ICAEW AUDIT & ASSURANCE FACULTY

# Auditing groups: a practical guide

## INCLUDES SUPPLEMENTARY MATERIAL

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ICAEW's Audit and Assurance Faculty is a leading authority on external audit and other assurance services. It is recognised internationally by members, professional bodies and others as a source of expertise on issues related to audit and assurance.

Through *AuditFutures*, the faculty has created a space to ask big questions about the future of the audit profession. It convenes stakeholders who normally do not talk to one another and aims to create opportunities for dialogue and for collaborative and creative solutions to emerge. In partnership with the Finance Innovation Lab, we are building a movement for a wider behaviour change and we are developing innovation projects for systemic effect.

In addition to providing guidance and sharing experience on good practice, the faculty provides through the *Audit Insights* programme an opportunity for auditors to publicise their knowledge, adding further value in the public interest.

Through the *re:Assurance* initiative, the faculty is finding out where assurance services over business information, such as quarterly reports or key performance indicators, could strengthen markets and enhance confidence; asking how the International Framework for Assurance Engagements can be applied and developed; and answering demands for practical guidance with publications such as *The Assurance Sourcebook*.

The faculty's Audit Quality Forum (AQF) brings together auditors, investors, business and regulatory bodies, encouraging stakeholders to work together by promoting open and constructive dialogue about transparency, accountability, reporting and confidence in the independent audit.

For more information on the Audit and Assurance Faculty, the current work programmes and how to get involved, please visit icaew.com/audit.



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# AUDITING GROUPS:
# A PRACTICAL GUIDE

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# INTRODUCTION

*Auditing groups: a practical guide* is a practical guide to some of the more challenging aspects of group audits performed in accordance with International Standard on Auditing 600, *Special considerations – audits of group financial statements (including the work of component auditors).*

This guide draws on the experience of auditors who have acted as both group and component auditors. However, it does not address all of the requirements of ISA 600 and is not, therefore, a substitute for reading and being familiar with those requirements, nor is it a comprehensive guide to the application of ISA 600. This guide replaces and expands the faculty's publication, *Auditing in a group context: practical considerations for auditors* published in November 2008.

The need to improve the quality of group audits is highlighted by the results of external regulatory inspections. In their 2012 *Summary report of inspection findings*, the International Forum of Independent Audit Regulators (IFIAR) identified group audits as one of their inspection themes, indicating that this is an issue in a number of countries. In the UK, for example, the Financial Reporting Council's *Audit quality inspections annual report 2012/13* identified a range of issues in respect of the quality of group audit work:

**'... principally related to the sufficiency of the group audit team's involvement in the component auditors' risk assessments or the extent of their review of component auditors' work ...'**

The report also noted that insufficient justification of component materiality, which should be lower than the materiality for the group financial statements as a whole, was also an issue on a number of audits.

ICAEW's Quality Assurance Department (QAD) found some similar points for the improvement of the audit of smaller groups, especially regarding the level and timing of the group auditor's input into work performed by component auditors.

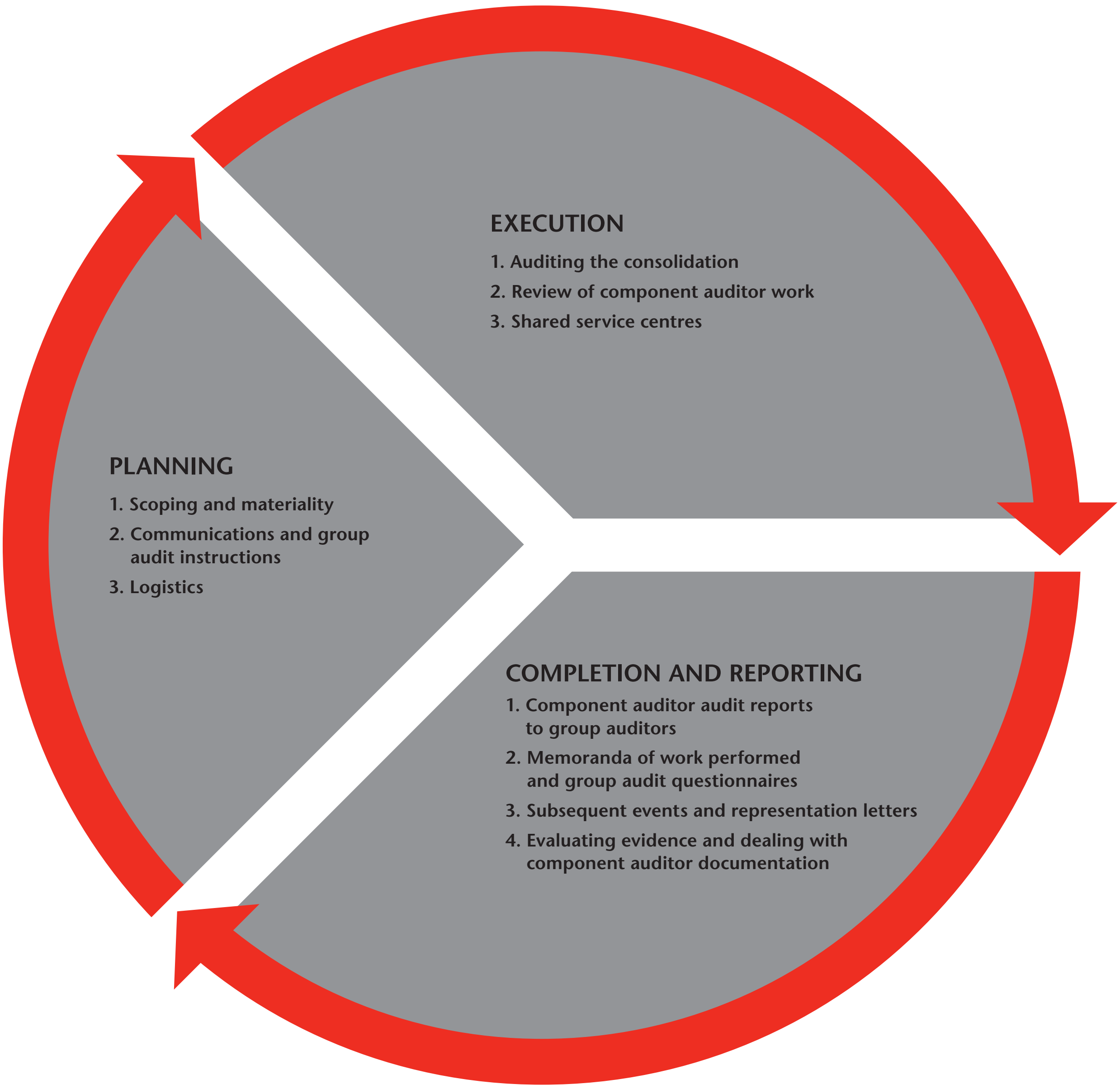
We can conclude from these regulatory findings, and from experience in practice, that group audits present real challenges, many of which relate to the need to work effectively with others. Typically, group auditors will need the support of component auditors who may be based in different countries and be from different firms. Early and thorough planning, comprehensive communication between group and component auditors, and effective project management are therefore vital, together with clear documentation on the audit file.

This guide looks at specific areas within the planning, execution and completion of group audits. It highlights issues for both group and component auditors to consider and we hope it will be of use to auditors operating in both capacities.

There is, of course, a wide range of group audits, from a simple group where most of the work is performed by a single team in one location, to a major multi-national group involving component auditors in many countries who are part of different audit firm networks. The formality with which communications take place varies significantly, and the project management of audits differ in their complexity. However, many of the principles underpinning group audits and the best practice in performing quality group audits are the same. This guide is designed to be relevant to group audits of any size where ISA 600 applies.

**November 2013**

# OVERVIEW OF THE MATERIAL COVERED IN THIS GUIDE




### SPECIFIC ISSUES

1. Non-conterminous year ends
2. Inconsistent accounting policies
3. 'Letterbox' companies
4. Subsidiary audit exemption

# SECTION 1: PLANNING

## PART A – PLANNING: SCOPING AND MATERIALITY



### 1. OVERVIEW AND SUMMARY: SCOPING AND MATERIALITY

Scoping is probably the single most critical element of a group audit. If group auditors get this wrong, there will be little they can do to salvage the audit because they will either be doing too much and inefficiently, or too little and non-compliant.

Scoping out components that should be scoped in, and performing too little work on components because they are not assessed as significant, is by far the greater and more serious risk. But scoping requires more than a little judgement and it is just as possible to err too far in the other direction. Inefficient and unprofitable audits matter because they are unsustainable.

In recent years, regulators across the world have publicly criticised the conduct of group audits. They claim that firms, under significant pressure to reduce fees, have changed the scoping of group audits by raising materiality levels without adequate justification.

Regulators have also criticised auditors for being insufficiently involved in the work of component auditors, and that involvement sometimes lacks focus: audit staff are sent to components or their auditors without a clear understanding of the purpose of the visit, they perform irrelevant procedures or fail to perform appropriate procedures, and they leave without a clear view as to what the visit has contributed to the group audit opinion. All of these, whether they relate to compliance or efficiency, are serious charges that auditors need to be aware of.

The causes of the problems identified by regulators include inertia, but a lack of effective communications between group and component auditors is a common and significant problem.

However, with proper planning and good communications, a group audit can be effectively and efficiently undertaken. At the planning stage, proper consideration of the following is needed:

- evaluating component auditor competence and independence, and the standards they apply;
- determining the coverage of components and the work to be performed;
- materiality;
- group auditor involvement in the work of component auditors; and
- the appropriate level of work effort and evaluating component auditors and their work.

## 2. EVALUATING COMPONENT AUDITOR COMPETENCE AND INDEPENDENCE AND THE STANDARDS THEY APPLY

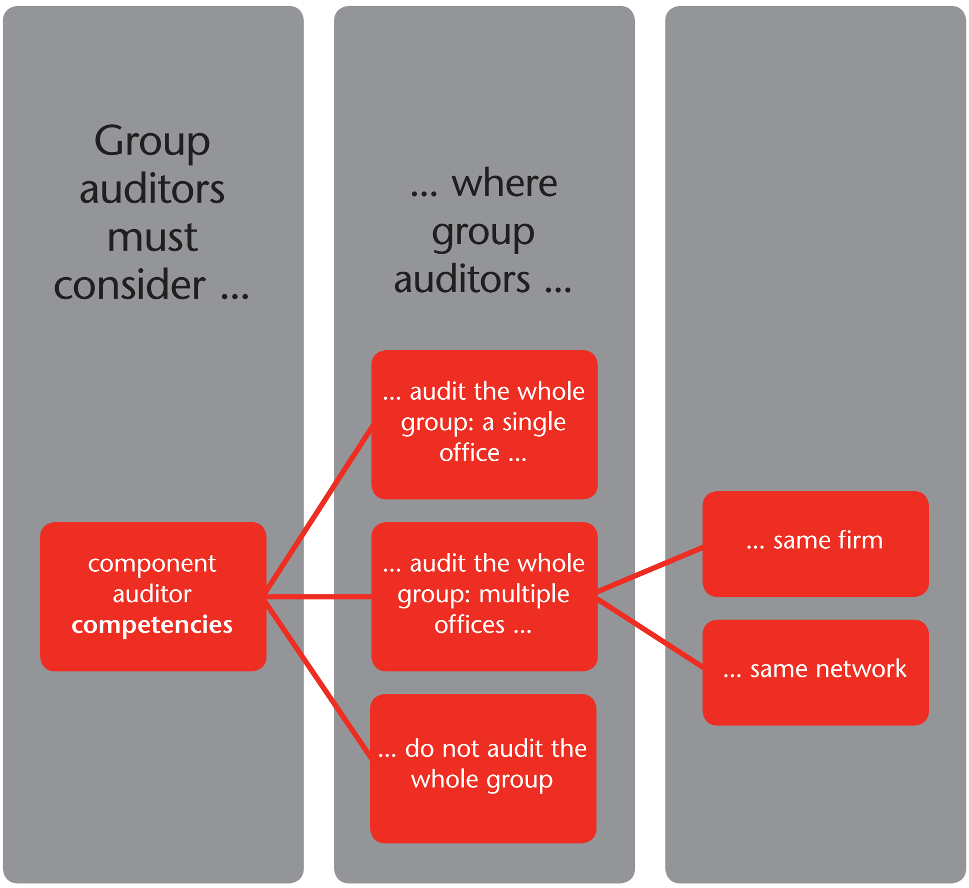
ISA 600 requires group auditors, if they intend to use the work of component auditors, to obtain an understanding of:

- whether component auditors will comply with **ethical requirements**, which may not be the same locally as they are for group purposes;
- component auditor **competence**;
- whether group auditors will be able to be **involved in the work of component auditors** as necessary; and
- whether component auditors operate in a **regulatory environment that actively oversees auditors**, which may be very difficult to assess long distance.

Part of the group auditors' role is to understand component auditor competencies and to be confident that component auditors can properly fulfil their group audit responsibilities. If group auditors fail to understand this, it is difficult to show that they have sufficient involvement in, or control over, the group audit. This understanding needs to be documented. The level of documentation required depends on the complexity of the process for obtaining the understanding. Group auditors need to be satisfied that component auditors:

- understand the auditing, quality control and other standards under which they should operate for group audit purposes, and are able and willing to comply with those standards;
- have the specialist skills, such as industry-specific knowledge, necessary to perform the work required; and
- have an understanding of the applicable financial reporting framework that is sufficient to fulfil their engagement responsibilities.

There are several permutations to consider:



## 2.1 Group auditors auditing the whole group: where group and all component auditors are part of the same firm or network

Where group and component auditors are part of the same firm or network of firms, whether in a single or multiple offices, and whether within one jurisdiction or several, group auditors should have a good understanding of component auditors.

Communications should be easier for firms with common audit approaches, quality control procedures and audit software, and partners and staff who undertake common training programmes. Nevertheless, ISA 600 still requires group auditors to document their understanding of component auditors, and for component auditors to acknowledge their compliance with group auditor requests.

Practically, distinctions need to be made in the approach between single office group audits, multiple office group audits (same firm) and multiple firm (same network) group audits.

### 2.1.1 Single office group audit

For a single office group audit, competency should not be too much of a problem, because all participants are subject to the same quality control policies and procedures, including ethics, independence, recruitment, training and performance. All participants operate under the same standards, and all participants use the same methodology and audit approach. Documenting the understanding that has been obtained, and why the group audit engagement partner is satisfied should be relatively brief and straightforward.

### 2.1.2 Multiple office group audit (same firm)

Being in the same firm is not a guarantee of competence for group audit purposes. Multiple offices within the same firm may have their own variations on the firm's quality control, training, recruitment and independence policies and procedures. Group auditors are less likely to have first-hand knowledge of the skills and experience of component auditor teams. It is also possible that not all offices use the same methodology or audit approach.

While differences need to be understood and documented, it should not be too difficult for group auditors to obtain a proper understanding of component auditor competencies, sufficient to satisfy them that component auditors will be able to fulfil their group audit responsibilities. Documentation of the understanding may again be relatively brief and straightforward unless offices within the firm are not homogeneous.

**Where there are significant differences between different offices in the same firm, it may be more appropriate, and easier for everyone, if group auditors adopt the approach set out below for a multiple firm group audit (same network).**

### 2.1.3 Multiple firm group audit (same network)

For a multiple firm group audit within a network, it is likely that individual firms have their own variations on the network's quality control policies and procedures – if they exist – particularly where they are based in different jurisdictions. Differences may be limited to ethical policies and procedures, but they may also extend to recruitment, training, and even audit approach and methodology issues. Group auditors need to take account of the cohesiveness of network firms.

As with different office (same firm) group audits, being in the same network is not a guarantee of competence for group audit purposes. It may make communication easier, and there may be some common policies and procedures, including network review procedures. But even then, group auditors have to understand how the commonalities are applied and if there are local modifications, some of which may be required by law.

### 2.1.4 The use of GAAS other than ISAs

One potential issue which applies in all cases, is the extent to which auditing, ethical and other standards that are nominally the same in different jurisdictions, are not in fact the same. **Many jurisdictions mandate the use of ISAs which have been translated into the local language, but translation is often a technically difficult, slow and expensive process, and firms in some jurisdictions may use out-of-date, superseded ISAs**.

