



Agenda Item 1C (1)

Issues Paper: Proposed Amendments to AU-C section 940, *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements*

AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* establishes requirements and provides guidance that applies when an auditor is engaged to perform an audit of internal control over financial reporting (ICFR) that is integrated with an audit of financial statements (integrated audit).

The Exposure Draft of the proposed SAS *Amendments to AU-C sections 725, 730, 930, 935, and 940 to Incorporate Changes From SAS No. 134 and SAS No. 137* (ED) includes the proposed revisions to AU-C section 940, to conform to the reporting requirements in SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*. In developing the proposed amendments, the amendments made to PCAOB AS 2201: *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* as part of PCOAB Release AS 2017-001, *The Auditor's Report On An Audit Of Financial Statements When The Auditor Expresses An Unqualified Opinion And Related Amendments To PCAOB Standards* were also considered.

The ED was issued in December 2019 with comments due by February 10, 2020. Fourteen comment letters were received. The following materials have been developed relating to the amendments to AU-C section 940 for discussion at the March 11, 2020 ASB meeting:

- Agenda Item 1C(1) – Issues Paper
- Agenda Item 1C(2) – AU-C section 940 revised due to comment letter comments
- Agenda Item 1C(3) – Summary of Comment Letter Responses

Ms. Delahanty and Mr. Santay will use agenda items 1C(1) and 1C(2) for discussion purposes and will focus on the proposed changes to document 1C(2). The ASB is asked to review these materials for discussion and final vote at the March 11, 2020 ASB telephonic meeting. The ASB is also asked to consider the following issues for consideration.

Issues for ASB Consideration

Issue 1 – Auditor’s Responsibilities (Paragraph .64f.ii.)

Background

Paragraph .64f.ii. of the proposed SAS requires the report on ICFR to include, in the “Auditor’s Responsibilities for the Audit of Internal Control Over Financial Reporting” section of the ICFR report, a statement that internal control over financial reporting is not effective if a material weakness exists. This differs from the requirement in paragraph .64e.iv.(1) of extant AU-C section 940 that requires a description of the audit by stating that “an audit of ICFR involves performing procedures to obtain audit evidence about whether a material weakness exists.”

At the July 2019 ASB meeting, the ASB was provided the following three options to consider including in the auditor’s report to describe the auditor’s responsibilities as they relate to an audit of ICFR.

Option 1 from July 2019 ASB meeting

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

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

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

- *Exercise professional judgment*, ~~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.

Option 2 from July 2019 ASB Meeting

Replace the green highlighted sentence in option 1 with the following: “**Internal control over financial reporting is not effective if a material weakness exists.**”

Option 3 from July 2019 ASB Meeting

Remove the green highlighted sentence from option 1, but modify the previous sentence to align with the language in the illustrative communication “Our objectives are to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects (*that is, whether material weaknesses exist as of the date specified in management’s assessment*), and to issue an auditor’s report...”

ASB outcomes from the July 2019 ASB Meeting

At the July 2019 ASB meeting the ASB noted that the sentence as proposed in option 1 is very similar to the statement in the second bullet included in the following paragraph of that section and therefore the majority of the ASB supported including option 2 wording. Accordingly, the wording from option 2 was reflected in the exposure draft. The following reflects the proposed language in the exposure draft:

Excerpt from the illustrative report (illustration 1):

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 on internal control over financial reporting.* ~~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.

Summary Comments Relating to the Amendment to Paragraph .64f.ii (Request for comment #2a).

Of the 14 comment letters received relating to request for comment #2a, 2 respondents (GT and PWC) did not support the wording as proposed. 3 respondents (MOAG, EY, and TXCPA) suggested other changes relating to this paragraph. See the related comment letter responses in agenda item 1C(3). The following lists some of the more significant responses from the comment letters relating to paragraph .64f.ii.

- GT (comment #24 in agenda item 1C(3)) prefers option 1 from the July 2019 ASB meeting.
- PWC (comment #23) believes the statement that “internal control over financial reporting is not effective if a material weakness exists” is not necessary and suggests it be deleted
- Michigan OAG (comment #20) recommends that the statement be placed in the opinion section of the report when a material weakness is identified and keep it as it is currently placed when a material weakness is not identified
- EY (comment #21) believes that the statement “Internal control over financial reporting is not effective if a material weakness exists” does not describe a responsibility of the auditor and therefore should not be included in the “Auditor’s Responsibilities” section of the auditor’s report. Rather, they would prefer to see it moved to the “Definition and Inherent Limitations of Internal Control Over Financial Reporting” section of the auditor’s report.

Action Requested of the ASB

The ASB is asked to consider the comments received relating to paragraph .64f.ii. and provide us with your preference about whether the proposed SAS should:

- a. Retain the statement in paragraph .64f.ii. as proposed
- b. Remove the statement altogether (PWC comment)
- c. Revise and/or relocate the statements set forth in the above comments.

