

# 1 ISA 600 Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)



## Essential reading

See Chapter 9 of the Essential reading for an overview of group accounting issues that you should have learned from your previous studies (including SBR).

The Essential reading is available as an Appendix of the digital edition of the Workbook.

As you know from your financial reporting studies, in a group situation the parent company will have to prepare its own audited financial statements, together with the audited **consolidated financial statements** incorporating all component companies.



**Component:** An entity or business activity for which the group or component management prepares financial information that should be included in the group financial statements.

**Component auditor:** An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

**Component materiality:** The materiality level for a component determined by the group engagement team.

**Group:** All the components whose financial information is included in the group financial statements. A group always has more than one component.

**Group audit:** The audit of the group financial statements.

(ISA 600: para. 9)

## 2 Responsibilities

The **group auditor** has sole responsibility for the opinion on the group financial statements. In most countries, this responsibility is not diminished by reliance on the work of any **component auditors**, who are a source of evidence only and are not referred to within the group auditor's report. There will be a **group engagement team** led by the **group engagement partner** who will be responsible for the performance of the group audit and providing an auditor's report on the group financial statements.

The group auditor must decide how much **reliance** they will place on the work performed by the **component auditor**. In order to do this, they will consider the qualifications, experience, competence, ethical standpoint and resources of the component auditors.

ISA 600 states that if a component company is audited by a component auditor and is deemed by the group auditor either to be so **significant in size** or to **pose a significant risk of material misstatement**, they can stipulate:

- That **further audit procedures** must be carried out; and
- The **extent** that the component auditor is involved (if at all).

The group auditor may not be able to access all the information it needs about components or component auditors, because of laws relating to confidentiality or data privacy, for example. The effect on the group audit opinion depends on the **significance of the component**.

If the **component is not significant**, then it may be sufficient just to have a complete set of financial statements, the component auditor's report, and information kept by group management.

If the **component is significant**, then it is possible that there will be an **inability to obtain sufficient appropriate audit evidence** about the component, in which case the audit opinion is either **qualified** or a **disclaimer of opinion** is issued. In this instance, it would also be impossible to

comply with ISA 600's requirement to be involved with the work of the component auditor (for significant components), which would also lead to an inability to obtain sufficient appropriate audit evidence.

## 2.1 Significant components

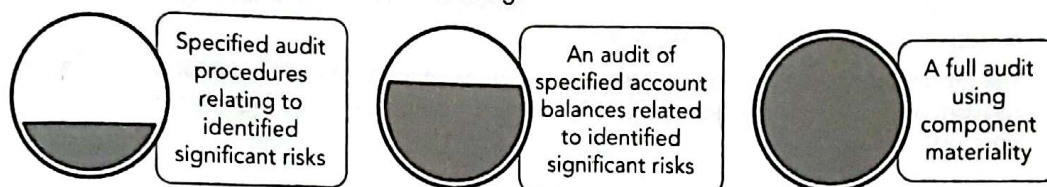


**Significant component:** A component identified by the group engagement team: (a) that is of individual significance to the group, or (b) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements. (ISA 600: para. 9(m))

ISA 600 states that a significant component can be identified by using a **benchmark** (para. A5). If component assets, liabilities, cash flows, profit or turnover (whichever is the most appropriate benchmark) **exceed 15% of the related group figure**, then the auditor may judge that the component is a **significant component**.

If a component is financially significant to the group financial statements, then the group engagement team or a component auditor will perform a full audit based on the component materiality level.

The group auditor should be involved in the assessment of risk in relation to significant components. If the component is otherwise significant due to its nature or circumstances, the group auditors will require one of the following.



Components that are not 'significant components' will be subject to analytical procedures at a group level – a full audit is not required for the purpose of the group audit/consolidated financial statements.

## 2.2 The component auditor

### 2.2.1 Understanding the component auditor

ISA 600 requires the group engagement team to obtain an **understanding** of the component auditor. This involves an assessment of the following.

- Whether the component auditor is **independent** and understands and will comply with the ethical requirements that are relevant to the group audit
- The component auditor's **professional competence**
- Whether the group engagement team will be **involved in the work of the component auditor** to the extent that it is necessary to obtain sufficient appropriate audit evidence
- Whether the component auditor operates in a **regulatory environment** that actively oversees auditors

### 2.2.2 Involvement with the component auditor

The extent of **involvement** by the group auditor at the planning stage will depend on the:

- Significance of the component
- Risks of material misstatement of the group financial statements
- Extent of the group auditor's understanding of the component auditor

The basic rule is that **where the component is significant, the group auditor must be involved in the component auditor's work**.

