

# BE PREPARED FOR THE NEW AUDITOR REPORTING STANDARDS

By Steve Grice, Ph.D., CPA, and Amanda N. Paul, CPA

**CURRICULUM:** Accounting and Auditing

**LEVEL:** Basic

**DESIGNED FOR:** Auditors and Auditing Practitioners

**OBJECTIVES:** To highlight some of the significant changes to the auditor's reporting requirements to help practitioners prepare for implementation of Statement on Auditing Standards No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*

**KEY TOPICS:** Re-ordering of the auditor's report sections, terminology and content changes, key audit matters, types of modified opinions, and going concern guidance

**PREREQUISITES:** None

**ADVANCED PREPARATION:** None

In May 2019, the Auditing Standards Board (ASB) ushered in new auditor reporting standards with the issuance of Statement on Auditing Standards No. 134 titled, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements* (SAS 134). The ASB's objective with this new guidance is to converge the U.S. reporting standards with those issued by the International Auditing and Assurance Standards Board (IAASB).

SAS 134 supersedes AU-C Sections 700 titled, *Forming an Opinion and Reporting on Financial Statements*, 705 titled, *Modifications to the Opinion in the Independent Auditor's Report*, and 706 titled, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*. (Note: These superseded sections are retained in the Auditing Standards Codification and are identified as AU-C Sections 700A, 705A and 706A).

In addition, the new guidance introduces reporting requirements related to key audit matters (KAM) for private companies in AU-C Section 701 titled, *Communicating Key Audit Matters in the Independent Auditor's Report*. The provisions of SAS 134 are effective for audits of financial statements for periods ending on or after December 15, 2020. The ASB prohibits early application. The purpose of this article is to highlight some of the significant changes to the auditor's reporting requirements to help practitioners prepare for the implementation.

## Report Sections Re-Ordered

Though the information in the audit report remains mostly unchanged, one of the more noticeable requirements in the new guidance is the re-ordering of the auditor's report sections. Exhibit

**Exhibit 1: Pre- and Post-SAS 134 Audit Report Sections**

Order	Pre-SAS 134 Sections	Post-SAS 134 Sections
1st	Introductory Paragraph	Opinion
2nd	Management's Responsibility for the Financial Statements	Basis for Opinion
3rd	Auditor's Responsibility	Responsibilities of Management for the Financial Statements
4th	Opinion	Auditor's Responsibilities for the Audit of the Financial Statements

1 compares the basic audit report sections in the pre-SAS 134 guidance to those in the post-SAS 134 guidance.

The illustrative auditor's reports shown in Exhibits 2 and 3 are prepared using the pre- and post-SAS 134 guidance to demonstrate the changes in the standards. A comparison of these reports highlights the re-ordered sections of the auditor's report required by the new auditor reporting standards.

The most significant change relates to the movement of the auditor's "Opinion" section from the last section to the first section in the report. In addition, the reporting standards now require the addition of a "Basis of Opinion" section following the "Opinion" section. The illustrative auditor's reports in the exhibits are based on the audit of comparative financial statements prepared in accordance with accounting principles generally accepted in the United States of America. In these illustrations, the auditor has not been engaged to communicate KAM (which will be discussed later).

### Terminology and Content Changes

Practitioners should be aware of changes in the terminology and content within each section of the auditor's report. Though the information presented in the pre- and post-SAS 134 reports is similar, the placement of that information across the report sections is changed. The "Opinion" section now includes the information that was previously in the "Introductory" paragraph of the pre-SAS 134 report. The "Auditor's Responsibility" section of the pre-SAS 134 report includes (1) a statement that the audit was conducted in accordance with auditing standards generally accepted in the United States of America and (2) a statement about whether the auditor believes that the audit evidence the auditor obtained is sufficient and appropriate to provide a basis for the auditor's opinion. These statements are included in the

"Basis of Opinion" section of the post-SAS 134 report.

The "Management's Responsibility for the Financial Statements" header is changed to "Responsibilities of Management for the Financial Statements" as required by paragraph .31 of AU-C Section 700. In addition, the "Responsibilities of Management for the Financial Statements" section in the post-SAS 134 reports includes a statement related to management's requirement to perform a going concern evaluation. The pre-SAS 134 report did not include a statement related to management's going concern evaluation.

