

AU-C Section 806

Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements

Source: SAS No. 122; SAS No. 125.

Effective for reports on compliance issued in connection with audits of financial statements for periods ending on or after December 15, 2012.

Introduction

Scope of This Section

.01 This section addresses the auditor's responsibility when the auditor is requested to report on an entity's compliance with aspects of contractual agreements or regulatory requirements, insofar as they relate to accounting matters, in connection with an audit of financial statements (referred to hereinafter as a report on compliance). Such a report is commonly referred to as a by-product report. (Ref: par. .A1–A2)

.02 Entities may be required by contractual agreements, such as certain bond indentures and loan agreements, or regulatory agencies to provide an auditor's report on compliance. For example, loan agreements may impose a variety of obligations on borrowers involving matters such as payments into sinking funds, payments of interest, maintenance of current ratios, and restrictions of dividend payments. Loan agreements may also require the borrower to provide annual financial statements that have been audited. In some instances, the lenders or their trustees may request the auditor to report that the borrower has complied with certain covenants of the agreement relating to accounting matters. The auditor may satisfy this request by issuing a report on compliance in accordance with the requirements of this section.

.03 As described in paragraph .01, this section addresses reporting on an entity's compliance with aspects of contractual agreements or regulatory requirements in connection with an audit of financial statements. When the auditor is engaged or required by law or regulation to perform a compliance audit in accordance with generally accepted auditing standards (GAAS), the standards for financial audits under *Government Auditing Standards*, and a governmental audit requirement that requires the auditor to express an opinion on compliance with applicable compliance requirements, section 935, *Compliance Audits*, applies.

.04 When the auditor is engaged to perform a separate attest engagement on an entity's compliance with requirements of specified laws, regulations, rules, contracts, or grants, AT-C section 315, *Compliance Attestation*, applies to an examination of an entity's compliance and to an agreed-upon procedures engagement related to an entity's compliance. When the auditor is engaged

to perform a separate attestation engagement related to an entity's internal control over compliance with requirements of specified laws, regulations, rules, contracts, or grants, AT-C section 205, *Examination Engagements*, applies to an examination of an entity's internal control over compliance and AT-C section 315 applies to agreed-upon procedures engagements related to an entity's internal control over compliance.

[Revised, April 2017, to reflect conforming changes necessary due to the issuance of SSAE No. 18.]

Effective Date

.05 This section is effective for reports on compliance issued in connection with audits of financial statements for periods ending on or after December 15, 2012.

Objective

.06 The objective of the auditor is to report appropriately on an entity's compliance with aspects of contractual agreements or regulatory requirements, in connection with the audit of financial statements, when the auditor is requested to report on such matters.

Requirements

Reports on Compliance With Aspects of Contractual Agreements or Regulatory Requirements

.07 The auditor's report on compliance should include a statement that nothing came to the auditor's attention that caused the auditor to believe that the entity failed to comply with specified aspects of the contractual agreements or regulatory requirements, insofar as they relate to accounting matters, only when

- a. the auditor has not identified any instances of noncompliance,
- b. the auditor has expressed an unmodified or qualified opinion on the financial statements to which the applicable covenants of such contractual agreements or regulatory requirements relate, and
- c. the applicable covenants or regulatory requirements relate to accounting matters that have been subjected to the audit procedures applied in the audit of financial statements.

.08 When the auditor has identified one or more instances of noncompliance, the report on compliance should describe such noncompliance (see paragraphs .12f and .13b).

.09 When the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor should issue a report on compliance only when instances of noncompliance are identified. Therefore, the requirement in paragraph .08 also applies in such circumstances. The auditor should modify the wording of the report on compliance, as appropriate to the circumstances. (Ref: par. .A3)

.10 Notwithstanding the requirements in paragraphs .07–.09, the auditor is not precluded from issuing a report on compliance if such report is required by another set of auditing standards (for example, *Government Auditing Standards*), and the auditor has been engaged to audit the financial statements in accordance with both GAAS and those other standards.

.11 The report on compliance should be in writing and should be provided either in a separate report (see paragraph .12) or in one or more paragraphs included in the auditor's report on the financial statements (see paragraph .13).

