

KREDITILSYNET

Norway

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Non-audit services to audit clients

1. Introduction

In this circular Kredittilsynet addresses a number of matters and issues associated with auditors' and cooperating firm's non-audit services in relation to the limitations pursuant to the Auditors Act, especially section 4-5. Kredittilsynet will base its application and enforcement of the Act on the principles and viewpoints presented in this circular. Kredittilsynet's interpretation of the Act will also be of interest and significance to auditors' clients and the general public. In addition, the Norwegian Institute of Public Accountants (DnR) has a set of ethical professional rules. These may act as a supplement to the content of this circular. Kredittilsynet stresses however that the aforementioned ethical rules do not provide a basis for departing from that which follows from the provisions of the Auditors Act.

2. The Auditors Act's provisions concerning auditors' non-audit service to audit clients

2.1 Purpose and content

The Auditors Act entered into force on 1st August 1999. Chapter 4 of the Auditors Act stipulates limitations as to which non-audit services an auditor can provide to auditing clients. The main provisions concerning such non-audit services follow from section 4-5 of the Act, which reads:

“Section 4-5. Non-audit services, etc.

An auditor who audits the annual accounts of an entity subject to the statutory audit obligation may not provide consulting or other non-audit services to that entity if doing so might influence or raise doubts about the auditor's independence and objectivity.

The auditor may not provide services which fall under the management and control tasks of the audited entity.

The auditor may not act as attorney-in-fact for the said entity. Exemptions to this apply in regard to assistance in tax matters under section 218 of the Courts of Justice Act.

In the case of audit firms, this provision shall apply to a corresponding extent to auditors who are not the statutory auditor in charge of the audit.”

The provisions prohibit an auditor who audits the annual accounts of an entity subject to the statutory audit obligation from providing consulting or other non-audit services to the entity subject to a statutory audit obligation if these services might influence or raise doubts about the auditor's independence and objectivity. The issue concerning which services "might influence or raise doubts" must be assessed specifically in each individual case. The borderline between forbidden and permitted non-audit services can therefore not be drawn exactly on a general basis. The auditor himself must therefore, in a careful and judicious manner, assess the extent to which the services might influence or raise doubts concerning his or her independence and objectivity. In addition to this Kredittilsynet, as the supervisory authority, may ask questions concerning the assessments that are made.

The preparatory work to the Auditors Act¹ particularly highlights the fact that an auditor can never put himself in a situation in which he is participating in or influencing the decision making process in the undertaking, and that great care must especially be shown in areas that are covered by the auditor's subsequent confirmation. The preparatory work nonetheless showed that a precise boundary for what are acceptable non-audit services is difficult to draw and that the boundary must be developed through standards and regulations.

Kredittilsynet notes that the wording of section 4-5 of the Auditors Act does not differentiate between non-audit services supplied to listed and non-listed companies. In practice however an auditor must take other matters into consideration when such services are being performed for listed companies, and in Kredittilsynet's opinion this is relevant to the understanding of the provision. The need for the capital market to have confidence in the auditors' attestations of accounting information is vital in this respect, and this should be an essential factor in the auditor's overall assessment of independence and objectivity when performing non-audit services.

Pursuant to section 4-7, paragraph three, second sentence, of the Auditors Act, the disqualification provisions in chapter 4 of the Auditors Act can be expanded by regulations to also include services performed by firms with which an auditor has a cooperation agreement. The Ministry of Finance has with effect from 1st April 2003 laid down such provision in section 4-2 of the auditors regulations of 25th June 1999 no. 712. A cooperation agreement as mentioned in section 4-7, paragraph three, of the Auditors Act is defined as an agreement on the use of identical names, sharing significant professional or other business related resources. The same applies to other cooperation agreements that might influence or raise doubts concerning an auditor's independence and objectivity. The provision will particularly affect the provision of services from cooperating consultancy and law firms. In those cases where there is such a cooperation agreement as mentioned in the regulations, the rules in the Auditors Act's section 4-1, paragraph one, two and five, section 4-2, paragraph two and four, section 4-4, section 4-5, paragraph one to three inclusive, and section 4-6 shall apply correspondingly to the cooperating undertaking. The rules for undertakings apply correspondingly to partners and senior employees in the undertaking, and members of the undertaking's governing bodies.

