Hong Kong Institute of
Certified Public Accountants
香港會計師公會

4 April 2005

To: Members of the Hong Kong Institute of CPAs
All other interested parties

INVITATION TO COMMENT ON IAASB EXPOSURE DRAFTS OF PROPOSED ISA 600 (REVISED) "THE AUDIT OF GROUP FINANCIAL STATEMENTS" ISA 260 (REVISED) "THE AUDITOR'S COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE"

Comments to be received by 30 June 2005

The International Auditing and Assurance Standards Board (IAASB) is seeking comments on the attached Exposure Drafts of proposed revised ISAs which have been posted on the Institute's website at: http://www.hkicpa.org.hk/index.php?mainLocation=/professionaltechnical/assurance/exposuredraft/exposuredraft.php. They can also be found on-line at http://www.ifac.org/IAASB/.

In accordance with the Institute's ISA Convergence Due Process, the Institute's Auditing and Assurance Standards Committee invites comments on the IAASB Exposure Drafts from any interested party and would like to hear from both those who do agree and those who do not agree with the proposals contained in the IAASB Exposure Drafts. Comments should be supported by specific reasoning and should be submitted in written form.

To allow your comments on the IAASB Exposure Drafts to be considered and included in the Institute's submission to the IAASB, they are requested to be received by the Institute on or before **30 June 2005**. Comments may be sent by mail, fax or e-mail to:

Stephen Chan
Director (Standard Setting)
Hong Kong Institute of CPAs
4th Floor Tower Two, Lippo Centre
89 Queensway
Hong Kong

Fax number (+852) 2865 6776
E-mail: commentletters@hkicpa.org.hk

Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

<u>Information for commentators</u>

IAASB ED of Proposed ISA 600 (Revised)

The proposed ISA 600 (Revised), *The Audit of Group Financial Statements*, contains standards and guidance on the audit of group financial statements. Following comments received on an earlier exposure draft, and in the interest of uniform and high quality standards, the IAASB has modified the original proposals that were previously exposed.

The key aspects of the proposed revised Standard are:

- It does not distinguish between sole or divided responsibility for the auditor's opinion but requires the group auditor to perform the same work under either circumstance.
- To accept or continue an engagement to audit group financial statements, the group auditor should be in a position to be sufficiently involved in the audit of components of the group.
- The auditor is required to perform the work, or to be involved in the work performed by other auditors, on all significant components.
- The group auditor is also required to perform procedures in relation to any other auditor's work and to consider its adequacy for purposes of the group audit.

IAASB ED of Proposed ISA 260 (Revised)

The proposed ISA 260 (Revised), *The Auditor's Communication with Those Charged with Governance*, includes new guidance dealing with the communication process in recognition of its importance in audit effectiveness and sets out a framework for communication with those charged with governance.

The key aspects of the proposed revised Standard are:

- It is more specific than the existing Standard about what the auditor should communicate and why.
- Serious matters beyond the financial reporting and disclosure process which the auditor becomes aware of require communication.
- For listed entities, it also requires certain categorized disclosures about fees charged for audit and non-audit services provided by the audit firm in the previous 12 months.

4 April 2005
Invitation to Comment

Response Due Date
30 June 2005

IAASB ED of Proposed ISA 600 (Revised)

The Audit of Group Financial Statements

IAASB ED of Proposed ISA 260 (Revised)

The Auditor's Communication with Those Charged with Governance

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

CONTENTS

These Exposure Drafts may be filed in the "Exposure Drafts, Invitations to Comment" section of Volume III of the Institute's Members' Handbook.

Copies of the Exposure Drafts can also be found on the Institute's website at: http://www.hkicpa.org.hk/index.php?mainLocation=/professionaltechnical/assurance/exposuredraft/exposuredraft.php.

International
Auditing
and Assurance
Standards Board

Exposure Draft
March 2005
Comments are requested by July 31, 2005

Proposed International Standard on Auditing ISA 600 (Revised)

The Audit of Group Financial Statements

International Federation
of Accountants

CONTENTS

REQUEST FOR COMMENTS

This exposure draft of the International Auditing and Assurance Standards Board (IAASB) was approved for publication in March 2005. The proposed revised International Standard on Auditing (ISA) may be modified in light of comments received before being issued in final form.

Comments should be submitted so as to be received by **July 31, 2005** preferably by e-mail or on computer disk, or in writing. All comments will be considered a matter for the public record. Comments should be addressed to:

Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Email responses should be sent to: Edcomments@ifac.org

The approved text of this exposure draft is published in the English language. In order to achieve maximum exposure and feedback, the International Federation of Accountants encourages the reproduction of this publication in any format.

EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background to, and an explanation of, the proposed International Standard on Auditing (ISA) 600 (Revised), "The Audit of Group Financial Statements" approved for re-exposure by the International Auditing and Assurance Standards Board (IAASB) in March 2005.

Background

In December 2003, the IAASB published a proposed revised ISA 600, under the new title of "The Work of Related Auditors and Other Auditors in the Audit of Group Financial Statements" and a proposed new International Auditing Practice Statement (IAPS), under the title of "The Audit of Group Financial Statements." The comment period closed March 31, 2004.

Due to the significance of the comments received, and changes proposed based on these comments, the IAASB agreed that it was necessary to re-expose the proposed revised standards and guidance. A summary of the significant comments and proposals is set out below.

Significant Comments and Proposals

Overall Support

Respondents were supportive of the project and acknowledged that the proposed standards and guidance fill an important gap in the existing ISAs. Although some respondents were of the view that the proposed standards and guidance will assist auditors in improving the quality of audits of group financial statements (while others indicated that it confirmed current best practice), many respondents asked that the group auditor's responsibilities be further clarified and strengthened.

The Option to Use Divided Responsibility

The exposure draft permitted the group auditor to divide responsibility for the audit opinion on the group financial statements with other auditors if national standards enable, and national law or regulation permits, that approach.

There was wide divergence of views on this proposal. Based on the arguments presented in the comment letters, the IAASB proposes that the revised standards and guidance do not refer to sole or divided responsibility, and therefore do not distinguish between the two. The group auditor is responsible for expressing an audit opinion on the group financial statements. In order to obtain sufficient appropriate audit evidence on which to base that opinion, the group auditor should determine the audit procedures to be performed on the consolidation and the type of work to be performed on the components' financial information, both by the group auditor and by other auditors. Consequently:

- The revised standards and guidance do not contain the terms "sole responsibility" and "divided responsibility."

- The group auditor's procedures are the **same** whether he or she accepts sole or divided responsibility. As a result, the revised standards and guidance apply equally to all audits of group financial statements performed in accordance with ISAs.
- Should the group auditor be unable to obtain sufficient appropriate audit evidence in relation to a component, it will constitute a scope limitation and he or she will have to consider the effect of such scope limitation on the audit opinion on the group financial statements. The group auditor will not be able to refer to the other auditor instead of modifying the audit opinion based on the scope limitation.

Related Auditor vs. Other Auditor

The first exposure draft distinguished other auditors that are "related" to the group auditor (referred to as "related auditors"[1] in that exposure draft) from other auditors that are not "related" to the group auditor (referred to as "other auditors"[2] in that exposure draft). This distinction affected the nature, timing, and extent of the procedures that the group auditor performs in relation to a related or other auditor's work.

Respondents to the exposure draft asked the IAASB to reconsider the definitions. They also commented on the effect that the distinction between a related and other auditor has on the group auditor's procedures.

Based on the comments received, the IAASB proposes that the revised standards and guidance use the terms "related auditor," "unrelated auditor," and "other auditor." These terms are defined in paragraph 6 of the re-exposure draft. Furthermore, as discussed later in this memorandum, the group auditor's procedures performed in relation to the other auditors' work are strengthened. However, the revised standards and guidance continue to distinguish between related and unrelated auditors, and this distinction continues to affect the approach to be taken by the group auditor in relation to their work.

Acceptance and Continuance as Group Auditor

To assist the group auditor in deciding whether to accept or continue an engagement to audit group financial statements, the first exposure draft contained standards and guidance on acceptance and continuance. The proposed revised ISA 600 and proposed IAPS provided for the group auditor to obtain a preliminary understanding of the group at the acceptance and continuance stage, and to consider the group auditor's ability to participate appropriately in the work of other auditors. The proposed IAPS suggested that it will be unusual for a group auditor to accept an engagement to audit group financial statements where the group auditor and related auditors directly perform work on less than approximately 50% of the group assets, liabilities, cash flows, profit, or turnover, unless the group auditor will be able to resolve this insufficiency

---

1 Related auditor" was defined as follows in the exposure draft: "Related auditor" means an independent auditor from the group auditor's office, other office of the group auditor's firm, a network firm or another firm operating under common quality control policies and procedures as described in International Standard on Quality Control (ISQC) 1, "Quality Control for Audit, Assurance and Related Services Practices."

2 Other auditor" was defined as follows in the exposure draft: "Other auditor" means an independent auditor other than the group auditor or a related auditor.

by participating appropriately in the work to be performed by the other auditors on the financial information of the components.

Respondents to the exposure draft were of the view that the standards on acceptance and continuance in the proposed revised ISA should be strengthened by revising the related guidance in the proposed IAPS and moving it to the ISA. In addition, it was argued that the "50% acceptance/retention proposal" does not reflect the importance of the group auditor being involved in the audit of significant components.

Based on the comments received, the IAASB has amended the standards and guidance on acceptance and continuance in paragraphs 6-17 of the re-exposure draft. The revised standards and guidance focuses on the extent of the group auditor's involvement in the audit of "significant components." These include those likely to include significant risks, and those of "individual financial significance." The latter term was not clear to many respondents, and so the revised guidance recognizes that the group auditor may apply a percentage to a chosen benchmark as an aid to identify components that are of individual financial significance. Depending on the nature and circumstances of the group, appropriate benchmarks might include group assets, liabilities, cash flows, profit or turnover. Although in practice there are ranges of possible percentages, a component representing 20% or more of group assets, liabilities, cash flows, profit, or turnover is regarded as financially significant. The nature and circumstances of the group, however, may make a lower percentage appropriate. (See paragraph 16 of the re-exposure draft.)

Access to Information

Respondents to the exposure draft commented that legal or professional impediments may prevent the group auditor from having the access to those charged with governance of the component, component management, component information, or the other auditors (including relevant parts of their audit documentation), contemplated by the proposals. For example, it was noted that access to another auditor's audit documentation is essentially a legal issue that depends on the laws of the jurisdiction in which the other auditor operates – such laws cannot be overridden by the provisions of an ISA.

The revised proposals to eliminate division of responsibility and on the nature and extent of the procedures that the group auditor performs in relation to the other auditors' work will further complicate this matter.

The IAASB is of the view that a restriction on the group auditor's access is a scope limitation and that the group auditor should consider the effect that this may have on the group audit opinion. Further, the IAASB proposes that the group auditor does not accept an engagement to audit group financial statements if (a) the group auditor's access will be restricted, and (b) the possible effect of the group auditor's inability to obtain sufficient appropriate audit evidence is material and pervasive to the group financial statements, such that the group auditor is likely to disclaim an opinion on the group financial statements.

Strengthening the Group Auditor's Procedures

Respondents to the exposure draft were of the view that the group auditor's procedures should be strengthened, both in respect of the direction of the audit by the group auditor and the group auditor's involvement in the work of the other auditors. They were of the view that this would be of particular importance if the distinction between sole and divided responsibility was eliminated.

Based on the arguments presented, the IAASB is proposing more stringent requirements with regard (a) the group auditor's determination of the type of work to be performed on the components' financial information (paragraph 51-58), (b) the group auditor's involvement in the work of the other auditors (paragraphs 59-68), (c) the group auditor's evaluation of the adequacy of the other auditors' work (paragraphs 77-83), and (d) the group auditor's communications with the other auditors (paragraphs 95-104).

Proposed Revised Standards and Guidance in a Single ISA

The proposed IAPS provided practical assistance on the application of the proposed revised ISA 600 and other ISAs to the audit of group financial statements. In revising the standards and guidance to strengthen the group auditor's procedures, as explained above, guidance was moved from the proposed IAPS to the proposed ISA.

The IAASB has always found the question of the division of the material on the audit of group financial statements between ISA and IAPS troublesome. In considering the revised standards and guidance for approval as a revised exposure draft, the IAASB had before it a single ISA, and an ISA together with a related IAPS. On balance the IAASB took the view that the single document should be exposed. In this instance, the single document was thought to eliminate the need for repetition, lead to a shorter document, and provide a clearer picture of the application of the audit risk model to the audit of group financial statements than the alternative presentation. Consequently, the IAASB agreed to expose the revised standards and guidance as a single new ISA under the title "The Audit of Group Financial Statements."

Effective Date

The IAASB recommends that the proposed new ISA is effective for audits of group financial statements for periods beginning on or after December 15, 2006.

Guide for Commentators

The IAASB has considered carefully the responses to its initial proposals. It is therefore not seeking further repetition of comments previously made, but rather views on the effect of the substantive changes in the final proposals, as follows:

1. Is the approach to the work of other auditors practical, having regard to the elimination of the divided responsibility option?
2. Are the revised standards and guidance on accepting or continuing an engagement to audit group financial statements appropriate?
3. Do the revised standards and guidance on access to information, given various laws of jurisdictions, give rise to any unnecessary foreseeable difficulty?
4. Is the proposal to move the guidance originally contained in the proposed IAPS to the proposed ISA appropriate? (Any suggestions to the contrary would have to be accompanied by a description of an alternative, and how that alternative maintains the requirements of the proposed ISA.)

Subject to respondents not repeating comments previously made, comments on other matters will be welcome. Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make explicit suggestions for any proposed changes to wording. When a respondent agrees with proposals in this re-exposure draft (especially those calling for change in current practice), it will be helpful for the IAASB to be made aware of this view.

Recognizing that the proposed new ISA will apply to audits of all sizes and in all sectors of the economy, the IAASB is also interested in comments on matters set out below:

Special Considerations in the Audit of Small Entities

Consistent with the IAASB's decision to include any special considerations in the audit of small entities within the text of the ISAs, respondents are asked to comment on whether, in their opinion, considerations in the audit of small entities have been dealt with appropriately in the proposed new ISA. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

Special Considerations in the Audit of Public Sector Entities

Special considerations in the audit of public sector entities have been included in the Public Sector Perspective at the end of the proposed new ISA. The Public Sector Perspective was prepared by the Public Sector Committee (now the International Public Sector Accounting Standards Board) of the International Federation of Accountants. Respondents are asked to comment on whether, in their opinion, special considerations in the audit of public sector entities have been dealt with appropriately in the Public Sector Perspective. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

Developing Nations

Recognizing that many developing nations have adopted or are in the process of adopting the ISAs, the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties in applying the proposed revised ISA in a developing nation environment. Reasons should be provided, as well as alternative or additional guidance.

Translations

Recognizing that many respondents intend to translate the proposed new ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing this exposure draft.

PROPOSED INTERNATIONAL STANDARD ON AUDITING ISA 600 (REVISED)

THE AUDIT OF GROUP FINANCIAL STATEMENTS (Including the Work of Other Auditors)

(Effective for audits of group financial statements for periods beginning on or after December 15, 2006)

CONTENTS

International Standard on Auditing (ISA) 600 (Revised), "The Audit of Group Financial Statements" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services," which sets out the application and authority of ISAs.

