Group audits and component auditors

MODULE 3 | 3.6.1 | STUDENT COMPANION

The **group engagement partner** is responsible for the whole group audit, including directing, supervising and reviewing the work of **component auditors**. The group auditor decides where work is needed by **risk**, not just size; expects access to information and people from the start; evaluates and instructs component auditors and understands their work; sets **component performance materiality** below group performance materiality; and audits the **consolidation** in its own right.

The standard and its terms

Group audits follow the revised international standard on group audits (ASA 600 in Australia), which applies to periods beginning on or after 15 December 2023 and takes a risk-based approach. A **component** is whatever unit the group auditor chooses for planning and performing the work. A **component auditor** is any auditor who performs work on a component for the group audit, whether from the same firm, a network firm or an unrelated firm.

Who's who in a group audit



What counts as a component?

Whatever unit the group auditor chooses for planning and performing the work: a subsidiary, a division, a shared function such as a central payroll centre, or a combination

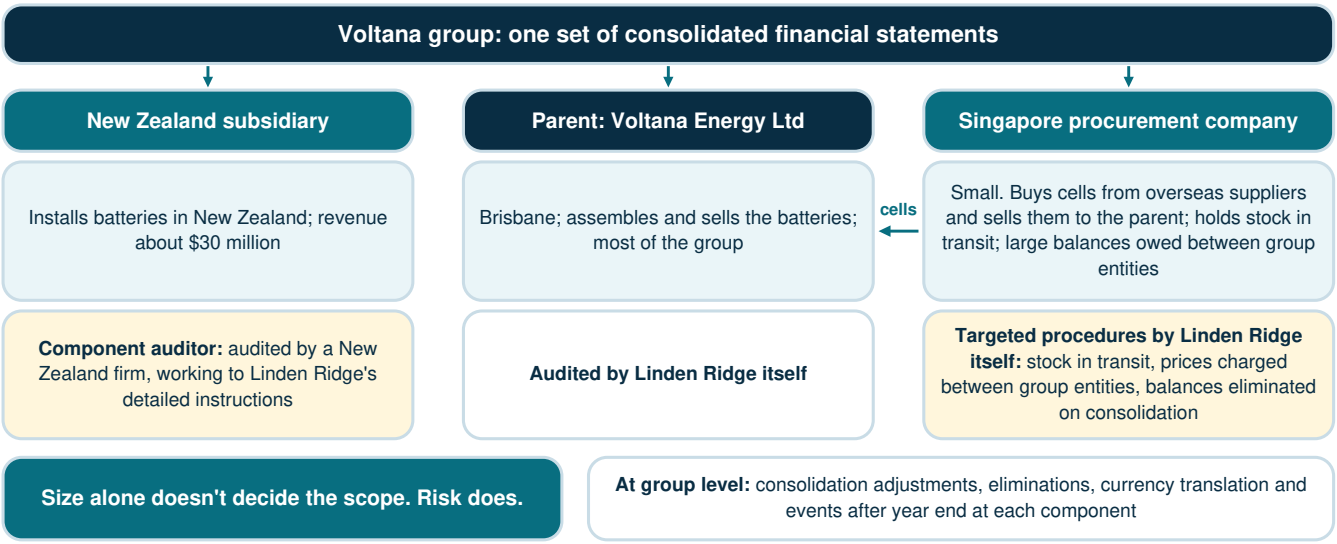
Deciding where work is needed

The group auditor first understands the group, its components and the consolidation process, then works out where the group financial statements could be materially misstated, and only then decides which components need work, and what kind.

Kind of work	When it suits
An audit of the component's financial information	Components that are large, or that carry risks across many of their balances
Audit procedures on specific balances or risks	Components where the risk sits in particular items, such as stock in transit or balances between group entities
No further work there, beyond the group auditor's own risk assessment at group level	Small, low-risk components

Access comes first. When deciding whether to accept the engagement, the group auditor considers whether it can reasonably expect sufficient appropriate evidence, including access to information and to people at the components. Serious restrictions can make that evidence unobtainable, leading to a declined engagement or a disclaimer of opinion.

