

AFM: There is a need for clear auditor independence rules

Today, the AFM presented its report "Incentives for Audit Quality" to the Netherlands Institute of Chartered Accountants (Nederlandse Beroepsorganisatie van Accountants, or NBA). The report describes the safeguards to auditor independence and the auditor's considerations to determine whether he can function independently. The report also highlights the dilemmas that occur or can occur in practice. In addition, the report deals with the role of financial incentives and quality incentives in the appointment, appraisal, remuneration and sanctioning of auditors within the major audit firms.

The AFM's report is exploratory in nature and we believe that it will provide valuable input into the comprehensive and open consultation that the Ministry of Finance, in consultation with the AFM and the NBA, will start this autumn. The report's main conclusion is that the AFM supports clearer and more restrictive rules for auditor independence.

"Auditors have to be independent, and the existing rules give too much room for the auditor's own judgement. We should have an open dialogue with all parties involved to determine which combinations of services are acceptable or unacceptable. Services providing assurance to external users are, by their very nature, clearly different from services provided to a company's management", according to Janine van Diggelen, Head of the AFM's Audit Firms Supervision Division.

Clearer and more restrictive rules can provide clarity to users of financial statements. The need to look critically at auditor independence is high on the political agenda, both in the Netherlands and abroad. The aim of the AFM's report is to make a timely and constructive contribution to the auditor independence discussion.

Tension for auditors

The AFM performed its review of incentives for audit quality at fifteen audit firms licensed to audit public interest entities including listed companies, banks and insurance companies (i.e. PIE licensees). Audit firms are organisations with commercial interests. They are paid by the organisations being audited, i.e. their audit clients, and they compete with each other to win and retain audit business.

This set-up creates inherent tension for auditors. On the one hand, the external auditor has to adopt an objective and sceptical attitude towards his audit client in order to perform a high-quality audit. On the other hand, the auditor aims to provide the best possible service to his audit client in order to win or retain the business of that client.

Given this inherent tension for auditors, the AFM's review explored auditor independence and the appointment, appraisal, remuneration and sanctioning of external auditors.

Appointment, appraisal, remuneration and sanctioning of external auditors

The majority of PIE licensees demonstrably considered audit quality aspects when appointing, appraising, and remunerating their external auditors. However, the extent to which audit firms had considered such aspects varied, and commercial aspects also played a role in the appointment, appraisal, and remuneration of external auditors. The AFM was not able to determine how much weight had been given to commercial aspects relative to quality aspects. In addition, our review shows that all PIE licensees had a sanctions policy in place aimed at taking appropriate action against external auditors violating the rules.

“Explicitly rewarding high-quality audits within audit firms will promote quality-oriented behaviour of auditors. That is why ‘quality’ should be embedded in the regulations as the most important factor in the appraisal and remuneration of auditors”, according to Janine van Diggelen.

Independence

An auditor’s report has value to users only if the audit is performed by an independent auditor. The AFM’s review shows that, where requirements and prohibitions are set out in the independence rules, external auditors and audit firms generally complied with such rules. For example, financial interests in audit clients are not allowed, and the external auditors conducting PIE audits have to observe a seven-year rotation period. Audit firms are required to ensure that such rules are complied with.

The current auditor independence rules include hardly any requirements and prohibitions for other situations occurring in practice that pose a threat to auditor independence. This concerns, in particular, the provision of services other than statutory audits to audit clients, business or sponsor relationships with audit clients and long-term relationships with non-PIE audit clients. In such situations, the external auditor and the audit firm are required to perform an independence assessment. This means, in fact, that auditors conduct a self-assessment of their independence by identifying and evaluating threats to their independence, and taking measures to safeguard their independence where necessary, with the rules leaving ample room for judgement. As a consequence, independence assessments and their outcomes were not consistent in similar situations.

"Our review explicitly focused on audit engagements where statutory audits had been conducted in combination with other services, or business or sponsor relationships of a certain significance. Our report includes examples of situations we encountered in the course of our review. They are not representative of all audit engagements performed by the audit firms reviewed, given that not all audit engagements involve the provision of various types of services, or the existence of business or sponsor relationships. For example, there are audit clients with a policy preventing the auditor from performing statutory audits in combination with other services. In discussions about where to draw the line it is very important to look at

situations involving combinations of services, business relationships and/or sponsoring. That is why our report is a good starting point for a constructive discussion based on situations encountered in practice", according to Janine van Diggelen.

The full report is available via the link in the top right corner of this page.