

# IAASB CAG REFERENCE PAPER

## IAASB CAG Agenda (September 2006)

### Agenda Item K.1

#### Using the Work of an Expert—Issues – July 2006 IAASB Agenda Item 7-A

### ISA 620 (Revised), “Using the Work of an Expert”—Issues

#### A. Definition of “Engagement Team,” and Independence

- A1. The definition of “engagement team” in ISQC 1<sup>1</sup>, ISA 220<sup>2</sup> and the IFAC Code<sup>3</sup> is: *All personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.* The definition of “personnel” is: *Partners and staff.*
- A2. It is not entirely clear from these definitions whether all experts who have anything to do with an engagement, even if only peripherally involved, should be treated as part of the engagement team and, therefore, e.g.:
- (a) Are subject in full to the independence requirements of the IFAC Code.
  - (b) Need to be covered by the firm’s system of quality control per ISQC 1.
  - (c) Are required to be included in discussions about the susceptibility of the entity’s financial statements to material misstatement per ISAs 240<sup>4</sup> and 315<sup>5</sup>.
- A3. What, e.g., should be the position with respect to:
- (a) An external lawyer asked a reasonably straightforward question about the interpretation of a clause in a contract, perhaps on a hypothetical/no names basis?
  - (b) An “in-house” lawyer used in the same situation as (a)?
  - (c) An expert partner or staff of a network firm who is directly and extensively involved in the engagement? (The position with respect to network firm personnel who are not experts is also not clear, as the definition does not mention them.)
- A4. Various explanations/interpretations of the definition have been considered at Task Force meetings, e.g.:
- (a) “Performing the engagement” means only those experts who are substantially involved in the engagement.
  - (b) “Performing the engagement” means only those experts who perform “audit” procedures.
  - (c) Use of the word “including” means only experts who are personnel should be considered part of the engagement team.

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<sup>1</sup> ISQC 1, “Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements”

<sup>2</sup> ISA 220, “Quality Control for Audits of Historical Financial Information”

<sup>3</sup> The IFAC Code of Ethics for Professional Accountants

<sup>4</sup> ISA 240, “The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements”

<sup>5</sup> ISA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement”

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It was also noted that the definition of “assurance team” in the IFAC Code includes people within a firm who “provide consultation regarding technical or industry specific issues, transactions or events for the assurance engagement.” Because “assurance team” is intended to be broader than “engagement team,” specific inclusion of these people in the definition of assurance team implies that for the purpose of the IFAC Code they are not intended to be members of the engagement team.

- A5. The Task Force believes that to ensure consistency of interpretation, the current definition of engagement team should be amended.
- A6. Because this matter affects the IFAC Code as well as the ISAs and ISQC 1, the Task Force has been liaising with the Independence Task Force (ITF) of the International Ethics Standards Board for Accountants (IESBA). While initial liaison has taken place, the ITF has not reached any conclusions on the matter, and in any case, the ITF will need to refer any final decisions to the IESBA itself. The 620 Task Force is, therefore, seeking initial reactions of the IAASB to the following suggested definition for the purpose of continuing liaison with the ITF.
- A7. Having considered a number of possible approaches, the Task Force is of the view that the definition of engagement team should be:

*Those partners and staff of the auditor’s firm, or a firm that shares common quality control policies and procedures with the auditor’s firm, who are directed and supervised by the engagement partner with respect to the audit.*

- A8. Implications of this approach include:

(a) *From an audit evidence perspective:*

- (i) All internal experts are subject to the quality control policies and procedures of ISQC 1, however, only those who are directed and supervised by the engagement partner should be included on the engagement team, and therefore covered by ISA 200.
- (ii) ISA 220 does not consider the position of expert personnel of network firms, or other firms that share common quality control policies and procedures with the auditor’s firm (e.g., where there is a syndicate of SMPs). It seems reasonable, however, that in those cases where such experts are directed and supervised by the engagement partner, the auditor should be able to rely on ISQC 1 (or equivalent common quality control policies and procedures), and ISA 220 in the same way as if they were members of the auditor’s own firm.
- (iii) The quality control policies and procedures of ISQC 1 and ISA 220 were primarily written for application to “personnel” rather than external experts. Therefore,

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external experts should be excluded from the engagement team because ISQC 1 and ISA 220 do not effectively deal with them<sup>6</sup>.

