

BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS
CH-4002 BASEL, SWITZERLAND

THE CHAIRMAN

24 October 2000

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

By fax: 001 212 286 9570

Dear Sir,

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

The Committee strongly believes that the interests of investors and depositors are best served by the publication by banks of financial statements that are prepared in accordance with high quality accounting standards and are independently audited in accordance with high quality auditing standards. The Committee therefore welcomes the IFAC's initiative to update the existing guidance in this area and to produce a revised Code. The comments that the Committee offers are intended to help improve the ED and so enhance minimum standards of auditor independence globally, but should not be seen as an endorsement of the IFAC Code.

You will find in the enclosed note our comments on the ED. The Basel Committee's Task Force on Accounting Issues, chaired by Dr. Arnold Schilder, has prepared the note.

If you have any questions regarding our comments, please feel free to contact Richard Thorpe at the Financial Services Authority (+ 44 207 676 3160) or Bengt A. Mettinger at the Basel Committee Secretariat (+ 41 61 280 9278).

Yours sincerely,



William J. McDonough

Annex

“Independence - Proposed Changes to the Code of Ethics for Professional Accountants” issued for comment 13 June 2000

General comments

Since the ED was published in June 2000 there has been an enormous increase in interest in the issues of reporting accountant independence around the world, and a number of jurisdictions are undertaking reviews of their independence standards. It is important for the rules on independence to be consistent (although clearly they will need to reflect local practice, cultures and legal systems) and the Committee would urge IFAC to review its ED in the light of the proposals and resultant comments that have emerged over the last several months.

The Committee notes that the ED makes no reference to particular requirements in certain industries and in particular does not acknowledge that limitations might be placed on the provision of non-assurance services in some sectors. Many of the comments in this letter could be met by providing specific guidance concerning the audit of banks, and it might be helpful generally to note that other international requirements may exist to supplement the Code in some industries.

The Committee also notes that the ED is directed at independence and ethics issues for all reporting accountants, many of whom are small firms with few large clients and limited opportunities to delegate responsibilities or separate the role of auditor from the role of business adviser. The Committee is concerned that the needs of large internationally active companies are not fully addressed because the ED affords a degree of flexibility that may be appropriate to a small business but should not be available to a reporting accountant for a large company.

The Committee would prefer not to introduce a two-tier Code of Ethics, but it is concerned that a stringent regime should be applied to reporting accountant engagements that have a high public interest. This would include internationally active companies and all but the smallest regulated financial institutions. In these cases, there is a greater need for a demonstrably independent audit of the financial statements. IFAC should consider providing extra guidance and perhaps eliminating flexibility in the Code for reporting accountants in such engagements.

Detailed comments on the ED are as follows:

1. Approach to regulation

The Committee notes that the ED is based on a conceptual framework that describes the factors that could threaten a reporting accountant's independence and the safeguards that can be put in place to preserve that independence. This is followed by a series of examples with suggestions of how to minimise the threats that arise. The Committee supports this approach,

on the basis that it is not appropriate to offer detailed rules in a document that is intended to be applied in a wide range of legal and cultural environments. Furthermore, the Committee is concerned that detailed rules run the risk of failing to keep up with developments in the market. The Committee also notes that even if independence is ultimately a state of mind, precise rules that support that state of mind will enhance the independence in appearance. However, as noted above, the Committee is concerned that the ED does not offer sufficient guidance, examples or descriptions of threats and safeguards for engagements that have a higher public interest.

2. Improved disclosure

The Committee strongly believes that improved disclosure and transparency are key elements of accountability to investors and other stakeholders. The revisions to the Basel Capital Accord that are currently underway acknowledge disclosure as one of the three key Pillars of regulation.

The ED makes no proposals for using disclosure as a method of enhancing the independence of reporting accountants, and the Committee recommends that this should be reviewed. Many of the key elements of disclosure (notably disclosure of fees for audit and non-audit services in annual financial statements) are outside the scope of this ED, but improvements could be made in disclosures by reporting accountants, both to the market and to their clients. For example, reporting accountants could be required to make specific disclosures to their clients (at an appropriate level of seniority) of threats they have perceived to their independence, and the safeguards they have put in place to overcome those threats. Consideration could also be given to increased public statements by reporting accountants of the fees they have earned from audit and non-audit services.

3. Investment in an audit client

The Committee notes that the ED allows a reporting accountant or immediate family member to have a financial interest in an assurance client as long as it is clearly insignificant (para 8.101). The Committee believes that it is essential for the reporting accountant to be seen to be completely independent of his client, particularly as there is no clear and robust definition in the ED of the term ‘clearly insignificant’. The Committee would recommend that the ED should prohibit any financial interest in an assurance client.

