International Auditing and Assurance Standards Board
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USA

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**IAASB Exposure Draft: Proposed International Standard on Auditing 600 (Revised)**
***Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors) - Group Audits***

## General background: ISA 600 requirements and compliance with Market Abuse Regulation for listed companies on European markets

We appreciate the opportunity to comment on the IAASB's Exposure Draft ("ED-600"), in particular in relation to certain elements of the extant standard that we consider conflicting with other restrictions on public companies, in particular the European Market Abuse Regulation ("MAR").

MAR established a common regulatory framework on insider dealing, unlawful disclosure of insider information and market manipulation for financial markets in the European Union, with the aim of increasing market integrity and investor protection and enhancing the attractiveness of securities markets for capital raising. Articles 10 and 14 of MAR specifically prohibit the disclosure of inside information on issuers of securities admitted to trading on European regulated financial markets.

In circumstances where an issuer of public securities is significantly influenced by another entity ("the investor"), the investor's auditor may seek to rely on the audit of the issuer for the purpose of their audit of the investor's consolidated financial statements. When applying ISA 600 to such situations, there are certain required communications in that standard that could be considered to meet the definition of "insider information", in conflict with the restrictions on the issuer imposed by MAR.

This potential "insider information" could include the following non-public information required to be communicated to the investor's auditors (and thus employees of the investor) under ISA 600 paragraph 41 (ED-600 paragraph 44):

- information on instances of non-compliance with laws or regulations;
- a list of uncorrected misstatements of the financial information of the component;
- indicators of possible management bias;
- description of any identified significant deficiencies in internal control at the component level; and
- other significant matters that the component auditor communicated or expects to communicate to those charged with governance of the component.

If there were situations where the component auditor reporting was required to be issued prior to the date of the issuer's own audited financial statements or trading results, this could also potentially include:

- identification of the financial information of the component on which the component auditor is reporting; and
- the component auditor's overall findings, conclusions or opinion.

Further non-public insider information could potentially be communicated following the requirements of paragraph 42 of ISA 600 (paragraph 45 of ED-600) for group auditors to discuss significant matters from the above with the component auditor and from reviewing other relevant parts of the component auditor's audit documentation.

The MAR definition of "inside information" is as follows:

> "*information of a **precise** nature, which has not been made public, relating, directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public, would be likely to have a **significant effect on the prices** of those financial instruments or on the price of related derivative financial instruments*"
> (Section 7, (1), (a) MAR).

The notion "***precise** information*" is further defined as follows:

> "*information shall be deemed to be of a precise nature if it indicates a set of circumstances which exists or which may reasonably be expected to come into existence, or an event which has occurred or which may reasonably be expected to occur, where it is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of the financial instruments or the related derivative financial instrument, the related spot commodity contracts, or the auctioned products based on the emission allowances*"
> (Section 7, (2) MAR).

The information provided in ED-600 paragraph 44 (mentioned above) either (i) inform the recipient of the existence of potential inaccuracies, in its broadest sense, in an issuer's financial documentation, or (ii) inform the recipient of the potential risk that factors exist (e.g. faulty control deficiencies) that may increase the likelihood of inaccuracies, in its broadest sense, in an issuer's financial statements. Such information is likely to be regarded "*specific enough*" to "*enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of the financial instruments* [of an issuer].

Information is considered to be **price-sensitive** under the MAR if it constitutes information "*a reasonable investor would be likely to use as part of the basis of his or her investment decisions*" (Section 7, (4) MAR). A "*reasonable investor*" is considered to be acting in a rational manner and in practice is often limited to professional investors (as they *make the market price* in the stock market nowadays).

The information provided in ED-600 paragraph 44 (mentioned above) are of a nature to influence a third party's perception of the reliability of an issuer's financial documentation and reporting. As the reliability of financial documentation and reporting is an important consideration for potential investors (in particular professional investors), it is very likely that the information provided in ED-600 paragraph 44 shall be considered price-sensitive information, as construed under MAR.

