

**Meeting:** IESBA  
**Meeting Location:** Toronto  
**Meeting Date:** April 7-9, 2014

## Agenda Item

# 8

### Auditor Reporting – Independence and Ethical Requirements

#### Objective of Agenda Item

1. To obtain IESBA's views on a specific matter arising from the IAASB's Auditor Reporting project as it relates to a proposed statement of compliance with independence and ethical requirements in the auditor's report.

#### Independence and Other Ethical Requirements, Including Listing of Sources

##### *Background*

2. In light of the importance of compliance with independence and other ethical requirements as a basis for the audit, and the increased focus on auditor independence more broadly, the IAASB's July 2013 Auditor Reporting Exposure Draft (ED) proposed to require that all auditors' reports contain (i) an explicit statement about auditor independence and other ethical responsibilities, and (ii) a statement specifying the sources of those requirements.<sup>1</sup>
3. The IESBA had expressed support in June 2013 for having the proposed statements in the ED in light of the underlying requirements of the IESBA *Code of Ethics for Professional Accountants* (IESBA Code). The IESBA noted that making reference in the auditor's report to the relevant ethical requirements that applied to the audit could provide transparency in a manner consistent with requiring the auditor to state that the audit was conducted in accordance with ISAs and to name the financial reporting framework used in the preparation of the financial statements.

##### *Feedback from Respondents to the ED*

4. Respondents to the ED across all stakeholder groups were generally supportive of the IAASB's proposed requirement to include a statement in the auditor's report about compliance with independence and other ethical requirements.
5. However, there was considerably less support for the proposal, in particular from auditors and some national auditing standard setters (NSS), to list the sources of these requirements. Those respondents expressed concern that:
  - The application of the requirement as drafted in proposed ISA 700 (Revised) would be

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<sup>1</sup> Proposed ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, states that the auditor shall include a section with the heading "Basis for Opinion" that includes a statement that the auditor is independent of the entity within the meaning of the [relevant ethical requirements or applicable law or regulation] and has fulfilled the auditor's other responsibilities under those ethical requirements. If the independence and other ethical responsibilities are established by different sources, then the second part of the statement shall also specify the source of the other relevant ethical requirements.

difficult or impossible to implement in certain jurisdictions (for example, Canada and Germany) and in certain circumstances (for example, multi-location group audits). Concern has been raised about the situation of “competing” codes, in particular where the code applicable to the parent company has more restrictive conditions than those applicable to the component entities and the parent is legislatively prevented from “exporting” the parent level requirements.

- 12 respondents were of a view that in group audit situations the statement about independence and ethical requirements should be limited to explaining the requirements imposed on the group auditor – either in relation to the IESBA Code or other national ethical requirements applicable to the group auditor.
  - Four respondents suggested that, in relation to group audit financial statement audits and other situations where it is impractical to apply the proposed requirement as drafted in the ED, the IAASB permit a generalized description of the sources of independence and ethical requirements applicable in the group auditor’s jurisdiction.
  - One respondent suggested that the ISA 700 (Revised) requirement should not apply when there are other comparable requirements to communicate about auditor independence imposed by national auditing standards, law or regulation even when disclosure of compliance with those requirements is not required to be in the auditor’s report.
- Users of financial statements would not be sufficiently familiar with the nuances of the independence and ethics rules in the context of an audit of financial statements to fully appreciate the more complex and possibly long list of disclosures that would be necessary. It was noted that in some countries, the independence and ethics requirements are contained in different codes, with one country providing an example that it would need to list between four and six sources in that country alone.

*Drafting Team’s Recommendation as Considered by the IAASB Consultative Advisory Group (IAASB CAG) and IAASB*

6. The ISA 700 Drafting Team (DT-700) considered the above feedback, as well as respondents’ suggestions to clarify the proposed wording for both the statement to be included in the illustrative auditor’s report, and the proposed requirement in the ISA. Below are DT-700’s recommendations as considered by the IAASB CAG and the IAASB at their March 2014 meetings:
  - Continue to require an explicit statement about independence and ethical requirements in the auditor’s report, with revised wording that avoids the use of the terms “...within the meaning of...,” and “...we are independent of the entity...”
  - Move away from requiring the listing of sources of independence and other ethical requirements in the auditor’s report, thereby assuaging concerns raised by respondents to the exposure draft.
7. DT-700’s recommended revisions to the proposed requirement in the ED and the statement in the illustrative auditor’s report text are as follows (with track changes from the ED):

