Agenda Item 2-B

PROPOSED INTERNATIONAL STANDARD ON AUDITING ISA 600
(REVISED AND REDRAFTED)
SPECIAL CONSIDERATIONS—AUDITS OF GROUP FINANCIAL STATEMENTS
(Including the Work of Component Auditors)

(Effective for audits of group financial statements for periods beginning on or after [date])

CONTENTS

	Paragraph
Introduction	
Scope of this ISA	1-3
Component Auditors	4-6
Effective Date	7
Objectives	8
Definitions	9-10
Requirements	
Responsibility and Cooperation	11-12
Acceptance and Continuance	13-15
Overall Audit Strategy and Audit Plan	16-17
Understanding the Group, Its Components and Their Environments	18-19
Understanding the Component Auditors	20-21
Materiality	22-27
Responding to Assessed Risks	28-35
Consolidation Process	36-41
Subsequent Events	42-43
Communication with the Component Auditor	44-45
Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained	46-49
Performing Analytical Procedures in the Overall Review at the End of the Group Audit	50
Communication with Group Management and Those Charged with Governance of the Group	51-54
Documentation	55

Application and Other Explanatory Material

Components Subject to Audit by Statute, Regulation or Other Reason A1
Definitions A2-A7
Responsibility and Cooperation A8-A10
Acceptance and Continuance A11-A22
Overall Audit Strategy and Audit Plan A23
Understanding the Group, Its Components and Their Environments A24-A32
Understanding the Component Auditors A33-A42
Materiality A43-A47
Responding to Assessed Risks A48-A56
Consolidation Process A57
Communication with the Component Auditor A58-A59
Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained A60-A62
Performing Analytical Procedures in the Overall Review at the End of the Group Audit A63
Communication with Group Management and Those Charged with Governance of the Group A64-A67
Appendix 1: Example of a Qualified Opinion where the Group Engagement Team is Not Able to Obtain Sufficient Appropriate Audit Evidence on which to Base the Group Audit Opinion (Paragraph A20)
Appendix 2: Examples of Matters about which the Group Engagement Team Obtains an Understanding (Paragraph A24)
Appendix 3: Examples of Conditions or Events that May Indicate Risks of Material Misstatement of the Group Financial Statements (Paragraph A31)
Appendix 4: Examples of a Component Auditor's Confirmations (Paragraph A36)
Appendix 5: Required and Additional Matters Included in the Group Engagement Team's Letter of Instruction (Paragraph A59)

International Standard on Auditing (ISA) 600 (Revised and Redrafted), "Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the authority of ISAs.

Introduction

Scope of this ISA

1. The International Standards on Auditing (ISAs) apply to group audits. This ISA deals with special considerations that apply to group audits, in particular those that involve component auditors.

2. An auditor of a single entity may find this ISA, adapted as necessary in the circumstances, useful when other auditors are involved in the audit of the financial statements of the single entity.

3. A component auditor may be required by statute, regulation, or for another reason, to express an audit opinion on the financial statements of a component. The group engagement team may decide to use the audit evidence on which the opinion on the financial statements of the component is based to provide audit evidence for the group audit, but the requirements of this ISA shall nevertheless be met. (Ref: Para. A1)

Component Auditors

4. In accordance with [proposed] ISA 220 (Redrafted), "Quality Control for Audit Engagements," the group engagement partner is required to be satisfied that those performing the group audit engagement, including component auditors, collectively have the appropriate capabilities and competence. The group engagement partner is also responsible for the direction, supervision and performance of the group audit engagement.

5. Meeting the requirements of this ISA enables the group engagement partner to meet the requirements of [proposed] ISA 220 (Redrafted). In the case of the group engagement team, or a component auditor that is from the group engagement partner's firm, the group engagement partner may be able to rely on the group engagement partner's firm's system of quality control with regard to compliance with ethical requirements, acceptance and continuance of client relationships and specific engagements, human resources, engagement performance, and monitoring (see [proposed] International Standard on Quality Control (ISQC) 1 (Redrafted), "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements").

6. [Proposed] ISA 200 (Revised and Redrafted), "Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing" explains that audit risk is a function of the risk of material misstatement of the financial statements and the risk that the auditor will not detect such misstatements. In a group audit, this includes the risk that the component auditor may not detect a misstatement in the financial information of the component that could cause a material misstatement of the group financial statements, and the risk that the group engagement team may not detect this misstatement. This ISA explains the matters that the group engagement team considers when determining the nature, timing and extent of its involvement in the risk assessment procedures and further audit procedures performed by the component auditors on the financial information of the components. The purpose of this involvement is to obtain

sufficient appropriate audit evidence on which to base the opinion on the group financial statements.

Effective Date

7. This ISA is effective for audits of group financial statements for periods beginning on or after [date].[1]

Objectives

8. The objectives of the auditor are:
   (a) To determine whether to act as the auditor of the group financial statements;
   (b) To communicate with component auditors on a timely basis; and
   (c) To obtain sufficient appropriate audit evidence about the financial information of the components and the consolidation process to express an opinion whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Definitions

9. The following terms are introduced in this ISA:
   (a) Component – An entity or business activity for which group or component management prepares financial information that is included, or should be included, in the group financial statements. (Ref: Para. A2-A5)
   (b) Component auditor – An auditor who performs work on the financial information of a component for the group audit at the request of the group engagement team.
   (c) Component management – Management responsible for preparing the financial information of a component.
   (d) Component materiality – The materiality level for a component determined by the group engagement team.
   (e) Group – All the components whose financial information is included in the group financial statements. A group always has more than one component. (Ref: Para. A4)
   (f) Group audit – The audit of group financial statements.
   (g) Group audit opinion – The opinion on the group financial statements.
   (h) Group engagement partner – The partner or other person in the firm who is responsible for the group audit engagement and its performance, and for the auditor's report on the group financial statements that is issued on behalf of the firm. Where joint auditors conduct the group audit, the joint engagement partners and their engagement teams

[1] This date will not be earlier than December 15, 2008.

collectively constitute the group engagement partner and the group engagement team. This ISA does not, however, deal with the relationship between joint auditors or the work that one joint auditor performs in relation to the work of the other joint auditor.

(i) Group engagement team – Partners and staff of the group engagement partner's firm who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

(j) Group financial statements – Financial statements that include, or should include, the financial information of more than one component. The term "group financial statements" also refers to combined financial information aggregating the financial information prepared by components that have no parent.

(k) Group management – Management responsible for preparing and presenting the group financial statements.

(l) Group-wide controls – Controls designed, implemented and maintained by group management over group financial reporting.

(m) Significant component – A component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements. (Ref: Para. A6-A7)

10. Reference to "the applicable financial reporting framework" means the financial reporting framework that applies to the group financial statements. Reference to "the consolidation process" includes:

(a) The recognition, measurement, presentation, and disclosure of the financial information of the components in the group financial statements by way of consolidation, proportionate consolidation, or the equity or cost methods of accounting; and

(b) The aggregation of the financial information of components that have no parent.

Requirements

Responsibility and Cooperation

11. Because the group engagement partner or the group engagement partner's firm is responsible for the group audit opinion, the auditor's report on the group financial statements shall not refer to a component auditor. (Ref: Para. A8-A9)

12. A component auditor, knowing the context in which the group engagement team will use the work of the component auditor, shall cooperate with the group engagement team. (Ref: Para. A10)

Acceptance and Continuance

13. In applying [proposed] ISA 220 (Redrafted), the group engagement partner shall determine whether sufficient appropriate audit evidence can reasonably be expected to be obtained in relation to the consolidation process and the financial information of the components on which to base the group audit opinion. For this purpose, the group engagement team shall obtain an understanding of the group, its components, and their environments that is sufficient to identify components that are likely to be significant components. Where component auditors will perform work on the financial information of such components, the group engagement partner shall evaluate whether the group engagement team will be able to be involved in the work of those component auditors to the extent necessary to obtain sufficient appropriate audit evidence. (Ref: Para. A11-A14)

14. If the group engagement partner concludes that:

    (a) it will not be possible for the group engagement team to obtain sufficient appropriate audit evidence due to restrictions imposed by group management; and

    (b) the possible effect of this inability will result in a disclaimer of opinion on the group financial statements (see [proposed] ISA 705 (Revised and Redrafted), "Modifications to the Opinion in the Independent Auditor's Report"),

    the group engagement partner shall:

    - in the case of a new engagement, not accept the engagement;
    - in the case of a continuing engagement, resign from the engagement; or
    - where law or regulation prohibits an auditor from declining, or resigning from, an engagement, and having completed the audit of the group financial statements, disclaim an opinion on the group financial statements. (Ref: Para. A15-A20)

Terms of Engagement

15. The group engagement partner shall agree on the terms of the group audit engagement in accordance with [proposed] ISA 210 (Redrafted), "Agreeing the Terms of Audit Engagements." (Ref: Para. A21-A22)

Overall Audit Strategy and Audit Plan

16. The group engagement team shall establish an overall group audit strategy and shall develop a group audit plan in accordance with ISA 300 (Redrafted), "Planning an Audit of Financial Statements."