Separate Report on Compliance With Aspects of Contractual Agreements or Regulatory Requirements

.12 When the auditor reports on compliance in a separate report, the report should include the following:

- a. A title that includes the word *independent* to clearly indicate that it is the report of an independent auditor.
- b. An appropriate addressee.
- c. A paragraph that states that the financial statements were audited in accordance with generally accepted auditing standards and an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards) and the date of the auditor's report on those financial statements.
- d. If the auditor expressed a modified opinion¹ on the financial statements, a statement describing the nature of the modification. (Ref: par. .A4)
- e. When no instances of noncompliance are identified by the auditor, a reference to the specific covenants or paragraphs of the contractual agreement or regulatory requirement and a statement that nothing came to the auditor's attention that caused the auditor to believe that the entity failed to comply with specified aspects of the contractual agreements or regulatory requirements, insofar as they relate to accounting matters (see paragraphs .07 and .10).
- f. When instances of noncompliance are identified by the auditor, a reference to the specific covenants or paragraphs of the contractual agreement or regulatory requirement, insofar as they relate to accounting matters, and a description of the identified instances of noncompliance. (Ref: par. .A5)
- g. A statement that the report is being provided in connection with the audit of the financial statements.
- h. A statement that the audit was not directed primarily toward obtaining knowledge regarding compliance, and accordingly, had the auditor performed additional procedures, other matters may have come to the auditor's attention regarding noncompliance with the specific covenants or paragraphs of the contractual agreement or regulatory requirement, insofar as they relate to accounting matters.
- i. A paragraph that includes a description and the source of significant interpretations, if any, made by the entity's management relating to the provisions of the relevant contractual agreement or regulatory requirement.

¹ See section 705, *Modifications to the Opinion in the Independent Auditor's Report*.

- j. A paragraph that includes an appropriate alert in accordance with the section 905, *Alert That Restricts the Use of the Auditor's Written Communication*.² (Ref: par. .A6–.A7)
- k. The manual or printed signature of the auditor's firm and the city and state where the auditor practices.
- l. The date of the report, which should be the same date as the auditor's report on the financial statements.³

[As amended, effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012, by SAS No. 125.]

Report on Compliance With Aspects of Contractual Agreements or Regulatory Requirements Included in the Auditor's Report

.13 When a report on compliance is included in the auditor's report on the financial statements, the auditor's report should include an other-matter paragraph⁴ that includes a reference to the specific covenants or paragraphs of the contractual agreement or regulatory requirement, insofar as they relate to accounting matters, and also should include the following:

- a. When no instances of noncompliance are identified by the auditor, a statement that nothing came to the auditor's attention that caused the auditor to believe that the entity failed to comply with specified aspects of the contractual agreements or regulatory requirements, insofar as they relate to accounting matters (see paragraphs .07 and .10).
- b. When instances of noncompliance are identified by the auditor, a description of the identified instances of noncompliance. (Ref: par. .A5)
- c. A statement that the communication is being provided in connection with the audit of the financial statements.
- d. A statement that the audit was not directed primarily toward obtaining knowledge regarding compliance, and accordingly, had the auditor performed additional procedures, other matters may have come to the auditor's attention regarding noncompliance with the specific covenants or paragraphs of the contractual agreement or regulatory requirement, insofar as they relate to accounting matters.
- e. A paragraph that includes a description and the source of significant interpretations, if any, made by the entity's management relating to the provisions of the relevant contractual agreement or regulatory requirement.
- f. A paragraph that includes an appropriate alert in accordance with section 905.⁵ (Ref: par. .A6–.A7)

² Paragraphs .06c, .07, and .11 of section 905, *Alert That Restricts the Use of the Auditor's Written Communication*. [Footnote amended, effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012, by SAS No. 125.]

³ Paragraph .41 of section 700, *Forming an Opinion and Reporting on Financial Statements*.

⁴ See section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*, for guidance on other-matter paragraphs.

⁵ See footnote 2.

[As amended, effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012, by SAS No. 125.]

Application and Other Explanatory Material

Scope of This Section (Ref: par. .01)

.A1 The financial statements being audited and to which the applicable covenants of the contractual agreements or regulatory requirements relate may be either general purpose or special purpose financial statements.

Considerations Specific to Governmental Entities

.A2 For most state or local governmental entities, the applicable financial reporting framework is based on multiple reporting units and, therefore, requires the presentation of financial statements for its activities in various reporting units. Consequently, a reporting unit or aggregation of reporting units of the governmental entity represents an opinion unit to the auditor. In the context of this section, the auditor is responsible for reporting on compliance for each opinion unit within a governmental entity, when requested.

