



Ernst & Young LLP
One Manhattan West
New York, NY 10001-8604

Tel: +1 212 773 3000
ey.com

Ms. Sherry Hazel
Audit and Attest Standards — Public Accounting
American Institute of Certified Public Accountants
1345 Avenue of the Americas, 27th Floor
New York, NY 10105

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Via email: commentletters@aicpa-cima.com

Proposed Statements on Auditing Standards — *Special Considerations* — *Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)*

Dear Ms. Hazel,

Ernst & Young LLP (EY US) is pleased to submit this comment letter to the Auditing Standards Board (ASB or Board) in response to the ASB's request for comment on its proposed Statement on Auditing Standards (SAS), *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)*.

We generally support the proposed SAS and its convergence with International Standard on Auditing (ISA) 600 Revised. We believe it would establish stronger linkages to the other AU-C sections and reinforce the requirement that all applicable AU-C sections be applied in a group audit. We are especially supportive of the proposed amendments to clarify the interactions that are needed between the group auditor and component auditors. However, we have the following recommendations for your consideration, which we discuss in more detail in the attachment to this letter.

- ▶ We believe the proposed guidance on equity method investments does not sufficiently address the common situation of a group auditor that is not able to direct the activities of the investee auditor and review its audit documentation. We note that under the amendments the Public Company Accounting Oversight Board (PCAOB) issued today, the auditors of equity method investees are not necessarily subject to the direction and supervision of the group auditor and, thus, would not always be considered part of the engagement team. That is, the PCAOB provides the group auditor the ability to determine when it may supervise the auditors of equity method investees. We recommend that the ASB converge its final standard with the PCAOB standards.
- ▶ We recommend that the ASB present the referred-to auditor requirements and application guidance together, in one section of the SAS or in a separate SAS. The presentation in the proposal makes it difficult to clearly identify the requirements and application guidance without using exhibit A.

We are in the process of evaluating the final PCAOB amendments, and we may submit an addendum to this letter.



In the attachment, we provide responses to the questions the ASB posed in the proposal. We would be pleased to discuss our comments with members of the ASB or its staff.

Sincerely yours,

Ernst + Young LLP

Attachment — Responses to request for comments

1. With respect to the linkages to other AU-C sections:
 - a. does the proposed SAS have appropriate linkages to other AU-C sections and to the proposed SQMSs?
 - b. does the proposed SAS sufficiently address the special considerations in a group audit as they relate to applying the requirements and application material in other relevant AU-C sections, including the proposed QM SAS? Are there other special considerations for a group audit that you believe have not been addressed in the proposed SAS?
 - c. does the proposed SAS result in a group audit that achieves the objectives of the proposed QM SAS?

The proposed SAS generally has appropriate linkages with other standards, adequately addresses special considerations in a group audit as they relate to applying the requirements and application materials in other relevant AU-C sections, and achieves the objectives of the proposed QM SAS. However, we believe there is a risk that without sufficient guidance for the following situations, firms may not apply the requirements consistently:

- ▶ Our understanding is that the “use of the work of another practitioner” in the first sentence of paragraph 33 of AT-C section 105 is not intended to address all situations in which the work of another practitioner is used (for example, a service auditor’s report). We encourage the Board to clarify the distinction between “use of the work of another practitioner” and reliance on another practitioner’s report in this paragraph or in the application paragraph.
- ▶ We believe the ASB should consider new guidance or clarifications to existing guidance to address how an auditor should apply procedures over attestation reports other than service organization reports. We have observed an increase in the use of other reports as audit evidence and believe guidance is needed in this area.

2. With respect to the structure of the proposed SAS, do you support the placement of subsections throughout the proposed SAS that highlight the requirements when component auditors are involved or when reference is made to the audit of a referred-to auditor in the auditor’s report on the group financial statements?

Yes, we support the placement of subsections throughout the proposed SAS that highlight the requirements when component auditors are involved. However, we have concerns about the presentation of requirements when reference is made to a referred-to auditor. See our response to Question 11 for further comments.

3. Is the scope and applicability of the proposed SAS clear? In that regard, is the definition of group financial statements, including the linkage to a consolidation process, clear?

We support the approach to the scope and applicability of the proposed SAS except as it relates to investments accounted for by the equity method. See our response to Question 9 for further comments.

4. With respect to the scalability of the proposed SAS:

- a. do you believe the proposed SAS is scalable to groups of different sizes and complexities, recognizing that group financial statements, as defined in the proposed SAS, include the financial information of more than one entity or business unit? If not, what suggestions do you have for improving the scalability of the proposed SAS?
- b. do you believe that the guidance in exhibit A, “Relevancy of Requirements in Various Group Audit Scenarios,” of the proposed SAS is understandable and provides clarity on the relevancy of certain requirements of the proposed SAS in various group audit scenarios? Would the relevancy of certain requirements of the proposed SAS in various group audit scenarios be clear without exhibit A?

We believe the proposed SAS is scalable. However, see our response to Question 11 for our concerns on exhibit A, “Relevancy of Requirements in Various Group Audit Scenarios,” related to a referred-to auditor.

