



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

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**IESBA exposure draft for section 290 of the code of ethics, independence –
audit and review engagements and section 291 of the code of ethics,
independence – other assurance engagements**

Dear Sir/Madam

The Basel Committee on Banking Supervision (Committee) welcomes the opportunity to comment on your recent exposure drafts on auditor independence. The Committee has a strong interest in promoting a high quality international code of ethics for accounting firms and auditors, and believes that these exposure drafts include many useful proposals.

The Committee strongly believes that auditor independence is at risk when firms are able to provide, on a concomitant basis, external and internal audit services to a significant public interest entity (eg a bank). In these cases, the self-review threat and management threat can become inappropriately high. Furthermore, the guidance on mitigating self-interest threats related to audit fees should be enhanced. Please find our detailed comments in the attached appendix. These comments have been prepared by the Committee's Accounting Task Force, chaired by Ms Sylvie Mathérat, Director of Commission Bancaire in France, and approved by the Basel Committee. The Committee trusts that you will find its comments useful and constructive.

If you have any questions regarding our comments, please feel free to contact Sylvie Mathérat (+31 20 524 3360), Marc Pickeur who chairs the Audit Subgroup of the Accounting Task Force (+32 2 220 5253) or Linda Ditchkus at the Basel Committee Secretariat (+41 61 280 9278).

Yours sincerely,

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Appendix

Basel Committee comments on IESBA exposure drafts of section 290 of the code of ethics: independence – audit and review engagements and section 291 of the code of ethics: independence – other assurance engagements

1. Introduction

The Basel Committee on Banking Supervision¹ has a strong interest in promoting a high quality international code of ethics for accounting firms and auditors and has carefully analysed the proposals of the International Ethics Standards Board for Accountants (IESBA) pertaining to the proposed revised section 290 of the code of ethics: independence – audit and review engagements and proposed section 291 of the code of ethics: independence – other assurance engagements (the Code).

The Committee has two major observations.

The Committee is concerned about whether the revised section provides sufficient robust guidance about providing internal audit services to public interest entities. In particular we believe that the self-review threat can become too significant if internal audit services are provided to entities of significant public interest, in particular banks. The Committee is of the view that, due to the level of public interest in such entities, a firm that audits the financial statements should not provide internal audit services to these entities in cases where the internal audit work would be relied upon in the course of auditing an entity's financial statements or where the firm personnel providing the internal audit service would undertake part of the role of management. These circumstances would impose a self-review threat or a management threat, respectively, that safeguards could not mitigate.

The Committee agrees with the IESBA that a self-interest threat can be created when an auditor becomes dependent on fees from an audit client. The proposed revision of the Code to provide additional guidance with respect to the relative size of fees from an audit client that is an entity of significant public interest could be strengthened and enhanced by modifying the tone, expanding the requirement's scope, and providing background information on the threshold percentage.

¹ The Basel Committee on Banking Supervision is a committee of banking supervisory authorities, which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

2. Internal audit services (paragraphs 290.186-191)

The Committee believes that the IESBA should consider clarifying certain aspects of paragraphs 290.186-191. These aspects include the following.

To make the proper responsibilities of the firm and the audit client clearer, the title that precedes paragraph 290.186 should include the word “participation” to become “Participation in Internal Audit Services”.

It would be helpful if the section would start with a definition of internal audit before elaborating on the wide range of activities that internal audit functions comprise. A useful and widely used definition of internal audit is the definition provided by the Institute of Internal Auditors. This definition is as follows:

“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance process.”
(see <http://www.theiia.org/guidance/standards-and-practices/professional-practices-framework/definition-of-internal-auditing/>).

The section should make it clearer in an introductory paragraph that providing internal audit services to an audit client creates three threats to independence:

- performing management functions for the audit client;
- becoming part of the client’s internal controls; and
- reviewing its own work in the course of a subsequent audit.

Each threat identified in the introductory paragraph could then be cross-referenced to the paragraphs where the threat is explained in more detail and where possible safeguards are provided.

We believe that the following changes would make paragraph 290.190 clearer.

We suggest adding the words “at all times” in paragraph 290.190(a): The client is *at all times* responsible for internal audit activities and acknowledges its responsibility for establishing, maintaining and monitoring the internal controls’.

We believe that for entities of significant public interest it is a good practice that the client always (and not “preferably”) designates a competent and experienced individual within senior management to be responsible for internal audit activities. We suggest modifying paragraph 290.190(b) accordingly.

We also believe that it is a good practice to establish a written contract between the client and the firm providing internal audit services. The contract should explicitly provide that senior management must give its prior approval to any risk analysis performed by the firm and to any internal audit plan that the firm has established. For an audit client that is regulated, the contract should also state that the client’s senior management (or its

representatives) and the regulatory or supervisory authority have access at any time to the work plan and working papers. Section 290.190 should include these principles.²

As explained in the Introduction of this Appendix, the Committee believes that firms should not provide internal audit services to entities of significant public interest in combination with performing the external audit of the same client's financial statements in cases where the internal audit work would be relied upon in the course of auditing the client's financial statements or where the firm personnel providing the internal audit service would undertake part of the role of management. In these circumstances, when the audit client is an entity of significant public interest, the self-review threat or management threat, respectively, would be so high that no safeguards could be implemented to mitigate the threat. Paragraph 290.191 should be modified accordingly. For example, this paragraph could be made applicable only to audit clients that are not entities of significant public interest.

3. Fees (paragraphs 290.213-220)

The Committee shares the concern of the IESBA that when the total fees from an audit client represent a large proportion of the total fees of the firm expressing the audit opinion, the dependence on that client and concern about losing that client may create a self-interest threat. The IESBA should consider enhancing the definition of the operating structure of the firm in paragraph 290.213 to specify that a self-interest threat could also arise at various levels within the firm, for example at the engagement partner, solo office, or regional/national office level.

The Committee believes that the remedies proposed in paragraph 290.214 are not sufficiently robust and should be significantly strengthened. We believe that the Code should make it impossible for a firm, an office or group of offices of a firm, or a partner to become dependent on one large client. To strengthen this paragraph, IESBA could delete the terms "considered and" and "when necessary" in the second sentence, and delete the word "might" in the last sentence. IESBA should also include more specific examples of safeguards, as the ones provided are fairly general. Thus, the revised paragraph, before the inclusion of more specific examples, would be:

"A self-interest threat may also be created when the fees generated from an audit client represent a large proportion of the revenue from an individual partner's clients. The significance of the threat should be evaluated and, if the threat is not clearly insignificant, safeguards should be applied to eliminate the threat or reduce it to an acceptable level. Such safeguards include having an additional professional accountant review the work or otherwise advise as necessary."

In response to the request for specific comments, the Committee noted that IESBA has not supported its view that 15% is an appropriate threshold by arguments in the Explanatory Memorandum. We encourage the IESBA to publish a basis for conclusions that explains its reasoning in arriving at a threshold of 15%, including how the IESBA took into account the effectiveness of this percentage and its impact on firms. Because this 15% threshold is applied only at the firm level, we recommend that IESBA apply a significance level for fees from an audit client at the office and group of offices levels and at the partner level.

² The Board may find it helpful to refer to the Committee's publication "Internal audit in banks and the supervisor's relationship with auditors" (August 2001). The document is available at www.bis.org.