The **component auditor** should consider whether there might be any **restrictions** on them providing the group auditor with access to information, such as laws relating to **confidentiality** or data privacy. It should be borne in mind that in general, the component auditor is **not normally**

obliged to co-operate with the group auditor (unless they are operating in a jurisdiction which requires them to do so). In practice, this means that the same audit firm will often be appointed as auditor of the group and its significant components.

### 2.2.3 Assessing the component auditor

For all companies in the group, the group auditor is required to perform a **review of the work done by the component auditor**. This is normally achieved by reviewing a report or questionnaire completed by the component auditor which highlights the key issues which have been identified during the course of the audit. The effect of any uncorrected misstatements and any instances where there has been an inability to obtain sufficient appropriate audit evidence should also be evaluated. On the basis of this review, the group auditor then needs to determine whether any additional procedures are necessary. These may include:

- Designing and performing further audit procedures. These may be designed and performed with the component auditors, or by the group auditor.
- Participating in the closing and other key meetings between the component auditors and component management
- Reviewing other relevant parts of the component auditors' documentation

### 2.2.4 Communicating with the component auditor

The group engagement team shall **communicate its requirements to the component auditor** on a timely basis. This communication shall set out the work to be performed, the use to be made of that work and the form and content of the component auditor's communication with the group engagement team (ISA 600: para. 40).

The group engagement team shall **request the component auditor to communicate matters** relevant to the group engagement team's conclusion with regard to the group audit (ISA 600: para. 41).



#### Essential reading

See Chapter 9 of the Essential reading for more detail on the communication between group and component auditors (specifically ISA 600: paras. 40–41).

The Essential reading is available as an Appendix of the digital edition of the Workbook.

### 2.2.5 Communicating with group management and those charged with governance

ISA 600 identifies the following as matters which should be communicated to group management.

- Material deficiencies in the design or operating effectiveness of group-wide controls
- Material deficiencies that the group engagement team has identified in internal controls at components that are judged to be significant to the group
- Material deficiencies that component auditors have identified in internal controls at components that are judged to be significant to the group
- Fraud identified by the group engagement team or component auditors or information indicating that a fraud may exist

Where a component auditor is required to express an audit opinion on the financial statements of a component, the group engagement team will request group management to inform component management of any matters that they, the group engagement team, have become aware of that may be significant to the financial statements of the component. If group management refuses to pass on the communication, the group engagement team will discuss the matter with those charged with governance of the group. If the matter is still unresolved, the group engagement team shall consider whether to advise the component auditor not to issue the auditor's report on the component financial statements until the matter is resolved.

### 2.2.6 Communication with those charged with governance of the group

The following matters should be communicated to those charged with governance of the group.

- An overview of the type of work to be performed on the financial statements of the component

- An overview of the nature of the group engagement team's planned involvement in the work to be performed by the component auditors on significant components
- Instances where the group engagement team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work
- Any limitations on the group audit, for example, where the group engagement team's access to information may have been restricted
- Fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls or others where fraud resulted in a material misstatement of the group financial statements



### Activity 1: Communication

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Communication is a two-way process. This is especially true in the context of the dialogue between the group auditor and the component auditor.

