



Group Audits Discussion Memorandum

Objective of Agenda Item 5

- To understand the proposed changes to ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, introduced in the October 2, 2020 IAASB exposure draft *Proposed International Standard on Auditing (ISA) 600 (Revised), Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (ED).
- To discuss certain sections of the ED presented at the March 2021 IAASB meeting that had been revised to reflect (1) comments from respondents and (2) the recommendations of the IAASB at its December 2020 meeting.

Background

The IAASB is revising ISA 600 to strengthen the auditor's approach to planning and performing a group audit and to clarify the interaction of ISA 600 with the other ISAs, including ISA 220 (Revised) *Quality Management for an Audit of Financial Statements*, ISA 315, *Identifying and Assessing the Risks of Material Misstatement*, and ISA 330, *The Auditor's Responses to Assessed Risks*. In September 2020, the ASB's Group Audits Task Force (ASB Task Force) provided the IAASB with a comment letter on the ED, and in March 2021, provided input to the ASB's IAASB representative on the March 2021 draft.

Members of the Group Audits Task Force

Dora Burzenski, Chair; assisted by Sally Ann Bailey
Mike Bingham
Monique Booker
Harry Cohen
Robert Harris
Clay Huffman

Workplan for the Issuance of an Exposure Draft

In accordance with the ASB's policy to converge its standards with those of the IAASB, Dora Burzenski, Chair of ASB's Group Audits Task Force and a member of the IAASB's ISA 600 Task Force will be leading the ASB in discussions of the IAASB's evolving drafts of the ED with the objective of issuing an exposure draft of proposed AU-C 600 in the first quarter of 2022. With that in mind, the task force will focus its attention on determining whether

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- additional requirements are needed in the draft or existing requirements need to be modified as a result of the US environment
- application material (1) needs to be elevated to a requirement, (2) is missing, or (3) needs to be deleted, as a result of the US environment.

IAASB’s Discussion of the ED

At its December 2020 meeting, the IAASB discussed respondents’ comments on the ED related to the scope and applicability of the proposed standard, the definition of *component*, the definition of *engagement team*, and the risk-based approach, including the involvement of component auditors, as well as the initial views and recommendations of the IAASB Task Force on these topics. At its March 2021 meeting, the IAASB discussed (1) respondents’ comments related to materiality and documentation, (2) the views and recommendations of the IAASB Task Force on these topics and (3) a marked draft of the ED showing proposed changes to the ED. The initial views and recommendations of the IAASB Task Force were also discussed.

Topics for Discussion at the May 2021 ASB Meeting

Dora Burzenski will lead the ASB in a discussion of the following topics, as they relate to the paragraphs in the March 2021 draft of the ED, shown beside each topic:

- Scope and applicability of proposed ISA 600 (paragraphs 1-6, and A1-A10)
- Definitions (paragraphs 9-11 and A11-A16B)
- Communications with component auditors (paragraphs 23A, and A52A-A52J)
- Materiality (paragraphs 29-30)
- Risk-based approach (paragraphs 31-32),

The following is an overview of these topics, including references to paragraphs where these topics are discussed in the IAASB’s:

- March 2021 draft of the ED (ASB Agenda Item 5A)
- March 2021 group audits issues paper (ASB Agenda Item 5B)
- December 2020 group audits issues paper (ASB Agenda Item 5C).

Scope and Applicability of the Proposed ISA 600

| | Paragraphs |
|---|---------------|
| IAASB’s March 2021 draft of the ED | 1-6, A1-A10 |
| IAASB’s March 2021 group audits issues paper | 11- 12, 16-28 |
| IAASB’s December 2020 group audits issues paper | 7-15, 20-31 |

The ED is applicable when the auditor is engaged to audit *group financial statements*, which has been defined in the ED as financial statements that include the financial information of more

than one entity or business unit through a consolidation process. Respondents provided the following comments on the scope and applicability of the ED:

- The definition of *group financial statements* needs to be clarified by differentiating the term *consolidation* (a financial reporting concept) from the term *consolidation process*, which, as used in the ED, is a much broader term that includes aggregating the financial information of branches or divisions within a single entity, and presenting in combined financial statements the financial information of entities or business units under common control. The IAASB Task Force responded to this comment by linking the definition of *group financial statements* in paragraph 9k of the ED to the explanation of the consolidation process in paragraph 11 of the ED. In the March 2021 draft of the ED, the description of consolidation process in paragraph 11 of the ED has become part of the definition of *group financial statements*. Also new paragraph 1A, which mirrors the changes made to the definition of *group financial statements*, has been added to the draft.
- Respondents identified practical difficulties in applying the definition of *group financial statements* to entities that are not considered to be typical ‘groups.’ Paragraph 11(b) of the ED (new par. 9k) states that the “consolidation process” includes the recognition, measurement, presentation, and disclosure, in accordance with the requirements of the applicable financial reporting framework, of financial information of entities or business units in the group financial statements by way of the aggregation of the financial information of branches or divisions. Many larger single entities operate sophisticated ledgers that have separate financial reporting capabilities for aspects of the business, such as revenue streams, segments, or divisions, which may be seen as giving rise to an ‘aggregation process.’ Paragraph A17 of the ED was viewed as being unclear as to whether the ED applies to such situations. In response to these comments, paragraph A17 of the March 2021 draft of the ED has been deleted and new paragraph A2B has been added. At its March 2021 meeting, the IAASB agreed with a proposal by the IAASB Task Force to replace paragraph A2B with two new paragraphs that contrast situations in which proposed ISA 600 (Revised) would and would not apply. These paragraphs are shown in paragraph 21 of the IAASB’s March 2021 issues paper and have been inserted below.

A2B In some cases, a single legal entity may be organized with more than one entity or business unit, for example, a company with operations in multiple locations, such as a bank with multiple branches. When those entities or business units have characteristics such as separate locations, separate management, or separate information systems (including a separate general ledger) and the financial information is required to be aggregated in preparing the single entity’s financial statements, the entity’s financial statements meet the definition of group financial statements because the financial statements include the financial information of more than one entity or business unit through a consolidation process (see paragraph 9(k)(iii) in Agenda Item 5-A).

In other cases, a single legal entity may configure its information system to capture information for more than one product or service line for regulatory reporting or other

management purposes. In these circumstances, the entity’s financial statements are not group financial statements because there is no separate aggregation of the financial information of more than one entity or business unit through a consolidation process. Further, capturing separate information in a single general ledger for regulatory or management purposes does not create separate entities or business units (e.g., divisions) for purposes of this ISA

- The IAASB Task Force noted that the requirements in the ED are intended to be applied in the context of the nature and circumstances of each group audit. For example, when a group audit is carried out entirely by the group auditor, some requirements in the ED are not relevant because they are conditional on the involvement of component auditors. For that reason, new paragraph A2C, which addresses scalability considerations in determining the applicability of the ISA, was added to the March 2021 draft.

Definitions

| | Paragraphs |
|--|---------------------------|
| IAASB’s March 2021 draft of the ED | 9-11 and A11-A16B |
| IAASB’s March 2021 group audits issues paper <i>group financial statements component</i> | 13-15 33 |
| IAASB’s December 2020 group audits issues paper <i>group financial statements component engagement team</i> | 16-19 32-47 103-118 |

Definition of Group Financial Statements: See “Scope and Applicability of Proposed ISA 600”

Definition of Component

Paragraph 9(b) of the ED defines a component as a location, function, or activity (or combination of locations, functions, or activities) determined by the group engagement team for purposes of planning and performing audit procedures in a group audit. Respondents to the ED provided the following comments about the definition of component:

- The discussion of component in paragraph A12 of the ED uses the terms “entities or business units,” to refer to components. This is inconsistent with the definition of component in paragraph 9(b) of the ED, which refers to components as locations, functions, or activities. In the March 2021 draft, the definition of component has been revised to include the phrase *entity or business unit* and the word *locations* has been deleted.
- The explanatory memorandum of the ED indicates that the revised definition of component in the ED focuses on the ‘auditor’s view’ of the entities and business units comprising the group in order to provide flexibility for the group engagement team to look beyond the group’s legal structure when planning and performing the group audit. Some respondents believe that the auditor’s view of the structure of the group may be

radically different from management’s view, which may result in practical challenges, for example, the availability and accessibility of financial information at the components identified by the group engagement team and the identification of component management for purposes of management inquiries and management representations. To address these concerns the following changes have been made to the ED:

- Paragraph 3 of the ED has been split into paragraphs 3 and 3A, and references to management’s view and the auditor’s view have been deleted.
- Paragraph A54 (which has been moved to become paragraph A3A) has been revised to state that a group may be organized in various ways, and that the group’s information system (including its financial reporting process) may or may not be closely aligned with the group’s organizational structure
- Paragraph 3A has been revised to state that proposed ISA 600 (Revised) provides flexibility for the group auditor to determine components based on the group auditor’s understanding of the group and its environment.