Introduction

1. This International Standard on Auditing (ISA) establishes standards and provides guidance on matters relating to the audit of group financial statements, in particular, the involvement of other auditors in the group audit. The group auditor also applies the standards and considers the guidance in the other ISAs.

2. The standards and guidance in this ISA, adapted as necessary in the circumstances, also apply where other auditors are involved in the audit of the financial statements of a single entity. For example, an auditor may plan to use the work of another auditor who observed the inventory count or inspected physical fixed assets at a remote location.

3. Group management is responsible for preparing and presenting the group financial statements in accordance with the applicable financial reporting framework. Group management is also responsible for designing and implementing group-wide controls.

4. **The group auditor should obtain sufficient appropriate audit evidence on which to base the group audit opinion. To obtain such audit evidence, the group auditor should determine (a) the audit procedures to be performed on the consolidation, and (b) the type of work to be performed by the group auditor or other auditors on the financial information of the components.**

Definitions

5. The following terms have the meanings attributed below:

   (a) "Applicable financial reporting framework" means the financial reporting framework applicable to the group financial statements.

   (b) "Audit methodology" means the policies and procedures adopted by a firm and applied by the engagement team to perform audits of financial statements that are of a consistent quality.

   (c) "Component" means a head office, parent, division, branch, subsidiary, joint venture, associated company, or other entity whose financial information is or should be included in the group financial statements.

   (d) "Component management" means management responsible for preparing the financial information of a component.

   (e) "Group auditor"[1] means the auditor[2] who signs the auditor's report on the group financial statements.

---

[1] Where the audit of the group financial statements is conducted by joint auditors, the joint auditors collectively constitute the group auditor. This ISA, however, does not establish standards or provide guidance on the relationship between joint auditors and the work that one joint auditor performs in relation to the work performed by the other joint auditor.

[2] The proposed revised "Glossary of Terms" (December 2004) defines auditor as follows: "… the term 'auditor' is used to describe either the engagement partner or the audit firm. Where it applies to the engagement partner, it describes the obligations or responsibilities of the engagement partner. Such obligations or responsibilities may be fulfilled by either the engagement partner or a member of the audit team. Where it is

(f) “Group financial statements” means financial statements that include or should include financial information of more than one component. The term “group financial statements” also refers to combined financial information aggregating the financial information of components in circumstances where there is no parent.

(g) “Group management” means management responsible for the preparation and presentation of the group financial statements.

(h) “Group-wide controls” means internal controls established by group management over group financial reporting.

(i) “Other auditor” or “another auditor” includes a related auditor and an unrelated auditor.

(j) “Parent” means the entity whose management prepares or should prepare group financial statements.

(k) “Related auditor” means an auditor from the group auditor’s firm or from a network firm who (i) operates under, and complies with, common monitoring policies and procedures as provided for in paragraph 87 of International Standard on Quality Control (ISQC) 1, “Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements,” and (ii) performs work on one or more components for purposes of the audit of the group financial statements.[3]

(l) “Reporting package” ordinarily consists of standard formats for providing financial information for incorporation in the group financial statements. Reporting packages generally do not take the form of complete financial statements prepared and presented in accordance with the applicable financial reporting framework.

(m) “Significant component” means a component that has been identified at the group level as likely to include significant risks of material misstatement of the group financial statements. This could be due to (i) the nature of, and circumstances

---

expressly intended that the obligation or responsibility be fulfilled by the engagement partner, the term ‘engagement partner’ rather than ‘auditor’ is used.”

[3] ISQC 1, paragraph 87 reads as follows:

“Some firms operate as part of a network and, for consistency, may implement some or all of their monitoring procedures on a network basis. Where firms within a network operate under common monitoring policies and procedures designed to comply with this ISQC, and these firms place reliance on such a monitoring system:

(a) At least annually, the network communicates the overall scope, extent and results of the monitoring process to appropriate individuals within the network firms;

(b) The network communicates promptly any identified deficiencies in the quality control system to appropriate individuals within the relevant network firm or firms so that the necessary action can be taken; and

(c) Engagement partners in the network firms are entitled to rely on the results of the monitoring process implemented within the network, unless the firms or the network advises otherwise.”

specific to, the component (risk), or (ii) the individual financial significance of the component to the group (size). (See paragraphs 15-16.)

(n) "Type of work" means the type of work that the group auditor or another auditor, at the request of the group auditor, performs on the financial information of a component for purposes of the audit of the group financial statements. Such procedures may, depending on the circumstances, be an audit performed in accordance with ISAs, using either a materiality level determined by the group auditor or a lower materiality level determined by the other auditor where the circumstances in paragraph 57 apply; an audit of specified account balances; specified audit procedures; or a review of the financial information of the component.

(o) "Uniform accounting policies" means the specific principles, bases, conventions, rules, and practices adopted by the group, based on the applicable financial reporting framework, that the components use to report similar transactions consistently. These policies are ordinarily described in the financial reporting procedures manual and reporting package issued by group management.

(p) "Unrelated auditor" means an auditor other than the group auditor or a related auditor who performs work on one or more component for purposes of the audit of the group financial statements.

In this ISA, reference to "consolidation" also includes the application of the equity method of accounting, and the aggregation of the financial information of components in circumstances where there is no parent.

Acceptance and Continuance as Group Auditor

6. ISQC 1 and ISA 220, "Quality Control for Audits of Historical Financial Information" establish standards and provide guidance on accepting and continuing client relationships and specific audit engagements.

7. **In deciding whether to accept or continue an engagement to audit group financial statements, the group auditor should also determine whether the group auditor will be able to obtain sufficient appropriate audit evidence on which to base the audit opinion on the group financial statements.** Other auditors may perform work on the financial information of one or more components for purposes of the audit of the group financial statements. The group auditor, however, takes responsibility for the audit opinion on the group financial statements (for purposes of this ISA referred to as "group audit opinion"). In order to obtain sufficient appropriate audit evidence, the group auditor performs the work on the consolidation and, as described in this ISA, either performs the work, or is involved in the work to be performed by other auditors, on the financial information of the components.

8. Ordinarily, the risk of not detecting a material misstatement of the group financial statements increases when the group auditor does not perform the work on the financial information of the components. This risk may be reduced when the group auditor is involved in the work that other auditors perform on the financial information of components.

9. The group auditor's consideration of the extent of the involvement in the work of other auditors is affected by the fact that the group auditor ordinarily will be able to rely to a greater extent on the procedures applied by a related auditor in performing the work on the financial information of a component as discussed in paragraphs 31-34. The group auditor's involvement in the work of other auditors is described in paragraphs 59-68.

10. **To obtain sufficient appropriate audit evidence on which to base the group audit opinion, the group auditor, at a minimum, should:**

    (a) **Perform the work on the financial information of significant components, or**

    (b) **Be involved in the work that other auditors perform on the financial information of significant components.**

11. **For purposes of determining whether to accept or continue an engagement to audit group financial statements, the group auditor should obtain an understanding of the group, its components, and their environments, sufficient to identify components where other auditors will perform the work on the financial information, and determine which of those components are likely to be significant.**

12. In the case of a new engagement, this understanding is obtained from information provided by group management, discussions with group management and, where applicable, discussions with the previous group auditor, component management and other auditors. In the case of a continuing engagement, the group auditor considers significant changes that may affect previous experience with the group.

13. The group auditor's understanding includes:

    - The group structure.
    - Components' business activities that are significant to the group, including the regulatory, economic and political environments in which those activities take place.
    - The use of service organizations, including shared service centers.
    - A description of group-wide controls.
    - The complexity of the group financial statements.
    - Whether other auditors will perform work on the financial information of any of the components.
    - Whether the group auditor (a) will have unrestricted access to those charged with governance of the group, group management, component management, component information, and other auditors (including relevant parts of their audit documentation), and (b) will be able to perform necessary work on the financial information of the components.

14. In the case of a continuing engagement, the group auditor considers whether there have been significant changes that may affect the group auditor's ability to obtain sufficient appropriate audit evidence on which to base the group audit opinion, for example:

    - Changes in the group structure (e.g., acquisitions, disposals, or reorganizations).

- Changes in components' business activities that are significant to the group.
- Changes in the composition of those charged with governance of the group, group management, or key management of significant components.
- Difficulties experienced by the group auditor with regard to the integrity and competence of group or component management.
- Changes in group-wide controls.

15. The group auditor may identify at the group level a component as likely to include one or more significant risks of material misstatement of the group financial statements due to the nature of, and circumstances specific to, that component. For example, a component could be responsible for foreign exchange trading and thus expose the group to a significant risk of material misstatement even though the component is not of individual financial significance to the group.

16. A component may also be likely to include significant risks of material misstatement of the group financial statements due to its individual financial significance to the group. As the individual financial significance of a component increases, the risks of material misstatement of the group financial statements ordinarily increase. Generally, a relatively small number of components will constitute a large portion of the group's operations and financial position, making them financially significant. The group auditor may apply a percentage to a chosen benchmark as an aid to identify components that are of individual financial significance. Depending on the nature and circumstances of the group, appropriate benchmarks might include group assets, liabilities, cash flows, profit or turnover. Although in practice there are ranges of possible percentages, a component representing 20% or more of group assets, liabilities, cash flows, profit, or turnover is regarded as financially significant. The nature and circumstances of the group, however, may make a lower percentage appropriate.

17. A group may consist only of components that are not of individual financial significance to the group. In these circumstances, the group auditor and related auditors (a) perform the work on the financial information of some of these components, and (b) are involved in the work performed by unrelated auditors on the financial information of other components to the extent the group auditor considers necessary to obtain sufficient appropriate audit evidence on which to base the group audit opinion.

Access to Information

18. **The group auditor should not accept an engagement to audit group financial statements if:**

    (a) **The group auditor's access to component information, those charged with governance of components, component management, or other auditors (including relevant parts of their audit documentation) will be restricted; and**

    (b) **The possible effect of the group auditor's inability to obtain sufficient appropriate audit evidence is material and pervasive to the group financial statements, such**

that the group auditor is likely to disclaim an opinion on the group financial statements.

19. The group auditor may not have access to component information, those charged with governance of components, component management, or other auditors (including relevant parts of their audit documentation) to the extent necessary to obtain sufficient appropriate audit evidence on which to base the group audit opinion. For example, the group auditor may not have access to a component accounted for by the equity method.

20. It may also not be practical for the group auditor to be involved in the work of another auditor. For example, the group auditor, or a related auditor on behalf of the group auditor, may not be able to be involved in the work of an unrelated auditor in the case of (a) a significant component operating in a foreign jurisdiction, or (b) a tight timetable for completing the audit of the group financial statements.

21. Where restrictions on access cannot be overcome by group management or it is impractical for the group auditor to be involved in the work of another auditor, the group auditor considers whether sufficient appropriate audit evidence can be obtained by other means. For example, the group auditor may not have access to those charged with governance, the management, or auditor (including relevant parts of the auditor's audit documentation) of a component that is accounted for by the equity method. The group auditor, however, may have a complete set of financial statements of the component, including the auditor's report thereon, and information retained by group management in relation to that component. The group auditor may conclude that, based on the insignificance of the component, this limited information constitutes sufficient appropriate audit evidence. If the group auditor concludes that it does not constitute sufficient appropriate audit evidence, the group auditor considers the possible effect on the group financial statements and the group audit opinion. Appendix 1 contains an example of an auditor's report containing a qualified opinion based on the group auditor's inability to obtain sufficient appropriate audit evidence in relation to a component accounted for by the equity method where, in the group auditor's judgment, the effect is material but not pervasive.

22. If the group auditor concludes that, because of restrictions on access or impracticalities, the group auditor will not be able to obtain sufficient appropriate audit evidence on which to base an unmodified group audit opinion, the group auditor considers the possible effect of this inability on the group financial statements.

23. In some circumstances, the possible effect of the inability to obtain sufficient appropriate audit evidence is in the group auditor's judgment material and pervasive to the group financial statements, thus requiring a disclaimer of opinion (see [proposed] ISA 705, "Modifications to the Opinion in the Independent Auditor's Report"). In these circumstances, the group auditor informs group management that it is not possible for the group auditor to accept the engagement.

24. **If restrictions on access occur after accepting an engagement and these restrictions cannot be overcome by group management, or by the group auditor obtaining sufficient appropriate audit evidence by other means, the group auditor should consider the possible effect of this inability to obtain sufficient appropriate audit**

evidence on the group financial statements. When the possible effect of this inability is material and pervasive to the group financial statements, the group auditor considers resigning from the engagement. Where law or regulation does not permit resignation, the group auditor expresses a disclaimer of opinion on the group financial statements.

Terms of Engagement

25. ISA 210, "Terms of Audit Engagements" establishes standards and provides guidance on agreeing with a client on the terms of engagement. In an audit of group financial statements, the group auditor may wish to include the following additional matters in the terms of engagement:

    (a) The applicable financial reporting framework;

    (b) The fact that the communication between the group auditor and other auditors should be unrestricted;

    (c) The fact that important communications between other auditors, those charged with governance of the component, and component management, including communications on material weaknesses in internal control, should be made available to the group auditor;

    (d) The fact that important communications between regulatory authorities and components related to financial reporting matters should be made available to the group auditor; and

    (e) The fact that, to the extent the group auditor considers necessary, the group auditor should be permitted (i) access to component information, those charged with governance of components, component management, and the other auditors (including relevant parts of their audit documentation), and (ii) to perform work on the financial information of the components.

26. **The group auditor should state, in the terms of engagement, that restrictions on (a) the group auditor's access to component information, those charged with governance of components, component management, or the other auditors (including relevant parts of their audit documentation), or (b) the work to be performed on the financial information of the components, imposed after the group auditor's acceptance of the engagement, constitute a scope limitation that may affect the group audit opinion.**

Consideration of Other Auditors

27. **The group auditor should consider the professional qualifications, independence, and professional competence of the other auditors, and the quality control systems of their firms.**

28. The group auditor considers, for example, whether the other auditor:

    - Possesses an understanding of the applicable financial reporting framework sufficient to fulfill the other auditor's responsibilities in the audit of the group financial statements (the group financial reporting procedures manual often describes the characteristics of the applicable financial reporting framework);

- Possesses an understanding of auditing and other standards applicable to the audit of the group financial statements, sufficient to fulfill the other auditor's responsibilities in the audit of the group financial statements;
- Possesses the special skills necessary to perform the work on the financial information of a particular component; and
- Operates in a regulatory environment that actively monitors the professional qualifications, independence, and professional competence of auditors, and the quality control systems of their firms.

29. The group auditor's consideration of the professional qualifications, independence, and professional competence of other auditors, and the quality control systems of their firms will affect the nature, timing and extent of the group auditor's involvement in the other auditor's work.

30. In the case of a multinational group, there may be additional factors that affect the nature, timing and extent of the group auditor's involvement in the other auditor's work. Examples of these other factors include language issues (commonality of language) and cultural issues (commonality of culture).

Related Auditors

31. The group auditor can ordinarily rely on the quality control policies and procedures of a related auditor's firm regarding the related auditor's professional qualifications, independence, and professional competence, in the absence of contrary evidence. For example, the group auditor ordinarily will be able to rely on established policies and procedures to provide reasonable assurance of the independence of the firm, its personnel, and others who are subject to independence requirements (including experts contracted by the firm and network firm personnel), where independence is required by the relevant ethical requirements (see ISQC 1, paragraph 18).