Also, the "Auditor's Responsibility" header is changed to "Auditor's Responsibilities for the Audit of the Financial Statements" as required by paragraph .34 of AU-C Section 700. Practitioners should note the expanded wording in this section and the required listing of the auditor's requirements in a financial statement audit. For example, auditors are now required to include a statement related to the required communications with those charged with governance on certain matters identified during the audit.

To ensure compliance with the new auditor's report terminology and section content, auditors should ensure their report templates are updated for the changes ushered in by SAS 134.

### Key Audit Matters

Paragraph .07 of AU-C Section 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." AU-C Section 260, titled *The Auditor's Communication with Those Charged with Governance*, identifies the following matters that should be communicated with those charged with governance and, thus, are potential KAM:

- The auditor's responsibilities with regard to the financial statement audit.
- Planned scope and timing of the audit.
- Significant findings or issues from the audit.
- Uncorrected misstatements.
- Material, corrected misstatements that were brought to the attention of management as a result of audit procedures.

Exhibit 2: Pre-SAS 134 Auditor Report

**Independent Auditor's Report**

**President  
Alpha Company  
Pike, Alabama**

We have audited the accompanying consolidated financial statements of Alpha Company, which comprise the balance sheets as of December 31, 2018 and 2019, and the related statements of income, changes in stockholders' equity and cash flows for the years then ended, and the related notes to the financial statements.

**Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America. This includes 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.

**Auditor's Responsibility**

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used, and the reasonableness of, significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Alpha Company as of December 31, 2018 and 2019, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*Omega, CPAs*

Troy, Alabama  
January 15, 2020



**Exhibit 3: Post-SAS 134 Auditor Report****Independent Auditor's Report**

**President  
Alpha Company  
Pike, Alabama**

**Opinion**

We have audited the financial statements of Alpha Company, which comprise the balance sheets as of December 31, 2020 and 2019, and the related statements of income, changes in stockholders' equity and cash flows for the years 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 Alpha Company as of December 31, 2020 and 2019, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

**Basis for Opinion**

We conducted our audits 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 Alpha Company and to meet our other ethical responsibilities in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

*(Insert "Key Audit Matters" section here when engaged to communicate KAM)*

**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 Alpha Company's ability to continue as a going concern within one year from the date the financial statements are issued.

**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 resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations or the override of internal control. Misstatements are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users made on the basis of these 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 to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Alpha Company's internal control. Accordingly, no such opinion is expressed.
- Evaluate the 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 Alpha 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.

*Omega, CPAs*  
Troy, Alabama  
January 15, 2021

- Significant findings or issues, if any, arising from the audit that were discussed, or the subject of correspondence, with management.
- The auditor's views about significant matters that were the subject of management's consultations with other accountants on accounting or auditing matters when the auditor is aware that such consultation has occurred.
- Written representations the auditor is requesting.

Prior to the issuance of SAS 134, there was no reporting guidance related to the communication of KAM for private companies. Pursuant to the new reporting guidance in AU-C Section 701, auditors are only required to communicate KAM in the audit report when they are engaged to do so.

#### Exhibit 4: KAM Report Section

##### *Key Audit Matters*

Key audit matters are those matters that were communicated with those charged with governance and, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

**Hedge Accounting:** The Company reports net derivative financial assets at fair value of \$100,000 and net derivative financial liabilities at fair value of \$50,000 as of December 31, 2020. Derivative financial instruments are used to manage and hedge commodity price risks, foreign currency exchange risks and interest rate risks. These instruments are typically designated in a fair value or cash flow hedge relationship. Financial instruments that are not designated in a hedging relationship, and where no hedge accounting is applied, are measured at fair value. The fair value of the derivative financial instruments is based on quoted prices in active markets or on valuation models using observable input data. We focused on this because of the number of contracts, their measurement and the complexity related to hedge accounting.

We performed the following audit procedures related to this matter:

- Obtained an understanding of the risk management policies and tested key controls for the use, the recognition and the measurement of derivative financial instruments.
- Reconciled derivative financial instruments data to third party confirmations.
- Compared input data used in the valuation models to independent sources and external market data.
- Compared valuation of derivative financial instruments with market data and with results from alternative, independent valuation models.
- Tested the applicability and accuracy of hedge accounting.
- Considered the appropriateness of disclosures in relation to financial risk management, derivative financial instruments and hedge accounting.