Many jurisdictions have adopted most, but not all ISAs. For example, in the UK, the ISA 700 and 800 series have not been adopted, and in some jurisdictions the current version of ISAs, including ISA 600, may not have been implemented. This may affect the conduct of the audit. And this is all before consideration is given to the effects of local economic and local conditions on the interpretation of ISAs.[1] For example, approaches to the audit of related party transactions using the same ISA can be significantly different, across different jurisdictions, even within the same firm, and if related parties are a significant audit risk to the group, the issue must be considered.

**If local conditions prevent the application of ISAs in the manner group auditors consider necessary, they may consider requiring the performance of specific audit procedures for group purposes to overcome this hurdle.**

Information on ISA implementation in different jurisdictions can be obtained from the IFAC website[2] and, in many cases, from national regulator websites. By itself though, this level of detail may not be sufficient for group auditors to make a proper assessment.

Group auditors may also be required to report on the group financial statements applying national GAAS that goes beyond ISAs in some respects. Even where a network of firms bases a common methodology on ISAs, group auditors may need to instruct component auditors to perform additional procedures, to comply with local variations of ISAs, as in the UK for example.

A related issue arising in transnational group audits is where component auditors are required to audit or perform specific procedures on financial statements prepared under IFRS or another financial reporting framework that is not the normal reporting framework for their client base. While this issue is not insurmountable, group auditors clearly need to satisfy themselves that component auditors do in fact possess the appropriate knowledge and experience. Their role may need to be redefined so that group auditors provide additional support or perform specific tasks either instead of, or in conjunction with, component auditors.

Usually, the best way to obtain a real understanding of how firms operate is to ask. An easy and practical way to obtain the depth of understanding needed, even when component auditors are in the same network as group auditors, is to use a questionnaire and/or checklist. However, checklists alone are unlikely to be sufficient because some narrative is needed to demonstrate how the group auditors obtained their understanding.

**Many networks require member firms to record the type of information needed to enable group auditors to evaluate component auditor competency as part of their internal policies and procedures. This is helpful to all concerned as it saves time and effort.**

### 2.2 Group auditors not auditing the whole group: competencies where group and component auditors are not all part of the same firm or network

Situations where the group auditors do not audit the whole group include multi-network group audits and where group or component auditors are not members of any network.

While the basic considerations are the same as those where group and component auditors all belong to the same network – competencies need to be evaluated and documented, regardless of the relationship between group and component auditors – group and component auditors are unlikely to use the same methodology when they have no connections. They are also less likely to have similar quality control policies and procedures in place, but given that compliance with ISQC 1 is a requirement for both group and component auditors in many jurisdictions, there are limits to how different these procedures can be.

Again, checklists and questionnaires are a simple and effective way to allow the group auditor both to obtain and demonstrate a sufficient appropriate understanding of component auditors, to enable them to:

- fulfil their own role; and
- evaluate whether component auditors are able to fulfil their role.

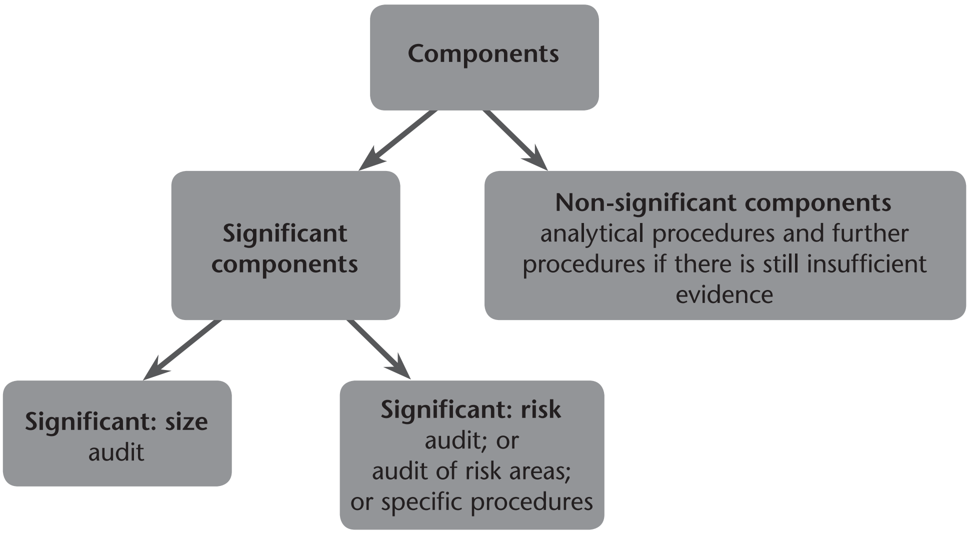
## 3. DETERMINING THE COVERAGE OF COMPONENTS AND THE WORK TO BE PERFORMED

For the purposes of ISA 600, components such as subsidiaries, joint ventures and associates fall into one of two categories: significant and non-significant components. Significant components are either significant in financial terms – the quantum is left to the group auditors' professional judgement – or because of the degree of risk they present which is also for group auditors to determine.

[1] The Audit Quality Forum publication *International Consistency* deals with the problem of applying ISAs and other international standards in different cultures and regimes. www.icaew.com/~/media/Files/Technical/Audit-and-assurance/audit-quality/audit-quality-forum/audit-quality-international-consistency.pdf

[2] www.ifac.org

Financially significant components require an audit of their financial information using group materiality. Components significant due to risk also require this, or an audit of specific risk areas, or specific audit procedures. Analytical procedures are performed on non-significant components. Further work is required where, after all of this, there is still insufficient evidence.




### 3.1 Indicators of 'significance'

There is no simple formula for determining which components should be audited because they are financially significant. Group auditors need to be satisfied that 'enough' work will be performed and 'enough' is a concept varying from engagement to engagement, depending on circumstances and determined by professional judgement. It is vital that the file reflects this judgement and explains how it was reached.

Examples of indicators of **financial significance** might include the overall size of the component's balance sheet or turnover, or the relative size of a component's contribution to a particular item in the group financial statements. The application material to ISA 600 indicates that 15% of a chosen benchmark (such as group assets or profit) might be chosen by group auditors as indicative of financial significance, but judgement is still required and higher or lower percentages may be appropriate, depending on the composition of the group. Group auditors choosing 15% might well be required to justify that amount in the circumstances.

Examples of indicators of **non-financial significance** might include the presence in a component of particular risks of material misstatement, such as those relating to estimates of impairments, inventory valuations, and tax provisions. Risks relating to complex areas such as financial instruments, and other highly subjective areas such as contingencies and subsequent events, may also determine non-financial significance.

### 3.2 Coverage

Determining what coverage of components is needed overall, and how to obtain it, are significant judgements, particularly where there are few significant components. Coverage is determined in part by the nature of the group, the quality of its controls, and the quality and sources of information and evidence available, such as the effectiveness of group-level analytical procedures. More coverage will probably be required where controls are poor and/or the evidence available at a group level is weak.

**Group auditors are required to perform, or have component auditors perform, full audits on all financially significant components.** For other significant components, the work performed can be full audits, audits of specific balances, classes of transactions or disclosures relating to identified risks, or specific procedures relating to identified risks.

Determining what coverage of components is needed overall, and how to obtain it, are significant judgements …

**In addition to the audit work required for significant components,** group auditors are also required to perform **procedures on group-wide controls, and analytical procedures on non-significant components …**

If, after all that, the group auditors are not happy … they then determine what **additional procedures** need to be performed …

In addition to the audit work required for significant components, group auditors are also required to perform procedures on group-wide controls, and analytical procedures on non-significant components. If, after all that, the group auditors are not happy that sufficient evidence can or is likely to be obtained to support the group audit opinion, they then determine what additional procedures need to be performed on non-significant components. The possibilities are the same as for components significant due to risk, or as an alternative, a review of the financial information of the component is possible although this option does not seem to be used in practice, at present.

**Additional procedures may be required where, for example, the outcome of controls testing is not as expected or where unforeseen issues arise in one component that are expected to be replicated in other components.** They may also be required in high-risk situations generally, or where group auditors are not as confident as they expected to be about the quality of the work performed by component auditors, regardless of whether it relates to their competence or the standards they have applied.

It is important to note that all the work required for components must be performed to a component materiality level set by group auditors. Component materiality may be higher than materiality levels which would be set by component auditors for the purposes of auditing the individual component's financial statements but is lower than the group overall materiality.

The key issue here is that for components other than those that are financially significant and require an audit, it is for group auditors to determine the level of work required, within the boundaries set by the ISA.

A good file will demonstrate that judgement was exercised, and the reasoning behind the judgement. It is perfectly possible that the group auditors' evaluation of the amount of work needed to generate sufficient appropriate audit evidence for the purposes of the group audit opinion will change year on year. **Group auditors must therefore actively consider the work that needs to be performed, and document that consideration, every year.**

There are other factors that auditors may legitimately take into account when deciding how work is to be performed, such as whether or not a given component is required to have an audit, whether it has an auditor in place, and the quality of the local regulatory regime. Such factors should not, however, be part of the decision as to the significance or otherwise of the component, and as to what work is to be performed. The only factors that should influence the group auditors' determination of the work to be performed, and on which components, are the requirements of ISA 600 and the group auditors' professional judgement about what is necessary to obtain sufficient, appropriate audit evidence for group audit purposes.

**Question: What happens if the group has a significant component which is exempt from audit?**

When a significant component does not have an auditor, or has never had an audit, group auditors often instruct a local network firm or another local auditor with whom they have a relationship to perform the work necessary for group audit purposes. In some circumstances, group auditors might perform the work themselves, although it might be expensive if the component is abroad. In such cases, the cost is typically borne by the entity's head office as part of the overall group audit cost.

Audit exemption is dealt with in more detail in Section 4.

### 3.2.1 Analytical procedures

Group auditors are required to perform analytical procedures at group level covering non-significant components to corroborate conclusions that there are no significant risks in those components. The degree of disaggregation of data used for these procedures may vary and is impacted by the nature and level of management information available.

When no additional risks are identified as a result of analytical procedures, group auditors may document their belief that there is nothing to indicate a need for the performance of additional procedures on these components. However, if the results of analytical procedures indicate that there may be a risk of material misstatement in one or more components, group auditors need to document the nature, timing and extent of the procedures that will be performed to address the identified risks.

## 4. MATERIALITY

Group auditors determine **group overall materiality** using professional judgement, just as they would for a single entity audit. Group auditors may also determine lower materiality levels for specific account balances, classes of transactions or disclosures, and they are **required** to determine **group performance materiality**. All are matters of professional judgement, although firms may have methodologies that guide the use of judgement.

For those components which have audits or reviews for group audit purposes, group auditors are also required to determine **component materiality** levels. **Component materiality must be lower than group materiality** to reduce to a sufficiently low level the probability that the aggregate of uncorrected and undetected misstatements in the component's financial information will exceed materiality for the group financial statements as a whole.

Component materiality is used when establishing the overall strategy for the audit of a component for group purposes. Different levels of component materiality are normally set for different components.

A common and simple method of setting component materiality is to divide the total for group materiality among the components, but this is not required. Indeed, the sum of component materiality levels may be higher than group materiality, particularly where the probability of undetected misstatements in many components is low. As with all materiality decisions, group auditors need to clearly explain and justify their decisions on file, particularly in the light of regulator observations in this area.

Performance materiality and thresholds for the communication of misstatements to group auditors are also set for the component.

### Determining component materiality

Factors which may influence component materiality levels include:

- the fact that **component materiality must always be lower than group materiality**;
- the **size** of the component;
- whether the component has a **statutory audit**, in which case the lower level of materiality for statutory audit purposes can be used leaving more to be allocated to other components, if that is the method used;
- the characteristics of or circumstances that make the component **significant**;
- the strength of the component's **control environment**; and
- the likely incidence of **misstatements**, taking account of past experience.

Setting component materiality is a matter for group auditors, because its function is to help them perform the group audit. While it is not required, component materiality set by group auditors is often higher than the materiality figure determined by component auditors auditing component financial statements. No additional work is needed in this case but if performance materiality at group levels is lower than performance materiality at a component – which could arise where, for example, the group consists of a mix of profitable and loss-making components – additional work will be required for group purposes, and the costs of this are often covered as part of the group audit fees.

Common problems with materiality in group audits involve communications. Where communications are good, and group auditors have informed all component auditors in a timely manner of the level of component materiality for their particular component, and of the procedures that are required for group purposes, there should be no problem. Problems arise when component auditors do not coordinate their work properly with group auditors.

Problems also arise if it becomes clear during the course of the audit that component materiality needs to be adjusted. There can be serious consequences if the following matters are not communicated and acted on promptly:

- indications that an adjustment might be needed arising from procedures performed by component auditors – component auditors need to communicate, group auditors need to act;
- a decision by the group auditor that an adjustment is needed – group auditors need to communicate, component auditors need to act.

Other materiality issues can arise where there are different approaches to the determination of materiality in different jurisdictions. The determination of materiality is a matter for professional judgement, but it is customary in some jurisdictions to take a rigidly mathematical approach, which can be disturbing for auditors who are more used to taking a more judgemental approach.

Provided the relevant file sections contain adequate documentation justifying the figures selected, using complex mathematical methods to support and inform professional judgement, is perfectly acceptable. The key is to ensure that the figures selected are both justifiable and are in fact justified in the circumstances.

Where group auditors also audit all of the components, issues regarding the communication of component materiality and any necessary adjustments do not arise. In all other cases, communication can be relatively straightforward provided everyone involved in the group audit is clear as to the:

- materiality levels that have been determined;
- procedures for communicating information that might lead to an adjustment to materiality; and
- procedures for communicating adjustments to materiality during the course of the audit.

## 5. GROUP AUDITOR INVOLVEMENT IN THE WORK OF COMPONENT AUDITORS

The level of group auditor involvement in the work of component auditors is important, not least because regulators criticise it. This was one of the key areas of change when ISA 600 was last revised. For significant components, group auditors are required to be involved in the component auditor's risk assessment in order to identify significant risks of material misstatement in the group financial statements.

This involvement is rarely face to face. The discussions referred to below tend to be a combination of email correspondence, telephone calls, video conferences and reviews of documentation. While the extent of involvement varies, it must as a minimum include:

**At the start of the audit**

- **discussing business activities that are significant to the group** with component auditors or component management;
- discussing with component auditors the **susceptibility of the component's financial information to material misstatement**; and

**Later during the audit**

- reviewing component auditor documentation of identified significant risks of material misstatement in the group financial statements. This documentation may take the form of a memorandum that reflects component auditor conclusions on identified significant risks.

In practice, group auditors will seek to review the audit planning documentation of significant components to inform the required discussions. The review of documentation relating to components is dealt with in more detail later in this section.

## 6. THE APPROPRIATE LEVEL OF WORK EFFORT AND EVALUATING COMPONENT AUDITORS AND THEIR WORK

The level of involvement of group auditors in the work of component auditors is closely linked to their evaluation of component auditor competence. The more concerned group auditors are about the component and its auditors – where there are concerns about the competence, independence or diligence of the component auditor, or concerns about the component itself or the jurisdiction in which it and its auditors operate, for example – the greater the potential risk to the group audit. The higher this risk, the greater the level of work effort group auditors are likely to require of component auditors, and the more direct involvement they may wish to have themselves.

> The level of involvement of group auditors is closely linked to their evaluation of the competence of component auditors. **The more concerned group auditors are about component auditors … the more work effort group auditors are likely to require of component auditors, and the more direct involvement they may wish to have themselves …**

Where group auditors also audit all of the components, the level of involvement of group auditors is less of a worry than where they do not. There is likely to be less uncertainty about independence and competence, there are common methodologies that help with classifying components and determining the work effort, and there are commonly understood protocols for communications.

Where group auditors do not audit all of the components, considerations regarding the level of work effort are broadly similar, irrespective of whether component auditors are from the same firm or network, or different firms or networks. These considerations include the extent to which group auditors consider they need to be involved in the component audit. This in turn determines whether a comprehensive set of group audit instructions is issued followed by a review, or whether group auditors visit the component. A visit can involve participation in, or performance of, risk assessment procedures, tests of controls, substantive procedures, and review and completion procedures. Group auditors rarely ignore the work performed by component auditors but they may well ask component auditors to do more than they were originally planning to do for local audit purposes.

