

**TO: CHAIRMAN, IESBA**

**FROM: IFAC SMP ADVISORY GROUP**

**DATE: May 23, 2022**

**RE: IFAC Small and Medium Practices Advisory Group Response to IESBAs Proposed Revisions to the Code Relating to the Definition of Engagement Team and Group Audits**

## **INTRODUCTION**

The IFAC SMP Advisory Group (SMPAG) is pleased to respond to the IESBA Exposure Draft Proposed Revisions to the Code Relating to the Definition of Engagement Team and Group Audits (ED). The SMPAG is charged with identifying and representing the needs of its constituents and, where applicable, to give consideration to relevant issues pertaining to small- and medium-sized entities (SMEs). The constituents of the SMPAG are small- and medium-sized practices (SMPs) who provide accounting, assurance and business advisory services principally, but not exclusively, to clients who are SMEs. Members and Technical Advisers serving the SMPAG are drawn from IFAC member bodies representing 22 countries from all regions of the world.

## **GENERAL COMMENTS**

The SMPAG agrees that aligning the IAASB and IESBA definitions and clarifying what the term "the relevant ethical requirements" means in the context of the group auditor's responsibilities under ISA 600 (Revised) as explained in proposed 405.2A1 is helpful.

However, the SMPAG raised concerns to IAASB in our [comment letter](#) on the ISA 600 Exposure Draft, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors) and Proposed Consequential and Conforming Amendments*, including the following in the introduction to that letter:

“The proposals may also unintentionally lead to a change in perception of the value of the statutory audit (in practical terms, clients may have to pay for work on components during group audits and again for (separate) statutory audits of components), possibly leading to less audits being required by local laws (where there are options) and thus have a significant impact on the audit market, potentially to the detriment of SMPs who would lose the statutory audits and may ultimately even exit the market – although this could be jurisdiction specific. There may also be a public interest issue concerning the impact on the audit markets – especially since the top-down approach to direction, supervision and review may adversely impact the use of SMPs from outside networks for work on components. Auditing standards should not drive anticompetitive behavior. In this context, we note that the EU Commission has expressed firm views on audit market concentration issues.”

While we understand that some of IESBA's proposals represent conforming amendments as a consequence of the recent proposed changes to the group auditing standards in ISA 600 (Revised)<sup>1</sup>,

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<sup>1</sup> ISA 600 (Revised), *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

expanding the scope of the proposed definitions in the *International Code of Ethics for Professional Accountants (including International Independence Standards)* (the “Code”) now widens the net to all individual professional accountants involved in group audits and also expands the scope to address when independence would be required for firms in group audit situations. The SMPAG has similar concerns that we raised with the related IAASB ED, whereby ISA 600 (Revised) will impact the use of SMPs and especially non-network SMPs in practice, as since there is no de minimis exception in the proposal, this could force some SMPs out of the component auditor market. The SMPAG believes the Board should strongly consider the SMP view on this matter as there is a risk the IESBA proposals could exacerbate market concentration issues, which are already of concern in some jurisdictions.

The proposed requirement of R405.10 regarding group audits that are public interest entities is also particularly concerning for SMPs. In many cases, SMPs who are not part of the group auditor’s network perform a required statutory audit for a group company that is not a PIE in their jurisdiction and may also act as component auditors for group audits involving procedures on the financial information of these components. Requiring such component auditors to adhere to independence requirements applicable to public interest entities may be appropriate only when such auditors perform significant audit procedures such that their work can directly influence the outcome of the group audit. We believe this requirement should not be extended to be applied as broadly as proposed as we outline further in our response to question 4.

## **DETAILED COMMENTS**

We have outlined our responses to each question (*in italics*) in the ED below.

1. *Do you agree with the proposed changes to the Code related to the revised definition of ET, including: (see Chapters 1, 4 and 6) (a) The revised definitions of the terms “engagement team,” “audit team,” “review team” and “assurance team;” and (b) The explanatory guidance in paragraphs 400.A – 400.D?*

There are aspects of these definitions that could be problematic. A key point for consideration is whether these definitions would stand the test of time with regard to Environmental, Social and Governance (ESG) and sustainability services and where those services might fit in with the current proposed definitions. For example, the ED does not include any information about the consequences of expanding the definition of ET to not only include audit engagements but also other kinds of assurance engagements and how they would apply Part 4B of the Code. The SMPAG believes the Board should consider addressing this issue in the current proposal since ESG and sustainability services are becoming more and more common in practice. For example, in the ESG reporting area, entities may assess the supply chain through supply chain due diligence. The auditors performing due diligence or assurance services over the supply chain could be considered as component auditors and member of the group engagement team.