5. Do you support the enhanced requirements and application material on documentation, including the linkage to the requirements of AU-C section 230? In particular:

- a. are there specific matters that you believe should be documented other than those described in paragraph 76 of the proposed SAS?
- b. do you agree with the application material in paragraphs A203–A219 of the proposed SAS relating to the group auditor’s audit documentation?

We support the enhanced requirements and application material on documentation in the proposed SAS.

6. Are the definitions of the terms referred-to auditor, component auditor, and group auditor clear, including as they relate to the definition of the term engagement team in the proposed QM SAS?

Yes, we believe definitions are clear and would help auditors understand the differences, which aren’t clear in extant AU-C section 600.

7. Is the requirement in paragraph 11 clear? Are there additional requirements or application material relating to paragraph 11 that are needed, and if so, what should they be?

We agree with the ASB that professional skepticism is important and support the emphasis in the proposed SAS. Paragraph 11 clearly states the requirement for the engagement team, including the group auditor, to plan and perform the group audit with professional skepticism and exercise professional judgment.

8. Do you agree with the deletion of this requirement [obtain reports from component auditors, if any, related to reviews performed of the interim financial information of significant components of the reporting entity, including its investees, or inquire of those auditors if reports have not been issued] and the related application paragraph [the auditor may find the guidance in section 600, Special Considerations — Audits of

Group Financial Statements (Including the Work of Component Auditors), useful in conducting a review of interim financial information for an entity that prepares group financial statements]? Do you have other suggestions for considering components in interim reviews now that the concept of “significant components” has been eliminated?

We agree with the deletion of this requirement and the related application paragraph. We suggest that the ASB add a requirement under paragraph 14c for auditors conducting a review of interim financial information to make the following additional inquiry of management:

- xiii. whether component auditors engaged to review interim financial statements of components, if any, communicated any material modifications that should be made to interim financial statements for them to be in accordance with the applicable financial reporting framework.***

The application paragraph in extant AU-C 600 would still be appropriate to support this requirement.

9. Do you agree with the application material in paragraphs A47–A49 of the proposed SAS relating to a noncontrolling interest in an entity that is accounted for by the equity method? Are there additional requirements or application material relating to EMIs that are needed in the proposed SAS, and if so, what should they be?

Though we agree with the application material regarding access restrictions, we believe the proposed guidance does not sufficiently address the common situation of group management and the group auditor not having sufficient access to component management, those charged with governance of the component, or the component auditor. Specifically, when the group has a non-controlling interest in an entity that is accounted for by the equity method, the group auditor is often not able to establish an arrangement with the investee auditor or investee management under which the group engagement team would direct the activities of the investee auditor and review its audit documentation.

We recommend that the ASB consider aligning the SAS with the PCAOB’s approach. We believe the PCAOB’s amendments offer a practical framework to design and execute a quality audit when investee auditors are involved. Additionally, having consistent US auditing standards would eliminate unnecessary complexity and inconsistencies in practice.

Lastly, additional application material relating to equity method investments (EMI) would be helpful to address practical challenges in applying ED-600 and proposed 600 SAS to EMIs.

Differences between the ASB proposal and the PCAOB standards

We are concerned that differences between this proposed SAS and the PCAOB’s amendments relating to the *Supervision and Audits Involving Other Auditors* would create unnecessary complexity and inconsistencies in practice. Under the PCAOB’s amendments, the auditor reporting on an EMI would not always be considered a component auditor, and the results of that auditor’s procedures would fall under the scope of PCAOB Auditing Standard (AS) 1105, *Audit Evidence*.

We agree with and support the PCAOB's approach in this matter (see section VII. Other Matters in Appendix 4 of **PCAOB Release No. 2022-002**), specifically that the group auditor should not be required to direct and supervise the work of the investee auditor in executing its audit separate from the group audit, and thus, it is possible that the investee auditor would not be considered a component auditor (i.e., not part of the engagement team). This approach would address situations in which the group auditor is unable to direct the activities of an investee auditor, as described above.

Further, we support the PCAOB's amendments, which allow a group auditor to use the work and report of the investee's auditor in situations in which the valuation of an investment is based on the investee's financial results by evaluating the sufficiency and appropriateness of audit evidence. We believe this principles-based approach will enable the group auditor to exercise professional judgment to scale its procedures to the facts and circumstances of the audit.

We recommend that the ASB converge its final standard with that of the PCAOB with respect to investee auditors, given the potential for diversity in practice.

Practical challenges in applying the proposed SAS to equity method investments

We believe that if the ASB decides to finalize its proposal, it would need to provide additional guidance to avoid diversity in practice. That is, we believe more guidance is needed to help auditors understand how to audit EMIs as components under the proposed SAS.

We agree that an EMI has characteristics of a component, but we note that an entity accounts for an EMI differently than it accounts for a legal entity, branch or geography under consolidation accounting and makes different disclosures. Specifically, the financial position and results of an EMI are presented in the group financial statements in a note to the financial statements, and the only financial statement line items affected are investment in the EMI and equity in net income of the EMI. We believe this is a significant difference that would warrant different procedures from those performed for a component that is a legal entity, branch or geography. Notably, we believe the determination of planning materiality and scoping of significant accounts would be different for EMIs.

