Agenda Item 2-C

DRAFT BASIS FOR CONCLUSIONS:
ISA 600 (REVISED AND REDRAFTED), SPECIAL CONSIDERATIONS—AUDITS OF GROUP FINANCIAL STATEMENTS (INCLUDING THE WORK OF COMPONENT AUDITORS)

This Basis for Conclusions has been prepared by staff of the International Auditing and Assurance Standards Board (IAASB). It does not form part of International Standard on Auditing (ISA) 600.

Background

1. Several bodies have requested requirements and guidance on the audit of group financial statements ("group audits"), including the European Commission, the International Organization of Securities Commissions, the former Panel on Audit Effectiveness in the United States, and the International Forum on Accountancy Development.

2. Although matters relating to the use of the work of component auditors are addressed at both international and national levels, group audits are not. Accordingly, the IAASB commenced a project in 2002 to deal with special considerations that apply to group audits and, in particular, those that involve component auditors.

3. The IAASB has consulted widely on its proposals. It has issued three exposure drafts:

   - December 2003: Proposed ISA 600 (Revised), "The Work of Related Auditors and Other Auditors in the Audit of Group Financial Statements" and proposed new IAPS, "The Audit of Group Financial Statements;"
   - March 2005: Proposed ISA 600 (Revised), "The Audit of Group Financial Statements;" and
   - March 2006: Proposed ISA 600 (Revised and Redrafted), "The Audit of Group Financial Statements."

   The IAASB has also presented its proposals at meetings of the IAASB Consultative Advisory Group, the IFAC Small and Medium Practices Committee, and the Transnational Auditors Committee.

4. As a result of these consultations, the IAASB has processed numerous changes to its proposals. The following summarizes the more significant issues raised during consultations, and how the IAASB addressed them.

Audit Quality and Public Interest vs. Cost

5. Respondents to the December 2003 Exposure Draft were of the view that the group engagement team's procedures should be strengthened, both in respect of the direction of the audit by the group engagement team and the group

engagement team's involvement in the work of the component auditors. They were of the view that this would be of particular importance if the distinction between full and divided responsibility was eliminated.

6. Based on the arguments presented, the March 2005 Exposure Draft proposed more stringent requirements with regard to (a) the group engagement team's determination of the type of work to be performed on the components' financial information, (b) the group engagement team's involvement in the work of the component auditors, (c) the group engagement team's evaluation of the adequacy of the component auditors' work, and (d) the group engagement team's communications with component auditors. The majority of respondents supported the proposals – in particular those performed in relation to the component auditors' work.

7. The Explanatory Memorandum to the March 2006 Exposure Draft stated that it was the IAASB's view that the proposed ISA will enhance the quality of group audits. It also explained that the IAASB, recognizing variances in current group audit practices, considered it necessary to be reasonably specific about the steps to be taken, and the work effort required, by the group engagement team. Respondents were asked whether such an approach was justified. The majority of respondents agreed that the proposed ISA will enhance the quality of group audits and supported the specificity of the group engagement team's procedures; however, a few respondents were concerned that the proposed ISA may give rise to an increase in the costs of group audits. The IAASB believes that amendments to the requirements and guidance relating to the group engagement team's understanding of the component auditors and communication with component auditors (as discussed in the relevant sections below) will address the respondents' concerns.

8. Significant variances in current group audit practices were confirmed by the responses to the three exposure drafts. The IAASB therefore aimed to develop requirements and guidance that are capable of consistent application and, as a result, will improve the quality of group audits and protect the public interest. To ensure the consistent application of the requirements and guidance, the IAASB continues to believes that it is necessary to be reasonably specific about the group engagement team's procedures. The ISA reflects this belief.

The Objectives of the Auditor

9. Many respondents to the March 2006 Exposure Draft were concerned about or commented on the proposed objectives of the auditor. They were of the view that the objectives focused on the process rather than the expected outcome. Some respondents recommended that the objective be linked to the overall objective of the auditor in [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."

10. The IAASB accepted the recommendation that the objectives of the auditor in ISA 600 (Revised and Redrafted) should be linked to the overall objective of the auditor in [proposed] ISA 200 (Revised and Redrafted).

11. The IAASB is of the view that determining whether the auditor is able to act as the auditor of the group financial statements and communicating with component auditors are also important objectives of the auditor in the context of a group audit. The IAASB therefore agreed the following objectives for the auditor: (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. (See paragraph 8 of the ISA.)

