

**Principles of Auditor Independence and the  
Role of Corporate Governance in Monitoring an  
Auditor's Independence**



**OICU-IOSCO**

**A Statement of the Technical Committee  
of the  
International Organization of Securities Commissions**

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## **Introduction**

1. The International Organization of Securities Commissions' Objectives and Principles of Securities Regulation recognize that issuers should make full, accurate and timely disclosure of financial results and other information that is material to investors' decisions. The principles also recognize that accounting and auditing standards of a high and internationally acceptable quality contribute to promoting relevant and reliable financial information useful to a wide range of users for decision-making purposes. Specifically, the principles note that, among other things, regulation should be intended to ensure:
  - An independent verification of financial statements and compliance with accounting principles through professional external auditing.
  - Any audit is conducted pursuant to well-defined and internationally acceptable standards.
  - Rules designed to ensure the independence of the auditor.
  - A mechanism for enforcing compliance with accounting and auditing standards.
2. The purpose of this Statement is to build on these principles by setting forth the views of the IOSCO Technical Committee on the principles that should govern independence of auditors of financial statements of listed entities. It reflects the interest of securities regulators in ensuring that auditor independence requirements contribute to promoting investor confidence in published financial statements, irrespective of whether such requirements are the responsibility of securities regulators in their jurisdictions. The Technical Committee recognizes that, while regulations on auditor independence exist in many individual jurisdictions, these regulations may differ in approach, scope, terminology and substance. Accordingly, the Statement also sets forth principles relating to the oversight of an external auditor's independence by a body or bodies within an entity's corporate governance structure. For ease of reference, this Statement uses the term "audit committee" to refer to such a governance body or bodies. The Technical Committee believes these principles and the supporting guidance are relevant regardless of the specific auditor independence regulations that exist in a particular jurisdiction.
3. The principles and supporting guidance relating to audit committees and similar governance bodies address such a body's role in relation to auditor independence only; they do not describe other significant functions that may be performed in overseeing the quality and integrity of an entity's financial reporting.

## **Principles of auditor independence**

4. The external auditor plays a critical role in lending independent credibility to published financial statements used by investors, creditors and other stakeholders as a basis for making capital allocation decisions. Indeed, the public's perception of the

credibility of financial reporting by listed entities is influenced significantly by the perceived effectiveness of external auditors in examining and reporting on financial statements. While any consideration of the effectiveness of external audits involves a wide variety of issues, it is fundamental to public confidence in the reliability of financial statements that external auditors operate, and are seen to operate, in an environment that supports objective decision-making on key issues having a material effect on financial statements. In other words, the auditor must be independent in both fact and appearance.

5. The importance of auditor independence standards that are reasonable and yet comprehensive, rigorous, robust and enforceable has been underlined by several significant corporate failures in which questions have been raised about the quality of financial reporting and, in particular, the independence of the auditor. The Technical Committee therefore encourages national and international professional accounting bodies to continue to work with regulators to strengthen existing national and international standards governing independence. Strengthened independence standards that, to the extent possible within the constraints of national laws, are consistent internationally, are a necessary element in reassuring the investing public that auditors are in a position to exercise objective judgment in concluding on management's representations in an entity's financial statements.
6. *Auditors of listed entities should be independent, both in fact and in appearance, of the entity being audited.*
7. *Standards of independence for auditors of listed entities should be designed to promote an environment in which the auditor is free of any influence, interest or relationship that might impair professional judgment or objectivity or, in the view of a reasonable investor, might impair professional judgment or objectivity.*
8. At present, the details of specific regulations and professional standards governing auditor independence vary from jurisdiction to jurisdiction, sometimes significantly. Differences relate to matters such as:
  - the scope of persons and entities, both within and outside the audit firm, to whom independence rules apply;
  - the types of financial, business or other relationships that an audit firm or individual within a firm may have with an entity that the firm audits;
  - the types of non-audit services that can be provided by an auditor to an entity that it audits; and
  - the safeguards that need to be implemented to protect against threats to independence.
9. Despite these differences, the Technical Committee has noted a growing consensus among securities regulators as to the nature of the threats to an auditor's independence and the limitations on the extent to which those threats can be mitigated by voluntarily applied safeguards of various types. Further, there appears

to be a growing consensus among securities regulators that a framework of principles governing independence is not sufficient in itself to protect investors without the greater clarity provided by specific prohibitions on activities and relationships considered unacceptable regardless of any safeguards applied.