Scoping the Voltana group

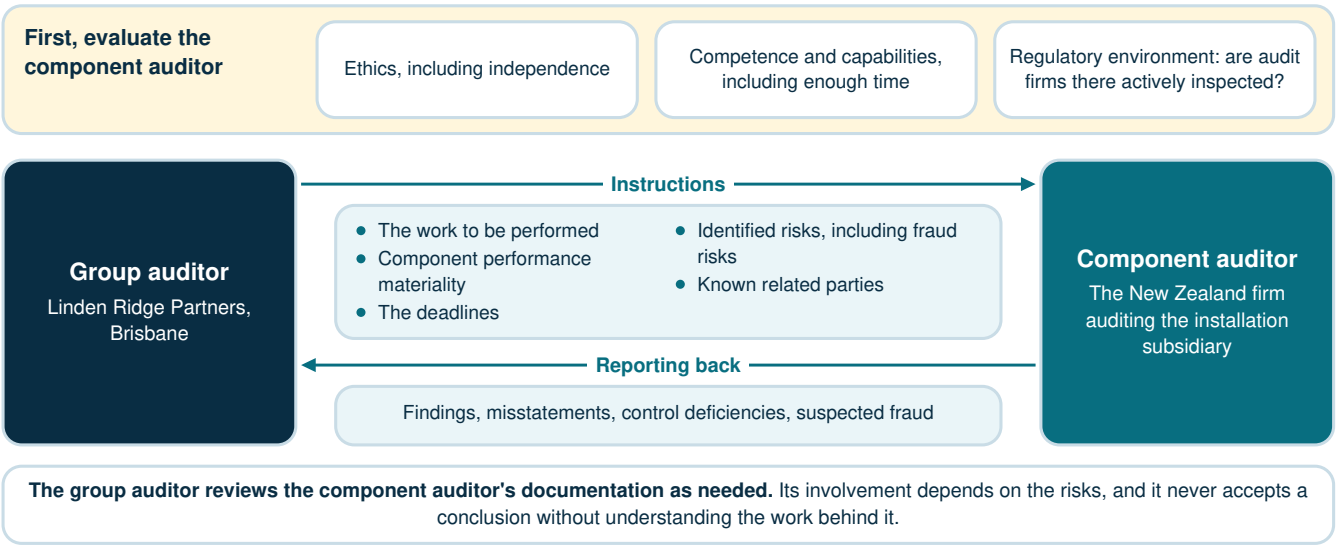


Why Singapore gets attention. It is the smallest component, but stock in transit, the prices charged between group entities and the balances to be eliminated are all places where the group numbers can go wrong, so Linden Ridge tests them itself.

Using a component auditor

Before using a component auditor, the group auditor considers whether it understands and will comply with the relevant ethical requirements, including independence, and whether it has the competence and capabilities the work needs, including enough time. The regulatory environment matters too, such as whether audit firms in that country are actively inspected.

Working with a component auditor



Materiality and the consolidation

Aggregation risk. If every component were audited to the group's full performance materiality, undetected misstatements just below that level in several components could add up to a material misstatement of the consolidated statements. Setting **component performance materiality** below group performance materiality reduces that risk; it need not be the same for every component.

The consolidation process gets its own procedures: consolidation adjustments, the elimination of balances and transactions between group entities, the translation of figures in foreign currencies, and events after year end at each component.

The report. Unless the law requires it, the auditor's report on the group financial statements doesn't refer to a component auditor. The group auditor takes full responsibility for the opinion.

Case note: Sino-Forest

Sino-Forest was listed on the Toronto Stock Exchange and reported that it owned large forestry plantations in China, with reported total assets of about US$5.7 billion. In June 2011 a short seller published a report alleging that the company had greatly exaggerated its assets. The share price collapsed, the company sought creditor protection the following year, and Ontario's securities regulator later found that former senior executives had committed fraud. The company had bought much of its timber through intermediaries, and ownership was hard to establish from documents alone. Its auditor later agreed to pay C$117 million to settle a class action, without admitting liability, and reached a separate settlement with the regulator.

The lesson for group audits: when key assets sit far away, under unfamiliar legal systems, the auditor needs evidence about existence and ownership that it can trust, from sources independent of management, and enough local knowledge to judge it.