2.2 Further information concerning Section 4-5, paragraph two

Pursuant to section 4-5, paragraph two of the Auditors Act, an auditor cannot provide services which fall under the management and control tasks of the entity subject to statutory audit obligation. What falls under the management and control tasks of the entity subject to

¹ Proposal no. 75 to the Odelsting (1997-98) "Concerning the Act on auditing and auditors (Auditors Act)" point 7.2.3.2, pages 81 and 82, and point 7.2.5.2, page 85.

statutory audit must, in the opinion of Kredittilsynet, be assessed specifically in each individual case and the relevant undertaking's management and organisational structure will be a factor. In general Kredittilsynet believes that company law provisions, especially sections 6-12 and 6-14 of the Limited Liability Companies Act and Public Limited Companies Act concerning the duties of the board of directors and general manager, provide a basis for determining which obligations must be seen as being the responsibility of the management of the entity subject to the statutory audit obligation, but these provisions cannot be regarded as exhaustive in this context. "Management and control tasks" can in concrete situations also include functions and responsibilities that are delegated or handed over to people further down in the organisation.

Kredittilsynet would nonetheless like to point out that an auditor's main task is to audit annual accounts and annual reports, and assess whether or not they provide adequate relevant information pursuant to the accounting legislation, cf. section 5-1, paragraph one, of the Auditors Act. Next auditors shall, as an administrative task, but limited to the audit work that is necessary to confirm the annual accounts, ensure that the entity subject to the statutory audit obligation manages its assets in an adequate manner and with proper controls. When assessing which services an auditor can or cannot provide in relation to the provisions in section 4-5, paragraph two, of the Auditing Act, it is of great importance to pay special attention to the types of management and control tasks associated with the audit client's asset and financial management. In other words, questions concerning independence arise in those cases where an auditor provides non-audit services regarding the client's asset and financial management and where the results of these services are included in what the auditor subsequently will control and check. In these circumstances one would quickly end up with auditors auditing their own work or auditing decisions they have influenced or participated in, which is incompatible with the requirements in the Auditors Act concerning the necessary actual and apparent independence and objectivity.

It follows inter alia from company law and accounting legislation that the management of the entity subject to the statutory obligation to keep accounting records/audit obligation, is responsible for establishing procedures that fulfil the obligations associated with the recording of information about transactions and other dispositions, and for submitting the annual accounts in accordance with statutory requirements. The auditor's statutory task is to assess whether or not these obligations have been fulfilled (section 5-1, paragraph one, of the Auditors Act) and express his opinion about the same matters in the auditor's report (section 5-6, paragraph three, of the Auditors Act). Should the auditor demonstrate deficiencies, he is obliged to notify this to the company's management in a numbered letter (section 5-2, paragraph four, of the Auditors Act). Legislators have placed significant emphasis on the fact that it is the management who shall fulfil this obligation and have in addition assigned an essential control and reporting role to auditors in this context.

3. The responsibilities of the auditor

In Kredittilsynet's opinion the threshold above which an auditor's non-audit services could conflict with the act is relatively low. Auditors must in general exhibit a high degree of care, especially when it comes to listed companies and other undertakings of public interest. The services provided must be subject to a specific assessment in relation to the applicable regulations. This is the responsibility of the statutory auditor. In order to ensure that the provisions of the regulations are fulfilled, a statutory auditor must, in light of this, obtain an

adequate overview of the services being provided by others in the audit firm or by cooperating firms, including the total effect of such non-audit services. In those cases where an audit firm is the elected auditor it is the responsibility of the statutory auditor to assess whether or not any additional services being provided contravene the regulations. The audit firm on its part is responsible for the existence of a policy and guidelines for adequate control routines that guarantee that independence is ensured in all audit tasks.