32. The group auditor considers any communications received in accordance with ISQC 1, paragraph 87, regarding the result of the related auditor's quality control process that are relevant to the audit of the group financial statements. The group auditor considers whether any noted deficiencies (a) could affect the audit of the group financial statements, and (b) if so, whether measures taken by the related auditor's firm to rectify such deficiencies appear to be sufficient in the audit of the group financial statements.

33. Where the group auditor and related auditor apply the same audit methodology, the group auditor ordinarily will be able to rely to a greater extent on the procedures applied by the related auditor in performing the work on the financial information of a component, in the absence of contrary evidence. For example, having common quality control and monitoring policies and procedures and applying the same audit methodology ordinarily will result in lower audit risk than having common quality control and monitoring policies and procedures alone. However, the increased audit risk associated with quality control policies and procedures or audit methodologies that are less alike may often be mitigated by the group auditor increasing the group auditor's involvement in the work of the other auditor.

34. When a related auditor will perform the work, or will be involved in the work to be performed by an unrelated auditor, on the financial information of a significant component, and the related auditor's professional competence is not personally known to the group auditor, the group auditor working with the related auditor's firm determines whether the related auditor possesses the necessary professional competence.

Unrelated Auditors

35. The group auditor uses a number of sources to obtain information about the professional qualifications, independence, and professional competence of an unrelated auditor, and the quality control system of that auditor's firm. For example, the group auditor may:

- Visit the unrelated auditor;
- Request the unrelated auditor to complete a questionnaire or written representation;
- Discuss the unrelated auditor with colleagues in the group auditor's firm, or with a network firm who has dealt with the unrelated auditor;
- Obtain confirmations from the professional body to which the unrelated auditor belongs, the authority by which the unrelated auditor is licensed, or other third parties; or
- Consider the results of previous contacts with the unrelated auditor.

36. **The group auditor should confirm whether:**

(a) **The unrelated auditor's firm's quality control system complies with ISQC 1; and**

(b) **There are any issues noted in recent monitoring reports that are likely to affect significantly the work that the unrelated auditor will perform on the financial information of the component.**

This confirmation is obtained either directly by the group auditor, or by the person assigned operational responsibility for the group auditor's firm's quality control system, from the engagement partner, who will be responsible for the work to be performed on the financial information of the component, or the person assigned operational responsibility for the unrelated auditor's firm's quality control system.

37. The group auditor obtains a copy of any report of the unrelated auditor's latest review that is published by the body responsible for conducting external quality control reviews, and is publicly available.

38. When the unrelated auditor is not independent, or the group auditor has serious concerns about the professional qualifications or professional competence of the unrelated auditor, or the quality control system of the unrelated auditor's firm, the group auditor obtains audit evidence relating to the financial information of the component without using the work of the unrelated auditor. Where the group auditor is unable to obtain sufficient appropriate audit evidence relating to the financial information of the component, the group auditor considers the effect of this scope limitation on the group audit opinion.

Enhancing the Understanding of the Group, Its Components, and Their Environments, and Obtaining an Understanding of the Consolidation Process

39. **The group auditor should enhance the understanding of the group, its components, and their environments, obtained in accordance with paragraph 11, and obtain an understanding of the consolidation process, sufficient to:**

    (a) **Identify, at group level, significant risks of material misstatement of the group financial statements, and confirm the group auditor's initial identification of significant components (see paragraph 11);**

    (b) **Determine the audit procedures to be performed on the consolidation; and**

    (c) **Determine the type of work to be performed on the financial information of the components.**

40. To enhance the understanding of the group, its components, and their environments, and to obtain an understanding of the consolidation process, the group auditor performs the following procedures:

    (a) Inquiries of group management, internal audit, and those responsible for consolidating and preparing the group financial statements.

    (b) Application of analytical procedures to financial information prepared at both the group and component level.

    (c) Observation and inspection of group-wide controls, and controls relevant to the consolidation.

41. Matters about which the group auditor obtains an understanding are set out in Appendix 2.

Assessing the Risks of Material Misstatement of the Group Financial Statements at the Group Level

42. **The group auditor should assess, at the group level, the risks of material misstatement of the group financial statements.** The assessment at the group level is of those risks identified as a result of the procedures performed in accordance with paragraph 39.

43. The group auditor's assessment of the risks at the group level is based on (a) information obtained from the understanding of the group, its components, and their environments, and of the consolidation process, including audit evidence obtained in evaluating the design and implementation of group-wide controls and controls relevant to the consolidation, and (b) information obtained through discussions with other auditors. Appendix 3 contains examples of conditions or events that may indicate risks of material misstatement of the group financial statements, including risks due to fraud.

44. The application of ISA 550, "Related Parties" to an audit of a complex group structure, will need to recognize that there is heightened risk of not identifying related parties and related party transactions. It is therefore important that, in assessing the risks of material misstatement of the group financial statements, the group auditor and other auditors are

alert for transactions that appear unusual in the circumstances, and that may indicate the existence of previously unidentified related parties.

Materiality

45. Proposed ISA 320 (Revised), "Audit Materiality in the Identification and Evaluation of Misstatements" establishes standards and provides guidance on materiality and the evaluation of misstatements.

46. The group auditor determines materiality level(s) for the group financial statements as a whole when establishing the overall audit strategy for the audit of the group financial statements.

47. **The group auditor should also determine the materiality level(s) to be used by other auditors in performing the work on the financial information of the components for purposes of the audit of the group financial statements.** To allow for aggregation of identified misstatements and possible undetected misstatements, the component materiality level(s) are lower than the group materiality level(s).

48. The structure of the group may affect the group auditor's determination of materiality level(s) for individual components. For example, it is likely that the greater the number of components that are of similar financial significance, the lower the materiality level(s) for components will be.

49. When planning the work to be performed on the financial information of a component for purposes of the audit of the group financial statements, the auditor responsible for performing that work ordinarily establishes one or more levels of tolerable error lower than the materiality level(s) referred to in paragraph 47. This will allow for the possibility that some misstatements of lesser amounts than the materiality level(s) for the component could be material in the aggregate.

Responding to Assessed Risks

50. **The group auditor should determine the type of work to be performed by the group auditor or other auditors on the financial information of the components to respond to the assessed risks of material misstatement of the group financial statements.**

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

51. The type of work to be performed on the financial information of a component will be affected by matters such as the significance of the component, and the group auditor's evaluation of the design and implementation of group-wide controls. The diagram in Appendix 4 illustrates how the group auditor may decide on the type of work to be performed on the financial information of the components.

Significant Components

52. For a component that, due to the nature of and circumstances specific to that component, has been identified at the group level as likely to include significant risks of material misstatement of the group financial statements (see paragraph 15), the group auditor ordinarily performs or requests other auditors to perform one of the following:

- An audit in accordance with ISAs using either a materiality level determined by the group auditor; or a lower materiality level determined by the other auditor where the circumstances in paragraph 57 apply.
- An audit of specified account balances relating to the identified significant risks.
- Specified audit procedures relating to the identified significant risks.

53. For a component that, due to its individual financial significance to the group, is likely to include significant risks of material misstatement of the group financial statements (see paragraph 16), the group auditor ordinarily performs or requests other auditors to perform an audit in accordance with ISAs, using either a materiality level determined by the group auditor; or a lower materiality level determined by the other auditor where the circumstances in paragraph 57 apply.

Components that are Not Significant in the Aggregate

54. After determining the work to be performed on the financial information of significant components (see paragraphs 52-53), the group auditor identifies components that are not significant in the aggregate. As discussed in paragraph 16, the group auditor may apply a percentage to a chosen benchmark as an aid to determine the individual financial significance of components to the group. While in practice there are ranges of possible percentages, components that in the aggregate represent less than 5% of group assets, liabilities, cash flows, profit or turnover will ordinarily be regarded as not significant in the aggregate. The group auditor may consider it appropriate not to perform audit or review procedures at components that are not significant in the aggregate. For these components, the group auditor's procedures ordinarily are limited to the analytical procedures performed at the group level.

Components that are Significant in the Aggregate

55. The type of work to be performed on the financial information of the remaining components could include one of the following:

    - An audit performed in accordance with ISAs, using either a materiality level determined by the group auditor; or a lower materiality level determined by the other auditor where the circumstances in paragraph 57 apply.
    - An audit of specified account balances.
    - Specified audit procedures.
    - A review of the financial information of the component.

    The type of work to be performed on the financial information of these components is affected by matters such as the following:

    - Whether it has been newly formed or acquired.
    - Whether significant changes have taken place in the component.
    - Whether internal audit has performed work at the component.

- The effectiveness of group-wide controls.
- The risks posed by, or the individual financial significance of, the component in comparison with other components within this category.

56. For example, analytical procedures performed at the group level might have indicated a significant increase in revenue and accounts receivable. Discussions with group management may have revealed that the increase is due to the establishment of a new market for one of the group's products. The new market may have been established in a country with severe economic problems, which might affect the collection of the accounts receivable. In this example, the group auditor determined that the product is manufactured and sold by three subsidiaries in the group. Although these subsidiaries are not individually significant, they might be significant in the aggregate. Based on the risk assessment performed at the group level, the group auditor performs, or requests the other auditors to perform, an audit of the accounts receivable at these three components.

Components Subject to Audit by Statute, Regulation or Other Reason

57. Statute, regulation or other authority may require the audit of the financial statements of a component. The group auditor may decide to use this audit to provide audit evidence for the purposes of the audit of the group financial statements. In these circumstances, the group auditor evaluates the effect of the financial reporting framework applied in preparing the financial statements of the component, and the auditing standards applied by the other auditors. The group auditor also considers whether the audit of the financial statements of the component will be performed in time to communicate the other auditor's memorandum or report of work performed to the group auditor (see paragraph 103).

58. When the group auditor decides to use the audit of the financial statements of a component performed by another auditor to provide audit evidence for purposes of the audit of the group financial statements, the risk assessment procedures and further audit procedures may have already been performed by the other auditor at the component (for example a component acquired close to the group reporting date). To meet the requirements described in paragraphs 59-68, the group auditor reviews the risk assessment procedures and further audit procedures already performed, and determines the additional audit procedures to be performed.

Involvement in the Work of Other Auditors

59. Involvement in the work performed by another auditor ordinarily includes the group auditor undertaking some or all of the following actions:
    - Meeting with component management to obtain an understanding of the component and its environment.
    - Performing risk assessment procedures and participating in the assessment of risks of material misstatement. These may be performed with the other auditor, or by the group auditor.
    - Determining and performing further audit procedures. These may be performed with the other auditor, or by the group auditor.

- Participating in the closing and other key meetings between the other auditor and component management.
- Reviewing relevant parts of the other auditor's audit documentation.

In the case of an unrelated auditor, the group auditor may request a related auditor to undertake the actions on behalf of the group auditor.

60. The extent of the group auditor's involvement in the work performed by another auditor is affected by matters such as the group auditor's evaluation of (a) the significance of the component, (b) the professional qualifications and professional competence of the other auditor, and (c) of the quality control system of the other auditor's firm. For example, the more significant the component, or the lower the level of the group auditor's satisfaction with the professional qualifications and professional competence of the other auditor, or with the quality control system of the other auditor's firm, the greater is the involvement of the group auditor, or related auditor on behalf of the group auditor, in the other auditor's work.

Significant Components

Risk Assessment

61. **When another auditor is requested to perform the work on the financial information of a significant component, the group auditor should be involved in the other auditor's risk assessment to identify significant risks of material misstatement of the group financial statements.**

62. When an unrelated auditor performs the work on the financial information of a significant component, the group auditor, or a related auditor on behalf of the group auditor, is involved in the unrelated auditor's risk assessment procedures. As part of this involvement, the group auditor or the related auditor:

    (a) Discusses with component management the component's business activities that are significant to the group, including the regulatory, economic and political environments in which those activities take place;

    (b) Discusses with the unrelated auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error; and

    (c) Reviews the unrelated auditor's documentation of the identified and assessed risks of material misstatement. Such documentation may be in the form of a memorandum, reflecting the related auditor's conclusion with regard to the identified and assessed risks of material misstatement.

63. When a related auditor performs the work on the financial information of a significant component, the group auditor reviews the related auditor's documentation of the identified and assessed risks of material misstatement. Such documentation may be in the form of a memorandum, reflecting the related auditor's conclusion with regard to the identified and assessed risks of material misstatement.

64. When a related auditor, on behalf of the group auditor, has been involved in the risk assessment procedures of an unrelated auditor, the group auditor reviews the related auditor's documentation of that involvement. Such documentation may be in the form of a memorandum.

Further Audit Procedures

65. **When significant risks of material misstatement of the group financial statements have been identified in a component on which another auditor performs the work, the group auditor and the other auditor together should determine the further audit procedures to be performed to respond to the identified significant risks.**

66. In certain circumstances, the group auditor may want to be involved, or to involve a related auditor, in performing further audit procedures. The nature, timing and extent of this involvement will be affected by the group auditor's assessment of the significant risks to which the component is subject, its individual financial significance, and the group auditor's evaluation of the professional qualifications and professional competence of the other auditor, and the quality control system of that auditor's firm.

67. When a related auditor, on behalf of the group auditor, has been involved in the further audit procedures of an unrelated auditor, the group auditor reviews the related auditor's documentation of that involvement. Such documentation may be in the form of a memorandum.

Components that are Significant in the Aggregate

68. To obtain sufficient appropriate audit evidence on which to base the group audit opinion, it may be necessary for the group auditor, or a related auditor on behalf of the group auditor, to be involved in the work to be performed by an unrelated auditor on the financial information of a component that is significant in the aggregate. This involvement may include some or all of the procedures described in paragraph 59, a review of the financial information of the component, or analytical procedures performed at the group level.

Consolidation

69. **The group auditor should determine the work to be performed on the consolidation to respond to the assessed risks of material misstatement of the group financial statements arising from the consolidation process.**

70. The consolidation process may require adjustments to amounts reported in the group financial statements that do not pass through the usual transaction processing systems, and that may not be subject to the same internal controls to which other financial information is subject. These adjustments typically consist of consolidation adjustments and reclassifications. The group auditor:

    (a) Considers the appropriateness and completeness of the consolidation adjustments, as well as the accuracy of calculations;

    (b) Considers whether the consolidation adjustments appropriately reflect the events and transactions underlying the adjustments;

(c) Determines whether significant adjustments have been correctly processed, authorized by group management and, where applicable, by component management, and are supported by sufficient appropriate documentation; and

(d) Checks the reconciliation and elimination of intra-group transactions and unrealized profits, and intra-group account balances.

71. Components that operate in diverse industry segments, or are located in jurisdictions that require different financial reporting frameworks, may use inconsistent accounting policies. If required by the applicable financial reporting framework, group management will ordinarily eliminate such inconsistencies by (a) requiring components to prepare financial information consistent with the accounting policies applied to the group financial statements, or (b) requiring component management to disclose the differences between the accounting policies applied to the component's financial information and those applied to the group financial statements and making the adjustment on consolidation. In these circumstances, the group auditor considers whether group or component management has appropriately adjusted the component's financial information for purposes of preparing and presenting the group financial statements. Where another auditor performs the work on the financial information of a component, and component management has made such adjustments, the group auditor requests the other auditor to confirm to the group auditor that such adjustments have been made.

72. **The group auditor should determine whether the financial information identified in the communication of the other auditor is the financial information that is incorporated in the group financial statements.** (See paragraph 103(e).)

