

Proposed Explanatory Memorandum

Introduction

1. This memorandum provides background to, and an explanation of, the proposed International Standard on Auditing (ISA) 600 (Revised and Redrafted), “The Audit of Group Financial Statements,” approved for exposure by the International Auditing and Assurance Standards Board (IAASB) in [date].

Background

2. Several bodies have asked for guidance on the audit of group financial statements, 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. Accordingly, the IAASB commenced a project on the audit of group financial statements (“group audits”). The objective of the project was to deal with special considerations in an audit of group financial statements and, in particular, the involvement of other auditors in group audits. It was agreed that extant ISA 600, “Using the Work of Another Auditor” be revised to deal with such considerations, and that the title thereof be changed accordingly.
3. In December 2003, the IAASB published a proposed revised ISA 600, under the 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.” Due to the significance of the comments received, and changes proposed based on them, the IAASB concluded that it was necessary to re-expose the proposed revised requirements and guidance.
4. In March 2005, the IAASB published proposed ISA 600 (Revised), “The Audit of Group Financial Statements” (“Exposure Draft”). The comment period closed July 31, 2005. Forty-four comment letters were received from a variety of respondents, including regulators, IFAC member bodies, and firms. As a result of these comments, the IAASB processed changes to the Exposure Draft, and redrafted the text to reflect the proposed clarity drafting conventions (see the Exposure Draft on “Improving the Clarity of IAASB Standards” issued by the IAASB in October 2005). The following summarizes the more significant issues raised by respondents, and how the IAASB addressed them.

Significant Issues and Related Proposals

Elimination of the Distinction Between Sole and Divided Responsibility

5. The Exposure Draft did not distinguish between sole and divided responsibility. The proposed requirements and guidance were based on the following:
 - The group auditor is responsible for expressing an audit opinion on the group financial statements (“group audit opinion”).
 - In order to obtain sufficient appropriate audit evidence to reduce audit risk for the group financial statements to an acceptably low level, the group auditor has to determine the audit procedures to be performed on the consolidation and the work to

- be performed on the components' financial information, both by the group auditor and by other auditors.
- The group auditor's procedures are the same whether he or she accepts sole or divided responsibility. As a result, the requirements and guidance apply equally to all audits of group financial statements performed in accordance with ISAs.
 - Should the group auditor be unable to obtain sufficient appropriate audit evidence in relation to a component, it constitutes a scope limitation and he or she has to consider the effect thereof on the group audit opinion. The group auditor is not able to refer to the other auditor instead of modifying the group audit opinion based on the scope limitation.
6. A majority of respondents supported the elimination of the distinction between sole and divided responsibility. The IAASB, however, was asked to revise the Exposure Draft to explicitly state that divided responsibility is no longer permitted. A small number of respondents were of the view that there are situations in which the divided responsibility alternative is particularly useful, for example, where an entity has significant components accounted for by the equity method of accounting that are audited by other auditors. Some noted that the reference to another auditor in the group auditor's report is necessary to preserving transparency to the users of group financial statements. Others were concerned about the resource and consequential cost implications of the proposed requirements.
7. The IAASB concluded that no new arguments against the proposal to eliminate the distinction between sole and divided responsibility were presented.
- The IAASB confirmed its previous conclusion that the group auditor is responsible for the group audit opinion and, consequently, has to obtain sufficient appropriate audit evidence to reduce audit risk for the group financial statements to an acceptable low level. This is explained in paragraph 4 and reflected in the objective in paragraph 6 of the proposed ISA.
 - Paragraph 47 explains that, unless relevant to the modification of the group audit opinion, the group auditor shall not refer to the involvement of other auditors in the group auditor's report on the group financial statements.
 - With regard to the comment on preserving transparency to the users of group financial statements, the IAASB concluded that should the group auditor not be able to obtain sufficient appropriate audit evidence on which to base the group audit opinion, the Basis for Modified Opinion paragraph in the group auditor's report will provide the necessary information to the users of the group financial statements.

Distinction between Related and Unrelated Auditors and the Definition of Group Auditor

8. The Exposure Draft defined "group auditor" as the auditor who signs the auditor's report on the group financial statements; "related auditor" as an auditor from the group auditor's firm or from a network firm who (a) operates under, and complies with, common monitoring policies and procedures as provided for in paragraph 87 of ISQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements," and (b) performs work on one

or more components for purposes of the audit of the group financial statements; and “unrelated auditor” as 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. The distinction between related and unrelated auditor affected the nature, timing and extent of the procedures that the group auditor performs in relation to the other auditor’s work.

