

Meeting: IAASB
Meeting Location: Orlando
Meeting Date: December 6-10, 2010

Agenda Item

11

IAASB Staff “Frequently Asked Question” – ISA 600

Objective of Agenda Item

1. To obtain the IAASB’s view on a proposed staff-prepared “Frequently Asked Question” (FAQ) as an immediate-term response to an issue raised on ISA 600¹.

Proposed Staff-Prepared FAQ

2. The following is the proposed staff-prepared FAQ:

Question: ISA 600 states the following: “If the group engagement team plans to request a component auditor to perform work on the financial information of a component, the group engagement team shall obtain an understanding of...whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent.” (ISA 600.19(a))

Does this requirement mean that the component auditor in all cases is subjected to the same specific independence rules applicable to the group engagement team, thereby extending or otherwise overriding the independence requirements of the International Ethics Standards Board for Accountants’ (IESBA) *Code of Ethics for Professional Accountants*, or other ethical requirements to which the group engagement team are subject, in a group situation?

Response: No. The remit of the International Auditing and Assurance Standards Board (IAASB) does not include establishing specific independence or other ethical requirements for auditors or component auditors. This is the responsibility of the IESBA and national bodies with similar responsibility. Therefore, the relevant ethical requirements and how they apply in a group audit situation is determined by those bodies.

3. The following provides background to the issue and discusses the basis for use of a FAQ in response.

Issue

¹ ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*

4. It has been drawn to the Steering Committee's attention that a question has been raised by some members of the IESBA and some firms as to the meaning of the phrase "ethical requirements that are relevant to the group audit" in ISA 600. There are two possible interpretations of the meaning of the phrase, with reference in particular to independence.

INTERPRETATION 1

5. One interpretation is that the ethical requirements relevant to the group audit are those ethical requirements (and therefore independence requirements) to which the group auditor is subject. This would mean that, in the case of a group that is a listed entity, the more restrictive listed entity independence requirements are relevant to all of the component auditors within the group audit. It would also mean that each component auditor in the group is required to be independent of all of the related entities of their audit client, including the parent (and possibly all related entities of the group) in accordance with the requirements that apply to the parent.
6. Such an interpretation would extend the application of the IESBA *Code of Ethics for Professional Accountants* (the Code) and could be seen as overriding the Code.

INTERPRETATION 2

7. Another interpretation is that the component auditors may also need to comply with the independence "regime" that is applicable to the group auditor.
8. For example, the group auditor may be auditing an SEC registrant. In such a case, if the group auditor is performing an ISA audit, the group auditor would comply with the independence requirements in the Code and also with SEC requirements (the "regime"). The SEC requirements extend to all "affiliates" of the SEC audit client. Accordingly, a component auditor of a controlled subsidiary would be required to comply not only with the independence requirements in the Code as they relate to non-listed entities but also the SEC requirements. This would require the component auditor to be independent of the parent in accordance with SEC requirements.
9. If, however, the group auditor is not auditing an SEC registrant, or a registrant with similar jurisdictional requirements, there is no additional "regime" and the relevant ethical requirements would be those in the Code. If a component auditor is performing audit procedures at the subsidiary level (an unlisted audit client), the component auditor is not required to be independent of the parent (listed) entity, unless, as provided by the Code in paragraph 290.106, the subsidiary is material to the parent.
10. Such an interpretation would not extend the application of the Code.

PROVISIONS OF ISA 600 AND THE IESBA CODE

11. The relevant provisions of ISA 600 are as follows [*emphasis added*]:

Definitions

Component auditor – An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit. (ISA 600.09(b))

Relevant ethical requirements – Ethical requirements to which the engagement team and the engagement quality control reviewer are subject, which ordinarily comprise Parts A and B and the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements together with national requirements that are more restrictive. (ISA 220.07(n))

Understanding the Component Auditor

If the group engagement team plans to request a component auditor to perform work on the financial information of a component, the group engagement team shall obtain an understanding of...whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent." (ISA 600.19(a))

If a component auditor does not meet the independence requirements that are relevant to the group audit...the group engagement team shall obtain sufficient audit evidence relating to the financial information of the component without requesting that component auditor to perform work on the financial information of that component. (ISA 600.20)

Related Application Material

When performing work on the financial information of a component for a group audit, the component auditor is subject to ethical requirements that are relevant to the group audit. Such requirements may be different or in addition to those applying to the component auditor when performing a statutory audit in the component auditor's jurisdiction. The group engagement team therefore obtains an understanding whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit, sufficient to fulfill the component auditor's responsibilities in the group audit. (ISA 600.A37)

Example Component Auditor Confirmation (ISA 600.Appendix 4)

In connection with the work that we will perform on the financial information of [name of component], a [describe component, for example, wholly-owned subsidiary, subsidiary, joint venture, investee accounted for by the equity or cost methods of accounting] of [name of parent], we confirm the following:...

We have an understanding of [indicate relevant ethical requirements] that is sufficient to fulfill our responsibilities in the audit of the group financial statements, and will comply therewith. In particular, and with respect to [name of parent] and the other components in the group, we are independent within the meaning of [indicate relevant ethical requirements] and comply with the application requirements of [refer to rules] promulgated by [name of regulatory agency]....

