


**INTERNATIONAL FEDERATION
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Agenda Item 5

Committee: IAASB
Meeting Location: New York
Meeting Date: May 11-13, 2003

Quality Control

Objectives of Agenda Item

To review and approve for exposure the proposed International Standard on Quality Control (ISQC) 1, *Quality Control for Audit, Assurance and Related Services Practices*, and ISA 220, *Quality Control for Audit Engagements*.

Activities Since Last IAASB Discussions

The Quality Control Task Force met in Melbourne during March 2003, and subsequently in New York. The Task Force also held two conference calls. The Task Force has received valuable comments from various IAASB members that have been of great assistance in preparing the latest drafts.

Specific Issues

The Task Force would appreciate the IAASB having particular regard to the following identified issues:

- (a) Engagement partner rotation;
- (b) Definition of professional standards;
- (c) Application of proposed standards by small and medium sized practices;
- (d) Complaints and allegations; and
- (e) Effective dates.

ENGAGEMENT PARTNER ROTATION

The draft of the proposed ISQC 1 previously presented to the IAASB included the following text:

“32. Using the same engagement partner on an audit engagement over a prolonged period may create a familiarity threat to independence or otherwise impair the quality of the engagement performance. The Code recognizes that the threat to independence is particularly relevant in the context of financial statement audits of listed entities. Consequently, for such engagements the Code requires the rotation of the engagement partner after a pre-defined period and provides standards and guidance on this matter.”

This has been amended as follows:

“26. Using the same engagement partner on an audit engagement over a prolonged period may create a ~~familiarity~~ threat to independence or otherwise impair the quality of ~~the engagement~~ performance of the engagement. The IFAC Code recognizes that the threat to independence is particularly relevant in the context of financial statement audits of listed entities. Consequently, for such

engagements the IFAC Code requires the rotation of the engagement partner after a pre-defined period, normally no more than seven years and provides standards and guidance on this matter. Other national requirements may establish shorter rotation periods.”

During the period after the March 2003 IAASB meeting, the Task Force received several comments from IAASB members and other interested parties regarding engagement partner rotation for audits of financial statements of listed entities. All the commentators expressed the view that the proposed ISQC 1 should state a rotation period for such audits. Some commentators (and also some members of the Task Force) expressed the view that an appropriate rotation period would be five years. This conflicts with the rotation period set in the IFAC Code, i.e. seven years. The Task Force concluded that it was not appropriate to draft a requirement more stringent than that of the IFAC Code. Consequently, the proposed ISQC 1 includes a reference to the seven year period set in the IFAC Code and to the fact that national requirements may require a shorter period. The Task Force believes that this is a compromise and prefers that the IAASB recommends to the IFAC Ethics Committee that the IFAC Code be revised to introduce a mandatory five year rotation period. The Task Force believes that such action would represent the leadership that IFAC as a whole is being asked to provide.

The draft of the proposed ISQC 1 previously presented to the IAASB also included the following text regarding engagement partner rotation, which has been removed from the latest draft:

“35. Some degree of flexibility over timing of the rotation of an engagement partner may be necessary in certain circumstances. Examples of such circumstances include:

- Situations when the engagement partner’s continuity is especially important to the client, for example, when there will be major changes to the client’s structure that would otherwise coincide with the rotation of the engagement partner.
- Situations when, due to the size of the firm, rotation is not possible or does not constitute an appropriate safeguard against the threat resulting from using the same engagement partner over a prolonged period.

In all such circumstances when the engagement partner is not rotated after such a pre-defined period equivalent the firm considers the application of safeguards to reduce any threats to independence to an acceptable level.”

This text was taken almost verbatim from paragraph 8.153 of the IFAC Code. It was inserted at the request of the IAASB during the March 2003 meeting to take account of the difficulties that may be faced by certain firms (typically small or medium sized firms) in certain circumstances. However, based on comments received it was clear that this paragraph was extremely unpopular and consequently the Task Force decided to remove it from the latest draft. The Task Force concluded that the paragraph allows far too much “license.” Again, the Task Force urges the IAASB to recommend to the IFAC Ethics Committee that the IFAC Code is revised to make it less easy for firms to avoid mandatory rotation.

DEFINITION OF PROFESSIONAL STANDARDS

The Task Force believes that the most appropriate definition for professional standards is as follows:

“IAASB engagement standards and relevant ethical requirements, which ordinarily comprise Parts A and B of the IFAC Code of Ethics for Professional Accountants and national ethical requirements”

However, the Task Force is aware that during the March 2003 IAASB meeting some IAASB members expressed the view that it was not appropriate to include national requirements in professional standards. The Task Force has considered this issue and it believes that ethics requirements are somewhat different than other standards (e.g. auditing standards). The IFAC

Code currently states that it is intended to serve as a model on which to base national ethical guidance. It acknowledges that, in those instances where a national requirement is in conflict with a provision in the IFAC Code, the national requirement would prevail. In addition, the IFAC Code caters for those countries that wish to adopt the IFAC Code as their own national code by providing wording that may be used to indicate the authority and applicability in the country concerned. The Task Force believes that it is clear that, under the current IFAC Code, national ethical requirements are still of primary importance. While the Task Force is aware that the new Section 8 of the IFAC Code is itself a standard, and that the IFAC Ethics Committee is currently working on a revision of the rest of the IFAC Code that has as one of its aims the elevation of the whole IFAC Code to the level of a standard, this is not currently the position. Consequently, the Task Force believes that it is appropriate to include national ethical requirements in the definition of professional standards.

APPLICATION OF PROPOSED STANDARDS BY SMALL AND MEDIUM SIZED PRACTICES

The Task Force has attempted to add additional wording to take account of the special circumstances of small and medium sized practices as requested by the IAASB during the March 2003 meeting. The Task Force believes that it would be appropriate for the IAASB to invite the IFAC SMP Task Force to develop material for small and medium sized practices to assist them in implementing ISQC 1.

COMPLAINTS AND ALLEGATIONS

The latest draft of the proposed ISQC 1 includes a new section on complaints and allegations. Recent events have highlighted the need for firms to have systems in place to deal with complaints and allegations. The Task Force believes that this section is a valuable addition to the document.

EFFECTIVE DATES

During the March 2003 meeting, the IAASB indicated that it believed that the effective dates of the two documents should be July 31, 2004. On reflection, the Task Force strongly believes that this date will not be achievable, particularly by small and medium sized practices. Consequently, both the proposed standards have an effective date of January 1, 2005. The Task Force believes that this will not affect the EU deadline.

Material Presented

Agenda Paper 5-A (Pages 497 – 516)	Draft ISQC 1 Quality Control for Audit, Assurance and Related Services Practices (Clean)
Agenda Paper 5-B (Pages 517 – 526)	Draft ISA 220 Quality Control for Audit Engagements (Clean)
Agenda Paper 5-C (Pages 527 – 548)	Draft ISQC 1 Quality Control for Audit, Assurance and Related Services Practices (Marked from draft previously presented to the IAASB)
Agenda Paper 5-D (Pages 549 – 558)	Draft ISA 220 Quality Control for Audit Engagements (Marked from draft previously presented to the IAASB)

Action Requested

1. IAASB is asked to review and approve for exposure the proposed ISQC 1 and ISA 220.
2. IAASB is asked to provide editorial comments directly to staff.