Upon receiving reports or as part of its ordinary supervision, Kredittilsynet's task will be to reach a conclusion on whether or not the statutory auditor has undertaken the necessary and correct assessments with respect to questions of disqualification associated with any additional services. The basis for Kredittilsynet's assessments in this area is the documentation requirement pursuant to section 5-3; paragraph three, of the Auditors Act, which stipulates that auditors shall, when carrying out non-audit services, be able to document the nature of the assignment, its scope and any recommendations. The requirement in section 5-3, paragraph three, of the Auditors Act only applies to the auditor himself and not to cooperating firms. One prerequisite for compliance with the requirement concerning independence and objectivity is nonetheless that the auditor obtain an overview of any non-audit services carried out by cooperating firms, including the nature of the assignment, its scope, any recommendations and the invoice amount.

4. Kredittilsynet's guidelines for auditors' non-audit service to audit clients

Kredittilsynet's assessments with respect to auditors' non-audit services to audit clients are based on a set of fundamental main criteria derived from the Auditors Act. These criteria also conform to what Kredittilsynet regards as following from good auditing practice and the EU Commission's Recommendation 2002/590/EC of 16th May 2002 – Statutory Auditors' Independence. The Norwegian Institute of Public Accountants (DnR) ethical professional rules may act as a supplement, but do not constitute a basis for deviating from that which follows from the Auditors Act.

The main criteria that Kredittilsynet will use as a basis for its assessments are:

- 1. An auditors cannot put himself in a situation in which he must subsequently audit himself/his own work.***

The auditor shall be objective so that deficiencies which may be of significance to the submission of the accounts can be identified. The auditor can therefore not act as an advisor in such manner that he later on may have to audit the results of his own advice or work. For example, an auditor cannot prepare a company's annual report since the auditor will subsequently have to audit this. Moreover, an auditor cannot perform the bookkeeping or recording of accounts data. This applies even if the vouchers are attested and the debit and credit accounts written by the management of the undertaking. The risk of having to audit one's own work is particularly high if the non-audit services have been provided in relation to functions, routines and systems that are of direct consequence to accounts transactions and the submission of the annual accounts. The risk of having to audit one's own work is increased if non-audit services are provided frequently and over a period of time.

Auditors must in connection with the auditing of annual accounts assess the arrangement and quality of the undertaking's internal control. In this work the auditor must be objective so that

deficiencies that may be of significance to the submission of the accounts can be identified. If the auditor provides advice concerning key elements of the undertaking's internal control, there is a risk that the auditor will have to audit the results of his own advice.

Another factor is that an auditor has an independent duty to assess whether an undertaking has arranged for satisfactory management of its assets and that proper controls are in place, cf. section 5-1, paragraph two, of the Auditors Act. It is true that this assessment is general in nature and exists within the limits of the auditing of the annual accounts. However, to the extent that an auditor becomes key to the shaping and execution of the undertaking's control systems, this deprives the auditor from the possibility of being adequately objective when undertaking the assessment pursuant to section 5-1, paragraph two.

2. *Auditors cannot perform functions that in reality form part of the undertaking's strategy work, business related transactions, operations, management, control and internal audits.*

In part, this follows directly from section 4-5, paragraphs one and two, cf. further information in item 2.2 above. It contravenes this provision if an auditor performs the aforementioned functions for his audit client, or is perceived to be performing such functions. Furthermore, if an auditor is contributing to strategy work and business activity, this will contravene the auditor's duties pursuant to section 5-1, paragraph two. The same applies if the auditor contributes to the establishment of principles or conducts assessments linked to the preparation of the undertaking's plans and budgets. Exactly where the line should be drawn is a matter of professional judgement, but one critical factor is the auditor's activities and involvement in the relevant non-audit services. Kredittilsynet believes that it is incompatible with the auditor's role that an auditor heads and functions as a driving force in projects or processes for an audit client. An auditor must not put himself in a situation where he may subsequently need to defend the results of his own advice or services related to the undertaking's operations, management or control, etc.