12. The phrase “ethical requirements that are relevant to the group audit” is not a defined term in the ISAs.

IESBA Code

13. The application of the independence requirements in the Code in a group audit is clear. The entities to which the independence requirements are to be applied differ depending upon whether the entity is, or is not, a listed entity. In addition, the Code contains more stringent independence requirements for auditors of listed entities (for example greater restrictions on the provisions of certain non-assurance services).

14. In summary, the relevant provisions of the Code are as follows:

- The auditor of a listed entity within a group applies the more restrictive independence provisions in the Code to the listed entity audit client and also to all of the related entities (as defined in the Code) of that audit client, as appropriate.
- The auditor of a non-listed entity within the group applies the less restrictive independence requirements in the Code to the non-listed entity audit client and also to any entity over which the client has control, provided that entity is material to the audit client. In addition the firm and the audit team are prohibited from having a direct or material indirect financial interest in a related entity [which could be a listed entity] that controls the audit client. (Paragraph 290.106).

15. Relevant extracts from the Code and some detailed illustrations are provided in the appendix to this paper.

Discussion

16. IAASB Staff is of the view that Interpretation 2 (that is, the component auditor is required to comply with the independence “regime” that is applicable to the group auditor – see paragraphs 7-10 above) is consistent with the intent of the IAASB.

17. This view is supportable on three fronts. Firstly, the remit of the IAASB does not include establishing specific independence (or other ethical) requirements for auditors or component auditors. While the IAASB can indicate that compliance with relevant ethical requirements is required for purposes of conducting an audit in accordance with the ISAs, it is beyond the scope of the ISAs to address matters that are within the purview of the IESBA or national ethical standards.

18. Secondly, in cases where a proposal potentially has effect on the application of the Code, the IAASB has raised the issue with the IESBA. This was not the case in this instance as the IAASB did not intend for ISA 600 to extend or override the Code.

19. Thirdly, a review by staff of relevant IAASB meetings’ audio recordings, agenda material and minutes on this specific ISA 600 provision does not indicate that the IAASB contemplated the establishment of specific independence requirements for component auditors beyond the need for such auditors to comply with the same ethical regime that applies to the group auditor.

20. In this regard, the initial IAASB discussion on the topic was in September 2002. The noted IAASB resolution² was that as the proposed ISA is provided in the international context, other auditors whose work is to be used by the principal auditor should be instructed to conduct their work in accordance with ISAs and the IESBA Code. In particular, the IESBA Code should be applied by the principal auditor and other auditors, where the principal auditor is to use the work of those auditors.
21. Since then there was little or no debate on the issue suggesting a change to the agreed principle. However, subsequent drafting changes had introduced ambiguity as to the Board's intent:
- a. Reference to the IESBA Code was replaced with the general phrase 'relevant ethical requirements,' as part of the Clarity project. However, the intent was not to change the meaning of the original requirement.³
 - b. Appendix 4 was added which introduced the following wording in the example component auditor confirmation: "In particular, and with respect to [name of parent] and the other components in the group, we are independent within the meaning of [indicate relevant ethical requirements]..."

This wording can be read as suggesting that Interpretation 1 applies. However, it also appears to contradict the wording in ISA 600.A37: "The group engagement team therefore obtains an understanding whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit *sufficient to fulfill the component auditor's responsibilities* in the group audit."
 - c. In March 2006, the IAASB minutes and corresponding Re-Exposure Draft of ISA 600 indicate that the requirement should clarify that the other auditor has to comply with those ethical requirements relevant to the group auditor.⁴ However, on listening to the audio recording it seems clear that the intent was with respect to the 'regime' rather than the specific independence requirements applicable to the group auditor. (The reference to "group auditor" was subsequently changed to "group audit" in finalizing the ISA.)

Recommendations

22. The IAASB Steering Committee has considered the above and recommends that staff make available the FAQ as proposed, or along the lines described, in paragraph 2 above.

² Per December 2002 IAASB agenda material.

³ Paragraph 98 of the March 2005 ISA 600 ED stated: "The group auditor's confirmation requirements should include the following: (a) Confirmation whether the other auditor sufficiently understands, and will comply with, the relevant ethical requirements, including independence, *to fulfill the other auditor's responsibilities in the audit of the group financial statements*."

⁴ Paragraph 14 of the March 2006 ISA 600 Re-ED stated: "...the group auditor shall obtain an understanding of ... (b) The other auditor's compliance with those ethical requirements relevant to the *group auditor* and, in particular, their independence and professional competence."

23. The FAQ makes a factual statement, and does not provide a specific interpretation on the issue which would not be appropriate for a non-authoritative FAQ.
24. Clearly, the FAQ can only be considered an interim measure. But it is one that could be done quickly and made available on the IAASB website immediately (within the Clarity Centre). This is an important consideration as firms approach 2010 calendar year audits.
25. Looking forward, some form of standard-setting activity may be appropriate to further clarify the ISA in this respect. Equally, there may be other aspects of ISA 600 for which clarification through amendment to the standard might be helpful. However, a piece-meal approach to standard setting would be undesirable. Accordingly, the Steering Committee recommends that the IAASB approach this and other matters arising in connection with ISA 600 or other ISAs as part of any overall response to implementation issues identified through the Clarity ISAs Implementation Monitoring Project.