73. If the group financial statements include the financial statements of any components with year-ends that differ from that of the group, the group auditor determines whether this is acceptable under the applicable financial reporting framework. The group auditor also considers the component's results between its financial year-end and the date of the group financial statements, and identifies significant transactions, including intra-group transactions and unrealized profits, or other events and disclosures that need to be reflected in or eliminated from the group financial statements. Where another auditor performs the work on the financial information of a component, the group auditor requests the other auditor to perform the procedures the group auditor considers necessary for that consideration and identification.

74. Sometimes adjustments that are processed on consolidation relate to misstatements. Where these adjustments have not been processed in the relevant component's accounting records, the group auditor requests group management to have them processed appropriately and, if applicable and not prohibited by confidentiality requirements, informs the other auditor.

Subsequent Events

75. **For significant components, the group auditor should perform, or request other auditors to perform, procedures designed to identify events at those components between the dates of the financial information of the components and the date of the auditor's report on the group financial statements.** The group auditor determines the

date up to which subsequent events reviews at components are performed, i.e., the date of the auditor's report on the group financial statements.

76. For components that are significant in the aggregate, the group auditor ordinarily inquires from other auditors whether they are aware of subsequent events that may require an adjustment to or a disclosure in the group financial statements.

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

Evaluating the Adequacy of Another Auditor's Work

77. **The group auditor should evaluate the adequacy of the work of another auditor for the group auditor's purposes.**

78. The nature, timing and extent of the group auditor's evaluation will be affected by matters such as the following:

- Whether a component is significant.
- Whether the other auditor is a related auditor or an unrelated auditor and, if a related auditor, whether the group auditor and the related auditor applies the same audit methodology (see paragraph 33).
- The group auditor's evaluation of the professional qualifications, independence, and professional competence of the other auditor, and the quality control system of that auditor's firm.
- The extent of the group auditor's or, in the case of an unrelated auditor, a related auditor's involvement in the work of the other auditor.

79. When other auditors performed the work on the financial information of significant components or components that are significant in the aggregate, the group auditor reads the other auditors' reports or memorandums of work performed, including the other auditors' lists of uncorrected misstatements. (See paragraph 103.)

80. **When another auditor performed the work on the financial information of a significant component, the group auditor should review relevant parts of the other auditor's audit documentation.** Where the other auditor is an unrelated auditor, the group auditor may request a related auditor to conduct the review of relevant parts of the unrelated auditor's audit documentation on behalf of the group auditor.

81. The parts of another auditor's audit documentation that will be relevant may vary depending on the circumstances. Ordinarily the group auditor, or a related auditor on behalf of the group auditor, focuses on audit documentation that is relevant to the significant risks of material misstatement of the group financial statements. The extent of the review ordinarily is affected by the fact that the other auditor's documentation has been subjected to the other auditor's firm's review procedures.

82. When a related auditor, on behalf of the group auditor, has reviewed an unrelated auditor's audit documentation, the group auditor reviews the related auditor's review memorandum, including the conclusions reached on the adequacy of the work of the unrelated auditor for the group auditor's purposes.

83. If the group auditor concludes that the work of another auditor is inadequate for the group auditor's purposes, the group auditor determines additional procedures to be performed. Depending on the circumstances, such additional procedures are performed by the other auditor or by the group auditor.

Sufficiency and Appropriateness of Audit Evidence

84. The group auditor evaluates whether sufficient appropriate audit evidence has been obtained from the audit procedures performed on the consolidation, and the work performed on the financial information of the components on which to base the group audit opinion. This evaluation includes the work performed by other auditors.

85. If the group auditor concludes that sufficient appropriate audit evidence has not been obtained, the group auditor obtains further audit evidence, if possible. In the case of components on which other auditors performed the work, the group auditor may request the other auditors to perform additional procedures. If this is not feasible, the group auditor performs the group auditor's own procedures on the financial information of the components. When the group auditor has not been able to perform sufficient additional audit procedures, the group auditor considers the effect of this scope limitation on the group audit opinion. (Appendix 1 contains an example of a qualified opinion.)

Considering the Other Auditor's Memorandum or Report of Work Performed

86. **The group auditor should consider the effect of the other auditor's memorandum or report of work performed (see paragraph 103) on the auditor's report on the group financial statements.**

87. The group auditor may consider it appropriate to discuss significant matters arising from the other auditor's memorandum or report of work performed with the other auditor, component management or group management. The group auditor may also conclude that additional audit procedures are necessary. Depending on the circumstances, such additional audit procedures are performed by the other auditor or by the group auditor.

Reporting Considerations

88. The group auditor considers whether matters communicated by another auditor are of such a nature and significance in relation to the group financial statements that a modification of the auditor's opinion on the group financial statements is required.

89. Uncorrected misstatements that are material to the financial information of the component may be immaterial when aggregated at the group level. As a result, they may not affect the group auditor's opinion on the group financial statements. Conversely, uncorrected misstatements that are immaterial to the financial information of the component may be material when aggregated with uncorrected immaterial misstatements of the financial information of other components. The group auditor considers the aggregated effect of the uncorrected immaterial misstatements of the financial information of the components on the group audit opinion.

Communication with Group Management and Those Charged with Governance

Communication with Group Management

90. The group auditor makes group management aware, as soon as practicable and at an appropriate level of responsibility, of material weaknesses in the design or operation of group-wide controls, including controls over the preparation and presentation of the group financial statements. The group auditor also makes group management aware of material weaknesses in internal controls at components that have been identified by the group auditor, or that have been brought to the attention of the group auditor by other auditors, that the group auditor judges are of significance to the group.

91. If fraud has been identified in components, or information indicates that a fraud may exist, the group auditor communicates this as soon as practicable to group management. If the group auditor believes or suspects that group management may be involved in the fraud, the group auditor communicates this to those charged with governance.

Communication with Those Charged with Governance

92. Proposed ISA 260 (Revised), "Communication with Those Charged with Governance" establishes standards and provides guidance on communication with those charged with governance.

93. **In an audit of group financial statements, the group auditor should also communicate the following to those charged with governance of the group:**

    (a) **The portion of the group financial statements on which the group auditor and related auditors will perform the work, and the portion of the group financial statements on which unrelated auditors will perform the work.**

    (b) **The components that have been identified as significant.**

    (c) **Instances where the group auditor is concerned about the professional qualifications, independence, and professional competence of another auditor and the related effect on the group auditor's planned involvement in the work to be performed by that other auditor.**

    (d) **The planned type of work to be performed on the financial information of the components.**

    (e) **The group auditor's planned involvement in the work to be performed by other auditors on the financial information of significant components.**

    (f) **Instances where the group auditor's evaluation of the work of another auditor gave rise to a concern about the quality of the work performed by that other auditor.**

    (g) **Any limitations on the audit of the group financial statements. For example, the group auditor's access to component information, those charged with governance of components, component management, or other auditors**

(including relevant parts of their audit documentation) may have been restricted.

94. The matters that the group auditor communicates to those charged with governance of the group include those matters brought to the attention of the group auditor by other auditors that the group auditor judges to be significant to the responsibilities of those charged with governance of the group. Communication with those charged with governance of the group takes place at various times during the audit of the group financial statements. For example, the matters referred to in paragraph 93(a)-(e) will be communicated after the group auditor has determined the work to be performed on the financial information of the components. On the other hand, the matter referred to in paragraph 93(f) will be communicated at the end of the audit, and the matter referred to in paragraph 93(g) will be communicated when it occurs.

Communications with Another Auditor

95. **When another auditor performs the work on the financial information of a component, the group auditor should communicate the group auditor's requirements to the other auditor.** The group auditor issues this communication as early as possible, ordinarily in the form of a letter of instruction that sets out (a) the work to be performed, (b) the nature of the other auditor's memorandum or report of work performed, and (c) the confirmations required by the group auditor. Appendix 5 contains examples of matters to be included in the group auditor's letter of instruction.

96. The group auditor requests the other auditor to confirm (a) receipt of the group auditor's letter of instruction, (b) that the other auditor will undertake the requested work, and (c) that the other auditor understands that the group auditor will consider and may use the other auditor's work for purposes of the audit of the group financial statements.

97. In the case of an unrelated auditor, the group auditor requests confirmation whether (a) the unrelated auditor's firm's quality control system complies with ISQC 1, and (b) there are any issues noted in recent monitoring reports that are likely to significantly affect the work that the unrelated auditor will perform on the financial information of the component (see paragraph 36).

98. **The group auditor's confirmation requirements should include the following:**

    (a) **Confirmation whether the other auditor sufficiently understands, and will comply with, the relevant ethical requirements, including independence, to fulfill the other auditor's responsibilities in the audit of the group financial statements.**

    (b) **Confirmation whether the other auditor sufficiently understands the applicable financial reporting framework to fulfill the other auditor's responsibilities in the audit of the group financial statements. (The group financial reporting procedures manual often describes the characteristics of the applicable financial reporting framework.)**

    (c) **Confirmation whether the other auditor sufficiently understands the auditing or other standards applicable to the audit of the group financial statements to fulfill the other auditor's responsibilities in the audit of the group financial statements.**

It is important to obtain these confirmations as early as possible in the audit process to enable the group auditor to consider their possible effect on the audit of the group financial statements. Appendix 6 contains an example of confirmations by another auditor.

99. **The group auditor should communicate the following to the other auditor:**

(a) **The type of work to be performed on the financial information of the component.**

(b) **The materiality level for the component and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.**

(c) **Significant risks, including fraud risks, identified at the group level that are relevant to the work of the other auditor.** This communication occurs when the group auditor, or a related auditor on behalf of the group auditor, is not involved in the other auditor's risk assessment procedures (see paragraphs 59-68). **The group auditor should request the other auditor to inform the group auditor of any other identified significant risks that may affect the group financial statements.**

100. The group auditor communicates to the other auditor laws and regulations applicable to the parent that are relevant to the other auditor's work. The group auditor requests the other auditor to communicate any non-compliance with laws and regulations applicable to the component that could materially affect the group financial statements.

101. **The group auditor should provide the other auditor with a list of related parties prepared by group management, and request the other auditor to be alert for transactions that appear unusual in the circumstances and that may indicate the existence of previously unidentified related parties. The group auditor should request the other auditor to communicate the names of any additional related parties, and the types of transactions with such related parties.**

102. **The group auditor should request timely communication of material weaknesses in controls that have come to the attention of the other auditor during the performance of the work on the financial information of the component, and information that indicates that a fraud may exist.**

103. **The group auditor should obtain from the other auditor a memorandum or report of the work performed on the financial information of the component**. This memorandum or report is obtained at the conclusion of such work, and contains matters relevant to the group auditor's conclusion with regard to the audit of the group financial statements. In particular, this memorandum or report:

(a) States whether the other auditor has complied with the quality control policies and procedures of that auditor's firm;

(b) States whether the other auditor has complied with the relevant ethical requirements, including independence;

(c) States whether the other auditor has complied with auditing or other standards applicable to the audit of the group financial statements;

(d) States whether the other auditor has complied with the group auditor's other instructions;

(e) Identifies the financial information of the component on which the other auditor is reporting;

(f) Sets out the work performed by the other auditor;

(g) Lists uncorrected misstatements of the financial information of the component (the list does not include misstatements that were below the threshold communicated by the group auditor for clearly trivial misstatements);

(h) Explains material weaknesses in internal control over financial reporting;

(i) Sets out other significant matters that the other auditor communicated or expects to communicate to those charged with governance of the component;

(j) Sets out any other matters that the other auditor wishes to draw to the attention of the group auditor; and

(k) Sets out the other auditor's findings, conclusions or opinion.

104. Where the group auditor is unable to obtain the other auditor's memorandum or report of work performed, the group auditor considers the effect of this scope limitation on the group audit opinion.

Communication with Another Auditor Who is Required to Audit the Financial Statements of a Component

105. **Where another auditor is required by statute, regulation or for another reason to express an audit opinion on the financial statements of a component, and the group auditor becomes aware of matters that may be significant to the financial statements of the component of which component management may be unaware, the group auditor should request group management to inform component management of such matters for the purpose of the component audit.** Examples of such matters include the following:

- Potential litigation.
- Plans for abandonment of material operating assets.
- Subsequent events.
- Significant legal agreements.

106. Group management may need to keep certain material sensitive information confidential. In these circumstances, the group auditor ordinarily discusses with group management the risk of component management issuing misleading financial statements, and requests group management to require component management not to issue the financial statements of the component. In addition, the group auditor may consider it necessary to direct the other auditor not to issue the auditor's report on the financial statements of the component until group management has resolved the outstanding matter. When group management remains

of the opinion that the matter should not be communicated to component management, the group auditor considers resigning from the engagement.

Documentation

107. Proposed ISA 230 (Revised), "Audit Documentation" and other ISAs establish standards and provide guidance on audit documentation. **In an audit of group financial statements, the group auditor should also document the following:**

(a) **The basis for the group auditor's conclusion to accept or continue the engagement as regards the group auditor's ability to obtain sufficient appropriate audit evidence on which to base the group audit opinion where other auditors will perform the work on the financial information of some components.**

(b) **The results of the consideration of the professional qualifications, independence, and professional competence of the other auditors, and the quality control systems of their firms, and the nature, timing and extent of the group auditor's or related auditors' involvement in the work performed by the other auditors.**

(c) **The results of the risk assessment performed at the group level, and a description of the audit procedures to be performed on the consolidation and the work to be performed on the financial information of the components.**

(d) **Identified and assessed significant risks of material misstatement of the group financial statements, the further audit procedures performed to respond to such risks, and the related results.**

(e) **The group auditor's communications with other auditors about the group auditor's requirements.**

(f) **The group auditor's conclusion as to whether the group auditor has obtained sufficient appropriate audit evidence of the adequacy of the work of the group auditor and other auditors for the group auditor's purposes.**

(g) **The group auditor's conclusion on uncorrected misstatements, and the effect of the other auditors' reports or memorandums of work performed on the group audit opinion.**

(h) **Discussions of significant accounting, auditing and financial reporting maters with those charged with governance, group management, component management, or other auditors.**

Effective Date

108. This ISA is effective for audits of group financial statements for periods beginning on or after December 15, 2006.

Public Sector Perspective

1. *Some terms in this ISA, such as "engagement partner" and "firm," are to be read as referring to their public sector equivalents.*

2. *In some jurisdictions, legislation provides for the appointment of different auditors for different tiers of government or classes of public sector entity. In addition, in auditing a combination of public sector entities, the group management may not be structured in the manner envisaged by the ISA. Such factors may result in additional complexity that affect, for example, the group auditor's approach to audit planning and risk assessment.*

3. *Where, in accordance with the mandate, the scope of the audit of the group financial statements is wider than that envisaged by this ISA, and the group auditor intends to use the work of another auditor, the group auditor will need to ensure that the other auditor has a proper understanding of the affect of this wider scope on the other auditor's work and report.*

Appendix 1

Example of a Qualified Opinion where the Group Auditor is Not Able to Obtain Sufficient Appropriate Audit Evidence on which to Base the Group Audit Opinion

In this example, the group auditor is unable to obtain sufficient appropriate audit evidence in relation to a significant component accounted for by the equity method because the group auditor did not have access to the accounting records, management, or auditor of the component.

The group auditor has read the audited financial statements of the component as of June 30, 20X1, including the auditor's report thereon, and considered related financial information retained by group management in relation to the component. The group auditor, however, was not able to obtain more recent audited financial statements of that component. The consolidated financial statements are for the year ended December 31, 20X1.

