

18 July 2016

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## **PCAOB Release No. 2016-002, PCAOB Rulemaking Docket Matter No. 042**

### **Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors And Proposed Auditing Standard – Dividing Responsibility for the Audit with another Accounting Firm**

Dear Sirs,

The IDW appreciates the opportunity to comment on the above mentioned Release, hereinafter referred to as “the Release”.

In this letter we include comments of a general nature before highlighting our concerns in respect of specific issues or specific aspects of the proposals. Since divided responsibility is not prevalent in Germany, we have chosen not to comment on the aspects of the Release relating to division of responsibility. Furthermore, we have not responded specifically to the 59 questions posed throughout the Release. However, certain of our comments may be directly relevant to one or more of these questions.

#### **General matters**

##### ***Support for aligning PCAOB standards with recent developments***

In general, we support the PCAOB’s initiative to improve audit quality by revisiting its now somewhat outdated interim standards dealing with the use of the work of other auditors. We specifically support using a risk-based approach

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that will align the PCAOB's standards more closely to recent improvements in the IAASB's standards (i.e., revision of ISA 600 during the IAASB's so-called Clarity Project) and the IAASB's ongoing consideration of this aspect of the audit as evidenced in its recently issued Invitation to Comment (ITC). Certain of our member firms have reported changes in auditing practice beyond this, which also mirror the Release's discussion of evolving practices.

This notwithstanding, we believe that the proposals would result in lead auditors having to adapt a highly bureaucratic approach to the supervision of other auditors, which, whilst it may make it easier for the PCAOB to fulfil its inspection responsibilities, will not necessarily result in improved audit quality. To the extent that in complex group situations the proposals lean towards having the lead auditor increasingly bypass other auditors who may be lead auditor at subgroup levels, the proposals seem to overly simplify situations or circumstances that are not simple in practice.

### ***Coordination with the IAASB in the light of the recently issued ITC***

As the PCAOB is aware, amongst other things the IAASB's ITC sought interested parties' views as to practicalities regarding group audits and the use of work performed by other auditors.

Aspects of the IAASB's current discussions including its analysis of responses received to this ITC will clearly be equally relevant to the PCAOB's standard setting beyond the current proposed amendments. Such aspects include diverse issues such as the increasing use of shared service centers, qualitative factors impacting the determination of the involvement of the lead auditor or approach to determining materiality, especially where a group is made up of a large volume of individually insignificant companies. Application of the concept of materiality in a group audit is another issue that is per se not specifically addressed within the PCAOB's proposals.

We encourage the PCAOB to liaise closely with the IAASB going forward in understanding the issues raised in the latter's deliberation of input to its ITC in order to monitor the potential impact on the PCAOB's suite of auditing standards.

### ***Support for global consistency using a principles-based approach***

The IDW continues to be a firm supporter of principles- rather than rules-based auditing standards. We therefore note the discussions within the Release asking

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for views as to whether certain aspects of the proposals might be strengthened, resulting in the inclusion of further rules-based requirements. In particular, the IDW does not believe the PCAOB should require that the EQC-reviewer evaluate the engagement partner's determination that the participation of his or her firm is sufficient for the firm to carry out the responsibilities of a lead auditor and to report as such on the company's financial statements and, if applicable, internal control over financial reporting (q. 45). The need for such evaluation should be based on the individual engagement circumstances, taking account of the related risks. We have similar views in respect of whether the lead auditor should specifically identify and document the engagement team members responsible for assisting the engagement partner of the lead auditor in fulfilling his or her supervisory responsibilities (q.19), whether quantitative thresholds or other criteria should be prescribed for determining whether a firm's participation is sufficient (q.21), issues pertaining to access to working papers (q.29), and required procedures in considering the work of the other auditor (q.32) amongst others.

### **Specific issues**

#### ***Proposal to withdraw AS 1205 and insert material into existing standards***

Complex group structures stretching across numerous different countries pose special challenges to lead auditors not encountered in audits of simple groups and single entities, e.g., differing financial reporting frameworks that need to be aligned, cultural differences, and access restrictions. Materiality in a group audit context is a further such issue. The practical application of acceptance, direction and supervision responsibilities will necessarily differ in practice in comparison to situations where the engagement team members all work directly within the firm issuing the audit report and no other auditors are involved. This may be especially pronounced where a company's management and the other auditor are physically located in another jurisdiction from that of the lead auditor's firm.