Reports on Compliance With Aspects of Contractual Agreements or Regulatory Requirements (Ref: par. .09)

.A3 The exhibit, "Illustrations of Reports on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements," provides an example of the wording of the report on compliance when the auditor has disclaimed an opinion on the financial statements.⁶

Separate Report on Compliance With Aspects of Contractual Agreements or Regulatory Requirements (Ref: par. .12d)

.A4 The auditor may include certain additional communications in the separate report on compliance when the auditor included such additional communications in the auditor's report on the financial statements⁷ that are not modifications to the auditor's opinion. For example, if the auditor included an emphasis-of-matter paragraph in the auditor's report on the financial statements because of an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time,⁸ the auditor may also include this in the separate report on compliance.

Reporting When Instances of Noncompliance Are Identified (Ref: par. .12f and .13b)

.A5 When instances of noncompliance are identified, and the entity has obtained a waiver for such noncompliance, the auditor may include a statement in

⁶ Illustration 4, "A Report on Compliance With Aspects of Contractual Agreements Provided in a Separate Report When Instances of Noncompliance Are Identified, and the Auditor Has Disclaimed an Opinion on the Financial Statements," in the exhibit, "Illustrations of Reports on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements."

⁷ See section 706.

⁸ See section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*. [Footnote revised, August 2012, to reflect conforming changes necessary due to the issuance of SAS No. 126.]

the report on compliance that a waiver has been obtained. The determination of whether to include such a statement is based on the procedures performed by the auditor to evaluate the waiver for the purposes of obtaining sufficient appropriate audit evidence in connection with the audit of the financial statements. All instances of noncompliance are required to be described in the report on compliance, in accordance with paragraph .08, including those for which a waiver has been obtained.

Restrictions on the Use of the Auditor's Report⁹ (Ref: par. .12j and .13f)

.A6 An alert, as discussed in paragraphs .12j and .13f, is necessary because, although compliance matters may be identified by the auditor during the course of the audit engagement, the identification of such matters is not the primary objective of the audit engagement. In addition, the basis, assumptions, or purpose of the provisions in contractual agreements or regulatory requirements to which the report on compliance relates are developed for, and directed only to, the parties to the contractual agreement or the regulatory agency responsible for the requirements. [As amended, effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012, by SAS No. 125.]

.A7 The alert that restricts the use of the report indicates that only the report on compliance with aspects of contractual agreements or regulatory requirements is restricted. Accordingly, the intended use of the auditor's report on the financial statements is not affected by this alert. [As amended, effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012, by SAS No. 125.]

⁹ See footnote 2.

.A8

Exhibit—Illustrations of Reports on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements (Ref: par. .12–.13)

Illustration 1 — A Report on Compliance With Aspects of Contractual Agreements Provided in a Separate Report When No Instances of Non-compliance Are Identified

Illustration 2 — A Report on Compliance With Aspects of Contractual Agreements Provided in a Separate Report When Instances of Noncompliance Are Identified

Illustration 3 — A Report on Compliance With Aspects of Contractual Agreements Provided in a Separate Report When Instances of Noncompliance Are Identified, and a Waiver Has Been Obtained

Illustration 4 — A Report on Compliance With Aspects of Contractual Agreements Provided in a Separate Report When Instances of Noncompliance Are Identified, and the Auditor Has Disclaimed an Opinion on the Financial Statements

Illustration 5 — A Report on Compliance With Aspects of Contractual Agreements Given in a Combined Report, and No Instances of Noncompliance Were Identified

Illustration 1—A Report on Compliance With Aspects of Contractual Agreements Provided in a Separate Report When No Instances of Noncompliance Are Identified

Independent Auditor's Report

[Appropriate Addressee]

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20X2, 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, and have issued our report thereon dated February 16, 20X3.

In connection with our audit, nothing came to our attention that caused us to believe that XYZ Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to YY, inclusive, of the Indenture dated July 21, 20X0, with ABC Bank, insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such non-compliance. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding the Company's noncompliance with the above-referenced terms, covenants, provisions, or conditions of the Indenture, insofar as they relate to accounting matters.

This report is intended solely for the information and use of the board of directors and management of XYZ Company and ABC Bank and is not intended to be and should not be used by anyone other than these specified parties.

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

Illustration 2—A Report on Compliance With Aspects of Contractual Agreements Provided in a Separate Report When Instances of Noncompliance Are Identified

Independent Auditor's Report

[Appropriate Addressee]

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20X2, 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, and have issued our report thereon dated March 5, 20X3.

In connection with our audit, we noted that XYZ Company failed to comply with the "Working Capital" provision of section XX of the Loan Agreement dated March 1, 20X2, with ABC Bank. Our audit was not directed primarily toward obtaining knowledge as to whether XYZ Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to YY, inclusive, of the Loan Agreement, insofar as they relate to accounting matters. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding noncompliance with the above-referenced terms, covenants, provisions, or conditions of the Loan Agreement, insofar as they relate to accounting matters.

