

Discussion–Letterbox Audit Considerations

Background

1. One of the “important themes”¹ noted in the 2013 International Standards on Auditing (ISA) Implementation Monitoring Findings² related to concerns about the applicability, practicality and cost effectiveness of ISA 600³ in certain circumstances. Amongst other concerns⁴, it was noted that there are mixed views on whether ISA 600 applies when the audit report on group financial statements is signed by a partner in a jurisdiction different from where the group’s operations, accounting records and management are located, and hence where the vast majority of the underlying audit work is performed – so called “letterbox audits.”⁵
2. Some audit inspection bodies / regulators have specifically called for the International Auditing and Assurance Standards Board (IAASB) to take steps to address concerns regarding the application of ISA 600 to letterbox audits.
 - In a July 2010 letter to the IAASB, the UK Financial Reporting Council (FRC) expressed its concern around the lack of participation in letterbox audits by the auditor that signs the audit report and thus failure to comply with the principles and specific requirements of ISA 600 and ISA 220.⁶ The FRC noted that it had sent letters in May 2013 to the audit firms that it inspects setting out its views about how the ISAs are to be applied in such circumstances.

In brief, the FRC’s concerns include how firms are interpreting and applying ISA 600 in situations where the letterbox audit is a group audit. The FRC notes that there is a degree of inconsistency in the firms’ interpretations of the ISAs. The largest concern is the extent of involvement in such audits by the group auditor. Inspection findings indicate that the majority of the work is performed by the component auditor, from other network or non-network firms who undertake the audit work in the jurisdiction(s) where the operations and accounting records are based. The involvement of the group auditor may be limited to a review of, and therefore extensive reliance is placed on, the inter-office (clearance) report received from that component auditor. Reliance on the inter-office report alone as the basis for signing the audit report is viewed by audit regulators as insufficient involvement in the audit and would be viewed

¹ A theme is key where there is a body of evidence to suggest that the ISA is not being consistently understood or applied in a manner that achieves the IAASB’s goals in revising it. A theme is important when there is some evidence to suggest that the ISA is not being consistently understood and implemented in a manner that achieves the goals in revising it. The ISA Implementation Monitoring Findings also noted two “key themes” related to ISA 600 regarding: (i) the inconsistency in the degree to which the group auditor becomes involved with the work of the component auditors; and (ii) the inconsistency in the determination of component materiality and the impact on the work effort.

² <https://www.ifac.org/sites/default/files/publications/files/Implementation-Review-of-the-Clarified-ISAs.pdf>

³ ISA 600, *Special Considerations–Audits of Group Financial Statements (Including the Work of Component Auditors)*

⁴ Concern was also expressed about the application of ISA 600 in relation to: (i) the approach to material equity investments; and “fund of funds” audits.

⁵ As defined in Agenda Item 6 footnote 2

⁶ ISA 220, *Quality Control for an Audit of Financial Statements*

as a failure of the group auditor to direct, supervise and review the audit work performed by the component auditor, as required by ISA 600.

- At its meeting in October 2013, the International Forum of Independent Audit Regulators (IFIAR) Standards Coordination Working Group, mainly voiced by the UK representative, encouraged the IAASB to clarify on a timely basis whether ISA 600 applies to letterbox audits.
- At the November 2013 meeting of the European Audit Inspection Group (EAIG), through a presentation led by the Netherlands' inspection body, concerns were expressed about non-compliance with ISA 600 in respect of letterbox audits.
- In May 2014, the FRC published the Audit Quality Inspection Annual Report for 2013/2014 that provides an overview of the audit quality work carried out by its Audit Quality Review team for the year ended March 31, 2014. Although a broader issue relating to group audits in general, one of the key messages in the report was that inspection work undertaken in that period indicated there were issues in respect of the control, supervision, and review of audit procedures performed by other auditors. The report further noted that firms should ensure their respective methodologies and guidance provide for a sufficient level of involvement at all stages of the audit work of the other auditors.

