

Mr Arnold Schilder
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529 Fifth Avenue 6th Floor
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The United States of America

Ref: Overview of the Invitation to Comment: *Enhancing Audit Quality in the Public Interest: A focus on Professional Scepticism, Quality Control and Group Audits*

Dear Mr Schilder,



The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the International Auditing and Assurance Standards Board's (IAASB) project *Overview of the Invitation to Comment "Enhancing Audit Quality in the Public Interest: A focus on Professional Scepticism, Quality Control and Group Audits" (Overview of the Invitation to Comment)*. The views expressed in this letter are made from the standpoint of securities regulators with the objective of enhancing investor protection.

ESMA highly welcomes the IAASB efforts in strengthening audit quality, as part of the IAASB Work Plan for 2015-2016. Reliable, transparent, informative and accurate financial reporting is crucial for the proper functioning of capital markets and essential for investors to make informed decisions. Maintaining high quality international standards on auditing (ISAs) that are relevant and effective in a changing financial reporting environment is an important element in promoting high quality audits and therewith high quality financial information.

As highlighted previously¹, ESMA believes that the topics prioritised by the IAASB – professional scepticism, quality control and group audits – are of the utmost importance for ensuring high quality audits. In addressing those aspects, the IAASB should also take into account the following factors: i) the significant judgement required under principles based accounting standards; ii) the increased relation between audit committees and auditors; and iii) the impact of technological developments.

¹ ESMA comment letter on the IAASB Consultation Paper: *IAASB's proposed strategy for 2015-2019 and the IAASB's work program for 2015-2016*, Paris, April 2014, ESMA/2014/363

Professional scepticism and professional judgment are key drivers in ensuring that users of financial statements receive high quality financial information. In view of the importance of professional scepticism for audit quality, ESMA encourages the IAASB to consider this area within a short timeframe. We would suggest addressing the professional scepticism project through both a global coordinated approach of the three International Federation of Accountants (IFAC) standard setting Boards (the International Accounting Education Standards board (IAESB), the International Ethics Standards Board for Accountants (IESBA) and IAASB) and a revision of the relevant individual standards in order to better shape the auditor's behaviour in highly judgmental areas.

ESMA considers the "tone at the top" approach essential in increasing audit quality e.g. by responding to quality risks. Consequently, ESMA welcomes the approach of using the quality management approach (QMA) at a firm level as this will encourage a proactive involvement of the audit firm's leaders as well as engagement partners. Similarly, we believe that the role and responsibilities of the engagement partner and the engagement quality control reviewer should be strengthened and clarified in the relevant auditing standards.

Group audits are particularly important because groups comprise the large majority of listed companies measured by market capitalisation. In that context, ESMA considers crucial that all group components shall benefit from a uniform high level application of the auditing standards and we believe it is important to revise the concept of 'materiality' by developing conceptually sound global guidance and review the related parts in the individual auditing standards.

Finally, in order to develop sound auditing standards and guarantee their proper application ESMA invites the IAASB to consider the developments in the European audit legal framework and to cooperate closely with the audit oversight bodies (such as the Committee of European Auditors' Oversight Bodies (CEAOB) and the International Forum of Independent Audit Regulators (IFIAR)).

Our comments on some of the questions from the Overview of the ITC are set out in the Appendix to this letter. Please do not hesitate to contact us should you wish to discuss all or any of the issues we have raised.

Yours sincerely,

A handwritten signature in blue ink, consisting of several fluid, connected strokes. The signature is positioned above the printed name 'Steven Maijoor'.