This report is intended solely for the information and use of the board of directors and management of XYZ Company and ABC Bank and is not intended to be and should not be used by anyone other than these specified parties.

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

Illustration 3—A Report on Compliance With Aspects of Contractual Agreements Provided in a Separate Report When Instances of Noncompliance Are Identified, and a Waiver Has Been Obtained

Independent Auditor's Report

[Appropriate Addressee]

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20X2, 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, and have issued our report thereon dated March 5, 20X3.

In connection with our audit, we noted that XYZ Company failed to comply with the "Working Capital" provision of section XX of the Loan Agreement dated March 1, 20X2, with ABC Bank. The Company has received a waiver dated February 5, 20X3, from ABC Bank. Our audit was not directed primarily toward obtaining knowledge as to whether XYZ Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to YY, inclusive, of the Loan Agreement, insofar as they relate to accounting matters. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding noncompliance with the above-referenced terms, covenants, provisions, or conditions of the Loan Agreement, insofar as they relate to accounting matters.

This report is intended solely for the information and use of the board of directors and management of XYZ Company and ABC Bank and is not intended to be and should not be used by anyone other than these specified parties.

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

Illustration 4—A Report on Compliance With Aspects of Contractual Agreements Provided in a Separate Report When Instances of Noncompliance Are Identified, and the Auditor Has Disclaimed an Opinion on the Financial Statements

Independent Auditor's Report

[Appropriate Addressee]

We were engaged to audit, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20X2, 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, and have issued our report thereon dated March 5, 20X3. Our report disclaims an opinion on such financial statements because of *[describe the scope limitation or matter causing the disclaimer]*.

In connection with our engagement, we noted that XYZ Company failed to comply with the "Working Capital" provision of section XX of the Loan Agreement dated March 1, 20X2, with ABC Bank. Our engagement was not directed primarily toward obtaining knowledge as to whether XYZ Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to YY, inclusive, of the Loan Agreement, insofar as they relate to accounting matters. Accordingly, had we been able to complete the audit, other matters may have come to our attention regarding noncompliance with the above-referenced terms, covenants, provisions, or conditions of the Loan Agreement, insofar as they relate to accounting matters.

This report is intended solely for the information and use of the board of directors and management of XYZ Company and ABC Bank and is not intended to be and should not be used by anyone other than these specified parties.

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

Illustration 5—A Report on Compliance With Aspects of Contractual Agreements Given in a Combined Report, and No Instances of Noncompliance Were Identified

Independent Auditor's Report

[Appropriate Addressee]

Report on the Audit of the Financial Statements¹

Opinion

We have audited the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20X1, 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, 20X1, 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.

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 the Financial Statements 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 the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

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 for [insert the time period set by the applicable financial reporting framework].

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. 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 misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one

¹ The subtitle "Report on the Audit of the Financial Statements" is unnecessary in circumstances in which the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed.²
- Evaluate appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- 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 audit.

Other Matter

In connection with our audit, nothing came to our attention that caused us to believe that ABC Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to YY, inclusive, of the Indenture dated July 21, 20X0 with XYZ Bank, insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such non-compliance. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding the Company's noncompliance with the above-referenced terms, covenants, provisions, or conditions of the Indenture, insofar as they relate to accounting matters.

Restricted Use Relating to the Other Matter

The communication related to compliance with the aforementioned Indenture described in the Other Matter paragraph is intended solely for the information and use of the boards of directors and management of ABC Company and XYZ

² In circumstances in which the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, omit the following: "but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed."

Bank and is not intended to be and should not be used by anyone other than these specified parties.³

Report on Other Legal and Regulatory Requirements

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

[Signature of the auditor's firm]

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

[Date of the auditor's report]

[Illustration added, effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012, by SAS No. 125. Revised, February 2020, to reflect conforming changes necessary due to the issuance of SAS No. 134, as amended.]

³ When the engagement is also performed in accordance with *Government Auditing Standards*, the alert may read as follows: "The purpose of the communication related to compliance with the aforementioned [*compliance requirements*] described in the Other Matter paragraph [*or, Report on Compliance*] is solely to describe the scope of our testing of compliance and the results of that testing. This communication is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering ABC Company's compliance. Accordingly, this communication is not suitable for any other purpose." The AICPA Audit Guide *Government Auditing Standards and Circular A-133 Audits* provides additional interpretative guidance, including illustrative reports.