(b) *From an independence perspective:*

- (i) Those personnel (whether from the auditor's own firm or a firm that shares common quality control policies and procedures with the auditor's firm) who are directed and supervised by the engagement partner are subject to the independence provisions of the Code because they are members of the engagement team.
- (ii) Because external experts would be excluded from the engagement team, they would not be subject to the independence provisions of the Code. This seems appropriate since the current provisions of the Code were written for application to members of the accounting profession and accounting firms. The draft, therefore, requires that experts comply with relevant independence and other ethical requirements that apply to them. It does not, however, attempt to stipulate what these requirements are as this is a matter for the IESBA, and where applicable, the expert's own professional body, and laws and regulations. The 620 Task Force has referred this matter to the ITF, which is considering what, if any, guidance should be specifically aimed at the independence of external experts. For example, if a lawyer/engineer/actuary who is a partner in a firm of lawyers/engineers/actuaries, is involved in an audit engagement, which of the following statements should be true:
  - The lawyer/engineer/actuary should not hold any shares in the entity subject to audit.
  - None of the professional staff in the law/engineering/actuarial firm who work on the engagement should hold any shares in the entity.
  - None of those who recommend the compensation of, or who provide direct supervisory, management or other oversight of the lawyer/engineer/actuary should hold any shares in the entity.
  - None of the partners in the law/engineering/actuarial firm should hold any shares in the entity.
  - None of the professional staff in the law/engineering/actuarial firm should hold any shares in the entity.
  - The spouse of the chief executive of the law/engineering/actuarial firm should not hold any shares in the entity

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<sup>6</sup> The draft does recognize, however, that some external experts work closely with engagement teams and may be subject to some of the firm's quality control policies and procedures. Paragraphs 16-17 of the draft do, therefore, note that this may provide the auditor with an important source of evidence concerning the work of such external experts.

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- ... etc ... can the law/engineering/actuarial firm undertake other engagements for the entity; what if a partner retires from the law/engineering/actuarial firm and joins the entity ... etc ...

In liaising with the ITF on this matter, the 620 Task Force will remain conscious of the potential for independence requirements to affect the availability of experts for audit work.

The Task Force seeks feedback, in light of the audit evidence and independence implications noted above, about the suggested definition of engagement team as a basis for further liaison with the ITF.

#### **B. Objectivity**

- B1. The draft differentiates between independence and objectivity. It treats independence as an ethical issue, which is discussed above. It treats objectivity as an audit evidence issue.
- B2. The draft requires the auditor to evaluate the objectivity of external experts (paragraph 17 (c)). Rather than attempting to set a benchmark for objectivity that should apply in all cases, the application material (A25-A28) notes the degree of objectivity that is required of an expert will vary with the circumstances in which the expert's work is used. This is a different approach from that in the Code with respect to professional accountants. The Code talks in terms of objectivity being a "zero/one" decision, i.e. a professional accountant is either objective or not.
- B3. The Task Force believes the approach it has taken is justified because the range of circumstances surrounding the use of an external expert's work will vary, and the auditor needs to consider this as a factor when evaluating the appropriateness of evidence obtained by the expert. Nonetheless, the draft does acknowledge that in some cases, "the auditor may conclude that the expert's objectivity is so impaired that the expert cannot be considered to be objective in the circumstances and, therefore, the auditor may need to engage another expert" (A28).
- B4. Paragraph A27 notes that representations from the expert and from the entity may assist the auditor in assessing the expert's objectivity.

