

The Audit of Group Financial Statements—Proposed Explanatory Memorandum

Introduction

This memorandum provides background to and an explanation of the proposed International Standard on Auditing (ISA) XXX, “The Audit of Group Financial Statements” approved for re-exposure by the International Auditing and Assurance Standards Board (IAASB) in March 2005.

Background

Several bodies, including the European Commission, the International Organization of Securities Commissions, the former Panel on Audit Effectiveness in the United States, and the International Forum on Accountancy Development, have asked for guidance on the audit of group financial statements. The International Auditing and Assurance Standards Board (IAASB) commenced a project to develop appropriate standards and guidance.

In December 2003, the IAASB published a proposed revised ISA 600, under a new title of “The Work of Related Auditors and Other Auditors in the Audit of Group Financial Statements” and a proposed new International Auditing Practice Statement (IAPS), under the title of “The Audit of Group Financial Statements.” The comment period closed March 31, 2004.

Due to the significance of the comments received, and changes proposed based on these comments, the IAASB agreed that it was necessary to re-expose the proposed revised standards and guidance. A summary of the significant comments and the IAASB’s proposals is set out below.

Significant Comments and Proposals

OVERALL SUPPORT

Respondents were very supportive of the project and acknowledged that the proposed standards and guidance fill an important gap in the existing ISAs. Although some respondents were of the view that the proposed standards and guidance will assist auditors in performing quality audits of group financial statements (while others indicated that it confirmed current best practice), many respondents asked that the group auditor’s responsibilities are further clarified and strengthened.

SOLE V. DIVIDED RESPONSIBILITY

The exposure draft permitted the group auditor to apply the divided responsibility approach if national standards enable and national law or regulation permits him or her to divide responsibility for the audit opinion on the group financial statements with other auditor(s). The table below provides an overview of the comments received on the approach followed in the proposed revised ISA 600.

Retain provisions for sole responsibility and divided responsibility, i.e. “as is”	3
Countries that do not permit divided responsibility should be able to make the necessary adjustment to the ISA to eliminate it in their national standard	2
Retain provisions for sole responsibility and divided responsibility, but strengthen requirements for / provide more guidance on sole responsibility / divided responsibility	2
Provide for sole responsibility as preferred method and divided responsibility as allowed alternative	1
Provide for sole responsibility as preferred method and divided responsibility as allowed alternative, but work towards elimination of allowed alternatives	2
Provide for sole responsibility as preferred method and divided responsibility as allowed alternative in ISA, and provide additional guidance on divided responsibility in a separate IAPS	1
Permit divided responsibility only when <i>required</i> by national law	2
Permit divided responsibility only when sole responsibility is not permitted	1
Permit divided responsibility only in very limited circumstances	3
Retain provisions for sole responsibility and divided responsibility, but the performance requirements for the group auditor should be same under both approaches	3
Provide for sole responsibility only	16
No specific mention of matter	4
TOTAL	40

Based on the comments received, the IAASB proposes the following:

The revised standards and guidance should not distinguish between sole and divided responsibility. The group auditor is responsible for expressing an audit opinion whether the group financial statements were prepared, in all material respects, in accordance with the applicable financial reporting framework. In order to obtain sufficient appropriate audit evidence on which to base the audit opinion, the group auditor should determine the audit procedures to be performed on the consolidation and the work to be performed by the group auditor and other auditors on the financial information of the components. Consequently:

1. The revised standards and guidance do not contain the terms “sole responsibility” and “divided responsibility.”
2. The group auditor’s procedures are the **same** whether he or she accepts sole or divided responsibility. As a result, the revised standards and guidance apply equally to all audits of group financial statements performed in accordance with ISAs.
3. Should the group auditor be unable to obtain sufficient appropriate audit evidence in relation to a component, it will constitute a scope limitation and he or she will have to consider the effect of such scope limitation on the group audit opinion. The group auditor will not be able to refer to the other auditor instead of modifying the audit opinion based on the scope limitation.

RELATED AUDITOR V. OTHER AUDITOR

The exposure draft distinguished other auditors that are “related” to the group auditor (referred to as “related auditors”¹ in the exposure draft) from other auditors that are not “related” to the group auditor (referred to as “other auditors”² in the exposure draft). This distinction affected the nature, timing, and extent of the procedures that the group auditor performs in relation to a related or other auditor’s work.

Respondents to the exposure draft recommended a “narrower” definition for “related auditor.” They also commented on the distinction between a related and other auditor, and the effect the distinction has on the group auditor’s procedures performed in relation to their work.

