

# **Results of the inspection of the quality of statutory audits at the Big 4 audit firms**

**25 September 2014**



## The Netherlands Authority for the Financial Markets (AFM)

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The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. We promote the fair and conscientious provision of financial services to consumers and private investors, as well as professional and semi-professional parties. We supervise the fair and efficient operation of the capital markets. Our aim is to improve consumers' and companies' confidence in the financial markets, both in the Netherlands and abroad. In performing this task, the AFM contributes to the stability of the financial system, the economy and the reputation and prosperity of the Netherlands.

## Contact

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Further information on the supervision of audit firms is available on the AFM website ([www.afm.nl](http://www.afm.nl)) under Professionals > Doelgroepen > Accountantsorganisaties. Specific questions regarding this report may be put by e-mail to [wta@afm.nl](mailto:wta@afm.nl) or by surface mail to the Netherlands Authority for the Financial Markets, attn. Oversight | Audit & Reporting Quality, Postbus 11723, 1001 GS Amsterdam, or by telephone to +31 20 797 2000.

### Disclaimer

This is an English translation of the [original Dutch text](#), furnished for convenience only. In the event of any conflict between this translation and the original Dutch text, the latter shall prevail.

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## 1 Introduction

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Between April 2013 and the end of July 2014, the Netherlands Authority for the Financial Markets (AFM) carried out regular inspections at the four largest audit firms in the Netherlands (the Big 4 firms): Deloitte Accountants B.V. (Deloitte), Ernst & Young Accountants LLP (EY), KPMG Accountants N.V. (KPMG) and PricewaterhouseCoopers Accountants N.V. (PwC). The Big 4 firms are licensed by the AFM to conduct statutory audits of both public interest organisations (PIEs) and other enterprises and institutions (non-PIEs).<sup>1</sup> In total, the Big 4 firms conduct approximately 90 per cent of all statutory audits of PIEs in the Netherlands and half of all statutory audits of non-PIEs. The Big 4 firms account for approximately 76 per cent of the total revenue earned by Dutch audit firms from the conduct of statutory audits.

The AFM's supervision of audit firms is designed to increase the quality of statutory audits and to ensure this in the longer term. The purpose of the regular inspections was to evaluate the quality of the statutory audits that the Big 4 firms had conducted, as well as to assess whether the measures the firms had in place provided an adequate safeguard of audit quality. The AFM also gained insight into the causes that the Big 4 firms thought to underlie the deficiencies that were present, and into the measures that the firms intended to take on their own initiative.

The AFM published a report on the first regular inspections it conducted at the Big 4 firms in the period 2009-2010 in September 2010. The regular inspections in 2013-2014 concern first follow up assessments: by carrying out subsequent inspections of the quality of the statutory audits conducted by the Big 4 firms, the AFM is in a position to assess whether and to what extent the improvement measures introduced in the intervening period have had the desired effect.

This report presents the AFM's findings from its regular inspections at the Big 4 firms. With effect from 1 January 2014, the AFM has been able to publish its principal findings and conclusions from its inspections at audit firms, subject to the condition that these findings and conclusions cannot be traced to persons other than the audit firms in question. The purpose behind the publication of findings and conclusions about specific firms is to increase transparency regarding the quality of individual audit firms. With these firm-specific findings and conclusions, users of financial accounting information, such as investors and lenders, can at least see how the audit firms concerned compare when it comes to the extent to which they meet the applicable standards. For supervisory boards, and especially audit committees, this

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<sup>1</sup> A statutory audit is an audit of the financial reporting of an enterprise for public use that is specifically designated as a statutory audit in the Audit Firms Supervision Act (Wet toezicht accountantsorganisaties, or 'Wta'). This concerns the audit of financial statements of medium-sized and large companies, municipalities, provinces and various financial enterprises, for instance. A distinction is made between the statutory audit of organisations known as PIEs and other enterprises and institutions (non-PIEs). PIEs are listed companies, banks and insurers.

information concerning specific firms can be useful for their role in the selection and evaluation of an external auditor.

The contents of this report are arranged as follows: Section 2 presents a summary of the report. Section 3 describes the relevant context and current developments in the audit sector. Section 4 contains the results of the inspections, and section 5 lists the AFM's recommendations and considerations with respect to the quality of statutory audits and the safeguarding thereof. Section 6 describes the objective, scope and progress of the inspections carried out at the Big 4 firms and the principal findings and conclusions at each Big 4 firm. The responses of these organisations to the AFM's findings and conclusions are also presented here.

All references to an external auditor in the masculine gender shall of course be taken to include the feminine.

Appendix 3 contains a list of abbreviations used in this report.

## 2 Summary

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Between April 2013 and the end of July 2014, the Netherlands Authority for the Financial Markets (AFM) carried out regular inspections at the four largest audit firms in the Netherlands (the Big 4 firms): Deloitte, EY, KPMG and PwC. The purpose of these regular inspections was to evaluate the quality of the statutory audits that the Big 4 firms had conducted, as well as to assess whether the measures the firms had in place provided an adequate safeguard of audit quality. The AFM also gained an understanding of the causes that the Big 4 firms thought were responsible for the deficiencies that were present, and of the measures that the firms intended to take on their own initiative. Based on the results of the inspections, the AFM has formulated its recommendations.

### Results of the inspections

The AFM evaluated whether the external auditor obtained sufficient appropriate audit evidence to justify his opinion and thereby complied with the professional standards. During its inspection of each firm, the AFM concentrated on the material parts of the audits. If the external auditor did not obtain sufficient appropriate audit evidence for any material part, he therefore did not obtain sufficient appropriate audit evidence to justify his opinion regarding the financial statements as a whole. In that case, the AFM classifies the conduct of the statutory audit as ‘inadequate’.

At each of the Big 4 firms, the AFM evaluated 10 statutory audits for the 2012 financial year. It classified a number of them as ‘inadequate’. This number breaks down as follows: four carried out at Deloitte, three at EY, seven at KPMG, and four at PwC. For these statutory audits, the AFM considers that the external auditors did not obtain sufficient appropriate audit evidence to justify their opinion on the financial statements in question as a whole. In total, the AFM classified the quality of 18 (45%) of the 40 statutory audits inspected as ‘inadequate’. Of the other 55%, the AFM did not conclude that they were ‘inadequate’.

A statutory audit conducted ‘inadequately’ does not, however, mean by definition that the audited financial statements are incorrect. The AFM did not examine the audited financial statements for correctness and therefore passes no judgement on this aspect. The Big 4 firms have examined what the consequences of the AFM’s classification of their statutory audits as ‘inadequate’ are for the audit opinions they issued, and have concluded that the audit opinions already issued do not require amendments. The AFM has not assessed whether these conclusions are correct. The most commonly occurring deficiencies concern the tests of controls, the substantive analytical procedures and the critical evaluation by the external auditor of the audit evidence he obtained. Most cases involved a combination of various deficiencies.

In 2010, the AFM stated in the conclusion to its final inspection reports that, for 52% on average of the statutory audits inspected, the external auditors had not obtained sufficient appropriate audit evidence. In recent years, partly as a result of the supervision conducted by the AFM, the Big 4 firms have taken various measures to safeguard the quality of statutory audits. Now, in 2014, the AFM's conclusion is that, for 45% of the statutory audits inspected, sufficient appropriate audit evidence was not obtained. Without detracting from the efforts that the Big 4 firms have made over the past few years, their measures have not achieved the desired result. The AFM found that, for several statutory audits, the external auditors concerned failed to or failed to adequately comply with the professional standards when conducting these audits. The measures the audit firms took to safeguard the quality of statutory audits failed to prevent this. Based on the results of its inspections, the AFM concludes that the average quality of the statutory audits conducted by the Big 4 firms has only slightly improved since 2010. Since the AFM considers that the number of statutory audits qualifying as 'inadequate' is still too high, it does not rule out the application of formal enforcement measures.

With this report, the AFM is publishing its principal findings and conclusions concerning individual audit firms, based on supervisory inspections, for the first time. The purpose of publishing findings and conclusions about specific firms is to increase transparency regarding the quality of individual audit firms. With these findings and conclusions about specific firms, users of financial accounting information, such as investors and creditors, can at least see how the audit firms concerned compare when it comes to the extent to which they meet the applicable standards. For supervisory boards, and especially audit committees, this information concerning specific firms can be useful for their role in the selection and evaluation of an external auditor.

### **Root causes and improvement measures**

At the request of the AFM, the Big 4 firms have for each of the inspected statutory audits prepared a list of what they consider the root causes of the deficiencies found. They have also set out the measures they will take in response to the results of the inspections.

The AFM finds that the root causes identified by the Big 4 firms vary considerably, in both substance and depth. Accordingly, the AFM regards several of the causes listed by the Big 4 firms primarily as symptoms. The actual underlying causes of the lack of consistent quality assurance in statutory audits are not yet completely clear.

Partly based on the results of the AFM's inspections and the root cause analysis performed, which were discussed prior to publication, the Big 4 firms have informed the AFM of the measures their organisations will be adopting to remediate the deficiencies found and to ensure the quality of statutory audits in the future. The

AFM notes that the measures announced are greater in number, as well as being more inclusive and extensive, than the measures the Big 4 firms took in response to the previous regular inspection. In terms of number and range, the measures announced focus mainly on the quality control procedures of the audit firms. In the opinion of the AFM, improvements in this area are indeed not only possible but also necessary to ensure the quality of statutory audits. The Big 4 firms have announced measures for other aspects as well, such as organisation culture, executive board, internal supervision and relationship with the rest of the field in which they operate. The degree to which the measures for these aspects have been concretely given shape in terms of form and content varies from firm to firm.

On 25 September 2014, simultaneously with the publication of the report from the AFM, the professional body NBA (Netherlands Institute of Chartered Accountants) working group 'Toekomst accountantsberoep' (Future Accountancy Profession Working Group) published its analysis and proposals for possible measures to regain the public's confidence through transparent assurance of quality and independence. It is expected that the Big 4 firms will further elaborate the measures they have announced to the AFM, if necessary adding to them in the light of the above sector analysis. Whether the total package of measures announced by the Big 4 firms will be effective enough remains to be seen. The extent to which the measures will prevent future deficiencies and remove the incentives<sup>2</sup> inherent in the system for conducting statutory audits largely depends in fact on the commitment and determination the that Big 4 firms put into their implementation.

### **Recommendations of the AFM**

Based on the results of its inspections, the AFM is making two recommendations to the Big 4 firms regarding:

1. Implementation of the measures they announced; and
2. Increasing the depth of their root cause analyses.

Furthermore, the AFM is advising the legislator to make additions to the legislation in a number of areas.

### **Implementation of the measures announced**

The AFM is recommending Big 4 firms to implement the measures announced, including the expected additions based on the proposals of the NBA working group 'Toekomst accountantsberoep', expeditiously and decisively, while constantly focusing on the public interest involved in statutory audits above all other interests.

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<sup>2</sup> For a closer consideration of the incentives inherent in the system for conducting statutory audits, see section 5.1.1 of the report.

The AFM also recommends these firms to, when elaborating the measures and when implementing them, give special attention and priority to the following matters, each individually, but also and especially as interrelated:

- *Strengthening of governance*

The AFM expects the measures only to be sufficiently effective if each of the Big 4 firms simultaneously strengthens its governance with other measures. In the opinion of the AFM, the following points in particular need to be addressed in this strengthening of governance:

- o Strengthening governance at a Big 4 audit firm needs to apply to all three of (i) the firm's executive board, (ii) the executive board of the firm's network in the Netherlands, and (iii) the firm's internal supervisory body (such as a supervisory board and/or public interest committee).
- o Strengthening the executive board, which includes:
  - Having the right tone-at-the-top and an executive board that acts as a role model help define the quality-oriented culture of an organisation where the public interest is the centre of attention.
  - Having a strategic vision for the objectives of the organisation and how to achieve them, understanding the major key performance indicators concerning quality in order to be in control, and sufficient authority to define and enforce effective policy and to take measures.
  - Ensuring that the members of the executive board have sufficient time, knowledge and managerial experience, so that as a group they are fit for purpose. Naturally, candidates with suitable managerial experience can also be recruited from outside the organisation.
- o Strengthening the internal supervision of the executive board of the audit firm and of its network, which includes:
  - Appointing a supervisory board at the level of the highest entity, to the extent that this has not already been done.
  - Filling the supervisory board with members who are independent of the audit firm, have the power to appoint and dismiss executive board members, and have duties and powers in line with the relevant provisions of the Dutch Corporate Governance Code and Book 2 of the Dutch Civil Code.

- *Creating a quality-oriented culture*

The AFM expects the effectiveness of the measures to depend largely on the extent to which audit firms are able to create a quality-oriented culture, accelerating the changes to their culture where necessary and continuing to pay attention to this matter. In the opinion of the AFM, when making

changes to the culture the following points in particular need to be addressed:

- o Encouraging willingness to change at all levels of an audit firm and its network is indispensable for implementing the announced measures effectively.
  - o Creating a culture that is focused on keeping at the centre of attention the public interest involved in high-quality statutory audits, as demanded by the public duty of an audit firm.
  - o Promoting an open culture that is focused on intensive cooperation contributes to putting the public interest at the centre of attention, as well as to the conduct of high-quality statutory audits.
  - o Bringing the review and remuneration policy into line with the quality-oriented culture by having this policy support the standards and values of the audit firm, as well as the quality objectives it aims for. It is important for these quality targets to be adequately monitored, down to the level of the individual statutory audit, for example by basing the monitoring function on suitable key performance indicators.
- *Embedding statutory quality standard*

The auditing standards that have applied for many years to the conduct of audits, and which were largely drawn up by the auditing profession internationally, contain objectives and requirements intended to ensure good quality in execution. During its inspections, the AFM found instances of these requirements not being met and the objectives not being achieved. The quality controls of the audit firms failed to prevent these deviations from the statutory quality standard. To ensure the quality of statutory audits, which always involve customised procedures and specific circumstances, it is necessary to embed the statutory quality standard throughout the audit firm. In the opinion of the AFM, the following points in particular need to be addressed when embedding this quality standard:

  - o Constantly maintaining, updating and where necessary expanding the knowledge that external auditors and other staff have of the statutory quality standard.
  - o Facilitation for and motivation of their external auditors and other staff by the audit firms in this respect.
  - o Ensuring that the audit firms' quality controls, such as the engagement quality control review and the internal quality inspection, provide sufficient information about the standard of quality achieved. This will mean that the measures can provide adequate feedback to external auditors and other staff about the quality they have delivered. These measures can also draw attention to deviations from the required quality standard in time and qualify them as such, so that the correct implications can be deduced.

- *Increasing transparency with respect to quality*

In the opinion of the AFM, increasing transparency with respect to the conduct of statutory audits helps improve their quality. This is because transparency reduces the information gap between audit clients, users of financial statements and interested parties on one side, and auditors and audit firms on the other. Transparency with respect to quality should increase competition on quality rather than simply the size of the fee, and promote consistency of quality delivered. In the opinion of the AFM, when increasing transparency the following points in particular need to be addressed:

- o The Big 4 firms need to be transparent about their audit approach, the quality they deliver, and in the short term especially about how they interpret the measures announced, as well as the progress and effectiveness of their implementation. They can do this in their transparency reports and/or annual reports, or via other statements.
- o External auditors need to be transparent about the audits they have carried out, including any matters of emphasis, in their more expanded auditor's reports, at the general meetings of shareholders of audit clients, or in other statements.
- o Audit firms should hold discussions with supervisory boards, and especially with the audit committees, of audit clients, about the results of reviews of the quality of statutory audits, including those the AFM conducts. From this, audit committees will gain more insight into the quality of statutory audits carried out, which they can utilise in their role in the selection and evaluation of the external auditor.

### **Increasing the depth of root cause analyses**

The AFM found that the actual underlying causes for the lack of consistent quality assurance for every statutory audit are not yet completely clear. Accordingly, the AFM is requesting the Big 4 firms to further deepen their analyses of root causes and reasons underlying the deficiencies found. If the firms identify additional causes or reasons, they need to assess whether the measures they are taking address these causes and reasons effectively, taking different or additional measures as necessary. Moreover, the AFM expects the Big 4 firms to make the root cause analyses part of their quality control procedures.

## Advice to the legislator

Based on the results of the inspections, the AFM sees reason to advise the legislator to make the following additions to the law:

- *Suitability test conducted by the AFM*  
In the opinion of the AFM, introducing a suitability test in which the AFM will assess the individual as well as the collective suitability of policymakers and co-policymakers of audit firms, i.e. the members of the executive and supervisory boards, will contribute to the necessary improvement of the management of these organisations.
- *The AFM to submit findings and conclusions directly to the bodies responsible for governance*  
If the AFM is granted the authority to submit its findings and conclusions directly to the bodies responsible for governance at audit clients, such as supervisory boards and in particular audit committees, this should increase transparency with respect to the quality of statutory audits.
- *Mandatory taking of corrective and improvement measures*  
The AFM considers it important to introduce a legal obligation for audit firms to take appropriate measures if deficiencies are found, to correct past violations, if any, and prevent their recurrence in the future.
- *Introduce additional categories for PIEs*  
Given its findings relating to the statutory audits of non-PIEs (public interest entities) that have a public function and which affect the interests of large groups of people, the AFM advises the legislator to utilise the option of expanding the definition of a PIE to include, for example, large housing corporations, large municipalities, large pension funds, large educational institutions, large health care institutions, and large energy companies. As a result, additional safeguards under the Audit Firms Supervision Act (Wta) will apply to the statutory audits of the financial statements of these organisations, which will enhance the quality of the audits.
- *Mandatory supervisory boards*  
To reinforce the supervision of executive boards at PIE audit firms, as well as the attitude of professional scepticism of such boards, the AFM considers it desirable to make it mandatory for these firms to establish supervisory boards, preferably along the lines of the two-tier board structure. The members of these boards must be independent of the audit firms and have the full powers of supervisory board members, such as approving strategic decisions and appointing and dismissing executive board members. The AFM considers it important that the relevant provisions of the Dutch Corporate Governance Code and Book 2 of the Dutch Civil Code be the guidelines for defining the rights and duties of a supervisory board.

### Follow up by the AFM

During the period following this regular inspection, the AFM will carefully monitor the implementation and effectiveness of the announced measures for the remediation of deficiencies found, and of the measures intended to prevent deficiencies in the future. Moreover, the AFM will especially check at each of the Big 4 firms whether its measures fully satisfy the AFM's recommendations, and are being implemented with sufficient progress and determination. In this context, an open dialogue with the firms on the follow up to the inspections discussed here is essential. If the progress and determination with which the announced measures are being implemented are not adequate, the AFM can apply formal enforcement measures to enforce the expeditious and decisive implementation that is required.

### 3 Context and current developments

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In this section, the AFM describes the context and some of the current developments surrounding the audit profession and the supervision thereof. These are relevant in the context of the inspections the AFM has carried out at the Big 4 firms and the associated findings and conclusions.

In the wake of several accounting scandals whereby confidence in the audit profession has been damaged, legislation and regulation has been tightened around the world since the year 2000 and new legislation and regulation has been introduced. Independent public supervisors have also been appointed to monitor compliance with this legislation and regulation.

#### 3.1 The importance of audits

When conducting an audit, the external auditor responsible forms an opinion with respect to the question of whether the financial statements have in all material respects been prepared in accordance with the applicable framework for financial reporting. The external auditor performs procedures that are designed to obtain audit evidence that is adequate and appropriate to the specific circumstances in which the company being audited operates.<sup>3</sup> This audit evidence substantiates the external auditor's opinion that the financial statements do not contain any material misstatements and therefore present a true and fair view of the capital and result of the company being audited. Auditing standards with objectives and requirements apply to the conduct of an audit that ensure the quality of the audit.

The external auditor reports his opinion with respect to the financial statements he has audited in his auditor's report. In this report, he also states that his opinion is based on the audit evidence he has obtained by means of his audit procedures, that this audit evidence is sufficient appropriate to substantiate his opinion and that he has conducted his audit in accordance with the applicable legislation and regulation, including the auditing standards.

An auditor's report by an external auditor increases the reliability of financial reporting and contributes to confidence in this reporting for a large group of users, including both private individuals and organisations. The audit therefore contributes to the fair and transparent operation of markets by improving the reliability and usefulness of financial reporting. External auditors thus fulfil an important social role.

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<sup>3</sup> Audit evidence includes, for example, information from the financial administration on which the financial statements are based, or other information from the audit client or from third parties. Sufficient appropriate audit evidence is needed to substantiate the auditor's opinion. 'Adequate' in this context refers to the amount of audit evidence. 'Appropriate' in this context refers to the quality of that audit evidence. Quality means that the audit evidence is relevant and reliable, so that it provides real substantiation for the auditor's opinion.

### 3.2 Transparency through new audit opinion and appearance at AGM

The International Auditing and Assurance Standards Board (IAASB), the body that draws up the international auditing standards, has produced a format for a new auditor's report in order to improve and strengthen communication by external auditors. In this new auditor's report, the external auditor describes the key issues for his audit and explicitly endorses the conclusions of the management regarding the company's ability to continue as a going concern. Research by Eumedion shows that 36 per cent of the AEX companies, 53 per cent of the AMX companies and 32 per cent of the AScX companies have already included a more expanded auditor's report in their financial reporting for 2013.<sup>4</sup> The format is not yet mandatory. A pilot study using the new auditor's report was launched in the Netherlands in 2014. The NBA will develop a standard based on the IAASB format and is expected to make this mandatory for all Dutch listed companies for the 2014 financial year.

The Dutch Investors' Association (VEB) called on the largest audit firms and the NBA to provide more detailed information on their audits at the shareholder meetings in early 2013. Research by the NBA shows that this appeal has been answered.<sup>5</sup> The study shows that at more than half of the shareholder meetings the auditor gave a presentation and further explanation. An important item for improvement is that these presentations usually were general in substance and included company-specific information to only a limited extent.

### 3.3 Current developments in legislation and regulation

The accountancy sector has to deal with recently enacted national legislation and regulation for the profession, new European regulation that will apply in the Netherlands from 2016 and the current political debate on tightening legislation. Clear and enforceable legislation and regulation contributes to the restoration of confidence in the accountancy profession.

#### *New legislation and professional regulation*

The introduction of the Accountancy Profession Act (Wab) on 1 January 2013 entailed the inclusion of two important new provisions in the Audit Firms Supervision Act (Wta) designed to improve the assurance of independence of the audit firm conducting a statutory audit of a PIE. In the first place, this concerns the prohibition of providing other services to PIEs in addition to audit services.<sup>6</sup> In the second place,

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<sup>4</sup> [Evaluation of the AGM season 2014 – Eumedion 23 July 2014](#)

<sup>5</sup> [See the NBA website](#)

<sup>6</sup> Section 24b Wta.

rotation of the auditor will be mandatory from 1 January 2016, meaning that an audit firm may no longer conduct statutory audits for a PIE consecutively for longer than the period permitted by law.<sup>7</sup>

Two new regulations by the NBA took effect on 1 January 2014: Code of Ethics for Professional Accountants, regulation with respect to Rules of Professional Conduct (Verordening gedrags- en beroepsregels accountants, or VGBA) and the Regulation on Independence of Accountants in Assurance Engagements (*Verordening inzake de onafhankelijkheid van accountants bij assurance-opdrachten*, or ViO). These new professional conduct and practice rules and rules governing independence for auditors are a positive step towards improving audit quality.

In its agenda for 2015/2016, the IAASB has prioritised a number of issues, including the audits of financial summaries of a group. The practical experience of supervisors in the application of the standard for what are known as ‘letterbox companies’ suggests that this standard may need to be reviewed. ‘Letterbox companies’ are financial holding companies for a company operating abroad and having its registered office in the Netherlands for tax reasons. In the audits of these companies, the external auditor has to rely heavily on the work carried out by an auditor in a different country. The standards announced by the IAASB will be endorsed by the NBA and the NBA will implement them in its ‘Further regulations on auditing and other standards’ (*Nadere voorschriften controle- en overige standaarden*, or NV COS).

### *New European legislation*

Under the leadership of European Commissioner Barnier, the European Commission has been focusing on the reform of the European market for statutory audits since 2010. The reforms are designed to increase the quality of audits and restore the confidence of investors in financial information. The reform plans have led to a Directive and a Regulation. These include stricter and additional rules in relation to the independence of auditors and audit firms and the way in which audit quality must be managed and monitored. The Directive has to be implemented in Dutch legislation by 16 June 2016, and the Regulation will then become effective directly. These European rules will effectively set the frameworks for Dutch legislation and regulation with respect to statutory audits.

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<sup>7</sup> Section 23 c Wta. This period was set at eight years at the time of introduction of the Wab. The Minister of Finance has now announced his intention to set this period at 10 years in line with the new European rules.

### *The debate on further tightening of legislation and regulation*

On 14 May 2014, the standing committee for Finance of the House of Representatives held a General Consultation with the Minister of Finance regarding accountancy. The purpose of the consultation was to discuss the implementation of the new European legislation, the quality of the accountancy profession and the legislation as a result of coverage of various issues in the media.

The House of Representatives subsequently adopted a motion in which it called upon the accountancy profession to present concrete proposals for improving the quality of audits. The House commented that “the improvements should concern ensuring quality and independence in governance, direction and the revenue model”.

The political debate on the need for tighter legislation for auditors will continue after the publication of the results of the evaluation of the Wta in September 2014<sup>8</sup>, the completion of the inspection of the quality of the statutory audits of the Big 4 firms by the AFM and the submission by the audit profession of its own improvement proposals.

The NBA has set up a working group that will elaborate these improvement proposals. The NBA’s instructions to the working group are formulated as follows: “improve quality, adapt governance, direction and the revenue model to improve the assurance of quality and independence and submit proposals in September”.<sup>9</sup> The working group has organised various debates and consulted with individual stakeholders as a basis for its proposals. The NBA has consulted with various market parties regarding the proposals, and these were published on 25 September 2014.

The improvement proposals are in line with previous initiatives by the NBA. In 2014, the NBA assigned a high priority to improving audit quality by introducing a mandatory programme consisting of file mentoring, a knowledge test and training to improve communication skills. The compulsory PE (continuing education) course ‘Say what you see’ (*‘Zeg wat je ziet’*) was also introduced with the aim of strengthening the individual auditor’s ability to issue alerts.

### *Corporate governance code*

The examination of accounting scandals has also involved scrutiny of the role of corporate governance. Transparency with regard to corporate governance is crucial.