Related to proposed 400.C, the SMPAG noted that at times, firms will consult with their local Professional Accountancy Organization (PAO) or other technical hotline service when they have questions related to application of the Code. In such cases, we question whether those responding to such requests might be brought into the definition of engagement team. An unintended consequence could be that PAOs and other related hotline services might become reluctant to answer such questions if they would then be considered part of the engagement team. We urge the Board to consider whether this definition needs to be refined or whether additional application material needs to be added to avoid this potential unintended consequence.

The SMPAG did find it a bit confusing with all these new teams being introduced and how they relate to each other. For example, we might suggest deleting the definition of "audit team for the group audit", since it only seems to be added to cover the very unusual situations that relate to item d) in the definition.

Another issue with 400.C relates to the complexity introduced when using all these different terms with slightly different definitions. For example, the first bullet that states that experts are within the engagement team. However, 400.C is about explaining the differences between engagement teams and audit teams, but at the same time engagement is one part of the definition of audit team, resulting in a bit of a circular reference. One suggestion would be to just delete this sentence in the introduction: "Depending on the role of the individuals, they might be engagement team or audit team members" to avoid any confusion.

2. *Do you agree with the changes to the definitions of "audit team," "review team" and "assurance team" to recognize that EQRs may be sourced from outside a firm and its network (see Chapter 6)?*

The SMPAG did not see use of an other service provider addressed here and perhaps it should be. In the explanatory memo, it was not clear who the other service providers would encompass. For example, what if you borrow staff from another firm? Would they be considered an other service provider? Clarification on this issue would be helpful.

3. *Do you agree with the proposed new defined terms that are used in Section 405 in addressing independence considerations in a group audit (see Chapters 1 and 6)?*

The SMPAG was not clear as to what is meant by "all others who can directly influence the outcome of the group audit". For example, would an ability to directly influence the outcome include those who can effect changes to the wording of any KAMs communicated in the audit report, or perhaps those who can cause the group auditor to make changes to the type of audit opinion to be issued or is it far broader? We believe that modifying this language and adding additional application guidance and examples will be helpful to understand what is meant by this term as used in the ED. There is a vast difference in the degree of influence individual members of the engagement team will have depending on their exact role and work performed in the group audit.

4. *In relation to the proposals in Section 405 (Chapter 1), do you agree with the principles the IESBA is proposing for: (a) Independence in relation to individuals involved in a group audit; and (b) Independence in relation to firms engaged in a group audit, including CA firms within and outside the GA firm's network?*

The proposed requirement of R405.10 regarding group audits that are public interest entities is particularly concerning for SMPs. In many cases, SMPs who are not part of the group auditor's network perform a required statutory audit for a group company that is not a PIE in their jurisdiction and may also act as component auditors for group audits involving procedures on the financial information of these components. Requiring such component auditors to adhere to independence requirements applicable to public interest entities may be appropriate when such auditors perform significant audit procedures such that their work can directly influence the outcome of the group audit, but this requirement should not be extended to be applied as broadly as is proposed. The SMPAG found the spirit behind 405.12 A2 to be helpful, but we believe that perhaps it should be moved to a requirement rather than in the application material such that its authority is clear – essentially it is a negative requirement.

In practical terms, an SMP (who is not a member of the group auditor's network) who is the statutory auditor of a non-PIE component will have performed the statutory audit applying the non-PIE independence requirements (i.e., the provision of specific allowed non-audit services and the lower required threshold for audit fees) but may be rendered "ineligible" to undertake any work whatsoever on the component for the group audit. It seems overly stringent to preclude such a firm who is considered sufficiently independent to perform a statutory audit of a full set of financial statements of the component from performing even minimal procedures - especially if the component is not of high significance to the group.

The SMPAG believes that, in determining whether the proposals as drafted in R405.10 are justified in all cases, IESBA must weigh the level of stringency proposed in R405.10 against potentially severe impacts on the audit market- and possibly leading policy makers to question both the need for duplication of work and the value of statutory audits. Specifically, not taking account of the relevant significance of procedures performed by non-network component auditors, nor the fact that a non-network firm does not pose the same degree of independence threat as would a network component auditor, is questionable.

In conclusion, we urge the IESBA to develop a scalable approach that recognizes the relative significance to the group audit of the relative ability of procedures performed by a non-network component auditor to directly influence the outcome of the group audit. This would be instead of requiring all work by a non-network component auditor (on even a single item in the financial statements of a non-PIE component) be performed under the PIE ethical requirements when the parent company is a PIE.

