Auditors' Independence – A Comparison Between the 1998 FEE Recommendation and Swedish Law

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1 Introduction

The regulations concerning auditors' independence are being reviewed both in Sweden and on a European level. The European work with the independence regulations took a major step forward in 1998 with the publication of the Fédération des Experts Comptables Européens (FEE) document "Statutory Audit Independence and Objectivity - Common Core of Principles For the Guidance of the European Profession - Initial Recommendations" (from now on the *FEE recommendation*). FEE's recommendation has initiated a lively discussion on the subject. In Sweden a Governmental Commission has used the FEE recommendation as a source of reference.[1]

In 1999 FEE followed up the recommendation with a survey of existing national independence requirements in the EU.[2] The purpose of the study was to identify the extent to which existing national provisions on independence differ from those contained in the FEE recommendation.

The *Swedish Supervisory Board of Public Accountants* (Revisorsnämnden - from now on *the Board*) has commissioned this paper. The purpose is to make a comparison between the principles laid down in the FEE recommendation and Swedish law. The paper focuses mainly on the question how the individual threats to the statutory auditor's independence mentioned in the FEE recommendation are dealt with in Swedish law.

I will begin the study by describing the Swedish legal system regulating the audit profession and the legal framework governing auditors' independence and the supervision of the qualified auditors (2). Thereafter I will make the comparison between the FEE recommendation and Swedish law (3). The study is concentrated on the statutory audit requirements on companies limited by shares set up in the Swedish Companies Act (Aktiebolagslagen [1975:1385]). Finally some remarks will be made about the proposed changes in the Auditors Act laid down in the Report of the Government Commission mentioned above (4).

[1] SOU (Statens offentliga utredningar – Reports of the Government Commissions) 1999:43 – Oberoende, ägande och tillsyn i revisionsverksamhet. See 4 below.

[2] FEE – Survey of Independence Requirements – Summary of Findings, June 1999.

2 The Swedish Legislation Governing Auditors Independence

The basis for the Swedish legal requirements on statutory auditors is the *Auditors Act* (Lag (1995:528) om revisorer).[3] According to section 1 the Act regulates approval and authorization of public accountants,[4] registration of public accounting firms, the scope of services of public accountants and registered accounting firms, as well as supervision and disciplinary sanctions.[5]

According to section 3 of the Act the Board shall handle matters relating to approval and authorization of auditors and registration of audit firms. The Board shall also supervise auditors and registered audit firms and consider disciplinary cases. Decisions by the Board under the Act may be appealed against to a general administrative court.

The Board has operated since 1995 when the supervisory powers were transferred to it from the Swedish Board of Commerce. It consists of a board of nine members, appointed by the Government, and a secretariat. The chairman of the Board must be a qualified judge but he need not currently hold such a position. One member of the Board must be an authorized auditor and one must be an approved auditor. The other six members must have experience from activities relating to auditing.[6]

The Board has given decisions in disciplinary cases and preliminary rulings according to section 15 of Auditors Act.[7] Furthermore the Board has issued regulations on theoretical and practical training, on the examinations of professional competence for approval and authorization as auditor and on the conditions for the services offered by auditors and audit firms.[8]

While carrying out its task the Board shall develop and promote *professional ethics* for auditors.[9] The concept "professional ethics" is a legal as well as a professional standard. An auditor has to live up to the standard in all his work

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[3] The translations of the Swedish regulations referred to in this paper are partly taken from the Swedish Institute of Authorised Public Accountants' publication Swedish Accounting & Auditing, 1998.

[4] Sweden has two levels of public accountants; approved public accountants and authorized public accountants. Inter alia listed companies and companies in specific fields like banking must be audited by an authorized public accountant.

[5] This paper is focused on the public accountant and the public accounting firm in their capacity as statutory auditors. I will, therefore, for the purpose of this paper use the terms used by the FEE; auditor, statutory auditor and audit firm.

[6] Section 3 of the ordinance (1995:666) with instructions for the Supervisory Board of Public Accountants.

[7] See p. 4 below.

[8] RNFS (Revisorsnämndens författningssamling – The Supervisory Board of Public Accountants' Statute Book) 1996:1 and 1997:1.

[9] Section 3 of the Auditors Act.

as a professional. The legislator has not specified the requirements of the standard. Instead the standard shall be given its content by the practice of the Supreme Court and the Supreme Administrative Court.[10] So far these courts have not given any rulings concerning the standard. In practice the content of the standard is set by the Board and by the profession.[11] Since the Board has been conferred competence to promote the standard it is reasonable to presume that the Board's decisions, when having gained legal force, will express the current requirements of the standard.

When performing a statutory audit the professional ethics require that the auditor meet the requirements set by the *generally accepted auditing standards*.[12] The detailed requirements are set in the same way as the standard professional ethics.

The Swedish *legal independence requirements* are based on the *Auditors Act* and the *Companies Act*. Section 14 of the Auditors Act stipulates that an auditor shall carry out his work with due care and in accordance with *professional ethics*, and that the auditor shall strictly observe all *applicable disqualification provision*s. If there are other particular circumstances that may undermine the confidence in the auditor's impartiality or independence, he shall decline or resign from his assignment. These provisions are also applicable to registered audit firms.

Section 15 of the Act stipulates that auditors and registered audit firms may not carry on any other business than audit business if such other business could undermine the confidence in their impartiality or independence. The Board shall, on application by an auditor or a registered audit firm, issue an advance ruling as to whether a certain activity is in conformity with this rule.