9. Although a majority of respondents supported the proposal to strengthen the group auditor’s procedures – in particular those performed in relation to the other auditor’s work – several respondents were concerned about the distinction between related and unrelated auditor, and the effect thereof on the group auditor’s procedures. Several respondents also asked that the IAASB further clarify the group auditor’s proposed involvement in the work of another auditor (including the review of the other auditor’s audit documentation).
10. Some respondents noted that it was not clear whether an auditor from another office of the group engagement partner’s firm is a member of the group engagement partner’s engagement team or a related auditor.
11. The IAASB acknowledges that the structures of audit firms and audit firm networks vary and that it is not possible to develop a distinction between related and unrelated auditors that will apply in all cases.
12. The IAASB concluded that:
 - The nature, timing and extent of the procedures to be performed by the group auditor to obtain an understanding of another auditor are affected by factors such as the group auditor’s previous experience with or knowledge of the other auditor; the degree to which the group auditor and the other auditor perform, or are subject to common policies and procedures; and the consistency or similarity of laws and regulations, professional oversight and discipline, education and training, professional organizations and standards, and language and culture (see paragraph A14).
 - The nature, timing and extent of the group auditor’s involvement in the other auditor’s work are affected by the significance of the component, identified significant risks and the group auditor’s understanding of the other auditor (see paragraph 27).
13. For example, the extent of procedures performed by the group auditor to obtain an understanding of another auditor who is subject to common policies and procedures and operates in the same jurisdiction as the group engagement partner will be less than those performed to obtain an understanding of another auditor who is not subject to common policies and procedures or operates in a foreign jurisdiction. Similarly, the extent of the group auditor’s involvement in the work of another auditor that is subject to common policies and procedures and operates in the same jurisdiction as the group engagement partner will be less than the extent of his or her involvement in the work of another auditor who is not subject to common policies and procedures or operates in a foreign jurisdiction. The latter, however, is also affected by the significance of the component and the identified significant risks.

14. Consequently, the IAASB has:
 - Eliminated the distinction between related and unrelated auditors.
 - Deleted the notion that the group auditor can “delegate” his or her responsibilities to a related auditor with the group auditor performing very limited or no procedures in relation to the work performed by the related auditor on behalf of the group auditor.
 - Revised the guidance to explain the effect on audit risk of using the work of another auditor and to clarify the meaning of the term “involvement” (see paragraphs 2-3).
 - Revised the requirements to base the group auditor’s decision whether to review relevant parts of another auditor’s audit documentation on his or her evaluation of the other auditor’s memorandum or report of work performed (see paragraph 42).
15. To clarify the distinction between members of the group engagement partner’s engagement team and other auditors, the IAASB has limited members of the group engagement partner’s engagement team to personnel of the group engagement partner’s firm, including any experts contracted by the group engagement partner’s firm in connection with the group audit engagement, who is directed and supervised by the group engagement partner to the same extent that a member of an engagement team responsible for the audit of the financial statements of a single entity is directed and supervised by the engagement partner in accordance with ISA 220, “Quality Control for Audits of Historical Financial Information” (see paragraphs 7(c), (g) and (h)).

Acceptance and Continuance as Group Auditor

16. According to the Exposure Draft, the group auditor’s decision to accept or continue an engagement is subject to the group auditor being able to obtain sufficient appropriate audit evidence on which to base the group audit opinion. This is achieved by the group auditor performing the work on the financial information of significant components, or being involved in the work that other auditors perform on the financial information of significant components. “Significant component” was defined as 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 components (risk), or (b) the individual financial significance of the component to the group (size).
17. The proposed guidance recognized that the group auditor may apply a percentage to a chosen benchmark as an aid to identify components that are of individual financial significance. It also explained that 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 make a lower percentage appropriate.
18. Although a majority of respondents supported the proposal referred to in paragraph 16 above (subject to further clarification of the meaning of “involvement” as noted in paragraphs 8 and 13 of this memorandum), many respondents opposed the proposed guidance on the percentage to be applied to the chosen benchmark. Some recommended

deletion of the proposed guidance. Others suggested a range of possible percentages, or expansion of the proposed guidance, possibly with more examples.

19. The IAASB is of the view that the proposed guidance on benchmarks and percentages will enhance the consistent application of the proposed requirements. However, in line with similar guidance in another ISA, the IAASB revised the text to be less prescriptive. Furthermore, the text now forms part of the application material. See paragraph A5.

