



Agenda Item 1I

EXPOSURE DRAFT

**PROPOSED STATEMENTS ON AUDITING
STANDARDS**

***Forming an Opinion and Reporting on Financial
Statements***

***Communicating Key Audit Matters in the Independent
Auditor's Report***

***Modifications to the Opinion in the Independent Auditor's
Report***

***Emphasis-of-Matter Paragraphs and Other-Matter
Paragraphs in the Independent Auditor's Report***

***The Auditor's Communication With Those Charged With
Governance***

Supersedes

- ***various sections in Statement on Auditing Standards (SAS) No. 122, Statements on Auditing Standards: Clarification and Recodification, as amended [AICPA, Professional Standards, AU-C secs. 700, 705, 706, and 260];***

Amends:

- ***various sections in SAS No. 122, [AICPA, Professional Standards, AU-C secs. 210, 220, 230, 510, 540, 600];***
- ***SAS No. 132, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern [AICPA, Professional Standards, AU-C sec. 570]***

August __, 2017

Comments are requested by November __, 2017

Prepared by the AICPA Auditing Standards Board for comment from persons interested in auditing and reporting issues.

Comments should be addressed to Sherry Hazel at Sherry.Hazel@aicpa-cima.com.



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Explanatory Memorandum

Introduction

This memorandum provides background to the following proposed Statements on Auditing Standards (SASs):

1. Proposed SAS *Forming an Opinion and Reporting on Financial Statements*
2. Proposed SAS *Communicating Key Audit Matters in the Independent Auditor's Report*
3. Proposed SAS *Modifications to the Opinion in the Independent Auditor's Report*
4. Proposed SAS *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*
5. Proposed SAS, *The Auditor's Communication With Those Charged With Governance*

The proposed SASs would supersede the following:

1. SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as amended [AICPA, *Professional Standards*, AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*]
2. SAS No. 122, [AICPA, *Professional Standards*, AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*]
3. SAS No. 122, [AICPA, *Professional Standards*, AU-C section 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*]
4. SAS No. 122, [AICPA, *Professional Standards*, AU-C section 260, *The Auditor's Communication With Those Charged With Governance*]

Background

In January 2015, the International Auditing and Assurance Standards Board (IAASB) issued new and revised International Standards on Auditing (ISAs) relating to reporting on audited financial statements (hereinafter referred to as the new and revised ISAs). Following is a list of the significant new and revised ISAs relating to reporting on a complete set of general purpose financial statements.

- 1) ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*
- 2) ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*
- 3) ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*
- 4) ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

- 5) ISA 570 (Revised), *Going Concern*
- 6) ISA 260 (Revised), *Communication with Those Charged with Governance*

The new and revised ISAs were effective for audits of financial statements for periods ending on or after December 15, 2016.

The issuance of the new and revised ISAs was the culmination of a process starting in 2006 with international academic research on user perceptions of the standard auditor's report that was jointly commissioned by the IAASB and ASB. The process also involved three public consultations by the IAASB, as well as extensive outreach and dialogue with global stakeholders.

A principal objective of the IAASB's auditor reporting project was to increase the informational value of the auditor's report, and therefore the relevance and usefulness of the report for users of financial statements. Users had indicated that they continued to value the "pass/fail" nature of the auditor's opinion, but that the remainder of the auditor's report was boilerplate in nature and provided little transparency into the audit, particularly those areas of the audit that posed higher risks of material misstatement or involved complexity and judgment by management and the auditor. IAASB stakeholders also supported expanding the description in the auditor's report of the responsibilities of management for the preparation of the financial statements, and of the auditor for the audit of the financial statements, as a way of addressing the long-standing expectations gap.

One of the most significant changes in the new and revised ISAs relates to the communication of key audit matters (KAM) in the auditor's report. ISA 700 (Revised) requires the auditor to communicate KAM in the auditor's report for audits of complete sets of general purpose financial statements for listed entities. This is done in accordance with ISA 701, which also applies when the auditor is otherwise required by law or regulation or decides to communicate KAM in the auditor's report. ISA 701 defines KAM as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. KAM are selected from matters communicated with those charged with governance. The IAASB's public consultations and outreach indicated that users of financial statements strongly supported the communication of KAM to provide greater transparency about the audit that was performed.