Source: Capital Markets Tribunal (Ontario) reasons and decision (July 2018); Ontario Securities Commission order (September 2014); Ontario Superior Court approval of the class action settlement (2013).

Practice questions

MODULE 3 | 3.6.1 | TRY THESE BEFORE THE WORKED ANSWERS

Question 1 - Scope the Varrigan group

Varrigan Cycles Ltd (imagined) is an ASX-listed designer of bicycles and e-bikes. The parent holds the brand and sells online; it has five subsidiaries. Decide what kind of work each subsidiary needs for the group audit, and who should do it.

Subsidiary and facts	Kind of work, and who does it	Why
(a) Varrigan Assembly Pty Ltd (Adelaide). Assembles the bikes; 62% of group revenue; holds most of the group's inventory and its warranty provision.		
(b) Varrigan NZ Ltd. Sells to bike shops in New Zealand; 7% of group revenue; steady trading, no unusual risks; audited by a local firm for its own statutory accounts.		
(c) Varrigan Frames (Vietnam). Makes frames and sells all of them to (a) at prices set by head office; no outside revenue, but 15% of group inventory; a new stock system went live this year; audited by a local firm.		
(d) Varrigan UK Ltd. A European distributor bought on 1 March; 14% of group revenue since then; $38 million of goodwill arose on the purchase; its auditor was appointed by the previous owners.		
(e) Varrigan Finance Pty Ltd. Holds the group's $120 million bank loan, with covenants tested quarterly, and its foreign exchange contracts; no revenue.		

Question 2 - Instructions to a component auditor

Varrigan's group auditor will use the UK firm that audits Varrigan UK Ltd as a component auditor. Draft the main contents of the group auditor's instructions to that firm.

Question 3 - No access to the working papers

The Vietnamese firm that audits Varrigan Frames tells the group auditor that it will not let anyone outside the firm see its working papers. How should the group auditor respond?

Worked answers

MODULE 3 | 3.6.1 | WORKED ANSWERS - ATTEMPT THE QUESTIONS FIRST

Question 1 - Scoping Varrigan (suggested)

	Work, and who	Why
(a) Assembly	An audit of its financial information, by the group team	The largest component; risks in inventory, warranty and revenue
(b) NZ	No further work may be needed beyond the group auditor's own risk assessment at group level	Small, stable and low risk
(c) Frames	Procedures on inventory, the prices charged to (a) and the balances to eliminate	Risk, not size: big inventory share, new stock system, prices set by head office
(d) UK	Audit by the UK firm as component auditor; the group team audits the acquisition accounting	Material and new, with an auditor to evaluate; goodwill and fair values are group judgements
(e) Finance	Specific procedures by the group team, possibly with a valuation expert	The loan, covenants, foreign exchange contracts and hedging all affect the group statements

Question 2 - Main contents of the instructions

Area	What to include
The work	An audit of Varrigan UK's financial information for the group audit, using the group's accounting policies and reporting package, at the group reporting date
Materiality	Component performance materiality, and the amount above which misstatements must be reported to the group team
Risks and related parties	Group risks that affect the component, including fraud risks and those from the acquisition; related parties known to the group, and a request to report any others
Ethics	The ethical requirements, including independence, and a confirmation of compliance
Timetable	Deadlines for planning, interim and final reports; key dates such as the stocktake
Reporting back	Findings; corrected and uncorrected misstatements; control deficiencies; fraud or suspected fraud; breaches of laws; going concern doubts; later events; significant judgements
Access	Which working papers the group team will review, and arrangements for discussions or visits

Question 3 - Refused access to working papers

- **Find out why.** A law that stops audit papers leaving the country, a firm policy or plain reluctance each needs a different answer. A restriction imposed by group or component management is more serious.
- **Look for other routes.** Review the papers at the firm's office or by supervised screen share, hold detailed discussions, and ask Varrigan's management and audit committee to help remove the restriction.
- **Do the work another way.** If the work still can't be understood and evaluated, the group team performs the procedures on inventory and group balances itself, or engages another firm.
- **Consider the opinion.** Without sufficient appropriate evidence, the opinion is modified: qualified, or a disclaimer if the possible effects are pervasive. Tell those charged with governance, document it, and weigh it when deciding whether to continue as auditor.