Access to Information

20. According to the Exposure Draft, the group auditor could not accept a group audit engagement if the group auditor's access to component information, those charged with governance of components, component management, or other auditors (including relevant parts of their audit documentation) will be restricted, and the possible effect of the group auditor's inability to obtain sufficient appropriate audit evidence is material and pervasive to the group financial statements, such that the group auditor is likely to disclaim an opinion on the group financial statements.
21. Many respondents were concerned that the proposed requirement will give rise to practical difficulty. They noted that jurisdictions exist where, due to legal or regulatory impediments, the group auditor may not have the required access, or that the group auditor may be prohibited by law or regulation not to accept or to resign from an engagement. They believed that there should be further guidance on what the group auditor should do if there are restrictions on access.
22. The IAASB is of the view that, before accepting or continuing a group audit engagement, the group auditor should have a reasonable expectation of obtaining sufficient appropriate audit evidence in relation to the consolidation process and the financial information of the components to reduce audit risk for the group financial statements to an acceptably low level. As explained in paragraph 9 of the proposed ISA, this is achieved by the group auditor performing the work on the consolidation process; and either performing the work on the financial information of significant components, or being involved in the work that the other auditors perform on the financial information of significant components to the extent necessary to obtain sufficient appropriate audit evidence.
23. The IAASB recognizes that circumstances may exist where the group auditor is not able to be involved in the work that another auditor will perform on the financial information of a component that is likely to be significant. The IAASB is of the view that, in such circumstances, it is unlikely that the group auditor will be able to obtain sufficient appropriate audit evidence. Consequently, paragraph 12 of the proposed ISA requires the group engagement partner not to accept or to resign from the engagement if he or she concludes that it will not be possible to obtain sufficient appropriate audit evidence, and the possible effect of this inability will result in a disclaimer of opinion on the group financial statements. This is in line with paragraph 17 of the "International Framework for Assurance Engagements." Where law or regulation does not permit the group engagement partner not to accept or to resign from an engagement, he or she is required to express a disclaimer of opinion on the group financial statements (see paragraph 13).

Distinction between Components that are Not Significant in the Aggregate and Other Components

24. The Exposure Draft dealt with the group auditor's procedures in relation to significant components, components that are significant in the aggregate, and components that are not significant in the aggregate. Some respondents were concerned about, or found it difficult to understand, the distinction between components that are significant in the aggregate and components that are not significant in the aggregate. The IAASB was asked not to convey the impression that the group auditor may presumptively decide to limit the work on the financial information of a component that is not significant in the aggregate to analytical procedures performed at the group level.
25. In response to the comments received, the IAASB concluded that the proposed ISA could be simplified by combining the categories of components that are significant in the aggregate and components that are not significant in the aggregate. The combined category is now referred to as "components that are not individually significant." To obtain sufficient appropriate evidence to reduce audit risk for the group financial statements to an acceptably low level, the group auditor has to select components that are not individually significant for which the group auditor, or another auditor at the request of the group auditor, has to perform an audit of the component's financial information, an audit of specified account balance, specified audit procedures, or a review of the component's financial information (see paragraph 25). For components not selected, the group auditor has to perform analytical procedures at the group level (see paragraph 26). Paragraph A27 of the proposed ISA lists factors that may affect the group auditor's selection of components that are not individually significant, and the work to be performed on the financial information of the individual components selected.

The Responsibilities of Other Auditors

26. Paragraph 15 of extant ISA 600 requires the other auditor, knowing the context in which the group auditor will use the other auditor's work, to cooperate with the group auditor. This requirement was not included in the Exposure Draft as the IAASB did not consider it appropriate to include a requirement for another auditor in an ISA that primarily contains requirements and guidance for a group auditor. Several respondents, however, noted that it would be helpful to clarify the responsibilities of the other auditor. Their comments mainly related to the other auditor's responsibility to provide the group auditor with access to relevant parts of their audit documentation.
27. The IAASB continues to be of the view that it will not be possible for the group auditor to obtain audit evidence of another auditor's compliance with a requirement to cooperate with the group auditor. The group auditor could, however, obtain an understanding (and written confirmation) whether the other auditor will provide him or her with the necessary access to relevant audit documentation. The IAASB therefore revised the Exposure Draft to require the group auditor to obtain an understanding whether, if not prohibited by law or regulation, the other auditor will provide the group auditor with the necessary access to relevant audit documentation (see paragraph 14(d)).