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<sup>8</sup> The Erasmus University of Rotterdam evaluated the Wta and the supervision of the AFM on the instructions of the Minister of Finance in the summer of 2014.

<sup>9</sup> [See the NBA website](#)

The Corporate Governance Code Monitoring Committee<sup>10</sup> announced that it would evaluate the corporate governance code in May 2014. It considers it important to consult with all stakeholders, including auditors, regarding the topicality and usefulness of the code.

Audit committees play an important part in safeguarding the quality of the reporting and the audit. This role mainly concerns the selection of and interaction with the external auditor and how to deal with the information obtained from the supervisor regarding the quality of the audit (transparency with respect to the supervisor's findings). As a result of the mandatory auditor rotation referred to above, audit committees will need more information in order to assess quality before appointing an auditor.

### 3.4 Supervision by the AFM

The Wta came into effect in the Netherlands in 2006. The Wta was introduced with the aim of ensuring the quality of audits and restoring justifiable confidence in auditors and the audit opinions they issue. The AFM has been supervising licensed audit firms that conduct statutory audits since 2006. Since the introduction of the Wta, the AFM has carried out various inspections at audit firms that fall under its supervision in order to form an opinion of the quality of the statutory audits they conduct. The AFM found deficiencies at the Big 4 firms in 2010<sup>11</sup>, and at the other PIE audit firms and the non-PIE audit firms in 2013<sup>12</sup>, and concluded that fundamental improvements were needed. The AFM moreover noted that the quality of the statutory audits conducted by the non-PIE firms was lower than that of the statutory audits conducted by PIE audit firms. This completed the baseline measurement by the AFM.

In addition, the AFM has conducted a number of thematic inspections and published generic reports on these inspections in recent years.<sup>13</sup> The AFM has also conducted investigations of incidents, the results of which have not been published in generic reports.

In recent years, partly as a result of the supervision conducted by the AFM, audit firms have taken various measures designed to safeguard the quality of statutory audits. These include improvements to the quality control systems at the audit firm,

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<sup>10</sup> The duty of the Corporate Governance Code Monitoring Committee is to encourage the topicality and usefulness of the Dutch Corporate Governance Code, as well as to monitor compliance with the Code by Dutch listed companies. The AFM has no direct supervisory relationship with audit committees other than at financial institutions.

<sup>11</sup> See the report '[General Findings Regarding Audit Quality and Quality Control Monitoring](#)'.

<sup>12</sup> See the '[Report: Quality audit and system of quality control and management at nine PIE licence-holders](#)', and the [Thematic review of non-PIE audit firms Part 1: NBA firms](#) and [Part 2: SRA firms](#).

<sup>13</sup> See the [AFM website](#)

the internal supervision at the audit firm and its network, and communication with stakeholders in the audit firm's environment.

### 3.5 The international perspective

All Big 4 audit firms in the Netherlands are part of an international network. How these firms operate in the Netherlands is affected to a greater or lesser extent by the network, depending on the way in which entities within the network work together. The various country firms that are part of the network are supervised by different national supervisory agencies. The network itself is not supervised. The international interrelationship of the audit networks can mean that the potential for taking national measures is to a greater or lesser extent limited.

#### *Cooperation with foreign supervisors*

The effectiveness of the AFM's supervision of the Big 4 firms in the Netherlands is to some extent determined by its cooperation with other agencies supervising the foreign elements of the network. On the basis of European regulation, the authorities in the European Economic Area (EEA)<sup>14</sup> supervising audit firms may conduct inspections together and exchange information. Cooperative agreements can be established with supervisors outside the EEA, as the AFM has done with the US Public Company Accounting Oversight Board (PCAOB). At European level, the supervisors work together within the European Audit Inspection Group (EAIG) and at international level within the International Forum of Independent Audit Regulators (IFIAR). The AFM is an active member of both these organisations.

At international level, the AFM also has a leading role in the Audit Quality Working Group of the International Organization of Securities Commissions (IOSCO). This global cooperation of supervisors works on initiatives designed to increase the quality of audits. For instance, the Audit Quality Working Group looks at the role of the audit committee and its relationship with the auditor, and at how the global auditing standards are developed. IOSCO is expected to publish concrete proposals on this issue in the autumn.

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<sup>14</sup> The European Economic Area includes all the countries in the European Union, plus Iceland, Norway and Liechtenstein.

### *Supervisory findings of foreign supervisors*

Recent public reports from IFIAR and other foreign supervisors in past years show that the AFM's findings with respect to the quality of statutory audits are in line with the conclusions of other supervisory agencies as well.

In April 2014, IFIAR published a second global survey of findings arising from the inspections of audit firms.<sup>15</sup> The survey states the findings with respect to important elements of the audit, such as the review of measurement at fair value, the conduct of tests of controls, EQCR and the assessment of the adequacy of the financial statements and disclosures. Several supervisors report a lack of adequate and appropriate audit evidence and an insufficiently professional and critical attitude. IFIAR concludes that while the firms have taken measures and continue to do so, there is still a lack of consistency in the conduct of statutory audits.

Various foreign supervisors have published the findings arising from their supervision. Recent examples include:

- In its inspections in 2013-2014, the UK Financial Reporting Council (FRC) identified shortcomings requiring reparative measures in approximately 40 per cent of the statutory audits it reviewed of five of the largest audit firms (including the Big 4 firms).<sup>16</sup>
- The PCAOB published a general report in 2013 on the EQCRs from its inspections in 2011. The PCAOB states that it found deficiencies that were not noticed or not adequately addressed in the quality review in 39 per cent of the reviewed statutory audits by the seven largest audit firms (including the Big 4 firms).<sup>17</sup>
- In its report on its inspections conducted in 2013, the Canadian Public Accountability Board (CPAB) concludes that the quality of audits has improved, but that it is still too soon to conclude that the improvements are permanent.<sup>18</sup>

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<sup>15</sup> See the [IFIAR website](#)

<sup>16</sup> See the [FRC website](#)

<sup>17</sup> See the [PCAOB website](#)

<sup>18</sup> See the [CPAB website](#)

### *Framework for the quality of statutory audits*

There has been an important international contribution to the understanding of the various aspects of the quality of statutory audits. Based on its review, the IAASB has produced a list of the indicators that affect quality.<sup>19</sup> These indicators concern the input, the process, the output and the context of the audit. The PCAOB has developed a similar framework with indicators.<sup>20</sup> Such types of framework with indicators is helpful in gaining a better understanding of the factors that affect quality.

### *The debate regarding the future*

To stimulate the public debate regarding the future of audit and assurance, the Federation of European Accountants (Fédération des Experts-comptables Européens, FEE) published a discussion paper entitled 'The Future of Audit and Assurance'.<sup>21</sup> According to the FEE, the audit profession must have the courage to open itself up to debate, especially when new developments occur in the field of audit policy.

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<sup>19</sup> See the [IAASB website](#)

<sup>20</sup> See the [PCAOB website](#)

<sup>21</sup> See the [FEE website](#)

## 4 Results of the inspections

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This section describes the results of the regular inspections the AFM carried out at the Big 4 firms in 2013-2014. Section 4.1 describes the AFM's main conclusions regarding the quality of the 40 statutory audits inspected. Section 4.2 compares the results of the regular inspections with the previous regular inspection, which the AFM reported on in September 2010. Section 4.3 lists the most common deficiencies in the conduct of the statutory audits that the AFM qualified as 'inadequate'.<sup>22</sup> Section 4.4 describes the relationship between the quality of the statutory audits inspected and certain features of the audit client<sup>23</sup>, the audit itself and the persons involved in the performance of the audit. Section 4.5 presents a summary and assessment of the causes that in the opinion of the Big 4 firms underlie the identified shortcomings and the additional quality measures announced by the Big 4 firms.

### 4.1 Conclusions of the AFM regarding the quality of statutory audits

The AFM has evaluated the quality of 40 statutory audits covering a diverse group of audit clients. The method used by the AFM to select these 40 audits, which do not represent a statistical sample, is described in section 6.1. Section 6.1 also explains the focus areas for the AFM, the way in which the AFM carried out its inspections of the quality of the 40 statutory audits selected, how the AFM arrived at an opinion with respect to the quality of the statutory audits and that the AFM has reconciled the facts with the Big 4 firms.

The AFM inspected whether the external auditor had obtained sufficient appropriate audit evidence in order to substantiate his opinion<sup>24</sup> and focused its inspections on material elements of the audit. If the external auditor did not obtain sufficient appropriate audit evidence for any material part, he therefore did not obtain sufficient appropriate audit evidence to justify his opinion regarding the financial statements as a whole.

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<sup>22</sup> The information in sections 4.1 and 4.3 is a summary of the main conclusions and findings described for each Big 4 firm in section 6.

<sup>23</sup> References in this report to the 'audit client' concern the company or institution for which an audit firm conducts the statutory audit.

<sup>24</sup> That is to say, the AFM established whether the external auditor complied with paragraph 17 of NV COS 200

'General objectives of the independent auditor, as well as the performance of an audit in accordance with the Standards': "In order to obtain a reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce the audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion."

In such cases, the AFM qualified the conduct of the statutory audit as ‘inadequate’.<sup>25</sup>

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A statutory audit conducted ‘inadequately’ does not, however, mean by definition that the audited financial statements are incorrect. The AFM did not examine the audited financial statements for correctness and therefore passes no judgement on this aspect in the inspections. The external auditor can check what the consequences are of the AFM’s qualification of the statutory audit as ‘inadequate’ for the audit opinion he has expressed. The AFM has called on the Big 4 firms to take suitable reparative measures where necessary as a result of the AFM’s findings. Among other things, reparative measures mean that the external auditor should now obtain sufficient appropriate audit evidence to substantiate his opinion, and if it emerges that his opinion needs to be changed, he should inform the market without delay. The Big 4 firms have studied what the consequences of the AFM’s classification of their statutory audits as ‘inadequate’ are for the audit opinions they issued, and have concluded that the audit opinions already issued do not require amendments. The AFM has not checked whether these conclusions are correct. There are currently no specific legal safeguards in place to oblige audit firms to ensure that the necessary reparative measures are taken with reference to shortcomings identified in the statutory audit. The AFM considers this to be a deficiency.

The AFM evaluated 10 statutory audits at each of the Big 4 firms and classified a number of them as ‘inadequate’. The number of ‘inadequate’ statutory audits at each Big 4 firm ranges from three to seven. The AFM’s opinion with respect to these statutory audits is that the external auditors have not obtained sufficient appropriate audit evidence to substantiate their opinion with respect to the financial statements as a whole.<sup>27</sup> In total, the AFM evaluated the quality of 18 (or 45%) of the 40

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<sup>25</sup> In the report on the thematic inspection conducted by the AFM of non-PIE audit firms in 2013, the AFM divided the statutory audits it qualified as ‘inadequate’ into three categories specifically for the purpose of that inspection. The AFM’s findings at the Big 4 firms concern “Inadequate audit procedures with regard to specific items” (category 2), meaning that the external auditor had not obtained sufficient appropriate audit evidence in order to substantiate his opinion of the financial statements as a whole. In the thematic inspection of non-PIE audit firms, category 1 concerned “No serious shortcomings”, category 3 included “Some audit procedures conducted, however very basic audit techniques either not or incorrectly applied” and category 4 concerned “No or very few audit procedures conducted, mainly administrative and compilation work only”.

<sup>26</sup> Since the AFM’s assessment is limited to one or more material elements of the audit, the AFM qualifies the quality of a statutory audit as ‘inadequate’ and not as ‘adequate’ if it does not observe that the external auditor has not obtained sufficient appropriate audit evidence. It can after all not be assumed that parts of the statutory audit not assessed by the AFM do not contain material shortcomings.

<sup>27</sup> Since the qualifications ‘adequate’ and ‘appropriate’ are in most cases inextricably linked, the AFM makes no distinction in this report between findings relating only to the inadequacy of audit evidence and findings relating to lack of appropriate audit evidence. The AFM always uses the formulation ‘lack of adequate and appropriate audit evidence’ in its conclusion that the quality of a statutory audit should be assessed as ‘inadequate’.

statutory audits inspected as ‘inadequate’. The AFM did not conclude that the other 55 per cent of the statutory audits inspected were ‘inadequate’.<sup>28</sup>

The AFM’s conclusions regarding the 40 statutory audits inspected are shown in table 1.

<b>Audit firm</b>	<b>Number of inspected</b>	<b>Number of inadequate</b>	<b>Percentage inadequate</b>
Deloitte	10	4	40%
EY	10	3	30%
KPMG	10	7	70%
PwC	10	4	40%
<b>Total</b>	<b>40</b>	<b>18</b>	<b>45%</b>

*Table 1.* Summary of the AFM’s conclusions regarding the statutory audits inspected

The AFM’s conclusions are exclusively based on findings relating to the failure to obtain sufficient appropriate audit evidence in order to substantiate the opinion regarding the financial statements as a whole. Any other findings, for example with regard to audit documentation or audit evidence that is not of sufficient importance to affect the opinion regarding the financial statements as a whole, have been left out of consideration by the AFM in its qualification of statutory audits as ‘inadequate’. Any other findings of this nature have been discussed by the AFM with the external auditors and audit firms during the inspection.

Section 6 presents the AFM’s findings for each statutory audit qualified as ‘inadequate’ for each Big 4 firm. This concerns summaries of the findings reported by the AFM in its confidential inspection reports to the individual Big 4 firms. These summaries are presented in anonymous form so that they cannot be traced back to entities other than the audit firm, for instance the company being audited.

## 4.2 Comparison with the previous inspections

The AFM carried out its first regular inspections at the Big 4 firms in 2009-2010. These inspections can be seen as a baseline measurement for the quality of the statutory audits conducted by the Big 4 firms. The regular inspections carried out by the AFM in 2013-2014 are the first follow up measurement that makes quality development visible.

In 2010, the AFM stated in the conclusion to its final inspection reports that, for 52% on average of the statutory audits inspected, the external auditors had not obtained

<sup>28</sup> In view of the fact that the 40 statutory audits assessed were not selected on the basis of a statistical sample, the results of the assessment of these 40 statutory audits are not mathematically representative of all the statutory audits conducted by the Big 4 firms. The findings do, however, answer the question of whether the audit firms provide adequate assurance of statutory audit quality.

sufficient appropriate audit evidence. In recent years, partly as a result of the supervision conducted by the AFM, the Big 4 firms have taken various measures to safeguard the quality of statutory audits. These include improvements to specific statutory audits, the quality control systems at the audit firm, the internal supervision at the audit firm and its network, and communication with stakeholders in its environment. Appendix 1 contains a list of examples of measures taken by one or more of the Big 4 firms in the period prior to the present round of regular inspections by the AFM.

Now, in 2014, the AFM's conclusion is that sufficient appropriate audit evidence was not obtained for 45% of the statutory audits inspected. Without detracting from the efforts that the Big 4 firms have made over the past few years, their measures have not produced the desired result. The AFM found that, for several statutory audits, the external auditors concerned had failed to or failed to adequately comply with the professional standards when conducting these audits. The measures taken by the audit firms to safeguard the quality of the statutory audits were not able to prevent this.<sup>29</sup> The AFM concludes on the basis of its inspections that the quality of the statutory audits conducted by the Big 4 firms has on average risen only slightly in comparison to the baseline measurement.<sup>30</sup> The number of statutory audits qualified as 'inadequate' is still too high in the AFM's view. The AFM accordingly does not exclude the possibility that it will employ formal enforcement measures.<sup>31</sup>

#### 4.3 Generic deficiencies

The AFM's conclusion that an external auditor has not obtained sufficient appropriate audit evidence to substantiate his opinion regarding the financial statements as a whole is based on the identification of various deficiencies in the conduct of the statutory audit. The most commonly occurring deficiencies concern the tests of controls, the substantive analytical procedures and the critical evaluation by the external auditor of the audit evidence he obtained. Most cases involved a combination of various deficiencies.

In his audit, an external auditor can perform both tests of controls and substantive analytical procedures in order to obtain audit evidence, and will usually combine these two methods. Thus the external auditor takes account of the assessed risks of

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<sup>29</sup> Section 14 Wta states that audit firms must ensure that the external auditors employed by or affiliated to them observe the provisions of or pursuant to Section 3.2 Wta. These include the rules governing professional competence, which among other things require compliance with the NV COS.

<sup>30</sup> Since the AFM was not authorised in 2010 to disclose its findings and conclusions for each audit firm individually, we cannot compare the present review results with the results in 2010 for each Big 4 firm in this report. We can, however, state that the number of statutory audits designated as 'inadequate' has declined at one or more audit firms, and that this number has increased at one or more audit firms.

<sup>31</sup> Examples of formal enforcement measures are the issuing of an instruction, the imposition of an order for incremental penalty payments or an administrative fine.

material misstatement at the level of the financial statements and assesses whether such material misstatements actually exist. The tests of controls concentrate on the assessment of the design, existence and operating effectiveness of internal controls at the audit client. These are the internal controls that, if they work effectively, offer a reasonable degree of certainty that the financial reporting is reliable. If the external auditor intends to base findings on the audit client's internal controls, he will have to establish by means of tests of controls that the internal controls are operating effectively. Substantive audit procedures consist of detailed checks of parts of the financial statement and the substantive analytical procedures and balancing checks.

### *Tests of controls*

The most common deficiency identified by the AFM in connection with tests of controls is that the tests conducted by the external auditor to establish that the internal controls are operating effectively were insufficient in the AFM's view. In these audits, the external auditor for example failed to:

- obtain sufficient understanding of the design of the relevant internal controls;
- evaluate whether the design of the internal control measure is adequate to prevent or reveal a material misstatement in the financial reporting;
- check important measures in the internal control system;
- in case of significant risks, establish that the internal control systems are operating effectively in the current financial year and not base his conclusion regarding their effective operation exclusively on his activities in the previous financial year;
- establish that the internal controls have operated effectively throughout the financial year and not base his conclusion exclusively on his activities with regard to a specific period within that financial year;
- conduct the minimum number of tests prescribed in the audit firm's methodology as necessary to substantiate his opinion regarding the operation of the internal controls;
- evaluate the implications of the fact that he has identified that an internal control measure has not or not adequately been complied with for his conclusion regarding the effective operation of the internal controls system as a whole, for the scope of his substantive analytical procedures and possibly the content of his audit opinion.

In several cases, the AFM takes the view that the audit procedures described by the external auditor as tests of controls were in fact substantive analytical procedures. In these cases, the external auditor did not actually test the internal control measure, but carried out a form of detailed analysis. If the control measure for the existence of inventory for instance states that an administrative employee at the audit client reconciles the delivery statements of the suppliers and the statements of receipt of stock every two weeks, the external auditor must in his audit establish that the

employee in question actually performed these reconciliations. He does this for example by establishing the external features of the control measure, for instance the appearance of the initials of the employee on the statements in question. If the external auditor only reconciles the statements himself, he only obtains certainty regarding the existence of the inventory by means of sampling, he does not obtain certainty regarding the operation of the internal control measure.

The AFM moreover observes that in several statutory audits external auditors did not carry out sufficient tests to establish the reliability of the automated data processing. At many companies, transactions are generated, recorded, processed and reported by means of automated data systems. The internal controls that are relevant to an audit of the financial statements of such companies therefore often involve automation aspects as well as manual aspects. If an external auditor wishes to base his opinion on the internal controls of a company that is automated to a significant extent, he will have to test the reliability of the automated data processing. This concerns procedures whereby the external auditor obtains information on the automated internal controls and then tests them with regard to design, existence and operating effectiveness.<sup>32</sup>

Adequate segregation of duties is a specific item of attention with respect to automated internal controls. The external auditor must establish which persons are authorised to access the system and the nature of their authorisation (established in a competence table or authorisation matrix), whether these authorisations correspond to the necessary segregation of duties within certain processes and whether the segregation of duties has applied throughout the year. In several statutory audits the AFM noted that the external auditor had not carried out these procedures adequately.

### *Substantive audit procedures*

The AFM identified deficiencies with regard to the substantive audit procedures in the conduct of substantive analytical procedures, test of details and balancing checks.

An external auditor uses a substantive procedure to establish that there are no material misstatements in a transaction flow (or part thereof), an account balance or a disclosure. In the opinion of the AFM, in several statutory audits the external auditors failed to carry out substantive procedures with respect to specific relevant transaction flows, account balances and disclosures. The AFM moreover noted that in

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<sup>32</sup> These internal controls relating to automated data processing concern firstly general control measures relating to automation ('general IT controls') and secondly specific control measures at application level ('application controls'). For further definition of general IT controls and application controls, see NV COS 315 paragraphs A96 and A97.

other cases the external auditor failed to carry out the number of substantive procedures prescribed in the guidelines of the audit firm.

Substantive analytical review procedures are audit procedures an external auditor can apply in order to obtain sufficient appropriate audit evidence regarding a specific item or flow in the financial statements. When conducting substantive analytical review procedures, an auditor evaluates financial information through analysis of plausible relationships between various financial and non-financial data. For instance, an external auditor can compare the financial information from the audit client with:

- comparable information from previous reporting periods;
- results expected by the audit client, such as budgets or forecasts, or expectations of the external auditor himself; or
- similar information from the sector.

Before making comparisons, the external auditor has to form an expectation regarding the result of the comparison and decide which differences require further investigation. He then evaluates the differences found and investigates further where necessary to establish whether the differences can be explained and substantiated or are the result of misstatement or fraud.

In several statutory audits, the AFM is of the opinion that the external auditor has carried out only a general numerical analysis and has not carried out substantive analytical review procedures that are required. In these cases, the external auditor failed (among other things) to:

- formulate expectations with regard to his analytical procedures;
- determine how great a difference may be while remaining acceptable without further investigation; and
- test the likelihood of the explanations of the differences identified provided by the audit client against underlying documentation.

One specific type of substantive analytical procedure is the conduct of balancing checks. The external auditor then considers relationships as part of his analytical procedure, for example:

- between elements of financial information that the auditor expects to display a predictable pattern on the basis of experience of the company;
- between financial information and relevant non-financial information.

A common form of balancing checks concerns the movement of money and goods. The simple formula ' $S=BI+IP-EI$ ' defines sales (S) as the beginning inventory (BI) plus inventory purchases (IP) minus the ending inventory (EI). This means that if the external auditor obtains sufficient appropriate audit evidence regarding the beginning and ending inventory, for instance by conducting stock counts or being in attendance at the beginning and end of the financial year and taking account of various forms of loss, and has audited the completeness of the inventory purchased, he can also obtain certainty with respect to the completeness of the inventory sold. If one then adds the factor of 'money' to this model (prices, discounts, etc.), a

connection can be made with the audit client's financial records. The extent to which the information generated from this movement of money and inventory is useful depends to some degree on whether the various functions (procurement, storage, registration and monitoring) are adequately separated within the company and from possible 'disruptions' to the interrelationships, such as losses.

In several of the audits inspected by the AFM, the external auditor used such a balancing check in order to obtain audit evidence with respect to the reported revenue. The AFM observed various shortcomings in the application of these checks, mainly that not all the elements in the model were audited in sufficient detail. If for instance inventory purchases or 'disruptions' to the interrelationships (for example, due to discounts or losses) are not properly audited, one cannot then draw the conclusion that the sales have been fully reported on the basis of the balancing check.

For most substantive audit procedures, both test of details and substantive analytical procedures, the external auditor uses information from summaries, lists and databases of the audit client. The AFM noted in several statutory audits that the external auditor had not sufficiently assessed whether these summaries, lists and databases were sufficiently accurate to provide reliable information for his audit.

#### *Critical evaluation of audit evidence*

When carrying out his activities, an external auditor should always adopt an attitude of professional scepticism: an attitude characterised by an investigative attitude, alertness to circumstances that could indicate potential misstatements that are due to error or fraud, and a critical evaluation of audit evidence. A critical evaluation of audit evidence means that the external auditor establishes that audit evidence does not contradict other audit evidence obtained and that he is alert to circumstances that could be cause for the conduct of additional audit procedures.

In several statutory audits, the AFM noted that the external auditor failed to follow up differences revealed by his detailed procedures, substantive analytical review procedures or tests of internal controls. In these cases, the external auditor failed to look for an explanation of these differences, did not adequately evaluate their significance for his audit and/or did not adjust his conclusion. The differences identified were in most cases indeed examples of contradictions between several sources of audit evidence or circumstances that could indicate the need for additional audit procedures.

A critical evaluation is also important with reference to audit evidence obtained directly from the management of the audit client, for example in the form of information. The AFM takes the view that in several statutory audits the external

auditors were not sufficiently critical in their evaluation of the information provided by the management, for example with respect to:

- the reasonableness of the assumptions on which an impairment is based, such as management estimates of developments in income, expenses, personnel and the market;
- whether the estimates forming part of the reported revenue are realistic or not;
- the basic principles and variables in the calculation of provisions;
- management information on failures to meet payment due dates;
- the question of whether the methods applied, for instance regarding the determination of the amount of revenue or the measurement of investments, are in accordance with the financial reporting requirements.

In many cases, in his audit an external auditor will make use of work by persons outside his own audit team, because he does not himself possess the necessary expertise, does not himself have access to the necessary information or because this increases the efficiency of his audit. For example, auditors may use the services of valuation experts, IT specialists, auditors at service organisations used by the audit client, the audit client's internal audit department, or other auditors. The work carried out by these other persons in fact constitutes 'derived' audit evidence for the external auditor: audit evidence that he has not obtained directly from audit procedures he has conducted himself but which he has obtained from procedures conducted by others.

Specific auditing standards apply for the use of procedures conducted by other persons in addition to the more general auditing standards with which the external auditor must comply.<sup>33</sup> One important principle in these standards is that the external auditor at all times bears full and final responsibility for forming an opinion with respect to the financial statements as a whole, even when procedures are carried out by others. The external auditor will therefore continually have to evaluate whether the procedures carried out by others have provided sufficient appropriate audit evidence. If this is not the case, additional procedures will have to be conducted in order to obtain this audit evidence.

The AFM noted that the external auditor failed to adequately carry out the procedures mentioned above in several statutory audits, because for example:

- he did not assess the relevance and reasonableness of the findings and conclusions of the valuation expert that he used;
- he did not follow up the findings of the IT specialist with respect to potential shortcomings in the audit client's automated system;
- he did not carry out any procedures of his own to verify the procedures of the internal audit department, he did not assess the depth of the work

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<sup>33</sup> See the NV COS, Standards 600 'Audits of financial statements of a group', 610 'Using the services of internal auditors', 620 'Using the services of an appointed expert' and 402 'Considerations when using a service organisation'.

programmes that had been carried out, and he did not ask any additional questions with regard to unusual items identified by the internal audit department; or

- he did not establish that the relevant internal controls in the processes at the service organisation he used operated effectively.