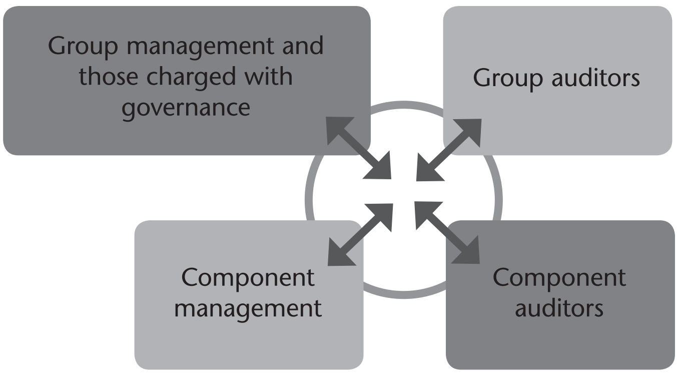
The performance of a statutory audit on the component does not diminish the group auditors' responsibility for the group audit, their need to be involved in the component audit and for work to be performed for group audit purposes.

The decision to visit component auditors is dealt with in more detail later in this section.

# PART B – PLANNING: COMMUNICATIONS AND GROUP AUDIT INSTRUCTIONS



## 7. OVERVIEW AND SUMMARY: COMMUNICATIONS




An efficient and effective group audit requires channels of two-way communication between:

- group and component management regarding information required to prepare the consolidated financial statements;
- group and component auditors regarding the group audit and the consolidation; and
- group auditors and group management and component auditors and component management.

Although it is less common, communication between group auditors and component management is sometimes possible, where audit committees want group auditors to be able to talk knowledgeably about the quality of component management, for example. Similarly, communication between group management and component auditors is sometimes possible where group management is a vital third party source of evidence for component auditors.

Many group audit communications are in writing, often by email, but there is benefit in conference calls and face-to-face meetings to follow up instructions and clarify misunderstandings.

On large group audits, there may be a group planning meeting, at which representatives of significant component audit teams and others can get together to discuss planning issues, such as identified significant risks. On smaller group audits this is rarely practical but much can still be achieved by conference calls.


1 – Planning: Scoping and materiality
1 – Planning: Communications and group audit instructions
1 – Planning: Logistics
2 – Execution: Auditing the consolidation
2 – Execution: Review of component auditor work
2 – Execution: Shared service centres
3 – Completion and Reporting
4 – Specific Issues

## 8. TWO-WAY COMMUNICATIONS BETWEEN GROUP AND COMPONENT AUDITORS

One of the objectives of ISA 600 is for group auditors to communicate clearly with component auditors about audit scope, timing and findings. Effective two-way communication is needed, the starting point for which is the clear and timely communication of the group auditors' requirements ie, the group audit instructions.

Component auditors communicate with group auditors not only in response to group audit instructions, but also when they are required by statute, regulation or for other reasons, to perform an audit on the component's financial statements. They need to understand how the component fits into the wider group and whether any risks at group level have an impact on the component audit.

Where group and component auditors are part of the same firm or network, group auditors often have a good understanding of component auditor procedures but group auditors are still required to document their understanding of component auditors and component auditors still need to acknowledge their compliance with group auditor requests.

It is not common for members of the group engagement team to act as component auditors, but it does happen occasionally, where the head office is a component, for example. This situation is dealt with in more detail in Section 4. In such cases, component auditor access to the overall audit strategy and audit plan may be sufficient to communicate the group engagement team's requirements, and a review of component auditor documentation by the group engagement team may be sufficient to communicate matters relevant to the group engagement team's conclusion.

### 8.1 Restrictions on what component auditors may communicate

Where a component is subject to a statutory audit, there may be a statutory obligation for component auditors and management to cooperate with group auditors for the purposes of the group audit, as in the UK, and there is often a contractual obligation between component management and component auditors in the engagement letter. These factors affect the lines of permissible communication. Where an audit is only performed for group purposes, it is likely that there will be some sort of contractual obligation between group and component auditors, and/or component auditors and whoever is paying for their work.

This will also affect the lines of communication. Any communications that are necessary outside these parameters need to be facilitated by means of written permissions.

Group auditors need to consider the need for group management to facilitate the necessary permissions at an early stage of the audit, as it can be a problem when information is needed from associated entities that group management cannot control, but must nevertheless account for.

Group and component auditors have to think not only about the need to obtain permission to communicate with each other from group and component management respectively, but the manner in which they are going to communicate. Will component auditors provide a formal report to group auditors, or simply report findings and the information requested, allowing group auditors to form their own opinions? Practice varies from firm to firm and may be open to negotiation. These issues are dealt with in more detail in Section 2.

### 8.2 Content: group and component auditor communications

| | | | |
|---|---|---|---|
| Group audit instructions | Independence confirmations/ understanding component auditors | Consolidation questionnaires and memoranda of work performed | Component auditor report on work performed |

The nature, extent and content of communication between group and component auditors depends primarily on the significance of the component to the group audit, including whether it is financially significant, and what work group auditors have decided on. Communications are also influenced by whether group and component auditors are part of the same firm or network, and whether the group and component auditors operate in the same country or under the same regulatory regime, for example.

Despite the need for clear, two-way communications between group and component auditors, it is normally only cost-effective for group auditors to meet component auditors face to face in the largest of audits. Group auditor involvement in component auditor work on component business activities significant to the group, and the discussion of the risks of material misstatement, are usually achieved through a review of files together with email correspondence, telephone discussions or videoconferencing.

### 8.2.1 Group audit instructions: independence confirmations and instructions

To conduct an efficient audit, group audit instructions need to be crystal clear in the following areas:

- the work component auditors are being asked to perform: are they going to perform an audit, a review, work on specified balances or transactions or audit procedures to address specific risks?
- group auditor involvement in component auditor work;
- the timetable and required reporting formats.

There are two distinct parts to what are widely known as 'group audit instructions'. The first asks questions about component auditor willingness to cooperate with group auditors and to make statements about compliance with independence, competence and other ethical requirements. This part also provides component auditors with some preliminary information about the group audit and sets out the work to be performed for those purposes, the use to be made of that work, and the form and content of the component auditors' report back to group auditors.

The response to this part of group audit instructions enables group auditors to determine whether they are going to be able to work with component auditors or whether, if component auditors are insufficiently willing, independent or competent, group auditors will need to obtain the evidence they need on the component themselves. Appendix 4 to ISA 600 provides an example component auditor response to this part of the instructions. These responses are sometimes known as 'independence confirmations' and are part of the work group auditors need to perform to understand component auditors before work starts on component financial statements.

ISA 600 requires that the first part of group audit instructions includes:

- a request for component auditors to confirm that they will **cooperate** with group auditors;
- relevant **ethical requirements**;
- component **materiality**, the 'clearly trivial' threshold for reporting uncorrected misstatements for group purposes and, if applicable, materiality for transactions, balances or disclosures;
- significant **risks of material misstatement** in the group financial statements relevant to the component, including fraud risks, with a request for component auditors to communicate any other significant risks to the group financial statements, together with the component auditors' response to those risks; and
- a list of **related parties** prepared by group management together with any other parties of which group auditors are aware, with a request that component auditors communicate the identity of any further related parties that come to their attention.

Other matters that are commonly communicated at this stage include:

- a timetable, including meetings between group and component management and auditors, and key contacts;
- work to be performed on intra-group transactions, balances and unrealised profits;
- subsequent events work to be performed where there is a gap between the group and component period-end or auditor reporting date;
- matters to be documented by component auditors for the purposes of the group audit;
- group auditor and internal audit findings from work on group-wide controls;
- a request for timely/early communication of any evidence that appears to contradict the original group risk assessment and of significant or unusual events;
- a request for timely confirmation of matters relating to going concern, litigation and claims, significant deficiencies in internal control, issues related to fraud and other significant accounting and auditing matters; and

- reference to ISQC 1, and the component auditors' awareness of any actual or potential threats to independence or objectivity in the component engagement team. Different requirements apply to listed entities and some of these are covered in Appendix 5 to ISA 600.

The example independence confirmation in Appendix 4 to ISA 600:

- includes confirmation that component auditors will comply with the group instructions, that the instructions are clear and understood, and that component auditors will cooperate with group auditors and provide access to relevant audit documentation;
- acknowledges that the financial information of the component will be included in the group financial statements, that group auditors may consider it necessary to be involved in the work they have requested that component auditors perform, and that group auditors intend to evaluate and use the component auditors' work; and
- includes confirmation that component auditors understand and will comply with relevant ethical requirements, ISAs and the applicable financial reporting framework, and that they are competent.

### 8.2.2 Group audit instructions: consolidation questionnaires and memoranda of work performed

The second part of the group audit instructions specifies the deliverables required from component auditors on completion of their work. It asks for reconfirmation of compliance with ethical requirements, for confirmation that the instructions have been complied with and, in practice, for details of work performed, particularly where group auditors do not intend to review files or visit component auditors. The contents of consolidation questionnaires and memoranda of work performed are dealt with in more detail in Section 3.

The document(s) prepared by component auditors in response may include a completed group audit questionnaire and/or information regarding the work performed, variously referred to by different firms as the 'summary review memorandum', the 'memorandum of completion' or the 'completion memorandum', for example. ISA 600 refers to this as a 'memorandum (or report) of work performed'.

## 9. THE COMPONENT AUDITORS' VIEW

It is important for component auditors to understand:

- the wider group of which their component is a part;
- to what extent group auditors will want to be involved in their work;
- whether there are any risks identified at group level that will have to be taken into account in planning the component audit; and
- whether any additional work needs to be performed and how matters are to be reported to the group auditor.

If group auditors are not careful, component auditors can be overwhelmed by requests for information from group auditors and may not respond, which is exactly what group auditors do not want.

Component auditors receive group audit instructions, including a request for independence confirmations and memoranda of work performed. Instructions may include requests to report on a local GAAP reconciliation and group reporting (consolidation) packages. On receipt of any of these communications, component auditors need to ensure that they fully understand what is being requested.

**Questions component auditors need to answer before responding to group auditors**

- Are the requirements clear and unambiguous? Are there any requirements that component auditors are either unable or unwilling to comply with? Are there alternatives? Is the proposed timetable reasonable and achievable? If it is unrealistic, if component auditors are unable to comply with any specific requests or if the requirements are unclear, component auditors need to seek clarification and/or mutually agreed alternatives as soon as possible.
- If component auditors are also asked to report to group management or group auditors on a group reporting package, what form of reporting is required? Is it covered by a suitable engagement letter, and if appropriate, a suitable limitation of liability?

**Questions component auditors need to answer before responding to group auditors (continued)**

- Do component auditors have sufficient knowledge and experience of the auditing standards and financial reporting framework used for group purposes if they are not the same as those used locally?
- Has any additional work required by group auditors been reflected in the timetable and budget? Who will pay for the additional work?
- Have group auditors been advised of any significant risks, related parties, or other matters that may affect the group audit strategy?
- Has the planned audit strategy for the component been amended for any significant risks, related parties, or other matters that group auditors have brought to their attention?
- If group auditors are planning to conduct testing on group-wide controls, have component auditors considered whether the work could be used for the purposes of the component audit? How will it be documented?
- Is the required form and timing of reporting to group auditors clearly specified and included in audit planning? Some matters need to be communicated without delay, others need timely communication and the remainder can be dealt with in the memorandum of work performed which is issued at the end of the audit.
- Have group auditors indicated their intention to review the component auditors' working papers or their desire for a meeting? Has this been included in the timetable? Do requests comply with component auditors' policies on access to working papers?

Where group auditors request that component auditors carry out specific procedures over and above those required for the local audit, component auditors need to consider the impact on their budget, fees and timetable. In some cases the costs may be borne by the component, in other cases the cost may be borne by group auditors. This needs to be clarified and agreed at the outset and the engagement letter needs to make it clear that such work does not form part of the local audit.

## 10. COMMUNICATIONS BETWEEN GROUP AUDITORS AND GROUP MANAGEMENT AND THOSE CHARGED WITH GOVERNANCE

Communications on group audits are not just about group and component auditors. Group auditors need to communicate a number of specifically group-related matters to those charged with governance and group management. These include deficiencies in group-wide internal control and deficiencies in internal control at components, regardless of whether they are identified by group auditors or brought to their attention by component auditors.

Any indication of fraud at group or component level also needs to be communicated on a timely basis to the appropriate level of group management.

Where component auditors report on component financial statements, group auditors are required to request group management to inform component management about anything group auditors are aware of that may be significant to the component's financial statements, but which component management may be unaware of. If group management refuses to do this – perhaps because the matter involves group management's intentions regarding the funding of the component, or intentions to dispose of or restructure the component – group auditors discuss the matter with those charged with governance of the group. If the matter remains unresolved, group auditors consider whether to advise component auditors not to issue a report on the financial statements of the component.

**Mandatory communications: group auditors to those charged with governance**

Group auditors are required to communicate the following to those charged with governance of the group.

- An overview of **the type of work to be performed** on the financial information of components – regulators seem keen for audit committees to pay more attention to this, as well as to the decisions of auditors as to which components are significant.

**Mandatory communications: group auditors to those charged with governance (continued)**

- An overview of **the group auditors' planned involvement in the work of component auditors** on significant components – whether they intend to visit the component, review files or attend meetings with component auditors, for example.
- Instances in which there is **concern about the quality of a component auditor's work**.
- Any **limitations in the scope of the group audit** – where access to component auditor working papers has been denied, for example.
- **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.

In all cases, the matters communicated include relevant matters brought to the attention of the group engagement team by component auditors.

# PART C – PLANNING: LOGISTICS



## 11. OVERVIEW AND SUMMARY: LOGISTICS

While the requirements of ISAs present their own problems in group audits, the sheer scale and complexity of some group audits and their logistics are among the biggest headaches auditors face.

This section deals with:

- documentation – including the documentation of the review of component auditor work;
- logistics proper – getting the right people to the right places at the right time;
- timelines;
- budgets, including the cost of work on associates; and
- access to working papers and component auditor reports to group auditors.

## 12. DOCUMENTATION

### 12.1 What are the main documentation requirements?

ISA 600's overarching requirements for documentation are unremarkable. Group auditors include in audit documentation:

- an analysis of components, indicating those that are significant and the type of work performed on their financial information;
- group auditor involvement in and evaluation of the work performed by component auditors on significant components, including the review of component auditor documentation; and
- written communications between group and component auditors about group audit requirements.

These requirements do not appear particularly onerous and most firms record far more than this. It is widely recognised that the last revision of ISA 600 codified best practice but for some firms, the requirements of ISA 600 represent a sizeable increase in the level of documentation required to issue a group audit opinion. The need to improve documentation of group audits is a common issue raised by a number of regulators.

### How to document a group audit

The following general suggestions regarding the documentation of any audit hold true for group audits.

- **State the obvious** – what is obvious to the group auditor may not be obvious to someone without knowledge of the client.
- **Tell a joined-up story** – documentation should explain and connect what auditors planned to do, changes to plans to take account of new information or risks identified as the audit progressed, the testing undertaken, the results of tests and the conclusions reached.
- **Document the thought processes** – record what was considered, what was tested, the supporting evidence obtained and the conclusions reached. Good documentation helps demonstrate that professional scepticism has been applied.
- **Keep it up to date** – have the group structure, systems or personnel changed? If they have, the changes should be reflected in the documentation.

## 12.2 What are the specific documentation issues arising on group audits?

**Computerised audit systems:** using a computerised audit system has benefits and may be necessary but there can be problems. For example, audit opinions for group and parent entities are normally signed at the same time, but it is common to include group audit working papers in the parent entity file. This means that one deadline for ensuring that all appropriate documentation has been uploaded applies. Where the file includes the group, parent and other component entities, the software may not be able to deal with audit reports being signed at different times, as is often the case. One solution is to take copies of electronic files and lock them down for each different sign-off date. Where components are signed off **after** the group audit is signed off, it is important that the file demonstrates that sufficient, appropriate evidence was obtained at the date of the group audit report.

**Different financial reporting and auditing frameworks:** group auditors need to understand and record any differences between the financial reporting frameworks used by the group and components and between the auditing standards used by group and component auditors. This record needs to be kept up to date.

**Significant components:** the classification of components as significant or non-significant and the reasons therefore should be clear. Recording this can be far from straightforward and the layout of documentation varies widely depending on the circumstances.

