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October 8, 2003

Dear Ana Maria,

**Re: IAASB Quality Control Exposure Draft**

Thank you for inviting me to meet with you and the other members of the IAASB Quality Control Task Force to discuss the views of the IFAC Ethics Committee (“the Committee”). As we explained, the Committee is very concerned that, as drafted, the IAASB Quality Control Exposure Draft (“ED”) is not consistent with the IFAC Code of Ethics (“the Code”). These inconsistencies are created by paraphrasing and interpreting the Code, extending its requirements and using different definitions.

The current Code was intended to service as a model on which to base national ethical guidance. The proposed Code, which was released for exposure in July 2003, will change the authority of the Code to a standard. It contains the following statement:

“No member body or firm is allowed to apply less stringent standards than those stated in this Code. However, if member bodies or firms are prohibited from complying with certain parts of this Code by law or regulation, they should comply with all other parts of this Code.”

Consequently, the Committee is concerned that the inconsistencies between the Code and the ED will, in addition to creating confusion for member bodies and practitioners, create enforcement difficulties. It will be unclear which of the two standards should take precedence. To avoid this situation, the Committee recommends that the final quality control standard refers to the Code but does not paraphrase it, interpret it or extend its requirements. The Committee also recommends smoothing out some of the inconsistencies that have been created by the use of different definitions.

### Consequences of paraphrasing and interpreting the Code

The following are examples of differences between the ED and the Code which have been created by paraphrasing or interpreting the Code:

- ISQC paragraph 18(a) states that the firm's policies and procedures should "enable the firm to identify and evaluate circumstances that may create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by the application of safeguards." The Code (8.11) requires the firm to identify and evaluate circumstances *and relationships* that create threats to independence (not *circumstances that may create threats*). In the Committee's opinion circumstances that *may* create a threat are not the same as circumstances that create a threat.
- ISQC paragraph 19(b) requires personnel to notify the firm in a timely manner of *matters that may pose* a threat to independence. This language is inconsistent with the Code, which refers to circumstances and relationships that create a threat to independence.
- ISQC paragraph 21 states that the Code requires the identification of relationships that exist between the firm and its network firms and client entities and their related entities that may *reasonably be thought to bear on the firm's independence*. This is not consistent with the Code which states that for audit clients, the members of the assurance team, the firm and network firms are required to be independent of the audit client – and for audit clients that are listed entities, audit client will always include its related entities. The Code further states that in the case of assurance clients that are not audit clients, consideration should be given to any threats that the firm has reason to believe may be created by network firm interests and relationships.
- ISA 220 paragraph 8 states that the engagement partner should *obtain an understanding* of whether there are *potential* threats to compliance with relevant ethical requirements. The Code requires that all members of the engagement team are independent of the assurance client, which requires the identification and evaluation of threats to independence. The requirement to obtain an understanding of potential threats could be viewed as a lower standard than the requirement to identify and evaluate threats.

### Consequences of extending requirements of the Code

It could be viewed that the ED extends the requirements of the Code in the area of partner rotation. The Code requires the lead engagement partner on a listed entity to rotate after a pre-defined period, normally no longer than seven years (8.151). The Code does not contain any other requirements with respect to partner rotation. The ED, however, contains some additional requirements in this area:

- ISQC paragraph 25 requires the firm to establish criteria against which all audits of non-listed entities, other assurance engagements and related services should be evaluated for the purpose of determining whether the engagement partner should be rotated after a specified period;
- ISQC paragraph 25(c) requires rotation of the engagement partner for all engagements meeting the established firm criteria;

Following our discussion we understand that the Task Force believes that consideration of the need for rotation on engagements other than the audit of listed entities is necessary to maintain the quality of such engagements. However, some may interpret paragraph 25 of the ISQC as

establishing rotation requirements that are more stringent than those established in the Code. Therefore, we would suggest that a link could be made to paragraph 8.150 of the Code, which states that “using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat.” Creating such a link would make it clear that the ISQC is not establishing rotation requirements; rather it is requiring a firm to establish policies and procedures to consider and address the familiarity threat to independence that may be created by long association of senior personnel. It would also be useful if the requirement to establish separate criteria (paragraph 25 b) and the requirement to comply with the established criteria (paragraph 25 c) were combined in one paragraph. Maintaining the two requirements in different paragraphs may foster the impression that the ISQC is establishing rotation requirements.

The ED also contains guidance on rotation for the quality control reviewer:

- ISQC paragraph 69 requires that the quality control reviewer did not participate in the performance of the audit, assurance or related service involving the same client and the same subject matter for the preceding period or, in the case of an audit client that is a listed entity, for a period of 24 months before the start of the period covered by the current engagement.

When Section 8 of the Code was developed there was no requirement for engagements to have a quality control reviewer. Consequently, the Committee did not address specific rotation requirements, if any, for such an individual. The Committee suggests that such guidance should be in the Code, rather than the ISQC, and would, therefore, suggest that the ISQC deal with the requirement for a quality control reviewer and the qualities that individual should possess, and the Code will deal with the requirement for rotation.

### **Consequences of use of different definitions**

The Committee believes that wherever possible, IFAC documents should use the same terms to describe the same thing. This is particularly important when one document refers to another document.

There are several inconsistencies in definitions between the Code and the ED:

- Engagement partner (ED) and lead engagement partner (Code);
- Engagement team (ED) and assurance team (Code); and
- Firm

In some cases, for example, engagement/assurance team, the Code needs a broader definition, but the Committee believes that the definitions can be made more consistent. We would be pleased to work with the Task Force to determine the best way to bring the definitions into line.

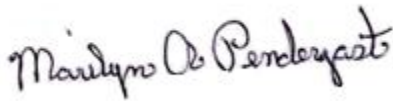
We note that the ED and the Code contain the same definition of network firm. In completing the Code, this definition was drafted very carefully after significant consultation. Therefore, the Committee would ask that if the Task Force, in responding to comments received on exposure, is considering any changes to this definition, the Task Force consults with the Committee so that

the implications to both documents can be carefully evaluated before any change is made to the definition.

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Thank you again for yesterday's very constructive meeting and the invitation to attend your next two Task Force meetings. I feel sure that we can find mutually agreeable solutions to bring the Code and your final standard into line. If you have any questions on our response please do not hesitate to contact Jan Munro or me.

Yours truly,

A handwritten signature in dark ink, reading "Marilyn A. Pendergast". The signature is written in a cursive style with a large, stylized 'M' and 'P'.

Marilyn Pendergast  
Chair, IFAC Ethics Committee

cc IFAC Ethics Committee  
Jim Sylph, Technical Director, IAASB