

ICAEW REP 4/05

Enhancing Corporate Governance for Banking Organisations

Memorandum of comment submitted in November 2005 by the Institute of Chartered Accountants in England and Wales to the Basel Committee on Banking Supervision in response to its consultative document “Enhancing corporate governance for banking organisations”, issued in July 2005.

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Introduction

1. The Institute of Chartered Accountants in England and Wales (the 'ICAEW') welcomes the opportunity to comment upon the Consultative Document "*Enhancing corporate governance arrangements for banking organisations*" issued in July 2005 by the Basel Committee on Banking Supervision
2. The ICAEW is the largest accountancy body in Europe, with more than 125,000 members. It operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Financial Reporting Council. The ICAEW's primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

Overview

3. The status of the guidance is unclear. Paragraph 1 suggests that the guidance is intended to assist banking supervisors in promoting sound corporate governance practices in banking organisations. However, some of the wording elsewhere in the guidance suggests that it is intended to also provide guidance also to banking organisations. The guidance should stick to its own remit of providing guidance for those banking supervisors charged with developing national codes of corporate governance or where national corporate governance codes do not meet the OECD principles. At present, the guidance suggests additional requirements for banking organisations and may be inconsistent with national codes or regulations.
4. We are concerned that the document, in places, gets into too much detail, with a result that it takes on the appearance of rules rather than overarching principles upon which national banking supervisors can build their own framework of rules and guidance. We also consider that considerable care needs to be given to the consequences of some of the suggested disclosures, which appear onerous and excessive. In other places, the proposals in the document imply an extension of the duty of care and scope of work of external auditors.

Structure, Role and Composition of Audit Committee

5. Paragraph 34 suggests that the audit committee "should be comprised of a majority of board members who are not executives of the bank". In the UK, the recommendation in the Combined Code on Corporate Governance is that all audit committee members are independent non-executive directors. We suggest the insertion of the words "at a minimum" after "comprised" in the above statement. The consultation paper also suggests that the Chairman or at least one other member of the audit committee should possess expert knowledge.
6. Whilst we agree that it is important that members of the audit committee should have backgrounds compatible with the duties of the committee, we have some concerns that one member of the committee is singled out as having expert knowledge in financial reporting, accounting or auditing. We believe that there is an important question as to whether the audit committee as a whole should have, and have access to, recent and relevant experience to enable the committee to discharge its responsibilities rather than

identify one individual as being so qualified. There is a concern that such a position exposes the specific individual to additional risk of liability and reputational damage.

7. Paragraph 34 states that “all members [of the audit committee] should have backgrounds compatible with the duties of the committee.” This might be interpreted as implying that all members of the audit committee require financial skills. Whilst it is important that the audit committee includes financial skills in addition to expert knowledge, skill diversity can also act as an effective control. It is more important that the committee as a whole has an appropriate mix of skills rather than that each and every member has a financial background. We suggest that the above statement is replaced with wording such as “the board should consider whether the balance of skills of the audit committee (or equivalent structure), taken as a whole, is appropriate for its role.”
8. Paragraph 34 provides a statutory board of auditors as an example. This refers to a specific structure limited to a few jurisdictions. It might be better if this example is removed, since it appears unnecessary and might be read to exclude other types of acceptable “equivalent structures”. It also suggests that the audit committee is typically responsible for approving the appointment of the auditors. This is not the case in the UK, where the audit committee makes recommendations to the Board on the appointment, reappointment and removal of the external auditors. Boards approve the resolution on this matter that will be put to the shareholders. Audit committees in the UK do not approve the appointment etc of the external auditors, albeit this may be the case in other jurisdictions. Responsibility for the approval of the appointment or removal of auditors rests with the shareholders acting as a body at the Annual General Meeting.

Work of External Auditors

9. Paragraph 38 deals with a number of issues relating to the work of external auditors which are dealt with more comprehensively elsewhere, for example in International Standards on Auditing, the IFAC Code of Ethics, the 8th Company Law (Audit) Directive in Europe, and by further national guidance and regulatory structures from auditors. We do not consider it appropriate for the Basel Committee to be issuing guidance on matters such as auditor independence and standards of professional conduct of auditors given that adequate guidance exists elsewhere in these areas. It would be better if the second, third and fourth bullet points were replaced with a general reference to professional guidance for auditors and national legal requirements.
10. The fourth bullet point, for example, suggests that auditors “understand their duty to the **bank and its stakeholders**” [emphasis added]. The use of the term stakeholders, rather than shareholders, appears to be a suggestion that auditors might owe a responsibility, for example, to bank depositors and others. In the UK, the Companies Act sets out the responsibilities of auditors. It is supported by an established body of case law which rejects extending a duty of care and potential liability “in an indeterminate amount for an indeterminate time to an indeterminate class”ⁱ, as elaborated in respect of auditors in the case of *Caparo*ⁱⁱ. In the UK (and elsewhere) the law states that auditors owe a duty of care to existing shareholders as a body, not to shareholders as individuals, the entity audited, its customers or other stakeholders as suggested in the consultation paper.