According to *chapter 10 section 16 paragraph 1* of the *Companies Act* an auditor is disqualified from auditing a company if he:

1. holds shares in the company or in a company of the same group,
2. is a board member or the managing director of the company or of a subsidiary or assists the company in its book-keeping or in the management of its assets or in the company's control thereof,
3. is employed by or is otherwise subordinated to or dependent on the company or on someone referred to in (2),
4. is active in the same enterprise as someone who professionally assists the company in maintaining its books of original entry or in the management of its assets or the company's control thereof,
5. is married to or cohabits under circumstances similar to marriage with or is a sibling or a relative in the ascending or the descending line of someone referred to in (2) or is related either by marriage to such a person in the ascending or the

[10] See e.g. SOU 1995:44, p. 227.
[11] See Governmental Bill 1984/85:30, p. 10, SOU 1993:69, pp. 73-74 and SOU 1995:44, p. 227.
[12] See Governmental Bill 1994/95:152, p. 71 and chapter 10 section 3 paragraph 1 of the Companies Act.

descending line or in such a way that one is married to the brother or sister of the other or

6. is indebted to the company or another company of the same group or has obligations for which such a company has provided collateral or a guarantee.

The requirements set up by the Companies Act, the Auditors Act and by the Boards practice are so central that they should be known and followed by every qualified auditor. By breaching any of these regulations the auditor seriously fails in his professional duties.[13]

3 The Comparison Between the FEE Recommendation and Swedish Law

3.1 Introduction

In this part of the paper I will make the comparison between the FEE recommendation and Swedish law. The disposition follows the one in the FEE document.

References to the Board's practice in this paper are made to decisions published in the Board's publications "Revisorsnämndens praxis 1995 – 1998" and "Revisorsnämndens praxis 1998 – 1999". Decisions given after June 30 1999 are referred to with The Board's diary number.

3.2 Personal, Business or Financial Links Between Statutory Auditors and Audit Clients

3.2.1 Personal or business relationships

3.2.1.1 The FEE position

The first category of threats to the statutory auditor's independence relates to personal, business or financial links that the statutory auditor may have with an audit client or the client's management.

[13] See case D 27/98 and the Boards decision 17 February 2000, diary no 1999-639.

FEE identifies three kinds of *personal* or *business links* between a statutory auditor and an audit client that seriously threatens the auditor's independence and therefore must be prohibited. The relations are:

- joint activities such as mutual investments,
- when a close relative is involved in senior management of a client company or is in a position to exercise direct influence on the preparation of accounts or has a material financial interest in the client company and
- accepting goods or services on favourable terms.

FEE also identifies a kind of *business relation* where a retired former partner of a statutory auditor serves as a nonexecutive director of an audit client. In these cases the statutory auditor must safeguard his independence.

3.2.1.2 Swedish law

The Auditors Act and the Companies Act only partly regulate the kind of relations mentioned above. Neither section 14 paragraph 2 of the Auditors Act nor the Companies Act holds any absolute prohibition against a statutory auditor having *business relations* with a client or its management with the exception of the situation where the joint business is a part of the same group as the client company.[14]

The Board has tried the question of the statutory auditor's personal and business relations with an audit client as well as the client's majority shareholders. In the case D 22/97 the Board pronounced that the need to uphold the statutory auditor's impartiality or independence demands that the auditor as a rule is prohibited to have any other business relations with his audit clients than those related to the statutory audit.[15] But the Board also stated that there is room for an exception from this rule in case the upholding of it should lead to unreasonable consequences, e.g. in day-to-day transactions.[16] However, not every ordinary transaction with an audit client is acceptable. The Board pronounced e.g. in an advance ruling that an auditor holding an insurance issued by an insurance company could not perform statutory audit in that company.[17]

Furthermore an auditor shall not *accept goods or services on favourable terms*. The prohibition covers not only transactions outside the audit assignment but also the situation where the auditor receives goods or services as a part of the audit fee.[18]

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[14] See chapter 16 section 10 paragraph 1 Companies Act.

[15] The Board considered the offence as especially serious because the transaction was made on favourable conditions for the auditor.

[16] E.g. shopping at a food store chain that is an audit client.

[17] Case F 21/97.

[18] See Cases D 4/96 and D 5/96 and the aforementioned D 22/97.

The prohibitions against close relations between the statutory auditor and his audit client are also applicable in situations where the auditor holds majority shares in a company – other than the audit firm –which has business relations with an audit client.[19] The prohibition covers not only situations in which the business relation already exists. It also applies to situations where there is a risk that a connection will be established that could threaten or appear to threaten the objectivity. The Board made that clear in a decision in which an auditor requested an advance ruling as to whether having a position as manager in a limited company together with some members of the local industry is in conformity with the requirements in section 15 of the Auditors Act.[20]

The Board has also made it clear that a joint venture with a majority shareholder in a client company threatens the statutory auditor's impartiality or independence.[21] The fact that the auditor joins the venture through an intermediary company does not change the Board's position.[22]

Swedish law does not entirely cover the situation where the *statutory auditor has business or personal relations with the management* of an audit client. According to chapter 10 section 16 paragraph 1 (3) of the Companies Act an auditor is disqualified from performing statutory audit if he is employed by or is otherwise subordinated to or dependent on a board member or the managing director of the company. It is reasonable to presume that the rules mentioned above are applicable also in other cases where the relation between the statutory auditor and the management of an audit client could threaten the independence of the auditor.