In a number of statutory audits, the external auditor did not adequately fulfil his role as group auditor in the opinion of the AFM. This concerned financial holding companies of businesses which were mainly active outside the Netherlands, whose business activities and the financial and operational management, including the preparation of the consolidated financial statements, mainly take place abroad ('letterbox companies'). In these audits, the external auditor has relied heavily on the work carried out by an auditor in another country, and in doing so failed, for instance, to design the audit appropriately. For example, he did not establish the procedures that the other auditor had to perform and state these procedures in his instructions to the other auditor. He also did not obtain sufficient information with regard to the company's business processes and the associated risks with respect to the financial statements. In these statutory audits, the external auditor moreover failed to follow up on unusual features that he identified in his review of the procedures of the other auditor for several items in the balance sheet and the unusual items that the other auditor reported to him. The involvement of the external auditor in these cases was not sufficient for him to be able to take responsibility for the audit engagement at group level, the conduct of the audit and the audit opinion attached to the group financial statements.<sup>34</sup>

#### 4.4 Features of 'inadequate' statutory audits

After the AFM had established for each of the 40 statutory audits which it inspected whether the external auditor had obtained sufficient appropriate audit evidence to substantiate his opinion regarding the financial statements as a whole, it assessed whether the following features affected the quality of the statutory audit:

- market segment;
- focus area;
- size of the audit client;
- engagement quality control review (EQCR);
- internal quality review;
- hours spent; and
- years of experience.

From its assessment of these features, the AFM notes that the statutory audits of PIEs, and especially of health insurers, were less frequently qualified as 'inadequate' than the statutory audits of non-PIEs. In the 'non-PIE' group, the AFM more frequently qualified the statutory audits it assessed at public and semi-public

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<sup>34</sup> As referred to in NV COS 600 'Audits of financial statements of a group'.

organisations and large non-PIEs as 'inadequate'. The statutory audits of pension funds were less frequently qualified as 'inadequate'. There also seems to be a positive relationship between the number of hours spent by the external auditor and his audit team on the conduct of the statutory audit and the quality of that audit. The other features appear to have little or no connection with the qualification of a statutory audit by the AFM as 'inadequate'. Although small differences can be seen for certain features, the inadequacies do not appear to be exclusively limited to specific focus areas, small audit clients, audits without an EQCR or an internal quality review or auditors with limited experience.

### *Market segment*

As stated in section 6, the AFM inspected 10 statutory audits conducted by each Big 4 firm: four PIEs, including one health insurer and three other PIEs, and six non-PIEs, including at least one pension fund, one public or semi-public organisation and one large company. Table 2 shows the AFM's conclusions with regard to the 40 statutory audits inspected by the market segment to which the audit client belongs. In total, 16 (40 per cent) of the 40 statutory audits inspected were PIEs. Of these 16 PIE audits, the AFM qualified 5 (31 per cent) as inadequate. Of the 24 non-PIE audits, the AFM qualified 13 (54 per cent) as inadequate. Table 2 shows that the only market segment not to include statutory audits qualified as 'inadequate' by the AFM was that of health insurers. There were also relatively few statutory audits qualified as 'inadequate' in the pension fund segment (25 per cent). There were relatively more statutory audits qualified by the AFM as 'inadequate' among the public and semi-public organisations and large non-PIEs.<sup>35</sup>

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<sup>35</sup> In view of the AFM's previous observation that the group of non-PIEs varies widely in terms of social relevance (see the [AFM's response](#) to the new professional and conduct rules of the NBA), these findings strengthen the AFM in its view that more far-reaching safeguards may be needed for large non-PIEs (such as large municipalities, housing corporations or large unlisted companies), for instance by legally defining them as PIEs.

Market segment	Number inspected	Number inadequate	Percentage inadequate
<i>PIE - total</i>	16	5	31%
Health insurers	4	0	0
Other PIE	12	5	42%
<i>Non-PIE - total</i>	24	13	54%
Pension funds	4	1	25%
Public and semi-public organisations	5	3	60%
Large non-PIE	4	3	75%
Other non-PIE	11	6	55%
<b>Total</b>	<b>40</b>	<b>18</b>	<b>45%</b>

Table 2. Summary of the AFM's conclusions regarding 40 statutory audits by market segment

### Focus area

As described in section 6.1, the AFM did not inspect the statutory audits in their entirety, it focused on certain material aspects of the audit, referred to as the focus areas. The choice of focus areas for the inspection of a statutory audit is appropriate to the risk-oriented approach of the AFM's supervision. The AFM thus obtained a realistic and broad-based opinion of the quality of statutory audits.

Table 3 lists the most common focus areas and the number of statutory audits inspected by the AFM for the focus area in question and how frequently the AFM came to the conclusion that the external auditor had failed to obtain sufficient appropriate audit evidence in this aspect of his audit (qualified as 'inadequate'). Among the general items in the financial statements, the AFM frequently qualified the following as inadequate: audit of revenue (58 per cent), intangible non-current assets, including goodwill (75 per cent) and construction contracts (60 per cent). Among the specific items, the audit of land development was frequently qualified as inadequate (67 per cent). The AFM did not conclude that any of the statutory audits assessed were inadequate with respect to the items 'property, plant and equipment' and 'equalisation payment'.

Focus area	Number inspected	Number inadequate	Percentage inadequate
<i>General</i>			
Revenue	26	15	58%
Inventory	9	4	44%
Intangible non-current assets (incl. goodwill)	8	6	75%
Construction contracts	5	3	60%
Property, plant and equipment	2	0	0
Cash and cash equivalents	2	1	50%
<i>Specific and sector-specific</i>			
Technical and other provisions	10	2	20%
Investments	6	2	33%
Equalisation payments	4	0	0
Tenders and procurement	4	2	50%
Land development	3	2	67%
<i>Other</i> <sup>36</sup>	5	2	40%
<b>Total</b>	<b>84</b>	<b>39</b>	<b>46%</b>

Table 3. Summary of the AFM's conclusions regarding 40 statutory audits by focus area

#### *Size of the audit client*

The size of the audit client, measured in terms of total revenue, total assets or number of employees, is a factor that contributes to the scale and complexity of the audit procedures that the external auditor has to perform. The audit clients involved in the 40 statutory audits inspected by the AFM vary considerably in terms of size, with revenues and assets ranging from a few million to many billions of euros, and workforces ranging from very small to hundreds of thousands. The AFM notes that the relationship between the size of the audit client and the quality of the statutory audit is only marginal: the external auditor obtained sufficient appropriate audit evidence more frequently for the very largest audit clients.

#### *Engagement quality control review (EQCR)*

In an EQCR, a quality reviewer - an auditor who is independent of the audit team - assesses whether the external auditor had a reasonable basis for the opinion he expressed in his auditor's report. The quality reviewer bases his work among other things on the main findings and conclusions emerging from the audit file and on any oral or written notes by the external auditor. The EQCR is usually conducted in

<sup>36</sup> The 'other' category concerns the focus areas assessed in only one statutory audit. This concerned the items of deferred tax assets, capitalised costs of acquisitions, accruals and deferred income, costs of claims, measurement of derivatives and measurement of commercial loans.

phases during the conduct of the audit and in any case is completed before the external auditor attaches his audit opinion. This means that a critical EQCR can contribute to the quality of the statutory audit.

An EQCR was carried out on 27 (68 per cent) of the 40 statutory audits inspected prior to issuance of the audit opinion. Of these 27 audits with an EQCR, the AFM qualified 11 (41 per cent) as inadequate. The EQCR did not achieve the desired aim in these cases: in the opinion of the AFM the EQCR actually failed to identify that the audit evidence obtained by the external auditor did not provide a reasonable basis for his audit opinion as expressed in his auditor's report. Of the 13 audits without an EQCR, the AFM qualified relatively more of them, in fact 7, or 54 per cent as inadequate. Based on its inspections, the AFM concludes that while an EQCR contributes to the quality of a statutory audit, in practice this procedure frequently fails to achieve the desired objective.

#### *Internal quality review*

Audit firms have a quality control system consisting of procedures, descriptions and standards which are intended to ensure that the audit firm and its employees, including the external auditors, meet the applicable legislative and regulatory requirements. Audit firms have to ensure that this quality control system is adhered to and evaluate the system on an annual basis. Part of this evaluation involves a regular internal quality review. In an internal quality review, the audit firm, often in cooperation with its international network, reviews a number of completed statutory audits in order to establish that these meet the requirements of its own quality control system and the legislative and regulatory requirements. The internal quality review is an important yardstick for the Big 4 firms. If the internal quality reviews are not carried out with sufficient depth and the results are not properly taken into account, the audit firm does not obtain any information regarding the actual quality of the statutory audits it conducts. This may lead to a situation in which external auditors and their audit teams wrongly assume that they have conducted a statutory audit with adequate quality. If the audit firm identifies shortcomings, this may be reason for it to have previously completed statutory audits corrected, impose sanctions on the auditors concerned and improve parts of the quality control system in order to prevent shortcomings in the future.

Table 4 presents the AFM's conclusions regarding the 40 statutory audits inspected in relation to the results of the internal quality review conducted by the audit firm. In 8 of the 40 statutory audits inspected, the audit firm in question had carried out an internal quality review. In none of these cases did the audit firm conclude that the external auditor had failed to obtain sufficient appropriate audit evidence to substantiate his opinion regarding the financial statements as a whole. The AFM qualified 3 of these 8 statutory audits for which an internal quality review had been carried out as 'inadequate'. Regarding these audits, the AFM established that the

internal quality review failed to identify the shortcomings identified by the AFM in its assessment, or that the shortcomings identified were not considered to be material. These internal quality reviews carried out by the audit firm therefore did not provide the same information regarding the quality of the statutory audits conducted as the inspections by the AFM.

Internal quality review (audit firm)	Number inspected (AFM)	Number inadequate (AFM)	Percentage inadequate
Yes	8	3	31%
No	32	15	54%
<b>Total</b>	<b>40</b>	<b>18</b>	<b>45%</b>

*Table 4.* Summary of the AFM's conclusions regarding 40 statutory audits with and without performance of an internal quality review

### *Hours spent*

The AFM requested the audit firms to state the total number of hours the external auditor and his audit team had spent on the conduct of the 40 statutory audits inspected. From the information received, it turns out that the external auditors themselves spent on average approximately 124 hours on the conduct of the 40 statutory audits inspected (ranging from less than 5 hours to more than 700). The audit teams as a whole, therefore including the external auditor, spent on average approximately 4,500 hours on the conduct of the 40 statutory audits inspected (ranging from less than 300 hours to more than 80,000 hours). The wide variation in the number of hours spent on each statutory audit was mainly due to the difference in size of the audit clients. If the number of hours spent by the external auditors and the audit teams is considered together with the size of the audit clients<sup>37</sup>, it turns out that the number of hours spent on the statutory audits qualified by the AFM as inadequate is on average lower. This applies to both the hours spent by the external auditor on the conduct of these statutory audits as well as the hours spent by the audit team as a whole. The involvement of the external auditor as measured by the percentage of the total number of hours spent by the external auditor himself on the statutory audit is on average exactly the same for the statutory audits qualified by the AFM as inadequate and the statutory audits not qualified by the AFM as inadequate. For the 40 statutory audits inspected, on average 5 per cent of the total hours spent was spent by the external auditor himself (ranging from around 0.5 per cent to around 16 per cent).

### *Years of experience*

<sup>37</sup> For instance, by considering the number of hours spent per €1,000 of total assets rather than only the absolute number of hours spent.

In addition to the number of hours spent, the AFM requested the audit firms to provide information on the experience of the responsible external auditors and the quality reviewers concerned:<sup>38</sup>

- the number of years that they had been involved with the audit client in question;
- the number of years that they had been involved with the audit client in question in the current role as external auditor or quality reviewer;
- the number of years that they had been employed as an external auditor or quality reviewer; and
- the number of years that they had been carrying out engagements in the sector in which the audit client in question operates.

From this information, there was little or no difference between the years of experience of the external auditors and quality reviewers involved in the statutory audits qualified as inadequate by the AFM and those involved in the statutory audits not qualified as inadequate by the AFM.

#### 4.5 Root cause analysis and improvement measures

In their written responses to the AFM's findings<sup>39</sup>, the Big 4 firms stated that they generally endorsed the findings and conclusions of the AFM regarding the statutory audits inspected. At the request of the AFM, the Big 4 firms analysed what they consider the root causes of (or reasons for) the deficiencies found in each of the statutory audits inspected. They did this by answering the question "Why did the external auditors fail to obtain adequate appropriate audit evidence in the cases in question?" The Big 4 firms also informed the AFM with respect to the measures they will take in response to the results of the inspections.

This paragraph describes only the causes and improvement measures that the individual Big 4 firms announced to the AFM. It does not address the contents of the sector-wide analysis by the NBA working group on the future accountancy profession.

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<sup>38</sup> In the thematic inspections the AFM carried out at non-PIE audit firms in 2013, the AFM also looked to see whether there was a relationship between the findings of the AFM's inspection of the quality of a statutory audit (whether qualified as inadequate or not) and the number of years that the external auditor in question had been registered as a Registered Accountant or an Accounting Consultant with the professional organisation the NBA (before or after the year 2000). In this review of the Big 4 firms, the AFM did not investigate this aspect further, and focused on the relevant experience of the auditor for the statutory audit concerned.

<sup>39</sup> See section 6 for the full responses from the Big 4 firms.

## Root cause analysis

Figure 1 contains summarised examples of causes that according to one of more Big 4 firms underlie the shortcomings identified. The examples stated relate to the individual external auditor, especially his professionalism and compliance with the auditing standards, to various elements of the organisation's quality control procedures and to the relationship with the audit client. No specific examples are mentioned with regard to acceptance and continuation of the engagement within the quality control procedures, the executive board and the internal supervision of the audit firm and the network to which the audit firm belongs.<sup>40</sup>

*Examples of answers to the question: "Why did the external auditors fail to obtain adequate and appropriate audit evidence in the cases in question?"*

Auditor:

- The external auditor did not apply his audit knowledge correctly.
- The external auditor made errors of judgment.
- The external auditor did not adequately supervise his audit team and did not adequately review the work of his audit team.
- The external auditor himself was not sufficiently involved in the conduct of the audit, or only became involved at a late stage.
- The external auditor relied too heavily on the internal audit department of the audit client, without carrying out adequate work himself.
- The external auditor and the engagement quality control reviewer focused too much on the generalities and final result of the audit without taking account of details of current auditing standards on a timely basis.
- The external auditor based his audit too much on his general knowledge of the industry and the client and not on the current and specific risks.
- The external auditor only understands the client's business processes at too high a level.
- The external auditor did not involve experts (such as IT specialists) in the design of the audit at an early stage because he wanted to keep the cost of the audit low.
- The audit team failed to take a sufficiently professional and sceptical attitude.

<sup>40</sup> The division into subjects is made by the AFM on the basis of the system of safeguards as described in paragraph 5.1.2.

## Organisation – Quality control procedures

### *Quality policy*

- There was no culture of calling each other to account with regard to keeping to agreements.
- The audit firm lost track of its core values.
- The audits were conducted too much based on the question 'Is that correct?' rather than 'Is that any good?'

### *Personnel policy*

- The external auditor was involved in the audit in question for the first time.
- The external auditor was responsible for too many audits.
- The audit team had to conduct several audits in the same sector in a short period.
- There were changes to the audit team during the conduct of the audit.
- The audit team did not exercise adequate discipline with respect to documentation, with the result that the external auditor did not identify shortcomings in his review.

### *Knowledge*

- The external auditor had insufficient knowledge of the specific financial reporting framework.
- Due to more extensive automation there was less communication between senior and junior members of the audit team and there was less 'training on the job'.

### *Standards*

- The audit firm did not have a clear standard for application of the audit methodology and documentation.
- Sound project or process management was lacking at the audit firm.

### *Internal quality monitoring*

- The external auditor was not aware of the fact that the quality of his audits was inadequate because his audits had always been given a relatively positive assessment in EQCRs and internal quality reviews.

### *Environment*

- The client did not provide information of sufficient quality for the audit on a timely basis.

Figure 1. Examples of causes identified by the Big 4 firms

The above examples show that the Big 4 firms identified various causes and reasons that in their opinion are the basis for the identified shortcomings. The AFM assumes that these examples indeed are related to the quality of the statutory audits conducted and the shortcomings identified therein.

The AFM observes that the examples differ and that they also vary in terms of depth. In the majority of cases, one can still ask *why* this should be the case. For instance, several Big 4 firms answered the question of ‘why did the external auditors fail to obtain adequate and adequate audit evidence in these cases?’ with: “because the external auditor himself was not sufficiently involved in the conduct of the audit, or only became involved at a late stage”. This does not answer the question of *why* was the external auditor himself not sufficiently involved in the conduct of the audit, or only became involved at a late stage. For example:

- Did he not have the time to be more closely involved because he had commitments at other clients, or due to personal circumstances?
- Did he take the view that closer involvement was not necessary? (And why did he take this view?)
- Did he want to restrict his involvement in the audit in order to keep the total costs of the audit low? (And why did he want to keep the total costs low?)
- Did the audit client not want him to be involved? (And why did the audit client not want him to be involved?)

Moreover, while several of the examples cited may well concern behaviour or situations that underlie the failure to obtain sufficient appropriate audit evidence, the behaviour or situations concerned are themselves examples of failure to comply with specific rules or standards. In other words, the fact that the external auditor had insufficient knowledge, time, resources or team members at his disposal in his audit can be a reason why he did not obtain sufficient appropriate audit evidence to substantiate his opinion regarding the financial statements as a whole. Based on the applicable legislation and regulations, the audit firm should have provided the external auditor with sufficient time, resources and personnel to be able to conduct his duties appropriately. The root cause analysis could be deepened further by answering the question of *why* the audit firm failed to do this or failed to do this adequately in the cases in question.

The AFM considers several of the examples cited above mainly as symptoms. The deeper actual underlying causes and reasons why the quality of statutory audits is not consistently safeguarded are not yet completely clear.

### *Improvement measures*

Partly based on the results of the AFM’s inspections and the root cause analysis performed, which were discussed prior to publication, the Big 4 firms have informed the AFM of the measures their organisations will be adopting to remediate the

deficiencies found and to ensure the quality of statutory audits in the future. Although the Big 4 firms stated during the regular inspections that to a greater or lesser extent they have already made a start on the implementation of various measures, the effectiveness of these measures has yet to be established. Appendix 2 lists examples of measures announced to the AFM by one or more Big 4 firms. These include repairs to and further investigation of specific statutory audits, improvements to the quality control procedures at the audit firm, the executive board and internal supervision at the audit firm, and communication with stakeholders in its environment.<sup>41</sup>

The AFM observes that the measures announced to it by the Big 4 firms are more numerous, have greater scope and go further than the measures they took in response to the last regular inspections.<sup>42</sup> In both number and variety, the measures announced focus significantly on the quality control procedures at the audit firm and are also elaborated in relatively concrete terms. In the opinion of the AFM, improvements in this area are definitely not only possible, but also essential for ensuring the quality of statutory audits. The Big 4 firms have announced measures for other aspects as well, such as organisational culture, executive board, internal supervision and relationship with the rest of the field in which organisations operate. In their specific form and content, the degree to which the measures for these aspects have been worked out varies from firm to firm.

On 25 September 2014, simultaneously with the publication of the report from the AFM, the NBA working group 'Toekomst accountantsberoep' published its analysis and proposals for possible measures to regain the public's confidence through transparent assurance of quality and independence. The Big 4 firms are expected to further elaborate and where necessary add to the measures they have announced to the AFM in the light of the above sector analysis. Whether the total package of measures announced by the Big 4 firms will be effective enough remains to be seen. The extent to which the measures will prevent future deficiencies and remove the incentives<sup>43</sup> inherent in the system within which statutory audits are conducted largely depends on the commitment and determination the Big 4 firms put into their implementation. The AFM sets out its recommendations in relation to the implementation of the measures announced in section 5.

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<sup>41</sup> The division into subjects is made by the AFM on the basis of the system of safeguards as described in paragraph 5.1.2.

<sup>42</sup> See appendix 1 for examples of the quality measures taken by the Big 4 firms in the period 2009-2012.

<sup>43</sup> For a closer consideration of the incentives inherent in the system for conducting statutory audits, see section 5.1.1 of the report.

## 5 Recommendations of the AFM

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Section 4 discussed the results of the regular inspections of the Big 4 audit firms conducted by the AFM: the shortcomings identified, the causes that according to the audit firms were responsible for the shortcomings and the measures that these audit firms have announced they will take as a result of the inspections. Section 5.1 first of all contains a general consideration of the AFM with respect to the system within which statutory audits are performed, and describes the AFM's views regarding the inherent incentives that it observes in this system and the safeguards needed in order to remove these incentives. This opinion is based on the impression formed by the AFM in recent years in its supervision of audit firms generally. Based on the findings of the inspections and the consideration of the system within which statutory audits are conducted, the AFM has formulated recommendations for improving the quality of statutory audits in section 5.2. The AFM calls on the Big 4 firms to pay special attention and give priority to four issues: governance, culture, level of quality and transparency. Furthermore, the AFM recommends that the legislator should introduce certain elements of additional legislation. Section 5.3 contains a brief description of the process that will follow the inspections.

### 5.1 System with incentives and safeguards

The quality of a statutory audit mainly depends on the proper performance of professional duties by the auditor conducting the audit. This proper performance is based on professionalism, expertise and diligence, objectivity and independence, integrity and confidentiality.<sup>44</sup> And, most of all, on an attitude of professional scepticism and on consistently acting in the public interest. Statutory audits are, however, conducted in a system in which there exist inherent incentives to prioritise other interests (such as commercial or the firm's own interests) over the public interest. There is thus a need for safeguards in order to mitigate these incentives. This requires a coherent body of measures in the auditor's environment that ensures proper professional conduct. These measures are mainly enshrined in legislation and regulation. Supervision is carried out on compliance with this legislation and regulation.<sup>45</sup>

The system within which statutory audits is conducted is shown in general terms in figure 2. The auditor and the audit firm for which he works stand in relation to their environment: the audit client, the users of the financial statements and society at

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<sup>44</sup> These are the fundamental principles as described in the Dutch Code of Ethics for Professional Accountants, regulation with respect to Rules of Professional Conduct (Verordening Gedrags- en Beroepsregels Accountants, or VGBA) of the NBA.

<sup>45</sup> For its consideration of the system within which statutory audits are performed, including the inherent incentives and necessary safeguards, the AFM has used (among other things) the framework of standards established in the Wta and the Bta, the IAASB's 'Framework for audit quality' (February 2014) and a discussion document on 'audit quality indicators' of the Public Company Accounting Oversight Board (PCAOB) (May 2013). See also section 3.5.

large. Section 5.1.1 describes the incentives inherent in this system. Section 5.1.2 presents a view of the most important safeguards that apply to the auditor, the audit firms and the relationships they have with their environment.

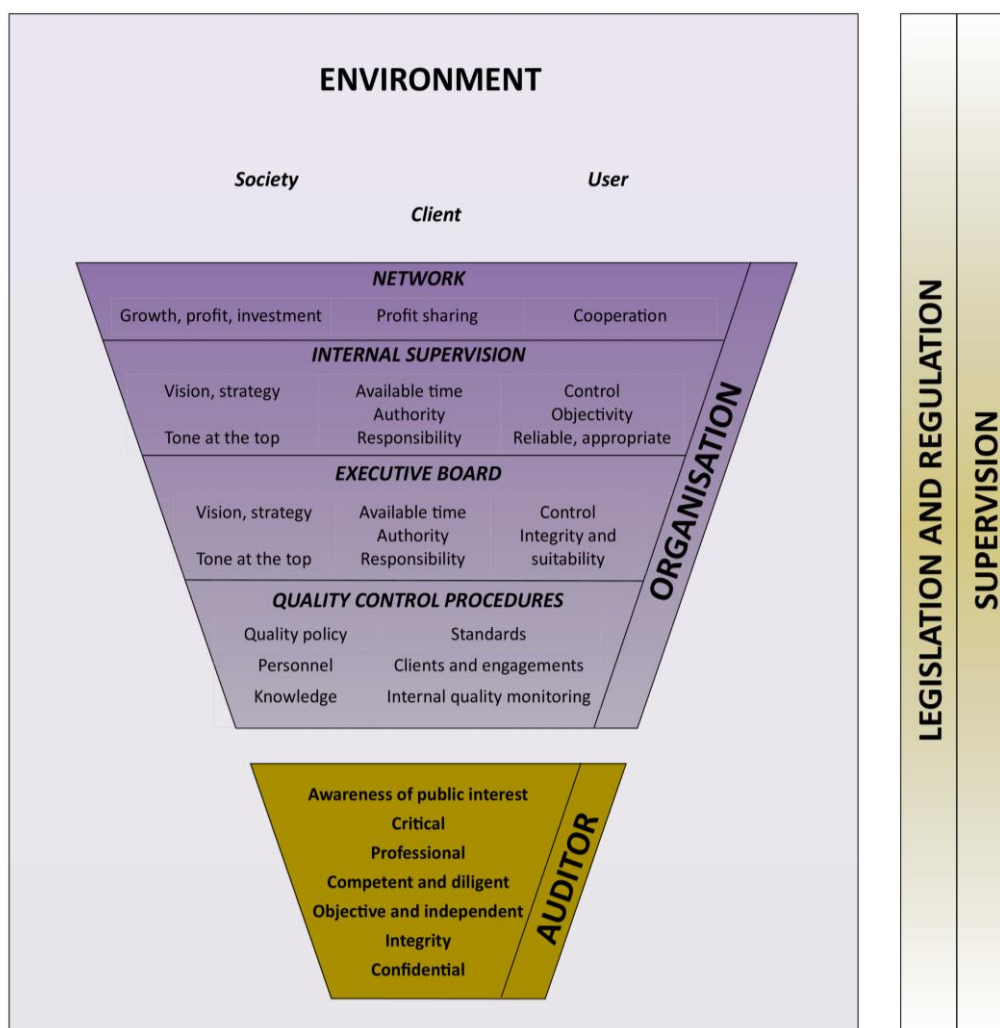


Figure 2. The system within which statutory audits are conducted.

