SSA 600: GROUP AUDITS
HIGHLIGHTS OF TECHNICAL CLINIC

Group audits raise a variety of issues. The group structure can be complex and the existence of numerous components within the group means that there may be several firms of auditors involved. It is therefore crucial that the group engagement team carefully plans and starts communicating with the component auditors early in the audit process. We present here the key points of a technical clinic on group audits.

Q1 What is the definition of a component? Must a component be a legal entity?

Singapore Standards on Auditing (SSA) 600 para 9(a) defines component as "an entity or business activity for which group or component management prepares financial information that should be included in the group financial statements".

Depending on the entity's organisation structure or financial reporting system, a component can be a legal entity or one that is organised by function, product, service, or geographic location. We illustrate with an example of a shipping group of companies that consists of subsidiaries and associates involving business activities, namely ship management, ship owning and ship chartering in various regions. In this example, the component of the group may be identified as (a) an individual subsidiary and associate; (b) an individual business activity; (c) an individual business activity by region; (d) a region, or (e) any other grouping, depending on how the financial reporting structure is organised.

Q2 How do we identify significant component(s) of a group?

SSA 600 states that the group engagement team may consider (a) applying a percentage (that is, 15%) to a chosen benchmark (for example, group assets, liabilities, cash flows, profits or turnover) to identify individual components that are of financial significance, and (b) identifying a component as likely to include significant risks of material misstatement in the group financial statements due to its specific nature of circumstances. When determining significant component of a group, the following should be considered:

❶ Components with insignificant revenue but many capital assets

We illustrate with an example of a group that has subsidiaries with significant revenue and profit and subsidiaries with insignificant revenue but many capital assets. The group engagement team may consider it appropriate to use two benchmarks, profit before tax and gross assets to identify significant component instead of merely sticking to one benchmark.

❷ Components that are loss-making companies

When determining whether components with reported losses are financially significant, the group engagement team should inquire about the reason(s) for the losses, and non-recurring charges that affect the quality of earnings. Take an example of a group comprising profitable components and loss-making components – the group engagement team may use revenue or gross profit instead of

profit/loss before tax to identify individually financially significant components.

❸ Components that carry a higher risk of misstatement

When determining such components, the group engagement team would consider the following scenarios which may indicate likely higher risk of material misstatement:

- A component with no obvious business rationale
- A newly-acquired component
- A component with continued reported losses or current year loss
- A component that is carrying out a specific activity of the group (for example, foreign exchange trading or hedging activity)
- Questionable competency of component management or concern that component management does not have the necessary knowledge of the applicable financial reporting framework
- Fraud risk factors of the components are identified that would indicate a risk of material misstatement due to fraud (for example, history of fraud or allegation of fraud)
- Other factors including:
  - Excessive pressure from the group for the component to meet certain performance targets
  - Significant portion of component management's remuneration is based on achieving performance targets
  - Accounting estimates subject to management bias
  - Risks associated with the location of the component (for example, political or economic instability)

Hence, the group engagement team would have to gather sufficient understanding of the group and circumstances to determine significant component which is not merely a mechanical or mathematical exercise.

Q4 Why is there a need for the group engagement team to identify significant component?

The group engagement team is responsible for providing the audit opinion on the group financial statements and therefore needs to gather sufficient and appropriate audit evidence to support the opinion on the consolidated financial statements. In order to do so, the group engagement team needs to identify significant components of the group that may expose the group to a higher risk of material misstatement either due to the financial significance of the component or due to the nature of the component's business. This is because a material misstatement in the financial statements of a component could become a material misstatement in the financial statement of a group.

> SSA 600 PARA 28 SPECIFICALLY STATES THAT "FOR COMPONENTS THAT ARE NOT SIGNIFICANT, THE GROUP ENGAGEMENT TEAM SHALL PERFORM ANALYTICAL REVIEW AT GROUP LEVEL".

Q5 What should the group engagement partner consider prior to the acceptance of a group audit engagement?