17. The group engagement partner shall review the overall group audit strategy and group audit plan. (Ref: Para. A23)

Understanding the Group, Its Components and Their Environments

18. ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" requires the auditor to identify and assess the

risks of material misstatement through obtaining an understanding of the entity and its environment. The group engagement team shall

(a) Enhance its understanding of the group, its components, and their environments, including group-wide controls, obtained during the acceptance or continuance stage, and

(b) Obtain an understanding of the consolidation process, including the instructions issued by group management to components. (Ref: Para. A24-A30)

19. The group engagement team shall obtain an understanding that is sufficient to:

(a) Confirm or revise its initial identification of components that are likely to be significant; and

(b) Assess the risks of material misstatement of the group financial statements at group level in accordance with ISA 315 (Redrafted). (Ref: Para. A31-A32)

Understanding the Component Auditors

20. When the group engagement team plans to request a component auditor to perform work on the financial information of a component, the group engagement team shall obtain an understanding of the following (Ref: Para. A34-A36):

(a) Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent; (Ref: Para. A38)

(b) The component auditor's professional competence; (Ref: Para. A39)

(c) Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence; and

(d) Whether the component auditor operates in a regulatory environment that actively oversees auditors. (Ref: Para. A37)

21. When a component auditor does not meet the independence requirements that are relevant to the group audit, or the group engagement team has serious concerns about the matters listed in paragraph 20(b) and (c), the group engagement team shall obtain sufficient appropriate audit evidence relating to the financial information of the component without requesting that component auditor to perform work on the financial information of that component. (Ref: Para. A40-A42)

Materiality

22. [Proposed] ISA 320 (Revised and Redrafted), "Materiality in Planning and Performing an Audit" requires the auditor:

(a) When establishing the overall audit strategy, to determine a materiality level for the financial statements as a whole.

(b) When establishing the overall audit strategy, to consider whether, in the specific circumstances of the entity, there are particular classes of transactions, account

balances or disclosures for which misstatements of lesser amounts than the materiality level for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. In such circumstances, the auditor determines the materiality levels to be applied to those particular classes of transactions, account balances or disclosures.

(c) To determine one or more amounts lower than the materiality level for the financial statements as a whole for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks.

23. The group engagement team shall determine the materiality level for the group financial statements as a whole when establishing the overall group audit strategy. (Ref: Para. A43)

23a. The group engagement team shall determine whether, in the specific circumstances of the group, there are particular classes of transactions, account balances or disclosures in the group financial statements for which misstatements of lesser amounts than the materiality level for the group financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the group financial statements. In such circumstances, the group engagement team shall determine the materiality levels to be applied to those particular classes of transactions, account balances or disclosures.

24. The group engagement team shall determine component materiality for those components where component auditors will perform an audit or a review for purposes of the group audit. To reduce the risk that the aggregate of detected and undetected misstatements in the group financial statements exceeds the materiality level for the group financial statements as a whole, component materiality is lower than the materiality level for the group financial statements as a whole. (Ref: Para. A44-A45)

25. The group engagement team shall determine the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements. (Ref: Para. A46)

26. Where component auditors will perform an audit for purposes of the group audit, the group engagement team shall evaluate the appropriateness of the amount or amounts lower than the component materiality level (and the amount or amounts lower than the materiality level for particular classes of transactions, account balances or disclosures, if applicable) determined for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks at the component level. (Ref: Para. A47)

27. When a component is subject to audit by statute, regulation or other reason, and the group engagement team decides to use that audit to provide audit evidence for the group audit, the group engagement team shall determine whether:

(a) the materiality level determined for the component financial statements as a whole; and

(b) the lower amounts determined for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks at the component level

meet the requirements of this ISA.

Responding to Assessed Risks

28. ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks" requires the auditor to design and implement appropriate responses to address the assessed risks of material misstatement of the financial statements. The group engagement team shall determine the type of work to be performed by the group engagement team, or the component auditors on its behalf, on the financial information of the components (see paragraphs 30-33). The group engagement team shall also determine the nature, timing and extent of its involvement in the work of the component auditors (see paragraphs 34-35). (Ref: Para. A48)

29. If the nature, timing and extent of the work to be performed on the consolidation process or the financial information of the components are based on an expectation that group-wide controls are operating effectively, or when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level, the group engagement team shall test, or request a component auditor to test, the operating effectiveness of those controls.

Determining the Type of Work to Be Performed on the Financial Information of Components

Significant Components

30. For a component that is significant due to its individual financial significance to the group, the group engagement team, or a component auditor on its behalf, shall perform an audit of the financial information of the component using either component materiality, or a lower materiality level determined by the component auditor where the component auditor is required by statute, regulation or for any other reason to express an audit opinion on the financial statements of the component.

31. For a component that is significant because it is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances, the group engagement team, or a component auditor on its behalf, shall perform one or more of the following:

    (a) An audit of the financial information of the component using either component materiality, or a lower materiality level determined by the component auditor where the component auditor is required by statute, regulation or for any other reason to express an audit opinion on the financial statements of the component.

    (b) An audit of one or more account balances, classes of transactions or disclosures relating to the likely significant risks of material misstatement of the group financial statements. (Ref: Para. A49)

    (c) Specified audit procedures relating to the likely significant risks of material misstatement of the group financial statements. (Ref: Para. A50)

Components that Are Not Significant Components

32. For components that are not significant components, the group engagement team shall perform analytical procedures at group level. (Ref: Para. A51)

33. If the group engagement team does not consider that sufficient appropriate audit evidence on which to base the group audit opinion will be obtained from:

(a) The work performed on the financial information of significant components;

(b) The work performed on group-wide controls and the consolidation process; and

(c) The analytical procedures performed at group level,

the group engagement team shall select components that are not significant components and shall perform, or request a component auditor to perform, one or more of the following on the financial information of the individual components selected:

(a) An audit of the financial information of the component using either component materiality, or a lower materiality level determined by the component auditor where the component auditor is required by statute, regulation or for any other reason to express an audit opinion on the financial statements of the component.

(b) An audit of one or more account balances, classes of transactions or disclosures.

(c) A review of the financial information of the component using either component materiality, or a lower materiality level determined by the component auditor.

(d) Specified procedures.

The group engagement team shall vary the selection of components over a period of time. (Ref: Para. A52-A53)

Involvement in the Work Performed by Component Auditors (Ref: Para. A55-A56)

Significant Components—Risk Assessment

34. When a component auditor performs an audit of the financial information of a significant component, the group engagement team shall be involved in the component auditor's risk assessment to identify significant risks of material misstatement of the group financial statements. The nature, timing and extent of this involvement are affected by the group engagement team's understanding of the component auditor, but at a minimum shall include:

(a) Discussing with the component auditor or component management those of the component's business activities that are significant to the group;

(b) Discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error; and

(c) Reviewing the component auditor's documentation of identified significant risks of material misstatement of the group financial statements. Such documentation may take the form of a memorandum that reflects the component auditor's conclusion with regard to the identified significant risks.

Identified Significant Risks of Material Misstatement of the Group Financial Statements—Further Audit Procedures

35. When significant risks of material misstatement of the group financial statements have been identified in a component on which a component auditor performs the work, the group engagement team shall evaluate the appropriateness of the further audit procedures to be performed to respond to the identified significant risks of material misstatement of the group

financial statements. Based on its understanding of the component auditor, the group engagement team shall determine whether it is necessary to be involved in the further audit procedures.

Consolidation Process

36. In accordance with paragraph 18, the group engagement team obtains an understanding of group-wide controls and the consolidation process, including the instructions issued by group management to components. In accordance with paragraph 29, the group engagement team, or component auditor at the request of the group engagement team, tests the operating effectiveness of group-wide controls if the nature, timing and extent of the work to be performed on the consolidation process are based on an expectation that group-wide controls are operating effectively, or when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

37. The group engagement team shall design and perform further audit procedures on the consolidation process to respond to the assessed risks of material misstatement of the group financial statements arising from the consolidation process. This shall include evaluating whether all components have been included in the group financial statements.

38. The group engagement team shall evaluate the appropriateness, completeness and accuracy of consolidation adjustments and reclassifications, and shall evaluate whether any fraud risk factors or indicators of possible management bias exist. (Ref: Para. A57)

39. If the financial information of a component has not been prepared in accordance with the same accounting policies applied to the group financial statements, the group engagement team shall evaluate whether the financial information of that component has been appropriately adjusted for purposes of preparing and presenting the group financial statements.

40. The group engagement team shall determine whether the financial information identified in the component auditor's communication (see paragraph 45) is the financial information that is incorporated in the group financial statements.

41. If the group financial statements include the financial statements of a component with a financial reporting period-end that differs from that of the group, the group engagement team shall evaluate whether appropriate adjustments have been made to those financial statements in accordance with the applicable financial reporting framework.

Subsequent Events

42. Where the group engagement team or component auditors perform audits on the financial information of components, the group engagement team or the component auditors shall perform procedures designed to identify events at those components that occur between the dates of the financial information of the components and the date of the auditor's report on the group financial statements, and that may require adjustment to or disclosure in the group financial statements.

43. Where component auditors perform work other than audits of the financial information of components, the group engagement team shall request the component auditors to notify the group engagement team if they become aware of subsequent events that may require an adjustment to or disclosure in the group financial statements.

