group audit issues

relevant to ACCA Qualification Paper P7

objectives and responsibilities

In October 2007, the International Auditing and Assurance Standards Board issued International Standard on Auditing (ISA) 600 (Revised and Redrafted), *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*. As ISA 600 is a fairly lengthy document, this article summarises only some of its sections. In addition, it is important to appreciate that ISA 600 does not cover all of the issues relevant in a group audit situation, and that the auditor or assurance provider must consider a wide variety of issues, including detailed financial reporting standards, and issues currently being debated within the profession.

ISA 600 (REVISED AND REDRAFTED), SPECIAL CONSIDERATIONS – AUDITS OF GROUP FINANCIAL STATEMENTS (INCLUDING THE WORK OF COMPONENT AUDITORS)

Definitions

The group auditor is responsible for providing the audit opinion on the group financial statements. Components of the group financial statements can include subsidiaries, associates, joint ventures, and branches. The components may be audited by the group auditor, but may instead be audited by a different firm of auditors known as the 'component auditors', also known as the 'other auditor'. The term component auditor is introduced by the revised and redrafted ISA 600. This article focuses on the objectives and responsibilities of the group auditor.

Objectives

The objective of the group auditor is twofold. First, the group auditor should establish that it is appropriate to act as group auditor. Second, the group auditor should gather sufficient and appropriate evidence in order to reach an opinion on the consolidated financial statements. This article focuses on the second of these two objectives.

It is useful to consider the process by which the group financial statements are produced before considering the group auditor's objectives in relation to evidence. This three-stage process is summarised in **Figure 1** on page 75.

STAGE ONE – GATHERING EVIDENCE ON THE COMPONENTS

Planning and risk assessment

It is imperative that the group auditor has a good understanding of the structure of the group, the significance (ie materiality) of each component of the group, the mechanics of the consolidation process, and the risk of material misstatement presented by each of the company's financial statements. Materiality levels should be established for the group in aggregate, and for the individually significant components.

Involvement in the work of component auditors

In a group, it is likely that some companies will be audited by a different firm of auditors. The group auditor has two issues to resolve. First, the group auditor cannot simply rely on another auditor's opinion on the financial statements of the company. In other words, if the other auditor has concluded that the financial statements of the component are free from material misstatement, the group auditor should not just rely on this opinion and assume that the figures taken from the company's financial statements into the consolidated financial statements are correct. A material misstatement in the financial statements of a company could become a material misstatement in the financial statements of the group.

For all companies within the group, regardless of materiality, the group auditor should review a report of work done by the component auditor. This report of work done could be in the form of an executive summary, or a memorandum of audit issues arising from the audit of the company. Alternatively, the group auditor may issue a questionnaire, to be completed by the component auditor, which would highlight key issues arising from the audit of the component. Following this review, the group auditor will need to decide on the extent of any further actions which need to be taken, or any further work which needs to be carried out, in order to ensure that the financial statements are free from material misstatement. Such actions could include:

- a review of the component auditor's overall audit strategy
- performing a risk assessment at the company level
- participating in closing meetings with the component auditor and the management of the company
- a review of relevant parts of the component auditor's audit working papers.

Where a company is material to the group financial statements, the group auditor should carry out further actions, including:

- discussing with the component auditor, and/or the management of the company, the business activities that are significant to the group
- 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.

It may be the case that, having performed the actions outlined above, the group auditor

The group auditor must ensure that the group audit is carefully planned and that communications with component auditors are made early in the audit process. The group auditor needs to gather two types of evidence. Evidence regarding individual components of the group may be gathered using a joint audit arrangement, though this is not without disadvantages. Evidence on the consolidation process must be thorough, and planned with regard to numerous complex financial reporting standards.

concludes that further audit work is required on the financial statements of a company, or that a memorandum of audit issues arising from the audit of the company is needed. For example, the group auditor may consider that an element of the financial statements of the company could be materially misstated, and that further audit evidence is necessary.

The group auditor should determine the nature of the work necessary, and whether the work should be carried out by the group auditor or the component auditor.

Having taken the actions outlined above, the group auditor should now have obtained sufficient evidence to show that the individual company financial statements are free from material misstatement, and are a sound basis for the preparation of the consolidated financial statements.

