Group auditing

In March 2008, Lisa Weaver, examiner for Paper P7, wrote an article about auditing groups and joint audits.

This article is a reminder of some of the most significant elements of group audits, which feature frequently in the Paper P7 exam. The significant changes to ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* that were introduced as a result of the recent Clarity project are likely to make group auditing even more examinable. Exam questions may focus on the audit of group financial statements, or on the requirements of the group auditor to report to management on matters all around the group.

Similarities within the ISA 600 series of auditing standards

Group auditing often necessitates that the group auditor places considerable reliance on other audit firms. However, ISA 600 doesn't allow the group auditor to wholly outsource responsibility for parts of the audit to another auditor.

To begin at the beginning: acceptance of the assignment

ISA 600 requires the group engagement partner each year formally to assess whether it is appropriate to act as group auditor. If at any point the group engagement partner concludes that they lack the professional skills necessary to form a group audit opinion, they should resign. ISA 600 requires that the group engagement partner resign immediately if there is any significant restriction placed by the parent company management on information made available from within the group (or disclaim opinion if resignation is not legally possible).

ISA 600 (revised and redrafted) extends this responsibility to require that the auditor relying on the third party's work has obtained their own understanding of the specialist area in question, or business of each subsidiary or associate (referred to as 'components' in ISA 600, with that company's auditor referred to as the 'component auditor'). **The group auditor must form their own concurring opinion on any judgmental areas.** This does not require having the same depth of knowledge as the expert/other auditor, but they would need to be able to review the third party's files and have sufficient independent knowledge to understand the work done, the reason for the work and the conclusions from that evidence.

Group audit opinion

The parent company of a group will normally publish its financial statements as an individual company and the group financial statements in the same document, so, the audit opinion will normally be expressed on 'the financial statements of the company and of the group as at...' Although presented as one opinion, it logically contains two separate opinions; one on the entity financial statements of the parent itself and another on the financial statements of the group. ISA prohibits the group auditor from making any reference to the work of any other experts or auditors, as doing so would diminish the credibility of the audit opinion and allow the group auditor to 'pass the buck' for responsibility for part of the audit. You should be prepared to explain this point in the exam. This is an example of where ISA differs from US audit standards, where reference to other auditors conducting some of the work on components is permissible.

Planning work required
Groups often have a number of subsidiaries that are either dormant or immaterial. At a minimum, the group engagement team must develop an understanding of each component of the group and review the financial statements of each subsidiary.

Where a component is judged to be material or a significant contributor of inherent risk at the group level, further work will be required to be satisfied that the financial statements of each component, in order to be satisfied that the component is unlikely to introduce errors that could be material at the group level. This work might include:

- discussing with the component auditor, and/or the management of the component, the business activities that are significant to the group
- reviewing the more significant parts of the component auditor's working papers
- discussing with the component auditor the susceptibility of the company's financial statements to material error or deliberate misstatement
- reviewing the component auditor's documentation of identified significant risks, and the conclusions reached on these risks
- observing final clearance meetings between the component auditor and the management of the company.

The group auditor as the repository of information
The group engagement team's role brings information flowing to them that is useful to disseminate around the group. This includes materiality (see below) and matters such as related party relationships, which may be unknown at the component level, because two subsidiaries may be unaware of each other's existence. The group auditor asks each component auditor for known related party relationships and then communicates a collated list of all related party relationships to each component auditor.

Materiality
At the planning stage, the group engagement partner must determine several figures for materiality for each component part of the group (ISA 600:21).

	Group	Parent	Each component
Financial statements materiality	Group auditor	Group auditor	Component auditor
Materiality for the consolidation package as a whole	Group auditor	Group auditor	Group auditor
Level of reduced materiality for sensitive figures	Group auditor	Group auditor	Group auditor
Performance materiality	Group auditor	Group auditor	Group auditor

Performance materiality is the figure below that any errors in the financial statements may be considered trivial. The component auditor will be required to communicate to the group auditor a summary of all unadjusted errors in the consolidation package.

It is common in larger group audits for the financial statements to be prepared using a consolidation package of information that is sent to the parent company by each component company. This will omit many of the disclosures that will be in the eventual entity financial statements. The component auditor may, therefore, be required to issue a special audit opinion on the truth and fairness of the consolidation package. This opinion is likely to be addressed to the directors of the component company, or may be addressed to the group auditor directly.

In order to minimise the risk of several accidental or deliberate errors in the financial statements together exceeding group materiality, component materiality figures will normally be significantly lower than the group materiality figure, even for the largest component companies.