Communication with the Component Auditor

44. The group engagement team shall communicate its requirements to the component auditor on a timely basis. (Ref: Para. A58-A59) 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. It shall also include the following:

    (a) The ethical requirements that are relevant to the group audit and, in particular, the independence requirements.

    (b) In the case of an audit or review of the financial information of the component, component materiality (and the amount or amounts lower than the materiality level for particular classes of transactions, account balances or disclosures, if applicable) and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.

    (c) Identified significant risks of material misstatement of the group financial statements, due to fraud or error, that are relevant to the work of the component auditor. The group engagement team shall request the component auditor to communicate any other identified significant risks of material misstatement of the group financial statements, due to fraud or error, in the component, and the component auditor's responses to such risks.

    (d) A list of related parties prepared by group management, and any other related parties of which the group engagement team is aware. The group engagement team shall request the component auditor to communicate related parties not previously identified by group management or the group engagement team. The group engagement team shall determine whether to identify such additional related parties to other component auditors.

45. The group engagement team shall request the component auditor to communicate matters relevant to the group engagement team's conclusion with regard the group audit. In particular:

    (a) Whether the component auditor has complied with ethical requirements that are relevant to the group audit, including independence and professional competence;

    (b) Whether the component auditor has complied with the group engagement team's requirements;

    (c) Identification of the financial information of the component on which the component auditor is reporting;

    (d) Information on instances of non-compliance with laws or regulations that could give rise to a material misstatement of the group financial statements;

(e) In the case of an audit of the financial information of the component, the lower amount(s) determined by the component auditor for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks at the component level;

(f) A list of uncorrected misstatements of the financial information of the component (the list need not include misstatements that are below the threshold for clearly trivial misstatements communicated by the group engagement team (see paragraph 44(b));

(g) Indicators of possible management bias;

(h) Description of any identified material weaknesses in internal control over financial reporting at the component level;

(i) Other significant matters that the component auditor communicated or expects to communicate to those charged with governance of the component, including fraud or suspected fraud involving component management, employees who have significant roles in internal control at the component level or others where the fraud resulted in a material misstatement of the financial information of the component;

(j) Any other matters that may be relevant to the group audit, or that the component auditor wishes to draw to the attention of the group engagement team, including exceptions noted in the written representations that the component auditor requested from component management; and

(k) The component auditor's overall findings, conclusions, or opinion.

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

Evaluating the Component Auditor's Communication and Adequacy of Their Work

46. The group engagement team shall evaluate the component auditor's communication (see paragraph 45). The group engagement team shall:

    (a) Discuss significant matters arising from that evaluation with the component auditor, component management or group management, as appropriate; and

    (b) Determine whether it is necessary to review other relevant parts of the component auditor's audit documentation. (Ref: Para. A60)

47. If the group engagement partner concludes that the work of the component auditor is insufficient, the group engagement partner shall determine what additional procedures are to be performed, and whether they are to be performed by the component auditor or by the group engagement team.

Sufficiency and Appropriateness of Audit Evidence

48. [Proposed] ISA 200 (Revised and Redrafted) requires the auditor to obtain sufficient appropriate audit evidence on which to base the audit opinion. The group engagement partner shall evaluate whether sufficient appropriate audit evidence has been obtained from the audit procedures performed on the consolidation process and the work performed by the group

engagement team and the component auditors on the financial information of the components, on which to base the group audit opinion. (Ref: Para. A61)

49. The group engagement partner shall evaluate the effect on the group audit opinion of any misstatements (either identified by the group engagement team or communicated by component auditors) and any instances where there has been an inability to obtain sufficient appropriate audit evidence. (Ref: Para. A62)

Performing Analytical Procedures in the Overall Review at the End of the Group Audit

50. The group engagement team shall perform analytical procedures at group level at or near the end of the group audit in accordance with ISA 520, "Analytical Procedures." (Ref: Para. A63)

Communication with Group Management and Those Charged with Governance of the Group

Communication with Group Management

51. The group engagement team shall make group management aware, on a timely basis and at an appropriate level of responsibility, of:

    (a) Material weaknesses in the design or operating effectiveness of group-wide controls;

    (b) Material weaknesses that the group engagement team has identified in internal controls at components and judges are of significance to the group; and

    (c) Material weaknesses brought to the attention of the group engagement team by the component auditors that the group engagement team judges are of significance to the group.

52. If fraud has been identified by the group engagement team or brought to its attention by a component auditor (see paragraph 45(i)), or information indicates that a fraud may exist, the group engagement team shall communicate this on a timely basis to group management. (Ref. Para. A64)

53. A component auditor may be required by statute, regulation, or for another reason, to express an audit opinion on the financial statements of a component. In that case, the group engagement team shall request group management to inform component management of any matter of which the group engagement team becomes aware that may be significant to the financial statements of the component, but of which component management may be unaware. If group management refuses to communicate the matter to component management, the group engagement team shall discuss the matter with those charged with governance of the group. If the matter remains unresolved, the group engagement team, subject to legal and professional confidentiality considerations, shall consider whether to advise the component auditor not to issue the auditor's report on the financial statements of the component until the matter is resolved. (Ref: Para. A65-A66)

Communication with Those Charged with Governance of the Group

54. The group engagement team shall communicate with those charged with governance of the group the following matters, in addition to those required by [proposed] ISA 260 (Revised and Redrafted), "Communication with Those Charged with Governance" and other ISAs:

(a) An overview of the type of work to be performed on the financial information of the components.

(b) An overview of the nature of the group engagement team's planned involvement in the work to be performed by the component auditors on the financial information of significant components.

(c) 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.

(d) Any limitations on the group audit, for example, where the group engagement team's access to information may have been restricted.

(e) Fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls or others where the fraud resulted in a material misstatement of the group financial statements (Ref: Para. A67)

Documentation

55. The group engagement team shall document the following matters in addition to those required by [proposed] ISA 230 (Redrafted), "Audit Documentation" and the other ISAs:

(a) An analysis of components, indicating those that are significant, and the type of work performed on the financial information of the components.

(b) The nature, timing and extent of the group engagement team's involvement in the work performed by the component auditors on significant components.

(c) Communications between the group engagement team and the component auditors about the group engagement team's requirements.

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Application and Other Explanatory Material

Components Subject to Audit by Statute, Regulation or Other Reason (Ref: Para. 3)

A1. Factors that may affect the group engagement team's decision whether to use an audit required by statute, regulation or for another reason to provide audit evidence for the group audit, include the following:

- Differences in the financial reporting framework applied in preparing the financial statements of the component and that applied in preparing the group financial statements
- Differences in the auditing and other standards applied by the component auditor and those applied in the audit of the group financial statements; and
- Whether the audit of the financial statements of the component will be completed in time to meet the group reporting timetable.

Definitions

Component (Ref: Para. 9(a))

A2. The structure of a group affects how components are identified. For example, the group financial reporting system may be based on an organizational structure that provides for financial information to be prepared by a parent and one or more subsidiaries, joint ventures, or investees accounted for by the equity or cost methods of accounting; by a head office and one or more divisions or branches; or by a combination of both. Some groups, however, may organize their financial reporting system by function, process, product or service (or by groups of products or services), or geographical locations. In these cases, the entity or business activity for which group or component management prepares financial information that is included in the group financial statements may be a function, process, product or service (or group of products or services), or geographical location.

A3. Various levels of components may exist within the group financial reporting system, in which case it may be more appropriate to identify components at certain levels of aggregation rather than individually.

A4. Components aggregated at a certain level may constitute a component for purposes of the group audit; however, it may also prepare group financial statements that incorporate the financial information of the components it encompasses (i.e., a subgroup). This ISA may therefore be applied by different group engagement partners and teams for different subgroups within a larger group.

A5. Although all components will have component management, it may not be possible to identify those charged with governance for all components.

Significant Component (Ref: Para. 9(m))

A6. As the individual financial significance of a component increases, the risks of material misstatement of the group financial statements ordinarily increase. The group engagement team may apply a percentage to a chosen benchmark as an aid to identify components that are of individual financial significance. The group engagement team exercises professional judgment in identifying a benchmark and determining a percentage to be applied to it. Depending on the nature and circumstances of the group, appropriate benchmarks might include group assets, liabilities, cash flows, profit or turnover. For example, the group engagement team may consider that components exceeding 15% of the chosen benchmark are significant components. A higher or lower percentage may, however, be deemed appropriate in the circumstances.

A7. The group engagement team may also identify a component as likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances (i.e., significant risks that require special audit consideration – see ISA 315 (Redrafted)). For example, a component could be responsible for foreign exchange trading and thus expose the group to a significant risk of material misstatement, even though the component is not otherwise of individual financial significance to the group.

Responsibility and Cooperation (Ref: Para. 11-12)

A8. Although component auditors may perform work on the financial information of the components for the group audit and as such are responsible for their overall findings, conclusions or opinions, the group engagement partner or the group engagement partner's firm is responsible for the group audit opinion.

A9. When the group audit opinion is modified because the group engagement team was unable to obtain sufficient appropriate audit evidence in relation to the financial information of one or more components, the basis for the modification paragraph in the auditor's report on the group financial statements describes the reasons for that inability in accordance with [proposed] ISA 705 (Revised and Redrafted) without referring to the component auditor.