**Communications with component auditors:** the record of group auditor involvement and discussions with component auditors needs careful consideration. Notes of all calls and meetings should be taken and kept on file, so there is clear evidence of group auditor involvement. Group audit documentation must also include written communications between group and component auditors about the group engagement team's requirements, irrespective of whether group and component auditors are part of the same network or jurisdiction. Documentation of communications is required even when group and component auditors are effectively the same people.

It is important for group auditors to review the deliverables requested from component auditors carefully each year, paying particular attention to standardised questionnaires. This is to make sure that requests cover all the information needed while avoiding duplication and redundancy. This is not always straightforward, but the quality of group auditor requests, in terms of how well they are articulated, will have a significant effect on the quality and timing of responses from component auditors.

**Competence of component auditors:** the ease of evaluation of component auditor competence depends on the proximity of the relationship between group and component auditors. The documentation of the group auditors' understanding of component auditors must in all cases cover component auditor compliance with ethical requirements, group auditor involvement in the component audit and whether the component auditor operates in a regulated environment with proper oversight.[3]

**Review guidance:** staying focussed when reviewing component auditor working papers is a challenge. A great deal of material on component auditor files is irrelevant to the group audit and it can be difficult to filter this out. It is therefore useful for firms to provide guidance in this area. Regulators note that this is a weaker area in group audits. Many firms have introduced

[3] ISA 600 paragraph 19.

templates which include space for component auditors to explain the work they have undertaken on significant audit risks relevant to the group audit, their conclusions on this work, and group auditor conclusions on whether the work undertaken provides sufficient appropriate evidence to support the group audit opinion.

## 13. LOGISTICS PROPER

Successful logistics that overcome the tyrannies of time, distance and language are the backbone of efficient and compliant group audits. They are difficult to achieve, particularly when they are most needed which is when budgets are tight. The following elements are worth considering.

### 13.1 Communications generally

Good quality communications are critical to ensure that all auditors involved in the assignment understand their role. This applies to members of the group engagement team as well as component auditors. Poor communicators do not make good group audit team leaders.

### 13.2 Language issues

Group auditors need to be aware of and deal with the fact that component auditors may be unable to speak fluently in the group auditors' language or read or respond to group audit instructions. Group auditors need to determine what languages the various significant components and their auditors are able to use.

If the group audit team does not have the necessary business language skills to accommodate those components or auditors who are unable to communicate in the group auditors' language:

- are translators required, and if so, are those with the right business experience available at the right time and at reasonable cost?
- can local members of the firm's network be used as translators?
- are translators needed to review files or working papers, to translate in meetings, or both?
- are translators required to travel to components or their auditors or are they available locally?
- do components or their auditors have translators that they use regularly, and are they able to translate instructions to components or their auditors, and their responses and other information to group auditors?

In practice, obtaining sufficient appropriate audit evidence does not necessarily mean that group auditors must be able to read every document on component auditor files. Group auditors may be able to read a language well enough to demonstrate that they have reviewed relevant communications from component auditors. If not, it may be possible for key documents to be translated and summary translations for the group engagement partner prepared.

### 13.3 Foreign travel

Travel mistakes can be expensive and cause delays. Not obtaining visas and sending people who are unable to read the files because they are in a foreign language and then having to find translators at short notice are two examples.

Firms sometimes underestimate the documentation requirements and the length of time needed to obtain visas. The information required often includes an invitation letter, and for the person travelling to send in their passport which affects their other travel plans. Some jurisdictions permit individuals to hold two passports if they can show that they need to travel frequently to jurisdictions with protracted visa application processes.

Other issues firms need to consider, some of which may seem minor, but which can cause frustration, expense, embarrassment and danger if they are overlooked include:

- whether the firm's travel insurance covers the countries to be visited;
- arrangements and instructions for the use of mobile phones, laptops, Wi-Fi and travel adaptors;
- clear instructions on how hotel bills, taxis and other expenses need to be dealt with;
- the firm's rules regarding air, car and train travel, and the balance between flexibility and cost – unforeseen problems, such as unsatisfactory results in audit testing need to be budgeted for; and

- the need to make staff aware of local customs, specific dangers and expected behaviour in different jurisdictions including dress codes and attitudes toward punctuality and women staff, for example.

## 14. TIMELINES

Timelines for group audits need to be prepared backwards from the group audit reporting date. They are heavily dependent on the timetable for the preparation of group and component financial statements.

A group audit of any size, particularly if it involves different jurisdictions, is likely to involve components and auditors using auditing and financial reporting standards that are not the same as those used by the group and its auditors. It may also involve different year ends that cannot be changed. Additional work and information will be needed in such cases.

Timelines are often very difficult to estimate. This is especially true in the first year of a group audit and where there are significant changes in the client from the previous year, or significant changes are to be made to the audit approach. The timeline needs to be established as early as possible. The following suggestions may be helpful.

- Draw a timeline: start with the date the audit report must be signed by and work backwards through the key dates and processes.

### Key dates in a timeline

Key dates in a timeline include dates for:

- discussions with auditors of significant components, in writing or face to face, on component business activities that are significant to the group;
- the receipt of component auditor planning memoranda detailing risks assessed and responses thereto, and independence confirmations;
- discussions with auditors of significant components, in writing or face to face, on the susceptibility of the component's financial information to material misstatement;
- communication of the results of the review of component planning memoranda/ independence confirmations and any alterations to or additional work requested;
- completion of the group audit plan;
- the issue of group audit instructions;
- the receipt of memoranda of work performed and/or responses to group audit questionnaires;
- completion of work on group-wide controls, analytical procedures and the review of component auditor files;
- any planned meetings between component auditors and component management (which the group auditor may wish to participate in) and between group auditors and group management;
- subsequent events reviews, letters of representation, confirmations of opinions to be issued and any planned wrap-up meeting; and
- component and group audit reports.

The chronology of these dates will differ from firm to firm and audit to audit. The required discussions between group auditors and auditors of significant components may take place before or after the receipt of component auditor planning memoranda, for example.

Dates also need to be included for the production of consolidated financial statements by group management and for component auditors to issue requests for accounting information from component management and/or component auditors.

- To set a benchmark for the time it will take to review component auditor files, ask suitable members of the group audit team to review an audit file of a client of a similar size unknown to them.
- Include estimates for the time needed to raise and close off any issues highlighted by reviews, giving enough time for component auditors and management to respond to questions raised.

- Where translators are used, whoever they are, double the review time.
- Establish the absolute information receipt deadline for all significant components, taking account of the nature and extent of the review and involvement by the group audit team in component auditor work, and any past experience the firm has had with component auditors and management.
- Include chasing time – component auditors and management may not provide information by the date requested.
- Consider how group, group auditor, component and component auditor systems process emails with large attachments or a large number of attachments. If these are processed during the early hours of the morning, deadlines need to reflect that fact.
- Consider different time zones, particularly near the end of the assignment when things need to come together quickly.

### 14.1 Managing timelines

Agreeing precise dates for discussions and meetings with component auditors, component management and group management can be hard work. There are a number of online resources such as doodle.com and agreeadate.com which can help with this process.

Establishing timelines is complicated and once outlines have been hammered out, it is tempting to impose intermediate deadlines. The best-planned timelines will not survive first contact with component auditors or management if group auditors do not get buy-in. If component auditors consider a deadline to be unreasonable and restrictive, they are unlikely even to try to meet it.

Prompts can be used a few days before meetings and deadlines. Secretaries and administrators working for group auditors or the parent entity can send reminders of approaching deadlines to component auditors and management.

If component auditors or management start missing deadlines, it may be helpful to inform group management. Having an ally in a position to place pressure on a component to speed the process up can be invaluable. Reminders can be sent at suitable intervals by more senior group management and audit staff.

## 15. BUDGETS AND THE COST OF WORK ON ASSOCIATES

Preparing a budget for an audit is not an exact science and for a group audit assignment there are many variables to consider. Just some of questions group auditors need to ask include:

- what changes have there been in the group's composition, how will the related risks be addressed and what impact will this have on the consolidation process?
- have there been changes in component auditors?
- what changes have there been in group reporting processes and how will this affect segmental analyses and impairment reviews?
- which of the issues identified in the prior year are likely to recur? For example, where the group has been rolling out a change in accounting software, what impact did this have on the relevant components in the prior year? What alterations to the roll-out process has the group made and are similar issues likely to recur in the current year?
- what is the group auditors' past experience of dealing with component management and auditors? Is information made available on time?
- review the recovery rates for the prior year assignment. Are there useful explanations in the comparison of the actual to budgeted time which should be taken into account this year?

### 15.1 The costs of additional work for group purposes

Budgeting for additional work performed by group auditors on components for group purposes is relatively straightforward. Where group auditors request component auditors to do the same, group auditors also have to consider who will pay for the work. It helps if the group has a policy for this.

Some groups require all component auditors to invoice the component for additional work. Some groups require the component to invoice the parent entity for the additional work. Some groups require component auditors to invoice group auditors, in which case obtaining a budget or fee-quote from component auditors will provide a reasonable basis for the amount that group auditors recharge to the group.

Budgets should be reviewed to confirm that they include the necessary time to complete, review and resolve any issues for **risks which may only be addressed at the group level**, such as goodwill, intangible assets, impairment reviews and reviewing the consolidation process.

> … Budgeting for **additional work performed by group auditors on components for group purposes is relatively straightforward. Where group auditors request component auditors to do the same, group auditors also have to consider who will pay for the work.** It helps if the group has a policy for this …

A group audit budget is likely to include an element for **contingencies**. Items allocated to this heading depend on the level of detail in the budget, but the heading is often used to cover time spent on reminders or chasing components for information, time spent on organising meetings, videoconferencing and telephone calls, and to provide a cushion for unplanned activities.

Obtaining a fee-quote from **translators** and any other members of the group audit team who may not be directly employed by the firm will improve the reliability of the budget.

Logistics influence the budgeting process. The cheapest **train and air fares**, normally purchased months in advance, cannot be changed. The most flexible fares are often, but not always, the most expensive. If the budget includes expenses and other out-of-pocket expenses, estimates will have to be made on the basis of the firm's policy and past experience.

If **additional software or hardware** is required for a particular group audit, the firm will have to decide whether the costs should be allocated to a central cost code or asset pool, or if they can be charged to the client.

Time records are a useful tool and the more detailed they are, the easier budgeting becomes, not least because unusual and one-off items can be identified.

## 15.2 The cost of work on associates

When group financial statements include the consolidation of a significant associate, group auditors need to consider carefully how sufficient appropriate audit evidence can be obtained.

> … Despite the fact that **associates fall squarely into the definition of components** for audit purposes, **group auditors sometimes struggle to gain access to their auditors' working papers**, or perform testing at the associate, usually because the associate's management and auditors do not regard the entity as a component …

Despite the fact that associates fall squarely into the definition of components for audit purposes, group auditors sometimes struggle to gain access to their auditors' working papers, or perform testing at the associate, usually because the associate's management and auditors do not regard the entity as a component. Group management does not control the associate and is not in a position to instruct the associate's management or, through them, its auditors. Group management can only **request** that access is provided.

Identifying significant associates before the end of the financial reporting period is critical to prevent the costs of auditing the component spiralling. While associates have a direct impact on very few items in the group's financial statements, those items are some of the most important, including the group share of the associate's profits, total assets and total liabilities. Group auditors may consider it necessary to review the entire audit file and/or perform testing throughout the year. Where possible, group auditors should obtain a copy of the associate's management accounts from group management as early as possible to focus the audit approach.

Groups do not control associates and associates are therefore less likely to operate the same group-wide controls as other components, but **if group-wide controls are in place covering the reporting of associate financial results in the consolidated financial statements, it is likely to be efficient to test them**.

Group auditors need to consider the effects of any changes in the ownership of the associate during the year and how the group has calculated its share of profits for the year. If this is based on management information, group auditors need to consider the effect of the associate's year-end journal entries. Do they relate to a specific period, or should they be spread through the reporting period? If so, what timescale should be used? Obtaining the level of detail required to answer such questions can be time-consuming and the costs of this need to be accounted for.

If a significant associate is either unwilling or unable to provide information to support the group audit opinion, either directly or indirectly through auditors, a modification to the group audit opinion is possible. This sort of situation is usually avoided for obvious reasons, but if it does arise, group auditors need to consider whether it amounts to an imposed limitation in audit scope with all that that entails.

## 16. ACCESS TO WORKING PAPERS AND COMPONENT AUDITOR REPORTS TO GROUP AUDITORS

### 16.1 Access to working papers

Group auditors need to decide whether and when to:

- **visit** component auditors and/or component management;
- **request access** to component auditors' working papers; and
- **request details** of component auditors' findings.

While it is incumbent on group auditors to ensure that appropriate access arrangements are in place before audit work commences, they can only do this with the help of group management.

Where access to component auditors and/or their working papers is required, group auditors need to consider what can be done at group level to facilitate this. The group engagement letter needs to require group management to obtain various permissions and consents concerning components.

In the EU[4] and elsewhere, legislation has been enacted requiring that group auditors review audit work conducted by other persons for group audit purposes, and record that review. In many jurisdictions though, issues can arise with auditors of components who are not subject to any legal or other duty to cooperate[5] with group auditors, and who may be reluctant to share information. Group auditors may try to address potential problems in this area up front by requesting acknowledgement that access will be granted as part of the group instructions, for example, but legislation impeding access to working papers can present difficulties.

**Question: Do I need to visit a given component?**

Factors you may wish to consider when deciding whether to visit a given component include:

- the significance of the component to the group financial statements;
- your evaluation of component auditor competence and independence;
- specific significant risks identified in the component;
- specific characteristics of the component's regulatory environment; and
- your previous experience of the component and its audits.

Countries within the EU are required to implement the Data Protection Directive and a number of member countries have introduced stricter legislation. At the time of writing, obtaining information legitimately from certain European countries, such as Denmark or Germany, can be very difficult.

Group auditors also need to consider whether component auditors are willing to respond to group auditors directly. Some component auditors prefer to respond via the audited component or via the group itself, rather than directly to group auditors. Component auditors may believe that providing any response directly to group auditors, whether in the form of a report or a response to a group audit questionnaire, results in a duty of care. Some component auditors therefore ask group auditors to sign an engagement letter confirming that component auditors do not owe such a duty of care to group auditors. The fear of owing a duty of care is also one of the reasons why component auditors may refuse to sign independence confirmations.

[4] Article 27(b) of the Statutory Audit Directive.

[5] In the UK, sections 499 and 500 of the Companies Act 2006 require subsidiary auditors (but not auditors of associates or joint ventures) to cooperate with group auditors for the purposes of group audits and to provide them with such information and explanations as they need for the group audit.

In providing access to working papers, some component auditors require group auditors to visit their offices to review their audit work. They are within their rights to do so. Group auditors do not have the authority to require audit files, whether electronic or paper-based, to be copied and/or sent to them. Nor do group auditors have any right to take photocopies of papers once they are there. The time needed to re-document tests relevant to the group audit, if considered necessary, needs to be taken account of by group auditors when preparing the group audit plan.

Audit regulation in different jurisdictions varies and what happens to information once it has crossed borders is contentious. Few firms send files, electronically or otherwise, if group auditors are based in the US. The US regulator – the Public Company Accounting Oversight Board (PCAOB) – would be able to review those working papers, bypassing any reciprocal agreements the PCAOB may have with component auditor regulators.

If component auditors refuse all access to their working papers, citing data protection requirements, for example, group auditors will instead need to perform their own testing.

**Questions group auditors need to ask when planning their review of component auditor files**

- Are files paper or electronic?
- Do group auditors need to visit component auditor offices to review the files?
- Will group auditors be permitted to take copies of component auditor files or working papers?
- If files are electronic, do group auditors have the necessary software to read files remotely or do they need to use component auditor laptops? If so, do keyboards have characters on them that the team understand?
- What provisions need to be made for files which are blocked by the firm's firewalls, because they contain images or are too large, for example?

### 16.2 Component auditor reports to group auditors

Where access to working papers is requested, component auditors need to consider whether there are data protection or privacy laws to consider. Where there are none, component auditors then need to consider whether they need to ask for the consent of component management, and whether any concerns about the associated risks to the firm can be dealt with by providing access to working papers locally ie, by not letting papers out of the country, and/or by obtaining a 'hold harmless' letter. ICAEW's Technical Release AAF 04/03 *Access to Working Papers by Investigating Accountants* provides guidance on 'hold harmless' letters relating to audit working papers.[6]

**In addition to being asked to complete group audit questionnaires and/or provide memoranda of work performed, component auditors may be asked to report directly to group auditors in the form of an audit or review opinion on financial information ie, the group reporting/consolidation package prepared by component management. Some firms refuse to do this, because of the duty of care that this potentially establishes between the component and group auditors, because there is no engagement letter between component and group auditors affording protection through limitation of liability clauses.** Practice varies and there are no mandatory requirements other than those imposed by firms themselves.