We believe that revision of AS 1205, aligning it to ISA 600 and incorporating adaptations to reflect developing audit practice, might be more appropriate than the proposed piecemeal changes to numerous existing standards, which give rise to copious cross references both within and between standards. The proposals add an (avoidable) challenge to most audit firms currently used to applying AS 1205 as well as firms familiar with ISA 600. The proposed addition of the term "other auditor" within the definition of "engagement team" means that certain requirements become less obvious or even unclear. In our view, the

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PCAOB has not made a sufficient case for proposing this course of action as opposed to the retention of a revised version of AS 1205.

### ***Need for a similar construct to “component” adopted by the IAASB***

Whilst the PCAOB is not proposing to use the IAASB’s concept of component and component auditor, it does still appear to us that a similar construct is needed, in particular for situations in which the operations of SEC registrants are highly decentralized. For example, in regard to the determination of the sufficiency of a firm’s participation to serve as lead auditor (page A4-14 et seq. and proposed paragraph B2 of AS 2101) the term “portion of the financial statements” is used. We further note that changes proposed to AS 2401 *Consideration of Fraud in a Financial statement Audit* involve the replacement of the term “component” with “business unit”. The Release uses “locations and business units” on occasion. Inconsistent use of terminology is not desirable.

### ***Sufficient participation of the lead auditor’s firm***

We note that the IAASB does not use the notion of meaningful portions of financial statements: instead phrasing its participation requirement for the group auditor in terms of the group engagement partner being satisfied as to the group engagement team’s ability to be involved in the work of component auditors to the extent necessary to obtain sufficient audit evidence of the consolidation process and the financial information of the components on which to base the group audit opinion. Such evidence is obtained by various means: direct performance of the audit procedures; appropriate extent of involvement in the work of the other auditor etc., supported by direction and supervision.

Our concern is that the standards may be insufficiently clear as to the need for the lead auditor to become more directly involved in certain aspects of the audit work. Phraseology that delineates “portions of financial statements” does not capture this concept at all, and may lead to misunderstandings in the context of sufficiency of participation.

### ***Lead auditor’s consideration of other auditors***

According to proposed paragraph B6 of AS 2101, the lead auditor is to gain an understanding of other auditors’ knowledge, skill, and ability. As proposed, this applies in respect of other auditors “who assist the lead auditor with planning or supervision”. Q. 28 specifically asks whether B6 is appropriate as proposed.

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Whilst we support not widening the proposed requirement to cover each and every individual who would be covered by the revised definition of engagement team, we believe a principles-based approach would be more appropriate. Specialists in particular, but also other members of the engagement team, may be involved in the performance of audit procedures which, whilst they do not equate with assisting the lead auditor's engagement partner in fulfilling planning and supervisory responsibilities, nevertheless could be judged by the lead auditor to be of a certain significance in the particular engagement circumstances. We suggest that the lead auditor's understanding, as required in paragraph B6 of AS 2101, should not be limited to certain individuals. A principles based approach to B6 would involve the lead auditor exercising professional judgment in obtaining the understanding sufficient for his or her purposes in the individual engagement circumstances. Furthermore, consideration should also be given to the structure of lines of accountability and reporting in the firms of other auditors. The members of the engagement team within another firm often report to a partner, who then reports to the engagement team in the firm of the leading auditor. In this case, the lead auditor's understanding should relate to the partner of the other auditor that reports to the lead auditor because, provided this partner is competent, he or she will ensure that the members of the engagement team within the firm of the other auditor will be appropriately competent and independent.

We note that the list in Appendix B of AS 2101 does not specifically include reference to factors affecting the ability of the lead auditor to use the work of another auditor, such as common quality control policies and procedures, and whether the other auditor is subject to robust professional oversight, etc. Such factors are also relevant to the determination of the extent of the lead auditor's own involvement in the work of the other auditor (refer to ISA 600.A33 and 600.A40) or the assignment of team members pursuant to AS 2301.05.