The situation where a *close relative* is *involved in senior management* of a client company or is in a position to *exercise a direct influence on the preparations of accounts* or has a *material financial interest* is regulated in the Companies Act. As cited above an auditor is disqualified from performing a statutory audit if he:[23]

> "is married to or cohabits under circumstances similar to marriage with or is a sibling or a relative in the ascending or the descending line of someone… [who is a board member or the managing director of the company or of a subsidiary or assists the company in its book-keeping or the management of its assets or in the company's control thereof]… or is related either by marriage to such a person in the ascending or

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[19] See e.g. case D 36/97. The Auditor appealed against the decision. The County Administrative Court settled the Board's decision. (Judgement of the County Administrative Court in Stockholm 9 January 2000 in case no. Ö 16457-97).

[20] Case F 12/96.

[21] Case F 5/96. The auditor appealed to the County Administrative Court. The Court settled the Board's ruling (Judgement of the County Administrative Court in Stockholm 11 September 1996 in case no. Ö 6378-96). The Administrative Court of Appeal did not grant a review dispensation.

[22] See Case D 13/96.

[23] Chapter 10 section 16 paragraph 1 (5) of the Companies Act.

> the descending line or in such a way that one is married to the brother or sister of the other."

As mentioned above the Board has stressed the importance of the disqualification rules in the Companies Act by stating that the regulation should be known and followed by every qualified auditor. By breaching the regulation the auditor seriously fails in his professional duties.[24] Only if the rules that the disqualification rules refer to are not clear enough the auditor can avoid disciplinary sanction.[25]

As was noted in the 1999 FEE survey there are no regulations covering the situation where a former partner of the auditor joins an audit client.

3.2.2 Financial relationships

3.2.2.1 The FEE recommendation

In its recommendation FEE identifies a threat in situations where the auditor has a financial relationship with the audit client. According to FEE this kind of threat may occur when a statutory auditor holds or deals with securities of an audit client, gives guarantees for a client's risks or grants loans to or receives loans from an audit client (if not in the normal course of the clients business).

The threat to the independence is implied by the self-interest that the auditor may have or appear to have. Therefore these relations must be prohibited.

3.2.2.2 Swedish law

The starting point for the argument regarding the relevance of financial relations between a statutory auditor and his audit client is the disqualification rules in the Companies Act. According to the Act a statutory auditor may not hold shares in the client company. Neither may he be indebted to the company or another company of the same group or have obligations for which such a company has provided collateral or a guarantee.[26] The prohibition of the Companies Act against loans does not include credits given by the audit client to buy goods, provided that they are given on normal terms.[27]

The Companies Act does not prohibit the auditor from granting loans to an audit client. But the Board has ruled that the auditor's independence is threatened if he grants an audit client a substantial loan.[28] It is uncertain

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[24] Case D 27/98.

[25] Judgement of the County Administrative Court in Stockholm 27 November 1997 in case no. Ö 8950-97, see note 46 below.

[26] Chapter 10 section 16 paragraph 1 (1) and (6) of the Companies Act.

[27] SOU 1971:15, p. 262.

[28] Case D 18/97.

whether this prohibition is applicable to smaller loans as well. Given the fact that the purpose of the prohibition is to limit the auditor's financial relation to the audit client, it is reasonable to presume that the same principles shall apply irrespective of the fact whether the auditor is granting or receiving loans.[29]

3.2.3 Employment relationships between the statutory auditor and the client company

3.2.3.1 The FEE recommendation

When a principal or senior employee of the audit firm joins an audit client the relation with the former employee may threaten the independence of the firm. Therefore the firm must take steps to ensure its independence. Some of the steps must be taken as soon as the firm learns that the employee is leaving.

Threats to the independence of an audit firm may also occur when an officer from a client company joins the statutory auditor. The new employee must not take part in the audit if he was an officer of the company during the period upon which the report is to be made or at any time in the two years prior to the first day thereof.

3.2.3.2 Swedish law

The Swedish legislation does not directly regulate this case. But it shall be noted that the Board has stated that an auditor must not be involved in an audit that covers a period of time during which he has taken part in the management or has been involved in the book-keeping of the audit client.[30]

3.3 Holding a Managerial or Supervisory Role in an Audit Client

3.3.1 The FEE recommendation

Through the involvement in an audit client's management the auditor gets involved in the decision making process of the client. This entails an extremely high, real or perceived, risk of self-interest and self-review. Therefore the auditor may not be a member of the board of directors.

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[29] See e.g. Urban Engerstedt & Henry Åkerlund – Revisionsbyråerna och oberoendet - Transaktioner med klienter, published in Balans no. 8-9 1995.

[30] Case D 42/98 and D 1/99.

3.3.2 Swedish law

According to the Companies Act an auditor is disqualified from performing a statutory audit in a company if he is a board member or the managing director of the company.[31]

3.4 Audit and Other Services

3.4.1 The FEE recommendation

The principal position of FEE is that the provision of non-audit services to an audit client brings benefits both to the client and to the users of the audited statement because it increases the auditor's understanding of the client's business and may result in a better audit. Therefore it is FEE's position that the statutory auditor may provide services other than the performance of the audit if that does not impair the auditor's independence. That could be the case if the extra services supplied put the auditor in a managerial role. This means that an auditor must not make any decisions on behalf of the client. He shall neither hold any managerial position nor play any managerial role in the company.