Component auditors need to consider whether to provide such opinions to group auditors and the format of such reports. The issue is essentially a risk management decision for which firms should develop risk management policies and procedures.

In group audits performed by network firms there are often formal or informal agreements between firms that for practical purposes, component auditors report directly to group auditors in the form of an audit report on the group reporting/consolidation package. Practice varies and again depends on the cohesiveness of the network.

**Clients often fail to appreciate the potential liability issues that the firms are exposed to and expect group and component auditors to cooperate. Refusal by component auditors to report in the manner requested by group auditors can cause disruption, and it is important that component auditors communicate any concerns they have at an early stage to group auditors and component management, rather than leaving it until the issue becomes critical.**

[6] See also www.icaew.com/en/members/regulations-standards-and-guidance/practice-management/managing-professional-liability

Component auditors also need to consider whether the work required to provide audit or assurance reports on group reporting/consolidation packages represents an additional engagement. In some cases, the information included in the group reporting/consolidation package may be the same as that on which component auditors are providing a statutory audit opinion. This is likely to be the case where the package is prepared under the same financial reporting framework as that used in the component's audited financial statements, and where the package only contains information already audited. Rather than provide an additional report on the package, it may be acceptable for component auditors to report that they have checked the information included in the package back to the information included in the entity's audited financial statements.

In many cases though, the information contained in the group reporting/consolidation package is not the same as that included in the component's audited financial statements. The information included in the package may be more detailed, or in a different format or the results may be different because of differences in financial reporting frameworks or because of adjustments to align component financial information with group policies. In these cases, component auditors may consider it necessary to perform additional procedures on this information for group purposes. The procedures will need to be agreed and an appropriate engagement letter signed.

# SECTION 2: EXECUTION

## PART A – AUDITING THE CONSOLIDATION



### 17. OVERVIEW AND SUMMARY: AUDITING THE CONSOLIDATION

Much of the time spent on a group audit is taken up dealing with the various components that make up the group. But the consolidation itself also needs to be audited. The complexity of this process varies enormously.

At one extreme are groups in which all of the components are dealt with by the group auditor and all of those components are subsidiaries which have been wholly owned since incorporation. In such cases, the audit of the consolidation is generally a fairly straightforward exercise. At the other end there are multinational groups, which have both acquired and sold components in the year, and which have possible impairment issues. Some of the procedures undertaken by auditors in the audit of the consolidation are common to both, but there are clearly many more issues likely to arise in the second situation.

### 18. OBTAINING AN UNDERSTANDING

ISA 600 requires group auditors to obtain an understanding of group-wide controls and the consolidation process. It also makes specific reference to the consolidation instructions that have been issued by group management to components. The requirements for group-wide controls are the same as for any other type of control – auditors need to test them if they are going to be taken into account in determining the extent of other work on the consolidation, or if substantive procedures are not expected to be sufficient. The only real difference is that group auditors can either test those controls directly as part of the group audit, or request that some or all of the testing be performed by component auditors.

#### 18.1 Group-wide controls

'Group-wide controls' is an ambiguous phrase. When used in ISAs, it refers to controls designed, implemented and maintained by group management over group financial reporting. This can mean:

- controls directly related to the financial reporting process, such as controls over the accuracy and completeness of the financial information provided by components; and
- common controls affecting each individual component separately, but applied centrally, such as controls built into IT systems.

The phrase 'group-wide controls' does not normally extend to controls which are intended to be the same across all components but where implementation needs to be undertaken locally, such as controls over physical access to inventory. This last category may be tested by component auditors as part of the component audit.

### 18.2 The consolidation process

When dealing with the consolidation process, group auditors need to obtain an understanding of how group management deals with a wide range of issues that affect the consolidation, such as the processes for:

- **identifying and accounting for components,** including the nature of the relationship between the component and the parent;
- **identifying differences between group and component accounting policies,** such as where local requirements for a component differ to those applied to the group;
- **dealing with foreign exchange translation issues,** where the financial information of components is prepared in a currency other than the group reporting currency;
- **identifying and recording consolidation adjustments;** and
- **agreeing transactions between components** and their effects, such as intra-group balances and any unrealised profits and losses arising on transactions between components.

## 19. GROUP INSTRUCTIONS

An important part of obtaining an understanding often involves assessing the adequacy of instructions issued by group management to components. In the very simplest cases, where there are few components, all of which are in the same jurisdiction and where there is significant central involvement in each component's financial reporting processes, for example, minimal instructions may be adequate. In practice, this is rare and instructions normally need to be comprehensive to ensure that all relevant information is captured. Group instructions often include a consolidation pack which needs to be completed by component management.

> **In the very simplest cases,** such as where there are few components, they are all in the same jurisdiction and there is significant central involvement in each component's financial reporting processes, **minimal instructions may be adequate …**

Auditors need to review the instructions or pack and ensure that they have been properly designed to obtain all the information needed, on a timely basis. Auditors need to ensure that the instructions or pack cover:

> Making sure that the instructions or pack are adequate is often the key to ensuring that the audit of a consolidation can be undertaken effectively …

- routine matters, such as ensuring that intra-group balances and transactions are identified; and
- non-routine matters, such as obtaining all the additional information that may be required if a component was acquired in the period.

Making sure that the instructions or pack are adequate is often the key to ensuring that the audit of a consolidation can be undertaken effectively. If the pack is not sufficiently well-designed to capture all the information required, it can cause significant problems later in the audit.

## 20. TESTING THE CONSOLIDATION PROCESS

Group auditors need to test the consolidation process. The extent of testing should be based on the risk assessment. It includes a specific evaluation of whether all components have been included in the consolidation.

Because the consolidation process is usually undertaken centrally, much of the audit work will be undertaken directly by group auditors. But component auditors may still need to be involved.

### Component auditor involvement in the audit of the consolidation

Even at an early stage of the planning process, group auditors may usefully distinguish between those consolidation matters which will be dealt with primarily at group level, and those which may involve direct communication with components or their auditors. Some consolidation adjustments, for example, may be historic and dealt with solely at group level. The determination of the extent of group auditor testing is also undertaken centrally and depends on the risk assessment.

Similarly, consideration of the nature of an investment in a component will often be based on information held by group management. If, however, a group has made a foreign acquisition, group auditors may need to decide at an early stage what work can be performed centrally and what should be performed abroad.

Early planning and communication are important, because some of the matters that need to be dealt with will be outside the information reported in the component's financial statements. For example: a group acquires a new foreign subsidiary which has a substantial amount of property, plant and equipment. Both the group and the new component state property, plant and equipment at depreciated cost. The relevant accounting frameworks define cost in the same way and have the same depreciation requirements. All of the other assets and liabilities of the component are recorded at amounts that are close to their fair value.

Even in such a simple example, group auditors will be aware that:

- while the local financial statements of the component will continue to record the assets at their depreciated historic cost to the component, this is not relevant to the consolidation;
- the cost to the group is the fair value of the assets at the date of acquisition of the new subsidiary; and
- these facts will lead to an original consolidation adjustment at acquisition, followed by further consolidation adjustments over the remainder of the assets' lives.

Group auditors need to understand how this issue is dealt with by group management. This will involve consideration of such questions as, 'Was the valuation of the assets controlled centrally or locally?' and 'Have experts been involved?' Once management's process is understood, group auditors need to consider the best way of obtaining sufficient appropriate audit evidence. Because the adjustments required will not be reflected in the financial statements of the component, obtaining relevant evidence does not form a normal part of the work undertaken by component auditors, assuming there are any.

In many cases the valuation exercise is undertaken or controlled centrally because the valuation is only reflected in the group financial statements. This may mean that group auditors are best placed to undertake the work. At the same time, component auditors may be in a better position to assess the adequacy of the valuation of assets, depending on their nature, because of their knowledge of local conditions. Group auditors need to decide whether to make use of work to be undertaken by component auditors, and if so, what the nature of that work will be. Such procedures will be in addition to component auditor work for local audit purposes.

## 21. CONSOLIDATION ADJUSTMENTS

Group auditors are required to evaluate the appropriateness, completeness and accuracy of consolidation adjustments. This involves the identification of any fraud risk factors and indicators of possible management bias.

This work often has two components. Firstly, there is the mechanical exercise of ensuring that routine consolidation adjustments have been made. If group auditors were satisfied with the accuracy of the consolidation pack prepared by group management, this stage involves checking that the packs have been reasonably completed, and that the matters identified within those packs have been included in the consolidation. This may involve procedures such as tracing items through the consolidation process, checking ongoing adjustments to prior year working papers, and reconciling balances.

The second part involves consideration of more complex matters. Testing the mechanical accuracy of the consolidation is necessary, but it is not sufficient. Group auditors also need to stand back and consider whether the adjustments made are required and, probably more importantly, whether they are complete.

Testing the mechanical accuracy of the consolidation is necessary, but it is not sufficient. Group auditors also need to **stand back and consider whether the adjustments made are required and, probably more importantly, whether they are complete …**

For example, where a component has been acquired, the group financial statements usually record goodwill and other intangible assets in relation to the component. Such assets are not (under most GAAPs) recorded in the component's own financial statements. In the year of acquisition, a valuation exercise should have been undertaken. In subsequent years, group auditors consider whether consolidation adjustments are carried forward from previous periods, and whether group management has properly considered whether other changes are required, such as ensuring that impairment issues have been considered and dealt with appropriately.

At the same time as checking consolidation adjustments, group auditors check that the information to be consolidated agrees with the information provided by component auditors, if there are any.

Group auditors also need to consider how the consolidation process is actually performed. While there are consolidation programmes available, many consolidations are undertaken on spreadsheets. When auditing a consolidation, auditors cannot simply check the data that has been entered, such as the amounts derived from component financial statements and the consolidation adjustments. Auditors also need to check that the consolidation spreadsheets are actually working properly.

## 22. DIFFERENT ACCOUNTING POLICIES

Group auditors also need to consider whether appropriate adjustments have been made where accounting policies applied by a component are not the same as those applied by the group.

Again, the first matter requiring consideration is the adequacy of management's group instructions or pack. Most consolidation packs require the inclusion of amounts and other information in accordance with group accounting policies, irrespective of whether they are the same as policies followed locally, but group auditors need to consider whether the information is nonetheless consistent with the local financial statements. A reconciliation between the amounts reported locally and the amounts reported to the group should be provided. Group auditors also need to decide whether this reconciliation can be dealt with centrally, or whether it should be considered by component auditors.

In some cases, it may be possible for adjustments to be made centrally to align accounting policies and where this is the case, the pack must provide sufficient information for this to be done.

Aligning inconsistent accounting policies is dealt with in more detail in Section 4.

# PART B – REVIEW OF COMPONENT AUDITOR WORK



We have already seen that if group auditors wish to use the work performed by component auditors, group auditors must be satisfied that component auditors are sufficiently competent and independent. They must also have the consent of component auditors to:

- be involved with their audit as necessary for group audit purposes; and
- have access to all the information they consider necessary from component auditors and management.

The necessary consents can be arranged through group management, a group engagement letter or by various other means.

> If appropriate access to component auditors cannot be obtained … group auditors need to perform the necessary work for group audit purposes themselves, **but reviewing the work of component auditors will almost always be preferable …**

If appropriate access to component auditors cannot be obtained for whatever reasons, group auditors need to perform the necessary work for group audit purposes themselves, but reviewing the work of component auditors will almost always be preferable, and cheaper.

> Where access to component auditor working papers is likely to be required, the group audit instructions include a request for **confirmation from component auditors** that they will:
>
> - provide group auditors with **unrestricted access** to their working papers; or
> - provide group auditors with **copies of their working** papers; or
> - **be unable to provide group auditors with unrestricted access** to their working papers or copies thereof because of legal or regulatory reasons, which should be detailed.

We have already seen that the logistics for the review of working papers are important. Two basic judgements have to be made: whether the component is significant and, if it is, whether group auditors need to visit component auditors.

## 23. VISITS TO COMPONENT AUDITORS

As a general rule, group auditors will seek to have component auditor papers, summaries and/or copies thereof sent to the group auditors' offices for review. Where the files are electronic, appropriate remote access to the files is usually organised if component auditors permit this. It is easier and less time-consuming than visiting component auditors. However, group auditors may decide to visit component auditors:

- where **component auditor working papers cannot be moved** out of the relevant jurisdiction;
- **because of the size or specific risks** associated with the component;
- because **group auditors believe that they will need to discuss matters face to face** with component auditors, including situations in which, despite component auditors being assessed as sufficiently competent and independent, there are doubts about their diligence;

- **where there is a change** of either group or component auditors;
- **where there are concerns** about the extent of central control by group management and/or the wider control environment in respect of the consolidation process itself;
- where **the component is recently acquired or disposal is anticipated**;
- **on the basis of work by internal audit**;
- **on the basis of audit adjustments that have been noted** by component auditors; or
- where there have been **changes in local management** or significant changes in the scale or type of **local activities**.

Some significant components may be visited each year, but a rotational approach is often possible.

> **When visiting component auditors** it is helpful to:
>
> - send an **experienced member of the engagement team** to perform the onsite review. Who should perform the review is a matter of judgement and depends on a number of factors, including the significance of the component and the associated risk. Sending relatively junior staff may send out the wrong messages;
> - **be clear about the purpose of the visit**, the files to be reviewed, particular areas of focus, the staff to be interviewed, copies of documents or files to be taken, any further evidence to be obtained and the work to be performed;
> - time the visit to **take place before the local closing meeting** so issues can be raised at that meeting and a member from the group engagement team can participate if necessary; and
> - time the visit to be **in conjunction with a group management visit**.

## 24. DOCUMENTATION

The group auditors' review of the relevant elements of work performed by component auditors must be documented. Group auditors also need to decide whether it is necessary to include certain component auditor working papers in the group audit file. Papers relating to components that are kept on the group file might include copies of the:

- component auditors' planning memorandum;
- component auditors' independence declaration;
- issues raised by component auditors that require follow up at group level, together with evidence as to how these issues have been resolved; and
- component auditors' completed consolidation questionnaire, memorandum of work performed or report to group auditors.