### 5.1.1 Incentives

The incentives that are inherent in the system within which auditors conduct statutory audits arise from:

- the fact that the auditor is paid by the company whose financial statements he audits;
- the fact that the quality of the statutory audit conducted is not visible, and
- the auditor's business or earnings model.

### *The auditor is paid by the audit client*

The conduct of a statutory audit is a legal duty that can only be performed by auditors: certain companies have a legal obligation to engage an auditor to audit their financial statements. The users of these financial statements, which include capital providers such as shareholders and banks, and other stakeholders such as suppliers, customers and employees, need reliable information regarding the company's financial position. Usually, they are not in a position to evaluate this reliability themselves. They therefore have an information disadvantage in comparison to the company's management. An auditor assesses whether the financial reporting submitted by the company management to capital providers and other stakeholders gives a true and fair view of the company's capital and result. The auditor thereby provides a degree of certainty and reduces the information disadvantage of the users of the financial statements. Auditors therefore carry out their activities primarily in the public interest. At the same time, they are paid by the organisation whose financial statements they audit and compete with each other in order to obtain and retain audit engagements. This creates an inherent conflict of interest. On the one hand, the external auditor has to be objective and critical with regard to his audit client in order to be able to fulfil his public duty to the users of this client's financial statements, on the other he has to provide the best possible service to the audit client in order to win or retain the engagement.

### *The quality of statutory audits is not visible*

Out of necessity, the users of financial statements, and also the companies audited, have no choice other than to *trust in* the auditor and the quality of the statutory audit he conducts.<sup>46</sup> The auditor, after all, has access to confidential commercial information, and has the specific expertise needed to plan and conduct the statutory audit in accordance with audit and other standards. In the conduct of his audit, the auditor takes decisions based on his professional evaluation regarding, for example, the estimation of risks, the total hours to be spent, and the choice of audit procedures to be carried out in order to bring the risk of a material misstatement to an acceptably low level. As outsiders or relative laypeople, neither the company audited nor the user of the financial statements to which the auditor attaches an audit opinion can assess whether these decisions are correct. They can also not assess whether the risk of a material misstatement has indeed been reduced to an acceptably low level after the conduct of the statutory audit.<sup>47</sup> The auditor thus has

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<sup>46</sup> For further consideration of the reliability features of an audit, see the article 'An Examination of the Credence Attributes of an Audit' by Monika Causholli and W. Robert Knechel, 2012, in *Accounting Horizons*, Vol. 26, No. 4, pp.631-656.

<sup>47</sup> The only way to verify this is to conduct the audit again. However, the audit client and the user do not have sufficient knowledge and expertise for this. And this would of course involve disproportionate expense.

an information advantage in comparison to the company audited and the users of the financial statements.

### *The auditor's business or earnings model*

Auditors perform their legal duties in a business or earnings model wherein they carry out their work for a company that has the aim of making a profit. Audit firms are by nature commercial enterprises. From these firms they also provide other services to clients<sup>48</sup> and they operate in a network together with for example tax advisers, consultants and legal experts. There is certain conflict between the objectives that are reasonably associated with the conduct of business, such as growth, efficiency and maximisation of profit, and the requirements imposed by various legislation and regulation regarding the quality of the audits conducted. Meeting these quality requirements indeed requires significant effort in terms of time and other factors.

The fact that the auditor is paid by the company he audits, the information advantage that the auditor has, and the auditor's own business or earnings model may lead to a situation in which the auditor puts the interests of his audit client or his own interests above the public interest of a properly conducted audit.<sup>49</sup> Instead of performing a good quality audit and thereby obtaining audit evidence that is sufficient appropriate to the specific circumstances of the company concerned, the risk is that the auditor may, for instance due to time or budget pressure, not audit the company adequately and therefore fail to obtain adequate and appropriate audit evidence.<sup>50</sup>

### **5.1.2 Safeguards**

The inherent incentives as described in section 5.1.1 require a coherent body of measures in the auditor's environment that ensures proper professional conduct. Such measures are established in, among others, legislation and regulation for individual auditors, the organisation for which they work and their relationship with their environment. In addition, compliance with this legislation and regulation is supervised. The extent to which the measures effectively ensure the quality of statutory audits depends on the way in which the measures are applied in practice.

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<sup>48</sup> For PIEs the audit firm is forbidden to provide other services in addition to the statutory audit service. For non-PIEs, the provision of other services alongside the statutory audit service is permitted, subject to certain conditions. Other types of service are also provided to companies for which the audit firm does not audit the financial statements.

<sup>49</sup> Examples of the auditor's personal interest are to achieve targets for the obtaining or retaining of audit engagements, achieving profit or growth and any associated assessment or remuneration.

<sup>50</sup> In a situation where the auditor can declare his time spent to the audit client without much discussion, there is also the risk that he will audit too much if he does not plan and perform the audit efficiently.

The following considerations describe important safeguards that are needed in view of the inherent incentives mentioned above, and do not therefore describe the way in which the Big 4 firms apply them in practice.

### *Auditor*

One external auditor always bears final responsibility for the conduct of a statutory audit. He is also the person who signs and issues the audit opinion. Individual auditors are bound by the regulations and further provisions of their professional body<sup>51</sup> which include rules of conduct and professional standards, rules governing independence and detailed standards for the performance of statutory audits. These professional standards are designed to create conditions that ensure that statutory audits are of good quality. An external auditor is considered to perform statutory audits with sufficient quality if his professional conduct features professionalism, competence and diligence, objectivity and independence, integrity and reliability. And, most of all, by adopting an attitude of professional scepticism and always acting in the public interest.

This also means that the external auditor is aware of his attitude of professional scepticism. He tests the assertions of the company (the financial statements) against the standards (the financial reporting framework), calls company management to account if the standards are not complied with, puts his foot down when necessary and draws the right conclusions if breaches of the standards are not corrected. An external auditor who is performing an audit has a fundamentally different attitude to an auditor acting in a consulting capacity.

This also means that the external auditor is aware that he is performing the audit primarily on behalf of the users of the financial statements and that a proper audit is of great value to these usually anonymous users and the operation of the economy as a whole. The external auditor should therefore always put the public interest first, above the interest of the company whose financial statements he is auditing and above his own interest and the interest of his organisation. In order to be able to fulfil his duty to the public, his independence must be beyond doubt.

### *Organisation*

While the external auditor is responsible for the conduct of a statutory audit and the issuance of an audit opinion, the audit firm for which he works also has an important responsibility for the quality of statutory audits. The audit firm must ensure that its external auditors observe the applicable legislation and regulation, including the

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<sup>51</sup> On the basis of the Accountancy Profession Act (Wet op het accountantsberoep, or Wab) the NBA is tasked with setting regulations and further provisions to ensure proper professional conduct by auditors.

VGBA and the NV COS. The audit firm is thereby also responsible for the quality of the statutory audits that its individual auditors perform.

The responsibilities of the audit firms include those stated in the rules imposed on them in the Audit Firms Supervision Act and Decree (*Wet en het Besluit toezicht accountantsorganisaties*, the Wta and the Bta). This legislation and regulation provides for the design and operation of the quality control procedures and quality monitoring. It also covers the integrity of directors and members of internal supervisory bodies<sup>52</sup>, the expertise of directors with respect to the quality control procedures at the audit firm and the professional competence of a majority of the directors.

Various levels can be distinguished within the audit firm, and various issues within these levels. These are separate to a greater or lesser extent; however, their main importance in ensuring the quality of statutory audits lies in their interrelatedness. These levels concern the quality control procedures, the executive board, the internal supervision and the network. These levels and the issues identified therein are shown in figure 2 and further explained below.

#### Quality control procedures and monitoring

The audit firm has a duty of care to create the preconditions for adequate performance by the external auditor and to take measures if this performance no longer meets requirements. The audit firm therefore has a duty to provide facilities for the external auditor so that he is able to perform his work as well as possible. The audit firm should encourage the external auditor to do this by giving the correct incentives (and reducing inappropriate incentives) and may impose sanctions on the auditor if necessary. Taken together, these facilities and the procedures designed to encourage good performance and impose sanctions form the quality control procedures in general terms. This general quality control procedures consist of various elements which, if properly designed, will contribute to the delivery of audit quality. Proper design means that the elements form a cohesive whole. The important elements that can be distinguished within the quality control procedures are: quality policy, personnel policy, acceptance and continuation of clients and engagements, standards, knowledge and internal quality monitoring.

- *Quality policy*

The quality policy describes how the audit firm encourages a culture in which quality-oriented thinking and acting in the public interest are put first. The quality policy thus also expresses the views of the leadership of the audit firm as to how the audit firm ensures the quality of the statutory audits for which it is responsible. For instance, by encouraging a culture focused on the cooperation needed for the performance of good quality audits. At the same

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<sup>52</sup> Referred to as 'policymakers and co-policymakers' in the Wta.

time, the current business or earnings model of audit firms requires that the leadership of the audit firm has a view as to how the audit firm deals with the continuing conflict between commercial interests and the public interest.

- *Acceptance and continuation of audit engagements*

Before an audit firm accepts a new audit engagement or continues an existing audit engagement, it assesses whether it and the external auditor it has appointed for the engagement meet all the quality requirements, whether the organisation has the professionally competent employees, time and resources it needs to perform the statutory audit appropriately, and whether the audit client is ethical. It is important that this assessment is carried out consciously and critically by the audit firm in order to ensure the quality of the statutory audit.

Furthermore, it is important that the audit firm makes a good assessment of the risk that the quality of the statutory audit will not be adequate. This risk may for example lie in certain features of the audit client, such as the degree to which the audit client acts in accordance with the spirit and the letter of the relevant legislation and regulation, the extent to which the internal control department at the audit client provides reliable reporting and makes it possible to perform a good and efficient statutory audit, or the degree to which the audit client wishes to have a good quality audit and a critical auditor, and does not allow the price of the audit to be more important than the public interest that the audit is performed with good quality. Based on this risk assessment, the audit firm determines whether it will be able to perform a good quality audit and whether additional quality control measures are needed in order to safeguard quality. Quality-oriented thinking within the organisation ensures that the risk is estimated in such a way that the necessary measures are actually taken and that the risk is not underestimated, e.g. for reasons of cost, resulting in the omission of certain quality control measures.

- *Personnel policy*

The quality policy and associated quality-oriented culture are also expressed in the audit firm's general personnel policy. This policy concerns matters such as the remuneration and sanctions policy of the audit firm, the staffing of audit engagements and the attraction and retention policy.

Activities that are particularly valued and rewarded often are especially attractive to employees. For this reason, it is important that evaluation and remuneration takes sufficient account of the quality of statutory audits. Significant evaluation and remuneration of commercial performance such as the achievement of revenue and time targets can have an undesirable effect on quality-oriented thinking and acting within the audit firm. Sanctions can deal with undesirable behaviour effectively, for example in cases of

shortcomings in the performance of a statutory audit, if the perceived chance of getting caught, the seriousness of the sanction and the chance that the sanction will be made known within the organisation are high enough. At the same time, it is important to avoid a situation in which too onerous sanctions or over-formalistic rules create a fear culture, for example by rewarding desirable behaviour as an example.

Another aspect of the personnel policy of an audit firm is the staffing of audit engagements. While personal contacts with an individual auditor often play an important part in the acquisition of new clients or new engagements from existing clients, that auditor is not necessarily the most suitable person to carry out the statutory audit. It is thus important that for each statutory audit the audit firm appoints an external auditor who has the necessary knowledge and experience for this statutory audit. Express account should also be taken of the total client and engagement portfolio of the auditor in question. After this, the audit firm has to make sufficient team members available who also possess the knowledge and experience necessary for the audit.

Besides sufficient knowledge and experience, the external auditor responsible and the employees concerned also need sufficient time to perform the statutory performance appropriately. This means that it is necessary that, in principle, sufficient time is scheduled and that more time is available if matters arise in the course of the audit that require additional audit procedures.

In order to be able to staff audit engagements adequately on a continuous basis, an audit firm has to have sufficient staff in terms of both numbers and quality, and thus needs to have an effective inflow and outflow policy. This is a policy focused on attracting sufficient and appropriate employees that are suitable for the engagements that the audit firm performs, and letting employees go who are no longer suitable. The workforce has to be highly flexible due to the peak periods of the activities, possibly through supplementation with temporary employees. It is important that sufficient time and an adequate number of expert employees are available for all statutory audits. The peak loads for audit firms arise from legal obligations and the desire of companies to have their audits performed soon after the close of the financial year, usually in the first half of the calendar year.

- *Knowledge*

A good theoretical and practical education is needed to be able to perform statutory audits satisfactorily. This not only concerns knowledge of auditing and financial reporting, it also requires adopting a professional attitude and learning specific skills. After completion of the theoretical basic education, good practical training whereby auditors gain experience of how to apply their theoretical knowledge in daily practice under the guidance of more

experienced auditors with sufficient time for this guidance is also important. Subsequently, the audit firm plays an important part in the continuous adjusting, updating and, where necessary, adding to the basic knowledge already gained, by means of permanent education and other training programmes. Furthermore, the audit firm can ensure that professional information is disseminated, for example in newsletters or regular meetings, in which context it is important that this information is also actually relevant to the recipients. Through consultation procedures set up for this purpose, auditors encountering unusual questions during the performance of a statutory audit can seek advice from internal or external specialists.

- *Standards*

The audit firm facilitates the conduct of statutory audits and the recording thereof by having standards and providing resources to auditors and teams and encouraging and monitoring that they are used correctly. The standards set the preconditions for the application of professional opinion forming, so these may be used in statutory audits in various situations. Depending on the audit firm's client base, the standards will be designed with the specific circumstances of clients in mind, for instance if they are highly automated, or taking account of the specific sectors in which the audits are conducted, such as municipalities or pension funds.

The standard for the conduct of the statutory audit, the audit methodology, is one of the important standards at an audit firm. This establishes how the statutory audit should be conducted and documented in accordance with legislation and regulation (e.g. NV COS). The external auditor and his audit team are expected to carry out the statutory audit in accordance with this audit methodology and to take the correct follow up action in unusual situations. This is for instance important in the determination of the correct combination of tests of controls and substantive procedures. If the audit client's internal controls operate effectively, the external audit can carry out the statutory audit relatively efficiently by primarily conducting tests of controls and limiting his substantive work to the minimum required. However, as soon as it appears that the audit client's internal controls do not operate effectively, the audit methodology prescribes a different audit approach in which more or even exclusively substantive procedures will be performed. Since substantive procedures are usually more labour-intensive than tests of controls, the conduct of this type of statutory audit will be relatively less efficient, which will put pressure on the schedule and the budget. Nevertheless, the external auditor will have to take the correct action and adjust his audit approach. In cases where the irreplaceable internal controls are also not present, this will often also have consequences for the auditor's opinion: the external auditor will in this case usually not be able to issue an unqualified opinion, he will have to issue a modified audit opinion or a disclaimer of opinion. The audit methodology assists the

external auditor in attaching the right consequences to unusual situations, if followed correctly.

- *Internal quality monitoring*

The above-mentioned elements of the quality control procedures contribute to the quality of performance of statutory audits. The audit firm furthermore has the duty of monitoring that sufficient quality is delivered and that compliance with its quality control procedures is ensured and evaluated. The EQCR and the internal quality review are important instruments in this regard. The aims and operation of these instruments are described in section 4.4. Audit firms that also perform statutory audits of PIEs also appoint a compliance officer: a person at the audit firm who supervises compliance by the audit firm with relevant legislation and regulation, and who is accountable on this to the executive board. It is very important that the quality reviews who conducts the EQCR, the reviewer conducting the internal quality review and the compliance officer are given sufficient time to conduct their duties in a timely manner and in sufficient detail. In addition, it is important that they are in a position to classify shortcomings as such and to call the external auditors or other employees concerned to account.

#### Executive board

The executive board of an audit firm is responsible for the design of the quality control procedures. A professional board is able to design a system that facilitates the auditor, encourages them to perform good quality audits (and rewards them for this), and imposes sanctions on the auditor if this is not the case. By its statements and actions and its 'tone at the top', the board has an important exemplary role and thereby determines the quality-oriented culture of the organisation in which the public interest is given the highest priority, above other interests. A professional board moreover has a strategic vision for the objectives of the organisation and how to achieve them, is 'in control' because among other things it understands the major key performance indicators concerning quality, and has sufficient authority to define and enforce effective policy and to take measures. It is thus important that the members of the executive board have sufficient time, knowledge and managerial experience, so that as a group they are fit for purpose. A good professional is not necessarily a good board member, and moreover he may not have sufficient time to carry out the duties of a director appropriately due to his client and engagement portfolio. Candidates with suitable managerial experience can also be recruited from outside the organisation.

#### Internal supervision

An internal supervisory body is tasked with ensuring that the executive board is kept aware of its responsibilities with respect to public expectations that high quality statutory audits are performed. An internal supervisory body can exercise this duty appropriately if it is correctly embedded in the structure of the organisation and has sufficient authority to actually supervise the activities of the executive board of the

audit firm. As for the members of the executive board, the 'tone at the top' and the example set by the members of the internal supervisory body is essential, as is their having a strategic vision, as well as sufficient authority, time, knowledge and experience. The effectiveness of an internal supervisory body is to a significant extent determined by its objectivity, shaped by members who are independent of the audit firm and its audit clients.

### Network

The Big 4 firms are part of a greater whole. They work within the network in the Netherlands together with other organisations in a wide field involving tax, financial and in some cases legal advice. Within this cooperation there are agreements regarding growth and profit targets, profit sharing and investments that could affect how and the extent to which the audit firm is in a position to safeguard the quality of statutory audits. This means that the executive board of the audit firm operates under the board of the joint venture and is represented on that body. Various elements of the legislation and regulation applying to audit firms also have consequences for the other organisations in the network, for example the legislation and regulation regarding the separation of auditing and consultancy services for PIE audit clients. It is important that the cooperation within the network does not hinder compliance with this legislation and regulation by the audit firm.

The networks of the Big 4 firms extend beyond the Netherlands and throughout the world. How these firms operate in the Netherlands is affected to a greater or lesser extent by the international network, depending on the way in which the entities within each network work together. Various standards such as the audit methodology and the associated automation are developed internationally and subsequently implemented in the Netherlands, with the further addition of specific national legislation and regulation if necessary.

### *Environment*

To ensure that the auditor and the audit firm put the public interest of a good quality statutory audit above other commercial interests, the auditor and the audit firm must be independent of the company whose financial statements they audit. The rules governing independence state that despite the contractual relationship between the audit firm and the audit client, the auditor must give an objective opinion regarding the reliability of the financial statements. Other engagements or relationships between the auditor, the audit firm or another part of the network and the audit client or a third party related to that audit client may constitute a threat to independence. This type of threat must be excluded or mitigated by means of measures, or the audit engagement must be refused or terminated.

The rules governing independence also include requirements for the appointment of the auditor. The auditor is in principle appointed by the Annual General Meeting

(AGM).<sup>53</sup> The Dutch Corporate Governance Code states additional principles for the appointment of the auditor, in which a primary role is assigned to the supervisory board, on the advice of the audit committee and the executive board.<sup>54</sup> Under the Code, the audit committee has an important role in the relationship with the auditor and ensuring that the primary focus is the quality of the audit and not only the height of the fee. Among other things, the audit committee is concerned with the independence and remuneration of and any non-audit services provided by the auditor, it functions as the first point of contact for the audit in case of irregularities, it consults with the auditor and it evaluates the auditor's performance. If these tasks are actually or primarily carried out by the executive board of the audit client (for instance, the CFO), or if the executive board or subordinates of the executive board are given a role in the pre-selection and consideration phase, this compromises the assumption of a sufficiently professional and sceptical attitude and the formation of an independent opinion with respect to the financial reporting for which the executive board (or CFO) is responsible. The European Parliament established rules in April 2014 that will come into force in the Netherlands by mid-2016 and which to a significant extent will embed the model as included in the Corporate Governance Code in law.

Requirements governing the transparency of audit firms and the audits they conduct increase users' insight into the quality of financial statements. The auditing standards require that the auditor communicate adequately with the persons charged with governance at the audit client, for instance with respect to unusual items in the statutory audit. At the AGM, the auditor may, after agreement with the executive and supervisory board of the audit client, provide further explanation with respect to his public role. To the wider public, the audit firm provides insight with an annual transparency report explaining how it is organised and how it ensures adequate quality. The insight into the statutory audit conducted will be increased further with the extension of the audit opinion, which is expected to come into effect from the 2014 financial year.<sup>55</sup>

### *Supervision*

The AFM was appointed as the independent public supervisor of audit firms that perform statutory audits on 1 October 2006. The ultimate goal of supervision is the restoration and safeguarding of justified confidence in auditors and the audit opinions they issue. The AFM therefore inspects the quality of the statutory audits conducted in order to call audit firms and auditors to account where necessary if they

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<sup>53</sup> If this body does not appoint the auditor, the supervisory board is authorised to do so, or, in the event that there is no supervisory board or the supervisory board fails to do so, the executive board is so authorised. See Section 2:393 (2) BW.

<sup>54</sup> See Dutch Corporate Governance Code V.2 Role, appointment, remuneration and assessment of the functioning of the external auditor.

<sup>55</sup> See also section 3.2.

have failed to comply with the applicable legislation and regulation and have not delivered the required level of quality. The AFM therefore assesses quality that is not visible to either the audit client or the users of the financial statements. Where possible, the AFM contributes to removing information asymmetry by making this quality transparent. Until now, this has been limited to the publication of generic findings and conclusions and the publication of formal enforcement measures. With effect from 2014, the AFM can also publish its principal findings and conclusions with respect to each audit firm it inspects. Because these findings and conclusions may not be used to identify the audit clients concerned, the AFM is not permitted to inform these audit clients (or their audit committees) regarding the results of its inspections. If the AFM were permitted to do this, this could strengthen the role of the audit committee with respect to the quality of the audit.

Depending on the type of company whose financial statements they audit, audit firms also have to deal directly or indirectly with other supervisory bodies, such as the Central Fund for Social Housing, the Dutch Healthcare Authority, De Nederlandsche Bank (DNB), various departmental authorities and the Monitoring Committee for the Dutch Corporate Governance Code.

## **5.2 Recommendations of the AFM**

In view of the incentives that are inherent to the system within which statutory audits are conducted and the shortcomings identified by the AFM in its inspections at the Big 4 firms, measures are needed in order to improve the quality of statutory audits and safeguard this on a long term basis.

The AFM has noted the measures announced by the Big 4 firms during and after the AFM's inspections (see also section 4.5). The AFM has gained an understanding of the intended measures of the Big 4 firms and recognises that they will make an improvement. Whether the measures will be sufficiently effective remains to be seen. The extent to which the measures announced will prevent future shortcomings and remove the incentives inherent in the system largely depends on the commitment and determination the Big 4 firms put into their implementation.

Based on the results of its inspections, the AFM is making two recommendations to the Big 4 firms regarding:

1. Implementation of the measures they announced; and
2. Increasing the depth of their root cause analyses.

Furthermore, the AFM advises the legislator to make additions to the legislation in a number of areas.

## Implementation of the measures announced

The AFM recommends to the Big 4 firms that they implement the measures announced, including the expected additions based on the proposals of the NBA working group ‘Toekomst accountantsberoep’, expeditiously and decisively, while constantly focusing on the public interest in statutory audits before other interests. The AFM also recommends to these firms that, when elaborating the measures and when implementing them, they give special attention and priority to the following matters, individually, but especially in the way they interrelate:

- *Strengthening of governance*

The AFM expects the measures only to be sufficiently effective if each of the Big 4 firms simultaneously strengthens its governance with other measures. In the opinion of the AFM, when strengthening governance the following points in particular need to be addressed:

- o Strengthening governance at a Big 4 audit firm needs to apply to all three of (i) the firm’s executive board, (ii) the executive board of the firm’s network in the Netherlands, and (iii) the firm’s internal supervisory body (such as a supervisory board and/or, as a part thereof, a public interest committee).
- o Strengthening the executive board, which includes:
  - Having the right tone-at-the-top and the executive board being a role model help define the quality-oriented culture of an organisation where the focus is on the public interest.
  - Having a strategic vision for the objectives of the organisation and how to achieve them, understanding the major key performance indicators concerning quality in order to be in control, and sufficient authority to define and enforce effective policy and to take measures.
  - Ensuring that the members of the executive board have sufficient time, knowledge and managerial experience, so that as a group they are fit for purpose. Obviously, candidates with suitable managerial experience can also be recruited from outside the organisation.
- o Strengthening the internal supervision of the executive board of the audit firm and of its network, which includes:
  - Appointing a supervisory board, to the extent this has not already been done.
  - Filling the supervisory board with members who are independent of the audit firm, have the power to appoint and dismiss executive board members, and have duties and powers in line with the relevant provisions of the Dutch Corporate Governance Code and Book 2 of the Dutch Civil Code.

- *Creating a quality-oriented culture*

The AFM expects the effectiveness of the measures to depend largely on the extent to which audit firms are able to create a quality-oriented culture, where necessary accelerating the changes to their culture and continuing to pay attention to this matter. In the opinion of the AFM, when making changes to the culture the following points in particular need to be addressed:

- o Encouraging willingness to change at all levels of an audit firm and its network is indispensable for implementing the announced measures effectively.
- o Creating a culture that is focused on keeping the public interest relating to high-quality statutory audits at the centre of attention, as demanded by the public duty of an audit firm.
- o Promoting an open culture that is focused on intensive cooperation contributes to putting the public interest at the centre of attention, as well as to the conduct of high-quality statutory audits.
- o Bringing the appraisal and remuneration policy into line with the quality-oriented culture by having this policy support the standards and values of the audit firm, as well as the quality objectives it aims for. It is important for these quality objectives to be adequately monitored, down to the level of the individual statutory audit, for example by basing the monitoring function on suitable key performance indicators.

- *Embedding statutory quality standard*

The auditing standards that have been applicable to the performance of audits for many years, and which were largely drawn up by the auditing profession internationally, embody objectives and requirements intended to ensure quality in execution. During its inspections, the AFM observed instances of these requirements not being met and the objectives not being achieved. The quality controls of the audit firms failed to prevent these misstatements from the statutory level of quality. To ensure the quality of statutory audits, which always involve customised procedures and specific circumstances, it is necessary to embed the statutory quality standard throughout the audit firm. In the opinion of the AFM, when embedding this quality standard the following points in particular need to be addressed:

- o Constantly maintaining, updating and where necessary expanding the knowledge that external auditors and other staff have of the statutory quality standard.
- o In that regard, facilitation for and encouraging of their external auditors and other staff by the audit firms.
- o Ensuring that the audit firms' quality controls, such as the engagement quality control review and the internal quality inspection, provide sufficient information about the standard of quality achieved. In doing so, measures can provide adequate

feedback to external auditors and other staff about the quality they have delivered. These measures can also draw attention to misstatements from the required quality standard in time and qualify them as such, so that the correct implications can be seen.

