

Opportunity for international networks: use independent internal supervision to enhance quality

The AFM conducted an [exploratory assessment](#) of the impact and working practices of independent internal supervision of six PIE audit firms¹ in the Netherlands over the period from 1 January 2020 to 31 December 2020. According to Dutch law, PIE audit firms are required to have a system of internal supervision in place since 2018. Depending on the governance, independent internal supervision consists of an independent supervisory board in a two-tier board system or independent non-executive director(s) in a one-tier board system.

Impact on preconditions for quality

The assessment shows that independent internal supervision has an impact on the preconditions for quality, and may reduce vulnerabilities in the structure of the audit sector. Independent internal supervision enhances quality by strengthening both senior leadership and governance of an audit firm. However, independent internal supervision will gain most benefit with support of and collaboration with the international networks. Therefore, the AFM raises the attention of international networks to this topic and encourages them to combine strengths to improve audit quality beyond national borders.

Internal supervision strengthens senior leadership

The assessment performed by the AFM shows that independent internal supervision can strengthen senior leadership of a member firm, as senior leadership of a member firm is challenged by the independent body. Also, the independent body encourages promotion of audit quality by senior leadership, and monitors whether decisions made are in line with public interest. Furthermore, it's noticed that independent internal supervision encourages a quality-oriented culture and encourages senior leadership to improve their quality safeguards. A practical example observed at one of the PIE audit firms is that the independent body assesses the budget for investments in quality. The independent body checks whether the budget for investment in quality is sufficient to realize the quality objectives set by the audit firm, and continuously challenges the board on the budget and the objectives.

Strengthening audit firm governance

Another observation in the assessment is the role of independent internal supervision in enhancing the setting and realization of quality objectives is by strengthening the audit firm governance. For instance, the independent body fulfills a key role in appointing and assessing the performance of board members. Furthermore, independent internal supervision focuses on quality in the selection of partners. A practical example observed at one of the PIE audit firms is that the independent body assesses whether a candidate partner-shareholder takes sufficient account of the public interest and displays adequate leadership.

Challenges for the future

Research shows added value of independent internal supervision. However, it acknowledges challenges as well. For example, the independent body has to deal with influences of partner-shareholders, who fulfil a dual role as they are both 'employees' and shareholders of the audit firm. As shareholder, partners are represented as owners at the general meetings of shareholders (GMS). During these meetings, partner-shareholders have the power to approve the appointment and dismissal of members of the independent body, and to approve the appointment of board members. This means that the GMS also has a role with respect to the powers of the independent body. The independent body therefore needs the support of the GMS to be effective.

As mentioned before, PIE audit firms are required to have a system of internal supervision in place according to Dutch law. Currently there is a legislative proposal to extend the reach of this Dutch law, which could lead to a requirement for non-PIE audit firms as well. The importance of and therefore the interest in independent internal supervision increased in the Netherlands throughout the years. There is an opportunity for the international networks regarding independent internal supervision, so why not take the chance?

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