When the auditor is engaged to communicate KAM, the auditor's report should include a "Key Audit Matters" section. The exhibit in paragraph .A81 of AU-C 700 places the "Key Audit Matters" section immediately following the "Basis for Opinion" section. Paragraph .A31 of AU-C Section 700 states that placing the "Key Audit Matters" section in close proximity to the "Opinion" and "Basis of Opinion" sections may give prominence to the information.

In general, the guidance stipulates that the description of the KAM should address why the matter was considered significant to the audit, as well as how the matter was addressed in the audit. Exhibit 4 provides an example of the "Key Audit Matter" section in the auditor's report.

When the auditor determines that there are no KAM to communicate, paragraph .15 in AU-C Section 701 indicates that the auditor should include a statement to this effect in the "Key Audit Matters" section. In some instances, the KAM may give rise to a qualified opinion. In these instances, paragraph .14 in AU-C Section 701 states that the auditor should not describe these KAM in the "Key Audit Matters" section, but rather, include a reference to the "Basis for Qualified Opinion" section.

In addition, there may be engagements where the auditor's conclusion is that there is substantial doubt about the entity's ability to continue as a going concern. The guidance indicates that the auditor should not describe the matters associated with the going concern issue in the "Key Audit Matters" section, but rather, include a reference to the "Substantial Doubt About the Entity's Ability to Continue as a Going Concern" section. It should be noted that paragraph .30 in AU-C Section 705 indicates that the auditor is prohibited from including a KAM section in the report when the auditor issues an adverse opinion or disclaims an opinion.

#### Modified Opinions

The provisions of SAS 134 did not change the types of modified opinions. The three types of modified opinions continue to be (1) qualified opinion, (2) adverse opinion and (3) disclaimer of opinion. However, practitioners should be aware of the modifications to both the "Opinion" and "Basis of Opinion" section headings when issuing a modified opinion. Exhibit 5 illustrates the change in section headings for the auditor's report containing a modified opinion.

Importantly, there were no significant changes to the guidance related to when a modified opinion is appropriate. This determination continues to focus on

## Exhibit 5: Section Headings for Modified Opinions

Opinion Type	“Opinion” Section Heading	“Basis of Opinion” Section Heading
Unmodified	“Opinion”	“Basis of Opinion”
Qualified	“Qualified Opinion”	“Basis for Qualified Opinion”
Adverse	“Adverse Opinion”	“Basis of Adverse Opinion”
Disclaimer	“Disclaimer of Opinion”	“Basis for Disclaimer of Opinion”

## Going Concern Guidance

SAS 134 provides additional guidance related to reporting when auditors encounter going concern issues in the engagement. Prior to the issuance of SAS 134, AU-C Section 570, titled *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going*

*Concern*, required auditors to include an EOM paragraph in the report when there was substantial doubt about the entity’s ability to continue as a going concern.

the materiality and the pervasiveness of a departure from the applicable financial reporting framework (e.g., GAAP) or a scope limitation. For example, the auditor should express a qualified opinion when a GAAP departure is deemed to be material, but not pervasive, to the financial statements.

The SAS 134 amendments to AU-C Section 570 eliminated the requirement to use an EOM paragraph for going concern reporting. Specifically, paragraph .24 of AU-C Section 570 was amended to state that a separate section should be added to the auditor’s report with the heading “Substantial Doubt About the Entity’s Ability to Continue as a Going Concern” when the auditor concludes that there is substantial doubt about the entity’s ability to continue as a going concern. However, paragraph .A2 of AU-C Section 706 indicates that the auditor may elect to use an EOM paragraph when the substantial doubt was alleviated by management’s plan and the financial statement disclosures are adequate.

## Emphasis-of-Matter and Other-Matter Paragraph

Prior to SAS 134, the guidance specified the placement of an emphasis-of-matter (EOM) and an other-matter (OM) paragraph within the auditor’s report. For example, the prior guidance stipulated that the EOM should immediately follow the opinion paragraph in the report. The new auditor reporting standards in SAS 134 do not stipulate the placement of the EOM or OM paragraph in the auditor’s report. Instead, paragraph .A14 of AU-C 706 indicates that the placement of an EOM or OM paragraph depends on the nature of the information being communicated and the auditor’s judgment of the significance of the information to the financial statement users.

## Preparing for the New Standards

It is imperative that practitioners begin to prepare for the significant changes in the new auditor reporting standards. The enhanced auditor’s report, KAM communication requirements and other amendments should be applied to calendar year-end December 31, 2020 audit engagements. Hopefully, the highlights covered in this article provide practitioners with helpful information as they prepare to implement the new auditor reporting standards.

