opinion on ICFR when the engagement partner decides to make reference to the report of a component auditor.

##### **Independent Auditor's Report**

[Appropriate Addressee]

#### **Report on Internal Control Over Financial Reporting<sup>1</sup>**

##### ***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].<sup>2</sup> ***In our opinion, based on our audit and the report of the other auditors, ABC Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [identify criteria].***

***We did not audit the effectiveness of internal control over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 percent and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 20XX. The effectiveness of B Company's internal control over financial reporting was audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other auditors.***

***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 [date of report, which should be the same as the date of the report on the audit of ICFR] expressed [include nature of opinion], based on our audit and the report of the other auditors.***

##### ***Basis for Opinion***

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<sup>1</sup> 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.

<sup>2</sup> 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)."

*We conducted our audit in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of Internal Control Over Financial Reporting section of our report. We are required to be independent of ABC Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audit. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.*

*Management's ~~Responsibility~~ Responsibilities for the Audit of Internal Control Over Financial Reporting*

Management is responsible for designing, implementing, and maintaining effective internal control over financial reporting and for its assessment about the effectiveness of internal control over financial reporting included in the accompanying [title of management's report].

*Auditor's ~~Responsibility~~ 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~~ Internal control over financial reporting is not effective if 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.*

~~Our responsibility is to express an opinion on the entity's internal control over financial reporting based on our audit. We did not audit the effectiveness of internal control over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 percent and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 20XX. The effectiveness of B Company's internal control over financial reporting was audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other auditors. We~~

~~conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.~~

~~An audit of internal control over financial reporting involves performing procedures to obtain audit evidence about whether a material weakness exists. The procedures selected depend on the auditor's judgment, including the assessment of the risks that a material weakness exists. An audit includes obtaining an understanding of internal control over financial reporting and testing and evaluating the design and operating effectiveness of internal control over financial reporting based on the assessed risk.~~

~~We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.~~

### ***Definition and Inherent Limitations of Internal Control Over Financial Reporting***

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements. Also, projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

### ***Opinion***

~~In our opinion, based on our audit and the report of the other auditors, ABC Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].~~

***Report on Financial Statements***

~~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 [date of report, which should be the same as the date of the report on the audit of ICFR] expressed [include nature of opinion], based on our audit and the report of the other auditors.~~

**Report on Other Legal and Regulatory Requirements**

~~[The form ~~Form~~ and content of this section of the auditor's report **would** ~~will~~ vary depending on the nature of the auditor's other reporting responsibilities.]~~

~~[Signature of the auditor's firm Auditor's signature]~~

~~[Auditor's city City and state where the auditor's report is issued]~~

~~[Date of the auditor's report]~~

## **Illustration 5 — Combined Report Expressing an Unmodified Opinion on ICFR and an Unmodified Opinion on the Financial Statements**

The following is an illustrative combined report expressing an unmodified opinion on ICFR and an unmodified opinion on the financial statements. The circumstances include *the following*:

- An audit of a complete set of general purpose financial statements (single year-~~prepared~~). *The audit is not a group audit.*
- *Management is responsible for the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America- as promulgated by the Financial Accounting Standards Board.*
- *The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in AU-C section 210, Terms of Engagement.*
- *The auditor has concluded that an unmodified (that is, “clean”) opinion is appropriate based on the audit evidence obtained.*
- *Based on the audit evidence obtained, the auditor has concluded that there are no conditions or events, considered in the aggregate, that raise substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time in accordance with AU-C section 570, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern.*
- *The auditor has not been engaged to communicate key audit matters.*

### **Independent Auditor’s Report**

[Appropriate Addressee]

#### **Report on the Financial Statements and Internal Control Over Financial Reporting<sup>1</sup>**

##### ***Opinions on the Financial Statements and Internal Control Over Financial Reporting***

We have audited the ~~accompanying~~ financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholders’ equity, and cash flows for the year then ended, and the related notes to the financial statements. *In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of ABC Company as of December 31, 20XX, and the results of*

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

*its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.*

We also have audited ABC Company's internal control over financial reporting as of December 31, 20XX, based on [identify criteria].<sup>2</sup> *In our opinion, ABC Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [identify criteria].*

### *Basis for Opinions*

*We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audits of the Financial Statements and Internal Control Over Financial Reporting section of our report. We are required to be independent of ABC Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audit. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.*

### ~~Management's Responsibility~~ **Responsibilities of Management for the Financial Statements and Internal Control Over Financial Reporting**

Management is responsible for the preparation and fair presentation of ~~these~~*the* financial statements in accordance with accounting principles generally accepted in the United States of America, **and for** the design, implementation, and maintenance of effective internal control over financial reporting relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. Management is also responsible for its assessment about the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report].

