

## Auditor Reporting—Preliminary Analysis of the European Commission’s (EC) Proposed Article 23<sup>1</sup>

### For Reference Purposes Only

#### I. Introduction

This paper has been prepared on a preliminary basis to facilitate the TF’s consideration of whether ISA 260<sup>2</sup> would provide a reasonable basis for the report to the audit committee envisioned by Article 23 of the proposed EC regulation for public-interest entities (PIEs),<sup>3</sup> including whether changes to ISA 260 (for example, new or revised requirements or additional application and other explanatory material) may be necessary to ensure the ISA remains “fit for purpose”. Paragraph A10 of ISA 260 explains that law or regulation, among other things, may provide for broader communication with those charged with governance (TCWG), and paragraph 3 of ISA 260 notes that nothing in ISA 260 precludes the auditor from communicating any other matters to TCWG. Accordingly, the additional communications required by the proposed EC regulation can be seen as supplementary to the matters required to be communicated by the principles-based ISA 260. However, there may be merit in revisiting ISA 260 to ensure that it is clear how it is envisaged to be applied for PIEs and promote consistency in practice in light of the proposed regulation.

Consideration will also need to be given as to whether ISA 260 is suitable in light of demands for auditor commentary in the external auditor’s report (see **Agenda Item 4-A**). Presumably, any additional information to be communicated externally should first be communicated to TCWG. Finally, recognizing that the UK Financial Reporting Council (FRC)<sup>4</sup> has also made recommendations to enhance reporting responsibilities to the full Board of Directors, there may be scope for other revisions to ISA 260 to ensure that the two-way communication between the auditor and the audit committee enables TCWG to fulfill their responsibilities to oversee the financial reporting process.

The TF is of the view that further consideration of Article 23 would be appropriate after the issuance of the June 2012 Consultation Paper (CP). This will allow the IAASB to leverage its thinking relating to the external audit report in determining whether more is needed to strengthen reporting to TCWG. This paper also makes reference to the Article 24 and Article 25 proposals, which may need to be further considered by the IAASB in due course.

The following table reproduces the proposal in Article 23 and indicates, on a preliminary basis how the requirements and guidance in ISA 260 and other ISAs would apply. It presents IAASB Staff’s initial views as to whether ISA 260 as currently drafted would likely be sufficient, or highlights areas where the subject matter is not addressed, the ISA may not be sufficient, or more information is needed in order to determine whether further action may be needed.

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<sup>1</sup> Article 23, *Additional report to the audit committee*

<sup>2</sup> ISA 260, *Communication with Those Charged with Governance*

<sup>3</sup> In evaluating changes to the external auditor’s report, the Building Blocks (BB) Subcommittee is considering whether and, if so, how the IAASB could address PIEs, in light of the varying definitions. Related, it is also considering conditional requirements for listed entities, which may also be relevant for any revision to ISA 260. See **Agenda Item 4-E**.

<sup>4</sup> Staff of the FRC has confirmed that changes will be proposed to ISA 260 to accommodate the new reporting. It is envisaged that the BB Subcommittee would explore how the auditor’s responsibilities in relation to reports of TCWG may be addressed in the auditor’s report under a revised ISA 700.

## II. Article 23 Proposals

ISA 260 deals with the auditor’s responsibility to communicate with TCWG in an audit for financial statements, provides an overarching framework for this communication, and identifies some specific matters to be communicated with TCWG. Additional matters to be communicated, which complement the requirements of ISA 260, are included in other ISAs (as referenced in Appendix 1 of ISA 260).

¶	Article 23 Requirement	Relevant ISA Communication Requirements	Likely Addressed by Extant ISAs?	Proposed Subcommittee <sup>5</sup> /Task Force Actions
1	<p>The statutory auditor(s) or the audit firm(s) carrying out statutory audit of public-interest entities shall submit an additional report to the audit committee of the audited entity. If the audited entity does not have an audit committee, the additional report shall be submitted to the body performing equivalent functions within the audited entity.</p> <p>The audit committee or the body performing equivalent functions shall be allowed to transmit the additional report to the management, administrative or supervisory body of the audited entity.</p> <p>The additional report shall be disclosed to the general meeting of the audited entity if the management or administrative body of the audited entity so decides.</p>	<p>Paragraph 11 of ISA 260 requires the auditor to determine the appropriate person(s) within the entity’s governance structure with whom to communicate.</p> <p>Paragraphs 12-13 of ISA 260 acknowledge that the auditor may communicate with a subgroup of TCWG, such as an audit committee, and also addresses circumstances when all of those charged with governance are involved in managing the entity.</p> <p>Paragraph A34 notes that when a written communication prepared for TCWG is provided to third parties, it may be important that the third parties be informed that the communications was not prepared with them in mind, with possible modifications to the communication to state that the</p>	Yes	Consider whether there may be merit in elevating the guidance in paragraph A34 to a requirement for PIEs to recognize the possible distribution of the long-form report to TCWG to third parties

<sup>5</sup> It is envisaged that the Insights Subcommittee and the Auditor Reporting Task Force will further evaluate these proposals and develop recommendations for the IAASB’s consideration.