10. The Technical Committee believes there is also a growing consensus that:

- establishment of standards governing auditor independence is not sufficient of itself to provide assurance that auditors are in fact independent; the standards must be supported by rigorous requirements for audit firms to establish and maintain internal systems and processes for monitoring, identifying and addressing threats to independence and ensuring compliance with the standards.
- the adequacy and effectiveness of audit firms' internal systems and processes relating to independence must be assessed and evaluated by an external oversight body (see IOSCO Technical Committee Statement on Principles for Auditor Oversight, October 2002).
- a governance body independent of management of an entity being audited should oversee both the process of selection and appointment of the external auditor and the conduct of the audit.

11. The Technical Committee has not in this Statement attempted to prescribe comprehensive standards of auditor independence and nor is it endorsing any particular existing set of auditor independence standards. The Committee notes, however, that the Code of Ethics for Professional Accountants of the International Federation of Accountants provides a useful analysis of potential threats to an auditor's independence under the following headings:

- Self-interest, where an auditor could benefit from a financial or other form of interest in or relationship with the company being audited, e.g., an investment in the company or undue dependence on fees from assurance or non-assurance services
- Self-review, e.g., performance of services for an audit client that result in the audit firm auditing its own work
- Advocacy, e.g., acting as an advocate for an audit client's position in dealings with third parties
- Familiarity, e.g., long association of an audit engagement partner or other key engagement personnel with a particular client or a recent former partner or senior staff member of an audit firm serving as CFO or in some other key management role at an audit client
- Intimidation, e.g., threat of replacement of an auditor over a disagreement on the application of accounting principles.

12. *Standards of auditor independence should establish a framework of principles, supported by a combination of prohibitions, restrictions, other policies and procedures and disclosures, that addresses at least the following threats to independence:*
- *self-interest;*
  - *self-review;*
  - *advocacy;*
  - *familiarity; and*
  - *intimidation.*
13. *Standards of auditor independence should identify appropriate safeguards that the auditor should implement in order to mitigate threats to independence that arise from permissible activities and relationships.*
14. *Standards of auditor independence should address specifically the need to ensure appropriate rotation of the audit engagement team such that senior members of a team do not remain in key decision-making positions for an extended period.*
15. *Standards of auditor independence should require the auditor to identify and evaluate all significant or potentially significant threats to independence, including those arising from recent relationships with the entity being audited that may have preceded the appointment as auditor, and document how the auditor has applied safeguards to mitigate those threats.*
16. *Securities market regulators should ensure that there is a system in place to require prompt disclosure of information about the replacement of an auditor of a listed entity.*
17. In some jurisdictions, replacement of an auditor requires the prior approval of a regulator. In other jurisdictions, when an entity replaces its auditor, it must disclose whether within a defined period of time prior to the change there were any disagreements with the former auditor on any matter relating to accounting principles or practices, financial statement disclosure or auditing scope or procedure and whether any disagreements were resolved to the former auditor's satisfaction. The former auditor may be required to confirm assertions by the former client's management concerning any matters of disagreement.

### **The audit committee**

18. The governance structure of an entity can play an important role in monitoring and safeguarding the independence of its external auditor. The exact form of an entity's governance structure and the roles that any individual governance bodies perform in relation to the external auditor may vary depending on the requirements of national laws. In some jurisdictions, a single body commonly known as an "audit committee"

oversees all matters relating to the external auditor. In other jurisdictions, more than one body within the governance structure of a listed entity may assume this responsibility. For ease of reference, this paper uses the term “audit committee” to refer to any governance body or bodies with responsibilities for overseeing the external auditor, regardless of whether they have that title.