Convergence

It is the ASB's strategy to converge its standards with those of the IAASB. In doing that, the ASB uses the corresponding ISA as the base in developing its standards. In making the proposed revisions to the accompanying proposed SASs, the ASB used ISA 700 (Revised), 701, 705 (Revised), 706 (Revised), and 260 (Revised) as the base.

The ASB has made certain changes to the language of the ISAs to use terms or phrases that are more common in the United States, and to tailor examples and guidance to the U.S. environment. However, the ASB believes that such changes will not create substantive differences in application between the ISAs and proposed SASs.

See the section “Changes From Existing Standards” below for a summary of the changes to extant AU-C sections that would result from the proposed SASs.

Other Projects Related to Auditor Reporting

Other Information

In April 2015, the IAASB issued ISA 720 (Revised), *The Auditor’s Responsibilities Relating to Other Information*. The ASB formed a task force to consider ISA 720 (Revised), and whether revisions should be made to AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* in order to converge with ISA 720 (Revised). The proposed SAS, *The Auditor’s Responsibilities Relating to Other Information Included in Annual Reports* addresses the auditor’s responsibilities relating to other information, whether financial or non-financial information (other than financial statements and the auditor’s report thereon), included in an entity’s annual report, including a new requirement to include an other-matter paragraph in the auditor’s report when, at the date of the auditor’s report the auditor has obtained some or all of the other information.

Disclosures

In July 2015, the IAASB issued an ISA, *Addressing Disclosures in the Audit of Financial Statements—Revised ISAs and Related Conforming Amendments* (Disclosures Project) aimed at focusing auditors on disclosures throughout the financial statement audit. The changes include strengthened requirements in ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, ISA 330, *The Auditor’s Responses to Assessed Risks*, and ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, as well as enhanced application material in these and several other ISAs to more explicitly address disclosures.

The ASB formed a task force to consider changes to various AU-C sections to converge with the Disclosures Project. The proposed SASs and amendments in this exposure draft highlight, in grey shading, changes related to the Disclosures Project. The ASB intends to vote to ballot for exposure a proposed SAS at the October 2017 ASB meeting that reflect these and other proposed changes stemming from the Disclosures Project.

PCAOB Auditor Reporting Model

On June 1, 2017, the PCAOB adopted a new auditing standard, AS 3101, *The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (new PCAOB standard). The new PCAOB standard, which retains the pass/fail nature of the auditor’s opinion, is intended to enhance the relevance and usefulness of the auditor’s report by providing additional and important information to investors.

The new PCAOB auditor reporting model is similar in many respects to the IAASB form of report. For example, both the PCAOB and IAASB require the Opinion section to be presented first in the auditor’s report, followed by the Basis for Opinion section. Both require a more explicit reference to independence in the Basis for Opinion section. However, there also are some differences between the two forms of auditor’s report. For example, the IAASB requires a more extensive description of the

responsibilities of management and the auditor for the preparation and audit of the financial statements, respectively.

The new PCAOB standard also requires a discussion of critical audit matters (CAM) in the auditor's report for audits conducted under PCAOB standards, except for certain types of entities that are specifically scoped out of the CAM requirement. A CAM is any matter arising from the audit of the financial statements that was communicated or was required to be communicated to the audit committee, and that relates to accounts or disclosures that are material to the financial statements, and involved especially challenging, subjective, or complex auditor judgment. In reference to the IAASB's approach to determining KAM and auditor reporting models in other jurisdictions that require the communication of similar types of matters in the auditor's report, the PCAOB has indicated that "although the processes of identifying these matters vary across jurisdictions, there are commonalities in the underlying criteria regarding matters to be communicated and the communication requirements, such that expanded auditor reporting could result in the communication of many of the same matters under the various approaches."

The requirements in the new PCAOB standard are largely the same as those in the PCAOB's May 2016 repropoed standard. The ASB considered the requirements in the PCAOB repropoal in the development of the proposed SASs and related amendments. Although certain changes were made to the proposed SASs and amendments in view of the PCAOB reporting model, the ASB's primary focus was on convergence with the ISAs, as explained in the Convergence section above.

