AICPA

**Agenda Item 3**

# The Accountant's Response in a Review Engagement When Identified Misstatements are Material and Pervasive

## Objective of Agenda Item

To continue discussions as to the appropriate response in a review engagement when an accountant identifies material and pervasive misstatements and provide direction as to whether revisions are necessary to AR-C section 90, *Review of Financial Statements*; AT-C section 210, *Review Engagements* or AU-C section 930, *Interim Financial Information*. If the ARSC determines that revisions should be made to AU-C section 930, a recommendation will be made to the Auditing Standards Board (ASB).

## Background

The following represents the three separate bodies of literature with respect to limited assurance engagements under the jurisdiction of either the ARSC or the ASB:

- AT-C section 210, *Review Engagements*
- AU-C section 930, *Interim Financial Information*
- AR-C section 90, *Review of Financial Statements*

Additionally, the International Auditing and Assurance Standards Board addresses limited assurance engagements in International Standard on Review Engagements (ISRE) 2400 (Revised), *Engagements to Review Historical Financial Statements* and International Standard on Attestation Engagements (ISAE) 3000 (Revised), *Assurance Engagements Other than Audits or Reviews of Historical Financial Information.*

With respect to known misstatements of the subject matter, AU-C section 930 and AR-C section 90 both include a step in which the practitioner considers whether modification of the standard report is sufficient to address the misstatement. If the practitioner concludes that modification of the standard report is not sufficient, then the practitioner is required to withdraw. AT-C section 210 requires the practitioner to jump right to withdrawal when the effects of the matter are material and pervasive and does not permit modification of the standard report.

At its meeting in August 2017, the ARSC considered proposed revisions to AT-C section 210 which would result in the literature being consistent. However, upon discussion, certain ARSC members questioned whether it was in the public interest to permit a practitioner to issue any report on subject matter that the practitioner reasonably knows is materially and pervasively misstated. Those ARSC members believe that requirements in AT-C section 210 are more appropriate (that is, the practitioner would be required to withdraw from the engagement) than the requirements in AR-C section 90 and AU-C section 930.

The ARSC reaffirmed that the prohibition on the expression of an adverse review conclusion remains appropriate.

The following illustrates how material and pervasive misstatements are treated in the various literature.

| | AR-C section 90 | AU-C section 930 | AT-C section 210 | ISRE 2400 (Revised) |
|---|---|---|---|---|
| Consider whether modification of the conclusion in the standard report is sufficient to disclose misstatement. | Paragraph .56 | Paragraph .34 | Paragraph .51 | Paragraph .75<br>(also permits a modified conclusion when the practitioner is unable to obtain sufficient appropriate evidence) |
| Include a separate paragraph in the practitioner's report that provides a description of the nature of the matter giving rise to the modification | Paragraph .57 | Paragraph .35 | Paragraph .52<br><br>Paragraph .53 precludes a modified conclusion if the effects of the misstatement are "pervasive." | Paragraph 77<br><br>Permits an "adverse conclusion" if the misstatement is "pervasive." |
| If modification of the conclusion in the standard practitioner's report is not sufficient address the misstatement, withdraw and provide no further services | Paragraph .59 | Paragraph .36 | Paragraph .55<br><br>Paragraph .53 requires withdrawal if the effects are "pervasive." | |
| Prohibition on adverse conclusion | Paragraph .60 | | | |

## Issue for Discussion with the ARSC

Consideration of the accountant's response when an identified misstatement is material and pervasive

Neither AR-C section 90 or AU-C section 930 differentiate the practitioner's response when a misstatement is both material and pervasive. Therefore, if the practitioner determines that he or she can sufficiently disclose a pervasive misstatement in the report, the practitioner is not required to withdraw from the engagement.