- *Increasing transparency with respect to quality*

In the opinion of the AFM, increasing transparency with respect to the conduct of statutory audits helps improve their quality. This is because transparency reduces the information gap between audit clients, users of financial statements and interested parties on one side, and auditors and audit firms on the other. Transparency with respect to quality is expected to increase competition on quality rather than simply the size of the fee, and promote consistency of quality delivered. In the opinion of the AFM, when increasing transparency the following points in particular need to be addressed:

- o The transparency of the Big 4 firms regarding their method of operation, the quality they deliver, and especially, in the short term, about how they interpret the measures announced, as well as the progress and effectiveness of their implementation. They can do this in their transparency reports and/or annual reports, or via other statements.
- o External auditors need to be transparent about the audits they have carried out, including any matters of emphasis, in their more expanded audit opinions, at the general meetings of shareholders of audit clients, and in other statements.
- o Audit firms should hold discussions with supervisory boards, and especially with the audit committees of audit clients, about the results of inspections of the quality of statutory audits, including those conducted by the AFM. From this, audit committees will gain more understanding of the quality of statutory audits carried out, which they can utilise in their role in the selection and evaluation of the external auditor.

### **Increasing the depth of root cause analyses**

The AFM observed that the actual underlying causes for the lack of consistent quality assurance for every statutory audit are not yet completely clear. Accordingly, the AFM calls on the Big 4 firms to further deepen their analyses of root causes and reasons underlying the deficiencies found. If the firms identify additional causes or reasons, they need to assess whether the measures they are taking address these causes and reasons effectively, taking different or additional measures as necessary. Moreover, the AFM expects the Big 4 firms to make the root cause analyses part of their quality control procedures.

## Advice to the legislator

In the exercise of its supervisory duty, the AFM focuses primarily on the audit firm and the external auditor. The present legal framework, including the powers of the AFM, for the time being offers adequate possibilities for the proper exercise of this supervisory duty. However, the AFM considers there is good reason to advise the legislator to supplement existing legislation in the following respects:

- *Suitability test conducted by the AFM*

As stated above, the AFM expects good governance at audit firms to be an important means of improving the quality of statutory audits and ensuring this in the longer term. Both the AFM and DNB have several years of experience with suitability tests as part of their supervision of financial institutions. A suitability test involves an assessment by the supervisory agency of the suitability of the persons who determine or co-determine the policy of the institution or organisation concerned, both individually and collectively. This suitability consists of knowledge, competences and professional conduct.<sup>56</sup> The suitability test contributes to better governance at financial institutions.

In the case of audit firms, the rules currently govern only the integrity, expertise and professional competence of policymakers and co-policymakers. There are no concrete requirements for the suitability of these persons in the current legislation and regulation. The AFM considers this to be a deficiency. In its supervision of the PIE audit firms, including the Big 4 firms, the AFM will devote special attention to the way in which these firms are governed. In the AFM's view, this will need to include an assessment of the individual and collective suitability of the policymakers and co-policymakers of the audit firm, in other words the executive and supervisory board members.

- *The AFM to submit findings and conclusions directly to the bodies responsible for governance*

With reference to previous inspections, the AFM has called on audit firms and audit committees of audit clients to discuss the results of reviews of the quality of statutory audits, including the inspections carried out by the AFM. The AFM considers it important that the bodies responsible for governance at PIE audit clients, such as supervisory boards and, in particular, audit committees, have sufficient information to adequately evaluate the quality of their auditor or an auditor they intend to appoint for a new audit engagement. The AFM's inspection findings can be an important source of information that these bodies can use as the basis for consultation with this auditor. The AFM considers that this process can be accelerated and strengthened if it is able itself to provide its inspection findings to the body

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<sup>56</sup> The competences relevant to suitability are listed in the [appendix to the 2012 Policy Rule on suitability](#).

responsible for governance at the PIE audit client, such as the supervisory board and, in particular, the audit committee. The requirements regarding confidentiality to which the AFM is subject do not currently permit this.

- *Mandatory taking of corrective and improvement measures*

The AFM has called on the Big 4 firms to take suitable corrective and improvement measures where necessary as a result of the AFM's findings. The AFM considers it important to introduce a statutory obligation for audit firms to take appropriate measures if deficiencies are found, to correct past violations, if any, and prevent their recurrence in the future. These violations may for instance relate to individual statutory audits or the quality control procedures. Deficiencies can be found by the AFM, other (external) supervisory bodies, audit firms or the external auditor himself. To ensure that such measures are also taken in situations in which the AFM is not involved, the AFM recommends to the legislator that a legal basis for this be created.

- *Introduce additional categories for PIEs*

PIEs are currently defined as: listed legal entities, banks and insurers. In addition to this, the legislation provides for the designation of categories of companies, institutions or public bodies as PIEs. Given its findings relating to the statutory audits of various non-PIEs with a public function and large groups of stakeholders, the AFM advises the legislator to utilise the option of expanding the definition of a PIE to include, for example, large housing corporations, large municipalities, large pension funds, large educational institutions, large health care institutions, and large energy companies. As a result, additional safeguards under the Audit Firms Supervision Act (Wta) will apply to the statutory audits of the financial statements of these organisations, which will enhance the quality of the audits.

- *Mandatory supervisory boards*

To reinforce the internal supervision of executive boards at audit firms that audit PIEs, as well as the professional skeptical attitude of such boards, the AFM considers it desirable to make it mandatory for these firms to establish supervisory boards at the highest level, preferably along the lines of the two-tier board structure. The members of the supervisory board must be independent of the audit firms and have the full powers of supervisory board members, such as approving strategic decisions and appointing and dismissing executive directors. The AFM considers it important that the relevant provisions of the Dutch Corporate Governance Code and Book 2 of the Dutch Civil Code be the guidelines for defining the rights and duties of a supervisory board.

### 5.3 Follow up by the AFM

During the period following the inspections discussed here, the AFM will carefully monitor the implementation and effectiveness of the announced measures for the remediation of deficiencies found, and of the measures intended to prevent deficiencies in the future. Moreover, the AFM will especially assess at each of the Big 4 firms whether its measures sufficiently satisfy the AFM's recommendations, and whether they are being implemented with sufficient progress and determination. In this context, an open dialogue with the firms on the follow up to these inspections is essential. If the progress and determination with which the announced measures are being implemented are not adequate, the AFM can apply formal enforcement measures to enforce the expeditious and decisive implementation that is required.

## 6 Firm-specific findings and conclusions

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Section 6.1 describes how the AFM designed and conducted its regular inspections at the Big 4 firms, thus providing the background information and context necessary for the firm-specific findings and conclusions that are given in sections 6.2 to 6.5. These paragraphs contain a summary of the principal findings and conclusions that the AFM has reported to the Big 4 firms in confidential firm-specific reports.

### 6.1 Description of the inspection

#### *The regular inspection*

Since licences were granted for the performance of statutory audits, the Big 4 firms have been subject to ongoing supervision by the AFM. As part of its ongoing supervision, the AFM carries out inspections to check whether licensed audit firms are continuing to comply with the requirements set by and pursuant to the Wta and are thereby ensuring that the statutory audits they perform are of adequate quality. In a inspection, the AFM periodically assesses the quality of the statutory audits performed and specific measures in the quality control procedures. In addition to its inspections, the AFM carries out investigations of incidents and thematic inspections.

The AFM published a report on the first regular inspections it conducted at the Big 4 firms in the period 2009-2010 in September 2010. The inspections in 2013-2014 concern a first follow up assessment: by a subsequent inspection of the quality of the statutory audits conducted by the Big 4 firms, the AFM is in a position to assess whether and to what extent the improvement measures introduced in the intervening period have had the desired effect.

#### *Selection of statutory audits*

The AFM requested each of the Big 4 firms to provide a list of all their statutory audit clients, including information regarding the name of the external auditor, whether or not an EQCR or internal quality review was carried out, and what level of risk is attached to the audit in question in the opinion of the audit firm. The AFM selected a total of 40 statutory audits for its inspections. The AFM selected only statutory audits relating to the 2012 financial year for which an audit opinion had been issued and the audit file had been closed. The majority of the audit opinions were issued in the period from February to September 2013. In the selection of the audits to be inspected, the aim was to ensure variation in market segments and other features of the audit.

At each Big 4 firm, the AFM selected four statutory audits of PIEs and six audits of non-PIEs. In the PIE segment, the AFM selected at least one health insurer and two

listed companies (AEX and AScX). In the non-PIE segment, the AFM selected at least one pension fund, one public or semi-public entity and one large non-PIE. Table 5 provides an overview of the total number of statutory audits the AFM selected in the various market segments.

Market segment	Number of statutory audits selected
PIEs	16
Health insurers	4
Listed companies in the AEX	4
Listed companies in the AScX	4
Other public interest entities (PIE)	4
Non-PIEs	24
Pension funds	4
Public and semi-public institutions	5
Large unlisted companies (non-PIE)	4
Other non-PIE	11
<b>Total</b>	<b>40</b>

*Table 5. Statutory audits selected by market segment*

In addition, the selection of the statutory audits to be assessed took account of the following other audit features:

- audits by various external auditors;
- distribution of audits across organisational elements of the audit firm, for example across branches and business units;
- EQCRs;
- internal quality reviews; and
- average or higher risk profile.

By applying these criteria the AFM intentionally selected statutory audits of a diverse group of audit clients. Given this non-random selection and the fact that only ten audits were selected for each Big 4 firm, this does not constitute a statistical sample on the basis of which the results of the assessment of the ten audits are mathematically representative of all the statutory audits performed by the audit firm in question. The findings do, however, answer the question as to whether the audit firms provide adequate assurance of statutory audit quality.

#### *Joint inspections with the PCAOB*

Under American legislation, the Big 4 firms are registered with the PCAOB and are thus subject to supervision by the PCAOB. In the conduct of its supervision of Dutch audit firms, the PCAOB collaborates with the AFM. Dutch audit firms are not permitted themselves to provide confidential information directly to the PCAOB. Under international collaborative agreements, the AFM is permitted to do this. The AFM and the PCAOB accordingly carry out joint inspections. In a joint inspection, the

AFM obtains all the relevant information from the audit firm and after a test for legality shares this with the PCAOB. The AFM combined only the joint inspections at Deloitte and EY with its own regular review.<sup>57</sup>

### *Selection of focus areas in the statutory audits*

The AFM focused on certain material aspects of the audit in the 40 statutory audits it selected, known as the focus areas. Two material focus areas were selected for each audit, i.e. focus areas that were important for the picture presented by the financial statements. The choice of focus areas for the assessment of a statutory audit is appropriate to the risk-oriented approach of the AFM's supervision. The AFM thus obtained a realistic and broad-based view of the quality of statutory audits conducted.

The choice of focus areas is mainly based on the nature and size of the activities of the audit client. This means that the AFM assessed the audit of the revenue item in many cases. In addition, the AFM selected various general financial statements items for its review on the basis that by nature or size the items were important for the picture presented by the financial statements of the audit client in question. This mainly concerned the items inventory, construction contracts, intangible non-current assets (including goodwill), property, plant and equipment and cash and cash equivalents. In certain cases the AFM selected additional items in the financial statements specific to the sector in question for its review. These mainly concerned expenditure and procurement, land exploitation, investments, technical and other provisions and equalisation payments.

The focus of the review on a limited number of items in the financial statements means that the AFM did not assess the entire audit of the financial statements. It is therefore possible that the external auditor failed to obtain adequate appropriate audit evidence in other parts of his statutory audit that were not assessed by the AFM. The AFM has called on the Big 4 firms to assess themselves whether there were shortcomings in the parts of the statutory audits not assessed by the AFM.

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<sup>57</sup> The PCAOB published the results of the inspection it conducted in 2012/2013 at [EY](#), [KPMG](#) and [PwC](#) on its website (the results of the inspection at Deloitte had not yet been published at the time of publication of this report)

### *Conduct of the inspections*

An inspection by the AFM is interactive: the AFM requests the external auditor to explain the parts of the audit selected by the AFM using his audit file. By means of question and answer, the supervision officers of the AFM form an opinion of the audit procedures performed and regarding the quality of the audit. It is up to the external auditor to demonstrate on the basis of the audit file that the audit opinion he has issued is adequately substantiated and that the statutory audit has been performed in accordance with the auditing standards.

After the conclusion of each inspection, the supervisors of the AFM have discussed their preliminary findings and conclusions with respect to the focus areas selected by the AFM with the external auditor and representatives of the audit firm.

### *Evaluation by the AFM*

The AFM evaluates the conduct of the audit by the external auditor with respect to material aspects. This means that the AFM evaluates whether the external auditor has obtained sufficient appropriate audit evidence with respect to the focus areas selected by the AFM. The term ‘sufficient’ is the measure for the quantity of the audit evidence. The term ‘appropriate’ is the measure for the quality of the audit evidence. Quality means that the audit evidence is relevant and reliable, so that it provides real substantiation for the auditor’s opinion. With this audit evidence, the external auditor substantiates his opinion that the capital and result presented in the audit client’s financial statements do not contain material misstatements.

The external auditor reports his opinion with respect to the financial statements he has audited in his auditor’s report. In this report, he also states that his opinion is based on the audit evidence he has obtained by means of his audit procedures, that this audit evidence is sufficient appropriate to substantiate his opinion and that he has conducted his audit in accordance with the applicable legislation and regulation, including the auditing standards. The AFM has assessed whether in accordance with the auditing standards the external auditor indeed obtained sufficient appropriate audit evidence in order to substantiate his opinion.<sup>58</sup> If the external auditor failed to obtain sufficient appropriate audit evidence with respect to a material item in the financial statements, he has also failed to obtain sufficient appropriate audit evidence in order to substantiate his opinion with regard to the financial statements

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<sup>58</sup> In other words, the AFM established whether the external auditor complied with paragraph 17 of NV COS 200 ‘General objectives of the independent auditor, as well as the performance of an audit in accordance with the Standards’: “In order to obtain a reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion.”

as a whole. In that case, the AFM classifies the conduct of the statutory audit as 'inadequate'.

A statutory audit conducted 'inadequately' does not however mean by definition that the audited financial statements are incorrect. The financial statements may still present a true and fair view of the size and composition of the capital and the result. However, at the time he issued his audit opinion, the external auditor had not obtained sufficient appropriate audit evidence in order to be able to substantiate his opinion with respect to this true and fair view. The AFM did not examine the audited financial statements for correctness and therefore passes no judgement on this aspect.

#### *Written report*

After the conclusion of the inspection, each Big 4 firm received a report stating the AFM's preliminary conclusions and findings. These conclusions and findings were substantiated with detailed and client-specific information from the audit file, or indeed with the absence of such information. These reports are therefore confidential.

On the basis of its inspections, the AFM only reported its findings to the Big 4 firms that related to the failure to obtain sufficient appropriate audit evidence. Other findings have been notified to the external auditor responsible during the inspection.

The report with preliminary findings has been sent to the audit firm for the purpose of agreeing the facts. If the audit firm does not agree with the findings and preliminary conclusions, or believes that the facts included in the report are inaccurate or incomplete, it may inform the AFM accordingly in a written response stating its arguments and supported by documentation if necessary.

The AFM has requested the Big 4 firms to take measures to remediate the audits qualified as 'inadequate'. Remediation measures mean that the external auditor gathers the audit evidence to substantiate his opinion after the fact.

The AFM has moreover requested the Big 4 firms to conduct a root cause analysis with reference to 'inadequate' audits and to report their findings to the AFM. The purpose of a root cause analysis is to obtain a better understanding of the factors that have led to the audit being conducted inadequately and the audit opinion lacking sufficient substantiation. The AFM expects the Big 4 firms to be able to take more targeted measures on the basis of the root cause analysis to prevent quality shortcomings in future.

Lastly, in the report of its preliminary findings, the AFM has requested the firms to state the measures they will take in order to ensure the quality of the statutory audits they are conducting now and will conduct in future.

The AFM has assessed the responses from the audit firms. The responses by the audit firms may have led to the AFM withdrawing or changing its preliminary conclusions and findings. The AFM has informed the Big 4 firms regarding the outcome of this assessment. The AFM may subsequently decide to take enforcement measures.

The AFM will send a report with its final conclusions and findings to these organisations within reasonable time. In this definitive report the AFM will call on the Big 4 firms to share the findings and conclusions of the AFM regarding specific statutory audits with the supervisory board (and in particular the audit committee or other body charged with governance) of the audit client in question.

### *Public report*

Section 6.2 to 6.5 contain a summary of the principal findings and conclusions that the AFM has reported to the Big 4 firms in confidential firm-specific reports. All information that could be used to identify the audit client or other persons has been removed.

The results of the review as described in sections 4 and 6 of this public report were sent to the Big 4 firms on 4 September 2014 and discussed with them at a meeting on 8 September 2014. The AFM requested the Big 4 firms to give their response to sections 4 and 6 in writing, and these responses are included in sections 6.2 to 6.5 of this report.

## 6.2 Deloitte Accountants B.V. (Deloitte)

### 6.2.1 Background information

Certain features and key figures for Deloitte are shown in the table below.<sup>59</sup>

1.	Number of policymakers and co-policymakers	15
2.	Number of external auditors	136
3.	Total number of employees	1,610
4.	Number of statutory audits of PIEs	140
5.	Number of statutory audits of non-PIEs	2,736
6.	Total fees charged to audit clients	€124 million
7.	Total revenue of Deloitte Accountants B.V.	€243 million
8.	Total revenue of Deloitte Holding B.V.	€631 million (44% assurance services, 26% tax services and 30% other services)

In its inspection, the AFM assessed elements of the following statutory audits:

Audit client	AFM assessment as 'inadequate'	Type of company	PIE	EQCR	Internal quality review
A	No	PIE	Yes	Yes	No
B	Yes	PIE	Yes	Yes	No
C	No	PIE	Yes	Yes	No
D	No	Health insurer	Yes	Yes	No
E	No	Pension fund	No	Yes	No
F	Yes	Public or semi-public organisation	No	Yes	No
G	No	Public or semi-public organisation	No	Yes	Yes
H	Yes	Large non-PIE	No	Yes	No
I	Yes	Other non-PIE	No	Yes	Yes
J	No	Other non-PIE	No	Yes	Yes

<sup>59</sup> The information in lines 1-2 is taken from the registers of the AFM. The information in lines 3-7 is taken from the AFM Monitor of Audit Firms 2013, for which Deloitte provided information to the AFM on its most recent completed financial year, which was the financial year that closed on 31 May 2013. The information in line 8 is taken from the 2012/2013 financial statements of Deloitte Holding B.V.

### 6.2.2 Conclusion

Based on its findings as described in section 6.2.3, the AFM concluded that the external auditor concerned failed to or failed to adequately comply with the professional standards with respect to important elements in the conduct of the statutory audit in four of the ten statutory audits it assessed. The measures that Deloitte took to ensure the quality of statutory audits failed to prevent this. In these statutory audits, these external auditors failed to obtain sufficient appropriate audit evidence with respect to important and material items and issues in the financial statements. Their opinions with regard to these four financial statements as a whole are therefore not adequately substantiated. At the time of issuing the auditor's report, the external auditor had not obtained sufficient appropriate audit evidence. This does not necessarily mean that the financial statements in question are incorrect. The AFM did not examine these financial statements for correctness and therefore passes no judgement on this aspect. As a result of the AFM's inspection, Deloitte carried out root cause analyses which led to remediative work being carried out in some cases. Deloitte had no reason to request its clients to amend their financial statements.

### 6.2.3 Findings with respect to statutory audits

#### Audit client B

Audit client B is a service provider.

The external auditor did not obtain sufficient appropriate audit evidence regarding the completeness of the revenue from secondment and the valuation of the goodwill. The external auditor included IT specialists in the audit team due to the importance and complexity of the automated data processing environment. The external auditor used experts in the audit of the valuation of the goodwill.

#### *Completeness of revenue*

The external auditor had planned to use a combination of tests of controls and substantive audit procedures in order to audit the revenue from secondment. These procedures consisted mainly of establishing the effective operation of the internal controls at B and the conduct of a balancing check ('job time vs. shop time'). The performance of the tests of controls and of the substantive procedures was, however, insufficient with respect to relevant elements, meaning that the external auditor could not obtain sufficient appropriate audit evidence. The external auditor failed to do the following:

- Obtain sufficient understanding regarding the design of the relevant internal controls and establish that the internal controls were operating effectively. For instance, the external auditor did not establish that the design of the internal controls did not adequately ensure that the revenue was reported in

full. The external auditor also failed to establish that the hours reported were authorised by project managers;

- Adequately audit the maximum capacity in hours for completeness and to adequately audit the indirect hours for correctness. These elements form part of the job time vs. shop time balancing check whereby the external auditor intended to establish that the hours reported are complete. The external auditor reconciled the maximum hours capacity with the salary administration, but he failed to follow up on an identified relevant difference in days between the balancing check and the salary administration. For the indirect hours, the external auditor made a comparison with the previous financial year, but did not formulate an expectation for this substantive analytic test in advance, did not define a threshold figure and did not obtain a satisfactory explanation for the differences.

#### *Valuation of goodwill*

Goodwill incurred as a result of acquisitions. B recognised an impairment of the goodwill on the basis of an impairment test. The discounted cash flow model, which takes the budget for the succeeding financial year as a basis, was used. Other relevant assumptions in the calculation are the WACC<sup>60</sup>, the expected productivity, the expected increase in FTE and the expected increase in costs, including salary increases. The external auditor had planned to carry out substantive procedures to audit the valuation of the goodwill. These mainly concerned the evaluation of the assumptions made by B in its calculations. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to evaluate the reasonableness of the assumptions on which the recognition of the impairment was based. The external auditor instructed the expert he had engaged to evaluate the appropriateness of the model and the WACC that was applied. The external auditor formed his own conclusion regarding the other assumptions. However, he failed to test the reasonableness of the estimates with respect to FTE growth, productivity and salary costs by for example comparing them with market research or the actual figures for the initial months of 2013.

#### **Audit Client F**

Audit client F is a large municipality.

The external auditor did not obtain sufficient appropriate audit evidence regarding the lawfulness of F's tender procedure and the valuation of its land developments.

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<sup>60</sup> Weighted Average Cost of Capital: this figure expresses the cost incurred by a business for the capital used to fund the business.

### *Lawfulness of tender procedure*

The external auditor had planned to test that F's procurement transactions had been conducted correctly in accordance with the European tender directives using substantive procedures. These procedures consisted mainly of test of details of procurement orders for which employees in F's internal audit department were instructed by the external auditor to check whether the selected procurement orders were lawful, using source documentation. The external auditor's conduct of the procedures was, however, inadequate in certain relevant respects. The external auditor did not carry out any appropriate audit procedures to establish that the procedures of F's internal audit department were adequate for the external auditor's purposes. The external auditor in fact failed to do the following:

- Carry out procedures to establish that the procedures of F's internal audit department were adequate for the external auditor's purposes;
- Ask additional questions with regard to the unusual items that were revealed by the procedures carried out by F's internal audit department.

### *Valuation of land developments*

The external auditor had planned to carry out substantive procedures to test the valuation of F's land developments. Land in development is measured as the balance of the realised costs and revenues after deduction of a provision for expected losses. The procedures mainly concerned the use of the procedures of F's internal audit department on the land developments. The external auditor also used the services of a valuation expert from the Deloitte network for the assessment of the reasonableness of certain assumptions in the calculation of the valuation of selected land developments. The procedures of the external auditor were, however, not carried out adequately in certain relevant respects, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Adequately evaluate the procedures of F's internal audit department and carry out audit procedures to determine whether the procedures of the internal audit department were adequate for the external auditor's purposes. The external auditor did not establish which audit procedures had been carried out by F's internal audit department with regard to the future costs and as yet unrealised proceeds of the land in question;
- Evaluate whether the procedures of the valuation expert engaged by the external auditor were adequate for the external auditor's purposes;
- Adequately follow up on the findings of the valuation expert engaged by the external auditor.

## Audit client H

Audit client H is a provider of online services.

The external auditor did not obtain sufficient appropriate audit evidence regarding the completeness of the revenue. H's revenue consists of a commission percentage on the value of the services it offers. The external auditor included IT specialists in the audit team due to the importance and complexity of the automated data processing environment.

### *Completeness of revenue*

The external auditor had planned to use a combination of tests of controls and substantive procedures in order to audit the revenue from commission income. These procedures consisted mainly of establishing the effective operation of H's internal controls with respect to the calculation of commissions and the monitoring of relationships between various systems and regular analyses of income by H. The procedures also included a substantive analytical review procedures, detailed checks of the cut-off of revenue and an assessment of the logical access security and change management procedures. The conduct of the tests of controls and the substantive procedures with respect to relevant elements was, however, inadequate, meaning that the external auditor could not obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Follow up on the findings of the IT specialist. The IT specialist had established that a large number of people who had no role in this respect were authorised to adjust the commission percentages in the systems. The external auditor failed to establish who these people were and whether they had made changes that were not justified. The IT specialist also established that a number of persons had access to both the development and production environments. This lack of segregation of duties could lead to improper changes to the systems and the data included therein. The external auditor failed to establish whether improper changes had indeed been made;
- Instruct the IT specialist to carry out procedures with respect to all the elements in the automated environment relevant to the recognition of income. The IT specialist indeed did not carry out any procedures on the database in which the agreed services are recorded;
- Obtain an understanding of the design of the relevant internal controls and establish that the internal controls were operating effectively. The external auditor concluded that he could not rely on the internal control measure regarding exception reports of the minimum commission percentage. The external auditor concluded that he could rely on the internal controls in relation to the reconciliation between the data from the commission application and the financial administration and on the regular internal analysis, and review of the consolidated income statement. However, the design of these internal controls did not adequately ensure the correctness

of the commission percentages and thereby the completeness of the revenue;

- Conduct the substantive analytical procedures in sufficient depth. These procedures were conducted at a too general level and the external auditor did not develop any expectations in advance on the basis of the minimum commission percentage determined by the management and contractual agreements regarding minimum commission percentages.

