Analysis of the proposals from the European Commission for the reform of the audit market

31 January 2012

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The Netherlands Authority for the Financial Markets

The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. The AFM promotes the conscientious provision of financial services to consumers and supervises the honest and efficient operation of the capital markets. Our aim is to improve consumers' and the business sector's confidence in the financial markets, both in the Netherlands and abroad. In performing this task the AFM contributes to the prosperity and economic reputation of the Netherlands.

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1 Introduction

On 30 November 2011, European Commissioner Barnier of the Directorate-General Internal Market presented his proposals for the reform of the audit market. The proposals concern an amendment to Directive 2006/43/EC (the Statutory Audit Directive, or SAD)[1] (the draft Directive) and a new Regulation (the draft Regulation) concerning specific requirements for the statutory audit of public-interest entities (PIEs)[2]. It shall be emphasised that the proposals do not or merely partly concern the statutory audits in the SME segment, unless these SME audit clients qualify as PIE.

The Council negotiations regarding the proposals will begin in 2012 under Danish chairmanship. Parallel to this, the plans will be debated in the European Parliament (EP). After the Council and the EP have reached agreement, the revised Statutory Audit Directive will have to be implemented in national legislation. The Regulation will take effect directly. In the forthcoming Council negotiations, the AFM strives to advise the Ministry of Finance regarding the determination of the stance to be taken in the negotiations, and to be in attendance at those negotiations where possible. The AFM will moreover advise the Ministry of Finance with regard to the implementation of the Directive in the Netherlands.

This document contains a description and analysis by the AFM of the major issues arising from the draft Regulation and the draft Directive. For each topic, we give a summary of the proposal of the European Commission and the changes to the current situation in the Netherlands that the proposals entail.

The proposals are of great importance to the supervision by the AFM and – through the AFM – for the public. The AFM gladly takes the opportunity to respond to the consultation document accountancy, as published by the Ministry of Finance on 21 December 2011, just as other interested parties have done so. A more final stance of the AFM and/or a final advice to the Minister of Finance will be determined only after the AFM has reviewed in more detail the other responses to the consultation document. Therefore, for the time being, the following analysis is with certain reservation.

2 General conclusion

Largely, the AFM assesses the proposals from the European Commission as positive. The AFM expects these proposals to contribute to an improvement in the quality of statutory audits, the recovery of confidence in auditors, and to strengthen the financial markets. We present the highlights from our analysis below.

Independence

The most important problem with regard to the independence of auditors and audit firms identified by the European Commission is that this independence is neither assured nor demonstrable. The statutory audit has effectively become one of a range of (commercial) services. A lack of

[1] *Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, COM(2011) 778, 2011/0389 (COD).*

[2] *Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on specific requirements regarding statutory audit of public-interest entities, COM(2011) 779, 2011/0359 (COD).*

independence is leading to a lack of an attitude of professional skepticism on the part of the auditor. Many of the provisions in the draft Regulation are intended to safeguard the independence of auditors and audit firms. The AFM has certain comments regarding the following points.

Limitation of fees from audit-related services and non-audit services

As previously stated in the consultation document, the AFM recommends that the services provided by audit firms be separated into two main categories:

1) services designed to provide assurance regarding the information provided by the audit client for external users of this information, and
2) services for the audit client itself.

The AFM takes the view that measures are necessary if the independence of auditors or audit firms is threatened. In the case of the statutory audit of a public-interest entity (PIE), this threat should be completely removed. Services from the first main category that are performed at the same time as the statutory audit are usually related to the audit and seldom form a threat to independence. The AFM therefore does not see a need for the measure proposed by the European Commission regarding a limitation of the fees from these audit-related services to a maximum of 10 percent of the total fees from the statutory audit. On the other hand, services falling into the second main category do often constitute a threat to independence. These services increase the risk of self-review, self-interest, conflicts of interest, familiarity and/or intimidation. The AFM therefore supports the proposal by the European Commission in principle to entirely forbid the provision of these services in addition to the conduct of the statutory audit. After all, an arbitrary limitation of the fees from these non-audit services would not remove the threat to independence.

Mandatory tendering and rotation of audit firms

The AFM supports a regular and transparent tendering procedure for statutory audits of PIEs, whereby the audit committee of the PIE concerned takes a prominent role in the selection and appointment of the audit firm. Such a tendering procedure, whereby the quality of the audit is evaluated on a regular basis, can form an important incentive for quality. The AFM is not at this point convinced of the need to rotate the audit firm after six years *in all cases*. From a public point of view, striving for a more long-term relationship by the best quality audit firm may be beneficial, especially if alternatives are not available, and if an open tendering process and critical assessment have been carried out.

