



## Agenda Item 1B (1)

### Conforming Amendments to AU-C section 935, *Compliance Audits*

#### Objective

To vote to ballot for issuance as a final standard proposed amendments to AU-C section 935, *Compliance Audits*, to conform to SAS No. 134 and to be consistent with current governmental requirements.

#### Task Force

The AU-C 935 Task Force (Task Force) members are:

- Monique Booker (Chair)
- Jeanne Dee
- Reem Samra, assisted by Kelly Chamberlin
- Erica Forhan
- John Good
- Mandy Nelson
- George Strudgeon
  
- Mary Foelster, *AICPA, Government Accounting and Auditing Team*
- Teresa Bordeaux, *AICPA, Government Accounting and Auditing Team*

Mr. Good, Ms. Nelson, Ms. Samra, and Mr. Strudgeon are members of the GAQC Executive Committee, and Ms. Forhan is its immediate past Chair.

#### Summary of Comments Received

13 comment letters were received.

Respondents are:

Michigan Office of the Auditor General	01 MI
Grant Thornton	02 GT
EY	03 EY

Texas Society of CPAs	04 TXCPA
BDO	05 BDO
Tennessee Department of Audit	06 TN
Virginia Office of the State Auditor	07 VA Public Auditor
Deloitte Touche LLP	08 Deloitte Touche
Office of the Washington State Auditor	09 WA State Auditor
George Rippey	10 George Rippey
Terry Ramsey	11 Terry Ramsey
Florida Institute of CPAs	12 FICPA
KPMG	13 KPMG

## Summary of Responses to Requests for Comment

### Questions 1 and 2

In response to question 1, all respondents agreed that the proposed amendments are appropriate and complete, including the proposed amendments to be consistent with current government requirements. Many respondents included editorial suggestions and specific revisions.

In response to question 2, all respondents agreed with how the combined report and the separate reports are addressed in the standard.

### Other Comments

#### *1. Definition of material noncompliance.*

Ten respondents commented on the definition of material nonconformity and the statement on materiality in the auditor's report. Three supported the revision as proposed; one suggested retaining the extant definition, and the others suggested edits to the proposed revisions. See rows 22-31 of agenda item 1B(3).

One respondent (GT) suggested that the extant definition be retained.

The extant definition of material noncompliance is as follows:

**Material noncompliance.** In the absence of a definition of material noncompliance in the governmental audit requirement, a failure to follow compliance requirements or a violation of prohibitions included in the applicable compliance requirements that results in noncompliance that is quantitatively or qualitatively material, either individually or when aggregated with other noncompliance to the affected government program

SAS No. 134 requires a statement in the revised auditor's report about materiality that begins "Misstatements are considered material if...". Adapting this statement for the auditor's report on compliance using the extant definition is problematic because the extant definition of material

noncompliance is circular. Substituting the term *noncompliance* for the words “a failure to follow compliance requirements or a violation of prohibitions included in the applicable compliance requirements”, which is the definition of noncompliance, results in a definition that defines *material* noncompliance as “noncompliance that is... material”.

One respondent (BDO) noted that AU-C section 935 does not contain any guidance about the assumptions an auditor may make with respect to “reasonable users” and the guidance provided in the amended paragraph .04 of AU-C section 320, *Materiality in Planning and Performing an Audit*, may not align with those an auditor may make when performing a compliance audit. However, the Task Force believes that developing such guidance is beyond the scope of this project and, because the amendments to AU-C section 320 were not intended to change practice, is not necessary.

One respondent (BDO) noted that the definition of material noncompliance in the proposed SAS includes the words “compliance with the requirements of the government program as a whole.” This terminology may imply a broader scope than what may be required in certain situations associated with compliance audits. However, the definition notes that it is applied in the absence of a definition of material noncompliance in the governmental audit requirement.

Two respondents (GT, WA) objected to having determination of materiality be based on the auditor’s report on compliance, when what is being reported is based on the determination of materiality. Accordingly, the Task Force recommends revising the definition to refer to a reasonable user *of* the report.