Paragraph .53 of AT-C section 210 requires the practitioner to withdraw from the engagement when a misstatement is pervasive, as follows:

> **.53** The practitioner should express a qualified conclusion when the effects of a matter are material but not pervasive. A qualified conclusion is expressed as being "except for the effects" of the matter to which the qualification relates. When the effects of a matter are material and also pervasive, the practitioner should withdraw from the engagement, when withdrawal is possible under applicable laws and regulations. (Ref: par. .A83)
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> **.A83** Pervasive effects on the subject matter are those that, in the practitioner's professional judgment a. are not confined to specific aspects of the subject matter; b. if so confined, represent or could represent a substantial proportion of the subject matter; or c. in relation to disclosures, are fundamental to the intended users' understanding of the subject matter.

Paragraph .77 of ISRE 2400 (Revised) requires the expression of an "adverse conclusion" when a misstatement is pervasive.

> **77.** If the practitioner determines that the financial statements are materially misstated, the practitioner shall express:
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> (a) A qualified conclusion, when the practitioner concludes that the effects of the matter(s) giving rise to the modification are material, but not pervasive to the financial statements; or
>
> (b) An adverse conclusion, when the effects of the matter(s) giving rise to the modification are both material and pervasive to the financial statements.

Paragraph .60 of AR-C section 90 expressly prohibits the expression of an adverse review conclusion, as follows:

> **.60** The accountant should not modify the standard report to include a statement that the financial statements are not in accordance with the applicable financial reporting framework. (Ref: par. .A103–.A105)
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> **.A103** Including a statement that the financial statements are not in accordance with the applicable financial reporting framework would be tantamount to expressing an adverse opinion on the financial statements. Such an opinion can be expressed only

in the context of an audit engagement. Furthermore, such a statement in an accountant's review report may confuse users because it would contradict the statement required in paragraph .39*f* about whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework.

**.A104** Depending on the accountant's assessment of the possible dollar magnitude of the effect of the departures, the significance of the affected items to the entity, the pervasiveness and overall impact of the misstatements, and whether disclosure has been made of the effect of the departures, the accountant may, in accordance with paragraphs .52–.55, include a separate paragraph in the accountant's review report stating the limitations of the financial statements. The following is an illustration of such a separate paragraph with respect to an accountant's review report on financial statements prepared in accordance with accounting principles generally accepted in the United States of America:

> ***Limitations of the financial statements***
>
> Because the significance and pervasiveness of the matters described in the Known Departures From Accounting Principles Generally Accepted in the United States of America paragraphs makes it difficult to assess their impact on the financial statements, users of the accompanying financial statements should recognize that they might reach different conclusions about the company's financial position, results of operations, and cash flows if they had access to revised financial statements prepared in accordance with accounting principles generally accepted in the United States of America.

**.A105** Inclusion of a separate paragraph, such as that illustrated in paragraph .A104 in the accountant's review report is not a substitute for disclosure of the specific departures or the effects of such departures if such effects have been determined by management or are known as a result of the accountant's procedures.

**Action Requested of ARSC**

The ARSC is asked to consider the appropriate response when an identified misstatement is material and pervasive. As the professional literature should be consistent in this regard, the ARSC should consider whether AR-C section 90 should be revised; whether a recommendation should be made to the ASB that AU-C section 930 should be revised; or AT-C section 210 should be revised.

If the ARSC concludes that AT-C section 210 should be revised, the Committee is asked whether such revision should be (a) included as part of the ASB's project to consider amending the attestation standards for examination, review and agreed-upon procedures engagements to address situations in which a responsible party does not provide a written assertion to the practitioner or (b) exposed for public comment earlier.

For convenience, the full text of the applicable sections from AR-C section 90; AU-C section 930; AT-C section 210; and ISRE 2400 (Revised) are presented as an exhibit to this memorandum.

The Audit Issues Task Force considered the same issue and concluded that there is sufficient concern to warrant a project and exposure draft should changes be proposed. The AITF noted that AT-C section 210 is consistent in this regard with AT-C section 205, *Examination Engagements*. The issue becomes whether it is more appropriate for the attestation engagement to be consistent or the review literature.