***Impact of effective communication and associated documentation requirements on audit quality***

We support the proposed requirements governing the lead auditor's communication with other auditors in Appendix B of AS 1202 *Supervision of the Audit Engagement*. Communication between the group auditor and component auditors is one of many issues discussed by the IAASB in its ITC. It is clear that deficiencies in the two-way communication between the lead auditor and other auditors can have an adverse impact on audit quality.

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However, we are concerned that the overly-prescriptive requirements concerning the report to be prepared by the other auditor proposed in AS 1201 Appendix B2b and B2d (written report describing the other auditor's procedures, findings, conclusions and, if applicable, opinion) may not be appropriate in all circumstances, particularly when the lead auditor will have full access to audit documentation prepared by the other auditor. Besides being costly, duplication of matters at the level of detail proposed will not, of its own, lead to an improvement in audit quality, and may even be counterproductive if it diverts resources from the primary audit work. We are not convinced that the arguments put forward in the Release as to the potential for this aspect of the proposals to increase other auditor accountability will justify the costs in all cases. The IDW believes – emerging practice in many firms notwithstanding – that there needs to be sufficient flexibility to address a multitude of situations including taking into account the relative risk of material misstatement and circumstances where access to working papers is straightforward as well as where this is expected to be problematical.

Page A4-42 of the Release explains that in some circumstances (in particular, issues relating to restricted access/transfer of documentation) lists of other auditor's working papers reviewed by a senior team member of the lead auditor would allow the engagement partner in the office issuing the auditor's report (or other internal and external reviewers) to determine the extent of that senior team member's review of documents located in the other auditor's office. The desire to have such a list of documentation drawn up – which is in addition to the detailed reports on the audit mentioned in the preceding paragraph – seems not to be essential to increasing audit quality. When the engagement partner in the office issuing the auditor's report elects to delegate the review of work performed by other auditors to a senior team member of his or her own office, we see little benefit within that office in terms of increased audit quality of having a list drawn up as proposed.

We therefore agree with the position explained in the Release that requiring the lead auditor to compile a list of all audit documentation i.e., that reviewed and that not reviewed in a different country from that of the lead auditor would not be necessary for audit quality and would therefore be unnecessarily burdensome.

### ***Delegation of supervision responsibilities***

The Release explains how a risk based approach should be taken in determining whether the lead auditor may delegate certain supervision responsibilities in a multi-tiered group structure. The proposed additions to

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AS 1202 are unclear as to the risk based application of the 6<sup>th</sup> sentence of B3 of AS 1201 (the lead auditor, in supervising the first other auditor, should evaluate the first other auditor's supervision of the second other auditor's work) when read in conjunction with footnote 24 (the requirements of this paragraph also apply to audits in which there are multiple second other audits). Firstly, in a complex group structure with numerous layers, should each other auditor acting as "reviewer" act in the same way down the chain? If so, this would result in the lead auditor reading a report on the review of a review of a review...etc. potentially far removed from the actual audit procedures performed. This would appear to us to be likely excessive for a low risk area, and possibly mean that the lead auditor were too far removed from the audit procedures in the case of an area of higher risk. It would be preferable to keep in mind the lead auditor's objective and use a more flexible and risk-based approach; otherwise following this requirement to the letter could become absurd in practice, detracting from the lead auditor's need to be satisfied that sufficient audit evidence has been obtained to enable him or her to form an opinion.

***Statement concerning potential increases in costs***

We take issue with the statement on page 40 of the Release immediately preceding question 7: "To the extent that auditors incur higher costs to implement proposed requirements and are able to pass on at least part of the increased costs through an increase in audit fees, companies could incur an indirect cost." This statement implies in the public domain that the PCAOB may take a somewhat complacent view, considering it reasonable for audit firms alone to bear part or all of any additional costs resulting from revisions to its auditing standards, which may also have other audit quality implications. We suggest that consideration of the cost: benefit in terms of increased audit quality for the market as a whole would be more appropriate.

If you have any questions relating to our comments in this letter, we should be pleased to discuss matters further with you.

Yours truly,

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Executive Director

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