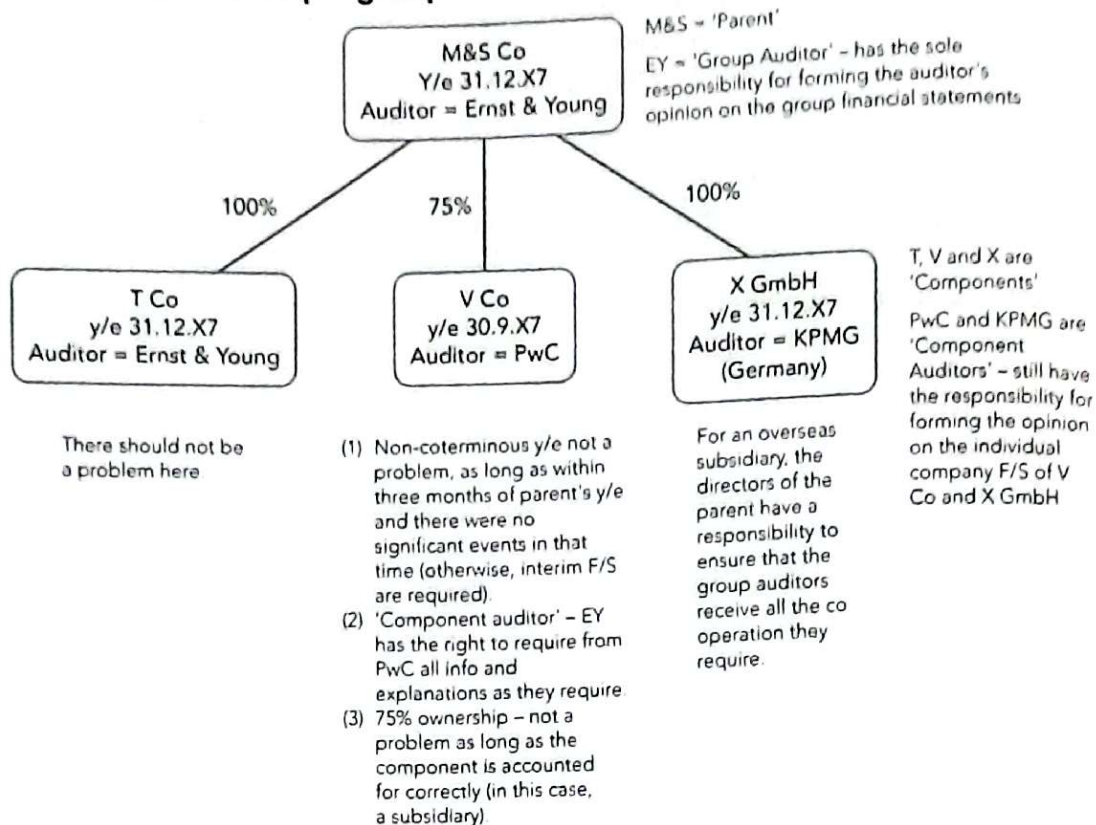
#### Required

- (1) Suggest some of the requirements that the group auditor would communicate to the component auditor.
- (2) Suggest some of the matters that the component auditor needs to tell the group auditor.

#### Solution

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## 2.3 Illustration of a simple group



### Other considerations

Are any of the components immaterial? If so, obtain draft financial statements from them and perform an analytical review only. If this review suggests any errors exist, more detailed work will be needed.

Have there been any **changes** to the group structure? Changes such as acquisitions, disposals (or even part-disposals) are required under ISA 600 para. A12 as part of understanding the group. Is the **going concern** status of any component dependent on the parent's ongoing support? If so, a letter of support or comfort letter should be obtained by the auditor.

Given the nature of most consolidated groups in the 21st century, the group auditor's job is extremely **complex** and likely to be subject to a number of risks not faced during the audit of the parent company alone:

- Understanding the **structure of the group**, paying close attention to any **changes** and the risk of 'hidden' or 'shell' companies, as discovered during the Enron scandal
- Consideration of **group-wide controls** (controls designed, implemented and maintained by group management over group financial statements) to ensure there are no inherent problems in the audit
- The fact that their group opinion is **often based upon the work of others** and as such, this demonstrates significant audit risk

Consequently, **great care** must be taken when deciding whether or not to **accept** such work.

## 3 Matters to consider before accepting appointment as parent company auditor

Taking factors from Section 2 into account, the group auditor should consider whether or not their participation is sufficient to be able to act as the group auditor. For this purpose, the group

engagement partner **must obtain an understanding of the group before acceptance** (ISA 600: para. 12) which should include the following:

- The **materiality** of the portion of the financial statements which the group auditor audits (and therefore, by implication, **the proportion that they do not audit**)
- The group auditor's degree of **knowledge** regarding the business of the components
- The **risk of material misstatements** in the financial statements of the components audited by the component auditor(s)
- The ability, where necessary, to perform **additional procedures** to enable them to act as group auditors
- The nature of the group auditor's **relationship** with the firm acting as component auditor