## 25. SUGGESTIONS FOR REVIEWING COMPONENT AUDITOR DOCUMENTATION

When reviewing component auditor files, reviewers seek to cover the areas in the table below. When considering the performance of audit procedures, the review may focus on selected areas of the working papers only, such as those areas where there are significant risks.

| Planning and Risk Identification |
| --- |
| **Component audit planning memorandum** |
| Attach the component's audit planning memorandum as per the group audit instructions, and confirm that it covers:<br>• the fact that internal control has been evaluated to identify and assess any risk of material misstatement;<br>• the risk assessment at an assertion level for all material accounts; and |

| Planning and Risk Identification |
|---|
| **Component audit planning memorandum** |
| • the component auditors' documentation of their understanding of:<br>– the component, its control environment, including IT controls and its accounting and information systems<br>– the way in which transactions are processed by the component<br>– the component's closing process and the controls applicable to accounting entries. |
| **Identified significant risks**<br>For identified significant risks, confirm that there are appropriate planned audit responses and document the assessment of the implications of those risks for the group financial statements. |
| For identified fraud risks, confirm that appropriate planned procedures have been recorded. |
| **Detailed work programmes**<br>Review the detailed work programmes and confirm they have been prepared for all material accounts and disclosures.<br>Confirm that the nature, extent and timing of tests of controls and substantive procedures are appropriate to the component's characteristics and the risks identified.<br>Confirm that the work programmes have been appropriately reviewed and approved by the component engagement partner.<br>Where substantive procedures alone do not provide the requisite level of assurance, confirm that component auditors have identified and plan to obtain further evidence, including testing applicable controls. |
| **Performance of Audit Procedures** |
| **General**<br>Confirm that specialists or experts (such as legal, tax, and IT specialists) have been involved in the audit of the component as appropriate and that consideration of their competence and capabilities has been documented. |
| Confirm that audit work has been performed on the basis of the materiality thresholds allocated by, or approved by, group auditors in advance. |
| Confirm that there is evidence that audit work has been carried out as planned and appropriately supervised and reviewed. |
| **Tests of controls**<br>Confirm that component auditors have tested controls as follows:<br>• the controls identified during audit planning and on which component auditors wish to place reliance; and<br>• the group-wide controls identified for testing by group auditors and included in the group audit instructions. |
| Where component auditors have identified significant control deficiencies, confirm that there is evidence that:<br>• the implications for substantive procedures have been assessed;<br>• deficiencies have been discussed with component management; and<br>• deficiencies have been communicated to group auditors. |
| **Substantive procedures**<br>Confirm that conclusions in respect of substantive procedures are appropriate and have been properly documented. |
| Confirm that procedures have been performed to ensure that significant accounting judgements and estimates, and transactions outside the normal course of business do not constitute evidence of a risk of management bias on the part of component management. |
| **Related parties**<br>Confirm that adequate audit procedures have been performed in respect of related parties and transactions, particularly those outside the normal course of business and material transactions. |

| Performance of Audit Procedures |
|---|
| Check that appropriate audit procedures have been undertaken for any related party transactions undertaken at arm's length. |
| Confirm that component auditors obtained appropriate information in respect of material contracts taking effect during the period. |
| **Other**<br>Where component management or component auditors have relied on experts, confirm that component auditors have assessed their work as well as their competence, capabilities and independence. |
| Confirm that component auditors have addressed the risk of non-compliance with applicable laws and regulations. |
| Confirm that component auditors have reviewed the minutes of meetings of component management and component governance bodies, and minutes of any other important meetings, and that they have assessed the impact of decisions taken. |
| Confirm that component auditors have performed adequate audit procedures to identify any litigation likely to be material at group level. |
| Confirm that procedures have been performed to ensure proper disclosure of material component contingent assets and liabilities. |
| Confirm that appropriate procedures have been performed to assess the validity of the going concern basis for the component. |
| Confirm that component auditors have checked that the consolidation package has been prepared in accordance with the group's accounting policies. |
| When audit work has been performed before the year end, confirm that component auditors have performed appropriate roll-forward procedures. |
| Confirm that component auditors have performed the following procedures in response to the risk of management override of controls:<br>• testing journal entries;<br>• reviewing significant accounting judgements and estimates made by component management; and<br>• obtaining an understanding of the economic justification for material transactions outside the normal course of business. |
| **Finalisation** |
| Provided a component audit has been completed, confirm that component auditors have obtained an appropriate signed management representation letter from component management. |
| Confirm that all significant points outstanding that are relevant to the component auditors' report to the group auditor have been cleared by the time of the issue of the report. |
| Confirm that all significant matters described in the working papers have been communicated to component management and that this was communicated before the financial statements were approved by the component. |
| Assess whether, for the elements of the file reviewed, the audit work performed is adequate and complies with the group audit instructions and the applicable auditing standards. |
| Confirm that component auditors have performed analytical procedures on any information provided in completed consolidation packages, corroborating conclusions, and that they have obtained satisfactory explanations for material or unusual variances. |
| Confirm that component auditors have agreed the consolidation package to the component's trial balance and the component file working papers. |
| Confirm that any report issued, and opinion expressed, are consistent with the audit conclusions recorded, including the list of corrected and uncorrected misstatements. |
| From the review of the component auditors' files, do the conclusions and observations communicated to the group auditors appear to be appropriate and complete? |
| Check that component auditors' communications with component management do not contain any significant information not already brought to the group auditors' attention. |

# PART C – SHARED SERVICE CENTRES



## 26. UNDERSTANDING THE USE OF SHARED SERVICE CENTRES

Many companies now use shared service centres. Such centres provide information processing services and other services related to the finance function to multiple components in a group. In effect, components outsource some elements of their financial reporting system to a shared service centre which is itself another component in the same group.

In establishing the group audit strategy and developing the group audit plan, group auditors are required to obtain an understanding of group-wide controls and the consolidation process. This inevitably involves understanding the way the group uses shared service centres, the nature and extent of services provided by them and how this affects the provision of financial information within the group reporting process. The location of service centres may also have a significant impact on group audit planning.

In a group audit, **sending multiple teams from different components to perform work at a shared service centre each for their individual purposes is unlikely to be efficient or effective**.

A better approach is usually for **group auditors to establish the evidence needed, by discussion with component auditors, and to assign a single team to perform the necessary procedures**, both for group purposes and for the purposes of statutory reporting by component auditors.

Group auditors need to consider the **risks arising from the use of shared service centres** and whether they constitute significant risks from a group viewpoint. In doing so, group auditors need to consider systems and controls operated by service centres, as well as group-wide controls. Component auditors also assess risk in relation to the components they are reporting on.

Where component auditors are simply reporting for group purposes, it may be possible to scope out of their work any information derived from service centres, on the grounds that it is dealt with centrally from a group standpoint. Where component auditors provide a local statutory audit opinion on the financial statements of the component though, they need to make their own assessment of risk in relation to the component's financial statements and may wish to obtain assurance over controls operated by service centres.

Shared service centres may be subject to scrutiny by a group's **internal audit** function. It may be possible for group and component auditors to use this work, in accordance with ISA 610 *Using the work of internal auditors.* In some jurisdictions, particularly the US, internal auditors may provide direct assistance to external auditors in performing the external audit. With effect from financial periods ending on or after 15 June 2014, such direct assistance will be prohibited in the UK.[7]

[7] This creates potential problems for auditors of multinational groups operating under UK standards dealing with component auditors elsewhere in the world who have been provided with direct assistance by internal auditors.

When determining **materiality**, group auditors and auditors of shared service centres, where they are different, need to bear in mind that for local audit purposes, component auditors may operate to different (and normally lower) materiality levels to those used by group auditors. Work performed on service centres for group purposes may therefore need to be supplemented by extended or additional procedures to meet the needs of component auditors.

## 27. OBTAINING EVIDENCE REGARDING THE OPERATIONS OF SERVICE CENTRES

It is important, at the group audit planning stage, to liaise closely with a**uditors of components served by service centres** to determine:

- **the respective needs of group and component auditors regarding assurance** over the accuracy of transactions processed and controls operated by centres;
- **the effects of different local and group materiality levels on the scope of work performed**, including the extent of substantive transactions testing;
- **who is going to do the work at service centres, where and when**, particularly if more than one auditor needs audit evidence regarding the work at service centres; and
- **how the results of the work will be communicated** where component auditors plan to rely on work carried out by group auditors or another central team.

**Group-wide controls implemented through service centres can normally be viewed as a homogeneous population**, and one single sample can therefore be tested for the purposes of the group audit and for the component audits affected. **The same does not hold true for substantive testing** because populations will need to be specific to the transactions of each component, and it is generally necessary to test multiple samples.

One approach to controls is for group auditors to require an agreed-upon procedures report setting out the controls tested and the results. Another approach might be for the group to arrange for a report on controls of the service centre as envisaged by ICAEW's Technical Release AAF 01/06 *Assurance engagements* to provide comfort over the design, implementation and operating effectiveness of controls, although this does not seem to be common at present. Reports provided on the operational effectiveness and/or design and implementation of controls, might be used to provide assurance to:

- group management;
- group auditors on the overall effectiveness of controls operated by service centres; and
- component auditors on controls relating to services provided.

Reports might be provided by group auditors, service centre auditors or other auditors, possibly with specialist IT skills. There may be some advantage in having such an engagement performed by a team that is separate from the group and component audit teams. The scope of work involved in such engagements needs to be agreed between a service centre's management, group and component auditors, and group management, as appropriate. The team performing the work supplement reports by further agreed-upon procedures if necessary.

# SECTION 3: COMPLETION AND REPORTING

## REPORTING BY COMPONENT AUDITORS AND OTHER COMPLETION PROCEDURES



### 28. OVERVIEW AND SUMMARY: REPORTING BY COMPONENT AUDITORS

Component auditors report to group auditors on their work in the form agreed in the group audit instructions, whether it is an audit report on financial information or certain account balances, or a report on specified procedures. We have already seen that some component auditors agree to report directly to group auditors, others do not. Component auditors may also provide memoranda of work performed and/or completed group audit questionnaires, depending on their policies and procedures. Group and component auditors need to consider who will obtain representation letters and perform subsequent events procedures.


### 29. COMPONENT AUDITOR AUDIT REPORTS TO GROUP AUDITORS

Audit reports prepared by component auditors for group audit purposes are typically on financial information prepared for consolidation purposes, which is less than a complete set of financial statements.

The precise form of the report will depend on whether group and component auditors are part of the same network where there are standard reporting templates, or whether they are from different firms. The basic principles are the same in any case.

#### 29.1 Suggestions for component auditors: component auditor reports

As a component auditor, when drafting your inter-firm/office audit report, consider the following.

- **Does the introductory paragraph clearly identify the financial information that is being reported on?** A reporting package may include additional information outside the scope of the component auditors' work, including non-financial information, such as production volumes. This needs to be excluded from the scope of the report.
- Group auditors commonly request that component audits are performed using a prescribed component materiality. **Where such a component materiality is used, is this restriction clearly explained?** The auditor's responsibility section in the inter-firm/office report can include wording such as the following to make this issue clear.

> - As requested by you, we planned and performed our audit using the materiality level specified in your instructions, which is different to the materiality level that we would have used had we been designing the audit to express an opinion on the special purpose financial information of the component alone.
> - We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion. The conclusions reached in forming our opinion are based on the component materiality level specified by you in the context of the consolidated financial statements of the group.

- **Are any modifications to your audit opinion clearly explained?** Modifications may include:
  - Scope limitations agreed with group auditors as part of the group instructions: for example, group auditors may request that component auditors do not perform work on taxation balances, or on a provision for outstanding litigation, because the work will be performed by group auditors centrally.
  - Scope limitations arising because it has not been possible to complete certain audit procedures: for example, when working to very tight group reporting deadlines where accounts receivable confirmations have not yet been obtained, although it should generally be possible to perform alternative procedures.
  - Material misstatements arising from financial information not prepared in accordance with the relevant financial reporting framework, such as the group accounting manual/instructions.
- **Does your report include a restriction on use and distribution?** This explains that the financial information has been prepared for the purposes of enabling the parent company to prepare consolidated financial statements and may not be suitable for another purpose, and that the component auditors' report is intended solely for the group auditor and is not to be used by, or distributed to, other parties.
- **If you think you will need to modify your report, contact the group auditor as soon as possible.** They may be able to help resolve the issue. For example, if you think component management will be unable to provide information on time, group auditors can raise this with group management, who may be able to put pressure on component management to deliver, or provide them with some practical help to do so.
- Where you plan to modify your report, follow your firm's consultation requirements and remember that **any modification you make to the inter-firm/office report might subsequently also apply to your local statutory audit report**.

### 29.2 Suggestions for group auditors: component auditor reports

As a group auditor, make sure that you **review the reports you receive** and follow them up as necessary. This may seem obvious, but situations do arise where group auditors fail to notice that component auditor reports are modified, and do not consider the implications.

It is best practice for component auditors to discuss proposed modifications with the group auditor before their report is issued, so modified reports should not be a surprise. **Consider what impact any modification may have on the group financial statements.** If the impact is material, group auditors should consider whether further work can be performed at a group/head office level to address the issue.

**Put in place processes for 'early warnings':** request component auditors to notify you as soon as they believe that they might need to modify their inter-firm report.

**Assign a team member who is responsible for reviewing all component auditor reports** and drawing to the engagement manager's and partner's attention any modifications in any reports, so that they can be followed up.

## 30. COMPONENT AUDITOR REPORTS ON SPECIFIED PROCEDURES

As a component auditor, the biggest challenge is to make sure that your report on specified procedures:

- provides sufficient clarity on the work performed, and therefore as to work not performed; and
- does not express assurance in the form of conclusions on the work. Some component auditors simply provide group auditors with copies of their working papers, but they should still make it clear that they are not providing any assurance.

As with audit reports, it is important that group auditors review reports from component auditors. Where exceptions are identified, have they been followed up and resolved by component auditors? If not, is it necessary to ask component auditors to perform further work, or can work be performed by group auditors directly?

**Question: I am the engagement partner for the group audit, but also act as engagement partner for two of the components within the group for which an audit of financial statements is being performed. Do I need to issue a component auditor report to myself?**

You can, but it adds unnecessary formality to the group audit so there is little benefit in doing so. What is important here is clear communication of the results of the audit work on the component, but where you act as engagement partner for the group and the component, your review of the component audit file can achieve that. The group audit file should, however, evidence that you were satisfied that the audit of the component's financial information was completed before the date of the group audit report, and that significant matters relevant to the group audit were properly considered. Where the component audit has not been completed, the file should evidence your satisfaction that sufficient, appropriate evidence has nevertheless been obtained in relation to the relevant component for the purposes of the group audit.

## 31. MEMORANDA OF WORK PERFORMED AND GROUP AUDIT QUESTIONNAIRES

Group auditors generally request a memorandum of work performed to accompany the reporting package and the component auditors' report. This can provide additional information relevant to the group auditors' conclusion.

The memorandum can help group auditors understand the component's financial information by providing some commentary, perhaps based on the results of overall analytical procedures performed by component auditors. To be of use, this commentary should be concise, but insightful. Comments to the effect that the value of inventory has increased because the entity was holding more inventory at the year end are not insightful.

**Matters for inclusion in a Memorandum of Work Performed**

The following information might be included in a Memorandum of Work Performed provided to the group auditor by component auditors, and used in conjunction with an inter-firm/office report to communicate matters relevant to the group auditors' conclusion:

- reconfirmation that component auditors have complied with ethical requirements, ISAs and ISQC 1;
- confirmation that component auditors have complied with the group auditors' requirements;
- the scope of work performed, including explanations for significant changes to the audit strategy and any variations from group audit instructions;
- identification of the financial reporting information, with commentary on significant variances from prior year;
- instances of fraud or non-compliance with laws and regulations, and indicators of management bias;
- significant matters arising from the work, including details of significant risks that may affect the group financial statements, including those communicated by group auditors at the planning stage, and a summary of responses to those risks;

**Matters for inclusion in a Memorandum of Work Performed (continued)**

- details of uncorrected and corrected misstatements, including explanations from component management for why misstatements remain uncorrected;
- significant deficiencies in internal control identified;
- details of any related parties and transactions;
- subsequent events procedures performed, and whether any adjusting/non-adjusting events were identified;
- specific representations for inclusion in the group letter of representation;
- matters to be communicated to those charged with governance of the group;
- other matters that may be relevant to the group audit, such as information regarding litigation and claims; and
- the component auditors' overall findings, conclusions or opinion if there is no separate inter-firm/office report.

**If details of work performed** are required, which is sometimes the case where no group audit questionnaire is provided, the following information may be requested to the extent not covered by the matters above:

- analytical review of component financial statements – a high-level commentary on significant profit and loss and balance sheet variances with budget and prior year actuals, and any other significant transactions;
- key estimates and judgements – an overview and explanation of the key estimates and judgements made by management;
- financial reporting issues, including an update on prior year issues as well as current year issues, together with a summary of issues and material judgements discussed with local management, Including how there were resolved; and
- work, evidence and changes in specific areas such as:
  - significant controls, including the use of shared service centres or external service organisations,
  - the representation letter,
  - correspondence with regulators,
  - estimates, including pending litigation and other contingent liabilities, and accounting policies such as those covering income, tax, related parties and comparative information,
  - going concern.

Some group auditors request that group audit questionnaires are completed as a way of gathering information from component auditors about their audit. In practice, they vary in length and content. Some questionnaires reproduce ISA requirements, and seek confirmation that the requirements were met. Others are more targeted, asking questions such as, 'How did you demonstrate professional scepticism in your audit of management's impairment assessment for intangible assets?'

The use of questionnaires, and the form they take, depend on factors such as:

- the group auditors' knowledge and understanding of component auditors, including their prior experience of working with them;
- whether ISAs are commonly used in the component auditors' jurisdiction, and consequently whether component auditors will be familiar with ISA requirements;
- other review procedures being performed, such as a review of component auditor working papers; and
- how comfortable group auditors are with the use of questionnaires. There is always a risk that component auditors simply focus on answering the questions and do not provide information about other matters that are important to the group audit.

