Understanding the Auditor's Independence and Why this is Relevant for the Board of Directors

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1. Setting the scene

Auditor independence is a complex topic in today's regulated world. Whenever something goes wrong in our economy and the auditor was not able to prevent it, it seems the first measure that regulators take is to strengthen the independence requirements. No doubt, independence is a prerequisite for the credibility and quality of any audit. The problem is that regulatory overreaction has led to a jungle of national (e.g., Swiss, UK, US/SEC), regional (EU) and global independence rules. Depending on an audit client's public profile and direct or indirect exposure to different jurisdictions, this may render compliance a major challenge. Some argue that the easy way out is for an audit firm to only provide audit services to its audit clients and sell all its other services to its non-audit clients. But is that in the best interest of an audit client and the economy overall? Not to mention the mandatory audit firm rotation after 10 or 20 years, as adopted in the EU with related cooling-in and cooling-off requirements, and the voluntary periodical audit tenders conducted in Switzerland on the grounds of good governance, which limit the benefits of such an approach. This is because a change of a non-audit client to an audit client requires a thorough analysis of all non-audit services (NAS) world-wide and the discontinuation of prohibited services at a potentially unfavorable point in time, which will necessarily put an end to the efforts of building a longer-term «advisory-only» relationship with a client.

The auditor is well positioned to provide additional value to an audit client and its stakeholders to the extent permissible and within a reasonable, «healthy» scope, be it in the areas of tax compliance, M&A support or operational excellence. Not making use of the auditor's know-how and experience with respect to an audit client adds costs and complexity to that entity's dealings with third party service providers and misses an opportunity to deepen the auditor's understanding of the client's business.

The majority of the large audit firms have come to the conclusion that the multidisciplinary business model is best suited to provide the firms with the talents and expertise (e.g., tax & legal, IT, forensic, valuation, due diligence, etc.) needed to understand a client's business and perform a robust quality audit.

This model comes at a price, however, as the audit firms must be adequately equipped and prepared to effectively manage and monitor compliance with applicable independence regulations, and maintain independence in fact and in appearance at all times. Over the years, all large audit firms have developed sophisticated tools and processes to monitor independence world-wide, whether with respect to services, business relationships, or personal investments of those directly or indirectly involved in an audit engagement.

As it is the auditor's responsibility to secure independence and include a respective confirmation in the audit opinion, why should the Board care? At least when it comes to a «Public Interest Entity» (PIE)[1], the Board of Directors is expected to evaluate the auditor's performance.[2] The assessment of the auditor's independence is an important aspect of that and includes a determination of the additional services that a company can, and is prepared to, procure from its auditor. Effective from financial years beginning on or after 15 December 2022, IESBA[3] standards require that the auditor communicate with «Those Charged With Governance» (TCWG; usually the Board or the Audit Committee) about a proposed NAS and obtain their pre-approval, i.e., before an engagement is accepted. As this requirement extends to all NAS offered by the audit firm's network to the PIE audit client on a world-wide basis, the audit firm needs to agree with the client on a defined process to manage these approvals as efficiently and effectively as possible. This is why it is important that a Board or an Audit Committee understand the basic principles embedded in the applicable regulations.

1 For purposes in Switzerland, PIE is defined in Art. 2(c) of the Swiss Auditor Oversight Act (AOA) to include publicly traded companies in accordance with Art. 727 para. 1(1) of the Swiss Code of Obligations (CO), as well as supervised persons and entities within the meaning of Art. 3 of the Swiss Financial Market Supervision Act (FINMASA), which in accordance with Article 9a AOA must mandate a licensed audit company for a regulatory audit in accordance with Article 24 FINMASA.

2 The Directive on Information relating to Corporate Governance issued by SIX Exchange Regulation AG, 29 June 2022, Annex, 8.4 requires disclosure of the «Instruments pertaining to the external audit: A description of the instruments available to the board of directors that assist its members in obtaining information on the activities of external auditors. This includes, in particular, the means by which the auditing body reports to the board of directors, as well as the number of meetings the board of directors as a whole or audit committee has held with the external auditors.»

3 International Ethics Standards Board for Accountants.

While the following is written in the context of a PIE, the basic principles are equally or similarly applicable to privately held companies (except for the requirement to have all NAS pre-approved, which is limited to PIEs). However, when it comes down to the details, IESBA standards are often less strict with regards to the application of the basic principles to privately held companies.

