

## **Proposed Revised ISA 600 “Group Audits – Consider the Work of Other Auditors” – Explanatory Memorandum**

### **Framework and Related Principles on Which the Revision was Based**

#### FRAMEWORK AND PRINCIPLES

1. The Task Force agreed the following framework and related principles for the revision of ISA 600 “Using the Work of Another Auditor”:

- (a) The proposed revised ISA 600 should be drafted in the context of the audit of group financial statements, i.e., where the group financial statements include financial information of components that are audited by other auditors. However, it should indicate that it can also be applied in other circumstances (refer paragraphs 2(a) and (b) of the proposed revised ISA – Agenda Paper 9-B).
- (b) The objective of the group auditor is to obtain sufficient appropriate audit evidence on which to base his/her opinion on the group financial statements. Such audit evidence could be obtained by way of the group auditor performing audit procedures and/or by way of the group auditor instructing the auditor of a component to perform certain audit procedures. The group auditor should obtain information that the other auditor’s work and report provide him/her with the required audit evidence.
- (c) The nature, timing and extent of the group auditor’s procedures in relation to the work of the other auditor depends on his/her assessment of the following three circumstances:
  - The independence, professional competence and quality control process of the other auditor.
  - The materiality of the component and the level of risk of material misstatement in the group financial statements arising from that component.
  - Whether the group auditor’s report refers to a division of responsibility.

(Refer paragraph 15 of the proposed revised ISA – Agenda Item 9-B.)

2. An illustrative example of the application in practice of the circumstances set out in the first and second bullet of paragraph 1(c) is set out below (i.e., the illustrative examples applies to an environment where division of responsibility is not permitted):

	<b>Other auditor from network firm</b>	<b>Other auditor from firm with good reputation / quality control process</b>	<b>Group auditor uncertain as to reputation / quality control process of other auditor</b>
<b>Component – low materiality / risks</b>	Request closing memorandum on examination	Request closing memorandum Consider rotational visit	Request questionnaire regarding quality control process Request closing memorandum on examination Visit on rotational basis
<b>Component – high materiality / risks</b>	Request closing memorandum on examination Attend closing meeting	Request closing memorandum on examination Review working papers Attend closing meeting	Request questionnaire regarding quality control process Active involvement in planning Request closing memorandum on examination Review working papers Attend closing meeting

#### Action Required by IAASB

Does the IAASB agree with the framework and related principles applied in revising ISA 600?

Is the IAASB of the opinion that the proposed revised ISA reflects the framework and related principles?

TO WHAT EXTENT SHOULD THE GROUP AUDITOR OBTAIN AND UNDERSTANDING OF THE COMPONENTS, THEIR ENVIRONMENTS, INCLUDING THEIR INTERNAL CONTROLS

3. This issue is relevant only to an environment where there is no division of responsibility.

4. The following was discussed by the Task Force at its November 2002 meeting:

- (a) To what extent should the group auditor participate in the audit of components audited by other auditors? Does the group auditor focus on the parent company and consider the parent company's internal control in relation to the components, and the parent company's process of consolidating or combining financial information? Or should the group auditor obtain an understanding of the components, their environments, including their internal control, participate in the other auditors' risk assessments, etc.? If the latter, is such participation limited to material components where significant risks of material misstatement in the group financial statements arise from those components?

- (b) How should the group auditor participate in the audit process of the other auditor? Is the issuing of instructions sufficient? Should it be done at various stages of the audit process?
5. The Task Force concluded that the group auditor's participation in the audit process of the other auditor is dependent on his/her assessment of the matters set out in paragraph 1(c) above. However, the group auditor's acceptance of the client *inter alia* is based on his/her preliminary assessment of the components' business activities (refer paragraph 10(b) of the proposed revised ISA – Agenda Item 9-B).

#### Action Required by IAASB

Does the IAASB agree with the conclusion reached by the Task Force with regard to the group auditor's participation in the audit process of the other auditor?

Is the IAASB of the opinion that the proposed revised ISA reflects the Task Force's conclusion?