For all elements of the new auditor's report other than CAM, the effective date for the new requirements is for audits for fiscal years ending on or after December 15, 2017. The effective date for CAM is for fiscal years ending on or after June 30, 2019 for audits of large accelerated filers, and for fiscal years ending on or after December 5, 2020 for audits of all other companies to which the new PCAOB standard applies.

Effect on Extant AU-C sections 800, 805 and 810

The ASB recognizes the need to consider the potential effect of this exposure draft on extant AU-C sections 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*, and AU-C section 810, *Engagements to Report on Summary Financial Statements* (the 800 Series). The ASB concluded that the 800 series should be addressed after feedback is received on the proposed SASs in this exposure draft. The ASB intends to propose any necessary changes to the 800 series through a separate exposure draft, with the intent to align the effective dates of all the reporting standards to the extent practicable. Respondents are welcome to raise initial views on potential necessary amendments to the 800 series arising from this exposure draft to assist informing the ASB's deliberations.

Effective Date

The proposed SASs and related proposed amendments would be effective for audits of financial statements for periods ending on or after December 15, 2018.

Changes From Existing Standards

The following summarizes what the ASB believes would be the most significant changes to existing standards if the proposed standards were issued. Unless otherwise indicated, paragraph references below are to the relevant requirements in the respective proposed SASs, which should be read together with the related application material.

The supplementary materials accompanying this exposure draft include documents that provide a detailed comparison of the proposed SASs to the corresponding ISAs and extant AU-C sections. These documents may be helpful for respondents in further understanding the changes being proposed.

Proposed SAS, Forming an Opinion and Reporting on Financial Statements (AU-C section 700)

The proposed SAS is intended to converge with ISA 700 (Revised) and would change the form and content for all auditor's reports issued for audits of non-issuers. These changes would be consistent with the changes to the auditor's report resulting from the IAASB's new and revised ISAs, and would be consistent with the new PCAOB auditor reporting model with respect to the positioning of the opinion and the basis for opinion sections.

The following summarizes what the ASB believes would be the most significant changes resulting from the proposed SAS compared to extant AU-C section 700:

- Requires the "Opinion" section to be presented first in the auditor's report, followed by the "Basis for Opinion" section, unless law or regulation prescribe otherwise (paragraphs 22-26)
- Requires the "Basis for Opinion" section of the auditor's report to include an affirmative statement about the auditor's independence in accordance with relevant ethical requirements relating to the audit, and fulfillment of the auditor's other ethical responsibilities in accordance with these requirements (paragraph 26(c))
- Requires the auditor to report in accordance with AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (see further discussion in the "Proposed Amendments" section) (paragraph 27)
- Communication of KAM would not be required for audits of non-issuers but, if done voluntarily, the auditor would be required to do so in accordance with proposed SAS, *Communicating Key Audit Matters in the Independent Auditor's Report* (paragraph 28)
- Requires the auditor to report in accordance with proposed SAS, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports* (see further discussion in the "Other Projects Relating to Auditor Reporting" section) (paragraph 29)
- Expands the description of the responsibilities of management for the preparation and fair presentation of the financial statements, and includes a requirement to identify those responsible for the oversight of the financial reporting process, when those responsible for

such oversight differ from those responsible for the preparation of the financial statements (paragraphs 30-33)

- Expands the description of the responsibilities of the auditor and key features of an audit (paragraphs 34-37)

Proposed SAS, Communicating Key Audit Matters in the Auditor’s Report (proposed new AU-C section 701)

As discussed above, proposed SAS *Forming an Opinion and Reporting on Financial Statements*, would not require the communication of key audit matters for audits of non-issuers but, if done voluntarily, the auditor would be required to do so in accordance with proposed SAS, *Communicating Key Audit Matters in the Independent Auditor’s Report*.

The ASB discussed ways of providing guidance for auditors in those circumstances when KAM are communicated in the auditor’s report, and concluded that a separate standard similar to ISA 701 would be most appropriate. Accordingly, proposed SAS, *Communicating Key Audit Matters in the Independent Auditor’s Report*, converges closely with ISA 701.