In the auditor's judgment, the effect on the group financial statements of this inability to obtain sufficient appropriate audit evidence is material but not pervasive.

INDEPENDENT AUDITOR'S REPORT

[*Appropriate Addressee*]

Report on the Financial Statements

We have audited … (remaining words are as illustrated in the introductory paragraph of the example auditor's report in paragraph 60 of ISA 700 (Revised) (adapted as necessary for consolidated financial statements)

Management's Responsibility for the Financial Statements

Management is responsible for … (remaining words are as illustrated in the management's responsibility paragraph of the example auditor's report in paragraph 60 of ISA 700 (Revised) (adapted as necessary for consolidated financial statements)

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. Except for the matter described in the Basis for Qualified Opinion paragraph, we conducted our audit … (remaining words of the first two paragraphs are as illustrated in the first two paragraphs of the auditor's responsibility in the example auditor's report in paragraph 60 of ISA 700 (Revised) (adapted as necessary for consolidated financial statements)

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Basis for Qualified Opinion

ABC Company's investment in XYZ Company, a foreign associate accounted for by the equity method, is recognized at $15 million in the balance sheet as at December 31, 20X1, and ABC Company's share of profit of XYZ Company is recognized at $1 million in the income statement for the year ended December 31, 20X1. We were unable to obtain sufficient appropriate audit evidence in relation to the financial information of XYZ Company because part of the available financial information was unaudited and we were unable to obtain access to the accounting records, management, or auditor of XYZ Company.

Qualified Opinion

In our opinion, except for the possible effect of the matter described in the Basis for Qualified Opinion paragraph, the consolidated financial statements give a true and fair view of (*or "present fairly, in all material respects"*) the financial position of ABC Company and its subsidiaries as of December 31, 20X1, and of their financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards.

Report on Other Legal and Regulatory Requirements

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.*]

[*Auditor's signature*]

[*Date of the auditor's report*]

[*Auditor's address*]

Appendix 2

Matters about which the Group Auditor Obtains an Understanding (See paragraph 41)

Group Control Environment

1. The group auditor obtains an understanding of the group control environment. The group control environment includes the attitude, awareness, and actions of those charged with governance and management that relate to the group-wide controls and their importance.

Group-wide Controls

2. The group auditor obtains an understanding of the group-wide controls. Group-wide controls may include a combination of the following:
   - Regular meetings between group and component management to discuss business developments and to review performance.
   - Monitoring of components' operations and their results, including regular reporting routines, which enables group management to monitor components' performance against budgets, and to take appropriate action.
   - Group management's risk assessment process, i.e., the process for identifying, analyzing and managing business risks, including the risk of fraud, that may result in material misstatement of the group financial statements.
   - Monitoring, controlling, reconciling, and eliminating intra-group transactions and unrealized profits, and intra-group account balances at the group level.
   - A process for monitoring the timeliness and assessing the accuracy and completeness of financial information received from components.
   - A central IT system controlled by the same general IT controls for all or part of the group.
   - Control activities within an IT system that is common for all or some components.
   - Monitoring of controls, including activities of internal audit and self-assessment programs.
   - Consistent policies and procedures, including a group financial reporting procedures manual.
   - Group-wide programs, such as codes of conduct and fraud prevention programs.
   - Arrangements for assigning authority and responsibility to component management.
3. Where internal audit is regarded as part of group-wide controls, for example, when the internal audit function is centralized, and the group auditor plans to use the work of internal audit, the group auditor evaluates the competence and objectivity of the internal auditors.

Consolidation Process

4. The group auditor obtains an understanding of the consolidation process, including relevant controls. The group auditor's understanding includes:

   Matters relating to the applicable financial reporting framework, including the following:

   - The extent to which component management has an understanding of the applicable financial reporting framework.
   - The process for identifying and accounting for components in accordance with the applicable financial reporting framework.
   - The process for identifying reportable segments for segment reporting in accordance with the applicable financial reporting framework.
   - The process for identifying related party relationships and related party transactions for reporting in accordance with the applicable financial reporting framework.
   - The accounting policies applied to the group financial statements, changes from those of the previous financial year, and changes resulting from new or revised standards under the applicable financial reporting framework.
   - The procedures for dealing with components with financial year-ends different from the group's.

   Matters relating to the consolidation process, including the following:

   - Group management's process for obtaining an understanding of the accounting policies used by components, and ensuring that uniform accounting policies are used to prepare the financial information of the components for purposes of the group financial statements, and that differences in accounting policies are identified, and adjusted (where required in terms of the applicable financial reporting framework).
   - Group management's process for ensuring complete, accurate and timely financial reporting by the components for purposes of the consolidation.
   - The process for translating the financial information of foreign components into the currency of the group financial statements.
   - How IT is organized for purposes of the consolidation, including the manual and automated stages of the process, and the manual and programmed controls in place at the various stages of the consolidation process.
   - Group management's process for obtaining information on subsequent events.

   Matters relating to consolidation adjustments, including the following:

   - The process for recording consolidation adjustments, including the preparation, authorization and processing of related journal entries, and the experience of personnel responsible for the consolidation.
   - The consolidation adjustments required by the applicable financial reporting framework.

- Business rationale for the events and transactions that gave rise to the consolidation adjustments.
- Frequency, nature and size of transactions between components.
- Procedures for monitoring, controlling, reconciling, and eliminating intra-group transactions and unrealized profits, and intra-group account balances.
- Steps taken to arrive at the fair value of acquired assets and liabilities, procedures for amortizing goodwill (where applicable), and impairment testing of goodwill, in accordance with the applicable financial reporting framework.
- Arrangements with a majority owner or minority interests regarding losses incurred by a component (for example, an obligation of the minority interest to make good such losses).

5. To achieve uniformity and comparability of financial information, group management may issue financial reporting procedures manuals, reporting packages, and related instructions to components, specifying the requirements for financial information of the components to be included in the group financial statements. The instructions ordinarily cover (a) the accounting policies to be applied; (b) statutory and other disclosure requirements applicable to the group financial statements, including (i) the identification and reporting of segments, (ii) related party relationships and transactions, (iii) intra-group transactions and unrealized profits, and (iv) intra-group account balances; and (c) a reporting timetable.

6. The group auditor ordinarily considers the proposed reporting package for components at an early stage of the audit of the group financial statements, to determine whether it will provide sufficient appropriate information to prepare and present the group financial statements. The group auditor's consideration may include the following:
   - The clarity and practicality of the instructions for completing the reporting package.
   - Whether the reporting package:
     - Adequately describes the characteristics of the applicable financial reporting framework;
     - Provides for disclosures sufficient to comply with the requirements of the applicable financial reporting framework, for example disclosure of related party relationships and transactions, and segment information;
     - Provides for the identification of consolidation adjustments, for example intra-group transactions and unrealized profits, and intra-group account balances; and
     - Provides for the approval of the completed package by component management.

Fraud

7. ISA 240 (Revised), "The Auditor's Responsibility to Consider Fraud in the Audit of Financial Statements" establishes standards and provides guidance on the auditor's responsibility with regard to fraud. In an audit of group financial statements, the group auditor obtains an understanding of the following:

- Group management's assessment of the risks that the group financial statements may be materially misstated as a result of fraud.
- Group management's process for identifying and responding to the risks of fraud in the group, including any specific fraud risks identified by group management, or account balances, classes of transactions, or disclosures for which a risk of fraud is likely.
- Whether there are particular components for which a risk of fraud is likely.
- How those charged with governance of the group monitor group management's processes for identifying and responding to the risks of fraud in the group, and the controls that group management has established to mitigate these risks.

8. The group auditor inquires of those charged with governance of the group, group management, internal audit (and if considered appropriate, component management, other auditors, and others), whether they have knowledge of any actual, suspected, or alleged fraud affecting a component or the group.

Discussion Among Engagement Team Members Regarding the Risks of Material Misstatement of the Group Financial Statements, Including Risks of Fraud

9. ISA 315 and ISA 240 (Revised) require the members of the engagement team to discuss the susceptibility of an entity to material misstatement of the financial statements due to fraud or error, with a specific emphasis on the risks due to fraud. The group auditor determines, based on prior experience with the group and knowledge of current developments, who to include in the discussions, how and when they occur, and their extent. In an audit of group financial statements, the group auditor and other auditors may also discuss these matters.

10. The group auditor, or a related auditor on behalf of the group auditor, holds discussions with other auditors who perform work on the financial information of significant components.

11. These discussions provide an opportunity to:
    - Share knowledge of the components and their environments, including group-wide controls.
    - Exchange information about the business risks of the components or the group.
    - Exchange ideas about how and where the group financial statements may be susceptible to material misstatement due to fraud or error, how group management and component management could perpetrate and conceal fraudulent financial reporting, and how assets of the components could be misappropriated.
    - Identify practices followed by group or component management that may be biased or designed to manage earnings that could lead to fraudulent financial reporting, for example revenue recognition practices that do not comply with the applicable financial reporting framework.
    - Consider known external and internal factors affecting the group that may create an incentive or pressure for group management, component management, or others to

commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables group management, component management, or others to rationalize committing fraud.

- Consider the risk that group or component management may override controls.
- Consider whether uniform accounting policies are used to prepare the financial information of the components for purposes of the group financial statements, and whether differences in accounting policies are identified, and adjusted (where required in terms of the applicable financial reporting framework).
- Discuss fraud that has been identified in components, or information that indicates existence of a fraud in a component.
- Share information that may indicate non-compliance with national laws or regulations, for example payments of bribes and improper transfer pricing practices.

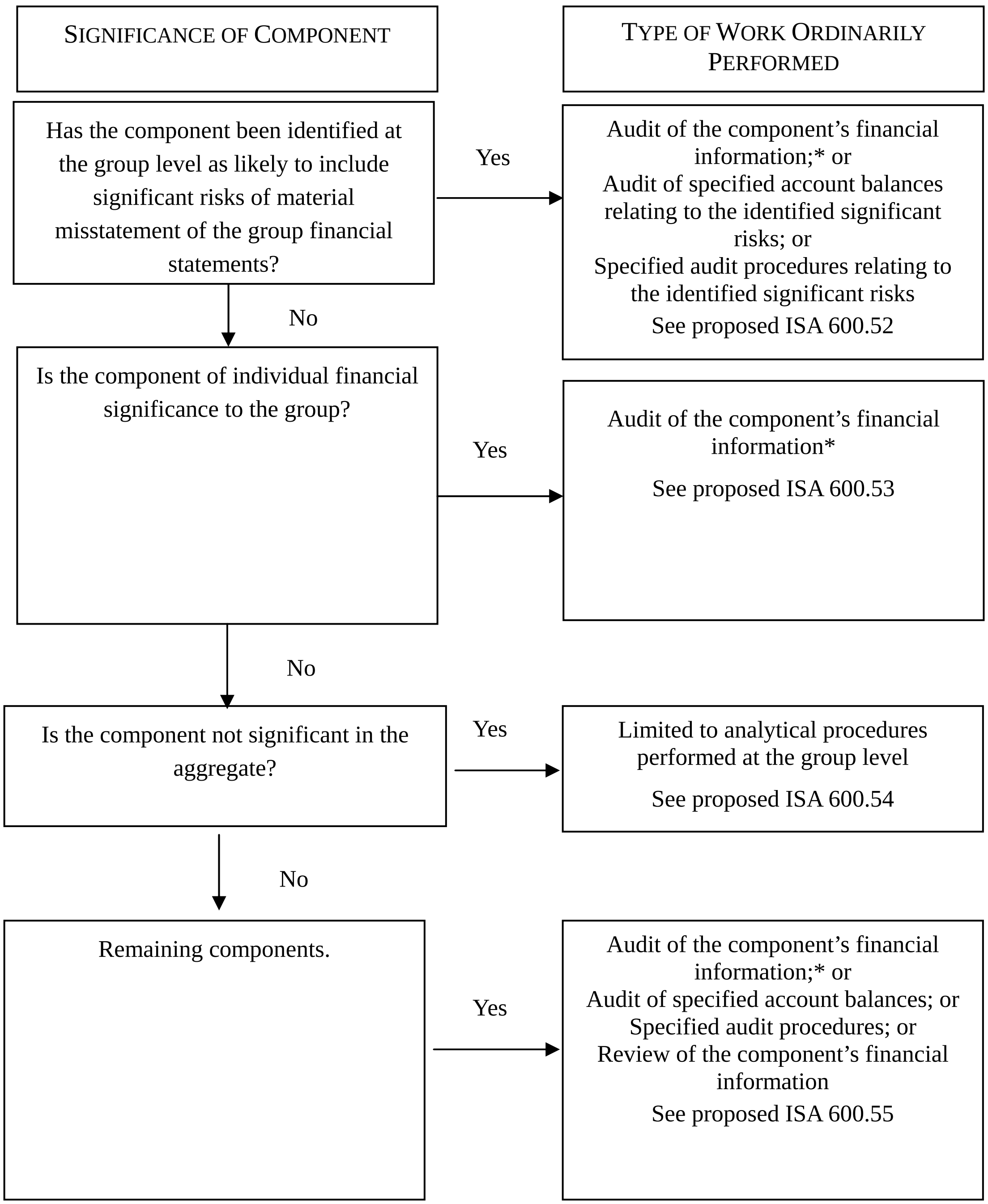
Appendix 3

Examples of Conditions or Events that may Indicate, at the Group Level, Risks of Material Misstatement of the Group Financial Statements, Including Risks of Fraud (See paragraph 43)

- A complex group structure, especially where there are frequent acquisitions, disposals, or reorganizations.
- Poor corporate governance structures, including decision-making processes, that are not transparent.
- Non-existent or ineffective group-wide controls, including inadequate group management information on monitoring of components’ operations and their results.
- Components operating in foreign jurisdictions that may be exposed to factors such as unusual government intervention in areas such as trade and fiscal policy, and restrictions on currency and dividend movements; and fluctuations in exchange rates.
- Business activities of components that involve high risk, such as long-term contracts or trading in innovative or complex financial instruments.
- Uncertainties regarding which components require incorporation in the group financial statements in accordance with the applicable financial reporting framework, for example whether any special purpose entities or non-trading entities exist and require incorporation.
- Related party relationships and transactions.
- Prior occurrences of intra-group account balances that did not balance or reconcile on consolidation.
- Components’ application of accounting policies that differ from those applied in the group financial statements.
- Components with different financial year-ends, which may be utilized to manipulate the timing of transactions.
- Prior occurrences of unauthorized or incomplete consolidation adjustments.
- Aggressive tax planning within the group or large cash transactions with entities in tax havens.
- More than one other auditor engaged to audit the financial statements of the components, and frequent changes of these auditors within the group.

Appendix 4

Determining the Type of Work to be Performed on the Financial Information of Components (See paragraph 51)



*Performed in accordance with ISAs using either a materiality level determined by the group auditor or a lower materiality level determined by the other auditor.