The provision of non-audit services to an audit client may threaten the independence of the auditor since there is an apparent risk of self-review. Whilst providing non-audit services the statutory auditor must take steps to safeguard the independence. The steps could be both internal and external. Among the internal steps FEE mentions development and maintenance of an overall control environment, compartmentalization of responsibilities and knowledge and involvement of an additional partner to carry out a review. As external steps are mentioned communicating an organ within the client company independent from the management and consulting the professional regulating body or another statutory auditor.

The solutions proposed by FEE are based on the assumption that the statutory audit is to be seen in a global corporate governance system. Therefore FEE prefers a solution based on an increased role of the internal procedures of the client company combined with an enhanced oversight by an independent organ within the company rather than rules on the disclosure of audit and non-audit fees paid to the statutory auditor.

On the basis of these general principles FEE discusses a number of cases in which the independence may be threatened by non-audit services. Those cases are:

[31] Chapter 10 section 16 paragraph 1 (2) of the Companies Act.

- preparing financial statements,
- valuing assets or liabilities for recording in financial statements - expert services,
- acting for a client in the resolution of litigation and
- recruiting senior management for the client.

In all these forms of non-audit services there is a real or perceived risk of *self-review* on behalf of the statutory auditor. Assisting a client in a resolution of litigation can also give rise to *advocacy threats* because the auditor may be seen as defending the management of the company.

3.4.2 Swedish law

The question whether a statutory auditor may provide other services than audit services to an audit client is one of the key issues in the debate on auditors independence in Sweden. The Swedish view is that independence requirements are a part not only of the corporate governance system but also of the system safe-guarding the interests of investors and other interested third parties. Therefore the existing prohibitions against providing non-audit services to an audit client are based not only on the risk of self-review but also on the risk of self-interest.[32] The independence rules are applicable to statutory audit in all limited companies.

According to Swedish law the general principle is that there is an absolute restriction on the provision of non-audit services to an audit client if the services rendered put the auditor in a managerial role or gives him influence over the financial reporting. The formal requirements are set by the Companies Act according to which an auditor is disqualified from performing a statutory audit if he:

> "…is a board member or the managing director of the company or of a subsidiary or assists the company in its book-keeping or the management of its assets or in the company's control thereof…".[33]

A further limitation is set by section 14 paragraph 2 of the Auditors Act, which prohibits the auditor from accepting or proceeding an audit assignment if there is any threat to his real or perceived independence.[34] A final limitation to the statutory auditor's possibility to provide non-audit services to an audit client is the prohibition in section 15 of the Auditors Act. This provision aims to prohibit the auditor from performing other business than audit business if that business in itself threatens or may threaten the impartiality or

[32] See e.g. SOU 1999:43, p. 146.
[33] Chapter 10 section 16 paragraph 1 (2) of the Companies Act.
[34] See p. 3 above.

independence of the auditor.[35]

Section 14 paragraph 2 of the Auditors Act does not present any general principles when regarding the statutory auditor's possibility to render non-audit services to an audit client. Instead the regulation is focused on the specific relationship between a statutory auditor and his client. The situation is somewhat different when it comes to section 15 in the Act. The Board has not only tried if non-audit services rendered threaten the auditor's independence in the specific case but also if the service in itself generally threatens the independence of the auditor. The Board's decisions under section 15 are based on the general presumption that the statutory auditor must stay free from business interests that can come into conflict with the audit assignment.[36]

When it comes to the relation between the regulation in section 14 paragraph 2 of the Auditors Act and the statutory auditor's involvement in a client's management or book-keeping the practice of the Board seems to be concentrated on the circumstances in the specific case. The Board has stated that the auditor must not only leave the decision-making to the management; he must also make it clear to the company that the advice rendered by him are not meant to be conclusive but are to be tested by the client company.[37]

The internal control mechanism mentioned in the FEE recommendation does not follow directly from the legislation. The Swedish Institute of Authorised Public Accountants has in its recommendation on internal quality control set up principles for such mechanisms.[38] The Board has somewhat clarified the situation by stating that the requirements on an audit firm to organize its internal control system are higher the more audit assignments the firm perform.[39] As stated in the 1999 study Swedish law does not deal with the FEE general requirements to make arrangements to reduce the threats to the statutory auditor's independence in any other way.

As mentioned before the Swedish view is that the independence requirements are a part not only of the corporate governance system but also of the system safe-guarding the interests of investors and other interested third parties. Therefore the legislators view is that internal control within a company cannot entirely substitute the need for public information on the financial relation between the statutory auditor and the client company.[40] The Annual Accounts Act (Årsredovisningslagen [1995:1554]) stipulates that a limited company shall disclose in its annual accounts the fees that have been paid to the

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[35] See p. 3 above.

[36] See e.g. case F 2/99.

[37] See e.g. case D 33/97.

[38] Swedish Institute of Authorised Public Accountants' recommendation Intern kvalitetskontroll.

[39] Case D 40/98. See also the Board's decisions 30 September 1999, diary no. 1999-687 and diary no. 1999-693.

[40] See e.g. Governmental Bill 1997/98:99, pp. 143-144.

statutory auditor as well as the relation between audit and non-audit fees paid to the auditor.[41]

One of the specific threats to an auditor's independence dealt with by FEE is *preparation of financial statements*. As stated in the recommendation there is a spectrum of services that the statutory auditor can supply in relation to a company's financial statement. As noted above the regulations' main purpose is to prevent the auditor from decision making in the client company. According to the Companies Act the auditor cannot be involved in the clients book-keeping or in the company's control thereof.[42] In section 6 of its regulation concerning i.a. conditions for the services of auditors and audit firms,[43] the Board has stated that a statutory auditor:

> "…may not assist with an audit client's accounting otherwise than by means of giving advice. The auditor shall be responsible for ensuring that no other person who takes part in the audit assignment offers any more extensive assistance."[44]

According to section 7 the term advice as used in section 6 refers to:

1. information concerning the accounting requirements entailed by applicable enactments and generally accepted accounting practice,
2. proposals concerning the design and organization of accounting systems,
3. proposals for book-keeping measures such as suggested corrections of booked items and suggested measures in connection with the year end closure as well as
4. proposals for measures in connection with the preparation of public accounts.