Definition of Group Engagement Team

The following is the definition of *group engagement team* in paragraph 9(h) of the ED

The group engagement partner and other members of the engagement team who are responsible for:

- (i) Establishing the overall group audit strategy and audit plan;
- (ii) Directing and supervising component auditors and reviewing their work;
- (iii) Evaluating the conclusions drawn from the audit evidence obtained as the basis for forming an opinion on the group financial statements.

ISA 220 (Revised) is applicable to all audits of financial statements, therefore the definition of engagement team in ISA 220 (Revised) is also applicable to group audits. The definition of *engagement team* in ISA 220 (Revised) includes component auditors. The definition of *group engagement team* in the ED is not intended to include component auditors. Component auditors are carved out of the designation *group engagement team* because component auditors are members of the engagement team who are not responsible for performing the functions in items i-iii of paragraph 9(h). Because the terms *engagement team* and *group engagement team* are so similar, many respondents appear to interpret the term *group engagement team* as simply meaning the engagement team as applied in the context of a group audit, as opposed to how the standard defines this term, as being a specific subset of the broader engagement team. To address this confusion, throughout the March 2021 draft of the ED, the term *group engagement team* has been replaced with the term *group auditor* and the definition remains the same.

Communications with Component Auditors

| | Paragraphs |
|--|----------------|
| IAASB’s March 2021 Draft of the ED | 23A, A52A-A52J |
| IAASB’s March 2021 group audits issues paper | 61-68 |

The ED strengthens and clarifies the requirements in a group audit regarding

- the importance of two-way communication between the group engagement team and component auditors,
- various aspects of the group engagement team's interaction with component auditors, including communicating relevant ethical requirements, determining competence and capabilities of the component auditor, and determining the appropriate nature, timing, and extent of involvement by the group engagement team in the work of the component auditor. The ED also includes a list of matters in paragraph 44 that component auditors should communicate to the group engagement team. Respondents provided the following comments regarding communication with component auditors:
 - Paragraph 43 of the ED and the related application material establishes the overall principles, throughout the group audit, for two-way communication between the group engagement team and component auditors. For that reason, paragraph 43 has been moved to an earlier place in the ED and renumbered as paragraph 23A. The related application material has also been moved to support paragraph 23A.
 - The wording of many of the requirements is more top-down in terms of communication from the group engagement team to the component auditors and more could be done to strengthen the requirements in relation to the expectations of communications from component auditors to the group engagement team (i.e., bottom-up). New paragraph 23A of the March 2021 draft (paragraph 43 of the ED) has been revised to refer to the group engagement team's expectations about communications from component auditors.
 - There is a perception among some respondents that communication of the matters in paragraph 44 of the ED occurs toward the end of the group audit. However, some of those matters may need to be communicated timely throughout the course of the engagement. Additional clarity should be provided about the timing of these communications. In the March 2021 draft, in new paragraphs A111A, A112A, and A112B, the related application material has been revised to provide greater clarity about the timing and form of communications.
 - Paragraph 44(c) of the ED requires the group engagement team to request component auditors to communicate uncorrected misstatements of the component's financial information. Some respondents recommended that the requirement be expanded to include communication of corrected misstatements in addition to uncorrected misstatements. Some IAASB members noted that this may be overly burdensome, accordingly, paragraph 44(c) has been revised to require communication of corrected misstatements above a specified threshold.
 - Paragraph 44(h) of the ED requires that the group engagement team request component auditors to communicate the component auditor's overall findings, conclusions, or opinion. Respondents were concerned about the possibility of undue reliance by the

group auditor on an ‘opinion’ provided by a component auditor. In response to this comment, the IAASB Task Force added (1) new paragraph A112A which indicates that the form and content of the deliverables from the component auditor are influenced by the scope of the audit work requested by the group auditor, and (2) new paragraph A112B which explains that although component auditor’s overall findings, conclusions, or opinion may provide audit evidence to support the work performed by the component auditor, such information typically is not sufficient on its own.

- The clarity of instructions from the group engagement team to component auditors is important, particularly when component auditors are (1) from a non-network audit firm and may not be familiar with the policies and procedures of the group engagement team, and (2) when the group engagement team is making use of the knowledge and expertise of the component auditors to properly understand and assess the risks of material misstatement of the group financial statements. To address this comment, changes were made to paragraphs A106-A108 of the ED (new paragraphs A52A-A52B and A52E-A52) and new paragraphs A52C and A52D were added to address this comment.