Based on the comments received, the IAASB proposes the following:

1. The revised standards and guidance should use the terms “related auditor,” “unrelated auditor,” and “other auditor.” These terms are defined as follows:

“Related auditor” means an auditor from the group auditor’s firm or from a network firm who (i) operates under common monitoring policies and procedures as provided for in paragraph 87 of International Standard on Quality Control (ISQC) 1, “Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements” and (ii) performs work on one or more components for purposes of the audit of the group financial statements.³

“Unrelated auditor” means an auditor other than the group auditor or a related auditor who performs work on one or more component for purposes of the audit of the group financial statements.

“Other auditor” or “another auditor” means a related auditor and an unrelated auditor.

2. Another auditor from a network firm, which does not operate under common monitoring policies and procedures as contemplated in paragraph 87 of ISQC 1, should be considered an “unrelated auditor.”
3. The group auditor, in the first instance, should determine whether another auditor is in fact a related auditor.

¹ “Related auditor” was defined as follows in the exposure draft: “Related auditor” means an independent auditor from the group auditor’s office, other office of the group auditor’s firm, a network firm or another firm operating under common quality control policies and procedures as described in International Standard on Quality Control (ISQC) 1, “Quality Control for Audit, Assurance and Related Services Practices.”

² “Other auditor” was defined as follows in the exposure draft: “Other auditor” means an independent auditor other than the group auditor or a related auditor.

³ ISQC 1, paragraph 87 reads as follows:

“Some firms operate as part of a network and, for consistency, may implement some or all of their monitoring procedures on a network basis. Where firms within a network operate under common monitoring policies and procedures designed to comply with this ISQC, and these firms place reliance on such a monitoring system:

- (a) At least annually, the network communicates the overall scope, extent and results of the monitoring process to appropriate individuals within the network firms;
- (b) The network communicates promptly any identified deficiencies in the quality control system to appropriate individuals within the relevant network firm or firms so that the necessary action can be taken; and
- (c) Engagement partners in the network firms are entitled to rely on the results of the monitoring process implemented within the network, unless the firms or the network advises otherwise.”

4. The revised standards and guidance should continue to distinguish between related and unrelated auditors. However, as discussed later in this memorandum, the group auditor's procedures performed in relation to the related and unrelated auditors' work are strengthened.

ACCEPTANCE AND CONTINUANCE AS GROUP AUDITOR

To assist the group auditor in deciding whether to accept or continue an engagement to audit group financial statements, the exposure draft contained standards on acceptance and continuance in the proposed revised ISA 600 and practical implementation guidance in the proposed IAPS. The proposed revised ISA 600 and proposed IAPS provided for the group auditor to obtain a preliminary understanding of the group at the acceptance and continuance stage, and to consider the group auditor's ability to participate appropriately in the work of other auditors. The proposed IAPS suggested that it will be unusual for a group auditor to accept an engagement to audit group financial statements where the group auditor and related auditors directly perform work on less than approximately 50% of the group assets, liabilities, cash flows, profit, or turnover, unless the group auditor will be able to resolve this insufficiency by participating appropriately in the work to be performed by the other auditors on the financial information of the components.

Respondents to the exposure draft were of the view that the standards on acceptance and continuance in the ISA should be strengthened by revising the related guidance in the IAPS and moving it to the ISA. They also opposed the "50% acceptance/retention proposal."

Based on the comments received, the IAASB proposes the following:

1. The group auditor should obtain a preliminary understanding of the group, its components, and their environment. Based on the group auditor's preliminary understanding, the group auditor should (a) identify significant components,⁴ (b) identify components where the work on the financial information will be performed by other auditors, and (c) determine whether those auditors are related auditors.
2. To obtain sufficient appropriate audit evidence on which to base the group audit opinion, the group auditor or related auditors, at a minimum should (a) perform the work on the financial information of significant components, or (b) be involved in the work that unrelated auditors perform on the financial information of significant components.
3. Involvement in the work performed by another auditor ordinarily will involve the group auditor, or a related auditor on behalf of the group auditor, undertaking some or all of the following actions:
 - Meeting with component management to obtain an understanding of the component and its environment.
 - Performing risk assessment procedures and participating in the assessment of risks of material misstatement. These may be performed together with the unrelated auditor, or by the group auditor or a related auditor.

⁴ "Significant component" means a component that has been identified at the group level as likely to include significant risks of material misstatement of the group financial statements. This could be due to (a) the nature of, and circumstances specific to, the component (risk), or (b) the individual financial significance of the component to the group (size).