A10. In cooperating with the group engagement team, the component auditor, for example, would provide the group engagement team with access to relevant audit documentation if not prohibited by law or regulation.

Acceptance and Continuance

Obtaining an Understanding at the Acceptance or Continuance Stage (Ref: Para. 13)

A11. In the case of a new engagement, the group engagement team's understanding of the group, its components, and their environments may be obtained from:

- Information provided by group management;
- Communication with group management; and
- Where applicable, communication with the previous group engagement team, component management, or component auditors.

A12. The group engagement team's understanding may include matters such as the following:

- The group structure, including both the legal and organizational structure (i.e., how the group financial reporting system is organized).
- Components' business activities that are significant to the group, including the industry and regulatory, economic and political environments in which those activities take place.
- The use of service organizations, including shared service centers.
- A description of group-wide controls.
- The complexity of the consolidation process.
- Whether component auditors that are not from the group engagement partner's firm or network will perform work on the financial information of any of the components, and group management's rationale for appointing more than one auditor.
- Whether the group engagement team:
    - Will have unrestricted access to those charged with governance of the group, group management, those charged with governance of the component,

component management, component information, and the component auditors (including relevant audit documentation sought by the group engagement team); and

- Will be able to perform necessary work on the financial information of the components.

A13. In the case of a continuing engagement, the group engagement team's ability to obtain sufficient appropriate audit evidence may be affected by significant changes, for example:

- Changes in the group structure (e.g., acquisitions, disposals, reorganizations, or changes in how the group financial reporting system is organized).
- Changes in components' business activities that are significant to the group.
- Changes in the composition of those charged with governance of the group, group management, or key management of significant components.
- Concerns the group engagement team has with regard to the integrity and competence of group or component management.
- Changes in group-wide controls.
- Changes in the applicable financial reporting framework.

Expectation to Obtain Sufficient Appropriate Audit Evidence (Ref: Para. 13)

A14. A group may consist only of components not considered significant components. In these circumstances, the group engagement partner can reasonably expect to obtain sufficient appropriate audit evidence on which to base the group audit opinion if the group engagement team will be able to:

(a) Perform the work on the financial information of some of these components; and

(b) Be involved in the work performed by component auditors on the financial information of other components to the extent necessary to obtain sufficient appropriate audit evidence.

Access to Information (Ref: Para. 14)

A15. The group engagement team's access to information may be restricted by circumstances that cannot be overcome by group management, for example laws relating to confidentiality and data privacy, or denial by the component auditor of access to relevant audit documentation sought by the group engagement team. It may also be restricted by group management.

A16. Where access to information is restricted by circumstances, the group engagement team may still be able to obtain sufficient appropriate audit evidence; however, this is less likely as the significance of the component increases. For example, the group engagement team may not have access to those charged with governance, management, or the auditor (including relevant audit documentation sought by the group engagement team) of a component that is accounted for by the equity method of accounting. If the component is not a significant component, and the group engagement team has a complete set of financial statements of the

component, including the auditor's report thereon, and has access to information kept by group management in relation to that component, the group engagement team may conclude that this information constitutes sufficient appropriate audit evidence in relation to that component. If the component is a significant component, however, the group engagement team will not be able to comply with the requirements of this ISA relevant in the circumstances of the group audit. For example, the group engagement team will not be able to comply with the requirement in paragraphs 34-35 to be involved in the work of the component auditor. The group engagement team will not, therefore, be able to obtain sufficient appropriate audit evidence in relation to that component. The effect of the group engagement team's inability to obtain sufficient appropriate audit evidence is considered in terms of [proposed] ISA 705 (Revised and Redrafted).

A17. The group engagement team will not be able to obtain sufficient appropriate audit evidence if group management restricts the access of the group engagement team or a component auditor to the information of a significant component.

A18. Although the group engagement team may be able to obtain sufficient appropriate audit evidence if such restriction relates to a component considered not a significant component, the reason for the restriction may affect the group audit opinion. For example, it may indicate that the parent does not control or have significant influence over the component and that the component therefore ought not to be included in the group financial statements.

A19. Law or regulation may prohibit the group engagement partner from declining or resigning from an engagement. For example, in some jurisdictions the auditor is appointed for a specified period of time and is prohibited from resigning before the end of that period. Also, in the public sector, the option of declining or resigning from an engagement may not be available to the auditor due to the nature of the mandate or public interest considerations. In these circumstances, this ISA still applies to the group audit, and the effect of the group engagement team's inability to obtain sufficient appropriate audit evidence is considered in terms of [proposed] ISA 705 (Revised and Redrafted).

A20. Appendix 1 contains an example of an auditor's report containing a qualified opinion based on the group engagement team's inability to obtain sufficient appropriate audit evidence in relation to a significant component accounted for by the equity method of accounting, but where, in the group engagement team's judgment, the effect is material but not pervasive.

Terms of Engagement (Ref: Para. 15)

A21. As required in [proposed] ISA 210 (Redrafted), the terms of engagement identifies the applicable financial reporting framework. Additional matters may be included in the terms of a group audit engagement, such as the fact that:

- The communication between the group engagement team and the component auditors should be unrestricted to the extent permitted by law or regulation.
- Important communications between the component auditors, those charged with governance of the component, and component management, including communications on material weaknesses in internal control, should be communicated as well to the group engagement team.

- Important communications between regulatory authorities and components related to financial reporting matters should be communicated to the group engagement team.
- To the extent the group engagement team considers necessary, it should be permitted:
  - Access to component information, those charged with governance of components, component management, and the component auditors (including relevant audit documentation sought by the group engagement team); and
  - To perform work or request a component auditor to perform work on the financial information of the components.

A22. Restrictions imposed on:

- the group engagement team's access to component information, those charged with governance of components, component management, or the component auditors (including relevant audit documentation sought by the group engagement team); or
- the work to be performed on the financial information of the components,

after the group engagement partner's acceptance of the engagement, constitute a scope limitation that may affect the group audit opinion. In exceptional circumstances it may even lead to resignation from the engagement where that is not prohibited by law or regulation.

Overall Audit Strategy and Audit Plan (Ref: Para. 17)

A23. [Proposed] ISA 220 (Redrafted) requires the engagement partner to take responsibility for the direction of the audit engagement. The group engagement partner's review of the overall group audit strategy and group audit plan is an important part of fulfilling this responsibility in a group audit.

Understanding the Group, Its Components and Their Environments

Matters About Which the Group Engagement Team Obtains an Understanding (Ref: Para. 18)

A24. ISA 315 (Redrafted) contains guidance on matters the auditor may consider when obtaining an understanding of the industry, regulatory, and other external factors that affect the entity, including the applicable financial reporting framework; the nature of the entity; objectives and strategies and related business risks; and measurement and review of the entity's financial performance. Appendix 2 contains guidance on matters specific to a group, including the consolidation process.

Instructions Issued by Group Management to Components (Ref: Para. 18)

A25. To achieve uniformity and comparability of financial information, group management ordinarily issues instructions to components. Such instructions specify the requirements for financial information of the components to be included in the group financial statements and often include financial reporting procedures manuals and a reporting package. A reporting package ordinarily consists of standard formats for providing financial information for incorporation in the group financial statements. Reporting packages generally do not, however, take the form of complete financial statements prepared and presented in accordance with the applicable financial reporting framework.

A26. The instructions ordinarily cover:

- The accounting policies to be applied;
- Statutory and other disclosure requirements applicable to the group financial statements, including:
  - The identification and reporting of segments;
  - Related party relationships and transactions;
  - Intra-group transactions and unrealized profits;
  - Intra-group account balances; and
- A reporting timetable.

A27. The group engagement team's understanding of the instructions may include the following:

- The clarity and practicality of the instructions for completing the reporting package.
- Whether the instructions:
  - Adequately describe the characteristics of the applicable financial reporting framework;
  - Provide for disclosures that are sufficient to comply with the requirements of the applicable financial reporting framework, for example disclosure of related party relationships and transactions, and segment information;
  - Provide for the identification of consolidation adjustments, for example intra-group transactions and unrealized profits, and intra-group account balances; and
  - Provide for the approval of the financial information by component management.

Fraud (Ref: Para. 18)

A28. ISA 240 (Redrafted), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" requires the auditor to identify and assess the risks of material misstatement of the financial statements due to fraud, and to design and implement appropriate responses to the assessed risks. Information used to identify the risks of material misstatement of the group financial statements due to fraud may include the following:

- Group management's assessment of the risks that the group financial statements may be materially misstated as a result of fraud.
- Group management's process for identifying and responding to the risks of fraud in the group, including any specific fraud risks identified by group management, or account balances, classes of transactions, or disclosures for which a risk of fraud is likely.
- Whether there are particular components for which a risk of fraud is likely.
- How those charged with governance of the group monitor group management's processes for identifying and responding to the risks of fraud in the group, and the controls group management has established to mitigate these risks.

- Responses of those charged with governance of the group, group management, internal audit (and if considered appropriate, component management, the component auditors, and others) to the group engagement team's inquiry whether they have knowledge of any actual, suspected, or alleged fraud affecting a component or the group.