*Revised Requirement in Proposed ISA 700 (Revised)*

28. The auditor's report shall include a section with the heading "Basis for Opinion" that:

- (c) Includes a statement that the auditor is independent under relevant ethical requirements of the entity within the meaning of the [relevant ethical requirements or applicable law or regulation] and has fulfilled the auditor's other ethical responsibilities under those ethical requirements. ~~If the independence and other ethical responsibilities are established by different sources, then the second part of the statement shall also specify the source of the other relevant ethical requirements;~~ and

*Illustration 1 – Auditor's Report on Financial Statements of a Listed Entity  
Prepared in Accordance with a Fair Presentation Framework*

**Basis for Opinion**

~~...We are independent of the Group within the meaning of [indicate under relevant ethical requirements or applicable law or regulation]~~ and have fulfilled our other ethical responsibilities under those ethical requirements. ...

8. Acknowledging the merits put forth by those respondents, in particular regulators, who supported listing of the sources of independence and ethical requirements in the auditor's report, and recognizing that some NSS indicate that they already have requirements in their respective jurisdictions to list sources, DT-700 also recommended that the IAASB develop application material that would support the optional listing of sources.
9. DT-700 considered a suggestion from some respondents to require that the statement about sources refer to the IESBA Code in all instances in the auditor's report, but opted against such an approach because it was noted that there are audit firms that apply the ISAs in performing audits of financial statements that are not members of the Forum of Firms (therefore do not base their policies on the IESBA Code), or work in jurisdictions that have not yet adopted the IESBA Code.

*Feedback from IESBA's Planning Committee*

10. In advance of the IAASB CAG and IAASB meetings, IAASB Staff sought views of the IESBA's Planning Committee (IESBA PC) about whether it agreed with DT-700's recommendation to retain the proposed requirement in proposed ISA 700 (Revised) for the auditor to make an explicit statement about independence and other relevant ethical requirements in the auditor's report, but to no longer require the auditor to provide a listing of sources of those requirements.
11. The IESBA PC was unanimous that the revised statement proposed by DT-700 would lose much of its value and be weak without a reference to the specific independence and other ethical requirements that applied in the context of the audit. The IESBA PC was of a view that it should be clear to the auditor which auditing standards and ethical requirements were applicable for the audit of the financial statements.
12. The IESBA PC also was of the view that it would not be necessary for the auditor's report to explain the complexity of multiple sources of independence and other ethical requirements. Rather, it was suggested that the auditor should simply state that the auditor has complied with the IESBA Code; the national independence and ethical requirements; or the IESBA Code and, where more

stringent, the national independence and other ethical requirements. In this regard, the PC noted that:

- (a) Members of the Forum of Firms are already required to use the IESBA Code as a starting point for developing their policies and methodologies for transnational audits; and
  - (b) The IESBA Code requires member bodies of IFAC or a firm to apply not less stringent standards than those stated in the Code.
13. The IESBA PC encouraged DT-700 to find a middle ground. The IESBA PC was of a view that the revised ISA should permit disclosure about compliance with other national codes where possible in a transnational audit context, but not require it. The IESBA PC also did not believe it would be necessary to provide application material to further explain the nuances of multiple sources of ethical requirements, believing that it would be best to leave it to NSS to resolve the matter in their particular circumstances.

*Feedback from IAASB CAG and IAASB*

14. The IAASB CAG and IAASB were supportive of DT-700's recommendation to retain an explicit statement in the auditor's report about auditor independence, but had mixed views about whether the sources of independence should be disclosed. Notwithstanding the challenges cited by the respondents, the IAASB CAG and the IAASB encouraged DT-700 to continue to explore opportunities for further transparency about the sources of independence and other ethical requirements in the auditor's report.
15. The IAASB did not reach a decision on the matter and will continue to deliberate the proposed requirement at its June 2014 meeting. DT-700 indicated that it was committed to continuing to work with IESBA on this issue. Some of the IAASB members and IAASB CAG representatives who were of a view that the sources should be included in the auditor's report provided a few suggestions for DT-700's further consideration as follows:
- Limiting reference to the independence requirements that applied to the group engagement partner or the group engagement team;
  - Listing of the requirements that applied in the country or jurisdiction in which the audit was performed; or
  - Listing of the requirements that the auditor complied with by indicating compliance with established policies that are in place by the audit firm. Similar to the IESBA PC on this point, it was noted that the networks in the Forum of Firms are required to develop requirements to comply, at a minimum, with the IESBA Code.
16. An investor representative on the IAASB CAG was of the view that knowing the sources of independence and ethical requirements, even if this may result in an even longer auditor's report, would signal a stronger message about auditor independence. It was also noted that the IAASB could consider requiring a more generic reference to sources of independence requirements in the auditor's report and allowing for reference to more detailed disclosure on the applicable sources on a website.