Views on Applicability of ISA 600

3. In the FRC's view, ISA 600 applies to the audit of letterbox companies that are part of a traditional group structure and also to the audit of single entity letterbox companies that have more than one component that produces financial information for inclusion in the group financial statements; the usual situation being a company with divisions or branches. If there is only one component, the FRC believes that ISA 600 does not apply; however, in that situation the auditor would still be required to comply with the requirements of all other applicable ISAs, including in particular, ISA 220.
4. The FRC letter notes a number of firms have issued internal guidance that promotes an approach whereby the auditor who signs the audit report relies on clearance reports from other network or non-network firms who undertake the audit work in the jurisdiction where the operations and accounting records are based (without performing any additional procedures) thus effectively dis-applying relevant requirements of the ISAs. In the FRC's view, such guidance has not appropriately reflected the requirements of ISA 220 regarding the responsibility of the engagement partner for the direction, supervision, performance and review of the audit, which apply to both single component and group audits. Further, when used for audits of more than one component, this internal guidance has not appropriately reflected the need for the group engagement team to comply with the requirements of ISA 600 in all such cases.
5. In addition, concern was noted in relation to the involvement of the group engagement team and group engagement partner in the consolidation process in the letterbox situations.
6. Similar to group audits, in the case of an entity that has only a single component (and would therefore not be considered a group under ISA 600), the FRC letter also notes the internal structuring of the audit when overseas network firms were involved did not result in an integrated audit team that was supervised by and reported to the engagement partner. Further, the FRC views terminology such as "signing firm", "performing firm" and "signing partner" that is used in firms' internal guidance to be inconsistent with the requirements of the ISAs.

7. In contrast, the FRC letter also notes that some firms have argued that the ISAs do not envisage the circumstances outlined above and, therefore, need not be applied, and that the guidance issued by their firm fills a 'gap' in the ISAs. In other words, the firms' perspective is that the IAASB did not specifically contemplate application of ISA 600 to letterbox audits; and because such audits are different from typical ISA 600 engagements as envisioned, it is appropriate that they are not considered to be within scope of ISA 600.
8. A non-authoritative publication to be issued by a national standard setter also indicates a view that ISA 600 applies to letterbox audits.
9. Other regulators have also concluded that ISA 600 applies to the audit of letterbox companies that are part of a traditional group structure and also to the audit of letterbox companies that have no head office or corporate operations, but nevertheless have more than one component that produce financial information for inclusion in the group financial statements; the usual situation being a company with divisions or branches. Further, where there is only one component, it was also concluded that ISA 600 does not apply.

Review of the Prior Audit of Group Financial Statements Project

Scope

10. In order to inform the ISA 600 Working Group (the WG), Staff performed a review of the prior project undertaken by the IAASB on the topic of Group Audits, to determine if letterbox audits were specifically considered as part of that project.
11. Documents reviewed as part of this exercise included:
 - (1) IAASB Board Meeting Agendas and Agenda Papers;
 - (2) IAASB Consultative Advisory Group (CAG) Meeting Agendas and Agenda Papers;
 - (3) IAASB Board Meeting Minutes (and related recording where considered necessary);
 - (4) Summary of significant comment letter responses; and
 - (5) Basis for Conclusion Document.⁷

Further, discussions were held with the relevant Task Force (TF) staff assigned to the project.

Findings

12. Discussions with TF Staff indicated that the situation specific to letterbox audits was contemplated as part of the ISA 600 project and that such deliberations are reflected in the final standard (albeit implicitly), notably the paragraphs discussing: scope (letterbox audits are not specifically excluded); definition of a component; and the required involvement of the group auditors in the work of the component auditors.
13. One comment was received in response to the final exposure draft (ED) noting that the standard could be clearer in respect of an entity where the work was largely performed in one jurisdiction, where the books and records were kept, but the audit opinion was signed by an auditor in the "home" (i.e., another / different) jurisdiction.