Discussion among Group Engagement Team Members and Component Auditors Regarding the Risks of Material Misstatement of the Group Financial Statements, Including Risks of Fraud (Ref: Para. 18)

A29. ISA 315 (Redrafted) and ISA 240 (Redrafted) require the key members of the engagement team to discuss the susceptibility of an entity to material misstatement of the financial statements due to fraud or error, specifically emphasizing the risks due to fraud. In a group audit, these discussions may also include the component auditors. The group engagement partner's determination of who to include in the discussions, how and when they occur, and their extent, is affected by factors such as prior experience with the group.

A30. The discussions provide an opportunity to:

- Share knowledge of the components and their environments, including group-wide controls.
- Exchange information about the business risks of the components or the group.
- Exchange ideas about how and where the group financial statements may be susceptible to material misstatement due to fraud or error, how group management and component management could perpetrate and conceal fraudulent financial reporting, and how assets of the components could be misappropriated.
- Identify practices followed by group or component management that may be biased or designed to manage earnings that could lead to fraudulent financial reporting, for example revenue recognition practices that do not comply with the applicable financial reporting framework.
- Consider known external and internal factors affecting the group that may create an incentive or pressure for group management, component management, or others to commit fraud, provide the opportunity for fraud to be perpetrated, or indicate a culture or environment that enables group management, component management, or others to rationalize committing fraud.
- Consider the risk that group or component management may override controls.
- Consider whether uniform accounting policies are used to prepare the financial information of the components for the group financial statements and, where not, how differences in accounting policies are identified and adjusted (where required by the applicable financial reporting framework).
- Discuss fraud that has been identified in components, or information that indicates existence of a fraud in a component.
- Share information that may indicate non-compliance with national laws or regulations, for example payments of bribes and improper transfer pricing practices.

Risk Factors (Ref: Para. 19)

A31. Appendix 3 sets out examples of conditions or events that, individually or together, may indicate risks of material misstatement of the group financial statements, including risks due to fraud.

Risk Assessment (Ref: Para. 19)

A32. The group engagement team's assessment at group level of the risks of material misstatement of the group financial statements is based on information such as the following:

- Information obtained from the understanding of the group, its components, and their environments, and of the consolidation process, including audit evidence obtained in evaluating the design and implementation of group-wide controls and controls that are relevant to the consolidation.
- Information obtained from the component auditors.

Understanding the Component Auditors (Ref: Para. 20-21)

A33. The group engagement team obtains an understanding of a component auditor only when it plans to request the component auditor to perform work on the financial information of a component for the group audit. For example, it will not be necessary to obtain an understanding of the auditors of those components for which the group engagement team plans to perform analytical procedures at group level only.

Group Engagement Team's Procedures to Obtain an Understanding of the Component Auditor and Sources of Audit Evidence (Ref: Para. 20)

A34. The nature, timing and extent of the group engagement team's procedures to obtain an understanding of the component auditor are affected by factors such as previous experience with or knowledge of the component auditor, and the degree to which the group engagement team and the component auditor are subject to common policies and procedures, for example:

- Whether the group engagement team and a component auditor share:
  - Common policies and procedures for performing the work (e.g., audit methodologies);
  - Common quality control policies and procedures; or
  - Common monitoring policies and procedures.
- The consistency or similarity of:
  - Laws and regulations or legal system;
  - Professional oversight, discipline, and external quality assurance;
  - Education and training;
  - Professional organizations and standards;
  - Language and culture.

A35. These factors interact and are not mutually exclusive. For example, the extent of the group engagement team's procedures to obtain an understanding of Component Auditor A, who consistently applies common quality control and monitoring policies and procedures and a common audit methodology or operates in the same jurisdiction as the group engagement partner, may be less than the extent of the group engagement team's procedures to obtain an understanding of Component Auditor B, who is not consistently applying common quality control and monitoring policies and procedures and a common audit methodology or operates in a foreign jurisdiction. The nature of the procedures performed in relation to Component Auditors A and B may also be different.

A36. The group engagement team may obtain an understanding of the component auditor in a number of ways. In the first year of involving a component auditor, the group engagement team may, for example:

- Evaluate the results of the quality control monitoring system where the group engagement team and component auditor are from a firm or network that operates under and complies with common monitoring policies and procedures as provided for in paragraph 87 of ISQC 1;
- Visit the component auditor to discuss the matters in paragraph 20(a)-(c);
- Request the component auditor to confirm the matters referred to in paragraph 20(a)-(c) in writing. Appendix 4 contains an example of written confirmations by a component auditor;
- Request the component auditor to complete questionnaires about the matters in paragraph 20(a)-(c);
- Discuss the component auditor with colleagues in the group engagement partner's firm, or with a reputable third party that has knowledge of the component auditor; or
- Obtain confirmations from the professional body or bodies to which the component auditor belongs, the authorities by which the component auditor is licensed, or other third parties.

In subsequent years, the understanding of the component auditor may be based on the group engagement team's previous experience with the component auditor. The group engagement team may request the component auditor to confirm whether anything in relation to the matters listed in paragraph 20(a)-(c) has changed since the previous year.

A37. In some countries, independent oversight bodies have been established to oversee the auditing profession and monitor the quality of audits. Awareness of the regulatory environment may assist the group engagement team to evaluate the independence and competence of the component auditor. Information about the regulatory environment may be obtained from the component auditor or information provided by the independent oversight bodies.

Ethical Requirements that are Relevant to the Group Audit (Ref: Para. 20(a))

A38. When performing work on the financial information of a component for a group audit, the component auditor is subject to ethical requirements that are relevant to the group audit. Such requirements may be different or in addition to those applying to the component auditor when performing a statutory audit in the component auditor's jurisdiction. The group engagement team therefore obtains an understanding whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit, sufficient to fulfill the component auditor's responsibilities in the group audit.

The Component Auditor's Professional Competence (Ref: Para. 20(b))

A39. The group engagement team's understanding of the component auditor's professional competence may include whether the component auditor:

- Possesses an understanding of auditing and other standards applicable to the group audit that is sufficient to fulfill the component auditor's responsibilities in the group audit;
- Possesses the special skills (e.g., industry specific knowledge) necessary to perform the work on the financial information of the particular component; and
- Where relevant, possesses an understanding of the applicable financial reporting framework that is sufficient to fulfill the component auditor's responsibilities in the group audit (instructions issued by group management to components often describe the characteristics of the applicable financial reporting framework).

Application of the Group Engagement Team's Understanding of a Component Auditor (Ref: Para. 20-21)

A40. The group engagement team cannot overcome the fact that a component auditor is not independent by being involved in the work of the component auditor or by performing additional risk assessment or further audit procedures on the financial information of the component.

A41. However, the group engagement team may be able to overcome less than serious concerns about the component auditor's professional competency (e.g., lack of industry specific knowledge), or the fact that the component auditor does not operate in an environment that actively oversees auditors, by being involved in the work of the component auditor or by performing additional risk assessment or further audit procedures on the financial information of the component.

A42. Where law or regulation prohibits access to relevant parts of the audit documentation of the component auditor, the group engagement team may request the component auditor to overcome this by preparing a memorandum that covers the relevant information.

Materiality (Ref: Para. 22-27)

A43. In the context of a group audit, materiality levels are established for both the group financial statements as a whole, and for the financial information of the components. The materiality

level for the group financial statements as a whole is used when establishing the overall group audit strategy.

A44. To reduce the risk that the aggregate of detected and undetected misstatements in the group financial statements exceeds the materiality level for the group financial statements as a whole, the component materiality level is set lower than the group materiality level. Different materiality levels may be established for different components. The component materiality level need not be an arithmetical portion of the group materiality level and, consequently, the aggregate of the component materiality levels may exceed the group materiality level. The component materiality level is used when establishing the overall audit strategy for a component.

A45. The group engagement team determines component materiality levels for those components whose financial information will be audited or reviewed as part of the group audit in accordance with paragraphs 30, 31(a) and 33(a). Component materiality is used by the component auditor to evaluate whether uncorrected detected misstatements are material, individually or in the aggregate.

A46. In addition to determining component materiality levels, the group engagement team also establishes a threshold for misstatements and requires the component auditor to communicate to the group engagement team misstatements identified in the financial information of the component that are above this amount.

A47. In the case of an audit of the financial information of a component, the component auditor (or group engagement team), in compliance with [proposed] ISA 320 (Revised and Redrafted) determines one or more amounts lower than the component materiality level for purposes of assessing the risks of material misstatement of the financial information of the component and to design further audit procedures in response to assessed risks. This is necessary to reduce the risk that the aggregate of detected and undetected misstatements in the financial information of the component exceeds the component materiality level. In practice, the group engagement team may set component materiality at this lower level. Where this is the case, the component auditor uses component materiality for purposes of assessing the risks of material misstatement of the financial information of the component and to design further audit procedures in response to assessed risks as well as for evaluating whether detected misstatements are material individually or in the aggregate.

