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Arnold Schilder
Chairman
International Auditing and Assurance Standards Board
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11 May 2016

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 Banking Authority (EBA) welcomes the opportunity to comment on the International Auditing and Assurance Standards Board ('IAASB') 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 ITC').

The EBA has a strong interest in promoting sound and high quality auditing standards for the banking and financial industry as well as high quality financial reporting by financial institutions, which are key elements of market confidence and discipline.

The EBA welcomes the IAASB efforts for enhancing audit quality, as part of the IAASB *Work Plan for 2015-2016*. Consistently with the EBA comment letter on the IAASB consultation paper *Work Plan for 2015-2016*¹, the application of professional scepticism by auditors, in particular in the audit of complex estimates, and the enhancement of quality control are both key to enhancing audit quality.

In this regard, we would encourage the IAASB to consider professional scepticism as a matter of priority (at least on the same level as audit quality and group audits), as we believe that it is fundamental to the public trust and confidence in financial reporting and it is also key in light of the audit of IFRS 9 *Financial instruments* ('IFRS 9'), which will require even more than under the current incurred losses model of IAS 39 auditors to exercise a significant degree of professional judgment and scepticism.

¹ <http://www.eba.europa.eu/documents/10180/547248/EBA+Comment+Letter+on+IAASB+Proposed+Strategy+2015-2019+and+Work+Plan+2015-2016+.pdf>

Besides standard-setting, we also encourage the IAASB to foster stricter application of the audit standards and recommend that the IAASB collaborates with audit oversight bodies, audit inspectors, International Forum of Independent Audit Regulators ('IFIAR') and the forthcoming Committee of European Auditing Oversight Bodies ('CEAOB') in the EU, in order to address and respond appropriately to the underlying reasons for the audit inspections' findings.

Regarding the IAASB considerations for strengthening the requirements on quality control, the EBA welcomes the IAASB considerations mentioned in the Overview of the ITC since sound quality control enhances the quality of an audit. We would also welcome further analysis by the IAASB on whether a Quality Management Approach ('QMA') could be applied at the engagement level, as part of an audit process, such as the audit of accounting estimates, to enhance the audit quality of areas which are key in an audit, as acknowledged in the Overview of the ITC and the Invitation to Comment: *Enhancing Audit Quality in the Public Interest: A focus on Professional Scepticism, Quality Control and Group Audits* ('ITC').

The EBA would also welcome further clarifications and additional requirements in the relevant auditing standards on the role and responsibilities of the engagement partners and engagement quality control reviewers related to quality control, together with further clarifications and additional requirements related to the role and responsibilities of these individuals as well as the audit committees related to professional scepticism and group audits.

The EBA supports the IAASB considerations and efforts in addressing issues related to group audits, which can be challenging when they include entities within a group which are located in several jurisdictions outside the jurisdiction of the engagement partner. In addition, under the audit rotation requirements in the EU Regulatory framework, cases of audit engagements with groups and component entities audited by different audit firms may become more common in the future. Therefore, further enhancement of the related audit requirements should enhance robust and consistent application of the auditing standards in group audits.

Our comments on the Overview of the ITC are set out in the Annex. We have not explicitly addressed the specific questions raised in the Overview of the ITC.

If you have any questions regarding our comments, please do not hesitate to contact us.

Yours sincerely

(signed)

Andrea Enria

Annex

General comments

The EBA welcomes the efforts of the IAASB to enhance audit quality which is a valuable input to banks' supervision and supports financial stability. The development of audit standards and guidance related to the key areas of professional scepticism, quality controls and group audits should facilitate achieving high-quality audits.

Firstly, we would urge the IAASB to complete in a timely way the amendments in International Standard on Auditing ('ISA') 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* so as to provide additional audit guidance, where necessary, in order to safeguard the audit quality in the context of the application of the expected credit loss accounting framework. Although we acknowledge the IAASB efforts in revising the ISA 540 to address the new audit challenges arising from the introduction of requirements for expected credit loss provisioning, such as IFRS 9, which include among others the audit of accounting estimates, we believe it is crucial that these efforts are completed in a timely manner when the new accounting frameworks are applied and audited.

Besides standard-setting, we encourage the IAASB to foster stricter application of the audit standards. In this regard, the EBA suggests that during the process of standard-setting and revising, the IAASB collaborates with audit oversight bodies, audit inspectors, IFIAR and the forthcoming CEAOB in the EU, in order to address and respond appropriately to the underlying reasons for the audit inspections' findings. The IAASB should focus particularly on addressing the issues which the audit inspectors believe are necessary for a high quality audit and which are related to auditing standards which are less clear or lack sufficient requirements.