Where questionnaires are used, it is important that group auditors review the responses carefully, and if necessary follow up points arising with component auditors.

### Group audit questionnaires and Memoranda of Work Performed

**Suggestions for group auditors**

Think carefully about what information you ask for. **Asking for too much means extra time and cost both for component auditors in drafting the information and for you in reviewing it.**

**Group audit questionnaires are not necessarily a substitute for reviewing component auditor work**, but may complement reviews that cover selected parts of the work. Use them with caution.

**Suggestions for component auditors**

It may be more efficient to **copy material already documented on your audit file** into the reporting memorandum, rather than producing original material.

**Do not use the reporting memorandum as a substitute for modifying your inter-firm report.** It can include additional explanation to provide context to the modification, but any limitations in the scope of your work, or any qualifications because material misstatements remain uncorrected, need to be included in the inter-firm report.

Take care not to give the impression of providing assurance where none is intended, or commenting on matters outside the scope of the work performed.

## 32. REPRESENTATION LETTERS

Whether component auditors need to obtain representations from component management, and what they cover, depends on what work was performed, the structure of the group and the instructions received from group auditors.

If component auditors perform an audit of the component's financial information, appropriate representations are needed in accordance with ISA 580, *Written representations*. However, if the work comprises specified procedures, component auditors need not obtain such comprehensive representations but may still request specific representations relevant to the procedures performed.

### Representation letters

**Suggestions for group auditors**

Consider whether to **use a consistent form of representation letter throughout the group**. If so, set out arrangements for obtaining representation letters, including a template, in the group audit instructions.

**Suggestions for component auditors**

**Component auditors may need to obtain representations from group management**. In such cases, inform group auditors as soon as possible so that they can coordinate requests for representations.

## 33. SUBSEQUENT EVENTS

Subsequent events procedures performed at each component cover both the period from year end to the date of the component auditors' inter-firm/office report, as well as the period between the component auditors' report and the date of the group auditors' report on the group financial statements.

Procedures for the first period are performed before component auditors report to group auditors, in accordance with ISA 560, *Subsequent events.*

In determining the nature, timing and extent of subsequent events procedures for the second period, group auditors need to consider the risk that subsequent events at component level will not be identified by group management or by the group auditors themselves. Normally, it will not be appropriate for group auditors to perform subsequent events procedures at components which are audited by component auditors. Rather, group auditors will ask component auditors to perform such procedures.

## 34. EVALUATING EVIDENCE OBTAINED

Group auditors need to form a view on whether they have sufficient appropriate audit evidence based on their review of component auditor work and their own procedures, such as the audit of the consolidation. Group auditors will need to:

- **prepare a consolidated summary of uncorrected misstatements** that includes all uncorrected misstatements from components that are not clearly trivial; and
- **evaluate the impact of limitations in scope reported by component auditors** that they have not been able to resolve.

Group auditors should think carefully about what uncorrected misstatements they want component auditors to report. If they set the level for reporting misstatements too high, there is a risk that unreported misstatements from a number of components could combine to represent a material misstatement in the group financial statements. If the reporting level is too low, group auditors will have extra work in reviewing and summarising misstatements.

**Question: Do I need to ask component auditors to perform subsequent events procedures in all cases, or only where they have performed an audit of the component's financial information?**

Normally, subsequent events procedures are only needed where component auditors perform an audit of the financial information. For all other types of work, such as an audit of particular account balances, or specified procedures, it is enough to ask component auditors to inform you if they become aware of any events.

However, consider the risk of a material subsequent event arising, and whether you want to ask component auditors performing work other than audits of the financial information to perform specific subsequent events procedures. For example, if you are aware of litigation in progress at a component, ask the component auditor to enquire whether there have been any developments.

## 35. ARCHIVING AND RETAINING COMPONENT AUDITOR DOCUMENTATION

ISA 230, *Audit documentation* requires that the assembly of the final audit file is completed on a timely basis, which is ordinarily not more than 60 days after the date of the group auditor's report. For component auditors, this means that the final audit file supporting their inter-firm/office report should be completed within 60 days of the group auditor signing their audit report on the group financial statements, not 60 days from the date of their inter-firm/office report. Different deadlines will apply to documentation for the local statutory audit.

Where component auditors also issue an audit opinion on local statutory financial statements at a later date, arrangements need to be made so that there is a record of the assembly of the final audit file supporting the inter-firm/office report. Component auditors who use electronic audit files typically do this by taking a copy of the file at or before the 60-day time limit, allowing them to continue to work in the original file. Auditors using paper files can similarly take a copy of their paper file.

Example:

| Date | | Action |
|---|---|---|
| 31/12/2013 | Entity's year end. | |
| 26/1/2014 | Deadline for group reporting. | Component auditors submit inter-firm/office report – work supporting the report is completed and documented in component auditors' audit file. |
| 20/2/2014 | Date of group auditors' audit report on the group financial statements. | |
| 21/4/2014 | 60 days after date of group audit report – deadline for final assembly of audit files supporting the group audit report. | If not already done, component auditors complete the assembly of the final audit file supporting their inter-firm/office report, and take a copy of this file for archiving. |
| 30/5/2014 | Date of component auditors' audit report on local statutory financial statements. | Work completed in the original audit file, with work performed for group reporting purposes supplemented by further audit evidence necessary to support the statutory audit opinion. |

Group auditors need to check that each component auditor will retain the file supporting their inter-firm/office report for the necessary retention period. In the UK, this is six years from the balance sheet date, but it is longer in some other jurisdictions.

### Archiving component auditor files

**Suggestion for group auditors**

Communicate the date of your audit report on the group financial statements so that **component auditors are clear about the deadline for the final assembly of their audit file** supporting their inter-firm/office report.

**Suggestion for component auditors**

Plan when and how you will archive your audit file for group purposes, so that where applicable you can continue working on the local statutory audit.

# SECTION 4: SPECIFIC ISSUES

## Non-conterminous year ends, inconsistent accounting policies, 'letterbox' companies, subsidiary audit exemption



### 36. OVERVIEW AND SUMMARY: SPECIFIC ISSUES

ISA 600 does not cover everything that creates problems for auditors. This section covers areas in which ISA 600 provides less guidance and which, if not dealt with carefully, can cause difficulties. These areas are:

- non-conterminous year ends;
- aligning inconsistent accounting policies;
- 'letterbox' companies; and
- subsidiary audit exemption and the audit of balances.

### 37. NON-CONTERMINOUS YEAR ENDS

In general, groups try and align their components' year ends to make the consolidation process simpler. This is not always possible:

- where there are legal or regulatory restrictions; or
- where joint ventures have different year ends, because it is not possible for the joint venture to align with all of them.

Group audit instructions covering the identification of events that may require adjustments or disclosures in the group financial statements are particularly important.


Where the parent company is listed or has an earlier filing deadline than the component, **group auditors may be required to sign their opinion on the group financial statements before the component audits have been completed, which involves risks …**

There are also **risks to component auditors if they are asked to report before they have completed their work …**


Where the parent company is listed or has an earlier filing deadline than the component, group auditors may be required to sign their opinion on the group financial statements before the component audits have been completed, which involves risks to group auditors. This risk can be minimised if group auditors seek the completion of work on significant components at the same time as the group audit, although even that can be difficult in practice.

There are also risks to component auditors if they are asked to report before they have completed their work. Such requests may appear innocuous but group reporting and consolidation packages may well require assurance on matters beyond the audit of component financial statements, such as assurance on individual revenue streams as well as the single turnover figure disclosed in the local financial statements. Such requests therefore need to be considered carefully.

Where there is a tight deadline for group reporting purposes, and component auditors are still waiting for bank or other confirmations, they can perform alternative procedures or, in some cases, include a scope limitation in their report to group auditors, which is often resolved by the time subsequent events are reported.

Accounting standards generally allow for non-conterminous year ends. For example, IFRS 10 requires that year ends should be aligned where practicable. If year ends are not aligned, an additional set of financial statements should be prepared to align with the group's financial year end. Only if that is impracticable can component financial statements drawn up to a different year end be used. These need to be adjusted for the effects of significant transactions or events that occur between the date of component financial statements and the date of the consolidated financial statements. In some jurisdictions there may be other limitations. For example, in the UK, FRS 2 only allows the use of subsidiary financial information drawn up to a date not more than three months before the group's year end.

ISA 600 does not provide specific requirements or application material to deal with this issue. Where non-conterminous year ends exist, group auditors need to consider how group management addresses the following:

- where additional financial statements are being prepared, will they be audited?
- if financial statements drawn up to a different year end are being used, who will decide whether there are significant transactions or events that need to be adjusted, and who will obtain the necessary evidence to conclude on these?

If, for example, a component prepares reliable management accounts, component auditor work on the management accounting system might provide some evidence relating to the existence of any significant events. Alternatively, group auditors may, having considered materiality, consider it appropriate to ask component auditors to carry out a review of component management accounts for a 'stub' period. Equally, if group auditors are aware of significant transactions or events that need to be accounted for, it may be appropriate to ask for specific audit procedures to be carried out on those transactions or events.

Similar issues may arise with joint ventures. Where additional work is needed for one venture's group audit, it will be useful to be clear as to whether the joint venture or the venture in question will pay for that work.

## 38. ALIGNING INCONSISTENT ACCOUNTING POLICIES

Audit reports on consolidation packages generally refer to group accounting manuals. Group auditors need to evaluate the adequacy of such manuals.

It may be possible for group management to ask component management to complete a reporting package in accordance with a group accounting manual which provides detailed guidance on the policies to be adopted. This avoids the problem of local management not being skilled in the GAAP used to prepare the group financial statements. However, this may not always be possible:

- for associates and joint ventures where group management may have less influence over component management and have not negotiated the right to receive a reporting package; or
- where accounting standards require different accounting at group and component levels, for interrelated items such as hedges and financial instruments, for example.

In these situations, the best approach is often for group auditors to understand how group management deals with the issue from an accounting perspective, and then design an audit response that reflects this. For example:

- is group management asking for supplementary information on a different accounting basis? If so, who will have the supporting evidence – group and/or component management? Who will be best placed to test this?
- is group management asking for more detailed information to enable them to carry out the conversion? If so, what is the best division of audit effort? Component auditors might be asked to test the accuracy and completeness of the information by checking that the group has been provided with all copies of relevant agreements, for example, and group auditors might test the calculation process carried out by group management.

## 39. 'LETTERBOX' COMPANIES

'Letterbox' companies are companies or groups of companies where the general and financial management and the company's operations are located in a different jurisdiction to that of the company's legal registration. Audits of 'letterbox' companies are increasingly noted by audit regulators as situations in which much or all of the audit fieldwork is carried out by one auditor, and the audit report is signed by another, often in jurisdictions that only permit locally registered auditors to sign audit reports.

In some of these audits, audit work is performed by one firm ('the fieldwork firm') and signed by another ('the signing firm'). This is not a group audit. There is no parent, whose opinion is being signed by a signing firm, and no component audited by a fieldwork firm. If the firm signing the opinion is required by law or regulation to take responsibility for the audit, it is responsible for making sure that an audit has been carried out and all relevant laws, regulations and ethical requirements have been complied with.

> 'Letterbox' audits are increasingly noted by audit regulators as situations in which **much or all of the audit fieldwork is carried out by one auditor, and the audit report is signed by another,** often in jurisdictions that only permit locally registered auditors to sign audit reports…

This means:

- being satisfied that there is sufficient appropriate audit evidence, adequately documented, which must amount to more than taking the fieldwork firm's word for it. Quality control requirements oblige the signing firm's engagement partner to take responsibility for the direction, supervision and performance of the audit, and for ensuring that where necessary, an engagement quality control review has been carried out;
- communicating with those charged with governance, which cannot be left to the fieldwork firm. The responsibility rests with the signing firm's audit partner;
- relevant legal and ethical requirements should be complied with in the signing firm's jurisdiction; and
- having control over the audit file, including the file containing work done by the firm performing the work.

There may be a group audit if there are separate components, such as where there is a head office which the group auditor audits directly, and components audited by component auditors. It is important for group auditors to demonstrate that they have applied ISA 600 appropriately in such cases. The group engagement partner should lead the engagement and communicate with those charged with governance, as well as directing the work on group-wide controls and the consolidation process.

ISA 600 requires that work on the consolidation is performed by group auditors and not by component auditors, although component auditors may assist. This may be challenging if the group's accounting function is in another jurisdiction where, for example, the location of a head office has changed after a new top company is added as part of a re-domiciliation exercise. It may be tempting for client management to think that the group audit team is the one based in the location of the new head office. Equally, group auditors need to make sure they have taken ownership of, and responsibility for, work done on their behalf by the other auditors.

In many cases, there will be a combination of approaches. Some work may be performed on the parent by other auditors, who are not component auditors, for which group auditors must take responsibility. Some work will be performed on components by component auditors, in the traditional fashion. And potentially, some work on components may be performed by group auditors, such as work on IT controls. This is fine for group audit purposes but the group auditor's work may need to be fed back to component auditors if they are signing an opinion on the component's local financial statements.

### The effects of jurisdiction-specific requirements on 'letterbox' engagements

- There may well be additional requirements of local auditing standards over and above the requirements of ISAs. The fieldwork team needs to be aware of and comply with these requirements. If it does not, the burden falls to the signing firm.
- There may also be additional independence requirements. Local ethical standards may go further than the IESBA *Code of Ethics for Professional Accountants.* The fieldwork team also needs to be aware of and comply with these.

**The effects of jurisdiction-specific requirements on 'letterbox' engagements (continued)**

- Local regulatory requirements may apply to fieldwork teams, such as requirements for members of engagement teams to be 'fit and proper' under UK Audit Regulations. Members of fieldwork teams may need to provide copies of the jurisdiction-specific 'fit and proper' declarations, which may be impeded by local privacy or professional secrecy laws. Alternative steps may be needed.
- Local requirements for the retention and inspection of working papers may also cause problems. Local regulation may require that where audit work is carried out by a firm other than the local signing firm, the audit working papers created by that firm must be returned to the local firm, or that the other firm must agree to keep those papers as required by local regulation and allow the local firm unrestricted access to the papers for whatever reason. Access may include access by a local audit regulator which further complicates the issue.

Engagement letters should attempt to cover these contingencies.

## 40. SUBSIDIARY AUDIT EXEMPTION

There are many jurisdictions in which components may not require local statutory audits, such as the US, or where exemptions may be available, as in EU countries such as Germany, the Netherlands, Ireland and the UK, where subsidiaries with debts guaranteed by a parent incorporated in the EEA may be exempt.

In all such cases, group auditors need to consider their audit approach carefully, particularly where local audit requirements have changed recently. If a local statutory audit is performed, it is often easiest to ask the local auditor to carry out a component audit to component materiality, regardless of the significance of the component to the group.

Where there are no local audit requirements, more thought may be needed as to the type of work necessary and different sources of evidence. Group auditors may need to instruct local auditors to perform an audit or other appropriate work or decide to perform it themselves.

If group auditors judge that the work on significant components is insufficient for the group audit opinion, the choice of additional work on non-significant components may be influenced by the ability to leverage work being carried out on local statutory audits. If local statutory audits are no longer necessary, alternative approaches to the selection of significant and non-significant components and the nature of work performed on them may be necessary. In all such cases, care may be needed in explaining the rationale for the work to be performed in the audit documentation, in communicating this to those charged with governance, and last, but not least, in explaining any changes to regulators.

# SUPPLEMENTARY MATERIAL

## Component auditor reports to group auditors for group audit purposes: matters for consideration and illustrative reports

**This supplementary material to the ICAEW publication** ***Auditing Groups: A Practical Guide*** ('the Guide') has been developed by the contributors to the Guide and is **designed to facilitate improved communications between group and component auditors.**

Under ISA 600[8] the format, detailed content and timing of any component auditor reports to group auditors on the audit of component financial information prepared for consolidation purposes, are matters are to be agreed between group and component auditors. Furthermore, subject to the requirements of ISA 600 and other relevant ISAs, the specific procedures performed by component auditors on component financial information are also agreed by group and component auditors.

The illustrative reports at the end of this supplementary material have been developed from illustrative reports included in the appendix to ISAs 800 and 805[9] and adapted to group audits. However, ISA 600 does not require auditors to apply the requirements of ISAs 800 or 805 to group audits, and using this supplementary material, including the illustrative reports, is not sufficient to comply with the requirements of ISAs 800 or 805.