Materiality

| | Paragraphs |
|--|------------|
| IAASB’s March 2021 draft of the ED | 29-30 |
| IAASB’s March 2021 group audits issues paper | 69-85 |
| IAASB’s December 202 group audits issues paper | |

The ED clarifies how the concepts of materiality and aggregation risk apply in a group audit. The ED introduces the term *aggregation risk* and defines that term in paragraph 9(a) and the term *component performance materiality* and defines that term in paragraph 9(e). Respondents to the ED provided the following comments related to materiality:

- Additional clarity is needed about the meaning of the term *aggregation risk*. To address that comment the following language from paragraph 80 of the explanatory memorandum of the ED was inserted in paragraph A11: “Generally, aggregation risk increases as the number of components increases at which audit procedures are performed separately, either by component auditors or other members of the engagement team.”
- The description of the consideration of whether a lower component performance materiality may be appropriate for a particular class of transactions, account balance, or disclosure in paragraph A74 of the ED is overly complicated or confusing. To address that comment
 - the last sentence of paragraph A73 has been moved to paragraph A74, and revised to indicate that proposed ISA 600 (Revised) does not require component performance materiality to be established for each class of transactions, account balance, or disclosure at the component level; and
 - the wording of the remainder of paragraph A74 was revised to align more closely with the relevant requirements and guidance in paragraphs 10 and A13 of ISA 320.

Risk-Based Approach

| | Paragraphs |
|---|------------|
| IAASB's March 2021 draft of the ED | 31-32 |
| IAASB's March 2021 group audits issues paper | 38-59 |
| IAASB's December 2020 group audits issues paper | 48-102 |

The risk-based approach relates to identifying and assessing the related risks of material misstatement of the group financial statements. The ED eliminates the concept of significant component, which is used in extant ISA 600 to ensure that sufficient work (including risk assessment procedures) is performed in a group audit. The risk-based approach in the ED is intended to align ISA 600 more closely with ISAs 315 and 330. Respondents had the following comments with regard to the risk-based approach:

- For the most part, respondents support a risk-based approach and the premise that the group engagement team should take responsibility for the risk assessment procedures and work performed to support the group audit opinion, including directly performing or taking over much of what component auditors do under extant ISA 600.
- Respondents noted that the application material for paragraph 33 of the ED (paragraphs A85-A93) place increased focus on the group auditor performing procedures centrally, and that the involvement of component auditors is portrayed in the ED as a less desirable approach, which may undermine the important role of the component auditor. In response to that comment, the application material related to paragraph 33 was revised to be more neutral by including factors that guide the auditor in making a decision about whether to perform further audit procedures centrally or at the component level.
- Based on comments from respondents, the IAASB concluded that the ED is missing a clear framework on how to apply the risk-based approach, especially in relation to: (1) what needs to be done to identify, assess, and respond to the risks of material misstatement of the group financial statements and (2) who needs to do the work (the group auditor or component auditors). In response, the IAASB Task Force made the following changes to the structure of the standard:
 - Added new paragraph 3B to the introduction to highlight upfront the important role that component auditors play in a group audit.
 - Added a requirement in new paragraph 17A that highlights the special considerations in a group audit related to the development of the overall group audit strategy
 - Merged paragraph 32 of the ED into paragraph 25 because when component auditors are involved in performing risk assessment procedures, they generally would be involved in both obtaining an understanding, and identifying and assessing the risks of material misstatement

- Clarified paragraph 33 of the ED by highlighting that determining the components at which to perform further audit procedures, and the nature, timing and extent of the work to be performed at those components forms part of the group auditor’s responsibility for the nature, timing, and extent of further audit procedures to be performed.

- Added subheadings to clarify the structure of the section.

Agenda Materials for the Discussion of Agenda Item 5: Group Audits

- Agenda item 5: Group Audits Discussion Memorandum
- Agenda item 5A: Proposed ISA 600 (Revised), *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (March 2021 Draft Marked from the Exposure Draft)
- Agenda item 5B: Proposed ISA 600 (Revised) – Issues Paper, March 2021 IAASB Meeting
- Agenda item 5C: Proposed ISA 600 (Revised) – Issues Paper, December 2020 IAASB Meeting