Definitions

Component

12. The March 2006 Exposure Draft defined "component" as "a head office, parent, division, branch, subsidiary, joint venture, associated company, or other entity whose financial information is or should be included in the group financial statements." Some respondents noted that it was not clear that the list of types of entity was illustrative only. Some respondents also noted that the definition did not recognize that some entities may not report financial information based on a typical organizational structure.

13. The IAASB revised the definition to read as follows: "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."

14. The IAASB also developed application material explaining that 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. (See paragraph A2 of the ISA.) The application material also recognizes that various levels of components may exist within the group financial reporting system. (See paragraph A3 of the ISA.)

15. In addition, the IAASB expanded the application material to indicate that the group engagement team's understanding of the group, its components, and their environments include matters such as the group structure, including both the legal and organizational structure (i.e., how the group financial reporting system is organized). (See paragraphs A12 and A13 of the ISA.)

Group Engagement Partner, Group Engagement Team and Component Auditor

16. The December 2003 Exposure Draft distinguished between related auditors and other auditors, recognizing that, in the case of a related auditor, the group engagement team ordinarily will be able to rely on common policies and procedures on recruitment, training, advancement, auditor independence, audit methodology and quality control. The distinction affected the nature, timing and extent of the procedures that the group engagement team performs in relation to a related or other auditors' work.

17. Based on the responses to the December 2003 Exposure Draft, the March 2005 Exposure Draft defined "group auditor" as "the auditor who signs the auditor's report on the group financial statements;" "related auditor" as "an auditor from the group auditor's firm or from a network firm who (a) operates under, and complies with, common monitoring policies and procedures as provided for in paragraph 87 of International Standard on Quality Control (ISQC) 1, 'Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements,' and (b) performs work on one or more components for purposes of the audit of the group financial statements." The distinction between related auditor and unrelated auditor affected the nature, timing and extent of the procedures that the group engagement team performs in relation to the component auditors' work.

18. Several respondents to the March 2005 Exposure Draft were concerned about the consistent application of the distinction between related auditor and unrelated auditor. Acknowledging that the structures of audit firms and networks vary and that it is not possible to develop a distinction between related auditors and unrelated auditors that is capable of consistent application in all circumstances, the IAASB agreed to eliminate the distinction. The requirements and guidance in the March 2006 Exposure Draft reflected the IAASB's conclusion that:

    (a) The nature, timing and extent of the procedures to be performed by the group engagement team to obtain an understanding of a component auditor are affected by factors such as the group engagement team's previous experience with or knowledge of the component auditor; the degree to which the group engagement team and the component auditor perform, or are subject to, common policies and procedures; and the consistency or similarity of laws and regulations, professional oversight and discipline, education and training, professional organizations and standards, and language and culture.

    (b) The nature, timing and extent of the group engagement team's involvement in the component auditor's work are affected by the significance of the

component, identified significant risks, and the group engagement team's understanding of the component auditor.

(c) Both (a) and (b) are affected by whether or not the auditors are related, but not in a clear and consistent way.

19. The March 2006 Exposure Draft defined "group auditor" as "the engagement partner who is responsible for the performance of the group audit and for the auditor's report on the group financial statements issued on behalf of the group engagement partner's firm. The obligations or responsibilities of the group auditor may be fulfilled by either the group engagement partner or another member of the engagement team under the direct supervision of the group engagement partner. Where it is expressly intended that the obligation or responsibility be fulfilled by the group engagement partner, the term 'group engagement partner' rather than 'group auditor' is used."

20. Respondents to the March 2006 Exposure Draft were concerned that:

- The definition did not mention the group engagement partner's firm;
- The second sentence of the definition made members of the engagement team responsible for the tasks devolved to the group engagement partner;
- The term "direct supervision" implied that the group engagement partner is required to have direct involvement at the time that the procedures or judgments are being performed by the group engagement team or component auditor; and
- The definition did not provide for circumstances where the partner who issues the auditor's report on the group financial statements on behalf of the firm may be different from the partner who is responsible for the performance of the group audit and for determining the contents of the auditor's report on the group financial statements.

21. The March 2006 Exposure Draft defined "members of the engagement team under the direct supervision of the group engagement partner" as "personnel of the group engagement partner's firm, including any experts contracted by the group engagement partner's firm in connection with the group audit engagement, who are directed and supervised by the group engagement partner to the same extent that members of an engagement team responsible for the audit of the financial statements of a single entity are directed and supervised by the engagement partner in accordance with ISA 220 …" Some respondents to the exposure draft were of the view that the definition should be clear, such that the group engagement partner can make an appropriate and consistent decision as to whether an auditor is a member of the engagement team.