Proposed revision to the definition in the exposure draft is as follows:

**Material noncompliance.** In the absence of a definition of material noncompliance in the governmental audit requirement, noncompliance with the applicable compliance requirements is considered ~~to be~~ quantitatively or qualitatively material if there is a substantial likelihood that, individually or in the aggregate, it would influence the judgment made ~~by a reasonable user~~ about compliance with the requirements of the government program as a whole ***by a reasonable user of*** ~~based on~~ the report on compliance

**Question for ASB:**

1. Does the ASB agree with the proposed revisions to the definition of material noncompliance?

**2. Other Comments** (see rows 56-57of agenda item 1B(3))

One respondent (PwC) asked that AU-C section 935 clarify whether an organization may voluntarily elect to have their audit conducted in accordance with GAGAS and a governmental audit requirement in addition to GAAS (for example, when the organization has been subject to these requirements in previous years and expects to be again in future years). Their comment noted that guidance as to how the form and content of the auditor's report would be amended in these circumstances could be provided in a manner similar to how “dual standards” are addressed in AU-C section 700. However, AU-C section 700 does not require the auditor’s report to state

*why* the audit was performed in accordance with more than one set of auditing standards, so the form and content of the auditor's report would not be amended in these circumstances.

One respondent (BDO) asked that the Board consider adopting additional language in AU-C section 935 that would make it applicable to compliance audits that are outside the purview of the United States Government Accountability Office (GAO), due to the recent increase in the number of compliance audits that are grant, program, and contract audits.

The Task Force believes that addressing these issues is beyond the scope for this project, which was to propose amendments for conformity with SAS No. 134 and to be consistent with current governmental requirements. The Task Force has referred these issues to the AICPA Governmental Audit Quality Center Executive Committee.

**Question for ASB:**

2. Does the ASB agree with the Task Force that these issues are beyond the scope of this project and should be addressed by the AICPA Governmental Audit Quality Center Executive Committee?

**3. Comments on Specific Paragraphs**

Paragraph 30 and paragraph A44

Four respondents (DT, GT, BDO, and EY) proposed revisions to paragraph 30, which contains the requirements for the auditor's report, and to paragraph A44, which contains the illustrative auditor's report. See agenda Item 1B(3), rows 32-48.

Paragraph 30g(v)

Paragraph 30.g.v requires the auditor to describe an audit by stating three specific auditor responsibilities, summarized as follows:

- (1) Exercise professional judgment and maintain professional skepticism
- (2) Identify and assess the risks of material noncompliance and design and perform audit procedures responsive to those risks
- (3) Obtain an understanding of the applicable compliance requirements and the entity's internal control over compliance relevant to the audit in order to design audit procedures but not for the purpose of expressing an opinion on the effectiveness of over internal control; accordingly, no such opinion is expressed.

One respondent (BDO) stated that "[I]n a compliance audit, we believe that the auditor would first obtain an understanding of the applicable compliance requirements, then identify the risks of material noncompliance whether due to fraud or error, obtain an understanding of the entity's internal control as specified by the governmental audit requirement, and only then assess the risk of material noncompliance whether due to fraud of error and design and perform audit procedures responsive to those risks." Suggested edits were as follows:

- Delete the words “the applicable compliance requirements” from (3) above;
- Move existing (2) to follow existing (3); and
- Create a new (2) that states: “obtain an understanding of the applicable compliance requirements”

The purpose of (3) above is to explain that no opinion on the effectiveness of internal control is being expressed. The understanding of the applicable compliance requirements is not relevant to this point. Further, the equivalent requirement in paragraph 36c of AU-C 700 only mentions obtaining an understanding of internal control and does not mention any of the many other things the auditor needs to understand. In addition, moving (2) to follow (3) would be inconsistent with the requirements of AU-C section 700. Accordingly, the Task Force recommends that the phrase “the applicable compliance requirements and” be deleted from point (3) and none of the other edits discussed above be made.

Other edits were suggested both to wording and to the order of the requirements in paragraph .30, primarily to align the elements of the auditor’s report in paragraph .30 with the illustrative auditor’s report in paragraph .A44 of AU-C section 935, *Exhibit — Illustrative Combined Report on Compliance and Internal Control Over Compliance*. Note that one respondent (WA) requested specific guidance as to the order in which the various report elements should be listed, as “it is not clear from the updated standard.”

Paragraph 30 includes references to “the compliance audit” while the auditor’s report refers to “the audit” or “our audit”; this is consistent with extant and the Task Force decided to not change this.

The Task Force considered one respondent’s (DT) editorial recommendations about deleting references to *applicable compliance requirements* but decided to be consistent with extant and not make those changes. Applicable compliance requirements are a subset of all compliance requirements that may need to be adhered to under a Federal program.