### Conflict between Market Abuse Regulation and information requested by the group auditor of a significant, non-controlling investor, in line with ISA 600

An issuer of listed securities on a European market may find itself in such a circumstance referred to above, where although it is not controlled by any single investor, it is an equity-accounted investee of another listed entity. Even more, if the investor is not listed on a European stock exchange, it is not subject to MAR, therefore it may have difficulties in understanding the relevant limitations or may simply ignore them, because they do not apply to its own entity. The auditor of that listed entity intends to seek access to the management and auditor of the non-controlled investment ("the component"). The component will find itself conflicted between information and access requests from this non-controlling but significant investor (via its auditor) and the interests of other shareholders, who would not expect additional non-public information to be selectively disclosed to another non-controlling shareholder or that shareholder's auditor. In such case, there may be significant misalignments between the component's interests and the significant investor's interests, which can result in various risks to the component, as described below.

The disclosure of non-public information such as internal control deficiencies and uncorrected misstatements could be a breach of the component's regulatory responsibilities under MAR, inadvertently providing one investor (via their auditor) with potentially advantageous information not available to other investors.

In addition, aside from the selective provision of non-public information and MAR considerations, unusual situations may appear, such as where the instructions received from the respective investor's auditor require the component's auditor to report such matters for the purpose of being included in the investor's representation letter. The approach is unreasonable, as the investor's management (directors of a separate entity) cannot provide representations in respect of issues rising from the component audit, as they have no legal responsibility or oversight over the component. Therefore, the collection of such information is unnecessary in the context of the investor's group audit.

Moreover, the component may have a larger asset base and profitability than its significant investor, thus its materiality may be higher than the investor's group materiality. Considering the MAR provisions followed by the component, the investor's group auditor will not be able to reperform the audit work to accommodate their lower level of materiality, as the component is not allowed to provide inside information to selective shareholders. If the component decides to provide this information to the investor's group auditor, then it may be required to disclose the same to the market. However, such a disclosure may have an adverse effect on the share price of the component and consequently, on its investors due to the unusual nature of such information being made public, as well as from the mere fact that the component has been requested by one its largest shareholders to provide more information on its audit procedures, the market may construe this as an indication that the component's financial reporting is unreliable, thus generating significant business risks for the component and potential material losses to all its shareholders.

Based on the above, component entities are conflicted due to the lack of alignment between capital market legislation (MAR) and ISA 600. The current potential courses of action are set out below:

1) They either do not provide any non-public information to their non-controlling investors due to MAR restrictions, and risk damaging relationships with such significant shareholders; this is likely to lead to qualified audit opinions for the non-controlling investors, which in turn will damage the component's reputation, as the audit opinions will effectively state that the numbers associated with the equity-accounted investment could not be verified. Also, this leads to significant business risks as those shareholders may decide to quickly divest a significant part of the investment in order to avoid receiving a modified opinion from their auditors;

2) They can provide the respective non-public information to the market (e.g. publish the audit working papers), which is not a common practice and leads to significant business and legal risks, as there is no history of companies publishing their audit working papers;

3) They can provide information to the investor's auditor but not publish it, which leads to material risks for the business due to potential non-compliance with MAR and potential personal risks for the directors (non-compliance with MAR is qualified as a criminal offence).

None of the above courses of action is acceptable and the consequences could involve material losses for both the component and its investors. These issues arise as a result of ISA 600 not being aligned with capital market legislation, as mentioned above.

We have therefore followed the IAASB's project for updating ISA 600 with interest, in particular how the exposure draft has sought to address certain "key public interest issues":

- clarification of scope of the standard regarding non-controlled entities, including equity-accounted investees and investments carried at cost (procedures in respect of non-controlled entities are expected to be different and more limited than those for controlled entities);
- adaptability and scalability of the provisions included in the revised ISA 600 for the wide variation in the structure of group entities and their environments, including the need for a principles-based approach that is adaptable to a wide variety of circumstances (which could

include circumstances where public companies are restricted from providing information to only some shareholders); and
- issues surrounding access to people and information, in particular the addition of a note that the IAASB recognises that ISA 600 (Revised) can't enforce access to people and information, but that it can help by developing guidance for situations where access to people or information is restricted.