The interpretation of these rules has been that the auditor should never be involved in the book-keeping in a way that gives him influence over the current recording of transactions.[45] As long as an advice does not present the auditor such influence, he may give the advice to the company. Furthermore another employee at the same audit firm is allowed to make the technical preparations on the year-end closure. The possibility for another employee at the audit firm to prepare the year-end closure is limited by the prohibition against involvement in the current recording of transactions. In the case D 2/95 an employee of an audit firm made some changes in the current recordings in order to be able to prepare the year-end closure. The question in the case was if the books of the company were of sufficient quality to form the basis of the year-end closure. The Board stated that the books were not of such quality and that the employee had done work prohibited by the disqualification

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[41] Chapter 5 section 19 a of the Annual Accounts Act.

[42] Chapter 10 section 16 paragraph (2) of the Companies Act.

[43] RNFS 1997:1.

[44] Section 6 of the regulation.

[45] See Governmental Bill 1975:103, p. 425. These prohibitions are applicable also in the case where the statutory auditor has a business relation with another auditor who has prepared the current recording of transactions. See the Board's decision 26 August 1999, diary no. 1998-25.

rules in the Companies Act.[46]

According to the Board the prohibitions mentioned above are applicable not only in the case where the auditor renders additional services to an audit client but also in the situation where the client does not fulfil his duties. In two cases where the auditor prepared the annual accounts because the client company did not do it, the Board stated that the auditor should have resigned the audit assignment and not finished the preparation of the accounts.[47]

The question of *valuing assets or liabilities* is not dealt with in the legislation. But it is reasonable to assume that the prohibition against involvement in financial statements means that an auditor may never be involved in the process of valuing assets or liabilities if the valuation will influence the statements. The principal idea is that an auditor is not allowed to make a professional valuation that will affect his audit. An example is the provision of the Companies Act stating that if capital is contributed in kind the companies statutory auditor shall make a statement i.a. that the property is correctly valued.[48] The auditor may not himself perform the valuation.

The Swedish law does not explicitly prohibit a statutory auditor to act on behalf of an audit client in a *resolution of dispute* or in a *resolution of litigation*. But the Board has in two decisions tried a statutory auditor's possibility to act for an audit client in such cases.[49] In its 1999 decision the Board tested the possibility in the light of section 14 paragraph 2 of the Auditors Act. The Board concluded that by acting for an audit client in a resolution of litigation a statutory auditor's independence is generally threaten.

A final situation identified by FEE in which the independence of the auditor may be threatened is when a statutory auditor *recruits senior management* for an audit client. The Board has tested this kind of assignments in two cases.[50] In both cases the service rendered was tested in the light of section 15 of the Auditors Act.[51] The conclusion was that a statutory auditor fails in his professional duties if he recruits a person whose tasks at the client company will affect the annual report, the accounts or the administration of the board of directors or the managing director of the company.[52]

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[46] The Auditor appealed against the decision. The County Administrative Court did not question the Board's principal view but overruled the Board's decision due to uncertainty of the legal requirements on the preparation of the current recordings (Judgement of the County Administrative Court in Stockholm 27 November 1997 in case no. Ö 8950-97).

[47] Cases D 45/97 and D 24/98.

[48] Chapter 4 section 6 paragraphs 2 and 3 of the Companies Act.

[49] See e.g. cases D 25/97 and D 2/99. Tax authorities were adverse parties in both cases.

[50] D 25/98 and D 14/99.

[51] See p. 3 above.

[52] In the 1998 case the auditor recruited a controller and in the 1999 case an employee that should be responsible i.a. for the book-keeping.

3.5 Audit Fees

3.5.1 The FEE recommendation

In its recommendation FEE discusses situations in which the auditor's remuneration can threaten his real or perceived independence. FEE identifies a number of threats to the independence of the statutory auditor. The threats relate to the calculation of fees – both contingent fees and pricing in general, dependence on fees from one audit client and the problem with overdue fees. Some of those threats can be safeguarded, while some are so serious that they cannot be allowed.

3.5.2 Swedish law

The Swedish rules governing audit fees have two purposes; primarily the protection of the interested parties but also the protection of the client company.[53] The situations that have been regulated by legislation and practice are audit service to a fixed price, contingent fee or remuneration other than monetary. The Board has also given decisions concerning the reasonability of fees and overdue fees.

There is no general legislative rule concerning the *pricing* of an audit assignment. The fundamental stand of the Board is that the question if a fee demanded for audit services is reasonable is a matter between the auditor and the client company and not for the Board to determine. However, the Board would probably intervene if the fee were *obviously unreasonable*.[54] This exception from the Board's fundamental stand is aimed not mainly to protect the client company but the credibility of the audit profession. The main demand on the auditor is that he must be prepared to give an account of the time and the kind of work put into the assignments for which the client is being charged. The Board has ruled that the auditor on request must account not only for the kind of work that has been done but also for who performed it and when it was done.[55]

The position of Swedish law is different when it comes to protecting the statutory auditor's independence in the interest of the users of the audit report. The Board has in a number of decisions answered the question if the pricing of an audit assignment is threatening the independence of the auditor based on

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[53] The latter aim is manifested mainly through the principle that the auditor must be able to specify the work put into the audit on the demand of the client. See e.g. Cases D 11/96 and D 15/98. The latter case was appeal against. The Court settled the Board's ruling (Judgement of the County Administrative Court in Stockholm 31 March 1999 in case no. Ö 8041-98). The Administrative Court of Appeal did not grant a review dispensation.

