



## Agenda Item 4

# Auditor Reporting — Cover Letter and Issue Paper

## Objective

To consider a discussion draft of proposed revisions to AU-C section 700 *Forming an Opinion and Reporting on Financial Statements*, that reflect convergence with ISA 700 (Revised) *Forming an Opinion and Reporting on Financial Statements*.

## Task Force

The Auditor Reporting Task Force (task force) members are:

- Dan Montgomery (Chair)
- Jan Herringer
- Susan Jones
- Richard Miller
- Marc Panucci
- Jeffrey Rapaglia
- Rick Reisig
- Mike Westervelt (TIC)

## Background

In 2015 the IAASB issued new and revised ISAs relating to reporting on audited financial statements. The following is a list of the new and revised ISAs, which are effective for audits of financial statements for periods ending on or after December 15, 2016.

- ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*
- ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*
- ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*
- ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*
- ISA 720 (Revised) *The Auditor's Responsibilities Relating to Other Information*
- ISA 570 (Revised), *Going Concern*
- ISA 800 (Revised), *Special Considerations — Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*

- ISA 805 (Revised), *Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*
- ISA 810 (Revised), *Engagements to Report on Summary Financial Statements*

At previous ASB meetings the ASB discussed certain threshold issues relating to ASB's stated goal of convergence with the new and revised ISAs while also considering the standards of the Public Company Accounting Oversight Board (PCAOB). The ASB discussed certain elements of the auditor's report relating to the ASB's convergence with ISA 700 (Revised) and a framework to help the task force with convergence. The ASB's discussion focused on the task force's suggested wording of the requirements in ISA 700 relating to the elements of the auditor's report as a starting point for proposed revisions to AU-C 700.

At the August 2016 ASB meeting, the ASB discussed certain elements of the auditor's report relating to the ASB's convergence with ISA 700 (Revised) in light of the PCAOB's reproposal of their auditor reporting model. The ASB also discussed the communication of key audit matters in the United States. The ASB provided the task force with direction on moving forward with convergence with ISA 700 (Revised). In addition, the task force plans to bring a proposed AU-C section on communicating key audit matters to a future ASB meeting.

### **Subsequent Task Force Discussion**

Subsequent to the August 2016 ASB meeting, the task force held a one-day meeting and discussed the following items:

1. Whether reporting on internal control over financial reporting should be included as an element of the auditor's report. (See Issue 1.)
2. Consider the ASB's feedback from the August meeting and revise the proposed AU-C section 700 to converge with ISA 700 (Revised). (See Issue 2)

The task force noted that the latest version of ISA 700 (Revised) contains amendments from the IAASB's *Disclosures Project (Addressing Disclosures in the Audit of Financial Statements)*. Because the ASB has not yet discussed this project and how it might affect GAAS, the task force has not included such amendments in the proposed SAS. (See Issue 3.)

### **Agenda Items Presented**

- Item 4 – Cover Letter and Issues Paper
- Item 4A – Proposed SAS marked to reflect changes from extant AU-C 700
- Item 4B – ISA 700 (Revised) marked to reflect differences from proposed SAS
- Item 4C – Illustrative report (proposed SAS)
- Item 4D – Illustrative report (proposed SAS marked to extant report)

Mr. Montgomery will lead the discussion through the issue paper (Agenda Item 4) and will walk through the proposed SAS (Agenda Item 4A) with the ASB.

## Issues for ASB discussion

### Issue 1 — Reporting on Internal Control Over Financial Reporting

#### Background

As part of the ASB's project on auditor reporting for employee benefit plans (EBP reporting project), the Department of Labor (DOL) requested a new section be added to the auditor's report that would provide the DOL with information relating to the auditor's communication responsibilities under AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*, including matters identified as a significant deficiency or material weakness.

At the October 2015 ASB meeting, the ASB raised concerns about reporting on internal control over financial reporting as part of the EBP reporting project because the performance requirements for internal control over financial reporting have broader applicability. Accordingly, the ASB directed the EBP task force not to address reporting on internal control over financial reporting as part of the EBP reporting project.

#### *Subsequent Letter from DOL – Reporting on Internal Control*

Subsequent to the October 2015 ASB meeting, the chair of the ASB received a letter from the Chief Accountant of the DOL expressing concerns about the ASB's decision to not address reporting on internal control.

At the May 2016 ASB meeting the EBP reporting task force asked the ASB to reconsider its decision to exclude reporting on internal control over financial reporting as part of auditor reporting for employee benefit plans. The ASB was asked to consider whether the communication of internal control related matters identified in an audit in accordance with generally accepted auditing standards is integral to the understanding of the financial statements and should be made available to the public.

Because AU-C section 265 applies to all audits, the ASB asked the Auditor Reporting Task Force (rather than the EBP reporting task force) to consider whether GAAS should require a public communication about internal control related matters identified in the audit for all or certain audit engagements.