¶	Article 23 Requirement	Relevant ISA Communication Requirements	Likely Addressed by Extant ISAs?	Proposed Subcommittee <sup>5</sup> /Task Force Actions
		<p>communication should not be relied upon by those charged with governance, no responsibility is assumed by the auditor to the third parties and any restrictions on disclosure or distribution to third parties. Paragraph A35 recognizes law or regulation may require the auditor to notify regulatory, enforcement, funding or other bodies of certain matters communicated with TCWG or submit certain reports to them or make reports prepared for TCWG publicly available.</p>		
2	<p>The additional report to the audit committee shall be in writing. It shall explain in detail and explicitly the results of the statutory audit carried out and shall at least:</p>	<p>Paragraph 19 of ISA 260 requires the auditor to communicate in writing with TCWG regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. It further explains that written communications need not include all matters that arose during the course of the audit. Written communication in all circumstances is not required by ISA 260.</p>	Partly	<p>Consider whether to require written communication to TCWG for PIEs (or listed entities)</p>

¶	Article 23 Requirement	Relevant ISA Communication Requirements	Likely Addressed by Extant ISAs?	Proposed Subcommittee <sup>5</sup> /Task Force Actions
(a)	include a declaration of independence as provided for in point (q) of Article 22(2); <sup>6</sup>	Paragraph 17(a) of ISA 260 includes a requirement for listed entities for the auditor to communicate (in writing, per paragraph 19) a statement that the engagement team and others in the firm, as appropriate, the firm, and, when applicable, network firms have complied with relevant ethical requirements regarding independence. While paragraph 17(b) requires communication of all relationships and other matters between the firm, network firms, and the entity that, in the auditor’s professional judgment, may reasonably be thought to bear on independence, and total fees charged during the period covered by the financial statement for audit and non-audit services, the declaration required by point (q) of Article 22(2) is beyond the scope of what is contemplated in paragraph 17(b) of ISA 260. The communication requirements in ISA 260 are directly linked to the independence requirements set forth in the <i>Code of Ethics</i>	Partly	The matter of independence and auditor reporting thereon will be addressed by the Clarifications (CL) Subcommittee (see <b>Agenda Item 4-D</b> ). Coordination may also be needed with the IESBA. Conforming changes may be needed based on changes to independence requirements or reporting thereon.

<sup>6</sup> Point (q) of Article 22(2) requires that the written audit report “declare that the non-audit services referred to in Article 10(3) were not provided and that the statutory auditor(s) or the audit firm(s) remained completely independent in conducting the audit. Where the statutory audit was carried out by an audit firm, the report shall identify each member of the audit engagement team and shall state that all members remained completely independent and had no direct or indirect interest in the audited entity.”

¶	Article 23 Requirement	Relevant ISA Communication Requirements	Likely Addressed by Extant ISAs?	Proposed Subcommittee <sup>5</sup> /Task Force Actions
		<i>for Professional Accountants</i> issued by the International Ethics Standards Board for Accountants (IESBA).		
(b)	identify the dates of the meetings with the audit committee or the body performing equivalent functions within the audited entity;	No corresponding requirement. <sup>7</sup>	No	Consider whether guidance could be added to highlight such additional reporting responsibilities
(c)	identify the dates of the meetings, if any, with the management, administrative or supervisory body of the audited entity;	No corresponding requirement.	No	Further understanding of the intent of this proposed requirement needed, as auditors have many meetings with management throughout the audit and it is unclear whether this proposal would require all such meetings to be identified.
(d)	describe the appointment procedure;	No corresponding requirement.	No	The broader topic of reporting on auditor appointment will be

<sup>7</sup> Paragraph A7 of ISA 260 notes that “good governance principles suggest that the auditor will be invited to regularly attend meeting of the audit committee.”