22. The IAASB concluded that:

(a) The requirements in the ISA should be addressed to the group engagement partner (i.e., an individual); not the group engagement partner's firm. The group engagement team may, however, assist the group engagement partner in fulfilling his or her responsibilities.

(b) A clearer distinction between group engagement partner and group engagement team may address some of the concerns. It therefore agreed that the definition of "group auditor" be replaced with a definition of "group engagement partner" and that the definition of "members of the engagement team under the direct supervision of the group engagement partner" be replaced with a definition of "group engagement team." (See paragraph 8 of the ISA.)

(c) The definition of "group engagement partner" should be aligned with the definition of "engagement partner" in the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants as follows: "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 …" The phrase "that is issued on behalf of the firm" is in line with that in the definition of "engagement partner" in the Code.

(d) Requirements to be fulfilled by the group engagement partner should be addressed to the group engagement partner. Where the group engagement team may assist the group engagement partner in fulfilling a requirement, the requirement is addressed to the group engagement team.

23. The IAASB agreed that:

(a) "Group engagement team" should be defined as "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." ("Staff" is defined in the Code as "professionals, other than partners, including any experts the firm employs.")

(b) The term "other auditor" should be replaced with the term "component auditor." This will aid clarity when the term is used in an ISA other than ISA 600 (Revised and Redrafted).

(c) "Component auditor" should be defined as "an auditor who performs work on the financial information of a component for the group audit at the request of the group engagement team."

24. The IAASB also agreed that the interrelationship between [proposed] ISA 220 (Redrafted), "Quality Control for Audit Engagements" and ISA 600 (Revised and Redrafted) should be explained in the ISA.

25. In accordance with [proposed] ISA 220 (Redrafted), the group engagement partner is required to be satisfied that those performing the group audit engagement 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.

26. The Introduction section of the ISA (see paragraph 5) explains that the 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").

Full vs. Divided Responsibility

27. The December 2003 Exposure Draft permitted the group engagement partner to divide responsibility for the group audit opinion with component auditors if national standards enable and national law or regulation permits such an approach. There was a wide divergence of views on this proposal.

28. The March 2005 Exposure Draft did not distinguish between full and divided responsibility. The proposed requirements and guidance were based on the following:

    (a) The group engagement partner is responsible for expressing the group audit opinion.

    (b) In order to obtain sufficient appropriate audit evidence on which to base the group audit opinion, the group engagement team has to determine the audit procedures to be performed on the consolidation process and the work to be performed on the components' financial information, both by the group engagement team and by component auditors.

    (c) The group engagement team's procedures are the same whether the group engagement partner accepts full or divided responsibility. As a result, the requirements and guidance apply equally to all group audits performed in accordance with the ISAs.

    (d) Should the group engagement team be unable to obtain sufficient appropriate audit evidence in relation to a component, it constitutes a scope limitation and the group engagement team has to consider the effect thereof on the group audit opinion.

29. The majority of respondents to the March 2005 Exposure Draft supported this proposal. A small number of respondents were of the view that there are situations in which the divided responsibility alternative is particularly useful, for example, where an entity has significant components accounted for by the equity method of accounting that are audited by component auditors. Some respondents noted that the reference to a component auditor in the auditor's report on the group financial statements is necessary to preserve transparency to the users of group financial

statements. Others respondents were concerned about the resources and consequential cost implications of the proposed requirements.

30. Responses to the March 2006 Exposure Draft indicated continued support for the approach described in paragraph 28 of this paper, while a small number of respondents were still of the view that there are situations in which the divided responsibility alternative is particularly useful. The IAASB considered the responses and concluded that no new arguments against the proposal to eliminate the distinction between full and divided responsibility were presented.

31. The March 2006 Exposure Draft, in the Introduction section, explained that "although other auditors may perform work on the financial information of components for the group audit and as such are responsible for their overall findings, conclusions or opinion in their memoranda or reports of work performed, the group auditor alone is responsible for the group audit opinion." Some respondents were of the view that the status of the Introduction section did not sufficiently underpin the importance of the assertion.

32. The IAASB moved the abovementioned text, appropriately amended, to the application material and developed a new requirement as follows: "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." (See paragraphs 11 and A8-A9 of the ISA.)

Acceptance and Continuance of Group Audits – Access to Information

33. All three exposure drafts reflected the IAASB's view that a restriction on the group engagement team's access to relevant information is a scope limitation, which may affect the group audit opinion.