Professional Scepticism

Prioritisation of professional scepticism

The application of professional scepticism by auditors is one of the key topics which needs to be given priority by the IAASB, as it is fundamental to the public trust and confidence in financial reporting. Considering the increasing complexity of accounting standards, as well as the evolving auditing practices, the exercise of professional scepticism is key for ensuring audit quality. We also note that the audit of IFRS 9, with the estimation of expected credit losses being subject to high estimation uncertainty and management judgment, will require auditors to exercise a significant degree of professional judgment and scepticism. Therefore, we would encourage the

IAASB to consider professional scepticism as a matter of priority for high-quality audits (at least on the same level as audit quality and group audits).

With that in mind, while we acknowledge that the process may be complex, particularly when other bodies are involved, we urge the IAASB to commit timely on a project plan and timetable for enhancing the application of professional scepticism. Paragraph 35 of the Overview of the ITC might indicate that the project on professional scepticism may extend so that no tangible outcome is achieved on a timely basis, which is not consistent with the IAASB's objective of enhancing the quality and consistency of audit practice and strengthening public confidence in auditing and assurance.

Consistency of professional scepticism across the ISAs, IESs and IESBA Code

In addressing issues related to the application of professional scepticism, as a starting point, the IAASB (jointly with the International Accounting Education Standards Board 'IAESB' or/and the International Ethics Standards Board for Accountants 'IESBA') could develop a common definition or framework for professional scepticism across the ISAs, International Ethics Standards ('IESs') and IESBA Code, to ensure a common understanding for this notion.

Professional scepticism is barely discussed in the ethical standards at present. It will be necessary for the IAASB to collaborate with IESBA because professional scepticism extends beyond auditing standards to the ethical requirements and ethical practices which need to be applied by auditors. Due to the inherent potential conflict of interest between an auditor being engaged by, and building relationships with, the management of an entity on one side and on the other side, serving in the interest of the shareholders and the public by enhancing the degree of confidence in the financial statements; familiarity and self-interest threats may arise. The skeptical mindset of the auditor is one of the safeguards against these threats and should, therefore, be part of the ethical standards. It then follows also that a concept that is fundamental to ethical and auditing standards needs to be part of the IAESB's educational material.

Application of professional scepticism

Professional scepticism should be applied throughout an audit and the auditing standards should require an auditor to remain skeptical and to demonstrate professional scepticism throughout the audit process. While we agree with the current efforts of the IAASB in reinforcing the concept of professional scepticism, which are listed in paragraphs 38-40 of the Overview of the ITC, we would emphasise and add the following:

- **Day to day application:** professional scepticism is more than independence of mind and it needs to be embedded in the daily audit practice. The audit standards should reflect practical steps that the auditor can take to apply and demonstrate professional scepticism.
- **Critical assessment of audit evidence:** the definition of professional scepticism in paragraph 13 and the relevant application guidance in paragraphs A18-A22 of ISA 200, *Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing* may be leading auditors to consider that they only need to assess whether management has provided sufficient evidence to support their assertions. However, we believe that professional scepticism goes beyond this and an auditor should also consider alternative sources of audit evidence. In this regard, the definition of professional scepticism could also refer to the auditor ‘gathering and weighing even-handedly evidence both for and against management’s assertions’. Having said that, we are also concerned that undue reliance may be placed by an auditor on audit evidence obtained in the form of management representations, without sufficient audit evidence obtained from alternative sources. In this regard, we would welcome further enhancements of ISAs to address this issue as part of the work on professional scepticism. We would also support extending the requirements of the revised ISA 540 for the need to consider ‘contradictory evidence that comes to the auditor’s attention’. Paragraph 39 in the Overview of the ITC seems not to address sufficiently the possible misinterpretation of ISA 540 (when an auditor remains passive and does not need to make reasonable efforts to look for contradictory evidence), although this contradiction is recognised in paragraph 21 in the Overview of the ITC.
- **Engagement partner’s role:** the role and responsibilities of the engagement partner could be enhanced and described more clearly and in more depth (in line with our comments below on engagement partner’s involvement in the audit), as it is very important, both in terms of the actions of the engagement partner towards the audited entity and the culture that a partner fosters within the team. The engagement partner should ensure that all members in an audit team are sufficiently trained and coached, including those with less experience, and should evaluate and foster professional scepticism all along the audit process including the planning stage.
- **Engagement quality control reviewer’s role:** the EBA supports enhancing the role of the engagement quality control (‘EQC’) reviewer in order to ensure appropriate application of professional scepticism. For example, (in line with our comments below on the EQC reviewer’s involvement in the audit), our view is that the EQC reviewer should be fostering the exercise of professional scepticism from the planning stage of an audit, challenging the audit team as to how it will be exercised.