¶	Article 23 Requirement	Relevant ISA Communication Requirements	Likely Addressed by Extant ISAs?	Proposed Subcommittee <sup>5</sup> /Task Force Actions
				addressed by the BB Subcommittee, <sup>8</sup> with consideration given as to whether further guidance is needed in ISA 260.
(e)	describe the distribution of tasks among the statutory auditor(s) and/or the audit firm(s);	Paragraph 15 of ISA 260 requires the auditor to communicate an overview of the planned scope and timing of the audit, and paragraph 16 requires communication of significant findings from the audit. Paragraph 49 of ISA 600 <sup>9</sup> also requires communication with TCWG in relation to group audits (see 2(m) below).	Partly	Further understanding of the intent of this proposed requirement needed.  It is unclear what level of detail is foreseen by this proposal and whether the communications required by ISA 260 and ISA 600 would suffice in meeting the aim of the proposed regulation, in particular as the ISAs do not explicitly address joint audits.

<sup>8</sup> For example, rather than including a requirement or guidance in ISA 260 specific to auditor appointment, there may be merit in including more generic guidance in a revised ISA 700, *Forming an Opinion and Reporting on Financial Statements*, that law or regulation may require additional communications in the auditor's report or to TCWG relating to auditor appointment.

<sup>9</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

¶	Article 23 Requirement	Relevant ISA Communication Requirements	Likely Addressed by Extant ISAs?	Proposed Subcommittee <sup>5</sup> /Task Force Actions
(f)	indicate and explain judgments about material uncertainty that may cast doubt about the entity's ability to continue as a going concern;	<p>Paragraph 23 of ISA 570<sup>10</sup> requires the auditor to communicate with TCWG events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. Such communication with those charged with governance shall include the following:</p> <ul style="list-style-type: none"> <li>(a) Whether the events or conditions constitute a material uncertainty;</li> <li>(b) Whether the use of the going concern assumption is appropriate in the preparation of the financial statements; and</li> <li>(c) The adequacy of related disclosures in the financial statements.</li> </ul> <p>Paragraph A18 of ISA 260 also notes that management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested may be a significant difficulty and thereby required to be communicated to TCWG.</p>	Partly	The broader issue of going concern will be addressed by the Going Concern / Other Information Subcommittee and any revised requirements or guidance to be included in a revision of ISA 700, or changes to ISA 570, may need to be applied to ISA 260. See Agenda Item 4-B.
(g)	determine in detail whether the bookkeeping, the	No corresponding requirement.	Probably no	Further understanding of

<sup>10</sup> ISA 570, *Going Concern*

¶	Article 23 Requirement	Relevant ISA Communication Requirements	Likely Addressed by Extant ISAs?	Proposed Subcommittee <sup>5</sup> /Task Force Actions
	accounting, all audited documents, the annual or consolidated financial statements and possible additional reports show appropriateness;	The concept of “appropriateness” is not defined in the ISAs, although it is most commonly used in relation to management’s use of the going concern assumption. It is unclear whether the auditor’s opinion on whether the financial statements give a true and fair view and have been prepared in accordance with the applicable financial reporting framework may be seen as determining whether they “show appropriateness,” and whether this would subsume bookkeeping, accounting, all audited documents and the financial statements.		the intent of this proposed requirement needed.
(h)	indicate and explain in detail all instances of non-compliance, including non-material instances as far as it is considered to be important to the audit committee in order to fulfill its tasks;	Paragraphs 22–24 of ISA 250 <sup>11</sup> requires the auditor to communicate matters involved non-compliance with laws and regulations that come to the auditor’s attention during the course of the audit, other than when the matters are clearly inconsequential, with communication required as soon as practicable if any non-compliance is believed to be intentional and material.	Partly	Further understanding of the intent of this proposed requirement needed.  While ISA 260 would be sufficient in relation to non-compliance with laws and regulations, if non-compliance is

<sup>11</sup> ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*

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		<p>Paragraphs 14 and 19 of ISA 250 also require initial inquiries of TCWG (where appropriate) and discussion with TCWG if the auditor suspects non-compliance, and paragraph 24 addresses circumstances then the auditor suspects TCWG are involved in non-compliance.</p>		<p>intended to be broader than laws and regulations, then ISA 260 would likely not be sufficient, and consideration may also need to be given to the effect on ISA 250.</p>
(i)	<p>assess the valuation methods applied to the various items in the annual or consolidated financial statements including any impact of changes of such;</p>	<p>Paragraph 16(a) of ISA 260 requires the auditor to communicate views about, among other things, significant qualitative aspects of the entity’s accounting practices, including accounting policies, accounting estimates and financial disclosure. The Appendix to ISA 260 notes that this communication may include matters such as the appropriateness of the accounting policies.</p> <p>It also notes that, for items for which estimates are significant, the communication required by paragraph 16(a) may include issues discussed in ISA 540,<sup>12</sup> including management’s process for making accounting estimates (which would include the method</p>	Partly	<p>Further understanding of the intent of this proposed requirement needed.</p> <p>There may be merit in clarifying the ISAs for PIEs given the emphasis on fair value accounting.</p> <p>The concepts of “assess” and “including any impact of changes of such [method]” may be seen as going beyond what is contemplated in the</p>