#### *DOL's Proposed Revisions to the Form 5500*

In July 2016, the DOL's Employee Benefits Security Administration (EBSA), the Internal Revenue Service, and the Pension Benefit Guaranty Corporation asked for public comments on proposed revisions to modernize and improve the Form 5500 Annual Return/Report filed by private-sector employee benefit plans. The Form 5500 is the primary source of information about the operations, funding and investments of private-sector, employment-based pension and welfare benefit plans in the U.S. The proposed form revisions would begin with the plan year

2019 Form 5500 series returns/reports. Comments on the proposal have been extended to a December 5, 2016 comment deadline.

As part of the proposed changes, the revised Form 5500 includes a question about whether the plan's independent qualified public accountant communicated "material internal control weaknesses" with those charged with governance.

### ***Task Force Discussions***

The Auditor Reporting task force discussed whether the required elements of the auditor's report should be expanded to include the details of the communications the auditor makes to those charged with governance about significant deficiencies and material weaknesses identified in an audit.

### ***Task Force Recommendations***

The task force does not believe that details about control deficiencies identified should be included in the auditor's report. Users of the financial statements would not have the benefit of the discussions about significant deficiencies or material weaknesses between the auditor and those charged with governance, and therefore would not have the same context as those charged with governance about the nature of the underlying control matters or actions taken (or being taken by management) to address them. In addition, the task force believes that the amount of audit work performed on internal control may differ significantly due to the auditor's risk assessment and audit strategy, which could lead to inconsistency in reporting.

The task force supports convergence with ISA 700 (Revised), and recognizes that the auditor's responsibilities section of the auditor's report is required to include a statement that the auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies and material weaknesses in internal control that the auditor identifies during the audit. (See paragraph .37(a) of the proposed SAS in agenda item 4A.)

Accordingly, an alternative for ASB consideration would be to expand the required statement in the auditor's responsibilities section to indicate whether the auditor identified deficiencies in internal control over financial reporting that were considered to be material weaknesses. For example, the following may be added to the paragraph required in paragraph .37(a) of the proposed SAS, as applicable:

1. *During our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, our consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses and, therefore, material weaknesses may exist that were not identified.*
2. *During our audit we identified certain deficiencies in internal control that we consider to be material weaknesses that we communicated to those charged with governance. However, our consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses and, therefore, material weaknesses may exist that were not identified.*

The task force acknowledged that the auditor has a responsibility to report on internal control to those charged with governance and believes that some type of communication about internal control to the DOL could be meaningful for EBP reporting. The task force believes that a question on the Form 5500 about whether the auditor communicated material weaknesses to those charged with governance in accordance with GAAS may be the most appropriate way for the EBSA to obtain such information. However, the task force recognizes that the proposal is not final.

The task force recommends the ASB solicit feedback through the EBP auditor reporting exposure process about whether the possibility of, and most appropriate mechanism for, communicating about internal control matters in the EBP auditor's report, and whether such communication would be meaningful.

***Action Requested of the ASB***

1. Does the ASB agree that reporting about internal control over financial reporting should not be required for all entities?
2. What are the ASB's views about the communication options discussed above (i.e., including an expanded statement in the auditor's responsibilities section of the report about whether material weaknesses were communicated to those charged with governance, or including a question to that effect on Form 5500)?
3. Does the ASB support soliciting feedback during the EBP auditor reporting exposure process about this issue?

**Issue 2 — Proposed AU-C 700**

Agenda Item 4A contains the proposed AU-C 700, marked to reflect changes from extant AU-C section 700. The proposed SAS has been developed by the auditor reporting task force to converge with ISA 700 (Revised).

***Action Requested of the ASB***

The ASB is asked to review the proposed SAS for discussion at the ASB meeting.

**Issue 3 — IAASB's Disclosures Project**

In July 2015, the IAASB's *Disclosures Project (Addressing Disclosures in the Audit of Financial Statements)* resulted in changes to various ISAs, including ISA 700 (Revised).

The task force has not included the changes from the *Disclosures Project* in the proposed SAS but will do so at a later time in connection with the ASB's broader consideration of changes to AU-C sections as a result of the *Disclosures Project*.

#### **Issue 4 — Auditor's Reports Prescribed by Law or Regulation**

Paragraph 50 of ISA 700 (Revised) includes minimum elements to be included in the auditor's report when the auditor's report is prescribed by law or regulation. This content was not included in extant AU-C section 700 because such reporting was not considered applicable in the United States for general purpose financial statements. Rather, paragraphs .22–.23 of AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* contain the applicable requirements when the auditor's report is prescribed by law or regulation.

Paragraph .43 in the proposed SAS includes the content from paragraph .50 of ISA 700 (Revised). The task force decided to retain this content in the proposed SAS for purposes of discussion by the ASB.

#### ***Action Requested of the ASB***

4. Does the ASB believe the content in paragraph .43 of the proposed SAS should be included or should it be retained in AU-C 800 only? If included in the proposed SAS, the ASB is asked for examples of situations in which the form of report may be prescribed by law or regulation for an audit of financial statements prepared in accordance with a general purpose framework.