**This supplementary material:**

**(a) describes matters group and component auditors might consider in a narrowly defined set of circumstances in which group auditors request component auditors from a different firm or network to perform an audit, in accordance with ISAs and any additional local requirements, of either:**

- **component financial information using component materiality;[10] or**
- **one or more account balances, classes of transactions or disclosures.[11]**

**(b) provides illustrative reports from component auditors to group auditors that may be adapted to the particular circumstances of the group and component.**

Both of these are common, relatively straightforward situations. This supplementary material is not intended to be adapted to other or more complex circumstances.

[8] ISA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors).*

[9] ISA 800 *Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks* and ISA 805. *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts of Items of a Financial Statement.*

[10] ISA 600.26, ISA 600.27(a) or ISA 600.29 1st bullet.

[11] ISA 600.27(b) or ISA 600.29 2nd bullet.

# Component auditor reports to group auditors for group audit purposes: matters for consideration

## Component financial information prepared for group audit purposes

1. Component auditors usually report on component financial information specifically prepared for the consolidated financial statements. Such information includes:
   - standard reporting forms;
   - trial balances;
   - individual financial statement or statements such as balance sheets, income statements, and cash flow statements;
   - one or more account balances, classes of transactions or disclosures such as accounts receivable balances;
   - any other financial information, such as lease or debt information relevant to the preparation of the notes to the consolidated financial statements;
   - other financial information submitted from a component to a corporate head office to support the preparation of consolidated financial statements.

Such information is often included in a reporting package prepared by component management. Such packages often include additional information excluded from the scope of the component auditors' report. For these reasons, the introductory paragraph of component auditor reports to group auditors often identifies the pages in the reporting package containing the component financial information covered by the audit opinion.

## Group auditor requests

2. When component auditors are asked to audit component financial information prepared for consolidation purposes, group auditors may include requests for component auditors:
   - to conduct the audit in accordance with ISAs and additional instructions in order for the audit of the consolidated financial statements to be conducted in accordance with group auditor requirements. Additional instructions may include direction on the nature, timing or extent of procedures to be performed in complying with ISAs, in order to agree on an appropriate response to a significant risk at group level, for example;
   - to use component materiality;
   - not to perform certain procedures required by ISAs because it is sufficient in the context of the group audit for those procedures to be performed at group level.

Group auditors may also request component auditors to perform additional procedures and to report on them separately.

## The responsibilities of group and component management

3. Group management is responsible for the consolidation process, including the group accounting policies and instructions issued to components.

4. Component management is responsible for ensuring that all component information relevant to the preparation of the consolidated financial statements in accordance with group GAAP is provided to group management. The purpose of the audit of component financial information prepared for consolidation purposes is often for component auditors to report on whether the component financial information has been prepared in accordance with group accounting instructions.

5. In performing the audit of the component financial information, component auditors may become aware of exceptions or omissions in the component reporting package that are likely to be relevant to the audit of the consolidated financial statements, such as unreported transactions or issues not addressed in the group accounting policies or instructions. Component auditors communicate such matters to component or group management, and to group auditors.

## Group audit instructions

6. Instructions from group auditors to component auditors usually cover:

   - the auditing standards to be applied;
   - where applicable, additional instructions and procedures to be performed by component auditors to meet group auditor requirements;
   - materiality, including as a minimum the materiality level to be used in the audit of the component financial information and the threshold above which misstatements cannot be regarded as clearly trivial to the consolidated group financial statements. The instructions might also specify performance materiality or, if performance materiality is determined by component auditors, the instructions might request that component auditors provide that information;
   - the group accounting instructions to be applied by components;
   - any other pertinent information component auditors may require to complete their work.

## Auditing specific elements of financial statements

7. Where component auditors audit a specific element of a financial statement such as receivables, they are required to comply with all ISAs relevant to the audit, irrespective of whether they are also engaged to audit the component's complete financial statements.

8. When auditing a specific element of a financial statement, component auditors may need to perform procedures on items other than the financial statement element. For example, if asked to audit accounts receivable, it may be necessary to perform audit procedures on revenues and cash.

## Materiality

9. Where either:

   - the materiality level specified by group auditors based on the consolidated financial statements is very high in relation to the component financial information; or
   - materiality determined for a single financial statement or element thereof is lower than materiality determined for the component's complete financial statements,

component auditors may not have an adequate basis on which to form an audit opinion. In such circumstances, a qualified opinion, even with the materiality restrictions appropriately described, might be misleading. In such circumstances, it may be possible to agree on a different materiality level that enables component auditors to report, or to perform specified procedures, where these are options.

## Procedures carried out at group level

10. When group auditors decide to carry out procedures at group level and request that component auditors exclude information or procedures from the scope of the audit, component auditors may convey that restriction in their report to group auditors. They either clearly identify the component financial information within the scope of the audit, or identify the excluded information and/or procedures that were not performed as a scope limitation.

11. If the exclusions of specified information from the scope of the audit reach a point where they constitute a substantial portion of the component financial information, particularly if component auditors are auditing an account balance, class of transaction or disclosure only, it may be preferable to restructure the engagement as a specified procedures engagement where this is an option.

## Risk management

12. Component auditors usually consider their risk management policies and procedures when dealing with requests for reports from group auditors. Some component auditors prefer to report to component or group management rather than directly to group auditors. Component auditors may ask group auditors to sign an engagement letter confirming that component auditors owe no duty of care to group auditors.

# Component auditor reports to group auditors for group audit purposes: illustrative reports

13. Under ISA 600, the format, detailed content and timing of any component auditor reports to group auditors on the audit of component financial information prepared for consolidation purposes, are matters to be agreed between group and component auditors. Reporting formats other than those provided in the illustrative reports in this Supplementary Material may be more suitable in specific cases. The illustrative reports in this Supplementary Material always need to be adapted to the specific circumstances of the group and component.

14. Component auditors may wish to consider making the following statements in reports to group auditors:

### Introductory paragraph

- that the audit engagement was performed for the purposes of the group audit in accordance with the group auditors' instructions;
- that the information audited is component financial information prepared for consolidation purposes and is referred to by titles or page numbers;
- that the component financial information has been prepared solely to enable the parent entity to prepare the consolidated financial statements.

### Description of component management's responsibilities

- that component management's responsibility is for the preparation of the component information in accordance with the accounting policies and instructions contained in the group accounting manual or instructions and the policies disclosed by the group;[12]

### Description of component auditors' responsibilities

- that the component auditors' responsibilities are for the conduct of the audit in accordance with relevant auditing standards;
- that when applicable, other instructions and procedures identified in the group auditors' instructions have been followed and performed;
- that the audit was planned and performed using the materiality level specified in the group auditors' instructions, which is different to the materiality level that would have been appropriate had component auditors been auditing the financial information of the component alone;
- that the conclusions reached in forming the component auditors' opinion are based on the group materiality level specified by group auditors;

### The component auditor's opinion

- that the component financial information has been prepared, in all material respects, in accordance with the accounting policies and instructions contained in the group accounting manual;[13]

### Restriction on use and distribution paragraph

- that the component financial information has been prepared for the purposes of providing information to the parent entity to enable it to prepare consolidated financial statements and that it is not a complete set of financial statements in accordance with the applicable financial reporting framework and may therefore not be suitable for other purposes.

[12]Typically, component financial information does not include all of the financial information and disclosures required by recognised financial reporting frameworks and the description of component management's responsibility does not therefore refer to the information having been prepared in accordance with a framework such as IFRS.

[13]The component auditors' report will not usually refer to the financial information giving a true and fair view of, or presenting fairly, in all material respects, the financial position, results or cash flows, and will not refer to IFRS or national accounting standards.

# ILLUSTRATIVE REPORT[14]

## INDEPENDENT AUDITORS' REPORT ON COMPONENT FINANCIAL INFORMATION PREPARED FOR CONSOLIDATION PURPOSES

To [name of group auditors and office]

As requested in your instructions [date and title of instructions], we have audited, for purposes of your audit of the consolidated financial statements of [name of group], the accompanying component financial information prepared for consolidation purposes of [name of component] as of [balance sheet date] and for the year then ended, on pages [xx] to [xx] of the accompanying financial reporting package of [name of group]. This component financial information prepared for consolidation purposes has been prepared solely to enable [name of group] to prepare its consolidated financial statements as of [balance sheet date] and for the year then ended.

**Management's Responsibility for the Component Financial Information Prepared for Consolidation Purposes**

Management is responsible for the preparation[15] of this component financial information prepared for consolidation purposes in accordance with the policies and instructions contained in [[name of group]'s accounting manual *or* disclosed accounting policies [dated] **or** issued by [name of group]'s management on [date]] and for such internal control as management determines is necessary to enable the preparation of component financial information for consolidation purposes that is free from material misstatement, whether due to fraud or error.

**Auditors' Responsibility**

Our responsibility is to express an opinion on this component financial information prepared for consolidation purposes based on our audit. We conducted our audit in accordance with [International Standards on Auditing/other standards]. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the component financial information prepared for consolidation purposes is free from material misstatement. As requested by you, we planned and performed our audit using the materiality level specified in your instructions, which is different to the materiality level that we would have used had we designed the audit to express an opinion on component financial information prepared for the component alone. [As requested, our audit followed the additional instructions and included the additional procedures identified in your instructions.]

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial information. The procedures selected depend on the auditors' judgement, including the assessment of the risks of material misstatement of the component financial information prepared for consolidation purposes, whether due to fraud or error. In making those risk assessments, auditors consider internal control relevant to the entity's preparation of the component financial information prepared for consolidation purposes 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. An audit also includes evaluating the appropriateness of accounting policies used, and the reasonableness of accounting estimates made, by management, [**and if relevant:** as well as evaluating the overall presentation of the component financial information prepared for consolidation purposes].

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion. The conclusions reached in forming our opinion are based on the component materiality level specified by you in the context of the audit of the consolidated financial statements of the group.[16]

[14]This illustrative report has been developed with reference to the illustrative report in ISA 800 *Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*.

[15]Reference could be made to 'preparation and presentation' in this paragraph to clarify that management is assuming responsibility for the presentation of the component financial information prepared for consolidation purposes (ie, the design of the reporting package).

[16]In some jurisdictions, requirements under local GAAS or professional responsibilities may require auditors to deal with the fact that the component audit has been conducted using group materiality in a different manner, such as a scope limitation.

**Basis for Qualified Opinion**

As requested, we did not perform the following procedures [.....] and thus the scope of our audit was restricted by your instructions].

**[Qualified] Opinion**

In our opinion, [except for the possible effects of adjustments, if any, as might have been determined to be necessary had we performed all audit procedures required by [International Standards on Auditing/other standards]] the accompanying component financial information prepared for consolidation purposes for [name of component] as of [date] and for the year then ended has been prepared, in all material respects[17] in accordance with the policies and instructions [contained in [name of group]'s accounting manual **or** disclosed accounting policies [dated] **or** issued by [name of group]'s management on [date]].

**Restriction on Use and Distribution**

This component financial information prepared for consolidation purposes has been prepared for the purposes of providing information to [name of parent entity] to enable it to prepare the consolidated financial statements of the group. As a result, the component financial information prepared for consolidation purposes is not a complete set of financial statements of [name of component] in accordance with [applicable financial reporting framework underlying the group's accounting policies] and is not intended to [give a true and fair view of/present fairly, in all material respects,] the financial position of [name of component] as of [date], and of its financial performance, and its cash flows for the year then ended in accordance with [applicable financial reporting framework underlying the group's accounting policies]. The component financial information prepared for consolidation purposes may, therefore, not be suitable for other purposes.

This report is intended solely for [name of group auditors] and should not be used by [or distributed to] other parties.

[Auditors' signature]

[Date and auditors' address]

[17]In some jurisdictions, requirements under local GAAS or professional responsibilities may require the auditors to use different wording for the auditors' opinion.

# ILLUSTRATIVE REPORT[18]

## Component Financial Information is Limited to an Account Balance, Class of Transactions or Disclosure Only

## INDEPENDENT AUDITORS' REPORT ON COMPONENT FINANCIAL INFORMATION PREPARED FOR CONSOLIDATION PURPOSES

To [name of group auditors and office]

As requested in your instructions [date and title of instructions], we have audited, for purposes of your audit of the consolidated financial statements of [name of group], the [account balance(s)/ disclosure(s) as of [balance sheet date]] / [class of transactions for the year ended [date]] included on pages [xx] to [xx] of the accompanying financial reporting package of [name of group], hereinafter referred to as component financial information prepared for consolidation purposes. This component financial information prepared for consolidation purposes has been prepared solely to enable [name of group] to prepare its consolidated financial statements as of [balance sheet date] and for the year then ended.

**Management's Responsibility fr the Component Financial Information Prepared for Consolidation Purposes**
Management is responsible for the preparation[19] of this component financial information prepared for consolidation purposes in accordance with the policies and instructions contained in [[name of group]'s accounting manual/disclosed accounting policies [dated] **or** issued by [name of group]'s management on [date]] and for such internal control as management determines is necessary to enable the preparation of component financial information for consolidation purposes that is free from material misstatement, whether due to fraud or error.

**Auditors' Responsibility**
Our responsibility is to express an opinion on this component financial information prepared for consolidation purposes based on our audit. We conducted our audit in accordance with [International Standards on Auditing/other standards]. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the component financial information prepared for consolidation purposes is free from material misstatement. As requested by you, we planned and performed our audit using the materiality level specified in your instructions, which is different to the materiality level that we would have used had we designed the audit to express an opinion on component financial information prepared for the component alone. [As requested, our audit followed the additional instructions and included the additional procedures identified in your instructions.]

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial information.[20] The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the component financial information prepared for consolidation purposes, whether due to fraud or error. In making those risk assessments, auditors consider internal control relevant to the entity's preparation of the component financial information prepared for consolidation purposes 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. An audit also includes evaluating the appropriateness of accounting policies used, and the reasonableness of accounting estimates made, by management [**and if relevant:** as well as evaluating the overall presentation of the component financial information prepared for consolidation purposes].

[18] This illustrative report has been developed with reference to the illustrative report in ISA 805 *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts of Items of a Financial Statement*.

[19] Reference could be made to 'preparation and presentation' in this paragraph to clarify that management is assuming responsibility for the presentation of the component financial information prepared for consolidation purposes (ie, the design of the reporting package).

[20] This sentence may need to be modified if, for example, the component financial information prepared for consolidation purposes is a disclosure, or the line item without the related disclosure.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion. The conclusions reached in forming our opinion are based on the component materiality level specified by you in the context of the audit of the consolidated financial statements of the group.[21]

**Basis for Qualified Opinion**

As requested, we did not perform the following procedures [.….] and thus the scope of our audit was restricted by your instructions].

**[Qualified] Opinion**

In our opinion, [except for the possible effects of adjustments, if any, as might have been determined to be necessary had we performed all audit procedures required by [International Standards on Auditing/other standards]], the accompanying component financial information prepared for consolidation purposes for [name of component] as of [[date] / [[and] for the year then ended]] has been prepared, in all material respects,[22] in accordance with the policies and instructions [contained in [name of group]'s accounting manual/disclosed accounting policies [dated] **or** issued by [name of group]'s management on [date]].

**Restriction on Use and Distribution**

This component financial information prepared for consolidation purposes has been prepared for purposes of providing information to [name of parent entity] to enable it to prepare the consolidated financial statements of the group. As a result, the component financial information prepared for consolidation purposes is not a complete set of financial statements of [name of component] in accordance with [applicable financial reporting framework underlying the group's accounting policies] and is not intended to [give a true and fair view of/present fairly, in all material respects,] the financial position of [name of component] as of [date], and of its financial performance, and its cash flows for the year then ended in accordance with [applicable financial reporting framework underlying the group's accounting policies]. The component financial information prepared for consolidation purposes may, therefore, not be suitable for other purposes.

This report is intended solely for [name of group auditors] and should not be used by [or distributed to] other parties.

[Auditors' signature]

[Date and auditors' address]

[21]In some jurisdictions, requirements under local GAAS or professional responsibilities may require the auditors to deal with the fact that the component audit has been conducted using group materiality in a different manner, such as a scope limitation.

[22]In some jurisdictions, requirements under local GAAS or professional responsibilities may require the auditors to use different wording for the auditors' opinion.

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