Responding to Assessed Risks

Determining the Type of Work to be Performed on the Financial Information of Components
(Ref: Para. 28-33)

A48. The group engagement team's determination of the type of work to be performed on the financial information of a component and its involvement in the work of the component auditor is affected by:

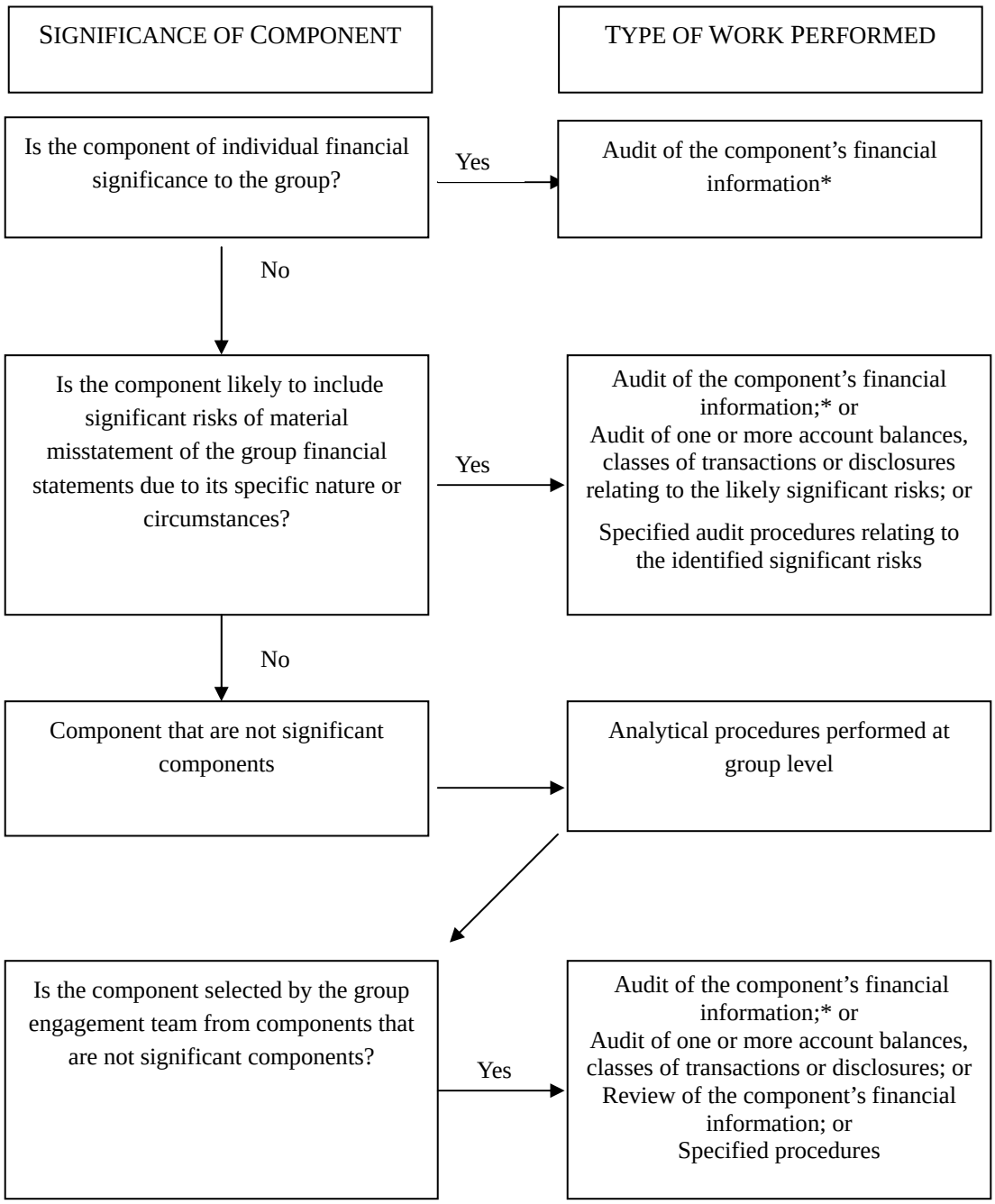
(a) The significance of the component;

(b) The identified significant risks of material misstatement of the group financial statements;

(c) The group engagement team's evaluation of the design of group-wide controls and determination whether they have been implemented; and

(d) The group engagement team's understanding of the component auditor.

The diagram shows how the significance of the component affects the group engagement team's determination of the type of work to be performed on the financial information of the component.



* Performed using either component materiality or a lower materiality level determined by the component auditor.

Significant Components (Ref: Para. 31(b)-(c))

A49. The group engagement team may identify a component as a significant component because that component is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances. In that case, the group

engagement team may be able to identify the account balances, classes of transactions or disclosures affected by the likely significant risks. Where this is the case, the group engagement team may decide to perform, or request a component auditor to perform, an audit of only those account balances, classes of transactions or disclosures. For example, in the situation described in paragraph A7, the work on the financial information of the component may be limited to an audit of the account balances, classes of transactions and disclosures affected by the foreign exchange trading of that component. Where the group engagement team requests a component auditor to perform an audit of one or more specific account balances, classes of transactions or disclosures, the communication of the group engagement team (see paragraph 44) takes account of the fact that many financial statement items are interrelated and specifies the auditing and other standards to be applied in performing the work.

A50. The group engagement team may design audit procedures that respond to a likely significant risk of material misstatement of the group financial statements. For example, in the case of a likely significant risk of inventory obsolescence, the group engagement team may perform, or request a component auditor to perform, specified audit procedures on the valuation of inventory at a component that holds a large volume of potentially obsolete inventory, but that is not otherwise significant.

Components that Are Not Significant Components (Ref: Para. 32-33)

A51. The analytical procedures for components that are not significant components are performed at group level when forming an overall conclusion as to whether the group financial statements as a whole are consistent with the group engagement team's understanding of the group (see paragraphs 50 and A63). The results of the analytical procedures corroborate the group engagement team's conclusions about the insignificance of the components.

A52. The group engagement team's decision as to how many components to select in accordance with paragraph 33, which components to select, and the type of work to be performed on the financial information of the individual components selected may be affected by factors such as the following:

- The extent of audit evidence expected to be obtained on the financial information of the significant components.
- Whether the component has been newly formed or acquired.
- Whether significant changes have taken place in the component.
- Whether internal audit has performed work at the component and any effect of that work on the group audit.
- Whether the components apply common systems and processes.
- The operating effectiveness of group-wide controls.
- Abnormal fluctuations identified by analytical procedures performed at group level.
- The individual financial significance of, or the risk posed by, the component in comparison with other components within this category.

- Whether the component is subject to audit required by statute, regulation or for another reason.

Including an element of unpredictability in selecting components in this category may increase the likelihood of identifying material misstatement of the components' financial information. The selection of components is often varied on a cyclical basis.

A53. A review of the financial information of a component may be performed in accordance with International Standard on Review Engagements (ISRE) 2400, "Engagements to Review Financial Statements," or ISRE 2410, "Review of Interim Financial Information Performed by the Auditor of the Entity," adapted as necessary in the circumstances. The group engagement team may also specify additional procedures to supplement this work.

A54. As explained in paragraph A14, a group may consist only of components that are not significant components. In these circumstances, the group engagement team can obtain sufficient appropriate audit evidence on which to base the group audit opinion by determining the type of work to be performed on the financial information of the components in accordance with paragraph 33. It is unlikely that the group engagement team will obtain sufficient appropriate audit evidence on which to base the group audit opinion if the group engagement team, or a component auditor, does not perform an audit of the financial information of some of the components.

Involvement in the Work Performed by Component Auditors (Ref: Para. 34-35)

A55. The group engagement team's involvement in the work of the component auditor is affected by:

(a) The significance of the component;

(b) The identified significant risks of material misstatement of the group financial statements; and

(c) The group engagement team's understanding of the component auditor.

In the case of a significant component or identified significant risks, the group engagement team performs the procedures described in paragraphs 34-35. In the case of a component that is not a significant component, the nature, timing and extent of the group engagement team's involvement in the work of the component auditor work will vary based on the group engagement team's understanding of that component auditor. The fact that the component is not a significant component becomes secondary. For example, even though a component is not considered a significant component, the group engagement team nevertheless may decide to be involved in the component auditor's risk assessment, because it has less than serious concerns about the component auditor's professional competency (e.g., lack of industry specific knowledge), or the component auditor does not operate in an environment that actively oversees auditors (see paragraph A41).

A56. Forms of involvement in the work of a component auditor other than those described in paragraphs 34-35 and 46 may, based on the group engagement team's understanding of the component auditor, include one or more of the following:

(a) Meeting with component management or the component auditors to obtain an understanding of the component and its environment.

(b) Reviewing the component auditors' overall audit strategy and audit plan.

(c) Performing risk assessment procedures to identify and assess the risks of material misstatement at the component level. These may be performed with the component auditors, or by the group engagement team.

(d) Designing and performing further audit procedures. These may be designed and performed with the component auditors, or by the group engagement team.

(e) Participating in the closing and other key meetings between the component auditors and component management.

(f) Reviewing other relevant parts of the component auditors' audit documentation.