⁷ http://www.ifac.org/sites/default/files/downloads/ISA_600_Basis_for_Conclusions.pdf

14. In the disposition of this comment, the TF noted, through a non-public TF compilation document, that the auditor in the home jurisdiction is the auditor responsible for the group audit opinion and has to comply with the requirements of ISA 600; in particular, the requirements for procedures to be performed in relation to the component auditor and his work.
15. A further comment was received in response to the final exposure draft (ED) in the context of the appropriateness of the definitions included in ISA 600, and particularly in relation to “direct supervision”. The respondent recommended that the application material of ISA 600 be amended to incorporate a letterbox situation and how the level of involvement of the group auditor can be adapted to these situations.
16. The disposition of this comment was traced, through a non-public document, to the April 2007 Agenda Item 3-A⁸ where, in conjunction with other comments received about definitions, it was noted that the group engagement partner is responsible for the direction supervision and performance of the group engagement team. Further, it noted that the requirements of ISA 220 applied regardless of whether the group engagement team or a component auditor performs the work on the financial information of a component. However no specific reference was made specifically to letterbox audits.
17. Review of the recording of the April 2007 IAASB Board Meeting highlighted a brief discussion as to whether ISA 600 applies to letterbox-type audits in response to a question that was posed by a Board Member to the TF chair. The question was whether the group auditor would be the auditor of the holding company in the situation where a holding company is located one jurisdiction and only held shares in subsidiaries in other jurisdictions where all operations were carried out.
18. The response to this question indicated that ISA 600 (as proposed in the ED) provided that the group engagement partner would be the partner responsible for the audit of the holding company and that he would need to be sufficiently involved with the work of the component auditor in order to obtain sufficient appropriate evidence on which to base his opinion.
19. However, other than the brief discussion highlighted above, within the Board's publically documented record, there is no reference to specific substantive debates around the application of ISA 600 to Letterbox audits, either by reference in issues discussed or as a significant issue addressed in the discussion of the ISA.

Other Relevant Information

20. Other relevant information relating to the WG's considerations about letterbox audits include:
 - ISA 600 does not incorporate explicit guidance dealing specifically with letterbox audits.
 - Paragraph 5 of ISA 600 clarifies the relationship between ISA 220 and ISA 600, noting that ISA 600 assists the group engagement partner in meeting the requirements of ISA 220 where component auditors perform work on the financial information of components, i.e., the application of ISA 600 is “layered on top of” ISA 220
 - Paragraph 2 of ISA 600 also states that ISA 600, adapted as necessary in the circumstances may be useful when the auditor involves other auditor in the audit of financial statements that are not group financial statements. This paragraph includes an example of involving another

⁸ <https://www.ifac.org/sites/default/files/meetings/files/2944.pdf>

auditor to observe an inventory count or inspect physical assets at a remote location. It's not clear, however, whether the intention of this paragraph is that ISA 600 should be applied (adapted as necessary) in all cases when more than one auditor is involved, i.e., regardless of whether the underlying entity is a group or not.

- Paragraph 9 of ISA 600 includes the following definitions:
 - **Group**—*All the components whose financial information is included in the group financial statements. A group always has more than one component.*
 - **Component**—*An entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.*
 - **Group engagement partner**—*The partner or other person in the firm who is responsible for the group audit engagement and its performance, and the for the auditor's report on the group financial statements that is issued on behalf of the firm. Where joint auditors conduct the group audit, the joint engagement partners and their engagement teams collectively constitute the group engagement partner and the group engagement team.*
- Paragraph A4 of ISA 600 further clarifies that it is the structure of the group that defines how components are identified, noting that the group financial reporting structure could give rise to components based on an organizational structure that: includes a parent, subsidiaries, joint ventures or investees accounted for under the cost or equity methods of accounting; or includes a head office and one or more divisions or branches. Alternatively, the group financial reporting structure could give rise to components based on functions; processes; products or services; or geographical location. As such, a component is not necessarily a legal entity and a legal entity is not necessarily a component.
- Based on the WG's review of project and Board documentation on the prior Audit of Group Financial Statements project, and taking into account extant ISA 600:
 - The application of ISA 600 to letterbox audits was not explicitly addressed as part of the Board's deliberations; and
 - The exclusion of letterbox audits from the scope of ISA 600 was not specifically contemplated.