The guidance also identifies situations in which the use of an EOM paragraph is not acceptable. Paragraph .08 of AU-C Section 706 makes clear that the use of an EOM paragraph is not a substitute for disclosing matters that would otherwise require the auditor’s report to be modified. That is, the auditor should follow the guidance in AU-C Section 705 when the matter gives rise to a modified opinion.

Also, Paragraph .A1 of AU-C Section 706 states that an EOM paragraph should not be used as a substitute to provide the description of KAM. That is, the KAM should be described in the “Key Audit Matters” section of the auditor’s report, not in an EOM paragraph.

## ABOUT THE AUTHORS:

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## CPE ARTICLE: BE PREPARED FOR THE NEW AUDITOR REPORTING STANDARDS

By Steve Grice, Ph.D., CPA, and Amanda Paul, CPA

Today's CPA offers the self-study exam for readers to earn one hour of continuing professional education credit. The questions are based on technical information from the preceding article. If you score 70 or better, you will receive a certificate verifying you have earned one hour of CPE credit – granted as of the date the test arrived in the TXCPA office – in accordance with the rules of the Texas State Board of Public Accountancy (TSBPA). If you score below 70, you will receive a letter with your grade.

- The new auditor reporting standards require that the "Opinion" section of the auditor's report be presented as the:**
  - Fourth section
  - Third section
  - Second section
  - First section
- According to SAS No. 134, which section is required to follow the "Opinion" section in the new auditor's report?**
  - Key Audit Matters section
  - Basis of Opinion section
  - Responsibilities of Management for the Financial Statements
  - Auditor's Responsibilities for the Audit of the Financial Statements
- Pursuant to the new reporting guidance in AU-C Section 701, auditors are required to communicate key audit matters (KAM) in the auditor's report:**
  - For all audit engagements
  - When three or more KAM exist
  - When they are engaged to do so
  - For audit engagements involving regulated industries only
- When engaged to communicate KAM, the auditor should:**
  - Communicate the KAM in a footnote only
  - Include a separate section in the auditor's report to communicate the KAM
  - Communicate the KAM within the "Basis of Opinion" section of the auditor's report
  - Never include the matters communicated to those charged with governance as KAM
- The new auditor reporting standards in SAS 134 are effective for audits of financial statements for periods ending on or after:**
  - December 15, 2020
  - December 15, 2021
  - September 15, 2020
  - September 15, 2021
- Which of the following is a true statement?**
  - The provisions of SAS No. 134 do not change the order of the sections in the auditor's report
  - The new auditor reporting standards prohibit the auditor from communicating key audit matters in the auditor's report
  - The new auditor reporting standards in SAS No. 134 do not apply to audits of nonpublic entities
  - The provisions of SAS No. 134 do not change the types of modified opinions
- When the auditor determines that there are no KAM to communicate, the auditor's report should:**
  - Include a statement to this effect in the "Key Audit Matters" section
  - Include a statement to this effect in the "Basis of Opinion" section
  - Include a statement to this effect in the "Opinion" section
  - Not include a statement to this effect in the "Key Audit Matters" section
- The types of modified opinions pursuant to the provisions of SAS 134 are:**
  - Qualified opinion and adverse opinion only
  - Qualified opinion, adverse opinion and disclaimer of opinion
  - Qualified opinion only
  - Qualified opinion and disclaimer of opinion only
- Which of the following statements is true?**
  - Prior to SAS 134, the guidance did not specify the placement of an emphasis-of-matter and other-matter paragraph within the auditor's report
  - The new auditor reporting guidance eliminated the use of an other-matter paragraph
  - The new auditor reporting standards in SAS 134 do not stipulate the placement of the emphasis-of-matter paragraph or the other-matter paragraph in the auditor's report
  - The new auditor reporting guidance eliminated the use of an emphasis-of-matter paragraph
- The SAS 134 guidance related to going concern reporting:**
  - Never requires a separate section to be added to the auditor's report related to the going concern issue
  - Requires the auditor to use an other-matter paragraph when reporting a going concern issue
  - Eliminated the requirement to use an emphasis-of-matter paragraph for going concern reporting
  - Eliminated the auditor's requirement to consider going concern issues in an audit

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