Proposed SAS, Modifications to the Opinion in the Independent Auditor’s Report (AU-C section 705)

The proposed SAS, *Modifications to the Opinion in the Independent Auditor’s Report*, is intended to converge with ISA 705 (Revised). The principal changes to extant AU-C section 705 relate to the form and content of the auditor’s report when the opinion is modified consistent with the requirements in proposed SAS, *Forming an Opinion and Reporting on Financial Statements*. See paragraphs 17-30 of Proposed SAS, *Modifications to the Opinion in the Independent Auditor’s Report* and related application material. The supplementary materials accompanying this exposure draft illustrate detailed changes made to extant AU-C section 705.

Proposed SAS, Emphasis-of-Matter and Other-Matter Paragraphs in the Independent Auditor’s Report (AU-C section 706)

The proposed SAS, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor’s Report*, is intended to converge with ISA 706 (Revised). The principal changes to extant AU-C section 706 relate to clarifying the relationship between emphasis-of-matter paragraphs and the communication of key audit matters in the auditor’s report. When proposed SAS, *Communicating Key Audit Matters in the Auditor’s Report* applies, the use of an emphasis-of-matter paragraph is not a substitute for a description of individual key audit matters (see paragraphs 8 and A1). Proposed SAS, *Emphasis-of-Matter and Other-Matter Paragraphs in the Independent Auditor’s Report*, also would require the auditor use an appropriate heading for an emphasis-of-matter paragraph that includes the term “Emphasis of Matter” (paragraph 9). The auditor would be able to add further context to the heading to further describe the nature of the matter (for example, “Emphasis of Matter – Subsequent Event”).

Proposed SAS, Communications with Those Charged with Governance (AU-C section 260)

The most significant change to extant AU-C section 260 would be a requirement for the auditor to communicate with those charged with governance about the significant risks identified by the auditor (paragraph 11). This would be done as part of the required communication of an overview of the planned scope and timing of the audit. The IAASB made this change to ISA 260 (Revised) to be consistent with a similar requirement in PCAOB AS 1301, *Communications with Audit Committees*, and to align with the considerations for the auditor in determining KAM in accordance with ISA 701. IAASB stakeholders noted that auditors in most cases were already communicating with those charged with governance about significant risks identified.

The proposed SAS also would add a requirement for the auditor to communicate with those charged with governance about circumstances that affect the form and content of the auditor's report, if any (paragraph 12d). This change is consistent with paragraph 10f of AU-C section 210, *Terms of Engagement*, which requires the documented agreed-upon terms of the audit engagement to include a reference to the expected form and content of any reports to be issued by the auditor. The requirement in the proposed SAS would address circumstances such as a modified opinion, inclusion of an emphasis-of-matter or other-matter paragraph, or the communication of KAM in the auditor's report.

The ASB does not believe these proposed changes would significantly affect current practice.

Proposed Amendments to Existing Standards

AU-C Section 570, Going Concern

The proposed amendments to AU-C section 570 modify the requirements relating to auditor reporting on going concern to be consistent with the corresponding requirements in ISA 570 (Revised). When SAS No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, was issued in February 2017, it was contemplated that these reporting requirements would be amended in connection with the ASB's auditor reporting project. The underlying auditor performance requirements relating to going concern are not changing.

If, after considering identified conditions or events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the auditor would include a separate section in the auditor's report under the heading "Substantial Doubt About the Entity's Ability to Continue as a Going Concern" instead of an emphasis-of-matter paragraph. The content of this separate section would be similar to that included in the emphasis-of-matter paragraph. See paragraph 24 in the proposed amendments to AU-C section 570.

Illustrations of auditor's reports relating to going concern also have been included that reflect these amended reporting requirements.

AU-C Section 210, Terms of Engagement

The proposed amendments to AU-C section 210 modify the application material relating to the form and content of the engagement letter (paragraph A24) and the example audit engagement letter

(paragraph A44) to be consistent with the changes to the elements of the auditor's report in proposed SAS, *Forming an Opinion and Reporting on Financial Statements* described in the Changes From Existing Standards section.

A new application material paragraph (A25) is being added to provide guidance when the auditor and management (and, as applicable, those charged with governance) have agreed that the auditor will communicate key audit matters in the auditor's report.

Certain other amendments are proposed to the application material in AU-C section 210 relating to proposed SAS, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*, and for changes resulting from convergence with the IAASB's Disclosures project.