## Agenda Items Presented:

None.

# Exhibit

**Relevant section from AR-C section 90**

## *Known Departures From the Applicable Financial Reporting Framework*

**.56** When the accountant becomes aware of a departure from the applicable financial reporting framework (including inadequate disclosure) that is material to the financial statements and if the financial statements are not revised, the accountant should consider whether modification of the standard report is adequate to disclose the departure.

**.57** If the accountant concludes that modification of the standard report is adequate, the departure should be disclosed in a separate paragraph of the report under the heading "Known Departures From the [*identify the applicable financial reporting framework*]," including disclosure of the effects of the departure on the financial statements if such effects have been determined by management or are known to the accountant as the result of the accountant's procedures. (Ref: par. .A101 and .A106)

**.58** If the effects of the departure have not been determined by management or are not known to the accountant as a result of the accountant's procedures, the accountant is not required to determine the effects of a departure; however, in such circumstances, the accountant should state in the report that such determination has not been made.

**.59** If the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements as a whole, the accountant should withdraw from the review engagement. (Ref: par. .A102)

**.60** The accountant should not modify the standard report to include a statement that the financial statements are not in accordance with the applicable financial reporting framework. (Ref: par. .A103–.A105)

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## *Known Departures From the Applicable Financial Reporting Framework (Ref: par. .57 and .59–.60)*

**.A101** Examples of headings that an accountant may use to disclose departures from an applicable financial reporting framework in the accountant's review report include the following:

- Known Departures From Accounting Principles Generally Accepted in the United States of America
- Known Departures From International Financial Reporting Standards as Promulgated by the International Accounting Standards Board

- Known Departures From the Cash-Basis of Accounting
- Known Departures From the Tax-Basis of Accounting

**.A102** Prior to withdrawing from a review engagement in those circumstances when the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements as a whole, the accountant may wish to consult with legal counsel.

**.A103** Including a statement that the financial statements are not in accordance with the applicable financial reporting framework would be tantamount to expressing an adverse opinion on the financial statements. Such an opinion can be expressed only in the context of an audit engagement. Furthermore, such a statement in an accountant's review report may confuse users because it would contradict the statement required in paragraph .39*f* about whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework.

**.A104** Depending on the accountant's assessment of the possible dollar magnitude of the effect of the departures, the significance of the affected items to the entity, the pervasiveness and overall impact of the misstatements, and whether disclosure has been made of the effect of the departures, the accountant may, in accordance with paragraphs .52–.55, include a separate paragraph in the accountant's review report stating the limitations of the financial statements. The following is an illustration of such a separate paragraph with respect to an accountant's review report on financial statements prepared in accordance with accounting principles generally accepted in the United States of America:

> ***Limitations of the financial statements***
>
> Because the significance and pervasiveness of the matters described in the Known Departures From Accounting Principles Generally Accepted in the United States of America paragraphs makes it difficult to assess their impact on the financial statements, users of the accompanying financial statements should recognize that they might reach different conclusions about the company's financial position, results of operations, and cash flows if they had access to revised financial statements prepared in accordance with accounting principles generally accepted in the United States of America.

**.A105** Inclusion of a separate paragraph, such as that illustrated in paragraph .A104 in the accountant's review report is not a substitute for disclosure of the specific departures or the effects of such departures if such effects have been determined by management or are known as a result of the accountant's procedures.

**.A106** Exhibit C, "Illustrations of Accountant's Review Reports on Financial Statements," contains an illustrative example of an accountant's review report that discloses a departure from the applicable financial reporting framework.