STAGE TWO – AUDITING THE CONSOLIDATION

The consolidation process

The group auditor must plan the audit procedures to be performed on the consolidation process. For some groups, the consolidation will be complex and is likely to involve some areas of judgement, and so there is a high degree of audit risk. Thorough planning will be essential to ensure that audit risk is minimised. The types of audit procedures that could be performed include:

- checking that figures taken into the consolidation have been accurately extracted from the financial statements of the components
- evaluating the classifications of the components of the group – for example, whether the components have been correctly identified and treated as subsidiaries, associates, or joint ventures
- reviewing the disclosures necessary in the group financial statements, such as related party transactions and minority interests
- investigating the treatment of any components which have a different financial year end from that of the rest of the group
- gathering evidence appropriate to the specific consolidation adjustments made necessary by financial reporting standards, including, for example:
  - the calculation of goodwill and its impairment review
  - cancellation of inter-company balances and transactions
  - provision for unrealised profits as a result of inter-company transactions
  - fair value adjustments needed for assets and liabilities held by the component
  - re-translation of financial statements of components denominated in a foreign currency.

Some of the evidence required to meet the above objectives will be gathered by the component auditor, and it is the group auditor's responsibility to communicate to the component auditor the evidence that they are expected to gather. This communication ideally occurs at the audit planning stage.

The group auditor must have a sound knowledge of the relevant financial reporting standards, which include:

- IFRS 3, *Business Combinations*
- IAS 28, *Investments in Associates*
- IAS 31, *Interests in Joint Ventures*
- IAS 32, *Financial Instruments: Presentation*
- IAS 39, *Financial Instruments: Recognition and Measurement*.

Note: The relevant UK financial reporting standards are:

- FRS 2, *Accounting for Subsidiary Undertakings*
- FRS 7, *Fair Values in Acquisition Accounting*
- FRS 9, *Associates and Joint Ventures*
- FRS 25, *Financial Instruments: Disclosure and Presentation*
- FRS 26, *Financial Instruments: Recognition and Measurement.*

Candidates are advised that, for the purposes of study for Paper P7, they must be very familiar with the above financial reporting standards. Particularly important are the accounting regulations relating to subsidiaries regarding goodwill, inter-company transactions, and fair value adjustments, as well as the financial reporting implications on the acquisition and disposal of a subsidiary. Candidates must also be aware of the principles of accounting for associates, joint ventures, and foreign subsidiaries.

It is also important to remember that the parent company's individual financial statements will contain balances and transactions pertinent to the components of the group. The parent company's statement of financial position (balance sheet) will carry the investments as non-current assets, and the statement of comprehensive income is likely to contain dividend receipts and other group transactions. The auditor expressing an opinion on the parent company's individual financial statements must gather sufficient appropriate evidence regarding these items, paying particular attention to the carrying value of the investments. Candidates are reminded that IFRS 3 (UK equivalent FRS 2 and FRS 7) contains detailed guidance on the treatment of group investments, particularly on the calculation of the cost of investment.

STAGE THREE – ISSUING THE GROUP AUDIT OPINION

The group auditor issues an opinion on the consolidated financial statements. This is done after a thorough review of all evidence gathered in the first and second stages; this third stage will be explored in a future article by the examiner.

OTHER MATTERS RELEVANT TO A GROUP AUDIT SITUATION

Joint auditing

A joint audit is when two audit firms are appointed to jointly provide an audit opinion on a set of financial statements. This is becoming increasingly common, especially in group audits, where a component may be audited by both the group auditor and another auditor. The main benefit of this type of arrangement is that when a new component is acquired by the group, for example the acquisition of a new subsidiary, it is advantageous to keep the subsidiary's existing audit firm, which will have built up considerable knowledge and experience of the business of the component. However, the group auditor will also need to build up knowledge of the new subsidiary's business, and also become familiar with the audit methods and procedures used by the other auditor. One way for this to happen is for the group auditor to be appointed, along with the other auditor, to jointly provide the audit opinion on the individual financial statements of the subsidiary. The two firms will work together to plan the audit, gather evidence, review the work done, and to finally provide the opinion.