Steven Maijoor

Appendix – ESMA's comments on the Overview of the ITC

General Questions

General Remarks

1. ESMA highly welcomes the IAASB efforts in strengthening audit quality and considers that the topics prioritized by the IAASB – professional scepticism, quality control and group audits – are of the utmost importance. Especially in a context marked by the negative effects of the financial crisis and increased negative economic factors, high quality audit is essential in maintaining market confidence and ensuring investor protection. Professional scepticism and professional judgment are key drivers in ensuring that users of financial statements receive high quality financial information on which they can make informed decision, thus allowing efficient allocation of capital in the markets. In that respect, the audit mission has to be conducted with a primary goal of public interest without being altered by any other interest of the audited company or the audit firm.
2. Challenging economic factors (such as increased volatility, low interest rates, etc.) put additional pressure on understanding the underlying economics and the financial reporting requirements to faithfully reflect those economic events. Also recently developed financial reporting standards (such as IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers* or IFRS 16 *Leases*) include significant changes requiring a very good understanding of the economic substance and the business model of the transactions. ESMA supports the development and maintenance of high quality ISAs that remain relevant and effective in a changing environment of financial reporting. ESMA also supports the IAASB's decision to focus more broadly on accounting estimates (page 6 of the Overview of the ITC) as auditors have to deal with financial statements that include elements based on estimates and models which are often subject to a significant level of judgement.
3. ESMA invites the IAASB to consider the impact of the audit reform in the European Union (EU) and in particular in relation to the improvement of the communicative value of the auditor's report and transparency report, the enhanced role of the audit committee and the possibility to tailor audit standards to serve the needs of the small and medium sized entities (SMEs). From European securities regulators' perspective, we see merit in the IAASB considering the EU requirements in view of the possible adoption of ISAs at EU level under certain circumstances.
4. ESMA suggests the IAASB to foster strict application of the standards within the scope of the IAASB's competency. Establishing principles and objectives and setting clear requirements without overcomplicating the standards would help auditors in understanding what is expected from them regarding content and process, drive behavioural change and enable enforceability. In that respect, we encourage the IAASB to set up or enhance a mechanism of effective cooperation with audit oversight bodies

(such as CEAOB and IFIAR), similar to the model that has been already established by the International Accounting Standard Board (IASB) with the securities regulators (the International Organisation of Securities Commissions (IOSCO) and ESMA). The audit oversight bodies' experience with the application of the audit standards would allow the IAASB to easily identify the points of pressure and thus address and improve standards on real needs basis (paragraph 19 of the Overview of the ITC).

5. ESMA supports the IAASB's possible actions, stated in page 3 of the ITC, to complement the standard-setting activities with the development of guidance and educational material. However, ESMA encourages the IAASB to consider whether adding more guidance, application material and creating new material drives the desired behavioural change and enables enforceability.

G2 To assist with the development of future work plans, are there other issues and actions (not specific to the topics of professional scepticism, quality control, and group audits) that you believe should be taken into account? If yes, what are they and how should they be prioritized?

6. As stated in paragraph 13 of the Overview of the ITC, the auditing standards need to better address increasing complexity, taking into account the rapidly technological developments in both the business and audit environment. Such developments have already changed the nature of audit by increasing the efficiency as well as the value of the audit to stakeholders; in the same time they require updated knowledge and enhanced skills from auditors. ESMA encourages the IAASB to assist auditors in following and addressing the technological challenges on a timely basis by already assessing the changes that might be needed in the ISAs as part of the project on enhancing audit quality.

G3. Are you aware of any published, planned or ongoing academic research that may be relevant to the three topics discussed in this consultation? If so, please provide us with relevant details.

7. The IAASB might consider the outcome of the forthcoming report required by the Audit Regulation² on the EU developments in the market for providing statutory audit services to public-interest entities. This report will assess the risks arising from high incidence of quality deficiencies, the performance of audit committees and the need to adopt measures to mitigate the risks identified.

² Article 27 of Regulation (EU) No 537/2014 of the European Parliament and of the Council on specific requirements regarding statutory audit of public interest entities and repealing Commission Decision 2005/909/EC (Audit Regulation).