To illustrate, consider a group audit that comprises 12 components, which include 10 consolidated legal entities and two EMIs. In the group financial statements, revenue would include the revenue of the 10 consolidated legal entities. Thus, a misstatement in the revenue of one component would represent a misstatement in the consolidated revenue of the group, but a misstatement in the revenue of one EMI would not affect the consolidated revenue of the group and would only affect the equity in net income account. We believe additional guidance could address diversity in practice regarding the following:

- ▶ How the group auditor should consider risks of material misstatement in the underlying EMI financial statements
- ▶ How to identify significant accounts in an EMI component when the significant accounts are consolidated and presented as different significant accounts on the group financial statements (i.e., revenues and expenses of the EMI component are consolidated and presented as the equity in net income)
- ▶ How to determine component materiality for a consolidated component and an EMI component

Practical guidance on how to apply ED-600 to EMIs, specifically as it relates to the above matters, would help drive consistency in practice.

10. Do you support retaining the option that exists in extant AU-C section 600 for the group engagement partner to make reference to the audit of a referred-to auditor (a component auditor per extant AU-C section 600) in the auditor's report on the group financial statements?

We strongly support retaining the option that exists in extant AU-C section 600 for the group engagement partner to make reference to the audit of a referred-to auditor in the auditor's report on the group financial statements.

Both the extant guidance and the proposed SAS provide a principles-based approach for the group engagement partner to take overall responsibility for managing and achieving quality on the group audit engagement. Additionally, removing the option would create a significant shift in practice, affecting preparers, auditors and others.

11. Are the specific requirements relating to referred-to auditors clear, appropriate, and easily identifiable within the proposed SAS, including when considering exhibit A?

The requirements related to referred-to auditors are appropriate, but they are not easily identifiable within the proposed SAS. We struggled to identify the requirements that would apply when component auditors and referred-to auditors are involved without reliance on the exhibit.

To enhance the readability and ease of use, the ASB should consider the following options:

- ▶ Issue a separate standard that includes the requirements and application material for circumstances when reference is made to the audit of a referred-to auditor in the auditor's report on the group financial statements: The PCAOB took this approach in its proposal, since the referred-to auditor has a different level of supervision than a component team and is not part of the engagement team.
- ▶ Present the requirements for circumstances when reference is made to the audit of a referred-to auditor in the auditor's report on the group financial statements as a separate section within the SAS: Though this would create some repetition in the proposed standard (i.e., requirements that apply to both the involvement of component auditors and referred-to auditors), it would enhance the clarity of the requirements and application when using a referred-to-auditor.

12. Is the last sentence of paragraph A41 clear? Is there additional application material that is needed, and if so, what should it be?

The last sentence of paragraph A41 is unclear and may cause diversity in how auditors accept or continue a group audit engagement. For example, an entity may have three components that represent approximately 15%, 25% and 60% of the total assets and revenue of the group. One group auditor may conclude that it can obtain sufficient appropriate audit evidence by auditing the 15% and 25% components and making reference to a referred-to auditor for the 60% component. However, a different group auditor may conclude that it is unable to obtain sufficient appropriate audit evidence in the same situation.

While we acknowledge that professional judgment is critical in concluding on the sufficiency of appropriate audit evidence obtained, providing a figure as a starting point in the SAS would be helpful in driving consistency in practice. Consistency is especially relevant, as this matter involves the coordination of different firms. We agree with the PCAOB revised standard AS2101, *Audit Planning*, paragraph 06A, which uses the following language:

In addition, in an audit that involves referred-to-auditors (see AS1206), the participation of the engagement partner's firm ordinarily is not sufficient for it to serve as lead auditor if the referred-to-auditors, in aggregate, audit more than 50 percent of the company's assets or revenues.

We believe similar language would be helpful in the proposed SAS and would still allow interpretation and professional judgment.

Further, we note that paragraph A41 relates only to referred-to auditors. We recommend that the ASB clarify whether the considerations in the paragraph, including the financial significance of the components and risks of material misstatements to the group financial statements associated with the components, also apply when component auditors are involved. That is, it would be helpful for the ASB to make clear whether there would ever be an instance where the component audited by a component auditor would be too significant, as determined by various criteria, for the group auditor to obtain sufficient appropriate evidence.

13. Does the proposed effective date provide sufficient time for preparers, auditors, and others to adopt the new standard and related conforming amendments, including sufficient time to support effective implementation of the proposed SAS?

While the proposed effective date would provide sufficient time to adopt the new standards, we expect many firms will need to early adopt them to align with the adoption of ISA 600 (Revised) and the International Auditing and Assurance Standard Board's suite of new and revised quality management standards. Thus, we strongly encourage the Board to develop transition guidance to help auditors that early adopt the guidance.

Implementation of this proposal would require significant effort, including potential discussions across global networks. It would also require early communication and planning with group management and those charged with governance of the group. Implementing a risk-based approach for a group audit would be particularly challenging for initial audits.