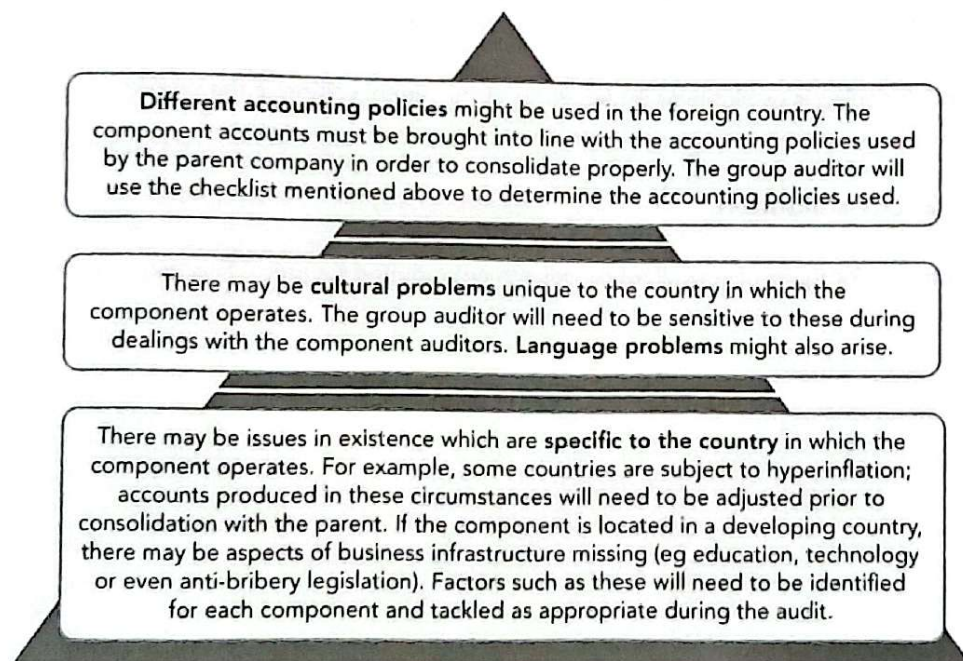
Under ISA 600, the group auditor will consider the following:

- The **quality of work** from **component auditors**;
- The ability of the group auditor to get involved with component auditors to obtain **sufficient appropriate audit evidence** if necessary; or
- The availability of **information on consolidation from the client**.

If the group auditor has **concerns** about any of these issues and are unlikely to be able to deliver anything other than a disclaimer of opinion, they should not consider either **accepting or continuing** with the engagement (ISA 600: para. 13).

#### 4 Issues arising when a component is located abroad

When a component is located abroad a number of potential difficulties could arise such as the following:



#### 5 The correct classification of investments



##### Essential reading

See Chapter 9 of the Essential reading for an overview of Associates and Joint Ventures that you should have learned from your previous studies (including SBR).

The Essential reading is available as an Appendix of the digital edition of the Workbook.

You know from your accounting studies that an investment is treated as a **subsidiary** when the parent company has **control** over that company. Where **significant influence** is held, the investment is treated as an **associate**. It is important that the degree of control exercised by the parent company is tested by the group auditor.

The auditor needs to consider how an investment fits into the activities of the group. They should **review board minutes** for evidence of the degree of influence exercised by the parent. They should also discuss the matter with the parent directors.

The existence of **other significant shareholders** may indicate that the parent company has little **influence**. The auditor should check the register of members to determine the level of shareholding and potential influence held by other shareholders.

The auditor should also consider how easy it is to obtain **information** about another company. This could also be an indicator of significant influence.

## 6 Consolidation audit procedures

There are a number of procedures that should be performed by the group auditor:

- Confirming the balances extracted from the financial statements of each component prior to their inclusion on the consolidation schedule
- Reviewing the disclosures necessary for the group accounts, such as related parties
- Gathering evidence appropriate to the various consolidation adjustments



### Essential reading

See Chapter 9 of the Essential reading for an overview of the problems with consolidations and associated audit procedures that you should have learned from your previous studies (including SBR).

The Essential reading is available as an Appendix of the digital edition of the Workbook.



### Activity 2: Consolidation

What are the major types of consolidation adjustment required for group financial statements?

**Solution**

**Goodwill** is calculated in accordance with **IFRS 3 Business Combinations**, to provide more transparency of the value of **non-controlling interests (NCI)**. The standard allows measurement of NCI, either at share of subsidiary net assets or fair value (FV). The latter results in 100% of goodwill on acquisition analysed between parent and NCI elements for consolidation.