17. IAASB CAG Representatives who were not in favor of listing sources noted that:
- Listing sources would be a cumbersome disclosure that would not be very meaningful to readers, in particular given that individual auditors on an engagement may be subject to a wide variety of sources of ethical requirements and independence.
  - There is not much incremental value to be derived from having the statement about independence in the auditor's report, because the title of the auditor's report already conveyed the appropriate message about auditor independence.
18. An IAASB CAG Representative and an IAASB member also suggested that DT-700 consider reinstating reference to the auditor being independent "of the entity" in the requirement and illustrative statement.

### Listing of Sources – Possible Options for a Way Forward

19. Taking into account the input received to date, DT-700 seeks IESBA's input on four options that are presented in decreasing order of transparency at paragraph 20 below. At its April 2, 2014 Teleconference, DT-700 plans to continue its consideration of the four options in determining a possible way forward to revising the requirement in proposed ISA 700 (Revised) related to including a statement about independence in the auditor's report including a listing of sources. DT-700 Chair, Bruce Winter, will provide IESBA an oral update of DT-700's discussions.
20. The options below are all premised on the fact that the auditor under the ISAs has certain responsibilities with respect to relevant ethical requirements including independence<sup>2</sup> and that those relevant ethical requirements ordinarily comprise of Parts A and B of the IESBA Code related to an audit of financial statements together with national requirements that are more restrictive.<sup>3</sup>
- (a) *Option 1: Retain the approach in the ED and require that the auditor include in the auditor's report a detailed listing of source(s) of independence and ethical requirements that are applicable to the audit of the financial statement.*

#### *Option 1 - Illustrative Statement to Be Included In ISA Auditor's Report*

*...We are independent of the Group [indicate relevant ethical requirements or applicable law or regulation] and have fulfilled our other responsibilities under those ethical requirements...*

- Option 1 would result in maximum transparency about the auditor's responsibilities with respect to relevant ethical requirements as it would require the auditor to list the specific ethical/ independence requirement(s) or applicable law (s) or regulation.
- See paragraphs 4-5 for feedback from respondents.

<sup>2</sup> The ISAs state that, "the auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements" ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 14, and that "the engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement," ISA 220, *Quality Control for an Audit of Financial Statements*.

<sup>3</sup> ISA 200, paragraph A14

- (b) *Option 2: Require the auditor to list the source(s) of independence and ethical requirements that are applicable to the audit of the financial statements with clarification that in a group audit situation, the listing of sources would apply to the group engagement team only.*

*Option 2 - Illustrative Statement to Be Included In ISA Auditor's Report*

...We are independent of the Group under [indicate relevant ethical requirements or applicable law or regulation **applicable to the Group engagement team only**] and have fulfilled our other ethical responsibilities in accordance with those requirements.

- Option 2 achieves a certain degree of transparency in the context of a group audit because the disclosure would be from the perspective of the group engagement team only.<sup>4</sup>
- Option 2 would help mitigate the practical challenges cited with listing sources for multi-jurisdiction group audits.

- (c) *Option 3: Require the auditor to include in the auditor's report a statement about the independence and ethical requirements that were applied in conducting the audit of the financial statements in the reporting jurisdiction.*

*Option 3 - Illustrative Statement to Be Included In ISA Auditor's Report*

...We are independent of the Group under the independence and other ethical requirements that are relevant to the audit of financial statements in [Country X] and have fulfilled our other ethical responsibilities in accordance with those requirements.

- Option 3 would require auditors to provide, at a high level, information about the country of origin that promulgates the independence and ethical requirements that are applicable to the audit of the financial statements.
- A further application of Option 3 could result in a reference to either the IESBA Code, or the national requirement related to independence and ethical requirements that is more restrictive.
- Though the statement in Option 3 would not result in the same degree of transparency as Option 1, it would help mitigate the concerns raised by some respondents about potentially having a long list of sources in the auditor's report.

- (d) *Option 4: Withdraw the requirement in proposed ISA 700 (Revised) to list sources of relevant ethical requirements, including those relating to independence in the auditor's report (DT-700's recommendation as per paragraphs 6-7 above).*

- Option 4 would not result in a statement about sources.
- See for paragraphs 10-18 for feedback from IESBA PC, IAASB CAG and IAASB.

