

BASEL COMMITTEE ON BANKING SUPERVISION

Technical Director
International Federation of Accountants
535 Fifth Avenue
26th Floor
New York, NY 10017

29 June 2001

Dear Sir,

The Basel Committee on Banking Supervision ("the Committee") has considered the revised proposed changes to the Code of Ethics for Professional Accountants on Independence ("the second ED") issued for comment by the IFAC Ethics Committee.

As you know, the Committee welcomes IFAC's initiative to update the guidance in this area and to produce a revised Code as part of the process of enhancing auditor independence globally. The Committee acknowledges that many amendments have been made to the second ED in response to comments on the previous draft.

Our comments on the second ED are contained in the enclosed note which has been prepared by the Committee's Task Force on Accounting Issues, chaired by Dr Arnold Schilder, Executive Director of De Nederlandsche Bank. These are intended to help improve the second ED further but should not be seen as an endorsement of the IFAC Code.

If you have any questions in relation to our comments, please do not hesitate to contact Deborah Chesworth at the Financial Services Authority (+44 20 7676 3880) or Bengt A Mettinger at the Basel Committee Secretariat (+41 61 280 9278).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'William J McDonough', written in a cursive style.

William J McDonough

ANNEX

“Independence – Proposed Changes to the Code of Ethics for Professional Accountants”: second Exposure Draft issued for comment April 2001

General comments

The independence of auditors and others involved in assurance engagements continues to be the subject of considerable importance and interest around the world. The Committee welcomes the efforts which IFAC has made in its second ED to achieve consistency with parallel initiatives in a number of jurisdictions (whilst acknowledging the relevance of national perspectives) and notes that this review process will need to continue during the finalisation of the revised independence framework.

The Committee also notes that extensive changes have been made to the second ED in response to comments received and is pleased to note that many of our suggestions in relation to the previous draft have been adopted.

Conceptual approach

The Committee reiterates its support for IFAC’s overall approach to independence, which is based on a conceptual framework supported by a series of examples. The fundamental concept which underpins the framework is that the overall level of “independence risk”, which is increased by threats and reduced by appropriate safeguards, must be at or below the level which a reasonable and informed third party would reasonably conclude to be acceptable. The acceptability threshold for overall independence risk can be reached in many different combinations of threats and safeguards but must be constant. The Committee has some concerns (the most important of which are explained below) that this balance may not have been achieved in all of the examples in the second ED and recommends that they are reviewed against this overall test as part of the process of finalising the revised framework.

High public interest entities

In broad terms, the Committee welcomes the explicit recognition that certain forms of engagement have a high public interest and that this has an impact on issues of independence. The second ED explains that there is a strong public interest in the audit of a listed entity and more specific guidance is given in relation to such engagements. The text goes on to note that there may also be “other significant public interest entities which are not listed entities and consideration should be given to the application of the principles set out in this section ... to such other audit clients”. Whilst this material goes some way towards addressing the Committee’s earlier concerns, it provides an incomplete solution in two particular respects. Firstly, it is difficult to understand why other assurance engagements for a listed entity should not give rise to the same degree of concern as the audit. Secondly, where an unlisted entity does give rise to significant public interest, the suggestion that the

assurance team “should give consideration to” applying the same independence standards as to listed entity engagements is rather weak.

The Committee therefore suggests that the more specific guidance in the second ED should apply to all assurance engagements conducted for “high public interest entities”. These could be defined as “entities which are of significant public interest because their business, their size or corporate status is such that they have a wide range of stakeholders. Examples might include banks, insurance companies, investment firms, pension firms and listed companies”.

Other comments on the second ED

1. Audit engagements and other assurance engagements

The Committee notes that the second ED defines both “assurance engagements”¹ and “audit engagements”, the latter being a subset of the former. As noted above, this distinction is used in specifying certain guidance which, it is proposed, should relate only to the audit of listed entities. It is also employed more broadly to identify certain types of potential threat to independence which, it is suggested, are relevant only in relation to audits. Particular examples include the provision of: internal audit services; services which involve the design and implementation of IT systems; temporary staff assignments; and legal services. The Committee believes that such activities could pose a considerable threat to independence in relation to any assurance engagement and that this should be reflected in the text.

2. Investment in an assurance client

The Committee notes that the second ED now prohibits the firm, a member of the assurance team or their immediate family member from having a direct financial interest or a material indirect financial interest in an assurance client. Whilst this is a welcome change, it would be helpful if some guidance could be provided on the meaning of “material” for this purpose; in particular, it is not clear whether materiality is to be judged in relation to the investor or the assurance client.²

The Committee continues to believe that guidance should be provided on the difficult question of whether or not a firm or member of an assurance team should be able to obtain insurance cover from an assurance client that is an insurance company.

3. Business relationships

The Committee welcomes the statement that, for the audit of listed entities, the lead audit engagement partner should be rotated, normally after seven years, and should not resume that role for a further period of time, although this second period should be four years rather than the two years proposed in the second ED.

¹ The term “assurance engagement” is defined as “An engagement conducted to provide a ... level of assurance ...”. It would assist readers whose first language is not English if the word assurance could be explained.

² More generally, the second ED uses both “material” and “significant” in various contexts. If these terms are intended to have the same meaning, it would be clearer to use only one of them throughout the document. If, on the other hand, they are different, their meanings should be explained.

4. Non-assurance services

Preparing accounting records and financial statements

The Committee continues to believe that a self-review threat will *always* be created when a firm assists a client in matters such as preparing accounting records or financial statements that will be the subject of the assurance engagement. That threat could not be reduced to an acceptable level by any safeguards if the firm personnel providing such assistance either: make management decisions (paragraph 8.149); or are members of the assurance team. Furthermore, the Committee believes that some of the tasks listed in paragraph 8.150 as a normal part of the audit process could in fact cause an unacceptable threat to independence if undertaken by a member of the audit team. An item of particular concern is assisting in the preparation of consolidated financial statements, which are, presumably, the subject of the audit opinion.

Other services

The inclusion in the second ED of text on the provision of internal audit and information systems design services is welcome. The Committee has the following comments on this material:

- (a) guidance is needed on the different degrees of threat to independence that could be posed by internal audit services of differing scope. For example, the provision of services involving the design of internal controls is likely to pose a greater threat than an “agreed-upon procedures” assignment in relation to compliance with established internal control processes. In this context, the text of paragraph 8.169 on the provision of services in connection with the assessment, design and implementation of accounting and risk management controls should also be reviewed and expanded;
- (b) it would be useful to clarify the meaning of “services involving an extension of normal audit services” in paragraph 8.162;
- (c) paragraph 8.164 should be more robust. Performing a significant portion of the client’s internal audit activities will usually create a self-review threat and there must be a threshold beyond which that threat is so great that no safeguards could reduce it to an acceptable level. A firm should therefore set an upper limit on the proportion of internal audit services it performs for an assurance client. A similar issue arises in relation to IT systems services in paragraph 8.167.

5. Fees and pricing

The Committee continues to believe that a specific benchmark should be offered on concentration of fees. The Committee also notes that overdue fees (paragraph 8.189) could be perceived as constituting a loan from the firm to the assurance client and should therefore be subject to the guidance in paragraph 8.117. Finally, in relation to pricing (paragraph 8.190), the Committee notes that the potential self-interest threat which may be created by particularly low fee levels for an assurance engagement is likely to be more severe when coupled with substantial fees for non-assurance work; a reference to this situation would be helpful.