34. The March 2005 Exposure Draft proposed that the group engagement partner do not accept an engagement to audit group financial statements if (a) the group engagement team's access to relevant information will be restricted, and (b) the possible effect of the group engagement team's inability to obtain sufficient appropriate audit evidence is material and pervasive to the group financial statements, such that the group engagement partner is likely to disclaim an opinion on the group financial statements.

35. Many respondents to the March 2005 Exposure Draft were concerned that the proposed requirement will give rise to practical difficulty. They noted that jurisdictions exist where, due to legal or regulatory impediments, the group engagement team may not have the access to relevant information, or the group engagement partner may be prohibited by law or regulation from refusing or resigning from an engagement. They believed that there should be further guidance on what the group engagement team should do if there were restrictions on access to relevant information.

36. The March 2006 Exposure Draft explained that, before accepting or continuing a group audit engagement, the group engagement partner should have a reasonable expectation of obtaining sufficient appropriate audit evidence in relation to the consolidation process and the financial information of the components on which to base the group audit opinion. This is achieved by the group engagement team performing the work on the consolidation process; and either performing the work on the financial information of significant components, or being involved in the work that component auditors perform on the financial information of significant components to the extent necessary to obtain sufficient appropriate audit evidence. Where the group engagement team is not able to be involved in the work that a component auditor performs on the financial information of a component that is likely to be significant, it is unlikely that the group engagement team will be able to obtain sufficient appropriate audit evidence. Consequently, the proposed ISA required the group engagement partner to refuse or resign from the engagement if he or she concludes that it will not be possible to obtain sufficient appropriate audit evidence, and the possible effect of this inability will result in a disclaimer of opinion on the group financial statements.

37. Various comments were received on this proposal. Some respondents were of the view that the requirement not to accept the engagement should be limited to cases where restrictions are imposed by group management. In all other cases, the group engagement partner should disclaim an opinion and explain the reason(s) for disclaiming an opinion in the auditor's report on the group financial statements.

38. The IAASB agreed that the requirement not to accept the engagement should be limited to cases where restrictions are imposed by group management. The relevant paragraphs were amended accordingly. (See paragraphs 14 and A15-A20 of the ISA.)

Materiality

39. The March 2006 Exposure Draft required:

    (a) The group engagement team to determine the materiality level for the group financial statements as a whole;

    (b) The group engagement team to determine an amount or amounts lower than the materiality level for the group financial statements as a whole for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks at the group level (i.e., "tolerable error" for the group, also referred to as component materiality); and

    (c) The group engagement team or component auditor to determine an amount or amounts lower than the component materiality level for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks at the component level (i.e., "tolerable error" for the component). Where such lower amount or amounts

are determined by the component auditor, the group engagement team has to determine whether it is appropriate.

40. Many respondents commented on these requirements. A small number of respondents questioned the detailed and procedural nature of the requirements, recommending greater alignment with the principles in [proposed] ISA 320 (Revised and Redrafted), "Materiality in Planning and Performing an Audit." Some respondents did not understand or agree with the different levels of materiality. Some respondents requested that application of the requirements in practice be clarified.

Should Proposed ISA 600 Contain Detailed and Procedural Requirements and Guidance on Materiality?

41. The IAASB concluded that the requirements and guidance in the ISA are important because [proposed] ISA 320 (Revised and Redrafted) does not deal with materiality in the context of a group audit.

Different Levels of Materiality

42. Some IAASB members agreed that, in the context of a group audit, three levels of materiality should be determined (see paragraph 39(a)-(c) above). Some IAASB members, however, were of the view that ISA 600 (Revised and Redrafted) should not deal with the third level of materiality, i.e., amount(s) lower than the component materiality level. Some IAASB members noted that the second and third levels of materiality are often combined in practice.

43. IAASB members who agreed with the three levels of materiality argued as follows:

- To reduce the risk that the aggregate of detected and undetected misstatements in the group financial statements exceed the materiality level for the group financial statements as a whole, the component materiality level is set lower than the materiality level for the group financial statements as a whole. If the component materiality level were to equal the materiality level for the group financial statements as a whole, the planned level of assurance would not be met; even if no misstatements were found in the financial information of the components.
- It is also important to reduce the risk that the aggregate of detected and undetected misstatements in the financial information of a component exceeds the component materiality level. To accomplish this, one or more amounts lower than the component materiality level are determined for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks at the component level. These lower amounts allow the component auditor to identify misstatements without having to change the scope of work performed on the financial information of the component. At the same time, they allow the group engagement team to avoid changing the scope of work to be performed on

the financial information of the other components when misstatements are identified in one or more components.