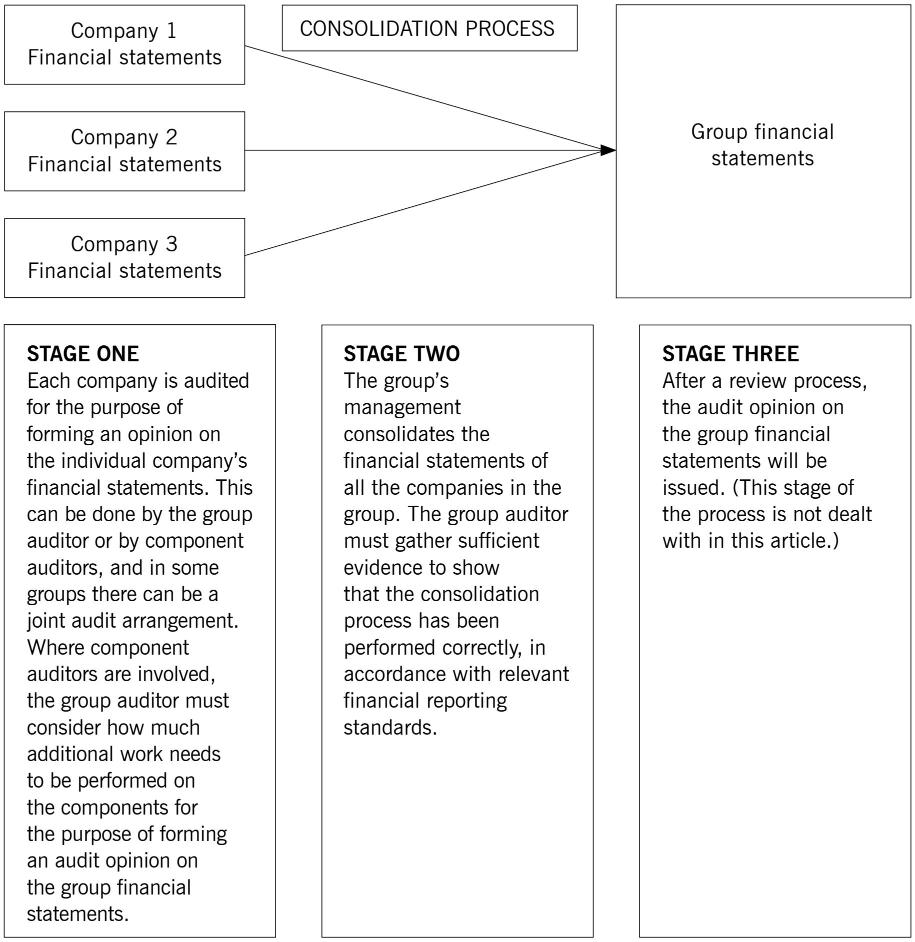
Other benefits from a joint audit may include better availability of resources and the provision of a higher quality audit, as there will be access to staff from both firms of auditors. The inclusion of members of staff from the group audit firm within the audit team of the subsidiary should also improve the efficiency of the audit of the consolidation process.

However, it may be difficult for the two firms to work together if they use different audit methods and it may take time to develop a 'joint audit' approach. There will also be cost implications for the client, as it will presumably be more expensive to use two firms of auditors to provide an audit opinion instead of one.

Joint auditing has been the subject of some debate within the profession in recent times. This is largely because it is seen as a way for small and medium-sized audit firms to continue to be involved in the audit of their client once the client has been acquired by another company. Prior to the emergence of the joint audit, it would have been most likely for the existing auditor (especially if a small or medium-sized audit firm) to be replaced by the group auditor (likely to be a larger audit firm) as the provider of the audit opinion on the individual financial statements.

As more and more companies become acquisition targets, it can be seen that if this practice were to continue, the small and medium-sized audit firms would continue to lose audit clients to the larger audit firms, and would be left with few clients to provide a source of income. Therefore, in the interests of maintaining revenue streams for small and medium-sized audit firms, and in the interests of competition in the audit profession, joint auditing is an important current issue, and will continue to be debated for the foreseeable future.

FIGURE 1: HOW GROUP FINANCIAL STATEMENTS ARE PRODUCED



CONCLUSION

Group audits raise a variety of issues. The group structure can be complex and the existence of numerous components within the group means that there may be several firms of auditors involved. The group auditor must ensure that the group audit is carefully planned and that communications with other auditors are made early in the audit process. The group auditor needs to gather two types of evidence. Evidence regarding individual components of the group may be gathered using a joint audit arrangement, though this is not without disadvantages. Evidence on the consolidation process must be thorough, and planned with regard to numerous complex financial reporting standards.

REFERENCE

- ISA 600 (Revised and Redrafted), *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*, IAASB, October 2007.

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