Appendix 5

Examples of Matters to be Included in the Group Auditor's Letter of Instruction (See paragraph 95)

Required Confirmations

- A request that the following confirmations are, whenever possible, submitted to the group auditor before the work on the financial information of the component is commenced:
  - In the case of an unrelated auditor, confirmation whether the unrelated auditor's firm's quality control system complies with ISQC 1, and there are any issues noted in recent monitoring reports that are likely to significantly affect the work that the unrelated auditor will perform on the financial information of the component.
  - Confirmation of receipt of the group auditor's letter of instruction and confirmation whether the other auditor will undertake the requested work.
  - Confirmation whether the other auditor understands and will comply with the relevant ethical requirements, including independence, sufficient to fulfill the other auditor's responsibilities in the audit of the group financial statements.[4]
  - Confirmation whether the other auditor understands the applicable financial reporting framework, sufficient to fulfill the other auditor's responsibilities in the audit of the group financial statements.
  - Confirmation whether the other auditor understands the auditing or other standards applicable to the audit of the group financial statements, sufficient to fulfill the other auditor's responsibilities in the audit of the group financial statements.
  - Confirmation whether the other auditor understands that the group auditor will consider and may use the other auditor's work for purposes of the audit of the group financial statements.

Matters Relevant to the Planning of the Other Auditor's Work

- The timetable for completing the audit.
- Dates of planned visits by group management and the group auditor, and dates of planned meetings with component management and the other auditor.
- A list of key contacts.
- The use to be made of the other auditor's work, the type of work to be performed, and arrangements for the coordination of efforts at the initial stage of and during the audit,

[4] When there are several components in the group and their names may not be known to the other auditor, it is advisable for the group auditor to list them in the letter of instruction to facilitate the other auditor's assessment of compliance with the relevant independence requirements.

including the group auditor's or related auditor's planned involvement in the work of the other auditor.

- Laws and regulations applicable to the parent that are relevant to the work to be performed by the other auditor.
- Work to be performed on intra-group transactions and unrealized profits and intra-group account balances.
- Results of the group auditor's risks assessment performed at the group level that are relevant to the other auditor's work.
- The materiality level that the group auditor expects the other auditor to use.
- The threshold for clearly trivial misstatements.
- Guidance on other statutory reporting responsibilities, for example reporting on group management's assertion on the effectiveness of internal control.
- Where there is likely to be a time lag between completion of the work on the financial information of the components and the group auditor's conclusion on the group financial statements, specific instructions for a subsequent events review.

Matters Relevant to the Conduct of the Other Auditor's Work

- The findings of the group auditor's tests of control activities of a processing system that is common for all or some components, and tests of controls to be performed by the other auditor.
- The findings of internal audit, based on work performed on controls at or relevant to components.
- A request for timely communication of audit evidence obtained from performing work on the financial information of the components that contradicts the audit evidence on which the group auditor originally based the risk assessment performed at the group level.
- A request for written representation on component management's compliance with the applicable financial reporting framework, or a statement that differences between the accounting policies applied to the financial information of the component and those applied to the group financial statements have been disclosed.
- Matters to be documented by the other auditor.

Matters Relevant to the Other Auditor's Communication

- The form and content of the memorandum or report of work performed to be provided to the group auditor.

Other Information

- A request for a list of uncorrected misstatements of the financial information of the component. The list does not include uncorrected misstatements that are below the threshold set by the group auditor for clearly trivial misstatements.
- A request that the following are reported to the group auditor in a timely manner:

- Significant accounting, financial reporting and auditing matters, including accounting estimates and related judgments.
- Material weaknesses in internal control
- Actual fraud, or information obtained that indicates that a fraud may exist, including any suspected or alleged fraud affecting the component.
- Instances of non-compliance with laws and regulations applicable to the component that could have a material effect on the group financial statements.
- Matters relating to the going concern status of the component.
- Matters relating to litigation and claims.
- Matters relating to compliance with laws and regulations.

- A request that the group auditor be notified of any significant or unusual events as early as possible.
- A request for the names of related parties that were not listed by group management, and the types of related party transactions.

Appendix 6

Example of Another Auditor's Confirmations (See paragraphs 98)

The following letter is not intended to be a standard letter. Confirmations may vary from one auditor to another (for example, whether the other auditor is a related auditor or an unrelated auditor) and from one period to the next.

The group auditor ordinarily requests the other auditor, whenever possible, to submit the confirmations before the work on the financial information of the component is commenced.

[*Other Auditor Letterhead*]

[*To Group Auditor*] [*Date*]

This letter is provided in connection with your audit of the group financial statements of [name of parent] for the year ended [date] for the purpose of expressing an opinion on whether the group financial statements give a true and fair view of (present fairly, in all material respects) the financial position of the group as of [date] and of its financial performance and cash flows for the year then ended in accordance with [indicate applicable financial reporting framework].

We acknowledge receipt of your instructions dated [date], requesting us to perform the specified work on the financial information of [name of component] for the year ended [date].

We confirm that:

1. We will be able to comply with the instructions. / We advise you that we will not be able to comply with the following instructions [specify instructions] for the following reasons [specify reasons].
2. The instructions are clear and that we understand them. / We would appreciate it if you could clarify the following instructions [specify instructions].

We also acknowledge that:

1. The financial information of [name of component] for the year ended [date] will be included in the group financial statements of [name of parent] for the year ended [date].
2. You intend to review and, if considered appropriate, use our work performed on the financial information of [name of component] for the year ended [date] for purposes of the audit of the group financial statements of [name of parent] for the year ended [date].

In connection with the work that we will perform on the financial information for the year ended [date] of [name of component], a [describe component, e.g. wholly-owned subsidiary, subsidiary, joint venture, associate company] of [name of parent], we confirm the following:

1. Our firm's quality control system complies with ISQC 1, and there are no issues noted in recent monitoring reports that are likely to affect significantly the work that we will perform in connection with this engagement.
2. We have an understanding of, and will comply with [indicate relevant ethical requirements], sufficient to fulfill our responsibilities in the audit of the group financial statements. In particular, and with respect to [name of parent] and the other components in

the group, we are independent within the meaning of [indicate relevant ethical requirements] and are in compliance with the applicable requirements of [refer to rules] promulgated by [name of regulatory agency].

3. We have an understanding of International Standards on Auditing and [indicate other national standards applicable to the audit of the group financial statements], sufficient to fulfill our responsibilities in the audit of the group financial statements and will conduct our work on the financial information of [name of component] for the year ended [date] in accordance therewith.

4. We have an understanding of [indicate applicable financial reporting framework or group financial reporting procedures manual], sufficient to fulfill our responsibilities in the audit of the group financial statements.

We will inform you of any changes in the above representations during the course of our work on the financial information of [name of component] for the year ended [date].

[*Auditor's signature*]

[*Date*]

[*Auditor's address*]

International Federation of Accountants
545 Fifth Avenue, 14th Floor, New York, NY 10017 USA
Tel +1 (212) 286-9344 Fax +1(212) 286-9570 www.ifac.org

International
Auditing
and Assurance
Standards Board

Exposure Draft
March 2005
Comments are requested by July 31, 2005

Proposed International Standard on Auditing 260 (Revised)

The Auditor's Communication with Those Charged with Governance

International Federation
of Accountants

CONTENTS

REQUEST FOR COMMENTS

This exposure draft of the International Auditing and Assurance Standards Board (IAASB) was approved for publication in March 2005. The proposed revised International Standard on Auditing (ISA) and proposed conforming amendments to other ISAs may be modified in light of comments received before being issued in final form.

Comments should be submitted so as to be received by **July 31, 2005** preferably by e-mail or on computer disk, or in writing. All comments will be considered a matter for the public record. Comments should be addressed to:

Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Email responses should be sent to: Edcomments@ifac.org

The approved text of this exposure draft is published in the English language. In order to achieve maximum exposure and feedback, the International Federation of Accountants encourages the reproduction of this publication in any format.

EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background to, and an explanation of, the proposed revised International Standard on Auditing (ISA) 260, under a new title of "The Auditor's Communication with Those Charged with Governance," and proposed conforming amendments to ISA 570, "Going Concern," approved for exposure by the International Auditing and Assurance Standards Board (IAASB) in March 2005.

Background

In light of significant regulatory and auditing standards developments in several jurisdictions, and shifts in the expectations of those charged with governance and other stakeholders, the IAASB initiated a project to review the provisions of the ISAs that relate to communication with those charged with governance.

This is a joint project with the Australian Auditing and Assurance Standards Board. The Project Task Force also has technical experts nominated by the International Organization of Supreme Audit Institutions, the Institute of Internal Auditors, and the Transnational Auditors Committee of the International Federation of Accountants.

Significant Proposals

The Communication Process

The proposed revised ISA 260 includes a new section dealing with the communication process in recognition of its importance in audit effectiveness. It acknowledges that the communication process will vary with the engagement circumstances, and requires the auditor to establish a mutual understanding with those charged with governance of the form, timing, and expected general content of communications. It explains that effective communication is ordinarily two-way, and provides guidance on establishing expectations, and the form, timing and confidentiality of communications. It also requires the auditor to evaluate the adequacy of the two-way communication.

Matters to be Communicated

The proposed revised ISA 260 sets out a framework for communication with those charged with governance and generally includes specific items to be communicated only when there is not an ISA on the relevant topic. Matters that other ISAs require to be communicated to those charged with governance, for example, communication regarding material weaknesses required by ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" are not repeated in the proposed revised ISA 260. Nonetheless, the proposed revised ISA 260 requires significantly more specific items to be communicated than the existing ISA 260, including serious matters beyond the financial reporting and disclosure process of which the auditor becomes aware. It also requires, for listed entities, certain categorized disclosures about fees paid to the audit firm and network firm in the previous 12 months and fees currently contracted for.

This approach is more specific than the existing ISA 260 regarding which matters should be communicated, while at the same time ensuring all matters that would be communicated under the existing ISA 260 will continue to be communicated under the proposed revised ISA.

All of Those Charged with Governance Involved in the Management of the Entity

The proposed revised ISA 260, at paragraphs 20 and 21, recognizes the different role that communication with those charged with governance plays when all of those charged with governance are involved in the management of the entity, which may be the case with some small entities in particular. It specifically acknowledges that in such circumstances:

(a) If matters required by the proposed revised ISA 260 are communicated to person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again to those same person(s) in their governance role; and

(b) Matters that are required to be communicated, but are relevant only to the oversight function of those charged with governance, ordinarily require no action on the part of the auditor because there is no oversight separate from management.

Communications regarding Auditor Independence

The proposed revised ISA 260, at paragraphs 49, introduces a requirement for written communications to those charged with governance regarding auditor independence. The proposed revised IFAC Code of Ethics for Professional Accountants requires written communications regarding auditor independence in the case of listed entities only. Consistent with the proposed revised Code, paragraph 49 applies to listed entities only. The matters required by paragraph 49 go beyond the proposed revised Code however, by specifically including disclosures regarding fees to the auditor’s firm and network firm. The IAASB considers such disclosures important in assisting those charged with governance in monitoring and protecting the auditor’s independence. While the primary requirement for these communications relates to listed entities only, paragraph 51 notes that the auditor considers whether they are also appropriate in the case of other entities.

Use of “Those Charged with Governance,” “Management,” and Other Terms

In conjunction with revising ISA 260, the IAASB has reviewed use of “those charged with governance,” “management,” and related terms, such as “directors,” “client” and “board,” in the ISAs.

Underlying use of the terms “management” and “those charged with governance” in most ISAs have been two general presumptions:

(a) Management and those charged with governance are different people.

(b) Management is responsible for the financial statements, whereas those charged with governance have an oversight responsibility only.

These presumptions are not appropriate in all circumstances however, which may cause difficulties when interpreting some ISAs in certain circumstances, for example, when those charged with governance are the same people (person) as management, and in jurisdictions where those charged with governance, rather than management, have the responsibility to approve the financial statements.

In recent years, documents issued by the IAASB have sought to be clearer about such matters by acknowledging, for example, “the role of those charged with governance is often undertaken by the owner-manager where there are no other owners” (ISA 315.71). Although there is an increased emphasis on clarifying the use of “management” and “those charged with governance,” there is currently no set IAASB approach for doing so, and some difficulty may persist, particularly in older documents.

The IAASB seeks comment on its proposal to apply the following approach to using “those charged with governance,” “management,” and related terms when developing new documents and revising current documents:

(a) In the Glossary of Terms, the definitions of “those charged with governance” and “management” are to be replaced with the definitions at paragraphs 7(a) and 7(b) of the proposed revised ISA 260, and will include reference to the discussion in paragraphs 9-21 of that ISA.

(b) Both those charged with governance and management should be referred to where appropriate, for example: “Management or those charged with governance are ~~is~~ responsible for the fair presentation of financial statements that reflect the nature and operations of the entity. (ISA 500.15)

(c) “Board,” “director(s),” and “audit committee” should not be used as generic terms. They may be used to illustrate a point, for example: “… recent change of senior management, those charged with governance, e.g. an entity’s board of directors, or ownership.” (ISA 210.11)

(d) “Client” should not be used (ordinarily “entity” will replace the term “client”).

In developing this proposal, the IAASB recognizes that strict adherence to the specific approach noted above will not necessarily always result in the desired clarity of expression, and in some circumstances therefore additional explanations may need to be added when “those charged with governance,” “management,” or a related term is used.

Guide for Commentators

The IAASB welcomes comments on the proposed revised ISA 260 and proposed conforming amendments to ISA 570. The IAASB is seeking comments on all matters addressed in the exposure draft, including but not limited to the significant proposals discussed above. Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make explicit suggestions for any proposed changes to wording.

Recognizing that the proposed revised ISA will apply to audits of all sizes and in all sectors of the economy, the IAASB is also interested in comments on matters set out below:

Special Considerations in the Audit of Small Entities

Consistent with the IAASB's decision to include any special considerations relevant to the audit of small entities within the text of ISAs themselves, the guidance in paragraph 41 of IAPS 1005, "The Special Considerations in the Audit of Small Entities," has been revised as considered necessary and incorporated in this proposed revised ISA. Consequently, paragraph 41 of IAPS 1005 **will be withdrawn** when the revised ISA 260 becomes effective. Respondents are asked to comment on whether, in their opinion, considerations in the audit of small entities have been dealt with appropriately in the proposed revised ISA 260 (see in particular the discussion above regarding "All of Those Charged with Governance Involved in the Management of the Entity"). Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

Special Considerations in the Audit of Public Sector Entities

Where considered necessary, any special considerations in the audit of public sector entities have also been included in this proposed revised ISA. These issues were addressed with the assistance of a nominee of the Auditing Standards Committee of the International Organization of Supreme Audit Institutions. Respondents are asked to comment on whether, in their opinion, special considerations in the audit of public sector entities have been dealt with appropriately in this proposed revised ISA. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

Developing Nations

Recognizing that many developing nations have adopted or are in the process of adopting the ISAs, the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties in applying the proposed revised ISA in a developing nation environment. Reasons should be provided, as well as alternative or additional guidance.

Translations

Recognizing that many respondents intend to translate this proposed revised ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing this proposed revised ISA.

PROPOSED INTERNATIONAL STANDARD ON AUDITING 260 (REVISED)

THE AUDITOR'S COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

(Effective for audits of financial statements for periods beginning on or after December 15, 2006)

CONTENTS

Appendix: Qualitative Aspects of Accounting Practices, Including Accounting Policies, Accounting Estimates and Financial Statement Disclosures

International Standard on Auditing (ISA) 260 (Revised), "The Auditor's Communication with Those Charged with Governance" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services," which sets out the application and authority of ISAs.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's communication with those charged with governance in relation to an audit of financial statements. While this ISA applies to all financial statement audits irrespective of governance structure or the size of the entity, particular considerations apply where all of those charged with governance are involved in managing an entity,[1] and for listed entities.[2]

2. The standards and guidance in this ISA are to be adapted, as necessary, for audits of historical financial information other than financial statements.

