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Marilyn Pendergast
Chair, IFAC Ethics Committee
International Federation of Accountants
545 Fifth Avenue, 14th Floor
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January 22, 2004

Dear Marilyn

Re: IAASB Quality Control Exposure Draft

Thank you for participating on our conference call on January 12, 2004. The Quality Control Task Force was pleased that it was able to reach agreement with you and Jan Munro on the final resolution of the ethics issues in the proposed ISQC 1 and the proposed revised ISA 220.

As discussed during the conference call, I am writing on behalf of the Task Force and the IAASB to urge the Ethics Committee to address, as a matter of priority in the IFAC Code, the following four particular issues, the first three of which concern the maintenance of the objectivity of an engagement quality control reviewer ("EQCR") when this reviewer is appointed for audits or reviews of historical financial information, or other assurance or related services engagements:

- a) *Rotation of EQCR* – the need to consider rotating the EQCR after having served in that role for a specified period. In this respect, the Task Force suggested that it might be appropriate to limit the total time that an individual could serve continuously as EQCR or engagement partner for the same client on a given engagement, to the time that such an individual could serve continuously as an engagement partner for the same engagement. For example, in the case of the seven year time limit for a listed audit based on the IFAC Code of Ethics ("IFAC Code"), the individual could serve as EQCR for this listed audit for three years and then as engagement partner for four years (all the years being contiguous) before having to rotate off serving on that audit.
- b) *"Fresh start" for the EQCR*. The Task Force suggested that the EQCR should not have participated in the performance of an audit or review of historical financial information, or other assurance or related services engagement involving the same client and with respect to the same subject matter information for the preceding period or, in the case of an audit of

financial statements of a listed entity, for a period of twenty four months before the start of the period covered by the current engagement.

- c) *EQCR not to be involved on any other assurance engagements for the same client* – the need to consider prohibiting an EQCR assigned to a given assurance engagement from being involved in any other assurance engagements for the same client. Whilst the Task Force felt it appropriate to highlight this issue for consideration by the Ethics Committee, it would like to emphasize that the issue will be specifically discussed by the IAASB at its meeting in February 2004 in New York.
- d) *Rotation of senior members of the engagement team* – the need to consider requiring the rotation of senior members of staff for assurance engagements (other than engagement partner rotation for listed audits). We draw the Ethics Committee’s attention, in particular, to comments 11 and 13 in the Appendix to this letter. With regard to this issue, the Task Force felt that that the IFAC Code should go further in requiring firms to establish criteria for such rotation.

In addition to the above, the Task Force and the IAASB believe that the Ethics Committee should consider addressing certain specific comments received from respondents during the Quality Control exposure period that touch upon ethics. The relevant comments are listed verbatim, together with the names of the respondents, in the attached Appendix. The Task Force would like to draw the Ethics Committee’s attention, in particular, to the pressing need to address the comments relating to definitions, especially that of “network firm”. Should these definitions be amended in a revision to the IFAC Code, conforming changes would be necessary in the Quality Control Standards and IFAC’s proposed Statements of Membership Obligations. The Task Force would be pleased to discuss any proposed changes to the definitions with the Ethics Committee.

Once again, the Task Force would like to thank you and your Staff for your input into the Quality Control project. If you have any questions regarding the above, please do not hesitate to let me, or IAASB Technical Manager Ken Siong, know.

Yours truly,

Ana Maria Elorrieta

Ana Maria Elorrieta
Chair, IAASB Quality Control Task Force

cc IAASB
 Jim Sylph, Technical Director, IAASB

APPENDIX

[Contextual notes are italicized in square brackets. Also, paragraph numbers refer to the revised QC drafts submitted to the IAASB for approval in February 2004.]