Issue(s) for Consideration

In drafting the proposed standards, the ASB identified the following issues for which feedback is specifically requested:

Issue 1—Addressee in the Auditor's Report

Paragraph .21 of proposed SAS, *Forming an Opinion and Reporting on Financial Statements*, requires the auditor's report to be addressed, as appropriate, based on the circumstances of the engagement. This is essentially identical to the requirement in extant AU-C section 700, and would not be expected to change current practice.

The ASB considered whether the proposed SAS should require the city and state of the addressee to be included in the auditor's report, or to include application material that would discuss including such information. Certain members of the ASB believed that providing information about where the client is located would serve to provide a nexus for the jurisdiction of the audit, which may be helpful in limiting multi-state disciplinary actions and therefore would be in the public interest.

While acknowledging that including the city and state of the addressee might be helpful information in certain situations, the ASB decided against requiring it in the auditor's report. The ASB noted that there may be practical difficulties for an auditor in determining the appropriate location to include in the auditor's report (for example, when the corporate office is in a different location than the office at which the principal books and records are maintained).

Respondents are asked to provide their views on whether they believe including the city and state of the addressee in the auditor's report should be required.

Issue 2—Timing of Communications with Those Charged with Governance

Paragraph .18 of extant AU-C section 260 requires the auditor to communicate with those charged with governance on a timely basis. The application material indicates that the appropriate timing for communications will vary with the circumstances of the matter and the action expected to be taken by those charged with governance. Proposed SAS, *The Auditor's Communication With Those Charged With Governance*, retains this flexibility regarding the timing of communications (see paragraph .18

of the proposed SAS). This also is consistent with the corresponding requirement in ISA 260 (Revised).

The ASB considered whether there should be a more specific requirement for the timing of the communication of certain matters. For example, PCAOB AS 1301: Communications with Audit Committees, states that all audit committee communications required by that standard should be made in a timely manner and prior to the issuance of the auditor's report, while also stating that the appropriate timing of a particular communication to the audit committee depends on factors such as the significance of the matters to be communicated and corrective or follow-up action needed, unless other timing requirements are specified by PCAOB rules or standards or the securities laws.

The ASB concluded that retaining the flexibility in the timing of communications would be appropriate given the variety of circumstances that may be encountered by auditors of non-issuers.

Respondents are asked to provide their views on whether the requirement in the proposed SAS should be more specific for the timing of the communication with those charged with governance about certain matters.

Issue 3—Communication of Key Audit Matters for Audits Conducted in Accordance With the Standards of the PCAOB and GAAS When the Audit Is Not Within the Jurisdiction of the PCAOB

[Placeholder for a possible discussion regarding certain non-issuers that may be more likely to want to communicate KAM (e.g., entities planning to go public for which audits may be conducted in accordance with both PCAOB auditing standards and GAAS).

Guide for Respondents

Respondents are asked to provide comments on Issues 1-3 as well as the content of the proposed SASs, including the illustrative reports. Respondents are asked to focus in particular on the proposed changes to AU-C sections as described in the Changes from Existing Standards section above.

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make specific suggestions for any proposed changes. When a respondent agrees with proposals in the exposure draft, it will be helpful for the ASB to be made aware of this view, as well.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available on the AICPA's website after November __, 2017, until a final standard is issued. Responses should be sent to Sherry Hazel at Sherry.Hazel@aicpa-cima.com and received by November __, 2017.

Supplement to the Exposure Draft

To assist respondents in identifying changes and in responding to this request to comment on the

proposed SAS, the Audit and Attest Standards staff has prepared a series of documents that provide a detailed comparison of the proposed SASs to the corresponding ISAs and extant AU-C sections. These documents are structured in four columns as follows:

- ISA xxx (Revised), *title*
- The requirements and application material of the proposed SAS, marked to show differences in language between ISA xxx and the proposed SAS
- The requirements and application material of the proposed SAS, marked to show differences in language between AU-C section xxx, *title* and the proposed SAS.
- Comments

This staff-prepared supplementary material is available on the AICPA Web site at [*insert link*]. It is for informational purposes only and does not form part of the exposure draft; however, it may be useful for respondents in formulating comments.

Comment Period

The comment period for this exposure draft ends on November __, 2017.

Auditing Standards Board

(2016–2017)

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