The Task Force seeks feedback about:

- (a) Whether an approach to experts' objectivity which differs from that in the Code for professional accountants is acceptable; and
- (b) Whether obtaining representations should be made a mandatory procedure when the expert provides principal evidence (see C below for the meaning of "principal evidence").

#### **C. Principal Evidence**

- C1. The Task Force is of the view that a cut-off point is required, beyond which the procedures in paragraph 17 become mandatory. It is using the term "principle evidence" to identify this cut-

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off point. Principal evidence is “evidence that is critical to support the auditor’s conclusions regarding a significant risk” (paragraph 16).

- C2. An alternative to introducing this term is to include the full phrase “evidence that is critical to support the auditor’s conclusions regarding a significant risk” wherever principal evidence is currently mentioned in the draft (i.e., paragraphs 16, 17 and A18, and the headings above A18, A19 and A20). This would avoid having to introduce a new term, but would remove the convenience of “shorthand”.

The Task Force seeks feedback about:

- (a) The appropriateness of using “evidence that is critical to support the auditor’s conclusions regarding a significant risk” as a cut-off point for determining when certain procedures should become mandatory; and
- (b) Whether the IAASB has a view about use of the term principal evidence as shorthand.

#### D. Structure

- D1. The Task Force is conscious of the need to ensure the revised ISA is consistent with the audit risk model articulated in ISAs 200<sup>7</sup>, 315 and 330<sup>8</sup>. An important aspect of applying the audit risk model is that the ISA properly distinguishes between:

- (a) The entity’s need for expertise in preparing the financial statements (which affects inherent and control risk); and
- (b) The auditor’s need for expertise in gathering sufficient appropriate audit evidence (which affects detection risk)<sup>9</sup>.

- D2. A diagram depicting the flow of the Requirements, other than the reporting section, is included in the Appendix to this paper. It also indicates how (i) the entity’s experts, (ii) personnel, and (iii) external experts, are dealt with.

The Task Force seeks feedback about the structure of the draft, in particular its integration of the audit risk model and the distinction between the 3 types of experts identified in D2 above.

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<sup>7</sup> ISA 200, “Objective and General Principles Governing an Audit of Financial Statements”

<sup>8</sup> ISA 330, “The Auditor’s Procedures in Response to Assessed Risks”

<sup>9</sup> The Task Force is still considering whether the auditor may need the assistance of an expert (particularly when obtaining an understanding of the entity and its environment) even when management do not need expertise other than accounting to prepare the financial statement. The outcome of their deliberation could affect the structure of the ISA, however, the fundamental flow should not change dramatically.

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##### **E. Engagement acceptance, and obtaining an understanding**

- E1. The starting point for the draft ISA is the initial planning for the audit. The draft assumes the engagement has been accepted and, therefore, does not deal with engagement acceptance issues regarding the auditor's (or management's) need for expertise.
- E2. ISQC 1 and ISA 220 each have a section on "Acceptance and Continuance of Client Relationships and Specific Engagements." ISQC 1.31 requires the firm to "establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will only undertake or continue relationships and engagements where it ... is competent to perform the engagement and has the capabilities, time and resources to do so." This black letter requirement is supported by grey letter guidance, which states that "the firm reviews the specific requirements of the engagement and existing partner and staff profiles at all relevant levels. Matters the firm considers include whether:
- Firm personnel have knowledge of relevant industries or subject matters;
  - Firm personnel have experience with relevant regulatory or reporting requirements, or the ability to gain the necessary skills and knowledge effectively;
  - The firm has sufficient personnel with the necessary capabilities and competence;
  - Experts are available, if needed;
  - Individuals meeting the criteria and eligibility requirements to perform engagement quality control review are available, where applicable; ..."
- E3. An alternative starting point for the draft ISA would be after the auditor has determined whether expertise is required to assist in obtaining an understanding of the entity and its environment. This approach may require amendment to ISA 315, which does not specifically deal with this issue.