19. *The Technical Committee believes that, regardless of the particular legal structure in a jurisdiction, a governance body that is in both appearance and fact independent of management of the entity being audited and acts in the interests of investors should oversee the process of selection and appointment of the external auditor and the conduct of the audit.*
20. While the auditor is accountable and commonly reports to the shareholders, he or she does not in practice have a direct relationship with them. The audit committee should therefore serve as a proxy for the shareholders.
21. *The audit committee should be the key representative body with which the external auditor interacts.*
22. *The audit committee should be established with a mandate that permits it to carry out its responsibilities free of any unreasonable restraints. Those responsibilities should include matters such as evaluating whether the audit fees charged by the auditor appear adequate in relation to the work required to support an audit opinion without regard to fees that might be paid to the auditor for other services.*
23. *The audit committee should on a regular and frequent basis meet with the auditor without management present and discuss with the auditor any contentious issues that have arisen with management during the course of the audit and whether they have been resolved to the auditor’s satisfaction.*
24. *When selecting an auditor to recommend for appointment or reappointment, the audit committee should satisfy itself that the auditor is independent in accordance with applicable standards.*
25. Examples of procedures the audit committee might follow to satisfy itself, both initially and on an ongoing basis, as to the auditor’s independence include:
  - obtaining an understanding of professional and regulatory requirements pertaining to objectivity and independence that apply to the auditor in the entity’s home jurisdiction. When an entity’s securities are offered or listed in one or more foreign jurisdictions, the audit committee would also consider any additional requirements that may apply in those foreign jurisdictions;
  - considering all relationships between the auditor<sup>1</sup> and management that might affect the auditor’s ability to act objectively, discussing those relationships with

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<sup>1</sup> The term “auditor” should be broadly construed to include not only an individual engagement partner but also the firm itself, including related entities such as what is sometimes termed a “network firm”.

the auditor and obtaining an understanding of how the auditor would guard against any identified threats;

- seeking from the audit firm information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including how its incentive and compensation policies for partners and senior staff align with the interest of the audit committee in ensuring independence;
- seeking from the audit firm information about how it monitors compliance with independence requirements by foreign affiliated or unaffiliated firms that carry out significant portions of the audit work required in order to permit the auditor to express an opinion on the consolidated financial statements of the entity; and
- discussing with the audit firm the findings of quality control inspections of the firm's systems and processes for maintaining independence.

26. To monitor independence effectively, it is good practice for the audit committee to discuss with the auditors, at least annually, matters relating to their independence, including all significant threats to independence identified by the auditors and the safeguards implemented. To provide support for such discussions, the audit committee may wish to consider obtaining a written statement from the auditors:

- confirming that they are, and have been throughout the conduct of the audit engagement, independent in accordance with the terms of all relevant professional and regulatory requirements; and
- summarizing all significant services provided to the entity and its affiliates, together with related fees, identifying separately audit services, other services required to be provided by the entity's auditor, such as in connection with an offering of securities, and other non-audit services grouped according to the nature of the services provided.

27. *The audit committee should oversee establishment of the entity's policies governing the circumstances in which contracts for the provision of permitted non-audit services can be entered into with the company's external auditors and the procedures that must be followed before doing so. The audit committee should also monitor compliance by management with those policies and procedures.*

28. To ensure it is satisfied the auditor's independence will not be compromised, the audit committee might consider, for example, the desirability of implementing a policy that all material non-audit services to be provided by the auditor must be approved in advance by the audit committee. The audit committee may also wish to consider requiring an open tendering process for all contracts with the auditor in excess of a specified monetary value. When the skills and expertise required to provide a particular non-audit service are readily available on similar terms from service-providers other than the entity's external auditor, even the appearance that independence could be compromised may be sufficient to militate against engaging the auditor.

29. *The audit committee should establish policies relating to the hiring from an entity's audit firm of senior officers for the entity, including the Chief Executive Officer and the Chief Financial Officer.*
30. In establishing such policies, the audit committee may wish to consider in particular matters relating to the hiring of senior members of the audit engagement team and the safeguards that could be put in place to mitigate any potential for compromising the independence of the audit.
31. *The audit committee should report to the shareholders on the actions it has taken to safeguard the independence of the auditor, including satisfying itself that the auditor is independent in accordance with applicable standards.*
32. Such reports to shareholders should, inter alia, describe the policies and procedures followed to establish that any contracts for non-audit services to be provided by the auditor do not compromise the auditor's independence. The nature of any non-audit service contracts entered into and the amount of the related fees should be disclosed.