[54] Case D 13/97.

[55] Case D 15/98. The auditor appealed to the County Administrative Court. The Court settled the Board's ruling, see note 53 above.

section 14 paragraph 2 of the Auditors Act. One such situation occurs when the auditor offers the client company a *fixed price* for the audit services. The Board has stated that if an auditor is offering to perform the statutory audit at a fixed price, he must make a reservation for unexpected factors in the audit work.[56] I suggest that this shall apply also in the situation where the *fee level offered by an auditor is significantly lower than the one charged by other statutory auditors*.

The Board has also prohibited auditors charging *contingent fees*. According to the Board the prohibition is applicable not only to audit assignments but also to other assignments performed by the auditor.[57]

Another situation that the Board has dealt with is when an auditor receives his *remuneration in another form than money*. In its practice the Board has prohibited fees charged as market analyses[58] or a free travel for the auditor and his family.[59] In those cases the Board has laid down the principle that by accepting goods or services instead of money the auditor is creating a situation in which his objectivity can be questioned.

The opinion that the interested third parties must be protected is especially stressed when it comes to *overdue fees*. The view of the Board is that it is of outmost importance that the auditor completes the audit. This means that an auditor must not withhold his audit report in order to force the client to pay overdue fees.[60] Neither may he threaten to cease his audit assignment during the latter part of a financial year.[61] Not only is he prohibited to withhold his own performance, he must also – in the interest of the client company's stakeholders – return all documentation the client has supplied for the performance of the audit.[62]

Another question discussed in the FEE recommendation is *undue dependence on fees* from one audit client. As noted in the 1999 study Swedish law is not in line with the FEE recommendation as far as the percentages demand are concerned. The Swedish legislator has taken the position that the question

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[56] Case D 4/96.

[57] The Board's decision Ö 1/98. This prohibition goes beyond the rule set up by the profession according to which an auditor may charge contingent fees for other assignments than those where the auditor is expected to express an opinion. See the Swedish Institute of Authorised Public Accountants (FAR) – Guidelines for FAR members' compliance with professional ethics rule 8.

[58] Case D 4/96. In the decision the Board stressed that the given analyses were important for the auditor and the client company. Accordingly it is uncertain if the same principle is applies when if the remuneration is minor in relation to the total amount fees charged.

[59] Case D 5/96.

[60] Case D 29/96. The Auditor appealed against the decision. The County Administrative Court settled the Board's decision as far as relates to the threat to withhold the audit report. The Administrative Court of Appeal came to the same conclusion (Judgement of the Administrative Court of Appeal 5 May 1999 in case no. 4178-1997).

[61] Cases D 4/96 and D 11/97.

[62] See judgements of the Supreme Court NJA 1981 p. 1050 and NJA 1982 p. 404.

whether an auditor is depending on fees from a single audit client shall be tried in the specific case according to section 14 paragraph 2 of the Auditors Act.[63]

3.6 Acting For a Client For a Prolonged Period of Time

3.6.1 The FEE recommendation

In its recommendation FEE notes that a perception of over-familiarity may arise if an auditor has been acting for an audit client for a prolonged period of time. The solution proposed by FEE is that the auditor takes internal steps to safeguard the perceived independence.

3.6.2 Swedish law

The Swedish law does not prohibit auditors from acting for an audit client for a prolonged period of time. When the Companies Act was reviewed in 1998 a provision was introduced limiting the auditor's mandated term to four years.[64] Re-election is, however possible. The reasons behind the limitation were as follows. If the term of assignment is too short the auditor's position may become tenuous whereas a very long or unlimited term can cause an over-familiar relation between the auditor and the management.[65]

3.7 Actual or Threatened Litigation Between a Statutory Auditor and a Audit Client

3.7.1 The FEE recommendation

FEE notes that both a self-interest and an advocacy threat may arise where litigation takes place between a statutory auditor and a client. It is according to FEE impossible to specify the point in which it would become improper for the auditor to continue his work. But the auditor must cease to act as soon as the circumstances of the litigation might reasonably be perceived by the public as threatening his independence.

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[63] See e.g. SOU 1993:69, p. 324. See also the Swedish Institute of Authorised Public Accountants (FAR) – Guidelines for FAR members' compliance with professional ethics - note to rule 2, paragraph 8.

[64] Chapter 10 section 20 of the Companies Act.

[65] Se Governmental Bill 1997/98:99, pp. 140-141.

3.7.2 Swedish law

The Swedish regulations do not explicitly cover this kind of threats to the independence of the auditor. The question if the independence of the auditor is threatened is to be tested according to section 14 paragraph 2 of the Auditors Act. That means that the assessment whether the litigation is threatening the independence of the auditor must be done in every specific case. As aforementioned the protection of interested third parties demands that the auditor finishes an ongoing audit assignment. Only if that is impossible he shall resign. That might be the case when the client does not provide the necessary documentation.[66]

3.8 Seeking Second Opinions From Other Statutory Auditors

3.8.1 The FEE recommendation

In its recommendation FEE identifies a situation where the statutory auditor may be put under undue pressure through an opinion of another auditor who is not the companies statutory auditor. In these cases the other auditor must make sure that the advice is based on full and correct information. In order to secure the quality of the information he shall contact the statutory auditor.