Consolidation Process

Consolidation Adjustments and Reclassifications (Ref: Para. 38, 41)

A57. The consolidation process may require adjustments to amounts reported in the group financial statements that do not pass through the usual transaction processing systems, and may not be subject to the same internal controls to which other financial information is subject. The group engagement team's evaluation of the appropriateness, completeness and accuracy of the adjustments may include:

- Evaluating whether significant adjustments appropriately reflect the events and transactions underlying them;
- Determining whether significant adjustments have been correctly calculated, processed and authorized by group management and, where applicable, by component management;
- Determining whether significant adjustments are properly supported and sufficiently documented; and
- Checking the reconciliation and elimination of intra-group transactions and unrealized profits, and intra-group account balances.

Communication with the Component Auditor (Ref: Para. 44-45)

A58. If effective two-way communication between the group engagement team and the component auditors does not exist, there is a risk that the group engagement team may not obtain sufficient appropriate audit evidence on which to base the group audit opinion. Clear and timely communication of the group engagement team's requirements forms the basis of effective two-way communication between the group engagement team and the component auditor.

A59. The group engagement team's requirements are often communicated in a letter of instruction. Appendix 5 contains guidance on required and additional matters that may be included in such a letter of instruction. The component auditor's communication with the group

engagement team often takes the form of a memorandum or report of work performed. Communication between the group engagement team and the component auditor, however, may not necessarily be in writing. For example, the group engagement team may visit the component auditor to discuss identified significant risks or review relevant parts of the component auditor's audit documentation. Nevertheless, the documentation requirements of this and other ISAs apply.

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

Reviewing the Component Auditor's Audit Documentation (Ref: Para. 46)

A60. What parts of the audit documentation of the component auditor will be relevant to the group audit may vary depending on the circumstances. Often the focus is on audit documentation that is relevant to the significant risks of material misstatement of the group financial statements. The extent of the review may be affected by the fact that the component auditor's audit documentation has been subjected to the component auditor's firm's review procedures.

Sufficiency and Appropriateness of Audit Evidence (Ref: Para. 48-49)

A61. If the group engagement partner concludes that sufficient appropriate audit evidence on which to base the group audit opinion has not been obtained, the group engagement team may request the component auditor to perform additional procedures. If this is not feasible, the group engagement team may perform its own procedures on the financial information of the component.

A62. The group engagement partner's evaluation of the aggregate effect of any misstatements (either identified by the group engagement team or communicated by component auditors) allows the group engagement partner to determine whether the group financial statements as a whole are materially misstated.

Performing Analytical Procedures in the Overall Review at the End of the Group Audit (Ref: Para. 50)

A63. In accordance with ISA 520, analytical procedures are performed at group level at or near the end of the group audit, when the group engagement team forms an overall conclusion as to whether the group financial statements as a whole are consistent with its understanding of the group. The resulting conclusions are intended to corroborate conclusions formed during the work performed on the financial information of the components or elements of the group financial statements. For example, the group engagement team may consider whether information obtained from the components about complex transactions between them reflects the group engagement team's understanding of such transactions when consolidated.

Communication with Group Management and Those Charged with Governance of the Group

Communication with Group Management (Ref: Para. 52-53)

A64. ISA 240 (Redrafted) contains requirements and guidance on communication of fraud to management and, where management may be involved in the fraud, to those charged with governance.

A65. Group management may need to keep certain material sensitive information confidential. Examples of matters that may be significant to the financial statements of the component of which component management may be unaware include the following:

- Potential litigation.
- Plans for abandonment of material operating assets.
- Subsequent events.
- Significant legal agreements.

A66. Subject to legal and professional confidentiality considerations, the component auditor would need to be advised of any matters that come to the attention of the group engagement team that may have an important bearing on the component auditor's work for purposes of the group audit.

Communication with Those Charged with Governance of the Group (Ref: Para. 54)

A67. The matters the group engagement team communicates to those charged with governance of the group may include those brought to the attention of the group engagement team by component auditors that the group engagement team judges to be significant to the responsibilities of those charged with governance of the group. Communication with those charged with governance of the group takes place at various times during the group audit. For example, the matters referred to in paragraph 54(a)-(b) may be communicated after the group engagement team has determined the work to be performed on the financial information of the components. On the other hand, the matter referred to in paragraph 54(c) may be communicated at the end of the audit, and the matter referred to in paragraph 54(d)-(e) may be communicated when it occurs.

Appendix 1

(Ref: Para. A20)

Example of a Qualified Opinion where the Group Engagement Team is Not Able to Obtain Sufficient Appropriate Audit Evidence on which to Base the Group Audit Opinion

In this example, the group engagement team is unable to obtain sufficient appropriate audit evidence relating to a significant component accounted for by the equity method (recognized at $15 million in the balance sheet, which reflects total assets of $60 million) because the group engagement team did not have access to the accounting records, management, or auditor of the component.

The group engagement team has read the audited financial statements of the component as of December 31, 20X6, including the auditor's report thereon, and considered related financial information kept by group management in relation to the component.

In the group engagement partner's judgment, the effect on the group financial statements of this inability to obtain sufficient appropriate audit evidence is material but not pervasive.

INDEPENDENT AUDITOR'S REPORT

[*Appropriate Addressee*]

Report on the Consolidated Financial Statements[2]

We have audited the accompanying consolidated financial statements of ABC Company and its subsidiaries, which comprise the consolidated balance sheet as at December 31, 20X6, and the consolidated income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

[2] The subheading "Report on the Consolidated Financial Statements" is unnecessary in circumstances when the second subheading "Report on Other Legal and Regulatory Requirements" is not applicable.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[3] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

ABC Company's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at $15 million on the consolidated balance sheet as at December 31, 20X6, and ABC's share of XYZ's net income of $1 million is included in the consolidated income statement for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in XYZ as at December 31, 20X6 and ABC's share of XYZ's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

Qualified Opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the consolidated financial statements give a true and fair view of (*or "present fairly, in all material respects"*) the financial position of ABC Company and its subsidiaries as of December 31, 20X6, and of their financial

[3] In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances."

performance and cash flows for the year then ended in accordance with International Financial Reporting Standards.

Report on Other Legal and Regulatory Requirements

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.*]
[*Auditor's signature*]

[Date of the auditor's report]

[Auditor's address]

If, in the group engagement partner's judgment, the effect on the group financial statements of the inability to obtain sufficient appropriate audit evidence is material and pervasive, group engagement partner would disclaim an opinion as follows:

Disclaimer of Opinion

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not obtained sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the consolidated financial statements.

The remainder of the report will be amended in accordance with [proposed] ISA 705 (Revised and Redrafted).

Appendix 2

(Ref: Para. A24)

Examples of Matters about Which the Group Engagement Team Obtains an Understanding

The examples provided cover a broad range of matters; however, not all matters are relevant to every group audit engagement and the list of examples is not necessarily complete.

Group-wide Controls

1. Group-wide controls may include a combination of the following:
   - Regular meetings between group and component management to discuss business developments and to review performance.
   - Monitoring of components' operations and their financial results, including regular reporting routines, which enables group management to monitor components' performance against budgets, and to take appropriate action.
   - Group management's risk assessment process, i.e., the process for identifying, analyzing and managing business risks, including the risk of fraud, that may result in material misstatement of the group financial statements.
   - Monitoring, controlling, reconciling, and eliminating intra-group transactions and unrealized profits, and intra-group account balances at group level.
   - A process for monitoring the timeliness and assessing the accuracy and completeness of financial information received from components.
   - A central IT system controlled by the same general IT controls for all or part of the group.
   - Control activities within an IT system that is common for all or some components.
   - Monitoring of controls, including activities of internal audit and self-assessment programs.
   - Consistent policies and procedures, including a group financial reporting procedures manual.
   - Group-wide programs, such as codes of conduct and fraud prevention programs.
   - Arrangements for assigning authority and responsibility to component management.
2. Internal audit may be regarded as part of group-wide controls, for example, when the internal audit function is centralized. [Proposed] ISA 610 (Redrafted), "The Auditor's Consideration of the Internal Audit Function" deals with the group engagement team's evaluation of the competence and objectivity of the internal auditors where it plans to use their work.

Consolidation Process

3. The group engagement team's understanding of the consolidation process may include matters such as the following:

   Matters relating to the applicable financial reporting framework:

   - The extent to which component management has an understanding of the applicable financial reporting framework.
   - The process for identifying and accounting for components in accordance with the applicable financial reporting framework.
   - The process for identifying reportable segments for segment reporting in accordance with the applicable financial reporting framework.
   - The process for identifying related party relationships, and related party transactions for reporting, in accordance with the applicable financial reporting framework.
   - The accounting policies applied to the group financial statements, changes from those of the previous financial year, and changes resulting from new or revised standards under the applicable financial reporting framework.
   - The procedures for dealing with components with financial year-ends different from the group's year-end.

   Matters relating to the consolidation process:

   - Group management's process for obtaining an understanding of the accounting policies used by components, and, where applicable, ensuring that uniform accounting policies are used to prepare the financial information of the components for the group financial statements, and that differences in accounting policies are identified, and adjusted where required in terms of the applicable financial reporting framework. Uniform accounting policies are the specific principles, bases, conventions, rules, and practices adopted by the group, based on the applicable financial reporting framework, that the components use to report similar transactions consistently. These policies are ordinarily described in the financial reporting procedures manual and reporting package issued by group management.
   - Group management's process for ensuring complete, accurate and timely financial reporting by the components for the consolidation.
   - The process for translating the financial information of foreign components into the currency of the group financial statements.
   - How IT is organized for the consolidation, including the manual and automated stages of the process, and the manual and programmed controls in place at various stages of the consolidation process.
   - Group management's process for obtaining information on subsequent events.