<sup>4</sup> ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* note that the “if the group engagement team plans to request a component auditor to perform work on the financial information of a component, the group engagement team shall obtain an understanding of... whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent.”

*A Statement About Auditor Independence Only?*

21. The four options above are anchored to the auditor's responsibilities under the ISAs, and are focused on providing information about auditor compliance with independence and other ethical requirements. A different approach could be for the IAASB to require a statement in the auditor's report about auditor *independence only* as follows:

We are independent of the Group within the meaning of [*indicate relevant independence requirements or applicable law or regulation*].

22. However, it is unclear based on review of the ISAs and the IESBA Code whether such a "de-linkage" of auditor compliance with independence and ethical responsibilities is possible. Also, it is uncertain that such an approach would mitigate the practical challenges that have been cited about listing multiple sources of independence.

**Matters for IESBA Consideration**

1. IESBA members are asked for views about:
  - (a) The above four options for a statement that deals with the listing of sources independence and ethical requirements in the auditor's report and to indicate whether there is a preference for a particular option; and
  - (b) The merits of having a statement in the auditor's report that focuses on auditor independence only, including the listing the sources thereof, rather than ethical requirements more broadly, including independence.

**Public Reporting of Breaches of Independence**

*Background*

23. The IAASB noted in its explanatory memorandum (EM) to its ED that the IESBA finalized and released changes to the IESBA Code that are effective on April 1, 2014 and that do not require public disclosure of breaches of independence requirements by the auditor. The IAASB also acknowledged in its EM that some users, including some regulators, may wish to know more about breaches of independence requirements.
24. The IAASB took the same view as the IESBA regarding public disclosure of breaches and agreed not to require the disclosure of breaches of independence in the auditor's report. The IAASB believed that the impediments to doing so likely would outweigh the value, in particular because:
- Reporting of all breaches would be impracticable, especially in the context of a large, global audit, as the IESBA Code does not establish thresholds for what may constitute either a minor or a significant breach of independence requirements and minor inadvertent breaches of independence requirements may have occurred that have been appropriately addressed.
  - Despite the perceived value of increased transparency about breaches, investors may draw incorrect conclusions about the auditor's ability to issue an auditor's report if all breaches were required to be communicated publicly, even when those charged with governance and the auditor had agreed that any breaches had been appropriately addressed.

*Feedback from Respondents to the ED*

25. Two respondents suggested that auditor's report should include more information about how those charged with governance (TCWG) and auditors communicate about non-audit related services and other aspects of the client/auditor relationship that are considered in connection with the overall assessment of auditor independence. Three respondents, including IOSCO, raised questions about the potential importance of disclosing information about breaches of independence in the auditor's report. DT-700 did not propose changes in response to these suggestions.

*Feedback from IESBA PC, IAASB CAG and IAASB*

26. With respect to whether breaches about independence should be disclosed, the IESBA PC members agreed with DT-700's recommendation to not require such disclosure in the auditor's report for the reasons explained in the EM to the ED. They agreed that having a statement in the auditor's report about any breaches of independence would raise questions about whether or not the auditor was independent.
27. The IESBA PC members were of a view that the impact of a breach of independence on the issuance of an audit report is already addressed within the scope of the IESBA Code in terms of the requirement for the firm to evaluate the significance and impact of the breach on its objectivity and ability to issue the audit report. One PC member added that if the consequences of a breach of independence could not be adequately addressed, the auditor would not be able to issue an auditor's report.
28. One IESBA PC member asked if breaches of independence could be determined to be a key audit matter (KAM). IAASB Staff noted that ISA 701<sup>5</sup> Drafting Team (DT-701) would continue to consider the question in the context of the overarching discussions of "sensitive matters."
29. One IAASB CAG representative was of a view that rather than including a list of sources of independence requirements in the auditor's report, the auditor should communicate breaches of independence requirements as such matters could meet the definition of KAM. Another IAASB CAG representative was of a view that information about breaches that is presented in manner that does not confuse the final conclusion that the auditor remained objective in performing the audit of financial statements is useful to investors, and should always be reported in the auditor's report unless the auditor is prohibited from doing so by law and regulation.
30. For purposes of an update, the IESBA is asked to note that DT-700 will monitor the discussions noted above (see paragraph 28) by DT-701 concerning KAM, but otherwise, based on discussions by the IAASB to date, is not recommending required disclosures about breaches in the auditor's report.

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<sup>5</sup> Proposed ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*