ⁱ Cardozo C.J in *Ultramares Corporation v. Touche* (1931) 174 N.E. 441, 444

ⁱⁱ *Caparo Industries PLC vs Dickman and others* [1990] 1 All ER 568 [1990] 2 WLR 358

11. The sixth bullet point of paragraph 38 suggests that rotation of external auditors should be considered. Audit firm rotation was fully considered, debated and rejected in Europe during the development of the newly issued 8th Directive, in favour of rotation of the audit partner. It would be unfortunate if the Basel Committee guidance was to reopen this debate or to impose stricter requirements than those under European Law. Independent research, conducted by the Università Bocconi School of Management into the impact of mandatory audit rotation in Italyⁱⁱⁱ, concluded that the “the policy seems to lead to additional cost, greater concentration of work amongst the largest audit firms, negative impact on audit quality (most noticeably in the years immediately after the rotation) and is ignored by the stock market”^{iv}. Furthermore, the 2005 literature review by Bocconi into other studies of the impact of mandatory audit rotation found that the majority of independent studies into auditor rotation in different jurisdictions did not support auditor rotation, with a greater majority in empirical studies. We suggest that the statement in paragraph 38 is replaced with a recommendation for a broader annual evaluation of the effectiveness of auditors, including arrangements for rotation of the lead partner and possibly other key members of the audit team.

External Auditor Reporting on Internal Controls

12. The final bullet point of paragraph 38 states that boards engage “external auditors to judge the effectiveness of key internal controls”. This is potentially a highly onerous requirement for companies and external auditors, one that has unintended consequences such as substantial costs and, depending upon the extent and nature of such work, could create independence conflicts for auditors. The proposal extends beyond the normal remit of external auditors and even beyond the costly requirements of section 404 of the Sarbanes-Oxley Act (where the jury is still ‘out’ on the benefits of this section of the Act) which restricts itself to internal control over financial reporting.
13. The UK takes the wider approach to internal control (operational, compliance and financial) linked to risk management and has very recently reviewed its existing guidance (the 1999 Turnbull guidance) to directors of listed companies. The Turnbull Review Group (TRG) of the independent Financial Reporting Council, after undertaking a very extensive evidence gathering exercise, considered and rejected any extension of external auditor reporting requirements in respect of internal controls beyond the limited, yet sufficient, existing requirements which are outlined in Appendix A^v.
14. The TRG, which published its final report in October 2005, gathered evidence from investors, listed companies, the accountancy profession and others. Listed company respondents accounted for in excess of 56% of the total market capitalisation of UK listed companies on the London Stock Exchange’s main market. The total funds under management were £2,367 billion for the individual institutions who responded; and £3,100 billion for the two investor representative bodies who responded.
15. The TRG asked three questions on the role of external auditors. (1) What benefit does the existing work performed by external auditors on internal control, and the

ⁱⁱⁱ SDA Università Bocconi “*The impact of mandatory audit rotation on audit quality and on audit pricing: the case of Italy*”, 2001 and updated in 2004

M Camaran, D Di Vincenzo and E Merlotti “*The audit firm rotation rule: a review of the literature*”, SDA Università Bocconi, 2005

^{iv} Camaran et al, 2005, *ibid*, page 4

^v Financial Reporting Council “*Review of the Turnbull guidance on internal control – Consultation Paper and Evidence Paper*”. June 2005

subsequent dialogue with the board, provide to (a) the board of a company; and (b) investors? (2) What are the advantages and disadvantages of extending the external auditors' remit beyond the existing requirements? If you consider that any change should be made to the existing remit, what might this be and why? (3) What impact, if any, might an extended role for the external auditor have on the relationship and dialogue between the external auditor and the board and its committees?

16. Responses to the consultation exercise were consistent on these issues, with similar views being held by business, investors and the accountancy profession. The general view was that the existing activities and limited remit of the external auditor in reviewing the company's internal control statement:
- were considered sufficient;
 - provide additional assurance to boards and shareholders; and
 - should continue to be undertaken.
17. There was virtually no support for the external auditor's role to be extended; in particular, there was no support for the external auditor being required to attest as to the effectiveness of the company's internal controls. The main arguments against an expanded role were that it was not appropriate for the external auditors to be asked to second guess the board's decisions about how to respond to many non-financial reporting risks that could not be measured against an objective standard, nor were they qualified to do so; and that evidence from the implementation of Section 404(b) of the Sarbanes-Oxley Act in the US suggested that there could be significant direct and indirect costs for the company if the external auditor were required to attest as to the effectiveness of internal controls, particularly as the range of controls covered by the Turnbull guidance was broader than those covered by Section 404.

External auditor – part of the internal control functions?