Questions on Professional Scepticism

General Remarks

8. Changes in the nature of business models and developments in the financial reporting increase the importance of professional scepticism to be exercised by auditors who must be confident when challenging issuer's management on a range of matters relevant to the preparation of financial statements. As emphasised in paragraph 15 of the Overview of the ITC, professional scepticism is key to the audit approach as it enables the auditor to detect irregularities³ and draw appropriate conclusions. Adopting a critical attitude is a fundamental component of auditors' behaviour in fulfilling their public interest mission to increase confidence in audit and thus, also in financial reporting. Consequently, ESMA welcomes the IAASB' proposals to reinforce the concept of professional scepticism and how this shall be applied in practice.
9. ESMA would also like to highlight the importance of professional scepticism in making professional judgment in an environment where new and amended financial reporting standards have become even more principles-based and with less bright lines than before. The success of principles based standards relies on the ability to exercise 'good quality' professional scepticism that can contribute to a sound judgement. The users of the financial statements must be able to trust that professional judgements and scepticism have been exercised without compromises by the issuers and auditors. ESMA encourages the IAASB to further elaborate on the link, relations and differences between professional scepticism and professional judgement.

PS1. Is your interpretation of the concept of professional scepticism consistent with how it is defined and referred to in the ISAs? If not, how could the concept be better described?

10. ESMA considers that the consultation document provides a high level overview on professional scepticism. However, it is our view that more concrete work is needed in order to have conclusions and actions to be carried out in the future. Suitable principles based definitions of the key concepts surrounding professional scepticism could be developed to ensure appropriate understanding and application. Having said that, ESMA acknowledges that the subject is an area relatively complex to address, because it requires judgement and it is directly related to auditors' state of mind and behaviour.
11. The degree of professional scepticism throughout the audit might vary with some areas such as risky assets complex financial instruments or accounting estimates requiring more professional judgment than others. The definition in ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* might not fully capture that the level of applied professional scepticism should change depending on the level of uncertainty or range of outcomes.

³ In the EU legal framework, Article 7 "Irregularities" and Article 10 "Audit Report" of the Audit Regulation and Article 21 "Professional ethics and scepticism" of Directive 2006/43/EC of the European Parliament and Council of statutory audits of annual accounts and consolidated accounts, as lately amended by Directive 2014/56/EU (Audit Directive).

The EU legal framework⁴ includes a definition of professional scepticism which is wider than the one in ISA 200 by providing direction on the circumstances when professional scepticism is of particular importance. In this regard, ESMA encourages the IAASB to assist auditors in upholding a higher degree of professional scepticism in judgmental areas by including triggering elements in the relevant auditing standards.

PS2. What do you believe are the drivers for, and impediments to, the appropriate application of professional scepticism? What role should we take to enhance those drivers and address those impediments? How should we prioritize the areas discussed in paragraph 37?

12. ESMA supports the drivers included in paragraph 37 of the Overview of the ITC for the appropriate application of professional scepticism and in particular, considers that education, professional skills and personal characteristics of the auditors involved in the audit work are among the most important ones. Auditors are able to perform statutory audits with satisfactory quality if their professional conduct features professionalism, competence and diligence, objectivity and independence, integrity and reliability. Furthermore, auditors have to adopt an attitude of professional scepticism and always act in the public interest.
13. ESMA is also of the view that professional scepticism could be significantly improved by strengthening the communication and interaction between the auditor and the audit committee⁵, as expressed by the IAASB in Table 1 and paragraph 10 of the Overview of the ITC. From a “tone at the top” perspective, the audit committee’s members with relevant knowledge are in a position to better assess audit quality, challenge the application of professional scepticism and auditors’ judgements, provide input on financial reporting and audit risks and discuss with the auditor any change in the audit focus that might be appropriate to reflect those risks. Auditors should be required to communicate⁶ more actively towards the audit committee on certain topics such as the application of professional scepticism, judgements made and previously identified audit deficiencies. ESMA considers that guidance to be issued by the IAASB for audit committees on certain topics might enhance audit quality.
14. ESMA also believes that improved communication at firm level and between the audit team members is also an important driver to develop and ensure the correct application of the professional scepticism. Professional scepticism is not only a concept to be applied by the audit engagement partners or engagement quality control reviewers but by all members of the audit team throughout the whole audit process including the planning stage.

⁴ In the EU legal framework, Article 21 “Professional ethics and scepticism” of the Audit Directive.

⁵ In the EU legal framework, Article 39 of the Audit Directive states that audit committees can be either a stand-alone committee or a committee of the administrative body or supervisory body of the audited entity.