44. IAASB members who opposed the three levels of materiality were concerned that they may result in a lower "tolerable error" for the component and hence more work; especially where the financial information of the component is not subject to an audit by statute, regulation or for another reason.

45. Some IAASB members (and some respondents) did not agree that the third level of materiality has to be determined by the group engagement team or, where it is determined by the component auditor, that the group engagement team has to determine whether it is appropriate. They were of the view that such a requirement is moving away from a principles-based approach into an area that is bound to cause confusion.

46. The majority of IAASB members agreed that:

    (a) It should be clear that the requirements and guidance apply only in the case of an audit or review of the financial information of a component, performed for the group audit at the request of the group engagement team;

    (b) The requirements for the first and second levels of materiality should be retained;

    (c) The requirement for the group engagement team to determine the third level of materiality should be deleted. The application material should explain that, 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. It should acknowledge that, 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.

    (d) The group engagement team should be required to evaluate the appropriateness of the abovementioned amount(s).

    (e) The requirements should also deal with components that are subject to audit by statute, regulation or for other reasons.

    (See paragraphs 22-27 and A43-A47 of the ISA.)

Determining the Work to be Performed on the Financial Information of Components

Significant Components

47. A limited number of respondents indicated that the "tests" in the March 2006 Exposure Draft for determining whether a component is significant are mutually exclusive. They were concerned that the ordering of "tests" and the consequent presentation of the diagram may mislead group engagement teams regarding the type of work to be performed on the financial information of significant components. As the diagram was presented, group engagement teams may respond "yes" to the first question (i.e., whether the component is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances) and believe that there is a choice as to the type of work to be performed on the financial information of a significant component. Group engagement teams may not move on to the second question, which indicates that an audit has to be performed on the financial information of components that are significant due to their individual financial significance to the group.

48. The IAASB agreed that, in the first instance, the group engagement team should identify components that are significant components due to their individual financial significance to the group. The requirements and guidance were amended accordingly. (See paragraphs 30-31 and A48 of the ISA.)

49. The Requirements section of the March 2006 Exposure Draft listed the types of work to be performed on the financial information of significant components. Some respondents recommended that the lists be moved to the application material, while other respondents requested that application material be developed to assist the group engagement team in deciding what type of work to choose from the list.

50. The IAASB concluded that the lists of types of work to be performed on the financial information of significant components should be retained to ensure consistent application of the requirements (see paragraphs 30-31 of the ISA). The IAASB developed guidance on the application of these requirements (see paragraphs A49-A50 of the ISA).

Components that Are Not Significant Components

51. The March 2006 Exposure Draft did not require, but only allowed, the group engagement team to vary the selection of components that are not significant components. Some respondents were concerned that some components may not be audited for a long period of time. The IAASB agreed that the following requirement should be added to the Components that Are Not Significant Components subsection: "The group engagement team shall vary the selection of components over a period of time." (See paragraph 33 of the ISA.) In addition,

new application material explains that the selection of components is often varied on a cyclical basis. (See paragraph A52 of the ISA.)

52. The March 2006 Exposure Draft required the group engagement team to perform analytical procedures at group level for components that are not significant components and that were not selected for the period under audit. Various comments were received on this requirement. The comments mainly related to the types of analytical procedure envisaged (i.e., substantive analytical procedures or analytical procedures performed at or near the end of the audit), how they would be applied (i.e., on individual components or components as a group), and why the group engagement team is required to perform analytical procedures on components that are not individually significant.

53. The IAASB agreed to restructure the Components that Are Not Significant subsection, amend the requirements, and expand the application material. For components that are not significant components, the group engagement team is required, in the first instance, to perform analytical procedures at group level (see paragraph 32 if the ISA). Application material explains that the analytical procedures 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 paragraph A51 of the ISA). If the group engagement team does not consider that sufficient appropriate audit evidence on which to base the group audit opinion will be obtained, the group engagement team is required to select components that are not significant components and perform, or request component auditors to perform, one or more of the prescribed types of work on the financial information of those components (see paragraph 33 of the ISA).

The Group Engagement Team's Procedures in Relation to Component Auditors

Obtaining an Understanding of the Component Auditors

54. Many respondents to the March 2006 Exposure Draft commented on the requirement and guidance relating to obtaining an understanding of the component auditors. Some respondents noted that the nature and extent of the evidence that needs to be obtained and documented to demonstrate compliance with the requirements were not clear.