**FV** is used to determine assets and liabilities for these calculations. Share price on acquisition is used for the FV of the NCI. The overall approach the auditor should follow for determining FV can be summarised as follows:

- Obtain an understanding of the entity's process for determining FV

- Identify and assess the risks of material misstatement at the assertion level
- Perform audit procedures on the data used to develop the FV
- Evaluate whether the FV measurements have been properly determined



### Activity 3: Wolf Co

You are the group auditor for Bad Co and are currently reviewing the consolidation adjustments for goodwill in respect of the acquisition of Wolf Co. Bad Co acquired 7.5 million of the 10 million ordinary shares in Wolf Co for \$12 million. At the time of acquisition, the FV of Wolf Co's net assets was \$10 million and the share price was \$1.50 each. Bad Co operates a policy of valuing NCI at fair value.

#### Required

Calculate goodwill on the acquisition of Wolf Co and explain the principal audit procedures you would perform on the goodwill calculation schedule.

	\$'000
Consideration transferred	
Non-controlling interest	
Net assets acquired	
Goodwill	
Non-controlling interest at fair value	
Non-controlling Interest at share of net assets	
Goodwill attributable to NCI	
Goodwill attributable to Bad Co shareholders	
Goodwill attributable to NCI shareholders	

#### Solution

## 7 Implications for the auditor's report where a component's report has been modified

In a group situation, **materiality** and **risk** must be assessed in the context of the group as a whole. The group auditor must consider the materiality of any modifications to a component's auditor's report in relation to the whole of the consolidated financial statements.

This can lead to situations where a component may have a material qualification that has no impact on the group opinion which would then remain unmodified. Similarly, a pervasive modification in a component's auditor's report may only have a material impact on the group opinion.

Ultimately the decision as to the impact of a modification to a component's auditor's report on the consolidated opinion is a matter of judgement for the group auditor. Where the group auditor concludes that adequate evidence about the work of the component auditor cannot be obtained, and has been unable to perform sufficient additional procedures with respect to that component, they should consider the implications for the auditor's report. A subsequent modification in these circumstances would be on the grounds of insufficient inappropriate audit evidence.

## 8 Joint audits

A joint audit means an audit where two or more auditors are responsible for an audit engagement and jointly produce an auditor's report to the client.

### Reasons for joint audits

Two or more firms could act as joint auditors for the following reasons:

- (a) In a new acquisition, the parent may insist that their auditor acts jointly with those of the new subsidiary.
- (b) A company operating from widely dispersed locations may find it useful to have joint auditors.
- (c) Foreign subsidiaries may need to employ local audit firms to satisfy the laws of the country in which they operate. These local auditors may act jointly with the group auditors.
- (d) Some companies may prefer to use local accountants, while at the same time, enjoying the wider range of services offered by a large national firm.

Before accepting appointment as a joint auditor, it will be necessary to consider the experience and standards of the other firm.

The allocation of work between the firms needs to be agreed and the auditors should agree whether joint or separate engagement letters will be sent.

Both firms must sign the auditor's report and both are responsible for the whole audit. They are jointly liable in the event of litigation. Such joint audits can therefore be seen to be complex to manage and potentially expensive.

## 9 Transnational audits

A transnational audit means an audit of financial statements which are, or may be, relied upon outside the entity's home jurisdiction for purposes of significant lending, investment or regulatory decisions. This will include audits of all financial statements of companies with listed equity or debt and other public interest entities which attract particular public attention because of their size, products or services provided.

The growth in such transnational engagements has led to a number of issues that clients are more aware of in the 21st century:

- (a) Variations in audit approaches and the role of regulators across different jurisdictions has led to variable degrees of engagement quality.
- (b) The incomplete nature of ISA adoption worldwide has led to variations in audit approach.
- (c) Cultural differences worldwide have also led to different audit approaches.

In response to this trend towards globalisation and the issues associated with transnational audits, a Forum of Firms (FOF) was created, initially by the 'Big Four' firms but now with over 20 member firms.

To support and provide guidance to the FOF the IAASB has set up the Transnational Auditors Committee.

Specific responsibilities of the TAC include the following:

- Identifying audit practice issues. When the issues suggest changes in auditing or assurance standards may be required, recommending to the appropriate IFAC standard-setting boards that the issue be reviewed.
- Providing a forum to discuss 'best practices' in areas including quality control, auditing practices, independence, and training and development.
- Proposing members to the IFAC Regulatory Liaison Group and identifying qualified candidates to serve on IFAC standard-setting boards.
- Acting as a formal conduit for interaction among transnational firms and international regulators and financial institutions with regard to audit quality, systems of quality control, and transparency of international networks.

## Chapter summary