#	Respondent	Comment
Definitions		
a) In relation to “network firm”		
1.	Basel Committee on Banking Supervision	The standard defines “Network firm” as “an entity under common control, ownership or management with the firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally.” Normally, the audit report adds credibility to financial information issued for consumption in capital markets. If an audit firm gives the impression that it is a member or part of an international audit network or organisation, it in effect implies that its product, the audit work and report, provides the level of reliability that the network stands for. Thus, the definition of network firm as drafted is not sufficient because it disregards the importance of how firms present themselves.
2.	IOSCO	In the context of ISQC 1, we question whether it is appropriate to qualify the definition of a “network firm” by referring to “a reasonable and informed third party <u>having knowledge of all relevant information</u> ” (emphasis added). By definition, most reasonable and informed third parties will not have knowledge of all relevant information dealing with the nature of the relationships that exist among, for example, national firms that operate as part of an international network. In our view, when the appearance is of a single firm that is sufficient to establish a network relationship regardless of whether knowledge of all relevant information might change that perception.
3.	KPMG	We acknowledge that the definition of “Network Firm” is the same as that which is included in the IFAC Code. However, we are quite concerned that by combining a legal situation of an entity being under common control together with a situation involving the perceptions of others regarding whether an entity should be considered part of a firm could result in an inappropriate conclusion that entities in a network firm are considered to be “controlled” by the network organization. We therefore suggest that the definition of “Firm” be expanded to include entities that are in fact, by virtue of the legal structure, controlled and therefore correctly included in the legal parameters of the firm. The definition of “Network Firm” should then be confined to addressing the other situation of entities that are not under direct or common control but which are included in the network organization. In this regard, we believe it important to unambiguously avoid any reference to control. We are not aware that such a situation (involving control) exists with any of the international organizations. In our experience each member firm is a separate legal entity from each other member firm and none of the firms are “under the common control, ownership and management” of the respective international entity. Accordingly, the definition of Network Firm should address “entities which, while not under common control....etc., belong to a common organization that seeks to establish consistent professional standards

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		among its members”.
b) In relation to “listed entity”		
4.	Canadian Institute of Chartered Accountants	<p>It is not clear that this definition would include the over-counter-markets and registrants with securities commissions. Consider expanding the definition (described as “public enterprise” in Canadian accounting and assurance standards) to read:</p> <p>“an enterprise that has issued debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), that is required to file financial statements with a securities commission, or that provides financial statements for the purpose of issuing any class of securities in a public market.”</p>
5.	Ernst & Young	<p>The term “Listed Entity” is defined as “an entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.” This definition should be clarified by adding that a “Listed Entity” is determined by country specific requirements.</p>
6.	IDW	<p>We believe that the definition of a “listed entity” does not encompass those situations where special accounting or other legal requirements may exist with respect to the public offering or trading of securities. Consequently, we suggest the following definition:</p> <p>“Any entity that has issued, or has specific intentions to issue, financial instruments that are or are intended to be quoted, listed or traded on a recognized stock exchange, offered or traded under the regulation of a recognized stock exchange or other equivalent body, or are subject to securities regulation over their public offering or trading”.</p> <p>We recognize that our proposed definition is inconsistent with the one used in the IFAC Code of Ethics, but the definition in the Code of Ethics is deficient because it does not cover derivative securities or the public offering or trading of securities where such offering or trading is subject to securities regulation but not an exchange or equivalent body.</p>
c) In relation to “firm”		
7.	FEE	<p>In defining a firm, paragraph 6 could refer to "any entity in whose name an assurance or related services report is issued" instead of making reference to specific legal forms such as partnerships and corporations of professional accountants which might not be sufficiently all-inclusive for an international standard.</p>
8.	IDW	<p>The definition of “Firm” is not precise enough to take into account all circumstances in which professional accountants may use the name of an entity in the issuance of an assurance or related services report. For example, given the desire of the IAASB to incorporate considerations with respect to government auditors (INTOSAI), we believe the definition should be more generic to cover all of the circumstances that might be encountered in practice. Furthermore, in Germany there are associations of auditors in whose name audit reports are issued that are not sole practitioners, partnerships or corporations of professional accountants.</p>