3.8.2 Swedish law

This situation is not dealt with in the Swedish legislation. But the Board has in one case tried the obligations of an authorized auditor when performing other services than audit.[67] The Board stated that the auditor must make sure that he has all information necessary to perform his work. He must also make sure that the client understands the scope of the service.

3.9 Audit Firms

3.9.1 The FEE recommendation

FEE proposes a number of measures – safeguards – that an audit firm shall take in order to make sure that individuals that are not auditors are unable to exert any influence over the way in which the audit is conducted. These

[66] See Case D 24/98.
[67] Case D 15/96. The auditor was also the company's statutory auditor.

safeguards are included in the Eighth Directive.

3.9.2 Swedish law

An auditor may carry out audit business as a sole trader or in a partnership or limited company, which only provides audit services and services compatible with the audit profession.[68]

If the auditor chooses to perform his business in a *partnership* only auditors may be partners, authorized signatories or holders of procuration.

Should the auditor carry out the profession in a *limited company* that is *not a registered audit firm* only auditors can be shareholders, members of the board and deputy members of the board, authorized signatories, managing director or deputy managing director.[69]

In order for a *limited company* to become *a registered audit firm* section 11 of the Auditors Act demands that its articles of association must state that:

1. the company's activities shall be restricted to professional auditing and compatible business,
2. at least three fourths of the board members and at least three fourths of the deputy board members as well as the managing director shall be approved or authorized auditors, and
3. the board of directors shall form a quorum only if the present approved or authorized auditors represent a majority of the votes at the meeting.

According to the Board these requirements prevent a company from being registered as an audit firm if the auditors hold the shares in the company through an intermediary company.[70]

If an audit firm chooses to be registered it will be disciplinary responsible for the professional misconduct of an employee provided the firm has been negligent in its supervision.[71] In one case the Board extended the responsibility of the audit firm by demanding that the firm, or its management, should make sure that an employee did not breach legislative and ethical requirements.[72] In the case in question an employee of an audit firm took a leave of absence to work as chief accountant and controller for an audit client. She had not applied for an exception from the employment rule of the Auditors Act.[73] The owner

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[68] Section 16 paragraph 1 of the Auditors Act.

[69] Section 4 of the RNFS 1997:1.

[70] Cases Ö 1/96 and Ö 2/96. In the preparatory work with changes in the Auditors Act this question is proposed to be subject to legislation, see SOU 1999:43, pp. 177 – 194 and 4 below.

[71] See Governmental Bill 1994/95:152, pp. 55-56.

[72] Case D 12/98.

[73] Section 16 of the Auditors Act according to which (1) "…An auditor may not be employed by anyone other than an auditor, a registered public accounting firm or a partnership or company as defined in Section 16."… and …(2) "If there are particular grounds, the Supervisory Board of Public

of the audit firm appealed to the County Administrative Court. The Court confirmed the Board's ruling.[74] In its decision the Court stated that the employee probably would not have been granted an exception according to section 16 of the Act. The owner of the audit firm had abetted the employee in her breach of the legal requirements and had therefore committed a breach of the ethical requirements himself.

3.10 Final Remarks

As shown above there are certain differences between the Swedish law and the FEE recommendation when it comes to regulating the auditors' independence. These differences exists in spite of the fact that both the FEE recommendation and Swedish law are based on the same underlying concepts; the expectations of those directly affected by the statutory auditors' work and the public interest. Furthermore, FEE as well as the Swedish legislator identifies some threats of general nature and some as related to the specific circumstances of an audit assignment.

Despite these common underlying concepts two important differences shall be noted. The first is that the Board has identified a self-interest threat in the provision of non-audit services. This has led to that the Board in its practice has shown a more stringent view on the statutory auditors' possibility to provide non-audit services to audit clients compared to the view of FEE.[75] The other difference of importance is that the Board in its practice apparently has applied section 14 paragraph 2 in a strict way when judging the statutory auditor's possibility to have relations with his audit client outside the audit assignment.

How can the existing differences be explained? One circumstance that may explain some of the differences is the Swedish legal demands on the statutory auditor to perform so-called administration (or management) audit.[76] When performing the administration audit the auditor must determine

a) if any act or omission which may give rise to a liability for damages can be attributed to a board member or the managing director and

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Accountants may grant exceptions from the prohibition in the first paragraph."

[74] Judgement of the County Administrative Court in Stockholm 29 October 1998 in case no. Ö 5921-98).

[75] See e.g. the Boards statement of opinion on the report of the Governmental Commission 1999:43 (see 4 below), p. 3. See also the Board's chairman Mr. Gruberg's speech at a meeting between representatives of the Board and the Swedish Institute of Authorised Public Accountants 18 January 2000. This view seems to be shared by the majority of the Boards members with the exception of the audit profession's representatives.

[76] See chapter 10 section 3 paragraph 1 of the Companies Act.

b) if a board member or the managing director otherwise have acted in contravention of the Companies Act or the company's articles of association.[77]

Since there is a connection between what shall be audited and the services that an auditor can provide to his audit client one can presume that a wider audit requirement limits the number of services that the auditor can provide to his audit client.