Prior to accepting a new engagement, the group engagement partner should assess the integrity of the potential client; consider whether he has the competence and expertise to take on the engagement, and whether the firm is in compliance with relevant ethical requirements. Specifically relating to the acceptance of group audit engagement, SSA 600 para 12 requires the group engagement team to obtain an understanding of the group, its components, and the environment to the extent that it is sufficient to identify components that are likely to be significant. Using this information, the group engagement partner then evaluates whether the group engagement team can be involved in the work of those component auditors to obtain sufficient appropriate audit evidence to form a basis for the group audit opinion.

Such understanding can be acquired by way of discussion with the group management, inquiry of the previous auditor, search engines like Google or Yahoo, or purchase of the company's business profile through the Accounting and Corporate Regulatory Authority (ACRA) website. Through the information gathered, the group engagement team would be able to understand the composition of the group, components that make up the group's core business activities, group's consolidation process and group-wide control (if any).

Where certain of the group's significant components are being audited by the other auditors, the group engagement partner needs to evaluate if his team can have access

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THE AUDIT ENGAGEMENT TEAM SHOULD CONSIDER DECLINING THE ENGAGEMENT IF THE LIMITATION COULD RESULT IN THE ENGAGEMENT PARTNER GIVING A DISCLAIMED OPINION ON THE GROUP FINANCIAL STATEMENTS.

to these component auditors, their documentation as well as component management. In some circumstances, the group engagement partner may be made aware that they will be denied access to the financial information, management and component auditor of a significant foreign entity of the group. The audit engagement team should consider declining the engagement if the limitation could result in the engagement partner giving a disclaimed opinion on the group financial statements.

Q6 Can the group engagement team perform the audit work of foreign components without involving the foreign audit firm? What are the implications to the overall audit?

SSA 600 does not prohibit the group engagement partner to perform the audit work on foreign components. The group engagement partner can decide whether he wants the group engagement team to perform the audit of the component or rely on the work of the component auditor. If the former is concluded, the group engagement partner needs to make sure the firm has the professional expertise and competency to perform the audit, such as an understanding of the culture and practices, and the legal and financial reporting framework of the component's environment which may affect how the audit is planned and carried out.

We take an example of an audit of a foreign component in China. The tax system in China is complicated and can be difficult for the group engagement team to understand. If the group engagement team does not understand how the tax in China is being computed, this may contribute to a potential risk that the tax element of the foreign component be materially misstated. Further, in the audit of cash and bank balances in China, there are certain banks within certain provinces that do not entertain foreign auditors and the bank confirmation requests have to be made through locally-registered auditors. Consequently, the group engagement team may still consider it necessary to involve another accounting firm that has the required expertise and competency to assist in the audit of certain element(s) of the foreign component.

Q7 If it is an insignificant component, what are the audit works the group engagement team can perform?

SSA 600 para 28 specifically states that "for components that are not significant, the group engagement team shall perform analytical review at group level". The group engagement team would normally perform analytical review procedures on the aggregated financial information of the components that are not significant, to corroborate the group engagement team's conclusion that there are no significant risks of material misstatement. If there is any significant variance from the comparable information for prior periods, management's budgets and expectation formed at planning stage, the group engagement team would need to investigate through inquiry with the group management and consider whether further audit procedures are required to gather the necessary audit evidence.

At times, after performing the audit work on the financial information of significant components, the review of the group-wide controls and consolidation process, and the analytical review procedures at the group level, the group engagement partner may conclude that there is still insufficient appropriate audit evidence gathered to form the group audit opinion.

The group engagement team may then select some non-significant components to perform audit work. In the selection of non-significant components, the group engagement team should include an element of unpredictability that may increase the likelihood of identifying material misstatement of the components' financial information and have it varied on a cyclical basis.

The additional audit work performed on the non-significant component(s) selected involve (a) an audit or review of the non-significant components' financial information using component materiality; (b) an audit of one or more account balances, classes of transactions or disclosures, or (c) any other appropriate audit procedures. The group engagement team can either perform the audit work themselves or request the component auditor to perform the audit work. Last but not least, the group engagement team must have these properly documented. CPA

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