*In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern [insert the time period set by the applicable financial reporting framework].*

### ~~Auditor's Responsibility~~ **Responsibilities for the Audits of the Financial Statements and Internal Control Over Financial Reporting**

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<sup>2</sup> 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)."

~~Our responsibility is to express an opinion on these financial statements and an opinion on the entity's internal control over financial reporting based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits. Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement and, whether due to fraud or error, and about whether effective internal control over financial reporting was maintained in all material respects, and to issue an auditor's report that includes our opinions. An audit of Internal control over financial statements reporting is not effective if involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's *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 financial statements or an audit of internal control over financial reporting conducted in accordance with GAAS will always detect a material misstatement or a material weakness when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users made on the basis of these financial statements.*

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

- *Exercise professional judgment, including the assessment of and maintain professional skepticism throughout the audits.*
- *Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error. In making, and design and perform audit procedures responsive to those risk assessments, risks. Such procedures include examining, on a test basis, evidence regarding the auditor considers amounts and disclosures in the financial statements.*
- *Obtain an understanding of internal control relevant to the entity's preparation and fair presentation of the financial statements statement audit in order to design audit procedures that are appropriate in the circumstances. An audit of financial statements also includes evaluating*
- *Obtain an understanding of internal control over financial reporting relevant to the audit 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.*
- *Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating evaluate the overall presentation of the financial statements.*

~~An audit of internal control over financial reporting involves performing procedures to obtain evidence about whether a material weakness exists. The procedures selected depend on the auditor's judgment, including the assessment of the risk that a material weakness exists. An audit of internal control over financial reporting also involves obtaining an understanding of internal control over financial reporting and testing and evaluating the design and operating effectiveness of internal control over financial reporting based on the assessed risk.~~

- ~~• *Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for a reasonable period of time.*~~

~~*We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the financial statement audit.*~~

### ~~*Definition and Inherent Limitations of Internal Control Over Financial Reporting*~~

~~An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.~~

~~Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements. Also, projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.~~

### ~~*Opinions*~~

~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America. Also, in our opinion, ABC Company maintained, in all~~

~~material respects, effective internal control over financial reporting as of December 31, 20XX,  
based on [identify criteria].~~

### **Report on Other Legal and Regulatory Requirements**

*[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]*

*[Auditor's signature]*

**[Auditor's Signature of auditor's firm]**

**[City and state where the auditor's report is issued]**

*[Date of the auditor's report]*

## EXHIBIT B — ILLUSTRATIVE WRITTEN COMMUNICATION OF SIGNIFICANT DEFICIENCIES AND MATERIAL WEAKNESSES

.A155 [No proposed amendments to paragraph .A155]

## EXHIBIT C — ILLUSTRATIVE MANAGEMENT REPORT

.A156 [No proposed amendments to paragraph .A156]

## EXHIBIT D — REPORTING UNDER SECTION 112 OF THE FEDERAL DEPOSIT INSURANCE CORPORATION IMPROVEMENT ACT

### .A157

1. The Federal Deposit Insurance Corporation (FDIC) has provided guidance on the meaning of the term *financial reporting* for purposes of compliance by insured depository institutions (IDIs) with Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) (Section 36 of the Federal Deposit Insurance Act [FDI Act], 12.U.S.C. 1831m), and its implementing regulation, 12 CFR Part 363. The FDIC's guidance indicates that financial reporting, at a minimum, includes both financial statements prepared in accordance with generally accepted accounting principles (GAAP) for the IDI (or its holding company) and financial statements prepared for regulatory reporting purposes. Financial statements prepared for regulatory reporting purposes include the schedules equivalent to the GAAP-based financial statements that are included in an IDI's (or its holding company's) appropriate regulatory report (for example, Schedules RC, RI, and RI-A in the Consolidated Reports of Condition and Income [Call Report]). Accordingly, to comply with the FDICIA and Part 363, management of the IDI (or its holding company) and the auditor are required to identify and test controls over the preparation of GAAP-based financial statements as well as the schedules equivalent to the GAAP-based financial statements that are included in the IDI's (or its holding company's) appropriate regulatory report. Further, both management and the auditor are required to include in their report on the IDI's (or its holding company's) internal control over financial reporting (ICFR) a specific description indicating that the scope of ICFR included controls over the preparation of the IDI's (or its holding company's) GAAP-based financial statements as well as the schedules equivalent to the GAAP-based financial statements that are included in the IDI's (or its holding company's) appropriate regulatory report.<sup>1</sup>

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<sup>1</sup> Refer to Section 36 of the Federal Deposit Insurance Act (FDI Act), Section 363.1: Scope and Definitions, for the requirements pertaining to compliance by subsidiaries of holding companies.