**<u>Relevant section from AU-C section 930</u>**

***Modification of the Auditor’s Review Report***

**.34** When the interim financial information has not been prepared in accordance with the applicable financial reporting framework in all material respects, the auditor should consider whether modification of the auditor's review report on the interim financial information is sufficient to address the departure from the applicable financial reporting framework. (Ref: par. .A44–.A47)

**.35** If the auditor concludes that modification of the standard review report is sufficient to address the departure, the auditor should modify the review report. The modification should describe the nature of the departure and, if practicable, should state the effects on the interim financial information. If the departure is due to inadequate disclosure, the auditor should, if practicable, include the information in the report that the auditor believes is necessary for adequate disclosure in accordance with the applicable financial reporting framework. (Ref: par. .A48)

**.36** If the auditor believes that modification of the review report is not sufficient to address the deficiencies in the interim financial information, the auditor should withdraw from the review engagement and provide no further services with respect to such interim financial information.

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***Modification of the Auditor’s Review Report (Ref: par. .34–.35)***

**.A44** Departures from the applicable financial reporting framework include inadequate disclosure and changes in accounting policies that are not in accordance with the applicable financial reporting framework.

**.A45** Section 700 addresses the reporting requirements when the circumstances contemplated by the "Accounting Principles Rule" (ET sec. 1.320.001) of the AICPA Code of Professional Conduct are present.

**.A46** If the interim financial information adequately discloses the existence of substantial doubt about the entity's ability to continue as a going concern (see paragraph .16) or a lack of consistency in the application of accounting principles affecting the interim financial information, the auditor may, but is not required to, include an emphasis-of-matter paragraph in the auditor's review report.

**.A47** Exhibit C, "Illustrations of Example Modifications to the Auditor's Review Report Due to Departures From the Applicable Financial Reporting Framework," contains illustrative examples of paragraphs modifying the auditor's review report.

**.A48** The information necessary for adequate disclosure is influenced by the form and context in which the interim financial information is presented. For example, the disclosures considered necessary for interim financial information presented in accordance with the minimum disclosure requirements of FASB ASC 270-10-50-1, which is applicable to condensed financial statements of public companies, are considerably less extensive than those necessary for annual financial statements that present financial position, results of operations, and cash flows in accordance with the applicable financial reporting framework. FASB ASC 270-10-50-3 states that a presumption exists that users of summarized interim financial data will have read the latest published annual report, including the financial disclosures required by GAAP and management's commentary concerning the annual financial results, and that the summarized interim data will be viewed in that context.

**Relevant section from AT-C section 210**

## Modified Conclusions

***Misstatement of Subject Matter***

.51 A practitioner who is engaged to perform a review engagement may become aware that the subject matter is misstated. If the misstatement is not corrected, the practitioner should consider whether qualification of the conclusion in the standard practitioner's report is adequate to disclose the misstatement of the subject matter. (Ref: par. .A82)

.52 When the practitioner qualifies the conclusion, the practitioner should include a separate paragraph in the practitioner's report that provides a description of the matter(s) giving rise to the qualification.

.53 The practitioner should express a qualified conclusion when the effects of a matter are material but not pervasive. A qualified conclusion is expressed as being "except for the effects" of the matter to which the qualification relates. When the effects of a matter are material and also pervasive, the practitioner should withdraw from the engagement, when withdrawal is possible under applicable laws and regulations. (Ref: par. .A83)

.54 If the practitioner has concluded that the material misstatement results in a qualified conclusion, the practitioner should report directly on the subject matter, not on the assertion, even when the assertion acknowledges the misstatement.

.55 If the practitioner believes that qualification of the conclusion in the standard practitioner's report is not adequate to indicate the misstatements in the subject matter, the practitioner should withdraw from the engagement.

.56 The practitioner's conclusion on the subject matter or assertion should be clearly separated from any paragraphs emphasizing matters related to the subject matter or any other reporting responsibilities.

.57 When the conclusion is qualified, reference to an external specialist is permitted when such reference is relevant to an understanding of the qualification to the practitioner's conclusion. The practitioner should indicate in the practitioner's report that such reference does not reduce the practitioner's responsibility for that conclusion.