*Paragraph A37 and A38 (see agenda item 1B(3) rows 50-52)*

Two respondents, George Rippey and Terry Ramsey, disagree with the revisions to paragraph A37 and A38 (par. A36 and A37 of extant) that address the auditor’s responsibilities in relation to the views of responsible officials.

Mr. Rippey believes that the statement in the example in paragraph .A38 that “Example Entity’s response was not subjected to the auditing procedures applied in the audit of compliance . . .” implies that the auditor applied no audit procedures to the entity’s response. However, paragraph 6.59 of GAS requires the auditor to review management’s comments for consistency with the auditor’s report and take action when there are inconsistencies or conflicts. Mr. Ramsey believes that paragraph A38 should be expanded to cover additional circumstances, as well as expanding paragraph .A37 to further describe the auditor’s responsibilities.

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The Task Force discussed these comments and proposed the following revisions to paragraph .A38 to clarify that the auditor performs limited procedures on management’s response:

**Government Auditing Standards require the auditor to perform limited procedures on Example Entity’s** ~~ABC Agency’s written response to the significant deficiencies [and material weaknesses]~~ **[insert type of finding(s) such as noncompliance or in-internal control over compliance] finding(s) identified in our compliance audit. Example Entity’s response** was not subjected to the **other** auditing procedures applied in the ~~compliance~~ audit of ~~ABC Agency’s compliance~~ and, accordingly, we express no opinion on ~~it~~ **the response.**

The Task Force believes that revisions to the next edition of Audit and Accounting Guide *Government Auditing Standards and Single Audits* provide sufficient guidance in this area and no additional changes to the application material in paragraphs .A37 and A.38 are necessary.

Other Paragraphs (see agenda item 1B(3) rows 49, 53-55)

Par.	Comment	Disposition
23b	For ¶23b (second line), we suggest modifying the language to “... and maintaining <u>effective</u> controls...”	No change; inconsistent with AU-C 700 (and redundant with the words “reasonable assurance” that follow)
Par. 36 and A37	Retain the phrase “significant findings from the compliance audit” from extant paragraph 37 of AU-C section 935. If the ASB decides to not make the changes proposed above, it should consider whether the use of the word “findings” in paragraph A37 of AU-C section 935, as amended, is appropriate.	No change; “significant findings from the audit” was deleted from par. 37 to avoid confusion with the auditor’s requirement under Government Auditing Standards to communicate findings that are not deemed significant deficiencies or material weaknesses.
A21	For ¶A21 regarding the reference to the AU-C Section 530, Audit Sampling, the board might consider adding a reference to or discussion about audit data analytics as a potentially more effective and efficient alternative to sampling.	Not appropriate to address in AU-C 935 if not addressed in AU-C 500 or AU-C 530
A43	For ¶A43 (appendix), we suggest an edit as follows: “... if the auditor believes doing so will provide <u>sufficient</u> appropriate audit evidence in the specific circumstances....	No change; following other AU-C sections may not be enough to <i>provide</i> sufficient evidence
A43	Add the following paragraphs to the Appendix <i>AU-C Sections That Are Not Applicable to Compliance Audits</i> : <ul style="list-style-type: none"> <li>○ Paragraph .33d of AU-C section 315, <i>Understanding the Entity and Its</i></li> </ul>	<ul style="list-style-type: none"> <li>● Disagree; paragraph 33d refers to another paragraph that is not</li> </ul>

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	<p style="text-align: center;"><i>Environment and Assessing the Risks of Material Misstatement</i></p> <ul style="list-style-type: none"> <li>○ Paragraph .41d of AU-C section 600, <i>Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)</i></li> </ul>	<p>excluded and therefore par. 33d should not be excluded</p> <ul style="list-style-type: none"> <li>• Agree</li> </ul>
A43	<p>However, the AU-C 700 paragraphs shown as “not applicable” in the updated standard (paragraph .A43) do not appear to align with the paragraphs considered not applicable in the current standard. Unless the change is intentional, the list should read .13-.17, .21-.44 and .46-.61.</p>	<p>Agree; corrected.</p>

**Question for the ASB:**

3. Does the ASB agree with the proposed revisions to agenda item 1B(3) based on the comments received?

**Materials Presented:**

- Item 1B(1) Issues Paper
- Item 1B(2) Proposed Amendments to AU-C section 935, marked from Exposure Draft
- Item 1B(3) Comments by Topic
- Item 1B(4) Illustrative Report, clean version for reference