Presentation of Requirements and Guidance

28. The IAASB has always found the question of the division of the material between ISA and IAPS troublesome. In considering the proposed requirements and guidance for approval as an Exposure Draft in March 2005, the IAASB had before it a single ISA, and an ISA together with a related IAPS. On balance the IAASB took the view that the single ISA should be exposed. In this instance, the single ISA was thought to eliminate the need for repetition, lead to a shorter document, and provide a clearer picture of the application of the audit risk model to the audit of group financial statements than the alternative presentation. A majority of respondents supported the single ISA approach.
29. Some respondents, however, commented that the single ISA was lengthy, duplicative of some of the requirements in other ISAs, and overly prescriptive. Others were concerned about the large number of cross-references and general lack of flow in the document. Several respondents suggested that issues relating to the length, structure, positioning of guidance (ISA vs. IAPS), etc. be considered when it is redrafted as part of the IAASB's project to improve the clarity of its pronouncements.
30. The IAASB concluded that many of the respondents' concerns could be addressed by applying the proposed clarity drafting conventions as set out in the Exposure Draft on "Improving the Clarity of IAASB Standards," which was issued in October 2005. To the extent that the responses to the Exposure Draft on "Improving the Clarity of IAASB Standards" give rise to further changes in the proposed clarity drafting conventions, these will be reflected in the final ISA 600 (Revised).
31. In redrafting the proposed ISA, the IAASB also reconsidered the number of requirements and extent of application material. Some application material was moved to appendices to aid presentation.
32. The Appendix to this memorandum "maps" the "should" requirements and present tense sentences in the March 2005 Exposure Draft to the related "shall" requirements and application material in the proposed ISA.

Effective Date

33. The IAASB will determine the effective date of the final ISA 600 (Revised) in due course, after considering the comments received on exposure.

Guide for Respondents

Request for Specific Comments

34. The IAASB has considered carefully the responses to its initial proposals. It is therefore not seeking further repetition of comments previously made, but rather views on the effect of substantial changes in the final proposals, as follows:
 - (a) The proposal to eliminate the distinction between related and unrelated auditor gave rise to substantial changes to some of the proposed requirements. Respondents are asked to indicate whether they are in agreement with the proposal, and the effect that it has on the procedures that the group auditor performs in relation to the work of other auditors. Respondents are asked also to consider the proposed definitions of

“group auditor,” “member of the engagement team under the direct supervision of the group engagement partner,” and “other auditor or another auditor.”

- (b) The IAASB is of the view that the proposed ISA reflects current best practice for the audit of group financial statements. Where current best practice is applied in a jurisdiction, application of the proposed requirements should not have significant cost implications. The IAASB recognize, however, that current best practice may not be applied universally. Where it is not applied in a jurisdiction, the proposed requirements may have significant cost implications. Respondents are asked to indicate which of the proposed requirements may have significant cost implications in their jurisdictions; recognizing that the increase in costs will be supported by an increase in audit quality.
- (c) With regard to the application of the proposed clarity drafting conventions, respondents are asked to respond to the following questions:
- (i) Is the objective to be achieved by the auditor, stated in paragraph 6 of the proposed ISAs, appropriate?
 - (ii) Have the guidelines identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements are at a level that promotes consistency in performance and the use of professional judgment by auditors?¹
 - (iii) Has the application material been edited in a way that makes it clearer?
 - (iv) Has an appropriate balance been achieved between eliminating duplicative material and retaining some repetition in the proposed ISA to help users understand the proposed ISA or how it interrelates with the other ISAs?
35. Subject to respondents not repeating comments previously made, comments on other matters will be welcome. Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make specific 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.

Comments on Other Matters

36. Recognizing that the proposed 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.

¹ In accordance with the Exposure Draft on “Improving the Clarity of IAASB Standards,” the IAASB will determine the requirements of a Standard as follows:

- The requirement is necessary to achieve the objective stated in the Standard;
- The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; and
- The objective stated in the Standard is unlikely to have been met by the requirements of other Standards.

In determining the requirements of a Standard, the IAASB will consider whether the requirements are proportionate to the importance of the subject matter of the Standard in relation to the overall objective of the engagement.

These guidelines, which are intended only to assist the IAASB in appropriately and consistently determining requirements, may be refined as further experience is gained.

Special Considerations in the Audit of Small Entities

37. 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 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

38. 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 proposed ISA. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

Developing Nations

39. Recognizing that many developing nations have adopted or are in the process of adopting the ISAs, the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties in applying the proposed ISA in a developing nation environment. Reasons should be provided, as well as suggestions for alternative or additional guidance.

Translations

40. The IAASB welcomes comment from respondents on potential translation issues noted in reviewing this exposure draft.

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