## Definition of ICFR for FDICIA Purposes

2. In accordance with paragraph .64g of this section, the auditor's report is required to include a definition of ICFR that uses the same description of ICFR that management uses in its report. The following is an illustrative definition paragraph that may be used when an IDI that is an insured bank (which is not subject to Section 404 of the Sarbanes-Oxley Act of 2002) elects to report on controls for FDICIA purposes at the bank holding company level:

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America. Because management's assessment and our audit were conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), our audit of [*Holding Company's*] internal control over financial reporting included controls over the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and with the instructions to the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C).<sup>2</sup> An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

## Requirements When the IDI Is Required to Report on ICFR at the IDI Level

3. This paragraph and the following paragraphs are applicable and provide guidance when an IDI is required by 12 CFR Part 363 to report on ICFR at the IDI level. An IDI that is a

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<sup>2</sup> This sentence would be modified if the insured depository institution (IDI) reports at the institution level rather than at the bank holding company level to refer to the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income instead of to the Form FR Y-9C. This sentence would also be modified if the IDI reports at a holding company level and employs another approach to reporting on controls over the preparation of regulatory reports as permitted by Section 36 of the FDI Act.

subsidiary of a holding company may use the consolidated holding company's financial statements (group financial statements) to satisfy the audited financial statements requirement of 12 CFR Part 363, provided certain criteria are met.<sup>3</sup> For some IDIs, however, an audit of ICFR is required at the IDI level. An audit of ICFR is required to be integrated with an audit of financial statements. Accordingly, to comply with the integrated audit requirements in this section, when the IDI elects to use the holding company's group financial statements to satisfy the audited financial statements requirement of 12 CFR Part 363 and the audit of ICFR is required to be performed at the IDI level, the auditor would be required to perform procedures necessary to obtain sufficient appropriate audit evidence to enable the auditor to express an opinion on the IDI's financial statements and on its ICFR. When the IDI does not prepare financial statements at the IDI level for external distribution, "financial statements" for this purpose may consist of the IDI's financial information in a reporting package or equivalent schedules and analyses that include the IDI information necessary for the preparation of the holding company's group financial statements, including disclosures. The measurement of materiality is determined based on the IDI's financial information rather than the holding company's group financial statements.<sup>4</sup> If the auditor is unable to apply the procedures necessary to obtain sufficient appropriate audit evidence with respect to the IDI's financial information, the auditor is required by paragraph .73 of this section to withdraw from the engagement or disclaim an opinion on the effectiveness of ICFR at the IDI level.

#### **Evaluation of IDI Financial Reporting Process**

4. As previously described, the FDIC indicated that financial reporting, at a minimum, includes both financial statements prepared in accordance with generally accepted accounting principles (GAAP) for the IDI (or its holding company) and financial statements prepared for regulatory purposes. Financial statements prepared for regulatory reporting purposes include the schedules equivalent to the GAAP-based financial statements that are included in an IDI's (or its holding company's) appropriate regulatory report. When the IDI does not prepare financial statements for external distribution, the auditor is, nevertheless, required by paragraph .24 of this section to evaluate the IDI's period-end financial reporting process. This process includes, among other things, the IDI's procedures for preparing financial information for purposes of the holding company's group financial statements, which are prepared in accordance with GAAP, and the schedules equivalent to the GAAP-based financial statements that are included in the IDI's appropriate regulatory report.

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<sup>3</sup> See footnote 1.

<sup>4</sup> See paragraph .10 of section 320, *Materiality in Planning and Performing an Audit*.