Discussion

Are letterbox audits involving more than one component a group audit, and therefore should ISA 600 apply? If so, is there a need for an IAASB response to address such situations through additional requirements or application guidance, or other non-authoritative material, to specifically address application to letterbox audits?

21. The unique aspect of letterbox structures is that the entity often has no more than a registered office or a correspondence address in its country of registration, with the management and all economic activity based elsewhere, including the exercise of financial control over the group or the company. There is, therefore, often very limited or no oversight of those overseas operations from the country of registration. This can make it difficult for the auditor in the jurisdiction of registration to maintain a dialogue with the entity's management (as management is usually based elsewhere, often out of the local jurisdiction), or gain a proper understanding of the business risks and the risks associated with

the audit. It may, therefore, make it challenging to perform an effective risk assessment, and the extent to which the audit approach can include reliance on internal control to address identified risks of material misstatement may also be limited.

22. The WG has not yet had the opportunity to inquire further about the rationale of the firms for their interpretation of the application of ISA 600 to these situations. Further, it is unclear whether circumstances in letterbox audit situations are such that application of ISA 600, or adjusting the structure of audit engagements, is impractical, and accordingly whether the current firm methodologies and approaches taken represent the reasonable and practical alternatives.
23. Notwithstanding the difficulties noted above, based on a preliminary understanding of the circumstances, the WG's initial view is that a letterbox audit involving more than one component is a group audit, and therefore ISA 600 should apply. However, the WG also acknowledges that it may not be that simple to clarify this in the standards without addressing the practical application issues.

Practical Application Issues

24. The WG had an initial discussion about the practical challenges relating to the application of ISA 600 to letterbox audit situations. Based on such discussions, the WG initially identified the following areas for further exploration where the application of ISA 600 may be challenging, noting that the extent of such challenges may vary based on the size and the structure of the audit firm, and also the jurisdictions involved.
 - Licensing issues—restrictions relating to practicing in a jurisdiction for which an appropriate license is not held. Local law and regulation may preclude unlicensed practitioners from practicing within a jurisdiction or signing audit reports for entities domiciled within that jurisdiction;
 - Access issues and data privacy—work papers may have to remain in the jurisdiction in which the audit work was performed and there may be restrictions on providing access to such work papers or copies thereof to others in different jurisdictions. Technology, risk management rules and jurisdictional law and regulation may complicate sharing of those work papers;
 - Fee structures—robust levels of review and supervision at more remote locations may not be practicable given level of fees involved;
 - Regulatory issues—fragmented regulatory regimes resulting in different interpretations and expectations of auditors and consequently a duplication of audit effort;
 - Language and cultural issues—these may complicate the ability of the engagement partner to effectively fulfil supervision and review duties.

The WG will also explore these practical application issues in more detail and will also consider whether there are other issues highlighted in subsequent discussions with the firms and regulators. The WG will also discuss the approaches that the firms are currently using or developing to address these challenges (in particular to respond to inspection findings in this area).

25. The WG believes further outreach to the firms is an important step that needs to be undertaken in order to fully understand the perspectives on the issues, including gaining a more in-depth understanding of the practical difficulties that are, or may, be encountered if ISA 600 is to be applied.

26. The WG also acknowledges that the challenges highlighted above are not necessarily unique to letterbox audit situations and could more broadly be applicable in most group audit situations. The WG will however, explore if any challenges are exacerbated in letterbox audits.

Proposals for the Way Forward

27. In moving forward on this topic, the Working Group intends to gather more information to:
- Understand the rationale for views that letterbox audits are not required to be audited in accordance with ISA 600; and understand the position of the regulators and others who believe that letterbox audits are within the scope of ISA 600.
 - Determine whether guidance is required in respect of how to address single component letterbox audits, including whether and if so how, the principles of ISA 600 should be applied.
 - Determine the most appropriate method of response to address these issues, including, potentially:
 - A Staff publication clarifying the applicability of ISA 600 to letterbox audits;
 - Updates to ISA 600 specifically in respect of letterbox audits; or
 - Incorporation of letterbox audit issues into the larger ISA 600 project.