Action Requested

The IAASB is asked for its views on use of a staff-prepared FAQ in responding in the immediate term to the question pertaining to ISA 600.

Appendix

Application of the Independence Requirements in the Code in a Group Situation

The IESBA Code states:

“In the case of an audit client that is a listed entity, references to an audit client in this section include related entities of the client (unless otherwise stated). For all other audit clients, references to an audit client in this section include related entities over which the client has direct or indirect control...” [290.27]

The Code defines a related entity as follows:

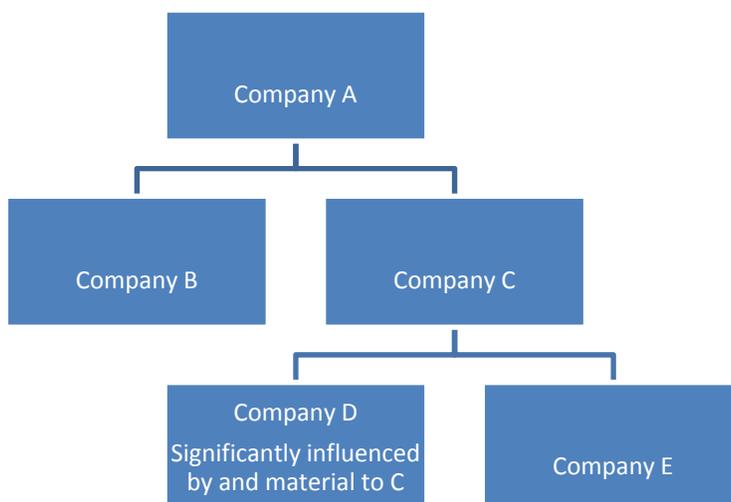
An entity that has any of the following relationships with the client:

- (a) An entity that has direct or indirect control over the client if the client is material to such entity;
- (b) An entity with a direct financial interest in the client if that entity has significant influence over the client and the interest in the client is material to such entity;
- (c) An entity over which the client has direct or indirect control;
- (d) An entity in which the client, or an entity related to the client under (c) above, has a direct financial interest that gives it significant influence over such entity and the interest is material to the client and its related entity in (c); and
- (e) An entity which is under common control with the client (a “sister entity”) if the sister entity and the client are both material to the entity that controls both the client and sister entity.

Under the Code, therefore, if the audit client is a listed entity independence is required by the auditor of that entity from the client and also those in (a)-(e) above. The auditor of the listed entity applies the more stringent independence requirements to the client and to (a)-(e) above.

If the audit client is not a listed entity, independence is required by the auditor of that entity from the client and those in (c) above. The auditor of the unlisted entity applies the less stringent independence requirements to the client and to (c) above. Compliance with paragraph 290.106 of the code is also required.

The application of the code can be illustrated as follows. In all cases, except for D, assume that the relationships are controlling and the controlled entities are material to the entities that control them. In the case of D, assume that C has significant influence over D and D is material to C.



Scenario 1

Company A is a listed entity and it is the only listed entity in the group structure.

The auditor of Company A needs to apply the more stringent listed entity independence provisions in the Code to Company A (its client) and also to Companies B-E (related entities of its client).

The auditor of Company B needs to apply the less stringent non-listed independence provisions in the Code to Company B (its client). Company B is non-listed and does not control, directly or indirectly, and other companies. Similarly the auditors of Companies D and E need to apply the independence provisions in the Code to their clients D and E respectively.

The auditor of Company C needs to apply the less stringent non-listed independence requirements to Company C (its client) and also to Company E, an entity over which its client has control and that entity is material to its client.

The auditors of B, C and E would need to comply with the requirement of para 290.106.

Scenario 2

Company C is listed and it is the only listed entity in the group structure.

The auditor of Company A needs to apply the less stringent non-listed independence provisions in the Code to Company A (its client) and also to Companies B and C, entities over which its client has control and that are material to its client. The auditor of Company A will need to apply the less stringent non-listed independence provisions in the Code to Company E, an entity over which its client has indirect control, if the entity (E) is material to its client (A).

The auditor of Company B needs to apply the less stringent non-listed independence provisions in the Code to Company B (its client). Company B is non-listed and does not control, directly or indirectly, and other companies.

The auditor of Company C needs to apply the more stringent listed entity independence provisions in the Code to Company (its client) and, because Company C, is a listed entity to Companies A, B, D and E, all of which are related entities of its client. The code's provisions would have limited impact for the auditor in relation to Company A, as "not subject to audit".

The auditors of Companies D and E need to apply the less stringent non-listed independence provisions of the Code to their clients, Companies D and E respectively.

The auditors of B, C and E would need to comply with the requirement of para 290.106.