#### What if there is no principal entity?

6. At its September 2002 meeting, the IAASB was requested to consider the proposed definitions to be used in the revised ISA. The Issues Paper noted that IAS 27 "Presentation of Group Financial Statements" defines "group" as "a parent and all its subsidiaries," and "group financial statements" as "the financial statements of a group presented as those of a single enterprise."
7. At the time, it was proposed that, for purposes of this project, "group" was defined as "a principal entity and its components," and "components" was defined as "a division, branch, subsidiary (including a special purpose entity), joint venture, associated company or other entity whose financial information is included in the principal entity's financial statements." "Principal entity" was then to be defined as "an entity whose financial statements include financial information of one or more components." In addition, it was proposed that reference was made to "group financial statements" and not "consolidated financial statements", defining "group financial statements" as "the financial statements of a group presented as those of a single enterprise."
8. The IAASB did not support the Task Force's proposal, noting that it did not want to deviate from definitions already existent in other international literature. The IAASB proposed that reference should be made to "financial statements that include financial information of components" (and in the case of ISA 600 "financial statements that include financial information of components audited by other auditors").
9. Reference was also made to circumstances where no principal entity existed, i.e., when the financial information of components were combined in a set of financial statements. The Task Force was advised not to use the term "principal entity" in order to provide for these circumstances. This issue was also raised by the Director of Technical Activities of the International Accounting Standards Board (IASB) at the October 2002 IAASB CAG meeting.
10. The Task Force debated the issue at its November 2002 meeting and concluded as follows:

- (a) As noted in paragraph 1(a), the focus of the proposed revised ISA is the audit of group financial statements and the Standards and guidance should focus on group financial statements. However, the existence of “combined financial statements” should be recognized and the proposed revised ISA should indicate that the Standards and guidance also apply to such financial statements. Refer to paragraph 2(a) of the proposed revised ISA (Agenda Item 9-B). The content of this paragraph was considered by the IASB Director of Technical Activities, who was of the opinion that it sufficiently addressed the issue.
- (b) To keep the proposed revised ISA as simple and short as possible – making it easier to read and understand – the terms “group auditor,” “other auditor,” “network firm,” “group,” and “component” should be defined. Although not necessary to be defined, as its meaning is obvious from these definitions, the Task Force agreed to use the terms “parent company” and “group financial statements.” (Refer paragraphs 5 – 9 of the proposed revised ISA – Agenda Item 9-B.)

#### **Action Required by IAASB**

The IAASB is asked to reconsider its conclusion reached at the September 2002 with regard to the terminology to be used in the proposed revised ISA 600, and the use of the term “principal entity” (now “parent company”), i.e., providing for circumstances where a principal entity/parent company does not exist.

#### **Audit Materiality in a Group Context**

11. Although not relevant to the proposed revised ISA, but impacting the new IAPS, the Task Force had preliminary discussions on audit materiality in a group context at its November 2002 meeting. These preliminary discussions included the following:

- Support for the Materiality Task Force’s proposal that two types of audit materiality exist, i.e., planning materiality and reporting materiality.
- Planning materiality for the statutory audit of a component will be lower than planning materiality for the group financial statements as a whole and planning materiality communicated to the other auditor.
- The more components there are in a group, the lower the planning materiality communicated to the other auditor, i.e., the planning materiality communicated to the other auditor may be lower than the planning materiality for the group financial statements as a whole.
- The larger the difference between the planning materiality communicated to the other auditor and the planning materiality for the group financial statements as a whole, the greater the risk of undetected misstatements.
- Reporting materiality will be higher than planning materiality for the group financial statements as a whole in order to allow for the aggregation of detected misstatements.

12. The Task Force agreed to communicate its preliminary discussions to the Materiality Task Force. The Task Force also requested the IAASB staff to evaluate any academic work conducted on materiality, as well as methodologies obtained from the audit firms before.

**Title**

13. To clearly reflect the principle set out in paragraph 1(a), the Task Force is of the opinion that the title of ISA 600 should be changed to reflect its focus on the audit of group financial statements. The Task Force proposes one of the following titles:
- (a) “Group Audits – Considering the Work of Other Auditors” (which is currently being used as the title of the proposed revised ISA – refer Agenda Item 9-B)
  - (b) “The Group Auditor’s Consideration of the Work of Other Auditors.”

**Action Required by IAASB**

The IAASB is asked to reconsider its conclusion reached at the September 2002 meeting, i.e., not to change the title of ISA 600.

Should the IAASB agree to a change in the title, the IAASB is asked to consider the titles proposed by the Task Force and/or to propose a more suitable title.

**Proposed Revised ISA 600**

14. The Task Force prepared the proposed revised ISA 600 contained in Agenda Item 9-B at its November 2002 meeting, based on its conclusions set out in this explanatory memorandum.

**Action Required by IAASB**

The IAASB is asked to review the proposed revised ISA 600 and to provide detail comment (paragraph by paragraph) to the Task Force.

Comments of an editorial nature should be provided to the responsible IAASB staff member.

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