2. Mutual dependencies inherent in the Swiss legal framework

Swiss law assigns responsibilities to the Board of Directors that extend beyond a pure oversight role, and imposes duties on the statutory auditor that extend beyond a pure audit role. These conditions affect the relationship between the two statutory bodies:

- The Board has the ultimate management responsibility, which includes, among others, the preparation of the annual report, including the financial reporting and management commentary to the shareholders.[4] The Board is required to provide the auditor with all documents and information needed by the auditor to perform the audit.[5] This leads to the special situation that the auditor expects a member of the Board (preferably the Chair of the Board and the Chair of the Audit Committee) to sign the representation letter, together with the CFO and possibly the CEO, while the Board usually waits for the auditor's green light (or draft audit report) before signing off on the financial statements.

- The auditor has a duty to notify the court in case of an obvious over-indebtedness if the Board does not proceed accordingly.[6] The Board, on the other hand, has a duty to oversee the performance of the auditor and propose (re-) election of the auditor to the shareholders.

4 Art. 716a CO.

5 Art. 730b para. 1 CO.

6 Art. 728c para. 3 CO.

Furthermore, considering that the auditor draws a conclusion over the quality of financial reporting prepared by the Board, while the Board is responsible for determining the fees the company is prepared to pay for the audit, it becomes evident that the Swiss legislation bears potential for conflicts of interests regardless of all the other independence rules that need to be adhered to. Therefore, a professional mindset, integrity and transparency about circumstances that bear on the auditor's independence are critically important to protect the quality of the audit.

3. The basic principles of independence

So what should a Board look out for when evaluating a non-audit service? While this article can merely scratch at the surface of independence regulations, it is important to be aware of the basic threats that independence rules generally try to address:

- Self-interest, i.e., the threat to independence when the auditor holds a financial interest or has another interest (e.g., when the audit firm has outstanding fees receivable from its prior year audit) that could inappropriately influence the auditor's judgment or conduct.

- Self-review, i.e., the threat that an auditor will not appropriately evaluate the results of a previous judgment made, or activity or service performed by the auditor or another individual within the same audit firm or network, on which the auditor will rely when forming a judgment as part of the audit (e.g., when the auditor or the audit firm has been involved in designing a process supporting financial reporting, or has been providing input to the calculation of an impairment loss or a provision included in the financial statements).

- Advocacy, i.e., the threat to independence when an auditor becomes involved in promoting or defending an audit client to the extent that it may impair the auditor's objectivity.

- Familiarity, i.e., the threat that due to a long or close relationship with a client, an auditor may not apply the required professional skepticism when forming a judgement about a client's position (e.g., when the CFO is a relative or close friend of the auditor in-charge).

- Intimidation, i.e., the threat that an auditor will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the auditor (e.g., when an audit client threatens to change auditors in the context of a disagreement over a financial reporting matter).

It is up to the audit firm to identify, evaluate and, by introducing safeguards, reduce such threats to an acceptable level, and explain the considerations to TCWG. If this is not possible in a specific circumstance, the audit firm may not proceed with the respective service. The various independence frameworks provide guidance on how to apply this «threats and safeguards» model. While international independence standards follow a more principles-based approach[7], SEC and EU independence provisions are more rules-based. All frameworks, however, stipulate that the auditor shall not assume any management responsibility for an audit client, as this may give rise to different threats that cannot be overcome. In addition, the revised IESBA standards effective 15 December 2022 recognized the need to strengthen the provisions on certain NAS in order to enhance stakeholder confidence in the auditor's independence. Specifically, the IESBA acknowledged that a self-review threat created by the provision of a NAS to a PIE audit client cannot be eliminated or reduced to an acceptable level by way of safeguards.

With respect to Swiss law, Art. 728 CO lists a number of explicit prohibitions, such as being part of a management function, holding a financial interest (self-interest), accepting special advantages (self-interest, intimidation), accepting an engagement that leads to a financial dependency (self-interest), having a close relationship to a member of management or the Board (familiarity), or contributing to the preparation of the accounting records (self-review).

7 Section 120 of the Handbook of the International Code of Ethics for Professional Accountants issued by the IESBA provides general guidance on the application of its framework.

The more detailed independence rules issued by EXPERTsuisse follow the guidance of the IESBA standards.