55. The IAASB agreed to revise the requirement as follows: "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: (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; (b) the component auditor's professional competence; (c) whether the component auditor will provide the group engagement team with the necessary access to relevant audit documentation; and

(d) whether the component auditor operates in a regulatory environment that actively oversees auditors. (See paragraph 20 of the ISA.)

56. To address concerns about the extent of evidence and documentation necessary to demonstrate compliance with the requirement, the IAASB restructured and amended the application material to explain that 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 perform, or are subject to, common policies and procedures. (See paragraphs A34-A35 of the ISA.)

57. The application material also explains that 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; request confirmations or completion of questionnaires; or discuss the component auditor with others. 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 has changed since the previous year. (See paragraph A36 of the ISA.)

Involvement in the Work Performed by Component Auditors

58. Various comments were received on the requirements in the March 2006 Exposure Draft that prescribed the group engagement team's involvement in the work of component auditors in general and for significant components. Based on these comments, the IAASB agreed that the paragraph prescribing the group engagement team's involvement in general should be moved to the application material, as examples of forms of involvement, because it does not apply in virtually all circumstances. (See paragraph A56 of the ISA.)

59. The IAASB continues to believe that, in line with ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" and ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks," the group engagement team has to be involved in the risk assessment procedures that a component auditor performs on a significant component and the further audit procedures to be performed in response to identified significant risks of material misstatement of the group financial statements.

60. The IAASB therefore agreed that the requirements for the group engagement team to be involved in the work of a component auditor should be retained, but revised, as follows: In the case of 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 the prescribed actions. (See paragraph 34 of the ISA.) 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 determine whether the further audit procedures to be performed to respond to the identified significant risks are appropriate. Based on its understanding of the component auditor, the group engagement team shall also determine whether it is necessary to be involved in the further audit procedures. (See paragraph 35 of the ISA.)

61. The application material explains how the group engagement team's involvement in the work of the component auditor is affected by the significance of the component, the identified significant risks of material misstatement of the group financial statements, and 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 paragraph 60 above. 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 will vary based on the group engagement team's understanding of the 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 A55 of this ISA.)

Communication with Component Auditors

62. Some respondents were concerned about the prescriptive nature of the requirements for the group engagement to communicate with the component auditors in the March 2006 Exposure Draft. Some respondents, for example, was of the view that, where there has been effective sharing of information during the planning and risk assessment stages between the group engagement team and the component auditor about significant matters relevant to the group audit, accompanied by comprehensive instructions on the nature and significance of the matters that the component auditor should communicate to the group engagement team, the completion process could often be simplified to confirmation of key information and further reporting only (by exception) on additional significant matters arising.

63. Some respondents commented on the form of communication. They recommended that the ISA allow for flexibility in this regard, recognizing that communication takes place throughout the audit process and by means other than letters of instruction, or memoranda or reports of work performed.

64. The IAASB agreed that:

    (a) The requirements and guidance should be revised to refer to "communication" instead of "letter of instruction" or "memorandum or report of work performed."

    (b) The group engagement team should be required to communicate its requirements to the component auditor on a timely basis. The communication sets out the work to be performed, the use to be made of that work, the form and content of the component auditor's communication with the group engagement team, and other prescribed matters. The communication includes requests for specific information to be communicated to the group engagement team during the course of performing work on the financial information of the component (e.g., significant risks of material misstatement of the group financial statements identified by the component auditor that were not included in the list of significant risks communicated by the group engagement team). (See paragraph 44 of the ISA.)

    (c) The group engagement team should be required to request the component auditor to communicate to the group engagement team matters relevant to the group engagement team's conclusion with regard to the group audit. Such matters are communicated after completing the work on the financial information of the component. (See paragraph 46 of the ISA.)

    (d) Application material should explain that communication between the group engagement team and the component auditor 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. However, the documentation requirements of the proposed ISA nevertheless apply. (See paragraph A59 of the ISA.)

Responsibilities of Component Auditors

65. Many respondents to the March 2006 Exposure Draft continued to be concerned about the fact that the proposed ISA did not contain explicit requirements for component auditors. Some respondents were of the view that the ISA should include a requirement for the component auditor, knowing the context in which the group engagement team will use his/her work, to cooperate with the group engagement team. The IAASB agreed to include a requirement and guidance in the ISA. (See paragraphs 12 and A10 of the ISA.)