- **Those charged with governance role:** the dialogue between auditors and audit committees/ those charged with governance in an entity should also address the application of professional scepticism by the auditors.
- **Requirements fostering training and professional education at firm level:** we believe that the requirements to foster training and professional education at firm level should also contribute to the development and the application of professional scepticism, since auditors will be able to exhibit the appropriate level of competencies for their given tasks and therefore be able to exercise professional scepticism when performing an audit.

Quality Control

We strongly believe that an effective QMA is key in ensuring audit quality at the audit firm level and raising the responsibility of the audit firms' leaders. The 'tone at the top' in an audit firm is even more crucial in increasing the audit quality and adequately responding to audit quality risks. We therefore support the revision of International Standard on Quality Control ('ISQC 1'), *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* in order to incorporate the use of a QMA and to provide guidance to audit firms in strengthening and implementing sound corporate governance principles. Good corporate governance is a fundamental means to support audit quality.

In addition, we believe that the involvement of the engagement partners and EQC reviewers in the application of professional scepticism, quality control and group audits are key to assuring audit quality (besides the detailed comments for each of these which are included in this comment letter). Therefore, the ISQC 1 and other ISAs should provide more clarity on the responsibilities of each of these parties, in particular the ECQ reviewer (paragraph 67 of the Overview of the ITC).

We also emphasise the need for and the importance of actions for audit firms in responding to inspection findings (paragraph 68 of the Overview of the ITC). These actions should help firms to strengthen their procedures and also raise the audit firms' responsibility for audit quality. The audit firms' actions shall be addressed through the audit firms' procedures, the actions of the engagement partner and the EQC reviewer.

QMA

Considering the importance of applying a QMA, we support QMA being separately addressed and incorporated into the ISQC 1 in order to give more prominence to it (paragraph 53 of the Overview of the ITC).

In addition, besides the IAASB considerations on the application of a QMA as a process assessing an audit which has been performed, the EBA would welcome further analysis by the IAASB on whether a QMA could be applied at the engagement level as part of an audit process, as acknowledged in paragraphs 75-83 of the ITC. In particular, enhancing the audit quality on those areas which include the exercise of a significant degree of judgement, such as the audit of accounting estimates and which are key within an audit and merit the additional focus of an auditor. In this regard, the IAASB could consider potential changes to ISA 220, *Quality control for an audit of financial statements* as envisaged in paragraphs 75-83 in the Overview of the ITC and paragraph 85 of the ITC.

We also welcome the IAASB's intention to consider that the QMA be tailored to the size, nature and services of the audit firms and the nature of the entities to which those services are provided, and thereby, ensuring a proportionate application of the auditing standards for smaller audit firms. In particular, we believe that the IAASB needs to be mindful of the challenges for smaller audit firms in developing a QMA and therefore a QMA should, in our view, ensure that the requirements do not impose undue burden to these audit firms (paragraph 57 of the Overview of the ITC). In this regard, we would support that the IAASB develops additional guidance and examples of how a QMA could be applied in different circumstances (for example by different entities in terms of types of activities or size or complexity). Notwithstanding the above, the audit firms of public-interest entities, including banks, will be subject to compliance to high quality standards, in respect of those audits, which is also envisaged in EU in Regulation (EU) No 537/02014².

Engagement partner's involvement

As far as the engagement partner's role is concerned, in the EU regulatory framework, as in the previous Audit Directive of 2006 on the statutory audits of annual accounts and consolidated accounts, Article 28 (4) of the Audit Directive requires that the audit report is signed and dated by the statutory auditor³. In this regard, we would support the ISAs explicitly require the engagement partner to sign the auditor's report, as a 'formal' acknowledgement of the engagement partner's responsibility for the direction, supervision and performance of the audit engagement.

In addition, we suggest that the ISAs (in particular paragraphs 19-21 of ISA 220 and paragraph 37 of ISQC 1) address more explicitly the need for a regular discussion and an appropriate

² Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC

³ Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts

documentation between the engagement partner and the EQC reviewer on all significant matters, in particular those areas involving significant judgment.