The Task Force notes that this statement is not present in ICFR reports under PCAOB standards and was likely included initially to provide the reader information as to the impact of a material weakness. Given that ICFR reporting has been part of U.S. financial reporting for several years, the Task Force recommends option B (deleting the statement).

Issue 2 – Additional Information (Paragraph .80)

Paragraph .80 of AU-C section 940 addresses how to report when additional information is included either within management’s report or in a document containing management’s report. Typically, this is intended to address circumstances in which management includes a description of a response to an identified material weakness, including plans to remediate.

Of the 14 comment letters received relating to request for comment #2d, five respondents were supportive of the proposed changes with comments. The following highlights some of the more significant comments received. All comments can be viewed in agenda item 1C(3).

- On respondent (GT- comment #64 & 77) was concerned about the clarity and readability of the requirements in proposed paragraph .80. While they supported the performance requirements, they believe the requirements could be more clearly set forth. Accordingly, they proposed revisions to paragraph .80.
- One respondent (EY - comment #65 &78) believe the phrase “and to become aware of material misstatements of fact” in proposed AU-C 940.80.a is confusing and suggested replacing this phrase with the words “or any material misstatements of fact.”
- One respondent (DT - comment #79) provided recommended edits to address an inconsistency related to material misstatements of fact.
- One respondent (MOAG - comment #62) believes that in the event management refuses to make a correction to a material misstatement or material inconsistency of information even after discussing the issue with those charged with governance, the proposed SAS should provide the auditor with the option to include an “Other Matter” paragraph informing the reader that the auditor is disclaiming an opinion on that information but is aware of a material misstatement (or material inconsistency) and that the auditor has informed management of this issue and management has decided not to modify the information.
- One respondent (PWC – comment #63 & 76) asked for further clarification about how paragraph .80 would interact with AU-C section 720. (Note: The task force believes no further guidance is needed relating to the interaction of paragraph 80 with AU-C section 720.)

Based on the comments received, we propose the following changes (see redlined changes) to paragraph .80 to clarify the requirement and make it more concise:

Excerpt of paragraph .80 (redlined for proposed changes)

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*:

- ~~When such information is included in management’s report, r~~*Read the additional information to identify material inconsistencies with management’s report and remain alert for to-become-aware-of material misstatements of fact while reading the additional information.*
- ~~If no material inconsistencies or material misstatements of fact are identified, disclaim an opinion, in an other matter paragraph, on the additional information.~~

~~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, and do the following, as applicable: :~~

- ~~i. If management agrees to make the correction, determine that the correction has been made.~~
- ~~ii. If management refuses to make the correction, communicate the matter to those charged with governance and request that the correction be made.~~
- ~~iii. If the correction is not made after communicating with those charged with governance, the auditor should do one or more of the following: (Ref: par. A129)~~

- ~~1. 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~~
- ~~2. Withhold the auditor's report~~
- ~~3. Withdraw from the engagement, when withdrawal is possible under the applicable law or regulation~~

~~c.b. When the additional information subject to the requirements of paragraph .80a is included in management's report and no material inconsistencies or material misstatements of fact are identified, the auditor should disclaim an opinion, in an other-matter paragraph, on the additional information. 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. 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 or more of the following: (Ref: par. A129-A130)~~

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

Action Requested of the ASB

1. The ASB is asked to consider the comments received relating to paragraph .80 and the proposed changes above. Does the ASB agree with the above changes to paragraph .80?

Issue 3 – Disclaimer of Opinion Additional Information (Paragraph .76)

Paragraph .76 of AU-C section 940 addresses how to report when the auditor disclaims an opinion but has concluded that one or more material weaknesses exist. The proposed SAS requires the auditor to include certain information about the material weakness in the “Basis for Disclaimer of Opinion” section of the auditor’s report.

One respondent (DT- comment #75) believes it would be more appropriate for this information to be reported in a separate section with the heading “Material Weakness” after the “Definition and Limitations of Internal Control Over Financial Reporting” section because including it in the basis for disclaimer section may confuse users that the material weakness and the reason for the disclaimer are related.

Staff notes that extant AU-C section 940 did not require the placement of this information within the “Basis for Disclaimer of Opinion” section and illustrated this content (extant illustration 3) as a separate section. Accordingly, we propose the following changes to paragraph .76

.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 a separate section in the auditor’s report with the title “Material Weakness[es]” 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*
- ~~bc.~~ *A* ~~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 .69 and .71.* (Ref: par. .A125)

Action Requested of the ASB

4. Does the ASB agree with the proposed edits to paragraph .76 to require the information about the material weakness to be included in a separate section in the auditor's report with the heading "Material Weakness"?
5. Does the ASB agree with the placement of the material weakness section as presented in illustration 3—*Disclaimer of Opinion* in Exhibit A—*Illustrative Reports* (paragraph .A154)?