## **Audit client I**

Audit client I is a company that operates a hotel.

The external auditor did not obtain sufficient appropriate audit evidence regarding the correctness and completeness of I's revenue from the letting of hotel accommodation.

### *Correctness and completeness of revenue*

The external auditor had planned to conduct substantive procedures on the room rates and a combination of tests of controls and substantive procedures on room occupancy in order to audit the revenue from the letting of the hotel accommodation. The procedures consisted mainly of establishing the effective operation of I's internal controls, detailed checks that the prices in the reservation system agreed with what was paid, substantive analytical review procedures and establishing that there was adequate segregation of duties in the automated environment. The performance of the tests of controls and the substantive procedures was, however, inadequate with respect to relevant elements, meaning that the external auditor could not obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Check that there was adequate segregation of duties in the automated environment. The external auditor did not check that the users did not possess authorisations in addition to those necessary for the conduct of their duties;
- Obtain an understanding of the design of internal controls regarding the design of the relevant internal controls and establish that the internal controls were operating effectively. For instance, the external auditor did not establish whether the internal controls were sufficient to respond to the significant risk that a room could be let without this being registered in the reservation system;
- Carry out the number of detailed checks of room prices as prescribed in Deloitte's methodology. In his detailed check of the room prices, the external auditor established that the price in the reservation system agreed with the amount paid. The external auditor did not, however, establish that the room prices agreed with the contractual prices or standard established prices, or that discounts were recognised correctly. The external auditor carried out

detailed checks because he had concluded that he could not rely on the internal controls with respect to room prices;

- Carry out the substantive analytical review procedures in sufficient depth, by formulating expectations in advance, testing the base data for reliability and doing more than an overall analysis of the revenue. For example, the external auditor made no distinction between room types and types of guest and reservation.

## 6.2.4 Response from Deloitte

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Mr G.J. Everts  
Stichting Autoriteit Financiële Markten  
P.O. Box 11723  
1001 GS AMSTERDAM

Date	From	Our reference
22 September 2014	M.J. van der Vegte RA	CD/PS/MvdV/ps
Subject		
Response Deloitte: AFM inspection into quality of statutory audits by Deloitte Accountants B.V. (audit year 2012)		

Dear Mr Everts,

We were interested to read the public report on the regular quality inspection you performed in 2013-2014 at the Big 4 audit firms, and we are pleased to take this opportunity to respond to the results contained within in such report.

**The standard is clear. Deloitte is not yet up to standard.**

The current standard based on Dutch auditing standards is crystal clear to us. Quality is Deloitte's main strategic objective, and it is essential to the trust that can and should be derived from our work. We observe that our audit quality has improved compared with your previous inspection. Yet the results of your inspection indicate that Deloitte has not yet realized its ambitions in terms of audit quality. Deloitte is fully aware that this gap must be bridged.

You have identified shortcomings in several of our 2012 audit files with respect to the performance of our audit procedures in important areas such as internal controls testing, revenue recognition testing and internal reviews. Based on the files inspected, you have established that Deloitte has taken insufficient care to ensure that the auditors involved meet the applicable regulatory requirements.

Op alle opdrachten vermeld door Deloitte zijn de 'Algemene Voorwaarden Dienstverlening Deloitte Nederland, Januari 2014' gedeponeerd bij de Kamer van Koophandel onder nummer 24362037 van toepassing.  
Deloitte Accountants B.V. is ingeschreven in het handelsregister van de Kamer van Koophandel te Rotterdam onder nummer 24362053.

Member of  
Deloitte Touche Tohmatsu Limited

Following on from your preliminary findings, we reported on 30 July 2014 on whether the shortcomings identified by AFM occur more often, on the reasons for these shortcomings and on the actions taken to comply with our duty of care. At the time, we informed you of our efforts over the past few years and of the initiatives that we are currently working on. Those initiatives are outlined below.

#### **Deloitte continues to work on excellent quality**

In 2012, we observed that the quality initiatives taken in the period 2008-2012 had been insufficiently obvious in the quality delivered. The results fell short of our standards and, hence, of our stakeholders' expectations. Deloitte believed – and still believes – that this gap should be bridged.

Deloitte launched a new Audit Quality Master Plan (hereinafter: AQMP) in the spring of 2013 as part of its Audit Strategy to elaborate on the quality measures implemented in the period 2008-2012. The fundamentals of this plan are behaviour and culture, transparency, and team work. The AQMP includes several initiatives to strengthen both culture and behaviour and to deliver consistently high quality audits, transparency towards our stakeholders, and strict quality control. Deloitte immediately introduced this plan in 2013 and continues to pursue its implementation. Early this year, we observed that our quality efforts had to be intensified. Therefore, in February 2014, we substantially reinforced the quality initiatives.

We sincerely welcome the introduction of the NBA proposals to safeguard Auditor Independence and Audit Quality. Please note that our system and our AQMP already largely guarantee the proper application of several components of these proposals. Examples include the measures aimed at transparency and the auditor's role in society (e.g., the expanded independent auditor's report), the governance of the audit firm, culture and behaviour, the importance of team work, the manner of performing the engagement, and the commitment to prevailing standards.

We also refer also to our Transparency Report FY14 (29 August 2014), in which we discuss our efforts to enhance audit quality and report on the results realized last year. Below we elaborate on several key elements.

(<http://www2.deloitte.com/nl/nl/pages/Over%20Deloitte/articles/deloitte-verslagen.html>).

#### **Culture and behaviour are the bearers of excellent quality**

Strengthening our culture is required to achieve the desired level of audit quality. We are convinced that a high performance culture is the bearer of excellent audit quality. Since the spring of 2013, we have launched a set of initiatives to develop this high performance culture. Examples include the personal commitment requested from the newly appointed directors that we register as external auditors. That commitment takes the form of an Audit Quality Commitment.

For any auditor whose internal review results are insufficient, a personal action plan is prepared. This includes a quality commitment agreed in writing and provides for the strict monitoring of realization in the subsequent period. Our assessment and remuneration policy focuses strongly on encouraging the desired culture by using KPIs agreed at the level of both the individual professional and the management of the regions and/or service lines. This requires striking the right balance between rewarding top quality and sanctioning a lack of such quality. These initiatives help us create a culture in which responsibility, pride and enthusiasm prevail and in which mediocrity is found unacceptable.

Quality to Deloitte also means communicating transparently our audit findings, and the quality we have delivered, with financial statement users. We are committed to the extensive independent auditor's report and to proactively explaining in the General Meeting of Shareholders any fraud or other risks identified, our procedures performed, as well as the risk profile and the quality of the client's risk management system. This also applies to reporting to the client's internal supervisors on the audit quality provided and discussing this in our Transparency Report.

Our own perceptions and the result of the AFM report have taught us that we will have to give a clearer signal to society in our auditor's report if the quality of the client's internal controls is insufficient, as a basis for our work.

#### **Firm governance from a fresh perspective**

A firm governance structure is essential if we are to attain and retain our ambition for quality. The Public Interest Committee [*"Commissie Publiek Belang"*, or "CPB"] is embedded in Deloitte's governance structure as a sub-committee of the Supervisory Board [*"Raad van Commissarissen"*, or RvC]. The CPB comprises all external members of the RvC. This structure guarantees solid governance – the RvC has the powers to effectively intervene in the organization, if necessary. One of the tasks of the RvC is to ensure the progress of the AQMP. The accelerated introduction of the AQMP in the course of 2013 took place partly at the request of the RvC. Likewise, in 2013, the RvC drew specific attention to additional investments in quality and the topic of quality in relation to the remuneration of our auditors.

#### **Causal analyses are crucial. Deloitte is a learning organization**

Performing a causal analysis based on a structured and consistent approach has been a fixed component of our quality system since 2013. The priorities embedded in the design and implementation of the internal reviews have led to consistency between the internal and external inspections of bodies like the AFM or the PCAOB. It is standard procedure for Deloitte to subject each file to a causal analysis if it fails to achieve a sufficient score following internal or external reviews. Likewise, we perform causal analyses on good quality files. This allows us to identify and share best practices.

A causal analysis focuses on the set-up of the audit team, its procedures, and the internal reviews performed. Performing recovery procedures is a fixed component of this approach. Where necessary, additional audit procedures have been carried out for the four files the AFM had qualified as insufficient, while it was assessed whether it was correct to issue an independent auditor's report. The assessment concluded that none of the reports issued needed any correction. Next, the causal analysis/analyses is/are converted into a personal action plan, linked to a specific, individual quality commitment.

Deloitte has found various causes for the shortcomings in performing the audits and they cannot be viewed from a single or different angle. A major part of the causes you refer to above applies equally to Deloitte. Deloitte is a learning organization in this respect. In our experience, the consistent performance of causal analyses raises the depth of the analyses to a higher level and answers the "why question" more and more profoundly, leading to more insight into the reasons for issues such as the insufficient application of COS standards, audit procedures being performed on autopilot, blind reliance on internal controls, insufficient communication and agreement with IT specialists, and/or critical review processes of procedures performed insufficiently. We have thus gained an understanding as to why the intrinsic motivation to provide the very best quality should be reinforced. One of the ways to achieve this is to have an open and critical mindset to anticipate social developments and their impact on the audit environment and/or audit procedures. This is why we work hard to strengthen our knowledge of the standard, increase partner involvement, and tighten the organization and management of the audit teams. The increase in partner involvement on engagements will also decrease the leverage.

The causal analyses also form continuous input for the recalibration of the AQMP and/or an increase in specific initiatives. On the back of causal analyses and our continuous monitoring of the results of the quality initiatives started, the Executive Board and the RvC requested an accelerated implementation of the AQMP in 2013. New components were added, too, such as structurally performing "impact reviews" for each of the quality initiatives in order to establish whether Deloitte effectively achieves the intended objective with the quality initiative used. Moreover, Deloitte will significantly increase capacity to shorten the lead time of the "newly styled" internal reviews considerably. This should result in an accelerated alignment of the entire organization to a consistent policy in terms of the quality standard we strive for.

**Deloitte is working on a continuous learning experience for its staff and reinforcement of consistent audit quality**

One of the major components of the strategic plan of the audit practice regards the development of our talent. Deloitte started a new training programme this year, which is based on a continuous learning experience and which places 'training on the job' at its heart. This approach requires stronger partner involvement with the audit team during the year, which will improve the team work.

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Early partner involvement should ensure a higher audit quality. With our Audit Quality Milestones, we monitor the involvement of our partners and directors during the year and report the results to our partners and directors through dashboards. Another objective of the AQMP is a structural increase of the hours partners/directors spend on statutory audits.

Deloitte believes the consistency in planning our procedures should be adjusted, too. The current planning of our procedures still focuses too much on an individual model – depending on the auditor, there is a large degree of mutual inconsistency. Innovation will follow a two-track policy: the technical development of the audit approach and the uniformity of the delivery model will receive equal attention. Deloitte has launched an initiative called “distinctive audit”. Its objective is standardization without losing sight of a client’s uniqueness. Two work flows have been started. The first one focuses on process optimization based on a change of cultural and behavioural components, while the second one concerns the increase of quality through more consistent work processes. Please refer to page 24 of the Transparency Report FY14 for more information about this initiative.

**Proper tone at the top: open and honest communication with staff**

A dialogue with our staff – about our ambition, the results realized, which processes are on the right track, what may and should be improved – is an essential component of the quality agenda. The CEO and the Function Leader Audit frequently use different channels to communicate the efforts taken and the results achieved. Deloitte has introduced a “Young Professional Audit Quality Board” to ensure that staff participate actively in a continuous quality debate. Staff are also asked regularly through surveys to provide their views on our quality. The organization is very transparent in sharing these results, too.

**The AFM fully contributes to attaining our ambition for quality**

Finally, your findings on our files and your vision of our quality control system are critical input for us in attaining our ambition for quality. This is why we value the open dialogue with you highly. Deloitte searches structurally and intensively for methods to improve our quality and to realize our ambition for quality. Our international organization supports us in this and has put in place a Global Audit Quality Board to that end. Deloitte Netherlands forms a part of this, and we support and implement its initiatives. We may not be there yet, but we are convinced the implemented quality measures we have described will take us a long way towards reaching our destination. Please also refer to our Transparency Report FY14. We trust the AFM will take note of Deloitte’s various efforts in this respect when finalizing its inspection.

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We gladly invite our stakeholders to discuss our audit quality in more detail.

Kind regards,

Deloitte Accountants B.V.

M.J. van der Vegte

## 6.3 Ernst & Young Accountants LLP (EY)

### 6.3.1 Background information

Certain features and key figures for EY are shown in the table below.<sup>61</sup>

1.	Number of policymakers and co-policymakers	15
2.	Number of external auditors	140
3.	Total number of employees	1,993
4.	Number of statutory audits of PIEs	182
5.	Number of statutory audits of non-PIEs	2,458
6.	Total fees charged to audit clients	€331 million
7.	Total revenue Ernst & Young Accountants LLP	€402 million
8.	Total revenue Ernst & Young Nederland LLP	€673 million (43% assurance services, 35% tax services and 22% consultancy services)

In its inspection, the AFM assessed elements of the following statutory audits:

Audit client	AFM assessment as 'inadequate'	Type of company	PIE	EQCR	Internal quality review
A	No	PIE	Yes	Yes	No
B	Yes	PIE	Yes	Yes	Yes
C	No	PIE	Yes	Yes	No
D	No	Health insurer	Yes	Yes	Yes
E	No	Pension fund	No	No	No
F	Yes	Public or semi-public organisation	No	Yes	No
G	Yes	Large non-PIE	No	Yes	No
H	No	Other non-PIE	No	No	No
I	No	Other non-PIE	No	No	No
J	No	Other non-PIE	No	No	No

<sup>61</sup> The information in lines 1-2 is taken from the registers of the AFM. The information in lines 3-7 is taken from the AFM Monitor of Audit Firms 2013, for which EY provided information to the AFM on its most recent completed financial year, which was the financial year that closed on 30 June 2013. The information in line 8 is taken from the 2012/2013 financial statements of Ernst & Young Nederland LLP.

### 6.3.2 Conclusion

Based on its findings as described in section 6.3.3, the AFM concluded that the external auditor concerned failed to or failed to adequately comply with the professional standards with respect to important elements in the conduct of the statutory audit in three of the ten statutory audits it assessed. The measures that EY took to ensure the quality of statutory audits failed to prevent this. In these statutory audits, these external auditors failed to obtain sufficient appropriate audit evidence with respect to important and material items and issues in the financial statements. Their opinions with regard to these three financial statements as a whole are therefore not adequately substantiated. At the time he issued his auditor's report, the external auditor had not obtained sufficient appropriate audit evidence. This does not necessarily mean that the financial statements in question are incorrect. The AFM did not examine these financial statements for correctness and therefore passes no judgement on this aspect. As a result of the AFM's review, EY carried out root cause analyses which led to remediative work being carried out in some cases. In the assessment of EY, this showed that the content of the auditor's reports was correct.

### 6.3.3 Findings with respect to statutory audits

#### Audit client B

Audit client B is a company that sells products. B uses foreign service organisations that provide order processing, inventory management, invoicing and debtor management services.

The external auditor did not obtain sufficient appropriate audit evidence regarding the completeness of B's revenue or the existence and valuation of the inventory.

#### *Completeness of revenue*

The external auditor had planned to use a combination of tests of controls and substantive procedures in order to audit the volume of product sales and the sale prices used. These procedures consisted mainly of the use of the ISAE 3402 reports of the auditors of the service organisations, establishing the effective operation of the internal controls at B, the conduct of a balancing check (movement of goods) and substantive analytical review procedures. The procedures were, however, not carried out adequately with respect to relevant elements, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Establish the effective operation of the relevant internal controls in the sales process at the service organisations and at B itself. He did not carry out adequate procedures for this purpose;
- Conduct an appropriate balancing check (movement of goods) to establish that the revenue was complete.

- o The movement of goods prepared by B gives the *expected revenue*. The *expected* revenue is, however, largely based on the same information as the *recognised* revenue in the financial administration and therefore the *expected revenue* does not provide the audit evidence intended by the external auditor for the balancing check;
- o Assess the correctness of the number of destroyed products or establish that the instructions to destroy products were given by an authorised person and whether the reported number of products destroyed reconciles with the underlying destruction documentation;
- In the substantive analytical review procedures of the margin per product:
  - o Select sufficient products for analysis;
  - o Develop an expectation of the margin for each product;
  - o Determine how great a difference may be while remaining acceptable without further investigation; and
  - o Investigate explanations by B for identified differences in greater depth;
- Conduct adequate substantive analytical review procedures of discounts granted, in addition to the comparison of discounts in the current financial year with discounts in the previous financial year, for instance by assessing underlying agreements or assessing authorisations for the granting of discounts by authorised persons.

#### *Existence and valuation of inventory*

The external auditor had planned to carry out a combination of tests of controls and substantive procedures in order to audit the existence of the inventory by establishing the effective operation of the only internal control measure and assessing stock counts as at the balance sheet date. The procedures were, however, not carried out adequately with respect to relevant elements, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Establish that the internal control measure was operating effectively. The external auditor for example did not actually test the internal control measure, he carried out a form of substantive testing.
- Establish that the information on stock counts received from B had been correctly processed in the inventory administration and investigate the explanations received from B with respect to stock differences in greater detail.

The external auditor had planned to carry out substantive procedures to audit the valuation of the inventory by assessing the principles used by B for the valuation of the capitalised costs of production and the provision for obsolete stock. The estimated sales pattern for each product segment is important for the determination of the valuation. The external auditor, however, failed to carry out audit procedures with respect to the sales pattern and the distribution across product segments.

## Audit Client F

Audit client F is a large municipality.

The external auditor did not obtain sufficient appropriate audit evidence regarding the correctness of F's tender process or the valuation of its land developments.

### *Correctness of tender procedure*

The external auditor planned to audit that F's procurement transactions had been conducted correctly in accordance with the European tender directives using substantive procedures. These procedures consisted mainly of test of details of procurement orders for which employees in F's internal audit department were instructed by the external auditor to check, using source documentation, whether the selected procurement orders were lawful. The procedures of the external auditor were, however, not carried out adequately in certain relevant respects, and the external auditor thus was not able to obtain sufficient appropriate audit evidence.

The external auditor in fact failed to do the following:

- Conduct audit procedures to establish the reliability of the statement of all the procurement transactions received from F, for example by reconciling this with the financial administration;
- Conduct audit procedures regarding the lawfulness of procurement transactions occurring in the period between the date of the overview and the balance sheet date;
- Carry out appropriate audit procedures to establish that the procedures of F's internal audit department were adequate for his purposes. In fact he did not:
  - o Repeat the procedures of F's internal audit department ('re-performance'), carry out similar procedures or observe the performance of procedures by the internal audit department;
  - o Assess the performance of the procedural programmes by the internal audit department in adequate depth;
  - o Ask additional questions with regard to the unusual items he identified arising from the procedures carried out by F's internal audit department.

### *Valuation of land developments*

The external auditor had planned to use a combination of tests of controls and substantive procedures in order to audit the valuation of land developments. Land in development is measured at previously incurred cost and realised proceeds, with expected future costs and proceeds. The procedures consisted mainly of the use of the procedures of F's internal audit department to establish that the recognised internal controls were operating effectively. The external auditor had also planned to use the services of a valuation expert from the EY network for the assessment of the feasibility of certain assumptions in the calculation of the valuation of selected land

developments. The procedures of the external auditor were, however, not carried out adequately in certain relevant respects, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Adequately evaluate the procedures of F's internal audit department and carry out audit procedures to determine whether the procedures of the internal audit department were adequate for the external auditor's purposes;
- Carry out audit procedures to assess the relevance and feasibility of the findings and conclusions in the report of the valuation expert;
- Carry out audit procedures for one selected land development in order to establish the correctness of the revised operating estimate whereby the expected shortfall was significantly reduced;
- Carry out adequate audit procedures with respect to specific elements of the valuation of the land development. The external auditor in fact failed to do the following:
  - o Reconcile the total recognised value of the land developments with F's project administration in which the land costs and proceeds are reported;
  - o Carry out adequate audit procedures on expected future costs, for instance by conducting detailed checks of plans or pre-calculations by contractors;
  - o Conduct adequate audit procedures with respect to expected future proceeds (including the estimated proceeds per residential unit), for instance by carrying out detailed checks of relationships with pre-calculations, market research reports and the municipal policy document on land prices.

## **Audit client G**

Audit client G is a company which develops, produces and sells products.

The external auditor did not obtain sufficient appropriate audit evidence regarding the correctness and completeness of G's revenue from product sales, nor regarding the existence and valuation of the trade debtors and the existence of the product inventory.

### *Correctness and completeness of revenue*

The external auditor had planned to use a combination of tests of controls and substantive procedures in order to audit the revenue from product sales. These procedures consisted mainly of establishing the effective operation of internal controls at G, carrying out substantive analytical review procedures and procedures with respect to the correct application of the criteria for processing of revenue and establishing the correct cut-off of the revenue. The conduct of the tests of control

and the substantive procedures with respect to relevant elements was, however, inadequate, meaning that the external auditor could not obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Obtain an understanding regarding the design of the relevant internal controls and establish that the internal controls were operating effectively. The external auditor for instance failed to establish the actions the employees concerned had to take in order to ensure that these internal controls would be carried out adequately. He also did not establish whether the overviews used by G in the application of the internal controls were accurate and complete. In addition, he failed to carry out the number of tests prescribed in EY's methodology;
- Conduct substantive analytical review procedures in adequate depth, by formulating expectations in advance and performing more than a general analysis of the revenue and margin per product group;
- Establish that G has applied the criteria for the processing of the revenue from product sales correctly and applied the correct cut-off of the inventory;
- Request an adequate number of confirmations from product purchasers in order to establish that no 'side agreements' had been made.

#### *Existence and valuation of trade debtors*

The external auditor had planned to use a combination of tests of controls and substantive procedures in order to audit the existence and valuation of trade debtors. These procedures consisted mainly of establishing that G's internal controls were operating effectively, conducting substantive analytical review procedures, sending requests for confirmation, carrying out a payment verification and assessing the provision for irrecoverable debts. The procedures were, however, not carried out adequately with respect to relevant elements, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Conduct substantive analytical review procedures in adequate depth by formulating expectations in advance and performing more than a general analysis of the total debtor position per country compared to the previous year;
- Request an adequate number of confirmations from debtors and carry out a payment verification in order to establish that the debtors had paid their invoices;
- Conduct adequate procedures to establish that the provision for irrecoverable debts was sufficient. The external auditor did not establish that he could use the overviews prepared by G with specifications of the age of the trade debtor items for the determination of the provision for irrecoverable debts.

#### *Existence of inventory*

The external auditor had planned to carry out substantive procedures to audit the existence of the product inventory. These procedures consisted mainly of

establishing that G's internal controls with respect to the existence of inventory were operating effectively. The procedures were, however, not carried out adequately with respect to relevant elements, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Establish that the interim stock counts as at 30 September 2012 were carried out by G's employees accurately and correctly, for instance by carrying out stock counts or recounts himself;
- Establish that the explanations provided by G for identified inventory differences were correct;
- Establish that all G's relevant group companies had followed the prescribed stock counting procedures and had reported these correctly;
- In addition to the substantive procedures for the existence of the inventory as at 30 September 2012, carry out adequate audit procedures on the period between 30 September 2012 and the balance sheet date.

### 6.3.4 Response from EY



The Executive Board of Stichting Autoriteit Financiële Markten  
Attn Mr G.J. Everts  
Postbus 11723  
1001 GS Amsterdam

22 September 2014

Reference: MH/JH/130914

Dear Mr Everts,

On 4 September 2014, we received your report of preliminary conclusions and findings further to your regular 2013/2014 investigation. On 12 September 2014, we shared our written draft response to that report with you. On 19 September 2014, you shared the - embargoed - definitive report of the investigation with us. This letter contains our definitive response. Part of the investigation was conducted in the form of a "joint inspection", together with the US Public Company Accounting Oversight Board ("PCAOB"). We experienced the collaboration with the AFM's and the PCAOB's investigative teams as professional and constructive. We also appreciate being allowed the opportunity to respond to your report.

## **1 Serving the public interest by providing quality services**

We support the AFM's mission to promote fairness and efficiency within capital markets, contributing to that mission on the basis of our focus on quality. We make ongoing investments in that respect, analysing findings to learn from them. Our policies aim to fundamentally improve our audit quality. Together with the proper "tone at the top", this will result in the further reinforcement of the appropriate professional scepticism. We take the results of investigations such as yours very seriously, as they yield additional insights and supplementary measures to shore up our quality even further.

The Netherlands Authority for the Financial Markets (Autoriteit Financiële Markten, "AFM") has presented significant findings with respect to elements of three audits of financial statements for the 2012 reporting year. We agree with the AFM that this is not acceptable. We regret the results of the investigation, in part in view of the gamut of measures we have taken since your previous investigation that aim to fundamentally improve our audit quality. We communicated about this both in respect of the AFM and, through our Transparency Report, in respect of society. Our in-house international quality investigations show that the measures we took have resulted in improved quality. The results of your investigation also show that the measures were effective. The number of working papers in respect of which the AFM has presented findings has decreased compared with your previous investigation. Unfortunately, the AFM's findings with regard to the three sets of working papers make it clear that, despite our efforts, we have not yet achieved our goal.

Further to the AFM's preliminary findings with respect to the three sets of audit working papers, we immediately initiated remedies to follow up on those findings. The conclusion from those remedies is that the independent auditor's reports are now sufficiently justified and that this has not resulted in different independent auditor's reports. In addition, we adjusted certain elements of our quality system, with further adjustments to follow suit.

EY focuses attention on the public interest in an auditor's work. We derive our quality and relevance from the importance of our work for society. As policy-makers, we take the lead in creating a culture in which professionals put the public interest first in their conduct.

The provision of quality services is key to our firm. As we are a learning organisation, we will continue to invest in quality, in our people's training and in the further reinforcement of our audits, on the basis of innovation. We will not cease to pursue our long-term goal of providing the highest quality.

Since your previous investigation, we have taken many policy measures to fundamentally improve our audit quality. This is bearing fruit, but there is a lot more to be done. In our opinion, quality improvement is mainly a matter of cultural and behavioural changes. By definition, such changes cost time. Moreover, it is an ongoing process.