   Matters relating to consolidation adjustments:

- The process for recording consolidation adjustments, including the preparation, authorization and processing of related journal entries, and the experience of personnel responsible for the consolidation.
- The consolidation adjustments required by the applicable financial reporting framework.
- Business rationale for the events and transactions that gave rise to the consolidation adjustments.
- Frequency, nature and size of transactions between components.
- Procedures for monitoring, controlling, reconciling, and eliminating intra-group transactions and unrealized profits, and intra-group account balances.
- Steps taken to arrive at the fair value of acquired assets and liabilities, procedures for amortizing goodwill (where applicable), and impairment testing of goodwill, in accordance with the applicable financial reporting framework.
- Arrangements with a majority owner or minority interests regarding losses incurred by a component (for example, an obligation of the minority interest to make good such losses).

Appendix 3

(Ref: Para. A31)

Examples of Conditions or Events that may Indicate Risks of Material Misstatement of the Group Financial Statements

The examples provided cover a broad range of conditions or events; however, not all conditions or events are relevant to every group audit engagement and the list of examples is not necessarily complete.

- A complex group structure, especially where there are frequent acquisitions, disposals, or reorganizations.
- Poor corporate governance structures, including decision-making processes, that are not transparent.
- Non-existent or ineffective group-wide controls, including inadequate group management information on monitoring of components' operations and their results.
- Components operating in foreign jurisdictions that may be exposed to factors such as unusual government intervention in areas such as trade and fiscal policy, and restrictions on currency and dividend movements; and fluctuations in exchange rates.
- Business activities of components that involve high risk, such as long-term contracts or trading in innovative or complex financial instruments.
- Uncertainties regarding which components' financial information require incorporation in the group financial statements in accordance with the applicable financial reporting framework, for example whether any special-purpose entities or non-trading entities exist and require incorporation.
- Unusual related party relationships and transactions.
- Prior occurrences of intra-group account balances that did not balance or reconcile on consolidation.
- The existence of complex transactions that are accounted for in more than one component.
- Components' application of accounting policies that differ from those applied to the group financial statements.
- Components with different financial year-ends, which may be utilized to manipulate the timing of transactions.
- Prior occurrences of unauthorized or incomplete consolidation adjustments.
- Aggressive tax planning within the group, or large cash transactions with entities in tax havens.
- Frequent changes of auditors engaged to audit the financial statements of components.

Appendix 4

(Ref: Para. A36)

Examples of a Component Auditor's Confirmations

The following is not intended to be a standard letter. Confirmations may vary from one auditor to another and from one period to the next.

Confirmations often are obtained before work on the financial information of the component commences.

[*Component Auditor Letterhead*]

[*Date*]

[*To Group Engagement Partner*]

This letter is provided in connection with your audit of the group financial statements of [name of parent] for the year ended [date] for the purpose of expressing an opinion on whether the group financial statements give a true and fair view of (present fairly, in all material respects) the financial position of the group as of [date] and of its financial performance and cash flows for the year then ended in accordance with [indicate applicable financial reporting framework].

We acknowledge receipt of your instructions dated [date], requesting us to perform the specified work on the financial information of [name of component] for the year ended [date].

We confirm that:

1. We will be able to comply with the instructions. / We advise you that we will not be able to comply with the following instructions [specify instructions] for the following reasons [specify reasons].

2. The instructions are clear and we understand them. / We would appreciate it if you could clarify the following instructions [specify instructions].

3. We will provide you with access to relevant audit documentation.

We acknowledge that:

1. The financial information of [name of component] will be included in the group financial statements of [name of parent].

2. You may consider it necessary to be involved in the work you have requested us to perform on the financial information of [name of component] for the year ended [date].

3. You intend to evaluate and, if considered appropriate, use our work for the audit of the group financial statements of [name of parent].

In connection with the work that we will perform on the financial information of [name of component], a [describe component, e.g. wholly-owned subsidiary, subsidiary, joint venture, investee accounted for by the equity or cost methods of accounting] of [name of parent], we confirm the following:

1. We have an understanding of [indicate relevant ethical requirements] that is sufficient to fulfill our responsibilities in the audit of the group financial statements, and will comply therewith. In particular, and with respect to [name of parent] and the other components in the group, we are independent within the meaning of [indicate relevant ethical requirements] and comply with the applicable requirements of [refer to rules] promulgated by [name of regulatory agency].

2. We have an understanding of International Standards on Auditing and [indicate other national standards applicable to the audit of the group financial statements] that is sufficient to fulfill our responsibilities in the audit of the group financial statements and will conduct our work on the financial information of [name of component] for the year ended [date] in accordance with those standards.

3. We possess the special skills (e.g., industry specific knowledge) necessary to perform the work on the financial information of the particular component.

4. We have an understanding of [indicate applicable financial reporting framework or group financial reporting procedures manual] that is sufficient to fulfill our responsibilities in the audit of the group financial statements.

We will inform you of any changes in the above representations during the course of our work on the financial information of [name of component].

[*Auditor's signature*]

[*Date*]

[*Auditor's address*]

Appendix 5

(Ref: Para. A59)

Required and Additional Matters Included in the Group Engagement Team's Letter of Instruction

Matters required by this ISA to be communicated to the component auditor are shown in italicized text.

Matters that are relevant to the planning of the work of the component auditor:

- The timetable for completing the audit.
- Dates of planned visits by group management and the group engagement team, and dates of planned meetings with component management and the component auditor.
- A list of key contacts.
- *The work to be performed by the component auditor, the use to be made of that work,* and arrangements for coordinating efforts at the initial stage of and during the audit, including the group engagement team's planned involvement in the work of the component auditor.
- *The ethical requirements that are relevant to the group audit and, in particular, the independence requirements.*
- *In the case of an audit or review of the financial information of the component, component materiality, and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.*
- *A list of related parties prepared by group management, and any other related parties that the group engagement team is aware of, and a request that the component auditor communicates to the group engagement team related parties not previously identified by group management or the group engagement team.*
- Work to be performed on intra-group transactions and unrealized profits and intra-group account balances.
- Guidance on other statutory reporting responsibilities, for example reporting on group management's assertion on the effectiveness of internal control.
- Where time lag between completion of the work on the financial information of the components and the group engagement team's conclusion on the group financial statements is likely, specific instructions for a subsequent events review.

Matters that are relevant to the conduct of the work of the component auditor

- The findings of the group engagement team's tests of control activities of a processing system that is common for all or some components, and tests of controls to be performed by the component auditor.

- *Identified significant risks of material misstatement of the group financial statements, due to fraud or error, that are relevant to the work of the component auditor, and a request that the component auditor communicates any other significant risks of material misstatement of the group financial statements, due to fraud or error, identified in the component and the component auditor's response to such risks.*
- The findings of internal audit, based on work performed on controls at or relevant to components.
- A request for timely communication of audit evidence obtained from performing work on the financial information of the components that contradicts the audit evidence on which the group engagement team originally based the risk assessment performed at group level.
- A request for a written representation on component management's compliance with the applicable financial reporting framework, or a statement that differences between the accounting policies applied to the financial information of the component and those applied to the group financial statements have been disclosed.
- Matters to be documented by the component auditor.

Other information

- A request that the following be reported to the group engagement team on a timely basis:
  - Significant accounting, financial reporting and auditing matters, including accounting estimates and related judgments.
  - Matters relating to the going concern status of the component.
  - Matters relating to litigation and claims.
  - Material weaknesses in controls that have come to the attention of the component auditor during the performance of the work on the financial information of the component, and information that indicates the existence of fraud.
- A request that the group engagement team be notified of any significant or unusual events as early as possible.
- *A request that the matters listed in paragraph 45 be communicated to the group engagement team when the work on the financial information of the component is completed.*

Proposed Conforming Amendment to ISA 220 (Redrafted), "Quality Control for Audits of Historical Financial Information"

A new paragraph is added after paragraph 20 as follows:

Assignment of Engagement Teams

19. **The engagement partner should be satisfied that the engagement team collectively has the appropriate capabilities, competence and time to perform the audit engagement in accordance with professional standards and regulatory and legal requirements, and to enable an auditor's report that is appropriate in the circumstances to be issued.**

20. The appropriate capabilities and competence expected of the engagement team as a whole include the following:

- An understanding of, and practical experience with, audit engagements of a similar nature and complexity through appropriate training and participation.
- An understanding of professional standards and regulatory and legal requirements.
- Appropriate technical knowledge, including knowledge of relevant information technology.
- Knowledge of relevant industries in which the client operates.
- Ability to apply professional judgment.
- An understanding of the firm's quality control policies and procedures.

20a. [Proposed] ISA 600 (Revised and Redrafted) contains additional requirements and guidance for audits of group financial statements that involve component auditors. An auditor of a single entity may find [proposed] ISA 600 (Revised and Redrafted), adapted as necessary in the circumstances, useful when other auditors are involved in the audit of the financial statements of the single entity.

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