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		<p>We suggest the following definition of firm: “Any entity in whose name an assurance or related services report is issued”.</p> <p>We recognize that this would make the ISQC 1 definition inconsistent with the one used in the IFAC Code of Ethics, but we consider the definition of “firm” in the IFAC Code of Ethics to be seriously deficient in this respect.</p>
Use of the term “safeguard”		
9.	IOSCO	<p>We also note in passing that some provisions of the Code of Ethics, such as paragraph 8.105, convey a confusing message by using the term “safeguards” in a context that encompasses taking action to eliminate a threat by, for example, disposing of a financial interest. We consider this a misuse of the word that the IAASB should not repeat in ISQC 1.</p>
Communication of threats to independence to the client		
10.	IOSCO	<p>In addition to establishing policies and procedures designed to enable the firm to identify potential threats to independence and to address those threats internally, we believe a firm should have clearly defined policies and procedures for communicating such matters to clients. We note that securities regulators commonly require an issuer to file financial statements that are accompanied by a report from an independent auditor. Accordingly, we believe issuers have a vital interest in being made aware on a timely basis of actual or potential threats to independence identified by the auditor and how the auditor plans to address those threats. In our view, issuers are entitled to expect to be made aware of such issues regardless of whether the auditor has concluded that the identified threat can be addressed through the application of appropriate safeguards.</p> <p><i>[Note: this matter has also been communicated to the IAASB’s Task Force charged with revising ISA 260, “Communications of Audit Matters with Those Charged with Governance,” for their consideration.]</i></p>
Rotation of engagement partner/senior personnel		
11.	Auditor General, New Zealand	<p>Paragraph 69(e) <i>[Note: this subparagraph in the original exposure draft of ISQC 1 now deleted in the revised draft]</i> restricts an engagement quality control reviewer from becoming the engagement partner (on completion of their reviewer responsibilities) until there has been a “cooling off” period. The logic for this requirement is difficult to understand because, if the engagement quality control reviewer has remained operationally independent of the engagement team and has had little or no involvement with the client, the familiarity threat will be negligible. We contrast this with the situation where an audit manager may be promoted to the position of partner and immediately assume the role of engagement partner. This is, in our opinion, a more significant instance of familiarity threat – but would be acceptable under the existing requirements of ISQC 1.</p>
12.	Ernst & Young	<p>Paragraphs 26 to 28 are too general and are not clear. As drafted, this section of the proposed ISQC will generate significant confusion and conflict with European Union based rules and does not promote convergence of standards. Specifically, paragraph 26 should address the relationship of the partner rotation requirements in certain countries to firm rotation requirements (e.g.,</p>

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		the Italian rule for mandatory firm rotation after nine years).
13.	IOSCO	<p>This paragraph addresses rotation of the engagement partner only. We refer the Board to the October 2002 statement by the IOSCO Technical Committee concerning Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence. Paragraph 14 of this statement indicates that: "Standards of auditor independence should address specifically the need to ensure appropriate rotation of the audit engagement team such that <u>senior members</u> of a team do not remain in key decision-making positions for an extended period." (emphasis added) We believe the Board should amend the paragraph to require that a firm's policies and procedures address the need for appropriate rotation of senior members of an engagement team consistent with the IOSCO Technical Committee statement.</p>
Rotation of the engagement quality control reviewer		
14.	Auditor General, New Zealand	<p>We consider that the engagement quality control reviewer should be able to function in that role up to the same length of time as the engagement partner – under the firm's rotation policy for engagement partners. We consider that the familiarity threat associated with an engagement quality control reviewer, who has remained operationally independent of the engagement team and has had little or no involvement with the entity, will be low – even if they have carried out this role for a period of up to seven years.</p> <p>We consider that an engagement quality control reviewer should be able to continue in the role of reviewer up to, but no longer than, the rotation period permitted for the engagement partner – under the firm's rotation policy for engagement partners.</p>
15.	Royal NIVRA, Netherlands	<p>The proposed requirements for quality control reviewers precludes engagement partners from moving directly into independent quality control review roles for the audit of the same entity. The wording included in paragraph 71 [<i>see bullet (ii) on page 2 of this letter</i>] seems to suggest that for listed entities, the time-out would be 3 years. This could prove challenging not only for smaller firms, but also for larger firms in situations where there is a small pool of partners with the requisite industry expertise.</p> <p>We appreciate and support the need for rotation. However, we note that the neither the Code of Ethics nor many national independence standards impose this required time out for independent quality control review. Rather some look to a maximum period of involvement with a particular client before mandatory rotation for both the audit and independent quality control review combined.</p> <p>We encourage IAASB to consider how other standard setters have addressed this issue to see if there are equally effective alternatives that might be more practicable.</p>