⁶ In the EU legal framework, Article 11 of Audit Regulation “Additional report to the audit committee” states that auditors have a specific obligation to report to audit committees.

15. As pointed out in paragraph 38 and 39 of the Overview of the ITC, ESMA believes that the focus of auditors should be in having an open mind-set and considering the effect of contradictory audit evidence (if any). In this regard, the IAASB could also explore to use language in the standards such as “challenging management and data received” that shifts the auditor’s mind-set from one of accepting received evidence to a more sceptical attitude.

PS3. What actions should others take to address the factors that inhibit the application of professional scepticism and the actions needed to mitigate them (e.g., the International Accounting Education Standards Board, the International Ethics Board for Accountants, other international or national standards setters, those charged with governance (including audit committee members), firms, or professional accountancy organizations)?

16. In view of the importance of professional scepticism, we encourage the IAASB to consider this area as a high priority and address it within a short timeframe. ESMA supports the global and coordinated approach within the three IFAC standard setting Boards but also suggests the IAASB to revise the relevant individual standards in order to better shape the auditor’s behaviour when dealing with professional judgment and highly judgmental areas. In this regard, judgmental areas within each ISA might be identified and enhanced via clear principles on professional scepticism.

Questions on quality control

QC1. We support a broader revision of ISQC 1 to include the use of a quality management approach (QMA) as described in paragraphs 51–66.

(a) Would use of a QMA help to improve audit quality? If so why, and if not, why? What challenges might there be in restructuring ISQC 1 to facilitate this approach? [...]

17. ESMA believes that the use of a QMA should contribute in improving audit quality and responding to quality risk at firm level as it would encourage a proactive involvement of the audit firms’ leaders. Therefore, ESMA supports revising ISQC1 - *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* to incorporate the use of QMA and to guide firms in implementing and strengthening sound governance principles. Furthermore, ISQC1 could be further clarified through additional requirements and application material to more explicitly incorporate commonly used and familiar terminology (e.g. “tone at the top” and “leading by example”) and thus, emphasising the responsibility of the audit firms leaders.

18. We also agree with the proposal in paragraph 58 of the Overview of the ITC, that ISA 220 - *Quality Control for an Audit of Financial Statements* should be revised in order to incorporate the adoption of a more proactive, scalable and robust approach to audit quality at the engagement level. ESMA concurs with the IAASB’s view that QMA should take into account the size and nature of a firm, the services provided, the nature of the

entities to whom those services are provided and the changes in the firm's environment. In all circumstances, we believe that scalability of measures shall not negatively impact the quality of the output. In this regard, the EU legal framework⁷ also recognises that measures can be taken to ensure proportionate application of auditing standards to the audits of small undertakings.

QC2. We are also thinking about revising our quality control standards to respond to specific issues about audit quality (see paragraphs 67–83).

(a) Would the actions described in paragraphs 68–83 improve audit quality at the firm and engagement level? If not, why?

19. The EU legal framework⁸ requires that an engagement quality control (EQC) review shall be performed to assess whether the statutory auditor or the key audit partner could reasonably have come to the opinion and conclusions expressed in the draft reports. ESMA supports the IAASB proposals, in paragraph 80 of the Overview of the ITC, to strengthen the EQC reviews requirements and provide clarity for example, in relation to the timing, scope, involvement and documentation.
20. ESMA believes that the engagement partner's role and responsibilities should be strengthened, as stated in paragraph 76 of the Overview of the ITC, to demonstrate appropriate direction in particular, when the engagement partner evaluates the audit evidence supporting significant management judgments and when other auditors are involved in an engagement to which ISA 600 does not apply.
21. ESMA also highlights the need and importance for audit firms in responding to internal and external inspection findings (paragraph 68 of the Overview of the ITC). In this regard, ESMA supports the requirement of obtaining an understanding of the root causes of audit deficiencies and the establishment of policies and procedures for corrective measures. These actions shall help firms in strengthening procedures and raising their accountability.
22. ESMA supports addressing elements of transparency reports⁹ into the ISQC1, as mentioned in paragraphs 72-74 of the Overview of the ITC. Transparency reporting by audit firms can contribute to improving audit quality by facilitating external scrutiny of an audit firm's quality control arrangements and enhancing their accountability to external stakeholders. As transparency reporting practices continue to evolve we encourage the IAASB to explore ways to stimulate continued improvements in audit quality reporting by the audit firms on their practices, policies and results to investors and other stakeholders.