Joint audits

Although the European Commission has not made joint audits compulsory, as previously suggested, the proposals do allow for Member States to make joint audits compulsory on a national level. The AFM does not support (compulsory) joint audits. The AFM sees potential risks with regard to quality if none of the engaged audit firms has a complete overview of the statutory audit, whereby full responsibility cannot be univocally allocated to one external auditor. The possibility for Member States to decide unilaterally whether or not to make joint audits compulsory is not consistent with the principle of the draft Regulation, which states that the same rules should apply for the whole European Union in order to promote one internal market for audit services.

Provision of information

Another important problem identified by the European Commission is the expectation gap. This means that the public expects more of auditors than the duties that auditors actually perform. The European Commission's proposals will increase transparency with regard to audit firms, the quality of

these firms and the statutory audits they conduct, and with regard to the supervision that is exercised. The AFM is of the opinion that the expectation gap can be reduced as a result of these measures.

European harmonisation and supervision

The European Commission has identified various problems in relation to the European harmonisation of legislation and regulation and the related supervision: 1) a high level of administrative burden as a result of fragmented national regulation, 2) limitations on cross-border provision of services by auditors, 3) a lack of common standards within the EU on audit practice, independence and the internal control of audit firms, 4) auditing standards do not take account of the size and complexity of audit clients, in particular of SMEs, and 5) associated problems with regard to the supervision of non-PIE audit firms.

The AFM endorses the harmonisation aimed for in the proposals of the European Commission through the simplification of cross-border activities by auditors, the obligation to make the application of the International Standards on Auditing (ISAs) – focused on the specific characteristics of the audit client – compulsory, and the tightening of the provisions for regulators. The AFM is also a proponent of closer cooperation between European regulators where this is necessary and effective, and sees ESMA as having an important coordinating role in this respect. The AFM had, however, expected that the European Commission would propose more changes with regard to the supervision of third-country audit entities. The regulation on this issue needs clarification and simplification in various respects.

In addition to the above three themes, which also appear in the consultation document accountancy [3], the European Commission identifies a problem with regard to the sizeable market share held by the 'Big Four' audit firms, resulting in a highly concentrated market, with an alleged lack of choice for (large) enterprises. The measures that the European Commission proposes in this context (including mandatory splitting up of large audit firms, joint audits, compulsory inclusion of 'small' audit firms in the tendering procedure), are in the AFM's opinion too far-reaching and arbitrary. The AFM considers that the above measures relating to independence, the provision of information, and the European harmonisation and supervision can adequately contribute to ensuring that there is sufficient competition (in terms of quality) between audit firms for performing statutory audits, and that enterprises have a wide enough range of suitable audit firms to choose from.

3 Background

The proposals of the European Commission form part of the legislative reforms that the European Commission is implementing in various parts of the financial sector. The European Commission considers the statutory audit of financial statements as one of the most important foundations for financial stability. Other legislative initiatives relate to corporate governance, financial reporting and credit ratings.

The European Commission has carried out an impact assessment in preparation for the legislative proposals, and has identified the following problems in relation to the statutory audit of PIEs:

[3] *Published by the Ministry of Finance on 21 December 2011.*

1. The expectation gap: the public expects more of auditors than the duties that auditors actually perform.
2. Independence: since the audit is but one activity in a range of commercial services, independence is neither assured nor demonstrable. Without the regular tendering for audit engagements and periodic rotation of audit firms, the audit lacks the required professional scepticism.
3. Market concentration and lack of choice: the market is dominated by the Big Four firms (accounting for more than 85% of the market for listed companies).

The European Commission has identified the following problems with regard to statutory audits in general, thus including the audits of non-PIEs:

4. Heavy administrative burden as a result of fragmented national regulation.
5. Cross-border provision of services by an auditor is only possible if the auditor passes an aptitude test and obtains registration in the Member State concerned. This constitutes a limitation for the free provision of services.
6. The lack of common standards across the EU regarding audit practice, independence and internal control of audit firms.
7. Auditing standards do not take account of the size of the audited companies, in particular of SMEs.
8. Associated problems regarding the supervision of non-PIE audit firms.