Furthermore, we agree that the engagement partner's role and responsibility needs to be clarified in particular to address the following cases (paragraph 76 of the Overview of the ITC):

- When other auditors are involved in an engagement not being a group audit and to which ISA 600, *Special considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* does not therefore apply (for example in the cases of specialised audit work performed by another engagement team within an audit firm). In this regard, we believe it is important that the engagement team assesses the sufficiency and appropriateness of the other auditors involved in the engagement.
- When the engagement partner evaluates the audit evidence supporting significant management judgments.
- When the engagement partner relies on the work of experts.

Engagement Quality Control Review

In the EU regulatory framework, Article 8(1) of Regulation (EU) No 537/02014 requires that an EQC review is 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 of these reports. Considering also that the EQC reviews shall enhance audit quality and are particularly important for audits which require significant judgments, we support that the requirement for performing an EQC review is extended to all public-interest entities, which besides listed entities, include banks (paragraph 79 of the Overview of the ITC).

In addition, we welcome strengthening the requirements for the EQC reviews and, in particular, the timing, involvement and documentation related to such EQC reviews (paragraphs 80 and 81 of the Overview of the ITC) as follows:

- Ensuring the involvement of the EQC reviewer from the start of the engagement and throughout the audit process, including at the acceptance and continuance of the client relationship and at the planning phases of the audit.
- Strengthening communication between the engagement partner and the EQC reviewer in order to ensure matters involving the application of significant professional scepticism and professional judgment are sufficiently discussed.

- Documentation of communication between the engagement partner and the EQC reviewer shall be extended to other matters than those where differences of opinion between both parties appear (for example, discussion of key audit matters, matters involving significant professional scepticism and judgment).

Networks of audit firms

We understand that it may be difficult to develop requirements for networks of audit firms (paragraph 71 of the Overview of the ITC), but we believe that since the group engagement partner is responsible for the entire engagement, the engagement partner would need to obtain quality control assurance for the entire group engagement. Therefore, we suggest explaining in detail in ISQC 1 and/or ISA 600 how and to what extent an audit firm can rely on a network's policies and procedures, in order to obtain quality control assurance.

In addition, we support considering further the incorporation of a QMA at a group/network level in ISQC 1 (paragraph 45 of the Overview of the ITC).

The IAASB could also consider whether a link could be established between the exercise of professional judgment that is addressed in ISQC 1 (paragraphs A31 and A37) and the concept of professional scepticism. The standards concerned could mention, for example, that professional scepticism is one component of the exercise of sound professional judgment.

Group audits

We strongly appreciate the IAASB's proposal to revise ISA 600 considering that financial statements may include several group dimensions with entities located in several jurisdictions outside the jurisdiction of the engagement partner. As acknowledged by the IAASB (paragraph 89-91 of the Overview of the ITC), the application of ISA 600 and its link to other relevant standards for group audits merits further enhancement in order to ensure that its requirements address sufficiently the challenges in a group audit.

In addition to that, following the requirements of Article 17 of Regulation (EU) No 537/2014 for the duration of an audit engagement and the mandatory rotation of the statutory auditor and the audit firm, the cases of audit engagements with groups and component entities audited by different audit firms may become more common in the future and hence the need for the IAASB to address the risks to audit quality for such engagements. In this regard, the EBA supports further enhancement of ISA 600 requirements supported by any complementary application material, if needed, to ensure robust and consistent application of the requirements (paragraph 97 of the Overview of the ITC).

We strongly believe that communication between the group engagement partner and component auditors needs further enhancement to ensure that both the group engagement partner and the component auditors engage in an effective two-way communication on all matters with significant impact on both the group and the local entity financial statements. It is hence felt that such communication shall not only take the form of a communication initiated by the component auditors upon the request of the group engagement partner, but that the requirement includes communication, if need be, from the component auditors on their own initiative to the group engagement partner (paragraph 91 of the Overview of the ITC). In this regard, we would also support further enhancement of the relevant ISAs on the role and the responsibilities of the EQC reviewer as well as the audit committee regarding the group audits.

We also support the IAASB initiative to revise ISA 600 by strengthening the requirements related to the understanding by the group engagement team of the component auditors' competence and capabilities, which is key to properly evaluate the nature and scope of the component auditor's involvement in the group audit (paragraph 96 of the Overview of the ITC).