18. The section on the use of auditors generally suggests that external auditors might form part of internal control functions. The heading to the section and paragraph 40 both suggest that auditors might perform control functions. It is important to distinguish between the role of audit (and particularly external audit), which is one of ex-post review, and that of control, which is to ensure effective operation. It is inappropriate for the external auditor to be involved with ensuring the effective operation of a business or control objective, which is the responsibility of management. The provision of non-audit services has been subject to considerable recent debate in the UK and Europe, with the conclusion being that a threats and safeguards approach to auditor independence was more effective than a proscriptive approach. However, auditing independence and ethical guidelines generally prohibit external auditors from undertaking work which might require the auditor to review his own work. Furthermore, it may be inappropriate for the board to rely upon work undertaken by external auditors, since the auditors are required to review the work of the board, creating a further potential independence conflict. It is appropriate for boards and senior management to consider any control weaknesses identified in the review by external auditors but not appropriate for this review by auditors to form part of the primary control functions. Paragraph 40 and the heading to the section should be amended to reflect this distinction.

Public Disclosures

19. Paragraph 47 sets out a number of recommended disclosures. These disclosures should be reconsidered in light of International Financial Reporting Standards and Company Law requirements in addition to the Basel II capital framework. The introductory comments suggest that the listed disclosures are recommended. It would be better if this was changed to state that the list provides disclosures to be considered. Some of the suggestions, for example the disclosure of full legal structure, appear inappropriate, particularly for a large, complex banking organisation whose ultimate holding company might not be a bank.
20. Paragraph 47 also states that the disclosures should be made in the public website and annual report. It would be better to allow disclosures to be made on the website or the annual report, since some of the suggested disclosures might be extensive and their inclusion in the annual report might add disproportionate costs. We have particular concern about potential for unintended consequences, and the resultant magnitude of those consequences, of a number of the suggested disclosures in paragraph 47. In particular, for example, the content of any corporate governance code or policy (e.g business conduct/ethics) and the process by which it is implemented, as well as a self certification of performance against this code. Careful thought needs to be given to the consequences of potential disclosures before the suggestions are finalised.
21. Paragraph 48 states that the full financial statements should be provided to customers, depositors and supervisors. Footnote 21 expands upon this to suggest that summary or abridged financial statements would provide insufficient information. This is contrary to the experience in the UK, where the large majority of shareholders elect to receive summary financial statements, as do most customers and depositors requesting financial information. Furthermore, it would be extremely onerous to require financial statements (either full or summary) to be “provided” to all customers, depositors and supervisors. For a large bank, this might run into several million sets of accounts needing to be printed and posted. It is reasonable to require the main supervisor to be provided with full financial statements but it should be sufficient for financial statements as published (either summary or full) to be made “readily available” to customers and depositors, for example through the public web-site.
22. The guidance implies that the disclosures need to be made at the level of the banking organisation. For banking groups, it should be sufficiently appropriate for disclosures to be made at the group level. The thrust of the guidance would greatly increase the volume of reporting at the level of subsidiary banks. This would have a disproportionate cost. We note that this was considered during the development of Pillar 3, which then stepped back from subsidiary level disclosures.

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Requirements relating to the audit of the financial statements

External auditors, as required by auditing standards, will obtain from their financial statement audit work knowledge of the company to enable them to understand the company's control environment and to assess the components of audit risk. In 2005 the UK will adopt International Standards on Auditing (ISAs)^{vii}. The requirements of the new ISA 315 – *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* – in relation to internal control are more detailed than the requirements of the standards that preceded them and, in particular, require external auditors to obtain a sufficient understanding of control activities to assess the risks of material misstatement at the assertion level. ISA 315 also describes the components of control (control environment, risks assessment process, information systems and communication, control activities and monitoring of controls).

Requirements relating to the Combined Code disclosures

UK requirements for external auditors build upon what the board of a company is required to do to enable the directors to disclose a summary of the process it has adopted in reviewing the effectiveness of the company's systems of internal control. External auditors are required, under the Listing Rules, to review whether the company's published statement on internal control is supported by documentation and appropriately reflects the board's process of reviewing the system of internal control.

The Auditing Practices Board provides guidance for external auditors (APB Bulletin 2004/3). It states that, in respect of the work that the external auditors should do on the internal control provision in the Combined Code, the objective of the external auditors' review (not audit) is to assess whether the company's summary of the process the board has adopted in reviewing the effectiveness of the system of internal control, is both supported by the documentation prepared by or for the directors and appropriately reflects that process.

The work of external auditors, in the context of Code provision C.2.1 is as follows:

- obtain an understanding through enquiry of the directors of the process defined by the board for its review of the effectiveness of internal control and compare their understanding to the statement made by the board in the annual report and accounts;
- review the documentation prepared by or for the directors to support their statement made in connection with Code provision C.2.1 and assess whether or not it provides support for that statement; and
- relate the statement made by the directors to the external auditors' knowledge of the company obtained during the audit of the financial statements. The directors' review will be considerably broader in its scope than the knowledge the external auditors can be expected to have based on their audit of the financial statements.

The external auditors will add an additional paragraph to their audit report if they believe that the directors' statement on internal control is inconsistent with their knowledge or is, in the auditors' opinion, misleading.

^{vi} Information extracted from the UK Financial Reporting Council's Evidence Gathering Phase - Consultation Paper. December 2004

^{vii} ISA 315 became effective in the UK for the audits of all periods commencing on or after 15 December 2004