As we are a learning organisation, we will continue to invest in quality, in our people's training and in the further reinforcement of our audits, on the basis of innovation. Together with the proper, consistently sent "tone at the top", this will result in the further reinforcement of the appropriate professional scepticism. We take incidents and the results of investigations such as the AFM's very seriously, as they yield additional insights as well as supplementary measures to shore up our quality further. Where necessary, we imposed sanctions, buttressing the preconditions for the adequate performance of our external auditors, geared to compliance with the relevant laws, rules and regulations.

The (quality) measures taken and to be taken should be considered within the context of these views. The measures we have implemented or will implement pertain to the subjects referred to and prioritised by the AFM, i.e. shoring up governance, creating a quality-oriented culture, decisively sending the message of thinking in terms of quality in-house and increasing transparency in relation to quality.

Below, we address in more detail the measures we have implemented since your previous investigation, as well as the measures we have implemented or will implement, in part further to the investigation you have now completed.

## **2 Building blocks of our quality policies**

The building blocks of our policies aiming to embed the public interest into our organisation's culture and our professionals' conduct are as follows.

- 1 Culture and conduct focusing on the public interest
- 2 Governance structure with supervision by independent third parties
- 3 Remuneration structure in which quality is remunerated and a lack of quality is sanctioned
- 4 Active dialogue with stakeholders in society
- 5 Quality control focusing on compliance with the requirements laid down in laws, rules and regulations

Below, we list the policy measures for each building block that have already been taken or that will stay on top of our policy and implementation agenda, now and in the upcoming period.

### **2.1 Culture and conduct focusing on the public interest**

- After the AFM had notified us, at the end of 2009, of its findings regarding the regular 2009 investigation, we organised mandatory meetings for all external auditors at the beginning of 2010. We also set up a taskforce that translated the findings from the AFM's investigation into

15 quality initiatives, comprising mandatory training courses for Partners and employees, adjustments to our methodology and honed supervision.

- In 2011 and 2012, an extensive "culture change" programme was rolled out throughout the auditors' practice, which primarily aimed to create a culture in which our professionals could function with an optimal focus on quality. Over 30 project groups - consisting of Partners and employees - were set up, conducting in-depth discussions about root causes in relation to quality. This resulted in a range of actions and was experienced by our organisation as highly positive. The actions pertained to such themes as training courses, creating a culture of professional scepticism, feedback and coaching, leadership, remuneration, planning and our governance model. Those themes are evaluated annually and updated on the basis of social trends.
- In 2013, in addition to providing the regular training courses, we trained our professionals in the areas of public interest and professional scepticism, with the auditor's scepticism towards his or her own work occupying centre stage.
- In 2014, "public interest" and "say what you see" workshops are provided, in which a critical attitude and speaking one's mind are trained.
- In a changing world, audit firms and their audit teams must change along. Such a - cultural - change benefits from diversity in the organisation. Diversity in professional and personal backgrounds is beneficial to audit quality, and results in positive changes. These next few years, therefore, we will increase our firm's and our audit teams' diversity levels.
- This year, we will also introduce an entirely new coaching programme, based on the philosophy that a large part of our people's training is to take place on the shop floor in order to achieve the desirable culture and professional scepticism.

## **2.2 Governance structure with supervision by independent third parties**

- Since 1 July 2013, we have created a supervisory role at EY by setting up a Public Interest Committee, which consists of three independent, external members that oversee the public interest being safeguarded by EY. Last year, the Committee attended over 30 meetings with EY representatives and spoke with several external stakeholders (including the AFM), as well as initiating consultations with other firms' committees. We involved the Committee in important matters, including remuneration, quality investigations, incidents, the ban on advisory services, the issue of rotation, guaranteeing quality and other policy matters. We experience our Committee's professional scepticism and its professional judgement regarding our position on public interest as important input for the preparation of our policies.
- Our international governance structure also makes a positive contribution to the checks and balances in our national structure. In the latter structure, the Dutch Partners have transferred their voting rights to Ernst & Young Europe LLP, which appoints and assesses the Dutch executives, as well as determining their remuneration. As a result, the influence the Dutch Partners have on the Dutch executives' actions is limited. Our governance is set out in further detail in our Transparency Report.

We will integrate the strength of our current checks and balances, as well as external supervision, when implementing the expected - statutory - changes in governance.

### **2.3 Remuneration structure in which quality is remunerated and a lack of quality is sanctioned**

- These past few years, we considerably refined our quality reviews of each external auditor, primarily to be able to review quality in a more objective and positive way. Our external auditors' performance is evaluated along 13 different quality dimensions, which results in a quality review that is, eventually, leading in the external auditor's overall assessment. Use is made during this process of input from several departments, including our Professional Practice Group, our Compliance Office and our Independence Desk. Both a positive and a negative outcome weighs heavily in an external auditor's overall assessment, and in his or her remuneration.
- To influence our professionals' conduct positively and to encourage them to put quality first in their day-to-day work, we have adjusted our assessment and remuneration system for Partners and Executive Directors. Since 2010, we have applied sanction policies pursuant to which any shortcomings identified in quality lead to a potentially significant income adjustment. A Partner or Executive Director whose score in relation to individual working papers is insufficient or mediocre must account for that score to the policy-makers and will be sanctioned. Potential sanctions include a standard-transferring conversation, a low Quality rating and a significant downward adjustment to the Partner's or Executive Director's remuneration. To record matters and monitor any recurrence, a note is made in the auditor's file. Our Compliance Office conducts extended investigations to establish, within a broader context, whether the quality of the work performed by the external auditor in question satisfies the requirements. The results of those extended investigations are also considered.
- These past four years, we remunerated or sanctioned dozens of external auditors. We - prematurely - let go of a number of external auditors. EY gives quality priority over anything else. The realisation that a commercial achievement can never compensate for a quality defect is quite clear and is broadly understood in our organisation. We also focus attention on "People" in our assessment policies, because we find the creation of the proper culture, focusing on the public interest, very important. Again, if an external auditor scores insufficiently in the areas of Quality or People, he or she will not be eligible for variable remuneration.
- We believe that not only sanctions, but specifically also positive incentives should be incorporated. We explicitly included measures in our quality policies with that in mind, such as annually celebrating three external auditors - and their teams - that distinguished themselves the most in the area of Quality. They will receive a prize, and messages are published about the event firm-wide.
- We will continue to put quality first in our assessment and remuneration system, in order to further the quality of our professionals' work in a positive way.

### **2.4 Active dialogue with stakeholders in society**

- Last year, we intensified the stakeholder dialogue on the basis of the theme of "EY talks with society". We organised over 10 "roundtables"/meetings with non-executive directors, supervisors, analysts, institutional and other investors, executive directors, academics and

politicians, to talk about the expectations as to an auditor's performance and communications, among other subjects. We also organised roundtables with stakeholders in specific sectors, including the financial and healthcare sectors. In addition, we conducted a series of dialogues with representatives of the AFM, the Dutch central bank (*De Nederlandsche Bank*, "DNB"), Dutch Ministries, employers, securities-issuing organisations, the Netherlands Institute of Chartered Accountants (*Nederlandse Beroepsorganisatie van Accountants*, "NBA") and the Dutch Association of Tax Advisers (*Nederlandse Orde van Belastingadviseurs*, "NOB").

- Some of those roundtables dealt with the subject of "auditor and risk management". On that basis, and with the public interest in mind, we published a white paper entitled "Who had seen this coming?". Its core message is that the trust society places in the auditor's role will grow as auditors can demonstrate more often in specific cases that they carried out their work on a professional, independent and critical basis. Any non-realistic expectations prevalent in society regarding the assurance auditors can offer must be explicitly mentioned and removed. Only realistic and justified trust will last.
- We play an active role during general shareholders' meetings of listed corporations, presenting the results of our audits. We received positive responses from executive and non-executive directors and shareholders alike.
- As we truly advocate a more informative independent auditor's report, we will start issuing the new, more extensive independent auditor's reports to all the Public Interest Entities ("PIEs") we audit and to a number of our public-sector clients with effect from the 2014 financial year.

## **2.5 Quality control focusing on compliance with laws, rules and regulations**

### ***Investing in innovation***

- This upcoming year, a new audit tool will be introduced in our audit practice, which has been developed by our international EY organisation and will be implemented globally at all of our EY member firms. We expect this new, state-of-the-art audit tool to result in the further improvement of our audits. Locally, we will make supplementary investments with regard to the performance of audits, on the basis of, among other things, training courses, greater use of our sector knowledge, and standardisation of methods and their documentation. Simultaneously with the tool's introduction, our people's attitude and conduct will be invested in and managed even more emphatically.

### ***Portfolio analyses and planning***

- During the summer of 2013, we started analysing the portfolios of each Partner and Executive Director in more detail. Further to the AFM's investigation, these analyses will be accelerated, intensified and broadened. This will relate not only to portfolio size, but also to the involved auditors' available time and required expertise. A number of sectors are already characterised by a high level of specialisation. Where this is as yet insufficiently the case, this trend will be continued. When needed, the number of professionals will be expanded, which may also involve their background or expertise. We wish to use our in-house professionals' expertise even better. In this respect, diversity will help improve quality further.
- This year, we will further professionalise our planning, in order to better distribute our people's talents to our clients, thus providing higher quality.

#### **Honing our organisation's quality control system**

- Findings of the AFM, from our in-house quality investigations and of our Compliance Office are translated into concrete Quality actions, such as feeding back the lessons learned through training courses, honing guidelines and procedures, and developing templates for fee earners.
- This autumn, we will further analyse and hone our procedures with regard to independent quality reviews and in-house quality investigations, in part further to the results of the AFM's investigation.
- These past years, we invested in quality within sectors. Regional quality partners were appointed. Furthermore, several consultation panels were set up at a central level, such as the Going-Concern Panel, the Fraud Panel, the Errors Panel and the Land Commercialisation Panel, to support our professionals. This year, we have added the VIO Consultation Panel, to support our fee earners during the further introduction and embedding of the Regulation on the Independence of Auditors Working on Assurance Engagements (*Verordening inzake de onafhankelijkheid van accountants bij assurance-opdrachten*, "VIO"), which took effect this year.

#### **Concluding comments**

We see that the measures we have taken are effective. In combination with the measures taken and intended to be taken, in part on the basis of your recent inspection, this will contribute to a further quality improvement. We are positive about the proposals drawn up by the Task Force on the future of the Audit Profession (*Werkgroep toekomst accountantsberoep*). The measures proposed in the report, as well as our own measures, will be implemented and make a positive contribution to quality assurance and audit independence.

In sum, all our actions and best efforts aim to buttress the preconditions for the adequate performance of our external auditors.

Quality improvement will stay on top of our agenda during the upcoming years as well. We realise that the proper "tone at the top", plus the associated conduct and culture, constitutes the foundation for fundamental quality improvement and preservation. Measures will only be effective on a lasting basis if our professionals are open to them and act upon them. Therefore, our quality measures focus, in particular, on changing our organisational culture and our people's conduct. We aspire to be a learning organisation that adds value to society and enjoys its trust.

We trust that, with the above, we have demonstrated that we are committed to further improving our audit quality, not only in the short term, but also in the long term, fundamentally focusing attention on the public interest in our work.



Finally, please allow us to thank you for your professional scepticism and, at the same time, your constructive input during the course of this investigation.

Obviously, we are willing to explain matters further or to discuss things with you.

Yours sincerely,  
Ernst & Young Auditors LLP

J. Hetebrij

M. Hagers

## 6.4 KPMG Accountants N.V. (KPMG)

### 6.4.1 Background information

Certain features and key figures for KPMG are shown in the table below.<sup>62</sup>

1.	Number of policymakers and co-policymakers	15
2.	Number of external auditors	142
3.	Total number of employees	1,726
4.	Number of statutory audits of PIEs	278
5.	Number of statutory audits of non-PIEs	2,225
6.	Total fees charged to audit clients	€209 million
7.	Total revenue of KPMG Accountants B.V.	€399 million
8.	Total revenue of KPMG N.V.	€613 million (42% assurance services, 24% tax services and 34% other consultancy services)

In its inspection, the AFM assessed elements of the following statutory audits:

Audit client	AFM assessment as 'inadequate'	Type of company	PIE	EQCR	Internal quality review
A	No	PIE	Yes	Yes	No
B	Yes	PIE	Yes	Yes	Yes
C	Yes	PIE	Yes	Yes	No
D	No	Health insurer	Yes	Yes	No
E	Yes	Pension fund	No	No	No
F	Yes	Public or semi-public organisation	No	No	No
G	Yes	Large non-PIE	No	No	No
H	Yes	Other non-PIE	No	No	No
I	Yes	Other non-PIE	No	No	No
J	No	Other non-PIE	No	No	Yes

<sup>62</sup> The information in lines 1-2 is taken from the registers of the AFM. The information in lines 3-7 is taken from the AFM Monitor of Audit Firms 2013, for which KPMG provided information to the AFM on its most recent completed financial year, which was the financial year that closed on 30 September 2013. The information in line 8 is taken from the 2012/2013 financial statements of KPMG B.V.

#### 6.4.2 Conclusion

Based on its findings as described in section 6.4.3, the AFM concluded that the external auditor concerned failed to or failed to adequately comply with the professional standards in the conduct of the statutory audit in seven of the ten statutory audits it assessed. The measures that KPMG took to ensure the quality of statutory audits failed to prevent this. In these statutory audits, these external auditors failed to obtain sufficient appropriate audit evidence with respect to important and material items and issues in the financial statements. Their opinions with regard to these seven financial statements as a whole are therefore not adequately substantiated. At the time he issued his auditor's report, the external auditor had not obtained sufficient appropriate audit evidence. This does not necessarily mean that the financial statements in question are incorrect. The AFM did not examine these financial statements for correctness and therefore passes no judgement on this aspect. KPMG has carried out root cause analyses as a result of the inspections by the AFM. KPMG has examined whether remediative procedures are needed and then carried out these procedures. KPMG concluded that the previously issued auditor's reports did not require amendment.

#### 6.4.3 Findings with respect to statutory audits

##### Audit client B

Audit client B is a service provider. The external auditor included IT specialists in the audit team due to the importance and complexity of the automated data processing environment. The external auditor used experts in the audit of the valuation of the goodwill.

The external auditor did not obtain sufficient appropriate audit evidence regarding the completeness of the revenue and the valuation of the goodwill.

##### *Completeness of revenue*

The external auditor had planned to carry out substantive procedures to audit the completeness of the revenue. These procedures consisted mainly of assessing the movement of goods in the form of packaging materials prepared by B and substantive analytical review procedures. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Carry out audit procedures on disruptions in the movement of goods (usage by foreign branches), test the internal standard used for the usage of ancillary materials and test the procurement for completeness;
- Carry out substantive analytical review procedures in adequate depth by formulating expectations in advance and investigating unusual items arising from substantive analytical review procedures.

### *Valuation of goodwill*

The external auditor had planned to carry out substantive procedures to audit the valuation of the goodwill. An impairment had been recognised on the goodwill. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Assess the reasonableness of the assumptions on which the impairment recognition was based. The external auditor did not assess the preparation of the budget and tested the estimated income and expenditure against market developments and the actual figures.

### **Audit client C**

Audit client C is a financial holding company for a company operating outside the Netherlands. Some of C's business operations take place in countries with particular risks. C's business activities and the financial and operational management, including the preparation of the consolidated financial statements, mainly take place abroad. The external auditor used the procedures of another foreign auditor, who had also used procedures carried out by other auditors.

The external auditor did not design the audit appropriately. The external auditor also failed to adequately evaluate whether the procedures carried out by the auditors of components constituted sufficient appropriate audit evidence.

### *Design of the audit*

The external auditor did not design the audit appropriately because he did not determine the procedures that the other auditor had to perform. In his instructions, he failed to include a description of the procedures he expected to be carried out. Moreover, the external auditor did not obtain an understanding with respect to the business processes of the various divisions of the company and the associated risks (of fraud, for instance) for the financial statements and the internal controls.

### *Evaluation of audit evidence*

The external auditor carried out a review at the other auditor and took note of the reports of this other auditor. He also took note of certain reports from other auditors on which these reports were based. However, the external auditor failed to follow up on the unusual items that he himself had noted in his review regarding several items in the statement of financial position and as stated by the other auditors in their reports. The reports from the other auditors also contain indications that they may not have obtained sufficient appropriate audit evidence regarding important and material items in the financial statements. The external auditor did not recognise these indications or did not follow them up adequately, even though he had identified significant risks with regard to these items.

## Audit client E

Audit client E is a pension fund.

The external auditor failed to obtain sufficient appropriate audit evidence regarding the correctness and completeness of E's technical provision for pension liabilities and the valuation of the unlisted investments held by the pension fund.

### *Correctness and completeness of the technical provision for pension liabilities*

The external auditor had planned to carry out a combination of tests of controls and substantive procedures with respect to the correctness and completeness of the base data used to calculate the provision. These procedures consisted mainly of establishing the effective operation of internal controls, a reconciliation with the payroll summaries of the affiliated employers, a data analysis and substantive analytical review procedures. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Establish that the automated data processing systems were reliable, even though he used information from these systems for his audit;
- Establish that the internal controls were operating effectively;
- Follow up on the unusual items he noted himself in his data analysis regarding the pension entitlements. For instance, he did not assess the effect of the identified differences on the technical provision for pension liabilities, and he failed to aggregate the differences and then evaluate them with respect to planning materiality;
- Carry out procedures with respect to the non-manual changes to the base data, such as new employees;
- Reconcile the payroll summaries of the affiliated employers, although he had planned to do this;
- Adequately investigate the root cause of the differences arising from substantive analytical review procedures.

### *Valuation of the unlisted investments held by the pension fund*

The external auditor had planned to carry out a combination of tests of controls and substantive procedures. These procedures consisted mainly of establishing that the internal controls relating to the processing of investment transactions were operating effectively, reconciling the value of each investment with the financial statements of the investment funds in question and evaluating this information for unusual items. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Obtain an understanding regarding the design of the relevant internal controls and establish that the internal controls were operating effectively. Two of the three internal controls identified by the external auditor did not relate to the correct and complete recording of investment transactions. The

external auditor also did not actually test the internal control measure, he carried out a form of detailed audit;

- Establish the extent of E's participation in the investment fund when reconciling the valuation of each investment with the financial statements of the investment funds concerned, or establish whether the conversion rate (if applicable) was correct, test the substantiation of the valuation at year-end if the investment fund's financial year does not coincide with the calendar year, and test the net asset value on which the valuation was based;
- Use criteria as the basis for his assessment of the financial statements of the investment funds, evaluate the effect on the valuation in the event that the accounting policies of the investment funds differ from E's accounting policies and follow up on non-standard auditor's reports attached to the financial statements of some of the investment funds concerned;
- Carry out audit procedures for a significant proportion of the unlisted investments held by the pension fund.

#### **Audit Client F**

Audit client F is a company involved in waste collection and treatment.

The external auditor failed to obtain sufficient appropriate audit evidence regarding the correctness and completeness of the revenue, the valuation of the provisions and the valuation of the investments, as well as with respect to the presentation and disclosure of the investments in the financial statements.

##### *Correctness and completeness of revenue*

The external auditor had planned to use a combination of tests of controls and substantive procedures in order to audit the revenue. These procedures consisted mainly of establishing that the internal controls operated effectively and detailed tests of the transactions leading to revenue recognition, an audit of the prices and an audit of the revenue cut-off. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Establish that the automated data processing systems were reliable, even though he used information from these systems for his audit;
- Obtain an understanding regarding the design of the relevant internal controls and establish that the internal controls were operating effectively. The external auditor concluded that he could not rely on the internal controls relating to prices. The external auditor for instance did not establish whether the other internal controls could respond to the significant risks with respect to the revenue;
- Evaluate that his detailed tests of the transactions only involved checking the sequential numbering of the transactions, but did not establish that the transactions were fully reported;

- Carry out adequate detailed tests to establish that transactions were correctly processed in the accounts;
- Adequately investigate the causes of various differences in the price analysis carried out by F, for instance by reconciling reported prices with contracts;
- Establish whether the revenue had been correctly allocated to the services provided by F and thus to the correct financial year.

#### *Valuation of provisions*

The external auditor had planned to carry out substantive procedures to audit the provisions. These procedures consisted mainly of evaluating the starting points and variables on which the calculation of the provisions was based. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Assess the assumptions and variables in the calculation of the provisions; The external auditor only took note of the minutes of the management and those charged with governance, he did not assess the technical information and price developments applied in the calculation;
- Establish that the method used to calculate the provisions is permissible under the system of financial reporting.

#### *Valuation, presentation and explanation of investments*

The external auditor had planned to carry out substantive procedures to audit the investments. These procedures consisted mainly of reconciling the valuation of the investments with statements from third parties. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Establish the authenticity of the statements from third parties;
- Evaluate the method used in the valuation, and whether this method is permissible under the system of financial reporting;
- Establish that the presentation and explanation of the investments is permissible under the system of financial reporting.

### **Audit client G**

Audit client G is a company engaged in the trading in and supply of gas and electricity. G uses a service organisation (usage registration, invoicing and collection) which is also the energy supplier.

The external auditor did not obtain sufficient appropriate audit evidence regarding the correctness and completeness of the revenue, the correctness and completeness of the accrued expenses and deferred income, the correctness and the valuation of the intangible non-current assets and the existence of the cash item. The external

auditor included IT specialists in the audit team due to the importance and complexity of the automated data processing environment.

#### *Correctness and completeness of revenue*

The external auditor had planned to carry out mainly substantive procedures to audit the revenue. These procedures consisted mainly of audit procedures with respect to the estimates in the revenue, the number of relationships and the prices. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Establish that the source data from the service data was reliable by for example using an ISAE 3402 report or by carrying out adequate other procedures;
- Check adequately that the estimates that accounted for approximately 50 per cent of the recognised revenue were realistic. For instance, the external auditor did not include settlements in the new financial year in his audit, although these payments were based on actual use;
- Check that the number of connections in G's administration corresponded with the number of relationships in the service organisation's administration. The service organisation registers the invoicing and the usage;
- Follow up on the differences arising from the audit of the prices and analysing them.

#### *Correctness and completeness of accrued expenses and deferred income*

The external auditor had planned to carry out substantive procedures to audit the accrued expenses and deferred income. The amount of this item concerned the balance of the flows of invoiced instalments less supplies not yet invoiced, together accounting for approximately 80 per cent of the revenue. The procedures consisted mainly of a comparison of the amount of the accrued expenses and deferred income compared to the previous financial year. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor actually failed to analyse the balance, failed to adequately investigate the root cause for the significant increase between the two financial years and failed to carry out a review of after-date transactions.

#### *Correctness and valuation of the intangible non-current assets*

The external auditor had planned to carry out mainly substantive procedures to audit the correctness and the valuation of the intangible non-current assets. These procedures consisted mainly of audit procedures in relation to the correctness of capitalised expenses and an evaluation of the amortisation term. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Establish that the capitalised expenses were correct by means of audit evidence obtained from third parties;
- Follow up on his finding that a material proportion of the capitalised expenses did not meet the criterion for capitalisation;
- Assess the reasonableness of the assumptions used by G with respect to the amortisation.

#### *Existence of the cash item*

The external auditor had planned to carry out substantive procedures to audit the existence of the cash balance. Cash accounted for approximately 50 per cent of the total balance sheet. The procedures consisted mainly of a reconciliation of the cash balance on a print screen from the 'electronic banking system' and obtaining a standard bank confirmation. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Establish that the print screen from the electronic banking system was authentic;
- Obtain the standard bank confirmation for a material sum that was held in G's name but for which power of disposal was held by the service organisation;
- Adequately investigate the root cause of the significant increase in the cash item.

#### **Audit client H**

Audit client H is a company which develops, produces and sells products.

The external auditor did not obtain sufficient appropriate audit evidence regarding the correctness and completeness of H's revenue and the related items in the balance sheet. Moreover, the external auditor failed to obtain sufficient appropriate audit evidence regarding the existence and valuation of the trade receivables.

#### *Correctness and completeness of revenue*

The external auditor had planned to carry out a combination of tests of controls and substantive procedures. These procedures consisted mainly of establishing that the internal controls were operating effectively and that the method used for revenue recognition was permissible under the system of financial reporting. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Obtain information regarding the design of the relevant internal controls and establish that the internal controls were operating effectively. For instance, the external auditor did not establish whether the internal control measure could cover the risk of expenses and material costs not being attributed to

the correct project. The external auditor also failed to establish that the hours reported were authorised by project managers;

- Carry out adequate procedures to establish whether the methodology for processing income and expenditure was in accordance with the system of financial reporting. The external auditor for instance did not establish whether the summary statements prepared by H were reliable, whether costs were attributed to the right projects, whether the income values according to the internal administration tallied with the contract, whether a reliable estimate was made of the progress of the projects and the costs yet to be incurred as at balance sheet date, and whether the conditions for interim profit recognition had been met;
- Carry out procedures for the other income.

#### *Existence and valuation of trade receivables*

The external auditor had planned to carry out substantive procedures. The procedures conducted mainly consisted of a verification of origin and an evaluation of the provision for irrecoverable debts. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- To make a connection with the supply in the verification of origin. The external auditor did establish that the invoice amount stated in the administration corresponded with the invoice. He did not, however, establish whether the receivables were based on actual performance;
- In the assessment of the provision for irrecoverable debts, test whether H's explanations regarding the exceeding of the payment term were correct;
- Carry out procedures on the balance of sums not yet invoiced under the trade receivables;
- For one specific debtor, to establish that the significant receivable on this debtor less the provision for doubtful debts existed and was correctly measured, given the uncertainties regarding the existence and valuation mentioned in the audit file from the previous financial year.

#### **Audit client I**

Audit client I is a company which produces and sells products.

The external auditor did not obtain sufficient appropriate audit evidence regarding the completeness of I's revenue and the correctness of the deferred tax asset and its write-off.

#### *Completeness of revenue*

The external auditor had planned to carry out a combination of tests of controls and substantive procedures. The procedures consisted mainly of establishing that the internal controls in relation to the correctness of the revenue were operating

effectively and assessing the movement of goods prepared by I, including reconciliation with the invoiced revenue, an analysis of the sale prices and an audit of the revenue cut-off. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Establish that the internal controls were operating effectively. The external auditor did not carry out any procedures with respect to the internal controls on which he relied;
- Carry out procedures on the various components in the balancing check regarding the movement of goods. He did not therefore carry out any procedures with respect to the completeness of the procurement and he failed to adequately follow up on the inventory differences identified in the inventory count at year-end.