Another circumstance that may help us to understand the differences is the fact that the Swedish legislation aims to secure the interested parties confidence in the auditors independence and therefore demands that the efforts made to protect the independence shall be visible to the third parties. This means that internal steps to safeguard the auditor's independence taken by the auditor or the audit firm itself are not enough to meet the requirements set up by the law.

An additional fact to take into account is that the rules in sections 14 and 15 of the Auditors Act have two purposes. Not only shall the rules protect the independence of the auditor in the specific assignment and his relation to the audit client. They are also aimed at protecting the reputation of the profession. Since the latter aim is general and not related to any specific assignment there is a high demand for general rules.

The double purposes of section 14 have had the result that the Board in its practice has felt free to use section 14 paragraph 2 of the Auditors Act quite extensively. In its decisions the Board has used the section not only in situations where the threat against the auditor's independence originates from the auditor's relationship with his audit client but also from external circumstances.

By using sections 14 and 15 of the Auditors Act the Board has prohibited or limited the scope of relations or services that may threaten the real or perceived independence of the statutory auditor. Taking that into account I would say that the presumtion is that Swedish law, with the two major exceptions mentioned above, is fairly in line with the FEE recommendation.[78]

[77] See chapter 10 section 30 of the Companies Act and the Swedish Institute of Authorised Public Accountants – The Audit Process, section 1.5.

[78] The Board's identification of a self-interest threat in the provision of non-audit services and the more stringent view on the statutory auditors' possibility to provide non-audit services to audit clients.

4 The Report of the Government Commission on Statutory Auditors Independence, Ownership and Supervision

4.1 Introduction

As mentioned above the Auditors Act has been subject to an overhaul by a governmental commission (Revisionsbolagsutredningen – The Governmental Commission on Public Accounting Firms – from now on *The Commission*).[79] The work of the Commission was initiated primarily because the Board in its practice has interpreted the Auditors Act as prohibiting auditors from owning audit firms through intermediary companies.[80]

In its instructions the Government directed the Commission to analyse the problems related to the statutory auditors independence and to the supervision of the auditors if ownership through intermediary companies were to be allowed. The Commission had also to examine if there is a necessity to change the meaning of the term auditing business and the question whether it is required to limit the services that an auditor may provide. The Commission's proposals were not allowed to threaten the official authorization and supervision system or the independence of the auditor.[81]

The Commission has proposed a number of changes in the legislation concerning statutory audit, the auditors and the audit business. In the following part of the paper I will briefly add up the proposed changes in the parts that are relevant to the questions previously dealt with.

4.2 The Specific Changes Proposed

The Commission initially suggested some changes in the terminology used in the Auditors Act. One of the most important changes is that the term *audit business* (revisionsverksamhet) shall be reserved for the performance of attesting services if the report is to be used not only by the client but also by others. The term shall also include additional services caused by the attesting service (e.g. if the auditor finds some errors in the examined material and gives advice as how to eliminate the errors). This means that other services related to audit would not be included in the term. Furthermore the Board's

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[79] SOU 1999:43 – Oberoende, ägande och tillsyn i revisionsverksamhet.

[80] See above note 70.

[81] Kommittédirektiv (Governmental Instruction) 1996:106 Översyn av regler för ägande av revisionsbolag m.m.

supervision is proposed to be limited to the so-called audit business. Hereby the role of the official supervision will be concentrated on services that are central to the supervision system. In other cases the Board shall only consider if the business is imposing a threat to an ongoing audit assignment.

In its report the Commission does not propose any new limitations to the services that an auditor may provide to a non-audit client. The main arguments are that the auditor builds up a competence by rendering such services and that such services do not generally threaten the independence of the auditor. But the Commission proposes a limitation to audit firms' possibilities to carry out other business than audit business.

When it comes to the statutory auditors' possibility to provide other services than audit services to an audit client the Commission is influenced by the FEE recommendation. Still the Commission does not propose any major changes in the legal prohibition. But the Commission suggests a new set of requirements on the auditor in situations where there is a relation between the auditor and his audit client other than the one constituted by the audit assignment.

The principal idea is still that the provision of non-audit services can threaten the statutory auditor's independence. Therefore the auditor is required to examine whether the conditions in the specific case are such that his independence may be threatened. In cases where a threat appears the auditor must decline or resign from his assignment if he cannot show that the assignment can be continued in spite of the threat. This may be the case if the threat in the specific case does not impair the auditor's objectivity or if the objectivity can be safe-guarded.

It should be stressed that the Commission is not prepared to let the auditors render supplementary services to audit clients without additional requirements. The additional demands are based on publicity. When an auditor performs statutory audit he is required not only to document his audit work but also to document the kind of additional services provided and the safeguards taken by him whilst providing them. On demand this documentation shall be presented to the Board. But this is not enough. In addition the Commission proposes that the scope of the services shall be noted in the financial statement of the client.

Furthermore the Commission proposes that an auditor shall be allowed to own an audit firm through an intermediary company. The intermediary company will not be allowed to carry out any other business than audit business and compatible business. At the same time the Commission suggests a right for the Board to examine not only the documentation of the audit firm but also companies related to the audit companies.

In this part of the paper I have very shortly described the proposed changes in the Auditors Act. It is impossible to say if the suggested changes will have any real impact on the services provided by the audit profession or change the independence requirements. The only certain conclusion to be drawn is that

the provisions of the Act – if the suggested changes become law – will be less concentrated on general threats and more focused on the threats in the specific cases. Whether this will change the auditors' day to day work depends on if and how the Government will open up the possibility for the profession to adjust to the clients' demands. We can only await the forthcoming bill.