***Modified Conclusions (Ref: par. .51–.53)***
.A82 A practitioner may issue an unmodified conclusion only when the engagement has been conducted in accordance with the attestation standards. Such standards will not have been complied with if the practitioner has been unable to apply all the procedures that the practitioner considers necessary in the circumstances.

.A83 Pervasive effects on the subject matter are those that, in the practitioner's professional judgment

a. are not confined to specific aspects of the subject matter;

b. if so confined, represent or could represent a substantial proportion of the subject matter; or

c. in relation to disclosures, are fundamental to the intended users' understanding of the subject matter.

**<u>Relevant section from ISRE 2400 (Revised)</u>**

Modified Conclusion

75. The practitioner shall express a modified conclusion in the practitioner's report on the financial statements as a whole when:

(a) The practitioner determines, based on the procedures performed and the evidence obtained, that the financial statements are materially misstated; or

(b) The practitioner is unable to obtain sufficient appropriate evidence in relation to one or more items in the financial statements that are material in relation to the financial statements as a whole.

76. When the practitioner modifies the conclusion expressed on the financial statements, the practitioner shall:

(a) Use the heading "Qualified Conclusion," "Adverse Conclusion" or "Disclaimer of Conclusion," as appropriate, for the conclusion paragraph in the practitioner's report; and

(b) Provide a description of the matter giving rise to the modification, under an appropriate heading (for example, "Basis for Qualified Conclusion," "Basis for Adverse Conclusion" or "Basis for Disclaimer of Conclusion," as appropriate), in a separate paragraph in the practitioner's report immediately before the conclusion paragraph (referred to as the basis for conclusion paragraph).

Financial statements are materially misstated

77. If the practitioner determines that the financial statements are materially misstated, the practitioner shall express:

(a) A qualified conclusion, when the practitioner concludes that the effects of the matter(s) giving rise to the modification are material, but not pervasive to the financial statements; or

(b) An adverse conclusion, when the effects of the matter(s) giving rise to the modification are both material and pervasive to the financial statements.

78. When the practitioner expresses a qualified conclusion on the financial statements because of a material misstatement, the practitioner shall, unless otherwise required by law or regulation, use one of the following phrases, as appropriate:

(a) "Based on our review, except for the effects of the matter(s) described in the Basis for Qualified Conclusion paragraph, nothing has come to our attention that causes us to believe that the financial statements do not present fairly, in all material respects (or do not give a true and fair view), … in accordance with the applicable financial reporting framework," (for financial statements prepared using a fair presentation framework); or

(b) "Based on our review, except for the effects of the matter(s) described in the Basis for Qualified Conclusion paragraph, nothing has come to our attention that causes us to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework," (for financial statements prepared using a compliance framework).

79. When the practitioner expresses an adverse conclusion on the financial statements, the practitioner shall, unless otherwise required by law or regulation, use one of the following phrases, as appropriate:

(a) "Based on our review, due to the significance of the matter(s) described in the Basis for Adverse Conclusion paragraph, the financial statements do not present fairly, in all material respects (or do not give a true and fair view), … in accordance with the applicable financial reporting framework," (for financial statements prepared using a fair presentation framework); or

(b) "Based on our review, due to the significance of the matter(s) described in the Basis for Adverse Conclusion paragraph, the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework," (for financial statements prepared using a compliance framework).

80. In the basis for conclusion paragraph, in relation to material misstatements that give rise to either a qualified conclusion or an adverse conclusion, the practitioner shall:

(a) Describe and quantify the financial effects of the misstatement if the material misstatement relates to specific amounts in the financial statements (including quantitative disclosures), unless impracticable, in which case the practitioner shall so state;

(b) Explain how disclosures are misstated if the material misstatement relates to narrative disclosures; or

(c) Describe the nature of omitted information if the material misstatement relates to the non-disclosure of information required to be disclosed. Unless prohibited by law or regulation, the practitioner shall include the omitted disclosures where practicable to do so.