We believe the wording of R405.9 should be revised so as to be clear that it does not imply that it would be unacceptable for a component auditor of a PIE component in a non-PIE group to apply independence rules for PIE entities when the group is a non-PIE. It should be possible to apply more stringent rules (e.g., where these apply to the statutory audit). As potentially implied by the wording - a ban would be counterintuitive. Thus, the wording should clarify that adherence to non-PIE rules is required and thus adherence to PIE requirements is not necessary or similar. For example, you need to apply PIE rules regarding long association and fees on the component audit, but not on the work done for the purpose of the (non-PIE) group audit. Some examples could be helpful.

5. *Concerning non-network CA firms, do you agree with the specific proposals in Section 405 regarding: (a) Financial interest in the group audit client; and (b) Loans and guarantees?*

Related to loans and guarantees, R511.3A1 states that "this section contains references to the "materiality" of a loan or guarantee. In determining whether such a loan or guarantee is material to an individual, the combined net worth of the individual and the individual's immediate family members may be taken into account." The SMPAG did not see where calculating materiality for purposes of a direct financial interest in an entity is provided, so additional application material similar to what is already in the Code related to loans and guarantees would be helpful to assist Professional Accountants (PAs) in performing this assessment.

6. *Is the proposed application material relating to a non-network CA firm's provision of NAS to a component audit client in proposed paragraph 405.12 A1 - 405.12 A2 sufficiently clear and appropriate?*

The SMPAG believes that the proposed sentence in paragraph 405.12 A2 that states, "the financial information on which a component auditor firm performs audit work is relevant to the evaluation of the self-review threat that might be created by the component auditor firm's provision of a non-assurance service"

should be elevated to a requirement rather than in the application material, and then perhaps keep the example in the second sentence in the application material.

7. *Is the proposed application material relating to changes in CA firms during or after the period covered by the group financial statements in proposed paragraph 405.13 A1 – 405.13 A2 sufficiently clear and appropriate?*

While the SMPAG feels these proposed paragraphs are clear, we do have concerns as stated earlier in this letter related to how this could force SMPs out of the component auditor market.

8. *Do you agree with the proposals in Section 405 to address a breach of independence by a CA firm?*

Overall, we believe the suggested approach regarding breaches is operable, especially since it refers to these factors that we have raised earlier, such as "evaluate the significance, impact on objectivity" (R405.15 b-c and R405.17) about exercising professional judgment and using the third-party test. However, in relation to the approach taken regarding the actual independence requirement, (i.e., applying the stricter PIE-rules without any distinctions - and motivating this with consistency and perception issues) it seems to be a bit contradictory.

One way to address this issue would be to use the reasoning behind the breaches sections consistently in section 405. As proposed, we believe the guidance appears to be unbalanced.

It was noted from one of our members that the proposals outlined related to a breach of independence by a component audit firms may not be feasible in some jurisdictions. In certain jurisdictions, the law may prohibit accounting firms from communicating internal information to the group auditor firms located overseas. In addition, group audit firms may have to wait until a component audit firms confess the breaches. This is because group audit firms and component audit firms do not use common independence infrastructures as the large firms use. The SMPAG proposes the Board consider whether the focus should be more on the impact the breach had on the work performed and related audit opinion, rather than on the breach itself.

9. *Do you agree with the proposed consequential and conforming amendments as detailed in Chapters 2 to 6?*

We believe additional clarification is needed as to what it means to expand the definition of engagement team to include all types of assurance engagements. For example, will other PAs now be included in the new definition and do they have to apply other independence requirements compared to now.

10. *Do you support the IESBA's proposal to align the effective date of the final provisions with the effective date of ISA 600 (Revised) on the assumption that the IESBA will approve the final pronouncement in December 2023?*

Although we have concerns about the impact of the proposal on SMPs in particular, we do agree that any changes should have a consistent effective date with ISA 600 (Revised) since they are so closely related. Going forward, we would urge the two Boards to coordinate the timing of interconnecting projects such that time available for implementation before the effective dates is not overly short. One reason for this is due to the amount of time needed for jurisdictions to translate the standards.

## **CONCLUDING COMMENTS**

The SMPAG urges the IESBA to consider a scalable approach in revising proposed R405.10. We are concerned that SMPs who are not within the group auditor's network will be most impacted by these proposed changes, yet they may be least likely to respond to this proposal due to the fact that they have limited resources and may also view this proposal as mainly being consequential and conforming amendments. As such, we suggest the IESBA also consider additional outreach to the SMP community and education to ensure they understand the impact these amendments could have on their practice. Perhaps IESBA could offer a roundtable for SMPs to participate in or send an informal survey that does not involve developing a formal response. The SMPAG is happy to support IESBA in obtaining additional feedback.

Please do not hesitate to contact me should you wish to discuss matters raised in this submission.  
Sincerely,

A handwritten signature in blue ink that reads "Monica Foerster".

Monica Foerster

Chair, IFAC SMP Advisory Group