<sup>12</sup> ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

¶	Article 23 Requirement	Relevant ISA Communication Requirements	Likely Addressed by Extant ISAs?	Proposed Subcommittee <sup>5</sup> /Task Force Actions
		used) and disclosures of estimation uncertainty. ISA 540 does not include a communication requirement in relation to the valuation methods used, though paragraph 144 of IAPN 1000 <sup>13</sup> provides guidance on what may be envisaged by the ISA 260 requirement in relation to financial instruments.		ISAs, in particular by providing auditor views about alternative valuation methods, and as a result may not be applied consistently without additional guidance in the ISAs.
(j)	provide full details of all guarantees, comfort letters, undertakings of public intervention and other support measures that have been relied upon when making a going concern assessment;	See 2(f). No corresponding requirement	No	The broader issue of going concern will be addressed by the Going Concern / Other Information Subcommittee and any revised requirements or guidance to be included in a revision of ISA 700, or changes to ISA 570, may need to be applied to ISA 260. See <b>Agenda Item 4-B</b> .  Further understanding of the intent of this

<sup>13</sup> IAPN 1000, *Special Consideration in Auditing Financial Instruments*

¶	Article 23 Requirement	Relevant ISA Communication Requirements	Likely Addressed by Extant ISAs?	Proposed Subcommittee <sup>5</sup> /Task Force Actions
				proposed requirement needed, specifically to understand how comfort letters are deemed to be related to an entity's assessment of going concern.
(k)	confirm the attendance at stock takes as well as other instances of physical verification, in case such stock takes or verifications took place;	ISA 501 <sup>14</sup> requires the auditor to attend physical inventory counting, unless impracticable, if inventory is material to the financial statements. This may be discussed with TCWG as part of the requirement in paragraph 15 to communicate the planned scope and timing of the audit, but it is unclear whether the intent of the EC regulation is for this to be discussed as part of the findings of the audit.	Partly	Further understanding of the intent of this proposed requirement needed.
(l)	indicate and explain the principles of consolidation in the case of a statutory audit of consolidated financial statements;	Paragraph 16(a) of ISA 260 requires the auditor to communicate views about accounting policies. However, practice varies regarding specific communication to TCWG about management's principles of consolidation as described in the financial	Partly	Further understanding of the intent of this proposed requirement needed.

<sup>14</sup> ISA 501, *Audit Evidence—Specific Considerations for Selected Items*

¶	Article 23 Requirement	Relevant ISA Communication Requirements	Likely Addressed by Extant ISAs?	Proposed Subcommittee <sup>5</sup> /Task Force Actions
		statements, and generally does not involve a detailed explanation to TCWG.		
(m)	indicate which audit work is performed by third-country auditor(s), statutory auditor(s), third-country audit entity(ies) or audit firm(s) in case of a statutory audit of consolidated financial statements;	<p>As noted in 2(e) above, paragraph 49 of ISA 600 requires the group engagement team to communicate the following matters with TCWG of the of the group:</p> <ul style="list-style-type: none"> <li>(a) An overview of the type of work to be performed on the financial information of the components.</li> <li>(b) An overview of the nature of the group engagement team’s planned involvement in the work to be performed by the component auditors on the financial information of significant components.</li> <li>(c) Instances where the group engagement team’s evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor’s work.</li> <li>(d) Any limitations on the group audit, for example, where the group engagement team’s access to information may have</li> </ul>	Partly	<p>Further understanding of the intent of this proposed requirement needed.</p> <p>It is unclear what level of detail is foreseen by this proposal and whether the overview communication required by ISA 600 would suffice in meeting the aim of the proposed regulation.<sup>15</sup></p>

<sup>15</sup> For example, point (h) of Article 22(2) of the proposed regulation expects the external audit report to describe the used methodology, including how much of the balance sheet has been directly verified and how much has been based on system and compliance testing, which would likely need to be communicated to TCWG prior to releasing the auditor’s report.