*Correctness of the deferred tax asset and its write-off*

The external auditor had not planned to carry out substantive procedures. The external auditor in fact failed to do the following:

- Evaluate the write-off of the deferred tax asset;
- Establish that the failure to form a deferred tax asset, although there was a balance of carry-over losses at I, was in accordance with the system of financial reporting.

#### 6.4.4 Response from KPMG



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Netherlands Authority  
for the Financial Markets (AFM)  
Attn: Mr. drs. G.J. Everts RA  
P.O. Box 11723  
1001 GS AMSTERDAM

Our ref: MH/MH/JF/GK

Amstelveen, 22 September 2014

#### **Response of KPMG Accountants N.V. to the public report of the AFM regarding the quality of statutory legal audits by Big Four audit firms**

Dear Mr. Everts,

We thank you for the opportunity to respond to your public report regarding the results of your investigation into the quality of the statutory legal audits.

#### **Introduction**

The accountancy profession is at a turning point in its history. One in which KPMG has traditionally significantly contributed to, through innovations in the field of professional conduct, codification of auditing standards and the anticipation of new developments at clients and in society as a whole. That contribution was done in the spirit of the principles on which Piet Klijneveld founded his business: delivery of high quality work by highly qualified professionals.

We acknowledge and support the signal being given through the findings by the AFM: to further improve the quality of our audits as precursor for regaining public trust. It is our sincere ambition to once again be the standard in the Dutch accountancy profession.

#### **Follow-up on individual findings**

We have followed up on the findings at individual audit file level. We have performed additional audit work and made the necessary adjustments, while taking into account our professional standards in this field. The responsible auditors have evaluated the impact of the additional audit evidence and findings on the previously issued auditors' opinions. Consequently, we have concluded that these opinions with respect to the financial statements do not require any amendment.



*Netherlands Authority for the Financial Markets  
(AFM)  
Response of KPMG Accountants N.V. to the public  
report of the AFM regarding the quality of statutory  
legal audits by Big Four audit firms  
Amsterdam, 22 September 2014*

## **Follow-up at organisational level**

### ***Analysis of root causes***

In addition to the individual case-by-case follow-up, we have also taken into consideration the possible organisational implications of the AFM's findings. We have therefore conducted a thorough analysis of the root causes at an organisational level and subsequently drafted an action plan to mitigate these root causes. We note that we believe these measures should not be focused on the symptoms, but on the underlying causes.

To that extent, we proactively discussed with the AFM at an early stage on the necessary measures to be introduced. We always considered these conversations with the AFM to be very constructive.

### ***Quality and compliance programme***

Our policymakers, chaired by Mr. Hommen, have initiated seven work streams to achieve a fundamental change within KPMG to focus on our core values and mission in our culture and behaviour, all based on the highest quality delivery. The quality and compliance programme we launched already in December 2013, has been integrated in these work streams, internally known as our *true blue* programme. A number of goals have already been achieved. Others are still in progress. We perceive that *true blue* is supported by our entire organisation.

### **Finally**

We are confident that our efforts will result in constructive criticism by the AFM and also that the AFM will continue to challenge us to maintain the required progress in reaching our mutual goal, the performance of excellent statutory legal audits.

Yours sincerely,

Marc Hogeboom  
*Member of the Board of Management,  
Head of Audit*

Marc Thunnissen  
*Country Quality & Risk Management  
Partner*

## 6.5 PricewaterhouseCoopers Accountants N.V. (PwC)

### 6.5.1 Background information

Certain features and key figures for PwC are shown in the table below.<sup>63</sup>

1. Number of policymakers and co-policymakers	21
2. Number of external auditors	147
3. Total number of employees	1,745
4. Number of statutory audits of PIEs	246
5. Number of statutory audits of non-PIEs	Not included in the AFM Monitor of Audit Firms 2013
6. Total fees charged to audit clients	€223 million
7. Total revenue PricewaterhouseCoopers Accountants N.V.	€302 million
8. Total revenue Holding PricewaterhouseCoopers Nederland B.V.	€664 million (45% assurance services, 34% tax services and 21% other consultancy services)

In its inspection, the AFM assessed elements of the following statutory audits:

Audit client	AFM assessment as 'inadequate'	Type of company	PIE	EQCR	Internal quality review
A	No	PIE	Yes	Yes	No
B	Yes	PIE	Yes	Yes	No
C	No	PIE	Yes	Yes	No
D	No	Health insurer	Yes	Yes	No
E	No	Pension fund	No	No	No
F	No	Public or semi-public organisation	No	Yes	No
G	No	Large non-PIE	No	Yes	Yes
H	Yes	Other non-PIE	No	No	No
I	Yes	Other non-PIE	No	No	No
J	Yes	Other non-PIE	No	Yes	No

<sup>63</sup> The information in lines 1-4 is taken from the registers of the AFM. The information in lines 5-11 is taken from the AFM Monitor of Audit Firms 2013, for which PwC provided information to the AFM on its most recent completed financial year, which was the financial year that closed on 30 June 2013. The information in line 12 is taken from the 2012/2013 financial statements of Holding PricewaterhouseCoopers Nederland B.V.

### 6.5.2 Conclusion

Based on its findings as described in section 6.5.3, the AFM concluded that the external auditor concerned failed to or failed to adequately comply with the professional standards with respect to important elements in the conduct of the statutory audit in four of the ten statutory audits that the AFM assessed. The measures that PwC took to ensure the quality of statutory audits failed to prevent this. In these statutory audits, these external auditors failed to obtain sufficient appropriate audit evidence with respect to important and material items and issues in the financial statements. Their opinions with regard to the financial statements as a whole are therefore not adequately substantiated. At the time of issuing the auditor's report, the external auditor had not obtained sufficient appropriate audit evidence. This does not necessarily mean that the financial statements in question are incorrect. The AFM did not examine these financial statements for correctness and therefore passes no judgement on this aspect. As a result of the inspections by the AFM, PwC carried out further investigation and implemented remediative measures. PwC also established that the auditor's reports issued could be retained.

### 6.5.3 Findings with respect to statutory audits

#### Audit client B

Audit client B is a service provider.

The external auditor did not obtain sufficient appropriate audit evidence regarding the correctness and completeness of the revenue from so-called 'fixed-price' contracts and the associated items in B's balance sheet, nor regarding the valuation of the goodwill.

#### *Completeness of revenue*

The external auditor had planned to use a combination of tests of controls and substantive procedures in order to audit the completeness of B's revenue. These procedures consisted mainly of establishing that the internal controls with respect to the fixed-price contracts were operating effectively and that the method used for revenue recognition was permissible under the system of financial reporting. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Establish that the internal controls were operating effectively. The external auditor concluded that he could not rely on three of the four internal control measure he had identified. He did not carry out any procedures with respect to the internal controls on which he relied;
- Carry out the procedures necessary in order to be able to use the procedures of the IAD. He failed to evaluate the procedures of the IAD and did not conduct any procedures in this regard;

- Carry out adequate procedures to establish whether the methodology for processing income and expenditure was in accordance with the system of financial reporting. The external auditor for instance did not establish whether the summary statements prepared by B were reliable, whether costs were attributed to the right projects, whether the income values according to the internal administration tallied with the contract, whether a reliable estimate was made of the progress of the projects and the costs yet to be incurred as at balance sheet date, and whether the conditions for interim profit recognition had been met.

#### *Valuation of goodwill*

The external auditor had planned to carry out substantive procedures to audit the valuation of the goodwill. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor failed to recognise that the goodwill was attributed to the cash-generating units at too high a level. The external auditor also failed to evaluate whether the goodwill should have been attributed to the cash-generating units at a lower, or an even lower, level under the system of financial reporting. If the cash-generating units are not established at a sufficiently low level, there is a risk that impairments to the goodwill that should have been recognised will not be recognised.

#### **Audit client H**

Audit client H is a company trading in products. The external auditor included IT specialists in the audit team due to the importance and complexity of the automated data processing environment.

The external auditor did not obtain sufficient appropriate audit evidence regarding the correctness and completeness of H's revenue or the existence and valuation of the inventory.

#### *Correctness and completeness of revenue*

The external auditor had planned to use a combination of tests of controls and substantive procedures in order to audit the completeness of H's revenue. These procedures consisted mainly of evaluating the establishment of the effective operation of the internal controls in relation to sales, substantive analytical review procedures and evaluation of the movement of goods prepared by H. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Establish that the internal controls were operating effectively. The external auditor for example did not actually test the internal controls, he carried out a form of detailed audit. He also failed to follow up on the differences

identified and did not evaluate the significance of this for his conclusion regarding the effective operation of the internal controls;

- Carry out substantive analytical review procedures in sufficient depth, by formulating expectations in advance, testing the base data for reliability and adequately investigating the differences;
- Carry out procedures on the various components in the association test regarding the movement of goods. This concerned procedures with respect to the completeness of the sales, the registered stock differences and the so-called 'leakage';
- Carry out procedures to assess the correctness of the discounts granted.

#### *Existence and valuation of inventory*

The external auditor had planned to carry out substantive procedures to audit the existence and management of the inventory. The procedures consisted mainly of establishing that the internal control measure relating to H's interim stock counts was operating effectively and auditing the existence and valuation of the 'stock in transit'. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Carry out procedures for a significant proportion of the 'stock in transit';
- Carry out procedures in relation to the base data for the determination of the provision for obsolete stock.

#### **Audit client I**

Audit client I is a construction company.

The external auditor did not obtain sufficient appropriate audit evidence regarding the valuation, correctness and completeness of the construction contracts and associated project income and expenditure in I's income statement.

#### *Valuation, correctness and completeness of construction contracts*

The external auditor had planned to use a combination of tests of controls and substantive procedures in order to audit the construction contracts. These procedures consisted mainly of establishing that the internal controls were operating effectively, detailed audits of the reported hours, detailed audits of the correctness of the recognised project costs and detailed audits of the additional work invoiced. The procedures were, however, not carried out adequately, and the external auditor thus was not able to obtain sufficient appropriate audit evidence. The external auditor in fact failed to do the following:

- Adequately follow up on differences he identified in the establishment of the effective operation of the internal controls in relation to wage costs;
- Establish that the internal controls were operating effectively. The external auditor for instance did not carry out any procedures with respect to the

internal control procedure relating to the project monitoring. The external auditor also failed to establish that the internal control measure relating to material costs and costs of sub-contractors was operating effectively. He based his conclusion on the procedures he carried out in the previous financial year. However, because he had identified a significant risk with respect to the valuation of construction contracts, he should have tested the measures each year;

- Carry out the detailed testing of the reported hours correctly, by establishing that there was an authorised substantiation of these hours;
- Carry out the detailed testing of the reported material costs and costs of sub-contractors correctly, by establishing that these costs had been attributed to the right projects;
- Carry out the detailed testing of the additional work invoiced as planned, meaning that with reference to material amount he failed to establish that this had been approved by the client;
- Test the assumptions of the management used for the valuation of the construction contracts with respect to future income and expenditure for reasonableness.

#### **Audit client J**

Audit client J is a financial holding company for a company operating outside the Netherlands. Some of J's business operations take place in countries with particular risks. J's business activities and its financial and operational management, including the preparation of the consolidated financial statements, mainly take place abroad. The external auditor had used the procedures carried out by another foreign auditor.

The external auditor failed to adequately evaluate whether the procedures carried out by the auditor of the significant group division abroad constituted sufficient appropriate audit evidence.

#### *Evaluation of audit evidence*

The external auditor carried out a review at the other auditor. However, the external auditor failed to follow up on the unusual items he identified with respect to revenue and various other balance sheet items that he had identified himself in his review and had been noted by the other auditor.

## 6.5.4 Response from PwC



The Executive board of The Netherlands Authority for the Financial Markets  
For the attention of Mr G.J. Everts  
P.O. Box 11723  
1001 GS AMSTERDAM

22 September 2014

**Subject: Unofficial translation<sup>1</sup> - Response to 'Results of review quality of statutory audits Big 4 audit firms'**

Dear Mr Everts,

Thank you for your report. We are in agreement with the recommendations you have made to the Big-4 audit firms as summarized in Section 2, and we confirm that we will be implementing these.

The results of your review are at odds with what we are striving to achieve in the area of quality, in particular the application of auditing standards (COS). In none of the other reviews in recent years we did receive 'unsatisfactory' ratings to the extent now reported as a result of your regular review 2013/2014 relating to 2012 audit engagements. These disappointing results have really struck home and hurt us. For us as policymakers, they were a clear message that a root cause analysis was needed, at individual engagement level, and that structural change needed to follow as a result. The steps we are taking are set out in general terms below. Our Transparency Report 2013/2014 describes them in more detail.

Four of the engagements reviewed are rated as 'unsatisfactory'. Our own internal review process has rated three of these four engagements as 'non-compliant'. As regards the fourth file, we would very much like to discuss this further with you. We are focussing all our efforts, including the measures set out below, to ensure that these findings do not recur in the future.

For your information, we performed follow up work and remediation on the 'non-compliant' audit engagements and we concluded that the auditor's reports issued are still appropriate. Obviously, we would like to make this information available to the AFM for review.

<sup>1</sup> This document is an English translation of the original letter prepared in Dutch. In case of differences between the English and the Dutch version, the latter shall prevail.

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PwC is the brand under which PricewaterhouseCoopers Accountants N.V. (Chamber of Commerce 34180285), PricewaterhouseCoopers Belastingadviseurs N.V. (Chamber of Commerce 34180284), PricewaterhouseCoopers Advisory N.V. (Chamber of Commerce 34180281), PricewaterhouseCoopers Compliance Services B.V. (Chamber of Commerce 34180286), PricewaterhouseCoopers Pensioens, Actuariële & Insurance Services B.V. (Chamber of Commerce 34220088), PricewaterhouseCoopers B.V. (Chamber of Commerce 34180289) and other companies operate and provide services. These services are governed by General Terms and Conditions (algemene voorwaarden), which include provisions regarding our liability. Purchases by these companies are governed by General Terms and Conditions of Purchase (algemene koopvoorwaarden). At [www.pwc.nl](http://www.pwc.nl) more detailed information on these companies is available, including these General Terms and Conditions and the General Terms and Conditions of Purchase, which have also been filed at the Amsterdam Chamber of Commerce.



#### **Causes**

It is difficult to pinpoint one systematic cause based on four individual engagements with different findings. We have therefore undertaken a deeper root cause analysis, including a survey into the culture within our Assurance practice, directed at removing the causes rather than treating the symptoms.

We are also supporting initiatives for independent academic research into audit technology and quality.

#### **Measures taken**

We are taking structural measures to reinforce our governance, our quality-focused culture, the application of auditing standards and the transparency as to how audits are performed. Our responsibility to society in all of this is leading.

We are working proactively with the initiatives of the working group 'Future of the Accountancy Profession' ('Toekomst Accountantsberoep') to implement sector-wide proposals for reform. We are intending to submit the following proposals to our General Meeting:

- To restructure our organisation by installing a Supervisory Board with external members at the level of the Dutch network organisation and in line with principles III.1, III.2 and III.3 of the Dutch Corporate Governance Code.
- To make the remuneration of the members of the Board of Management of the Dutch network firm and the Compliance Officer not profit-related.
- To introduce a deferred remuneration scheme with a claw-back period for external auditors.

We have translated your findings into a new quality improvement programme, focussing particularly on the following:

- Increased involvement of partners, directors, senior managers and managers in the teams.
- More technical and personal skills coaching and strengthening of training programmes.
- More extensive mandatory testing of knowledge levels.
- Increased scope of our engagement-specific quality review programme. Every external auditor being covered by at least one type of review every year.
- Formulation of additional quality indicators for external auditors to provide guidance and support for the behaviour patterns needed to focus on quality. Linking evaluation and remuneration more closely to quality through quality indicators.
- More in-depth technical coaching and supporting reviews, prior to the issue of the auditor's report, by an independent central team of 10-15 audit experts, with a strong focus on the planning phase, compliance with auditing standards and the consequent learning process for the audit teams.
- Centralisation of the QRP role (engagement-specific quality review programme) into a number of partners supported by a group of managers together with more detailed guidelines for this role.
- Support measures at engagement and firm levels. Providing guidelines for team rotation, taking measures to ensure that quality considerations play a more significant role in the allocation of team members and greater selectivity in client acceptance and continuance.

*The Netherlands Authority for the Financial Markets, 22 September 2014*

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We share your view that a consistent 'tone from the top', change management and further support to the audit teams will be crucial in determining whether the implementation of these measures has been successful.

***In conclusion***

We like to emphasise that we are taking the messages from your report very seriously. You can be assured that our organisation is working vigorously on the recommendations you have made to the Big 4 audit firms.

We look forward continuing the open dialogue with the AFM and other stakeholders with a view to further improvement and we are fully committed to this.

Yours sincerely,  
PricewaterhouseCoopers Accountants N.V.

M. de Ridder  
Chair of the Assurance Board

*The Netherlands Authority for the Financial Markets, 22 September 2014*

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## Appendix 1: Quality measures implemented by the Big 4 audit firms in 2009-2012

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### *Examples of quality measures taken by the Big 4 audit firms*

#### Statutory audits

- Remediative procedures carried out on specific statutory audits in which the AFM and/or the audit firm itself had identified shortcomings;
- Internal follow up reviews of other audits or elements thereof and other external auditors in order to establish whether shortcomings had occurred there as well. In certain cases, the entire client and engagement portfolio of the external auditor or of all auditors in a particular sector was evaluated.

#### Quality control system

- General
  - Procedures, descriptions and standards adjusted based on the results of the annual evaluation of the quality control system for the entire audit firm or for specific divisions within the audit firm, such as sector or industry groups.
- Quality policy
  - Organisation-wide programmes for cultural change and encouraging an attitude of professional scepticism;
  - Organisation-wide improvement applied in the fields of training, feedback and coaching, leadership and the management model.
- Acceptance and continuation of audit engagements
  - Regular evaluation and updating of the client and engagement portfolios of external auditors;
  - Stricter policy with respect to registration and monitoring of breaches and incidents;
  - In connection with specific incidents, questioning within the organisation to determine whether similar cases had occurred that should have been reported, for instance concerning ethical business conduct or which affect the independence of the audit firm.
- Personnel policy
  - Professional planning so that the talents of the employees are better divided across engagements and they can deliver better quality;
  - Encouraging and monitoring that the external auditor be more closely involved in the audit;
  - Encouraging the earlier engagement of experts, such as IT specialists or valuation experts;

- o Stricter formulation of the evaluation and remuneration system for external auditors with respect to quality, and conduct of a consistent sanctions policy in which inadequate conduct of a statutory audit will have consequences for the remuneration of the external auditor concerned.
- Knowledge
  - o Instruction to the employees concerned, for instance using the results of the evaluation by the quality control system, with training, courses, professional seminars and professional publications (such as a newsletter).
- Standards
  - o Changes to elements of the audit methodology;
  - o Changes to the methods of file creation and archiving, both digitally and on paper.
- Internal quality monitoring
  - o Changes to the EQCR procedures, for instance by centralising the organisation of the evaluations and further encouragement of critical conduct;
  - o Introduction of interim quality reviews in addition to the EQCR;
  - o Strengthening the compliance department;
  - o Making a root cause analysis part of the quality system (if shortcomings are identified, the root causes are analysed);
  - o Further additions to the sanctions policy and practical application by means of imposing sanctions on external auditors, such as designing individual improvement plans and if appropriate removing the auditor in question from the register of the AFM.

#### Internal supervision

- Formation of a Public Interest Committee with independent members from outside the audit firm.

#### Network

- Carrying out studies of the quality control system at the Dutch audit firm by foreign elements of the international network to which the audit firm belongs.

#### Environment

- Producing a more informative annual transparency report;
- Dialogue with external stakeholders.

## Appendix 2: Quality measures announced by the Big 4 audit firms

### *Examples of quality measures announced by the Big 4 audit firms*

#### Statutory audits

- Remediative measures regarding the identified shortcomings in the audits evaluated: obtain additional audit evidence, under the guidance of the professional practice department and under the supervision of the compliance department, and discuss results with the audit client;
- Internal follow up review to determine whether the identified shortcomings also occur in other parts of the statutory audits assessed that fall outside the focus area under review and in other statutory audits ('oil slick');
- Imposition of sanctions on the external auditors concerned: score 'inadequate' on the aspect of quality in the assessment (with consequences for remuneration), not allowing the auditors in question to act as external auditors in future, or terminating the employment contract with the external auditor concerned;
- Analysis of the client and engagement portfolio and parting with certain audit clients.

#### Quality control system

- General
  - Formulation of an action plan for changes to the quality control system for a specific sector or industry group.
- Quality policy
  - Having a cultural review of partners and employees carried out by an external agency, with the focus on the relationship between the tone at the top and the quality of the procedures;
  - Bringing about a change of culture, also by means of dialogue sessions;
  - Developing a 'high performance culture'.
- Acceptance and continuation of audit engagements
  - Centralised assessment of client and engagement portfolios of partners and the adequacy of audit budgets, and centralised decision-making with respect to continuation with clients and engagements;
  - A more critical evaluation of whether clients and engagements can be continued, taking account of the culture and attitude of the company being audited and the quality of its administrative organisation and internal controls;
  - Regular discussion of unusual files, for instance in case of signals or incidents.
- Personnel policy

- o Increasing the available time of external auditors for the performance of statutory audits, for instance by engaging additional external auditors and reducing the client and engagement portfolio;
- o More extensive coaching of external auditors and employees with respect to their performance in the conduct of audits;
- o Changing external auditors as a result of the evaluation of their client and engagement portfolios where necessary;
- o Strengthening the connection between the evaluation of quality and remuneration, for instance by adjusting quality indicators, reviewing appointment terms and embedding a commitment to quality in writing;
- o A new remuneration model for partners;
- o Adjusting the pension scheme and the retirement age
- o Giving awards for good quality in order to encourage and reward desirable behaviour.
- Knowledge
  - o Strengthening and testing of ready knowledge of auditing standards and training in basic auditing and documentation skills;
  - o Sharing and learning from experiences: convert the methodology and results of internal quality reviews and external supervisory inspections (national and international) into training courses and coaching programmes for employees;
  - o Training employees to follow a uniform project management methodology.
  - o Organise workshops on the subject of 'the public interest'.
- Standards
  - o Invest in improvement, standardisation and innovation of the audit methodology and digital file formation and align this more closely to legislation and regulation, including new developments in legislation and regulation;
  - o Cease activities that do not add value to the audit process;
  - o Develop additional audit resources for first-year audits;
  - o Encourage the engagement of experts (such as IT specialists);
  - o Change the policy for usage of procedures carried out by others (such as an internal audit department or IT specialists);
  - o Introduce the use of flow diagrams in the audit of revenue in large statutory audits in order to obtain a better understanding of and insight into business processes, the relevant internal controls and the important interactions, for instance with IT systems.
- Internal quality monitoring
  - o Strengthening the EQCR, for instance by:
    - Forming a centralised and independent team of quality reviewers;
    - Having the quality reviewers managed by the compliance department;
    - Deploying more experienced quality reviewers;
    - Allocating more time to an EQCR;

- Strengthening the phasing of the conduct of the EQCR during the various phases of the audit;
- Designing training courses for quality reviewers;
- Introducing additional procedures and guidelines for the involvement and other responsibilities of the quality assessor and the documentation of the EQCR;
- Implementing internal quality controls with respect to the operation of the EQCR, for instance by means of centralised reassessments;
- o Strengthening the internal quality reviews, for instance by:
  - Appointing a permanent team of reviewers who carry out internal quality reviews regularly during the year;
  - Changing the internal quality reviews to make them correspond more closely to external inspections, for instance by the AFM;
  - Introducing additional procedures and guidelines for the involvement and other responsibilities of the reviewers and the documentation of the internal quality review;
  - Carrying out the 'new' quality review with respect to all external auditors within one year;
  - Increasing the annual number of internal quality reviews, so that an engagement of each external auditor is reviewed at least once a year.
- o Increasing the external nature of the firm's own internal supervision;
- o Developing performance indicators and other measures to measure audit quality;
- o Central monitoring of the nature, timing and intensity of the external auditor's involvement;
- o Central monitoring of the nature and timing with which audit teams engage experts.

#### Executive board

- Appointment of external candidates (who are not accountants) as directors of the audit firm;
- Strengthening the 'tone at the top';
- Emphasising the importance of adequate involvement of external auditors in audits in writing;
- Increasing the transparency of the audit firm, and the remuneration of the directors and the compliance officer.

#### Internal supervision

- Appointment of a supervisory board with mainly external members;
- Appointment of a Public Interest Committee.

## Environment

- Improving communication by the auditor at shareholder meetings, and to the supervisory boards and audit committees of audit clients;
- Participating in the professional practices debate through professional publications and conducting academic research.

### Appendix 3: Abbreviations used

Abbreviation	In full
AEX	Amsterdam Exchange Index
AFM	The Netherlands Authority for the Financial Markets
AGM	Annual General Meeting
AMX	Amsterdam Midcap Index
AScX	Amsterdam Small Cap Index
Bta	Audit Firms Supervision Decree
CPAB	Canadian Public Accountability Board
Deloitte	Deloitte Accountants B.V.
DNB	De Nederlandsche Bank
EAIG	European Audit Inspection Group
EEA	European Economic Area
EY	Ernst & Young Accountants LLP
FEE	Federation of European Accountants / Fédération des Experts-comptables Européens
FRC	Financial Reporting Council
IAASB	International Auditing and Assurance Standards Board
IFIAR	International Forum of Independent Audit Regulators
IOSCO	International Organization of Securities Commissions
KPMG	KPMG Accountants N.V.
NBA	Nederlandse Beroepsorganisatie van Accountants (Netherlands Institute of Chartered Accountants)
NV COS	Nadere voorschriften controle- en overige standaarden (Further Regulations on Auditing and Other Standards)
EQCR	Engagement Quality Control Review
PIE	Public Interest Entity
PCAOB	Public Company Accounting Oversight Board
PE	Permanente Educatie (Continuing education)
PwC	PricewaterhouseCoopers Accountants N.V.
VEB	Vereniging van Effectenbezitters (Dutch Investors' Association)
VGBA	Verordening gedrags- en beroepsregels accountants (Code of Ethics for Professional Accountants, regulation with respect to Rules of Professional Conduct)
ViO	Verordening inzake de onafhankelijkheid van accountants bij assurance-opdrachten (Regulation on Independence of Accountants in Assurance Engagements)
Wab	Wet op het accountantsberoep (Accountancy Profession Act)
Wta	Wet toezicht accountantsorganisaties (Audit Firms Supervision Act)

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