- Performing further audit procedures. These may be performed together with the unrelated auditor, or by the group auditor or a related auditor.
- Participating in the closing and other key meetings between the unrelated auditor and component management.
- Reviewing the unrelated auditors' audit documentation.

To respond to requests for a definition of an "individual financial significance," the revised guidance recognizes that the group auditor may apply a percentage to a chosen benchmark as an aid to identify components that are of individual financial significance. Depending on the nature and circumstances of the group, appropriate benchmarks might include group assets, liabilities, cash flows, profit or turnover. Although in practice there are ranges of possible percentages, a component representing 20% or more of group assets, liabilities, cash flows, profit, or turnover is regarded as financially significant. The nature and circumstances of the group, however, may often make a lower percentage appropriate.

ACCESS TO INFORMATION

Respondents to the exposure draft commented that legal or professional impediments may prevent the group auditor from having the access to component management, component information, or the other auditors (including relevant parts of their audit documentation), contemplated by the proposals. For example, it was noted that access to another auditor's audit documentation is essentially a legal issue that depends on the laws of the jurisdiction in which the other auditor operates – such laws cannot be overridden by the provisions of an ISA.

The revised proposals to eliminate division of responsibility, for the group auditor (or related auditor on behalf of the group auditor) to be involved in the work of other auditors, and on the nature and extent of the procedures that the group auditor performs in relation to the other auditors' work will further complicate this matter.

The IAASB is of the view that a restriction on the group auditor's access is a scope limitation and that the group auditor should consider the effect that this may have on the group audit opinion. Consequently, the IAASB proposes that the group auditor should not accept an engagement to audit group financial statements if (a) the group auditor's access will be restricted, and (b) the possible effect of the group auditor's inability to obtain sufficient appropriate audit evidence is material and pervasive to the group financial statements.

If, after accepting the engagement, the group auditor's access is restricted and the restrictions cannot be overcome by group management or by other means, the group auditor should consider the effect of the scope limitation on the group audit opinion. If such scope limitation is likely to result in a disclaimer of opinion on the group financial statements, the group auditor considers resigning from the engagement.

STRENGTHENING THE GROUP AUDITOR'S PROCEDURES

The proposed IAPS applied when the group auditor takes sole responsibility for the auditor's report on the group financial statements. It provided practical assistance on the application of the proposed revised 600 and other ISAs to the audit of group financial statements. The guidance followed the *Audit Risk Standards* issued by the IAASB in 2003.

Respondents to the exposure draft were of the view that the proposed revised ISA 600, and in particular the group auditor's procedures, should be strengthened by moving guidance from the proposed IAPS to the proposed revised ISA.

Based on the comments received, the IAASB proposes the following:

1. The group auditor should determine the audit procedures to be performed on the consolidation and the work to be performed by the group auditor and other auditors on the financial information of the components to obtain sufficient appropriate audit evidence on which to base the audit opinion on the group financial statements.
 - For a component that, due to the nature of and circumstances specific to that component, has been identified at the group level as likely to include significant risks of material misstatement of the group financial statements, the group auditor ordinarily performs or requests other auditors to perform: an audit in accordance with ISAs using either a materiality level determined by the group auditor or a lower materiality level determined by the other auditor; an audit of specified account balances relating to the identified significant risks; or specified audit procedures relating to the identified significant risks.
 - For a component that, due to its individual financial significance to the group, is likely to include significant risks of material misstatement of the group financial statements, the group auditor ordinarily performs or requests other auditors to perform an audit in accordance with ISAs using either a materiality level determined by the group auditor or a lower materiality level determined by the other auditor.
 - After determining the work to be performed on the financial information of significant components, the group auditor identifies components that are not significant in the aggregate. The group auditor may apply a percentage to a chosen benchmark as an aid to determine the individual financial significance of components to the group. While in practice there are ranges of possible percentages, components that in the aggregate represent less than 5% of group assets, liabilities, cash flows, profit or turnover will ordinarily be regarded as not significant in the aggregate. The group auditor may consider it appropriate not to perform audit or review procedures at components that are not significant in the aggregate. For these components, the group auditor's procedures ordinarily are limited to the analytical procedures performed at the group level.
 - The work to be performed on the financial information of the remaining components could include: an audit performed in accordance with ISAs using either a materiality level determined by the group auditor or a lower materiality level determined by the other auditor; an audit of specified account balances; specified audit procedures; or a review of the financial information of the component.
2. When another auditor is requested to perform the work on the financial information of a significant component, the group auditor should be involved in the work of the other auditor to identify significant risks of material misstatement of the group financial statements.
 - When a related auditor performs the work on the financial information of a significant component, the group auditor reviews the related auditor's documentation of the identified and assessed risks of material misstatement.