¶	Article 23 Requirement	Relevant ISA Communication Requirements	Likely Addressed by Extant ISAs?	Proposed Subcommittee <sup>5</sup> /Task Force Actions
		<p>been restricted.</p> <p>(e) Fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls or others where the fraud resulted in a material misstatement of the group financial statements.</p>		
(n)	<p>indicate whether all requested explanations and documents were provided by the audited entity.</p>	<p>Paragraph 16(b) requires the auditor to communicate significant difficulties encountered during the audit, and paragraph A18 notes this may include the unavailability of expected information. Positive confirmation regarding access to information is not explicitly contemplated in ISA 260.</p>	<p>Yes</p>	<p>Consider whether guidance could be added to highlight such additional reporting responsibilities</p>
3	<p>In case of disagreement between the appointed statutory auditors or audit firms on auditing procedures, accounting rules or any other issue regarding the conduct of the statutory audit, the reasons for such disagreement shall be explained in the additional report to the audit committee.</p>	<p>Communication of views about significant qualitative aspects of the entity's accounting practices and significant difficulties, if any, encountered during the audit are required by paragraphs 16(a) and 16(b) of ISA 260. In addition, paragraph 49(c) of ISA 600 addresses communications when the group auditor questions the quality of the component auditor's work. However, joint audits as envisaged by the EC are not contemplated in the ISAs.</p>	<p>Yes</p>	<p>Consider whether guidance could be added to highlight such additional reporting responsibilities</p>

¶	Article 23 Requirement	Relevant ISA Communication Requirements	Likely Addressed by Extant ISAs?	Proposed Subcommittee <sup>5</sup> /Task Force Actions
4	The additional report to the audit committee shall be signed and dated by the statutory auditor(s) or the audit firm(s). Where an audit firm carries out the statutory audit, the additional report to the audit committee shall be signed by at least the statutory auditor(s) carrying out the statutory audit on behalf of the audit firm.	No corresponding requirement.	No	The broader issue of auditor report signature will be addressed by the CL Subcommittee and any revised requirements or guidance to be included in a revision of ISA 700 would likely apply to ISA 260. See <b>Agenda Item 4-D</b> .
5	Upon request, the statutory auditor(s) or the audit firm(s) shall make available without delay the additional report to the competent authorities.	See 1 above in relation to paragraphs A34–A35 of ISA 260.	Partly	Consider whether there may be merit in elevating the guidance in paragraph A34 to a requirement for PIEs to recognize the possible distribution of the long-form report to TCWG to third parties

### III. Article 24 and Article 25 Proposals

1. For reference, supplementing Article 23 is Article 24, *Oversight of the statutory audit by the audit committee*, which notes the following:
  - The audit committee of the PIE shall monitor the work of the statutory auditor(s) or audit firm(s) carrying out the audit.
  - The statutory auditor(s) or audit firm(s) shall report to the audit committee on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process.<sup>16</sup>
  - The audit committee shall inform the administrative or supervisory body of the audited entity of the outcome of the statutory audit, and shall explain how the statutory audit contributed to the integrity of financial reporting and which was its role in this process.
  - In the instance of the audited entity being exempted from the obligation to have an audit committee, the audited entity shall decide which body or organ of the entity shall engage with the statutory auditor or audit firm.
2. Finally, Article 25, *Report to supervisors of public-interest entities*, notes the statutory auditor or audit firm carrying out the statutory audit of a PIE has a duty to report promptly to the competent authorities supervising PIEs any fact or decision concerning that PIE which is liable to bring about any of the following:
  - A material breach of the laws, regulations or administrative provisions which lay down, where appropriate, the conditions governing authorization or which specifically govern pursuit of the activities of such PIE;
  - The impairment of the continuing of the PIE;
  - A refusal to certify the financial statements or the expression of reservations.
3. In addition, Article 25 notes that competent authorities supervising credit institutions and insurance undertakings shall establish a regular dialogue with the statutory auditors and audit firms carrying out the statutory authority of those institutions and undertaking. In this regard, the proposal envisages guidelines being developed by the European Banking Authority (EBA) and European Insurance and Occupational Pension Authority (EIOPA).
4. The IAASB will consider in due course whether there are implications for the ISAs in relation to the proposals in Article 25 to report to supervisors. The IAASB's planned work to liaise with the Basel Committee on Banking Supervision and others in 2012 to consider whether to develop guidance on the relationship between external auditors and banking supervisors is likely to be relevant (see **Agenda Item 5-A**).

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<sup>16</sup> Paragraph 9 of ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, requires the auditor to communicate significant deficiencies in internal control identified during the audit to TCWG on a timely basis. Paragraphs A9–A10 of ISA 265 were included to ensure the concept of significant deficiencies and the European focus on material weaknesses could be reconciled (see the Basis for Conclusions for ISA 265).