3. *An auditor cannot over time compensate for a lack of capacity and competence in the undertaking*

Basically, an undertaking must itself ensure that it has adequate capacity and competence to look after its operations and management. Irrespectively, the auditor cannot provide help with this over time². When the nature of the assistance is directly relevant to accounts transactions and the submission of the accounts, its scope and duration must be limited, cf. item 1 above. Should an auditor get involved in such a manner that he, over time, compensates for the undertaking's lack of capacity and/or competence, the auditor becomes part of the undertaking's operations, which conflicts with his role as auditor. What is meant by "over time" will be a matter of professional judgement, but if this type of assistance lasts for a significant part of a financial year, this will be a problem. It is also a problem if the assistance has a character of permanence in that *the same type of assistance* is repeated regularly over a period of several years.

² Proposal no. 75 to the Odelsting (1997-98) "Concerning the Act on auditing and auditors (Auditors Act)" point 7.2.3.2, page 82.

4. *An auditor cannot take decisions for a client, including participating in or influencing the decision making process or supplying significant premises for the undertaking's key decisions, or acting as an attorney-in-fact.*

It follows from section 4-5, paragraph three, of the Auditors Act that the auditor is not allowed to act as attorney-in-fact for the client. The auditor cannot involve himself in such a manner that he supplies significant premises to, participates in or influences the decision making process in the undertaking, especially in areas that are covered by the auditor's subsequent confirmation. The auditor cannot place himself in a situation where he becomes a key, or even crucial, supplier of premises vis-à-vis the undertaking's decisions.

Exactly where to draw the line in relation to decision making can be unclear, and it is often the case that the procurement of the premises and facilitation of the basis on which a decision is made is more important vis-à-vis the decision than the actual decision making process itself. The preparatory legislative work states that the auditor must not participate in or influence the decision making process in the undertaking³. This especially applies to areas that are covered by the auditor's subsequent confirmation.

5. *An auditor cannot put himself in a situation where his own independence and objectivity does not appear credible*

To ensure that capital market, owners, creditors, authorities and others have confidence in auditors, it is of vital importance that auditors appear and are perceived to be independent and objective in relation to the entity subject to a statutory audit obligation. One factor of significance in this context is the extent of the auditor's and auditor's cooperating firm's non-audit services provided to the entity subject to a statutory audit obligation. It is a problem when the non-audit services that are not related to the auditor task over time substantially exceed the fees for auditing. Correspondingly, it is a problem with respect to disqualification, if the auditor has personal or financial ties to the entity subject to a statutory audit obligation, the entity's management, and other key decision takers who could be perceived as having an influence on the auditor's objectivity.

5. Specific examples of non-audit services that auditors clearly can provide to their audit clients⁴ include, among others, the following services:

- Auditors can carry out reclassifications or process accounting materials so that they provide a better overview.
- Auditors shall assess the undertaking's internal controls and it is therefore acceptable for an auditor to suggest improvements to routines when deficiencies have been demonstrated. The point here is that the auditor can suggest improvements to routines once he has demonstrated deficiencies as part of his audit, but the auditor must at the same time be careful that he is not putting himself in a position where he may subsequently have to audit the results of his own advice. Suggestions concerning

³ Proposal no. 75 to the Odelsting (1997-98) "Concerning the Act on auditing and auditors (Auditors Act)" point 7.2.3.2, page 81 and point 7.2.5.2, page 85.

⁴ Proposal no. 75 to the Odelsting (1997-98) "Concerning the Act on auditing and auditors (Auditors Act)" point 7.2.3.2, page 81.

improvements to routines may in individual cases be acceptable, but the auditor must be careful with respect to developing and building up holistic routines in the undertaking that he may subsequently have to consider.

- Auditors may prepare objective consequence analyses when there is a choice between various alternative accounting or tax related solutions.
- Auditors may provide advice concerning the content of the legislation's valuation/appraisal rules.
- Auditors may provide advice concerning the accounting and presentation rules in the accounting legislation.
- Auditors can perform the purely technical setting up of accounts (technical accounting assistance), assuming that this set-up is based on material where both the principles and assessments are stipulated and implemented by the management itself. However, a great deal of care should be displayed with respect to such assistance and it does not take much for the assistance to cross the line of what can be regarded as acceptable advisory service. Kredittilsynet underlines that the auditor is the one who must document that principles and assessments were stipulated by the management, in order to ensure that no doubts are raised concerning his independence and objectivity.

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