- When an unrelated auditor performs the work on the financial information of a significant component, the group auditor, or a related auditor on behalf of the group auditor, is involved in the unrelated auditor's risk assessment procedures.
3. When significant risks of material misstatement of the group financial statements have been identified in a component on which another auditor performs the work, the group auditor and the other auditor together should determine the further audit procedures to be performed to respond to the identified significant risks. In certain circumstances the group auditor may want to be involved, or to involve a related auditor, in performing further audit procedures.
 4. When a related auditor (on behalf of the group auditor) has been involved in the risk assessment or further audit procedures of an unrelated auditor, the group auditor should review the related auditor's documentation of that involvement.
 5. To obtain sufficient appropriate audit evidence on which to base the group audit opinion, it may be necessary for the group auditor, or related auditors on behalf of the group auditor, to be involved in the work to be performed by unrelated auditors on the financial information of a component that are significant in the aggregate. This involvement may include some or all of the procedures described in paragraph 3 under Acceptance and Continuance as Group Auditor, a review of the financial information of the component, or analytical procedures performed at the group level.
 6. The group auditor should evaluate the adequacy of the work of another auditor for the group auditor's purposes.
 - When other auditors performed the work on the financial information of significant components or components that are significant in the aggregate, the group auditor reads the other auditors' reports or memorandums of work performed, including the other auditors' lists of uncorrected misstatements.
 - When an unrelated auditor performed the work on the financial information of a significant component, the group auditor, or a related auditor on behalf of the group auditor, should review the unrelated auditor's audit documentation.
 - When a related auditor performed the work on the financial information of a significant component, the group auditor considers whether to review the related auditor's audit documentation. Such documentation may be in the form of a memorandum, reflecting the related auditor's significant conclusions.
 - When a related auditor (on behalf of the group auditor) has reviewed an unrelated auditor's audit documentation, the group auditor should review the documentation of that review, including the conclusions reached on the adequacy of the work of the unrelated auditor for the group auditor's purposes.

PROPOSED REVISED STANDARDS AND GUIDANCE IN A SINGLE ISA

Based on the comments received on the exposure draft, and as explained in Strengthening the Group Auditor's Procedures, guidance was moved from the proposed IAPS to the proposed ISA.

Considering the revised standards and guidance, the IAASB is of the view that users of the ISAs may find it difficult to understand the interrelationship between the proposed ISA and the proposed IAPS,

and that the revised standards and guidance would be better presented in a single document. Furthermore, a single document eliminates the need for repetition, leads to a shorter document, and provides a clearer picture of the application of the audit risk model to the audit of group financial statements. Consequently, the IAASB proposes that the revised standards and guidance be combined in a new ISA with the title “The Audit of Group Financial Statements” and that extant ISA 600 is withdrawn.

Effective Date

The IAASB recommends that the proposed new ISA is effective for audits of group financial statements for periods beginning on or after December 15, 2006.

Guide for Commentators

The IAASB welcomes comments on the proposed new ISA. The IAASB is seeking comments on all matters addressed in the exposure draft. Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make explicit suggestions for any proposed changes to wording. When a respondent agrees with proposals in this exposure draft (especially those calling for change in current practice), it will be helpful for the IAASB to be made aware of this view.

Recognizing that the proposed new ISA will apply to audits of all sizes and in all sectors of the economy, the IAASB is also interested in comments on matters set out below:

SPECIAL CONSIDERATIONS IN THE AUDIT OF SMALL ENTITIES

Consistent with the IAASB’s decision to include any special considerations in the audit of small entities within the text of the ISAs, respondents are asked to comment on whether, in their opinion, considerations in the audit of small entities have been dealt with appropriately in the proposed new ISA. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

SPECIAL CONSIDERATIONS IN THE AUDIT OF PUBLIC SECTOR ENTITIES

Special considerations in the audit of public sector entities have been included in the Public Sector Perspective at the end of the proposed new ISA. The Public Sector Perspective was prepared by the Public Sector Committee (now the International Public Sector Accounting Standards Board) of the International Federation of Accountants. Respondents are asked to comment on whether, in their opinion, special considerations in the audit of public sector entities have been dealt with appropriately in the Public Sector Perspective. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

TRANSLATIONS

Recognizing that many respondents intend to translate the proposed new ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing this exposure draft.