The Swiss Auditor Oversight Act (AOA) adds a few additional independence requirements.[8] For example, when a person in a management function or senior accounting position at a PIE audit client joins the audit firm, that person shall not be involved, for the following two years, in any audit services provided to the same client. And more importantly, a PIE is prohibited (!) from hiring an individual who during the preceding two years either was leading statutory audit services provided to the PIE or had a management role in the respective audit firm.[9] The Swiss Federal Audit Oversight Authority (FAOA) also imposes a reporting obligation on an audit firm under state oversight when fees for additional services earned from a PIE audit client for a specific year exceed the statutory and regulatory audit fees.[10]

4. Evaluation of NAS by the Board or the Audit Committee of a PIE

The auditor has to provide to TCWG information to enable them to make an informed assessment about the permissibility of a NAS. This includes:

- Nature and scope of the service;
- Basis (hours, flat fee or success fee) and amount of the proposed fee;
- Any identified threats and the audit firm's assessment that they are at an acceptable level or will be after introduction of appropriate safeguards; and
- Whether the combined effect of providing multiple services creates or changes any threats.

While US SEC registrants (in Switzerland and elsewhere) have applied the pre-approval process in line with SEC regulations for many years, other PIEs in Switzerland have been confronted by these new regulations for the first time this year and are still gaining experience and building expertise. It has been advisable for a Board or an Audit Committee to:

- Appoint a member that takes a technical lead on the topic of auditor independence;
- Clarify the company's policy and expectations regarding NAS that can be procured from the audit firm, as well as the respective interaction between management and the Board or the Audit Committee; and
- Agree on a documented pre-approval policy with the audit firm, which defines:
  - (i) the type of services that are unlikely to pose any threat and are approved by inclusion in the pre-approval policy, (ii) the type of services that require approval on a case-by-case basis, and (iii) the type of services that shall not be provided by the statutory auditor;
  - a process that ensures the timely performance of the pre-approvals requested by the audit firm, including the identification of services, for which the approval will be delegated to members of management, such as the CFO; and
  - the entities to which the process would apply, including any other PIEs in the same corporate structure.

8 Art. 11 AOA.

9 Such a prohibition is not quite enforceable, but a violation of this rule immediately leads to an independence breach on behalf of the audit firm, which would have to withdraw from the audit engagement under such circumstances.

10 Section 22b of the FAOA Circular 1/2010

At least on an annual basis and earlier if there are significant changes, the auditor is required to report fees earned for audit and other services provided to the client, including a discussion of any threats created by the level and proportion of such fees and any actions taken to reduce such threats to an acceptable level. The FAOA considers a threat where the annual fees for NAS exceed the annual audit fees. In such case, the audit firm of a PIE is required to provide the FAOA with a respective independence assessment. Furthermore, a fee dependency exists where total fees earned from an individual client represent more than 10% (Swiss law)[11] or 15% (IESBA standards) of the audit firm's total annual fees earned and this situation is likely to continue.

The auditor also has a duty to report independence breaches to the Board, including an assessment to what extent the objectivity, integrity, impartiality of judgment and professional skepticism may be affected by the breach, as well as the measures undertaken to protect the quality of the audit. The auditor also needs to obtain approval from the Board to continue the audit engagement on that basis. If this is not possible, steps to discontinue the audit engagement need to be initiated.

5. Closing remarks

Independence needs to be looked at from different angles, such as NAS and related fees, financial arrangements and close business and other relationships. Independence rules are designed to address independence both in fact and in appearance, both needed to ensure the integrity of the audit in the eyes of the stakeholders and the public interest. The new IESBA provisions on independence applicable to PIE audit clients focus on enhanced transparency and oversight. Without imposing direct obligations to the Board, they imply that the Board and especially the Audit Committee need to develop an appropriate understanding of the applicable independence framework and enhance the cooperation and discussion of related matters with the auditor.

A formal pre-approval policy aligned with the needs of the company and its management, combined with a lean process regarding the performance of the approvals and the reporting of services provided and fees earned, will ensure an efficient and effective discharge of respective responsibilities. Last but not least, trust in the quality of the audit and the Board's oversight is created by a transparent disclosure and explanation of the services obtained from the auditor and the fees paid in the PIE's corporate governance report.

11 Art. 11 para. 1(a) AOA.