3. This ISA provides an overarching framework for the auditor's communication with those charged with governance and identifies some specific matters to be communicated to them. Additional matters to be communicated, which complement the requirements of this ISA, are identified in other ISAs (see paragraph 44).

4. **The auditor should communicate to those charged with governance, on a timely basis, matters related to the financial statement audit that are relevant to the responsibilities of those charged with governance.**

5. The principal purposes of communication with those charged with governance are for the auditor to:

   (a) Establish a mutual understanding of the scope and timing of the audit, and of the respective responsibilities of the auditor, those charged with governance and management;

   (b) Provide those charged with governance with timely observations arising from the audit that are relevant to their responsibilities; and

   (c) Share other information that will assist the auditor and those charged with governance to fulfill their respective responsibilities.

6. This ISA focuses primarily on communications from the auditor to those charged with governance. Effective two-way communication is also important to assist the auditor and those charged with governance to understand issues in context, and develop a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity. The auditor communicates issues clearly and unequivocally with those charged with governance, and reasonably expects those charged with governance to communicate in the same manner.

---

1 See paragraphs 20(b), 21 and 33.

2 See paragraph 49.

7. In this ISA:

   (a) "Those charged with governance" means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting and disclosure process. In some cases, those charged with governance are responsible for approving[3] the financial statements (in other cases management has this responsibility).

   (b) "Management" means the person(s) who have executive responsibility for the conduct of the entity's operations. In some entities, management includes some or all of those charged with governance, e.g., executive directors, or owner-managers. Management is responsible for preparing the financial statements, overseen by those charged with governance, and in some cases management is also responsible for approving[3] the financial statements (in other cases those charged with governance have this responsibility).

   (c) "Additional external requirements" means requirements imposed on the auditor with respect to a particular engagement that are not included in the ISAs. Examples may include: the standards of national professional accountancy bodies; legislation; regulation; and listing rules.

8. The remainder of this ISA is structured as follows:

   (a) *Those charged with governance:* This section discusses the diversity of governance structures and processes, and notes that the auditor's understanding of the entity and its environment is used to determine the relevant person(s) with whom to communicate particular matters.

   (b) *Matters to be communicated.* This section identifies the matters the auditor is required to communicate, including the auditor's responsibilities, the planned scope and timing of the audit, matters related to the conduct of, and findings from the audit, and a statement of auditor independence.

   (c) *The communication process.* This section discuses such matters as the form and timing of communications, which vary with the engagement circumstances.

   (d) *Legal considerations.* This section notes that certain legal requirements can affect the communication process.

Those Charged with Governance

9. **The auditor should determine the relevant person(s) in the entity's governance structure to whom to communicate particular matters.**

---

3 "Approving" in this context means they have the authority to conclude that the entity's complete set of financial statements, including the related notes, has been prepared – see paragraphs 55 and 56 of ISA 700 (Revised), "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements."

10. Governance structures vary by jurisdiction and by entity, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. For example:
    - In some jurisdictions a supervisory (wholly or mainly non-executive) board exists that is legally separate from an executive (management) board. In other jurisdictions, both the supervisory and executive functions are the legal responsibility of a single, unitary board.
    - In some entities, those charged with governance hold positions that are an integral part of the entity's legal structure, e.g., company directors. For other entities, a body that is not part of the entity is charged with governance, e.g., as with some government agencies.
    - In some cases, some or all of those charged with governance are involved in managing the entity. In other cases, those charged with governance and management comprise different people.

11. In most entities, governance is the collective responsibility of a board of directors, a supervisory board, partners, proprietors, a committee of management, a council of governors, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, e.g., the owner-manager where there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup such as an audit committee, or even an individual may be charged with specific tasks to assist the governing body as a whole in meeting its responsibilities. Alternatively, a subgroup or individual may have specific, legally identified responsibilities that differ from those of the governing body as a whole.

12. Such diversity means it is not possible for this ISA to specifically identify for all audits, the person(s) with whom the auditor is to communicate particular matters. In deciding with whom to communicate particular matters, the auditor uses the understanding of an entity's governance structure and processes obtained in accordance with paragraph 25 of ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement."

13. When the entity's governance structure is not formally defined such that the relevant person(s) in the entity's governance structure with whom to communicate particular matters may not be clearly identifiable, the auditor and the engaging party agree on the person(s) with whom the auditor will communicate particular matters. Examples of entities where the governance structure may not be formally defined include some family-owned entities, some not-for-profit organizations, and some government agencies.

Communication with a Subgroup of Those Charged with Governance

14. When considering communicating with a subgroup of those charged with governance, or an individual, the auditor takes into account such matters as:
    - The respective responsibilities of the subgroup, or individual, and the governing body as a whole.
    - The nature of the matter to be communicated.
    - Relevant legal or regulatory requirements.

- Whether the subgroup, or individual, (a) has the authority to act on the information conveyed by the auditor, and (b) can provide further information and explanations the auditor may need.
- Whether there is also a need to convey the information, in full or in summary form, to the governing body as a whole. This decision may be influenced by the auditor's assessment of how effectively and appropriately the subgroup, or individual, conveys relevant information to the governing body as a whole. Unless prevented by law, the auditor retains the right to communicate directly with the governing body as a whole, a fact the auditor may make explicit in agreeing the terms of engagement.

15. Communication with an audit committee, where one exists, has become a key element in the auditor's communication with those charged with governance. Good governance principles suggest that: the auditor will be invited to regularly attend meetings of the audit committee; the chair of the audit committee and, when relevant, the other members of the audit committee, will liaise with the auditor periodically; and the audit committee will ordinarily meet the auditor without management present at least annually. The auditor considers whether communication with the audit committee alone adequately fulfills the auditor's responsibility to communicate with those charged with governance, taking into account the considerations referred to in the previous paragraph. In some circumstances, the auditor may also need to communicate with the governing body as a whole.

Group Audits

16. When the entity being audited is a component of a group, depending on the engagement circumstances, the appropriate person(s) with whom to communicate on a particular matter may be those charged with governance of the group in addition to, or instead of (for some wholly-owned components), those charged with governance of the component. In some cases there is a legal obligation for the auditor of a component to communicate to those charged with governance of the group or the group auditor.

Communication with Management

17. Many matters are discussed with management in the ordinary course of an audit, including matters identified in this ISA as being appropriate to communicate with those charged with governance. Such discussions recognize management's executive responsibility for the conduct of the entity's operations and, in particular, management's responsibility for preparing the financial statements.

18. Before communicating matters with those charged with governance, the auditor ordinarily discusses them with management unless it is inappropriate to do so, e.g., it may not be appropriate to discuss questions of management's competence or integrity. In addition to recognizing management's executive responsibility, these initial discussions can clarify facts and issues, and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with the internal auditor before communicating with those charged with governance. If doing so will aid the understanding of those charged with governance, the auditor ordinarily

includes in communications, comments made by management or the internal auditor, and actions management has indicated it will take.

19. Communication by management with those charged with governance regarding the auditor's responsibilities, the planned scope and timing of the audit, and auditor independence does not relieve the auditor of the responsibility to also communicate these matters with those charged with governance. Other matters required by this ISA are also included in the auditor's direct communications with those charged with governance, unless management agrees to communicate them to those charged with governance, and the auditor is satisfied that this is appropriate and such matters have been effectively and appropriately communicated by management.

When All of Those Charged with Governance are Involved in Managing the Entity

20 In some cases, all of those charged with governance are involved in managing the entity, e.g., a small business where a single owner manages the entity and no one else has a governance role. In these cases:

(a) If matters required by this ISA are communicated to person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again to those same person(s) in their governance role; and

(b) Matters that are required to be communicated but are relevant only to the oversight function of those charged with governance, ordinarily require no action on the part of the auditor because there is no oversight separate from management (see paragraph 33).

21. In such cases, the auditor nonetheless considers whether communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. For example, in a company where all directors are family members involved in managing the entity, some of those directors (e.g., one responsible for marketing) may be unaware of significant matters discussed with another director (e.g., one responsible for the preparation of the financial statements).

Matters to be Communicated

22. The auditor communicates the following with those charged with governance:

(a) The auditor's responsibilities;

(b) The planned scope and timing of the audit;

(c) The conduct of, and findings from the audit;

(d) Matters required by other ISAs and additional external requirements, and matters agreed with the entity;

(e) Other matters of which the auditor is aware that the auditor judges to be serious and relevant to the responsibilities of those charged with governance; and

(f) In the case of listed entities, auditor independence.

These matters are discussed in the following sections.

The Auditor's Responsibilities

23. **The auditor should communicate to those charged with governance the responsibilities of the auditor.**

24. The auditor communicates with those charged with governance that the auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared and presented by the entity, and that the audit of the financial statements does not relieve the entity of its responsibilities.

25. In communicating the auditor's responsibilities, the auditor conveys that:

    - The auditor is responsible for communicating matters required by ISAs. These include significant matters arising from the audit of the financial statements that are relevant to those charged with governance in overseeing the financial reporting and disclosure process.
    - ISAs do not require the auditor to design procedures for the specific purpose of identifying other matters to communicate with those charged with governance, however, the auditor will communicate other matters of which the auditor becomes aware that are, in the auditor's professional judgment, serious and relevant to the responsibilities of those charged with governance.
    - When applicable, the auditor is also responsible for communicating matters required by an agreement with the entity or additional external requirements.

26 An agreement with the entity or additional external requirements may provide for broader communication with those charged with governance. For example, an agreement with the entity may provide for particular matters to be communicated when they arise from services provided by a firm or network firm other than the financial statement audit; or the mandate of a public sector auditor may provide for matters to be communicated that come to attention as a result of other work such as performance audits.

Planned Scope and Timing of the Audit

27. **The auditor should communicate an outline of the planned scope and timing of the audit to those charged with governance.** Communication of the planned scope and timing assists those charged with governance to, e.g., understand better the consequences of the auditor's work for their oversight activities, confer with the auditor regarding issues of risk and materiality, and identify any areas in which they may request the auditor to undertake additional procedures.

28. Care is required when communicating with those charged with governance about the scope and timing of the audit, not to compromise the effectiveness of the audit, particularly where those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures could make those procedures too predictable.

29. Matters communicated ordinarily include the following:

- How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error.
- The auditor's approach to internal control relevant to the audit.
- The application of materiality in the audit. The auditor explains that (a) both qualitative and quantitative factors are considered when making materiality judgments, and (b) due to the inherent limitations of an audit, which is designed to obtain reasonable assurance that material misstatements will be detected, not all material misstatements may be detected.
- Any significant limitations or additional external requirements that apply to the engagement.
- The nature of any matters the auditor has agreed to communicate with those charged with governance.

30. Other planning matters that it may be appropriate to discuss with those charged with governance include:

- Where the entity has an internal audit function, the extent to which the auditor will use the work of internal audit, and how the external and internal auditors can best work together in a constructive and complementary manner.
- The views of those charged with governance of:
    - The relevant person(s) in the entity's governance structure with whom the auditor is to communicate particular matters.
    - The allocation of responsibilities between those charged with governance and management.
    - The entity's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements.
    - Particular matters those charged with governance consider should influence the auditor's materiality decisions, or may otherwise influence the audit of the financial statements.
- The attitudes, awareness, and actions of those charged with governance concerning the entity's internal control and its importance in the entity, and how those charged with governance oversee the effectiveness of internal control.
- Any matters in relation to which the auditor will perform procedures in addition to those required by ISAs and additional external requirements, in response to a request from those charged with governance or management.
- The actions of those charged with governance in response to developments in law, accounting standards, corporate governance reporting, exchange listing rules, and other matters relevant to the entity's financial statements and annual report.

- How those charged with governance have responded to previous communications with the auditor.

31. While communication with those charged with governance may assist the auditor in planning the scope and timing of the audit, it does not change the auditor's sole responsibility to determine the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.

Conduct of and Findings from the Audit

32 **In addition to the matters required by paragraph 43 to be communicated to those charged with governance, the auditor should communicate:**

(a) **The auditor's views about the qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures** (see paragraphs 34-35);

(b) **Significant difficulties encountered during the audit** (see paragraph 36);

(c) **Uncorrected misstatements, other than those the auditor believes are clearly trivial** (see paragraphs 37-39); and

(d) **Other significant matters, if any, arising from the audit that are relevant to those charged with governance regarding the financial reporting and disclosure process** (see paragraphs 40).

33. **Unless all those charged with governance are involved in managing the entity, the auditor should also communicate:**

(a) **Material, corrected misstatements that were brought to the attention of management as a result of audit procedures.** Other corrected misstatements may also be communicated (see paragraph 41);

(b) **A summary of representations the auditor is requesting from management.** In some cases, the auditor may request both management and those charged with governance to sign a representation letter. The auditor explains the significance of representations that have been requested relating to non-standard issues; and

(c) **Major issues that were discussed, or subject to correspondence with management** (see paragraph 42).

Qualitative Aspects of Accounting Practices

34. Financial reporting frameworks ordinarily permit the entity to choose, in some areas, the specific accounting practices it will adopt. They allow for the entity to make accounting estimates, and judgments about accounting policies and financial statement disclosures. The auditor communicates openly and constructively, the auditor's views on both the quality and the acceptability of significant accounting practices adopted by the entity. The appendix provides guidance on the matters that may be included in this communication.

35. The auditor explains to those charged with governance why the auditor considers a significant accounting practice not to be appropriate and, when considered necessary, requests that changes be made. If requested changes are not made, the auditor informs those charged with governance that the auditor will consider the effect of this on the financial statements of the current and future years, and on the auditor's report.

Significant Difficulties Encountered

36. Significant difficulties encountered during the audit may include such matters as: significant delays in management providing required information; an unnecessarily brief time within which to complete the audit; extensive unexpected effort required to obtain sufficient appropriate audit evidence; the unavailability of expected evidence; and management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.

Uncorrected Misstatements

37. In accordance with [proposed] ISA 320 (Revised), "Materiality in the Identification and Evaluation of Misstatements," the auditor requests management to correct all known misstatements, other than those that the auditor believes are clearly trivial. If such misstatements remain uncorrected, the auditor communicates them to those charged with governance, again requesting their correction. The auditor addresses material misstatements individually. Where there is a large number of small uncorrected misstatements, it may aid communication if the auditor provides those charged with governance with a summary noting the number and overall monetary effect of the misstatements, rather than communicating the details of each individual misstatement.

38. The auditor ordinarily discusses with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, having regard to qualitative as well as quantitative considerations, including possible implications in relation to future financial statements.

39. To reduce the possibility of misunderstandings, the auditor may request a written representation from those charged with governance that explains why misstatements brought to their attention have not been corrected. Obtaining the representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

Other Matters Relevant to the Financial Reporting and Disclosure Process

40. Other significant matters arising from the audit that are relevant to those charged with governance in overseeing the financial reporting and disclosure process may include such matters as material misstatements of fact or material inconsistencies in information accompanying the audited financial statements, that have been corrected.

Corrected Misstatements

41. Communication of corrected misstatements identified as a result of audit procedures is important in assisting those charged with governance to fulfill their responsibility to oversee the financial reporting and disclosure process. The auditor may consider it appropriate to also

communicate other corrected misstatements, e.g., frequently recurring immaterial misstatements that indicate a particular bias in the initial preparation of the financial statements.