## Our response to ED-600

Our response to ED-600 is focused on the following specific question:

*7. With respect to the acceptance and continuance of group audit engagements, do you support the enhancements to the requirements and application material and, in particular, whether ED-600 appropriately addresses restrictions on access to information and people and ways in which the group engagement team can overcome such restrictions?*

We welcome the exposure draft's proposals to clarify the application material (proposed paragraphs A27-A32) around different access issues that exist, including the insertion of headers to differentiate the issues, explanations for the reasons for access issues (paragraph A28) and guidance on how the group engagement team may overcome access issues (paragraph A29). Of particular relevance is the following section of paragraph A29:

*When the group has a non-controlling interest in an entity that is accounted for by the equity method, the group engagement team may be able to overcome restrictions by:*
- *Determining whether provisions exist (e.g., in the terms of joint venture agreements, or the terms of other investment agreements) regarding access by the group to the financial information of the entity, and requesting management to exercise such rights;*
- *Considering financial information that is available from group management, as group management also needs to obtain the entity's financial information in order to prepare the group financial statements;*
- *Considering publicly available information, such as audited financial statements, public disclosure documents, or quoted prices of equity instruments in the non-controlled entity; or*
- *Considering other sources of information that may corroborate or otherwise contribute to audit evidence obtained. For example, if the group has representatives who are on the executive board or are members of those charged with governance of the non-controlled entity, discussion with them regarding the non-controlled entity and its operations and financial status may be a useful source of information.*

We would like to propose that the above paragraph of application material goes further to address situations where access to equity accounted components, their management and auditors is provided, but this access is limited to information that would not be considered insider information. This could also encompass situations where, for equity-accounted significant components, component auditor communications under paragraphs 44-45 of ED-600 should be limited to:
- directing the group auditor towards relevant publicly available information, such as the component auditor's opinion on the component's audited financial statements;
- confirmation of component materiality levels and key audit matters / significant risks, as already disclosed in the component auditor's extended audit opinion on the component's audited financial statements; and
- any other relevant audit documentation where access is not prohibited by law or regulation.

Paragraph A15 of the extant ISA 600 refers to the group auditor potentially being able to place reliance on audited financial statements and management information for non-significant components, but always having full access and involvement in the work of the component auditor for significant components to comply with the ISA. This also includes reference to the requirements of paragraphs 30-31 to be involved in the risk assessment and responses for significant components.

We welcome the removal of this paragraph and the inclusion of the revised wording in paragraph A29 of ED-600, as copied above. In our view this will allow for a more principles-based approach dependent on the group auditor's risk assessment and other sources of information available. In conjunction with access to information kept by group management in relation to that component, we believe that it would not be unreasonable for the group audit engagement team to conclude that the information obtained constitutes sufficient appropriate audit evidence in relation to the equity-accounted component. This would be a judgement for the group auditor after considering the significance and risk profile of the component.

We also welcome the insertion of the new paragraph 42 of ED-600, allowing group auditors to rely on audits performed for another purpose, subject to a satisfactory evaluation of the component auditors' responses to risks of material misstatement, performance materiality and other considerations such as independence and professional competence. We would like to see further guidance on this aspect, in particular for components that are non-controlled entities. In situations where the information available to the group auditor includes an extended audit report, the group auditor could conclude that they concurred with the component auditor's conclusions regarding significant risks and the appropriateness of their responses to these risks from performing a review of the key audit matters. Similarly, the group auditor may concur with the materiality levels disclosed in the extended audit report. Together with other information on the component and confirmations of the component auditor's independence and professional competence, the group auditor may then be in a position to conclude that the work of the component auditor was sufficient without requiring further access.

Our further suggestions are:

- The standard should clearly differentiate between procedures to be performed in relation to the components which are public companies compared to privately owned companies, in the context of MAR and/or similar legislation applied to the components. Where components are public companies, the group auditors should aim to focus exclusively on publicly available information, such as financial statements and extended audit reports, annual reports, public announcements, etc. Stock exchange disclosure requirements for public companies are very comprehensive and should not be ignored during the audit process.

- We suggest including a clear distinction between the procedures recommended for audit of controlled components compared to those for equity-accounted investees. Extensive access to the equity-accounted investee's financial information and audit working papers is not usually feasible, especially when the component is a public entity; thus, group auditors should design their audit procedures for equity-accounted components differently from the audit procedures applied for controlled subsidiaries.

## Conclusion

In conclusion, we are supportive of the development of guidance to support practitioners in applying ISA 600 in practice, and we would like to see more comprehensive application guidance to cover circumstances where access to the non-public information of listed companies is restricted by law or regulation. We believe ED-600 does improve the clarity, understandability and practicality of application of the requirements. We welcome the proposed clarification that ISA 600 (Revised) can't enforce access to people and information, but that it can help by developing guidance for situations where access to people or information is restricted. For equity-accounted investees we would suggest greater emphasis on a principles-based approach that is adaptable to a wide variety of circumstances, levels of significance and the group auditor's risk assessment.

Yours sincerely,

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