⁷ Article 26(5) "Auditing standards" of the Audit Directive.

⁸ Article 8(1) "Engagement quality control review" of the Audit Regulation.

⁹ In the EU legal framework, Article 13 "Transparency report" of the Audit Regulation.

Questions on group audits

GA1. We plan to revise ISA 600 (and other standards as appropriate) to respond to issues with group audits.

(a) Should we increase the emphasis in ISA 600 on the need to apply all relevant ISAs in an audit of group financial statements? Will doing so help to achieve the flexibility that is needed to allow for ISA 600 to be more broadly applied and in a wide range of circumstances (see paragraphs 84–97)? If not, please explain why. What else could we do to address the issues set out in this consultation?

23. From the standpoint of securities regulators, group audits are particularly important as many companies have significant operations and complex structures which are currently not addressed or are deficiently addressed by ISA 600. Therefore, ESMA welcomes the IAASB's proposal to revise ISA 600 *The work of related Auditors and Other Auditors in the Audit of Group Financial Statements*.
24. In order to reduce these risks and ensure a consistent application of this standard and its link to other relevant standards for group audits, ESMA believes that ISA 600 shall be strengthened by complementing and reinforcing its requirements and adding complementary application materials (paragraph 97 of the Overview of the ITC).
25. ESMA believes that the IAASB should address the 'materiality' concept from a group audit perspective, as considered in paragraph 96 of the Overview of the ITC, as auditing standards and other professional materials offer little practical guidance on the topic. As indicated in paragraph 254 of the ITC, determining materiality at group level and at individual components level has become a contentious issue as the number and complexity of large and international group audits increased. In order to ensure proper planning of the nature and extent of audit procedures for a group audit, the group engagement partner should determine group overall materiality and establish or approve appropriate materiality levels for the individual components.
26. ESMA agrees with the IAASB that the revision of the 'materiality' concept by developing a conceptually sound guidance should not be made in isolation in this project, but encourages the IAASB to revise the various group audit related topics in the auditing standards within a shorter timeframe. In particular, ISA 600 should be revised to include (i) principles on how "aggregation risk" (in conjunction with component significance) should work; (ii) requirements on how to determine the components auditors' materiality; (iii) guidance regarding determination of significant components and the work effort needed; and (iv) guidance in relation to the rotation of the components being reviewed.
27. ESMA agrees that the two-ways communication between the group engagement partner and component auditors needs significant strengthening, as stated in paragraph 91 of the Overview of the ITC. Communication by component auditors should not only

be upon the request of the group engagement partner but also at the own initiative of the component auditor. Furthermore, communication should be encouraged during all phases of engagement and on any matter relevant to the audit quality and especially on matters with significant impact on the component financial statements (such as non-compliance with laws, fraud, narratives and walkthroughs for significant processes). ESMA also believes that requirements should be strengthened in relation to the understanding of the group engagement team about the component auditors' competences and capabilities to be able to properly evaluate the nature and scope of their involvement. That shall be done independent on whether component auditors belong to the same or to a different audit firm.

28. Finally, as indicated in previous correspondence¹⁰, we would like to highlight the issue of the application of ISA 600 to "letterbox companies" (audits where the engagement partner is not located where the majority of the audit work is performed). We consider that the consultation documents do not fully convey or discuss in detail the unique challenges that exist in those cases. In our view, this represents a significant concern related to the quality and application of ISA 600 that should be identified and addressed as a matter of priority.

¹⁰ ESMA comment letter on the IAASB Consultation Paper: *IAASB's proposed strategy for 2015-2019 and the IAASB's work program for 2015-2016*, Paris, April 2014, ESMA/2014/363