## Organization Structure

5. The period-end financial reporting process may occur either at the IDI or the holding company, or both. The organizational structure, including where the controls relevant to the IDI's financial information operate, may affect how the auditor evaluates this process. For example

- a. when the period-end financial reporting process occurs at the holding company and the IDI comprises substantially all of the consolidated total assets, there may be no distinguishable difference between the IDI's and its holding company's process for purposes of the integrated audit. This is because the auditor's risk assessment, including the determination of significant classes of transactions, account balances, and disclosures, and their relevant assertions, the selection of controls to test, and the determination of the evidence necessary to conclude on the effectiveness of a given control, would likely be the same for the IDI and the holding company.<sup>5</sup> In this circumstance, the period-end financial reporting process of the holding company would be, in effect, the period-end financial reporting process of the IDI and, therefore, would be included in the scope of the integrated audit of the IDI.
- b. when the period-end financial reporting process occurs at the holding company and the IDI does not comprise substantially all of the consolidated total assets, the IDI's financial reporting process may be sufficient for the auditor to meet the requirement in paragraph .24 of this section, if the necessary GAAP information is prepared by the IDI or the holding company, and the process can be evaluated by the auditor. The auditor may determine that the IDI's preparation of the IDI's appropriate regulatory report, together with other financial information at the IDI level that is incorporated into the holding company's group financial statements, is sufficient for this purpose. In this circumstance, both the period-end financial reporting process of the holding company, as it relates to the financial information of the IDI, and the period-end financial reporting process of the IDI, with respect to the preparation of the schedules equivalent to the basic financial statements that are included in the IDI's appropriate regulatory report, would be included in the scope of the integrated audit of the IDI.

## IDI Not Subject to Section 404 of Sarbanes-Oxley Act of 2002

6. The illustrative reports in exhibit A, "Illustrative Reports," of this section may be used to report on the effectiveness of the IDI's ICFR. Because 12 CFR Part 363 does not require

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<sup>5</sup> See paragraph .A22 of this section.

the auditor to issue a separate auditor's report on the IDI's financial statements, the requirement in paragraph .65 of this section to add ~~an other-matter-a~~ paragraph to the ICFR report that references the financial statement audit will not apply when the auditor does not issue a separate auditor's report on the IDI's financial statements. In accordance with paragraph .64 of this section, the auditor's report on ICFR is required to include a definition of ICFR that uses the same description of ICFR as management uses in its report. The following is an illustrative definition paragraph that may be used when an IDI that is not subject to Section 404 of the Sarbanes-Oxley Act of 2002 is required to report on controls for FDICIA purposes at the IDI level, and the IDI uses the holding company's group financial statements to satisfy the audited financial statements requirement of 12 CFR Part 363:

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with generally accepted accounting principles. Because management's assessment and our audit were conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), our audit of [IDI's] internal control over financial reporting included controls over the preparation of financial information for purposes of [*consolidated holding company's*] financial statements in accordance with accounting principles generally accepted in the United States of America and controls over the preparation of schedules equivalent to basic financial statements in accordance with the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income (Call Report Instructions). An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

**Use of the *Internal Control — Integrated Framework (2013)* (COSO)**

7. Management may evaluate and report on the effectiveness of the IDI's ICFR based on the report *Internal Control—Integrated Framework (2013)*, issued by Committee of Sponsoring Organizations of the Treadway Commission's (COSO). For purposes of reporting under Section 112 of FDICIA, the COSO criteria relevant to internal reporting

objectives are appropriate only for the IDI and its regulatory agencies that are presumed to have an adequate understanding of the level of the auditor's service on historical financial information, considering the IDI does not prepare external GAAP-based financial statements. Accordingly, the report is required to include an other-matter paragraph, under an appropriate heading, that restricts its use.<sup>6</sup> An example of such a restriction is as follows:

***Restriction on Use***<sup>7</sup>

This report is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, the Federal Deposit Insurance Corporation and [*other federal bank regulatory agency*] and is not intended to be and should not be used by anyone other than these specified parties.

8. Likewise, the auditor's report and management's assessment about ICFR refer to the COSO criteria relevant to internal reporting objectives. 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) relevant to internal reporting objectives for the express purpose of meeting the regulatory requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA)."

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<sup>6</sup> See paragraphs .06a and .07 of section 905, *Alert That Restricts the Use of the Auditor's Written Communication* . Although reports on internal control issued in accordance with the guidance in this appendix are required to be restricted as to use, Section 36 of the FDI Act and Title 12 U.S. *Code of Federal Regulations* Part 363 require that these reports be available for public inspection.

<sup>7</sup> Another appropriate heading may be used.