Major Issues Discussed, or Subject to Correspondence with Management

42. Major issues discussed, or subject to correspondence with management may include such matters as concerns about management's consultations with other accountants on accounting or auditing matters,[4] and discussions or correspondence in connection with the initial or recurring appointment of the auditor regarding accounting practices, the application of auditing standards, or fees for audit or other services.

Other ISAs, Additional External Requirements, and Matters Agreed with the Entity

43. **The auditor should communicate to those charged with governance:**

    (a) **Matters that other ISAs or additional external requirements require to be communicated; and**

    (b) **Matters that have been agreed with those charged with governance or management to be communicated.**

44. Other ISAs require communication with those charged with governance of matters such as:

- Material weaknesses in the design or implementation of internal control that could have a material effect on the financial statements that have come to the auditor's attention (ISA 315, paragraph 120).
- Fraud the auditor has identified that involves:
    - Management;
    - Employees who have significant roles in internal control; or
    - Others where the fraud results in a material misstatement in the financial statements (ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements," paragraph 95).
- Noncompliance with laws and regulations that comes to the auditor's attention (ISA 250, "Consideration of Laws and Regulations," paragraph 32).
- Events or conditions that may cast significant doubt on the entity's ability to continue as a going concern (ISA 570, "Going Concern," see proposed conforming amendment at the end of this Exposure Draft).
- Circumstances that lead to expected modifications to the opinion in the auditor's report ([proposed] ISA 705, "Modifications to the Opinion in the Independent Auditor's Report," paragraph 36).

4 See paragraph 210.18 of the [proposed revised] IFAC Code of Ethics for Professional Accountants, or relevant ethical requirements, for ethical considerations regarding communication between the other accountant and the auditor.

45. Matters agreed with those charged with governance or management to be communicated may relate either to the responsibility of those charged with governance to oversee the financial reporting and disclosure process, or other responsibilities. In some cases, the auditor may be required to perform additional procedures to identify such matters; in other cases the auditor may be required to communicate only those matters that come to the auditor's attention as part of the audit of the financial statements.

Other Matters

46. **The auditor should communicate to those charged with governance other matters of which the auditor is aware that, in the auditor's professional judgment, are serious and relevant to the responsibilities of those charged with governance.**

47. Such matters, which may arise from the audit of the financial statements or otherwise come to the attention of the auditor, include, e.g., significant decisions or actions by senior management that lack appropriate authorization, and seriously deficient governance structures or processes.

48. Unless the auditor is required by additional external requirements or by an agreement with the entity to undertake procedures to determine whether matters such as those noted in the preceding paragraph have occurred, in reporting such matters, the auditor makes those charged with governance aware that:

    (a) The matters were identified as a by-product of the audit, and therefore no procedures were carried out in addition to those necessary to form an opinion on the financial statements;

    (b) No procedures have been undertaken to determine whether other matters of the nature of the items reported have occurred; and

    (c) When appropriate, these matters have been discussed with management.

Auditor Independence

49. **In the case of listed entities,[5] the auditor should communicate, at least annually, in writing to those charged with governance:**

    (a) **A statement that the engagement team and others in the firm as appropriate,[6] the firm and, when applicable, network firms are independent in accordance with**

---

5 The [proposed revised] IFAC Code of Ethics for Professional Accountants defines a listed entity as: "An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body."

6 Paragraph 290.1 of the [proposed revised] IFAC Code of Ethics for Professional Accountants requires that members of assurance teams, firms and, when applicable, network firms be independent of assurance clients. In addition to the members of the engagement team, the [proposed revised] Code includes as part of the assurance team, "all others within a firm who can directly influence the outcome of the assurance engagement." See the definitions section of the [proposed revised] Code for further elaboration.

relevant ethical requirements[7] and any additional external requirements that apply to the engagement; and

(b) (i) **All relationships and other matters between the firm, network firms and the entity that in the auditor's professional judgment may reasonably be thought to bear on independence,[8] including total fees charged in the preceding 12 months for audit and for non-audit services provided by the firm and network firms to the entity and components included in its financial statements,[9] allocated to appropriate categories; and**

(ii) **The related safeguards that have been applied to eliminate threats to independence or reduce them to an acceptable level.**

50. The relationships and other matters, and safeguards to be communicated vary with the circumstances of the engagement, but generally address the relevant matters set out in Section 290 of the [proposed revised] IFAC Code of Ethics for Professional Accountants. Section 290 provides guidance, including application to specific situations, on:

(a) Threats to independence, categorized as: self-interest threats, self-review threats, advocacy threats, familiarity threats, and intimidation threats; and

(b) Safeguards created by the profession, legislation or regulation, safeguards within the entity, and safeguards within the firm's own systems and procedures.

51. The auditor considers whether the communications set out in paragraph 49 are also appropriate in the case of entities that are not listed entities. Communications regarding independence may be unnecessary, e.g., where all of those charged with governance have been informed of relevant facts through their management activities. This is particularly likely to be the case where the entity is owner-managed, and the auditor's firm and network firms have little involvement with the entity beyond an annual audit.

The Communication Process

52. **The auditor should seek to establish with those charged with governance a mutual understanding of the form, timing and expected general content of communications.**

53. The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor's view of the importance of matters to be communicated. For example, the auditor will often communicate more formally with those charged with governance of listed companies than small entities.

---

7 Relevant ethical requirements ordinarily comprise Section 290 of the [proposed revised] IFAC Code of Ethics for Professional Accountants and relevant national ethical requirements.

8 Note for Exposure Draft: This requirement is consistent with paragraph 290.21 of the [proposed revised] Code of Ethics for Professional Accountants. If, prior to finalization of this ISA, paragraph 290.21 changes as a result of the due process currently underway for the [proposed revised] Code, paragraph 49(b)(i) will be changed to be consistent with it.

9 See [proposed] ISA 600 (Revised), "The Audit of Group Financial Statements" for the definition of "component."

Establishing Expectations

54. To help establish effective two-way communication, the expectations of both the auditor and those charged with governance regarding the form, timing and general content of communications are established at an early stage of the audit. Communication of the auditor's responsibilities (paragraphs 23-26) and the planned scope and timing of the audit (paragraphs 27-31) form the basis for establishing expectations. How these expectations are established will vary, reflecting the size and governance structure of the entity and how those charged with governance operate.

55. Matters that may be discussed in establishing expectations include:
    - The form in which communications will be made.
    - The person(s) with whom the auditor will communicate particular matters.
    - The purpose of communications. When the purpose is clear, the auditor and those charged with governance are better placed to have a mutual understanding of relevant issues and the expected actions arising from the communication process.
    - The process for taking action and reporting back on matters communicated by the auditor.
    - Any agreed extension of the auditor's responsibilities beyond those established by ISAs and additional external requirements that apply to the engagement.

Forms of Communication, and Documentation

56. **The auditor should issue a written communication to those charged with governance regarding significant matters arising from the conduct of, and findings from the audit**. This communication need not include all matters that arose during the course of the audit that were raised with those charged with governance but have subsequently been satisfactorily resolved. **Where matters relevant to the responsibilities of those charged with governance were communicated orally, the auditor should be satisfied that they are recorded in minutes of the discussion or the audit working papers.**

57. Effective communication ordinarily involves informal communications, including discussions, as well as formal presentations and written reports. The auditor's communications regarding paragraphs 49 and 56 are required to be in writing. Other communications may be oral or in writing.

58. In addition to the significance of a particular matter, whether to communicate orally or in writing is affected by such factors as:
    - The size, operating structure, control environment, and legal structure of the entity being audited.
    - Legal requirements. In some jurisdictions, a written communication to those charged with governance regarding the conduct of, and findings from each audit is required in a prescribed form by local law

- Arrangements made for periodic meetings or reporting.
- The amount of ongoing contact and dialogue the auditor has with those charged with governance.

59. When a significant matter is discussed informally with an individual member of those charged with governance, e.g., the chair of an audit committee, the auditor ordinarily summarizes the matter in later formal communications so that the others charged with governance have full and balanced information.

Confidentiality

60. On occasions, those charged with governance may wish to provide third parties, e.g., bankers or certain regulatory authorities, with copies of a written communication from the auditor. In some cases, that disclosure may not be appropriate. When providing to third parties a written communication prepared for those charged with governance, it is important to inform the third parties that the communication was not prepared with them in mind. The auditor therefore ordinarily states in written communications to those charged with governance that:

    (a) The communication has been prepared for the sole use of those charged with governance and, where applicable, the group management and the group auditor;

    (b) No responsibility is assumed by the auditor to other persons; and

    (c) It is not to be disclosed to a third party, or quoted or referred to, without the auditor's prior written consent.

61. In certain jurisdictions, and particularly in the public sectors, the auditor may have a duty to submit copies of certain reports prepared for those charged with governance to relevant regulatory, funding or other bodies. Similarly, there may be a requirement that reports will be made public. In such circumstances, application of the preceding paragraph is modified appropriately. Further, unless required by law or regulation to provide a third party with a copy of the auditor's written communications to those charged with governance, the auditor may require the prior consent of those charged with governance before doing so.

Timing of Communications

62. **Communications to those charged with governance should be made on a sufficiently timely basis to enable them to take appropriate action.**

63. The appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include the nature of the matter to be communicated, for example:

    - Findings from the audit that are relevant to the financial statements or the auditor's report, including the auditor's views about the qualitative aspects of the entity's accounting practices, are communicated before the financial statements are completed.
    - Communications regarding independence will be appropriate: before the financial statements are completed; and whenever significant judgments are made about threats to

independence and related safeguards, e.g., when accepting an engagement to provide non-audit services.

- Communications regarding planning matters will ordinarily be made early in the audit engagement and, for an initial engagement, may be made as part of agreeing the terms of the engagement.

64. The time at which the auditor identifies certain matters is also relevant to the timing of communications, e.g., the auditor may identify matters that need to be communicated to those charged with governance without delay, such as the existence of a material weakness in internal control. In some circumstances, the auditor may not identify a particular matter (e.g., noncompliance with a law) in time for preventive action to be taken, but communication of the matter may enable remedial action to be taken.

Adequacy of the Communication Process

65. **The auditor should evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit and, if it has not, should take appropriate action as required.**

66. Effective two-way communication assists the auditor and those charged with governance to understand issues in context, and develop a constructive working relationship. Further, paragraph 69 of ISA 315 identifies participation by those charged with governance, including their interaction with internal audit, if any, and external auditors, as an element the auditor considers when evaluating the design of the entity's control environment. Inadequate two-way communication may indicate an unsatisfactory control environment, which will influence the auditor's assessment of the risks of material misstatements. Examples of evidence about the adequacy of the two-way communication between the auditor and those charged with governance may include:

- The appropriateness and timeliness of actions taken by those charged with governance in response to matters raised by the auditor. Where significant matters raised in previous communications have not been dealt with effectively, the auditor enquires as to why appropriate action has not been taken and considers raising the point again. This avoids the risk of giving an impression that the auditor is satisfied that the matter has been adequately addressed or is no longer significant.
- The apparent openness of those charged with governance in their communications with the auditor.
- The willingness and capacity of those charged with governance to meet with the auditor without management present.
- The apparent ability of those charged with governance to fully comprehend matters raised by the auditor, e.g., the extent to which those charged with governance probe issues, and question recommendations made to them.
- Difficulty in establishing with those charged with governance a mutual understanding of the form, timing and expected general content of communications.

- Where all of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities.

67. If the two-way communication between the auditor and those charged with governance is not adequate for an effective audit, there is a risk the auditor may not have obtained all the audit evidence required to form an opinion on the financial statements. Consequently, the auditor takes actions such as:

- Modifying the auditor's report on the basis of a scope limitation.
- Obtaining legal advice about the consequences of different courses of action.
- Communicating with third parties (e.g., a regulator), or a higher authority in the governance structure that is outside the entity, such as the minority owners of a small private business, or the responsible government minister or Parliament in the public sector.
- Withdrawing from the engagement where permitted in the relevant jurisdiction.

Legal Considerations

68. In some jurisdictions there may be circumstances where the auditor is required to report to a regulatory or enforcement body certain matters communicated with those charged with governance. For example, in some countries the auditor has a duty to report misstatements to authorities where management and those charged with governance fail to take corrective action.

69. In some circumstances, the auditor may be prevented by law from communicating certain matters to those charged with governance, or others, within the entity. For example, local laws may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual or suspected illegal act, e.g., where the communication, or other action, could alert the perpetrator of an illegal act to the fact that it had been detected. Local laws that prevent the auditor from applying a requirement of this ISA may constitute a scope limitation that results in a modification of the auditor's report. In such circumstances the auditor ordinarily seeks legal advice.

Effective Date

70. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2006.

Appendix

Qualitative Aspects of Accounting Practices, Including Accounting Policies, Accounting Estimates and Financial Statement Disclosures

The communication required by paragraph 32(a) may include such matters as:

Accounting Policies

- The appropriateness of the accounting policies to the particular circumstances of the entity, having regard to the need to balance the cost of providing information with the likely benefit to users of the entity's financial statements. Where acceptable alternative accounting policies exist, the communication could include identification of the financial statement items that are affected by the choice of significant policies as well as information on accounting policies used by similar entities.
- The initial selection of, and changes in significant accounting policies, including the application of new accounting pronouncements. The communication could include: the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity; and the timing of a change in accounting policies in relation to expected new accounting pronouncements.
- The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative guidance or consensus).
- The effect of the timing of transactions in relation to the period in which they are recorded.

Accounting Estimates

- For major items for which estimates are significant, issues discussed in [proposed] ISA 540 (Revised), "Auditing Accounting Estimates and Related Disclosures (Other than Those Involving Fair Value Measurements and Disclosures)" and ISA 545, "Auditing Fair Value Measurements and Disclosures" including, for example:
  - Management's identification of accounting estimates.
  - Management's process for making accounting estimates.
  - Risks of material misstatement.
  - Indicators of possible management bias.
  - Disclosure of estimation uncertainty in the financial statements.

Financial Statement Disclosures

- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (e.g., disclosures related to revenue recognition, going concern, subsequent events and contingency issues).

- The overall neutrality, consistency and clarity of the disclosures in the financial statements.

Related Matters

- The potential effect on the financial statements of significant risks and exposures, and uncertainties, such as pending litigation, that are disclosed in the financial statements.
- The extent to which the financial statements are affected by unusual transactions including non-recurring amounts recognized during the period, and the extent to which such transactions are separately disclosed in the financial statements.
- The factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible assets. The communication could explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements.
- The selective correction of misstatements, e.g., correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings.

PROPOSED CONFORMING AMENDMENTS

INTERNATIONAL STANDARD ON AUDITING 570

GOING CONCERN

Communication with Those Charged with Governance

39a. **The auditor should communicate events or conditions that may cast significant doubt on the entity's ability to continue as a going concern to those charged with governance.**

39b. When events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor discusses with those charged with governance:

(a) Whether the events or conditions constitute a material uncertainty;

(b) Whether use of the going concern assumption is appropriate in the preparation of the financial statements; and

(c) The adequacy of related disclosures in the financial statements.

International Federation of Accountants
545 Fifth Avenue, 14th Floor, New York, NY 10017 USA
Tel +1 (212) 286-9344 Fax +1(212) 286-9570 www.ifac.org