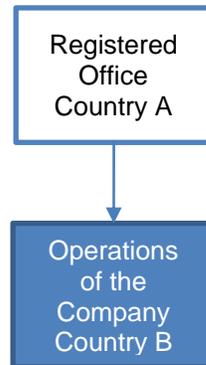
Matters for IAASB Consideration

1. The IAASB is asked whether it agrees with the WG's preliminary view that ISA 600 would apply to letterbox audits in situations where there is more than one component?
2. The IAASB is asked for its views about addressing single component letterbox audits, including whether and if so how, the principles of ISA 600 should be applied.
3. The IAASB is asked whether:
 - It agrees with the practical challenges of applying ISA 600 to letterbox audits identified by the WG on a preliminary basis, and as set out in paragraph 24, and whether there are additional perspectives or views relating to these challenges.
 - There are other practical applications not identified in paragraph 24 that the WG should be considering.
4. The IAASB is asked for its views on the approach to addressing the letterbox issues, including:
 - Whether the issues can be, or should be addressed in isolation, or whether it would be more appropriate to address the issues as part of the larger ISA 600 project?
 - Whether additional guidance is needed to outline and suggest approaches to addressing the practical challenges, and if so do members have suggestions about best to approach the development of this guidance?
 - Is there a short term action that could and should be taken, with the acknowledgement that the underlying issues would continue to be investigated and addressed either separately or as part of the larger ISA 600 project?

Examples of Letterbox Structures

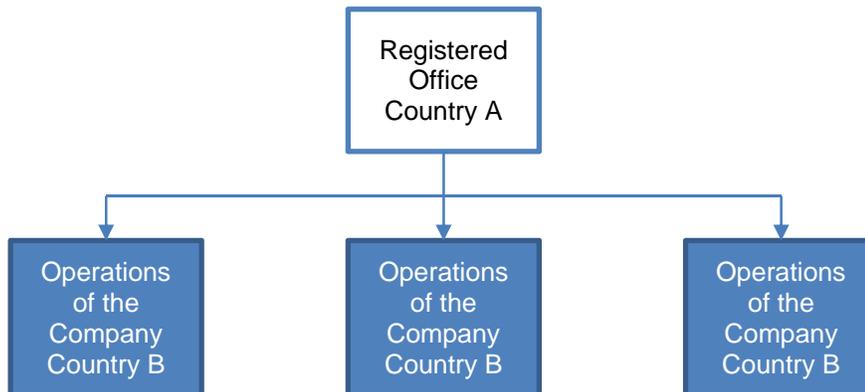
Example 1

The company has no business activity in the jurisdiction in which it is registered. The company has all of its operations in one other jurisdiction that is the sole branch or division of this company.



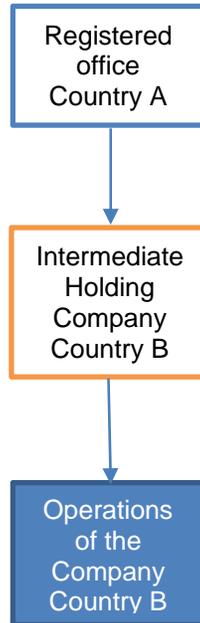
Example 2

The company has no business activity in the jurisdiction in which it is registered. The company has all of its operations in one other jurisdiction where there are 3 branches or divisions of this company.



Example 3

The company has no business activity in the jurisdiction in which it is registered. The company through an intermediate holding company has all of its operations in one other jurisdiction that is the sole branch or division of this company.



Example 4

The company has no business activity in the jurisdiction in which it is registered. The company through an intermediate holding company has all of its operations in one other jurisdiction where there are 3 branches or divisions of this company.