Example 1
Imagine that financial statements materiality is taken to be 10% of profit or loss for each entity within a group and performance materiality is set at 0.5% of profit. Imagine that a group has a parent company and two components, one of which is profit making and one of which is loss making:

$’000s	Parent	Subsidiary 1	Subsidiary 2	Group
Profit	2,000	12,000	(8,000)	6,000
Component materiality @ 10%	200	1,200	800	600
Performance materiality @ 0.5%	10	60	40	30

If subsidiary 1 were audited by another firm using the same materiality calculation method as the parent, an unadjusted error of $10m would correctly result in issuance of an unmodified audit opinion on the financial statements of that individual company. However, the effect of losses elsewhere in the group would mean that although this error would not be material at the component level, it would be material at the group level. Since it is only likely to be the parent auditor who has this overview of the group, the group engagement team must communicate materiality figures to component auditors in advance of audit work commencing. In this example, the maximum component materiality figure that the group auditor could communicate to the component auditors would be 600, but it would be wise to select a lower figure than this, in order to reduce to a tolerable level the risk of errors in both component companies together exceeding 600.

In the exam, if you are given extracts from draft financial statements, it's often a good start to recommend and briefly explain a figure for materiality.

Communication between auditors
ISA 600 in its revised form contains extensive new requirements on the communication between parent and component auditor. In addition to practical matters such as materiality, the required format of the consolidation package, deadlines and contact details, the group auditor must communicate a number of matters at the planning to the component auditor, including:

- related party relationships known anywhere around the group
- identified significant risks, whether due to error or fraud
- methodology to be used for impairment testing of goodwill. Audit of estimates is subjective and so it's essential that the group auditor's preferred method is used throughout the group. Be prepared to explain this in Paper P7.

Matters that the component auditor must communicate to the group auditor will include:

- any known related party relationships and related party transactions
- any indications of management bias
- any significant risks to the truth and fairness of the component financial statements, work done on these risks and the conclusions reached
- all intra-group transactions, period end balances and allowances for unrealised profit
- any observed non-trivial failure to observe relevant laws and regulations
- all observed control weaknesses, flagging significant weaknesses separately
- any known events after the reporting date.

Audit of the consolidation process
Once the group engagement partner is satisfied that the individual financial statements within the group are free from material misstatement, attention can now shift to audit of the consolidation process.

The good news for exam purposes is that this stage of the audit is very similar regardless of the specific company, so good marks can be obtained largely by memorising the risks and responses below.

Principal risks arising in the consolidation process include errors or omissions arising during:

- transcription of figures from individual financial statements to consolidation workings
- classification of components (eg associate, subsidiary)
- cancellation of intra-group trading, cancellation of intra-group balances and allowance for unrealised profit on intra-group transfers
- recognition of impairment of purchased positive goodwill
- determination of fair values being used on acquisition
- arithmetical inaccuracy in the consolidation process
- identification and disclosure of related party relationships and transactions
- foreign currency translation from functional currency of components to reporting currency of the group.

The most reliable evidence on completeness and accuracy of consolidation adjustments in a large group is likely to be determining whether the client's accounting systems adequately flags transactions with fellow group companies. The process is still likely to be highly substantive in nature and will probably include these tests of detail:

- line-by-line agreement of all items from audited component financial statements (or consolidation packages submitted to head office) to the consolidation schedules
- detailed discussion with management on the reason for classification of each component
- sample testing of known intra-group transactions to ensure that they have been eliminated in the client's consolidation
- recalculation of all significant workings, such as goodwill, non-controlling interests and foreign currency translation.

Final review of financial statements

The group audit opinion may be signed on some date on or after the audit opinions on material components are signed. Once the component auditor has issued their opinion, their responsibility for reporting on the impact on events after the reporting date is greatly diminished, yet there may be material events that could be material in the group financial statements. The group engagement team will normally agree in advance with the auditor of significant components that an update on events is given by the component auditor to the group engagement partner immediately before the group audit opinion is signed. It is the responsibility of the group engagement team to ensure that material events are reported.

Reporting to management and the board
In addition to the usual requirements for reporting to those charged with governance (the 'management letter'), ISA 600:49 requires the group engagement partner also to report to management on any concerns that they had about possible fraud anywhere in the group, any restrictions on information made available by component management and any concerns that they had about the quality of work performed by any component auditor.

In addition to the audit report to shareholders, the group auditor is required by ISA 600 to report on a group-wide basis to group management and separately to those charged with governance at a group level, such as the audit committee of the board. This split communication echoes the requirements of ISA 260 Communication with Those Charged with Governance to produce different letters to different levels of management.

The report to management will include details of all observed instances of non-trivial fraud and all non-trivial deficiencies in internal controls around the group.

The report to those charged with governance, most probably the audit committee, will include:

- an overview of the audit approach insofar as it affects component auditors
- any doubts that the group auditor may have about the quality of work performed by the component auditor, giving the group auditor a potentially awkward need to publicly question the skills of a fellow professional.
- any limitations on audit scope anywhere within the group
- any suspected fraud where management is suspected of involvement.

Summary
ISA 600 represents a significant extension of the responsibilities of both group auditor and component auditor compared with the previous ISA. It is likely to be a controversial standard in practice, and it is therefore likely to be in many Paper P7 exams.

Understanding and memorising the key points of the standard is a very good use of study time when preparing for the Paper P7 exam.

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