

13 March 2020

Mr. Tom Seidenstein
Chair
International Auditing and
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New York
NY 10017, USA

cc: Willie Botha, Technical Director

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Re.: New IAASB Standards Affecting Group Audits

Dear Tom,

Let me begin by saying how pleased we were to have been able to welcome you and Willie last February here in Düsseldorf. We hope that you and Willie enjoyed our meetings here and that both of you found our exchange of views as helpful as we did.

We are writing this letter to convey to you our concerns with respect to the potential impact of some of the proposed changes to ISA 220 (Revised) "Quality Management for an Audit of Financial Statements" and of some of the proposed changes to the exposure draft of ISA 600 (Revised) "Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)". We very much support the efforts of the IAASB to improve the ISAs to help improve audit quality in the public interest. However, we believe that the impact of some of the proposed changes to these standards will not be conducive to audit quality and also involve additional public policy issues that we believe the IAASB also needs to consider in its deliberations. While some of these issues are of particular importance to our members that acting as component auditors, some of the issues are also important to those acting as group auditors.

In particular, we are concerned with the impact of the proposed change to the definition of engagement team in ISA 220, which leads to ISA 600 including component auditors from outside the firm of the group engagement team to also being members of the engagement team. In our comment letter on the exposure draft of ISA 220, we had provided details of some of the difficulties we foresee

GESCHÄFTSFÜHRENDER VORSTAND:
Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands;
Dr. Daniela Kelm, RA LL.M.;
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arising in relation to the application of group engagement team independence requirements to component auditors and the nature, timing and extent of direction, supervision and review of component auditors by the group engagement team. In relation to the latter, we note that it is still unclear how direction, supervision and review can be operationalized effectively when the incentive and disincentive measures embodied in the quality management system of the group engagement team's firm cannot be extended to component auditors from another firm – especially a firm that is not in the same network as the firm of the group engagement team. We do not believe there is adequate recognition that the nature of the direction, supervision and review would need to be qualitatively very different than if a component auditor were to be from within the same firm as the group engagement team. Furthermore, the one-engagement team approach in ISA 220 together with its requirements for direction, supervision and review appear to lead to an overemphasis of a top-down approach to group audits in ISA 600 (see below).

We note that there was no discussion in the Explanatory Memorandum to the exposure draft of ISA 220 as to the potential impact of the change in definition of engagement team on ISA 600 and therefore in relation to component auditors on group audits. Other than those organizations that have access to those who were involved in the discussions at the IAASB on the exposure draft of ISA 220 or those organizations that were informed by organizations with such access, it appears that few, if any, respondents recognized, from text in the exposure draft and draft standard alone, the ramifications of the proposed change in the exposure draft of ISA 220 of the definition of engagement team on ISA 600 and therefore on the relationship between the group engagement team and component auditors. When an exposure draft does not explicitly indicate in the Explanatory Memorandum as to what is likely to be the single greatest impact of the changes being proposed, it appears to us to call into question whether the due process for the proposed standard was appropriate.

We recognize the efforts over the latest drafts of ISA 600 to move from a solely top-down approach (in which group engagement teams may largely seek to determine the nature, timing and extent of procedures performed by component auditors on their behalf) to also provide for a bottom-up element (by recognizing that the group engagement team can assign risk assessment and responses to component auditors under the responsibility of the group engagement team). However, we believe that the granularity of the requirements in new ISAs 540 and 315 – individually, but especially collectively – is not consistent with the continuing overemphasis in the draft of a top-down approach. Group engagement teams are often simply not capable of identifying and assessing

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risks of material misstatement and determining responses to these at component level for group audits across different legal systems, languages, business practices and cultures. While the group auditor has sole responsibility for the group audit, that sole responsibility needs to be appropriate by recognizing the important role that component auditors play in supporting the opinion issued by the group auditor.

Furthermore, the nature of many of these risks of material misstatement depend upon the accounting relationships between different accounts and information used for disclosures, which means that in many cases full audits are needed for significant components. For these reasons, we believe that the overemphasis on a top-down approach to group audits and the elimination of the requirements for full audits of significant components will actually reduce, rather than increase audit quality. We also believe that the overemphasis on the top-down approach and the move away from full audits of significant components also underestimate the symbiotic relationship between group audits and audits (whether statutory or otherwise) of the financial statements of components, in which group auditors and auditors of components need to cooperate so that each is able to meet the audit requirements of their respective entities.

We believe that the implementation in ISA 600 of one engagement team concept as currently proposed in ISA 220 together with the overemphasis of the top-down approach will inevitably lead to greater concentration of component auditors away from small and medium-sized firms towards firms from the same network so that the mechanisms for direction, supervision and review developed within a larger network can be used. From a public policy perspective, without clear evidence that the changes proposed will actually increase audit quality, such further concentration in the audit market for group audits towards larger networks is politically misaligned with the discussions in the EU, the UK and elsewhere about reducing market concentration, and may engender discussions about whether auditing standards are facilitating anti-competitive behavior.

However, differing rotation regimes etc. lead to numerous situations in which component auditors will not be from the same network as the firm of the group engagement team. In these circumstances, the one engagement team concept with the overemphasis of the top-down approach means that group engagement teams will also encounter considerable difficulties in directing, supervising and reviewing those component auditors in the manner contemplated in these standards.

For the reasons we explain above, we believe that ISA 220 with its expansion of the definition of the engagement team should not be issued as a final standard

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in the June 2020 meeting of the IAASB unless the issues we have identified have been adequately addressed. This also indicates to us that ISA 600 should not be issued as an exposure draft in the March 2020 meeting of the IAASB until after ISA 220 is issued as a final standard.

If you have any questions about this letter, we would be very pleased to be of further assistance. We have taken the liberty of providing a copy of this letter to Willie Botha, Technical Director of the IAASB.

Yours truly,

Klaus-Peter Naumann
CEO

Melanie Sack
Executive Director