The Committee is also concerned that the ED does not address the independence issues arising from a reporting accountant acting as a trustee of a trust that holds shares in an assurance client. The Committee suggests that IFAC could usefully draw on the rules developed in this area by a number of national or regional standard setters.

Another related issue where the Committee is concerned that the ED does not offer guidance is in relation to insurance. The ED does not indicate whether a reporting accountant should be able to obtain insurance cover from an assurance client that is an insurance company. This is a difficult issue, particularly in markets where there are very few providers of insurance

(notably professional indemnity insurance) but there are potential threats to independence that the Committee believes should be addressed. It might be useful to look at other developments in this area, as for trusteeships as described above.

4. Structures of firms

The Committee notes that the ED does not cover the structure of accounting firms, and that this will be considered in future consultations. The Committee is concerned that the ED does not provide adequate guidance on the independence requirements of the members of the accounting firm (and their immediate families), other than the professional participating in the assurance engagement. Such individuals, for example, would include the other partners and staff of the accounting firm in the same country – as well as the senior partners of the accounting firm to whom the professional participating in the assurance engagement reports, either directly or ultimately.

The Committee also has concerns that there is a lack of clear guidance about the extent to which independence could be compromised by ownership structures of multidisciplinary firms that might allow for cross holdings with suppliers and other professionals with close connections with assurance clients.

We look forward to the opportunity to comment on IFAC's proposals on the effects of multidisciplinary practices, and on the above issues.

5. Business relationships

The Committee agrees that long association of a reporting accountant with an assurance client creates at least a perceived risk of client influence (para 8.15 and 8.127), and agrees with the possible safeguards. The Committee believes that the most important safeguard is the rotation of senior members of the audit team, and recommends that rotation of at least the audit partner(s) should be required in all cases.

6. Non-assurance services

(a) Valuations

The Committee is concerned that the guidance on safeguards on valuations is not sufficient (para 8.113). In particular, the Committee does not believe that reporting accountants can rely on management accepting responsibility for a valuation provided by a reporting accountant. As management has sought expert advice from the reporting accountant, assurances that management has taken responsibility for the valuation clearly have limited value. In virtually all circumstances, therefore, the Committee believes that it would not be appropriate for the reporting accountant to undertake valuations of matters material to an assurance engagement, such as audit of a financial statement.

The Committee believes that the IFAC should develop guidance on valuations that are material to the assurance client although they may not be material to the assurance engagement. In those (limited) circumstances, it might be appropriate to develop further safeguards that stipulate that valuations should be undertaken by staff who is entirely separate from the members of the assurance engagement team.

(b) Human resources

The Committee believes that the proposed safeguards on recruitment of senior management are reasonable. However, the ED should emphasise that involvement in recruitment of senior management (and in particular those who will influence the assurance engagement) can compromise the reporting accountant's independence.

(c) Advocacy

The Committee is concerned that the guidance on threats arising from acting as an advocate for an assurance client (para 8.14) does not provide sufficient detail to be operational in practice, as there is no clear definition of what is meant by advocacy in this context, and the examples offered are clearly not intended to be definitive. The Committee is also unclear as to the extent to which the ED would allow a reporting accountant to undertake tax work for an assurance client. All but the most basic tax compliance work could be seen as advocacy on behalf of clients, and it is not clear whether the ED is intended to prohibit such work, or whether the prohibition in this context is intended to apply only to advocacy in a Court or Tribunal.

(d) Preparing accounting records and financial statements

The ED states (para 8.109) that "preparing an assurance client's prime records or financial statements presents a self-review threat" but the following paragraphs imply that there are circumstances in which this could be acceptable. The Committee believes that it is inconsistent with the reporting accountant's independence for him to prepare accounting records that will be the subject of the assurance engagement, and the ED should make it clear that there are no reliable safeguards to overcome this threat.

(e) Other services

The ED makes no specific references to two areas of non-audit work that are particular areas of concern for many national standard setters at the moment, i.e. Information Systems design and internal audit. The Committee believes that this is a major oversight, and that the ED should offer clear guidance that allows reporting accountants to offer such services only when they do not pose conflicts to independence.

In July, the Committee issued a Consultative Paper on internal audit services in banking organisations, and the role that external auditors can play in that process is one of the issues in

that paper. The key presumption in this area should be that a reporting accountant should not review (or rely on) work that has been performed by his own firm.

7. Dependence on fees

The ED notes that when fees generated by a client represent a large proportion of a reporting accountant's total fees there is a risk to independence (para 8.128–9), but it does not provide any guidance on what might be seen as a 'large proportion'. The Committee believes that concentration of fees is a major potential threat to independence, and that a specific benchmark should be offered, e.g. for a larger accounting firm, no more than 10–15% of fees from any one client.