The Task Force seeks the IAASB's feedback on its decision to "start" the draft ISA after engagement acceptance, but before obtaining an understanding of the entity and its environment.

##### **F. Accounting and auditing expertise**

- F1. The Task Force was asked by the IAASB to prepare the first draft of the ISA on the basis that accounting and auditing experts are excluded. The draft has achieved this through the definition of "expert" (paragraph 6 (a)) but mentions in paragraph 3 that parts of the draft may be helpful when using the work of an accounting or auditing specialist.
- F2. The Task Force was also asked to consider the effect on the draft if accounting and auditing experts were to be included. Having reviewed the current draft with this in mind, the Task Force considers that the main parts of the draft that could most easily be applied, and probably should be applied, to the work of accounting and auditing experts, are those relating to using the work of an auditor's external expert (paragraphs 13-17, and associated application

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material). Restricting application to *external* accounting and auditing experts would minimize the potential for confusion regarding definitional issues about whether all members of the audit team and all management personnel involved in preparing the financial statements are “experts,” which was an element in the IAASB’s tentative decision to exclude accounting and auditing experts. Including external accounting and auditing expertise would require some restructuring of the draft, or it could be added as a separate “Part B” to the current draft.

- F3. It is also worth noting that an effect of excluding accounting and auditing expertise is that the draft offers no guidance on what the auditor should do if management does not possess sufficient accounting expertise to prepare the financial statements, and does not employ or engage someone who does. This matter is not dealt with in any detail in the ISAs. It is touched on in Appendix 3 to ISA 315, which notes “Lack of personnel with appropriate accounting and financial reporting skills” as one of many conditions and events that may indicate the existence of risks of material misstatement. It may also be intended to be dealt with by the “material weaknesses” project.

The Task Force seeks the IAASB’s feedback on whether accounting and auditing expertise should be dealt with in the revised ISA.

#### G. Other Observations

##### *“Non-professional” experts*

- G1. The draft does not seek to restrict the definition of experts to people from identifiable profession, e.g., actuaries and engineers. It can, therefore, include such people as general industry experts. For example, in the insurance industry, it could be that an insurance industry expert, who is not an actuary, will be needed in addition to an actuary, particularly when the auditor is obtaining an understanding of the entity and its environment. Although it will ordinarily be the case that an auditor would not accept an engagement to audit an entity in a specialized industry without in-house industry expertise (as this is a basic to understanding the entity), it may be, e.g., that such expertise is brought in for the audit of a relatively minor subsidiary within a group.

##### *Reliance*

- G2. The draft does not refer to “relying on the work of the expert”. Rather, it uses such terms as “using the work of an expert as audit evidence” or “using audit evidence provided by an expert”. This is to avoid any implication that auditors can rely on an expert’s work without forming their own conclusions.

##### *Definition of “firm”*

- G3. The definition of a firm in the Code of Ethics is:

- (a) *A sole practitioner, partnership or corporation of professional accountants;*
- (b) *An entity that controls such parties; and*

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(c) *An entity controlled by such parties.*

- G4. During the CAG discussion of this project, one member noted that the Task Force’s approach to independence was open to the possibility that a firm may set up a subsidiary entity to house its experts in order to avoid the independence requirements. While the Task Force believes this is extremely unlikely for quality control reasons, the definition of “firm” in the Code would appear to make such a strategy ineffective in any case because the subsidiary entity would be part of the firm.
- G5. The Task Force has noted however, that the ISQC 1 / ISA 220 definition of a firm is different from that in the Code as it does not include (b) and (c) above, but does include entities that are not sole practitioners, partnerships or corporations. The Task Force intends to pursue the reason for this difference with the ITF, and may recommend that the two definitions be brought into line.

The Task Force would welcome any feedback the IAASB cares to offer on these other observations.
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