The European Commission proposals must be placed in the context of the numerous discussions of the audit market that have led to various national and international publications:

- The consultation document 'Auditor Communications', IOSCO, February 2010.
- The consultation document 'Enhancing the Value of Auditor Reporting: Exploring Options for Change' by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC), May 2011.
- The consultation document 'Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards' (PCAOB Release No. 2011-003, June 21, 2001) published 21 June 2011.
- The Green Paper 'Audit Policy: Lessons from the Crisis' (hereinafter: 'the Green Paper', European Commission, 13 October 2010. The European Commission has summarised the 688 responses to the Green Paper in a separate document.[4]
- The 'Report on General Findings Regarding Audit Quality and Quality Control Monitoring' of the AFM of 1 September 2010.
- The Report of the Parliamentary Commission to investigate the financial system ('the De Wit Committee')[5].
- The NBA Action Plan 'Lessons from the crisis' of November 2010, which has led to a number of consultation documents and advisory reports.[6]

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[4] *Summary of responses green paper audit policy: lessons from the crisis of 4 February 2011.*

[5] *Parliamentary Papers II 2009/10, 31 980, no. 4*

[6] *The consultation document 'Toezicht en transparantie' (August 2011), the advisory report 'De Raad van Commissarissen als opdrachtgever van de accountant' (September 2011), the consultation document 'Voorgestelde aanpassing VAO met een Verbod op het belonen van commerciële prikkels bij wettelijk controleopdrachten' (September 2011), the advisory report 'Verbreding poortwachtersfunctie' (October 2011). Parliamentary Papers II 2010/2011, 32 643, no. 1*

- The initiative note 'Accountancy after the crisis' by Member of Parliament Plasterk of 15 February 2011.
- The 'Report on Incentives for Audit Quality. An exploratory review' of the AFM of 6 October 2011.
- The views of the Minister of Finance regarding accountancy and financial reporting[7].

There has also been a public debate on the basis of one or more of the above-mentioned publications. On 1 February 2011, the AFM organised a round table conference with stakeholder organisations to discuss a number of themes from the Green Paper. On 26 October 2011, a General Consultation was held by the permanent parliamentary finance committee to discuss both the initiative note from Plasterk and the document expressing the views of the Minister of Finance. On the Accountants Day, 23 November 2011, both the Minister of Finance and the AFM expressed their views on issues such as the separation of advice and auditing, and the rotation of audit firms.

On 21 December 2011, the Minister of Finance published a consultation document in consultation with the AFM and the NBA in which the following issues were addressed:

- Independence of the auditor;
- Provision of information;
- European harmonisation and supervision.

The issues addressed in the consultation document mainly concerned the issues in the proposals of the European Commission.

4 Proposals - Regulation

This section gives a summary of the main proposals in the draft Regulation that entail changes to the current regulation in the Netherlands.

4.1 Scope of the Regulation

Proposal by the European Commission

The draft Regulation applies to audit firms that audit PIEs and in certain respects to the PIEs themselves.[8] The definition of a PIE is extended to include investment firms, payment institutions, undertakings for collective investments in transferable securities, electronic money institutions and EU alternative investment funds.[9]

Changes compared to the current situation in the Netherlands

The present definition of PIE will be extended to include certain categories of financial institutions. The possibility for Member States to designate other entities as PIEs will lapse. The current situation in the Netherlands is that other categories of enterprises, institutions or public bodies can be

[7] *Combined response to the evaluation review of the Wtfv, the view regarding accountancy and the reaction to the initiative note from Mr Plasterk. Parliamentary Papers II 2010/2011, 32 681, no. 2*

[8] *See Article 2 of the draft Regulation.*

[9] *See Article 1.2 (d) of the draft Directive, regarding the amendment of the definition of 'public-interest entities'.*

designated as PIEs by order in council [algemene maatregel van bestuur, or AMvB]. This option has so far not been used.

Conclusion

As a result of the financial crisis, the AFM agrees that there is a need to designate additional categories of financial institutions as PIEs. In some Member States there may be additional financial and other enterprises with a high degree of public interest that should be designated as PIEs. In this respect, a connection may be sought with Directive 2011/61/EU regarding managers of alternative investment funds (Alternative Investment Fund Managers Directive). In the Netherlands, this could include organisations such as the large pension funds and their administrators. The AFM takes the view that it would be useful for Member States to retain the option of being able to determine categories of organisations as PIEs themselves, so that financial and other enterprises that are not or not yet included in the definition of the draft Directive but are of significant public importance in certain Member States can still be designated as PIEs.

4.2 Separation of audit services and non-audit services for PIEs

Proposal by the European Commission

a. Audit firms may carry out statutory audits and audit-related services for a PIE (and for its parent undertaking and controlled (subsidiary) undertakings)[10], but may not provide non-audit services.[11] Other members of the network to which an audit firm belongs may also conduct statutory audits and audit-related services for this PIE (and for its parent undertaking and controlled undertakings within the European Union), but may not provide non-audit services. If a network member provides non-audit services for a controlled undertaking incorporated in a third country, the audit firm must assess the threat to its independence and apply safeguards to mitigate this threat. The audit firm may consult the regulator in this connection.[12]

b. Audit-related services include[13]:
   - the audit or review of interim financial statements;
   - providing assurance with respect to corporate governance statements;
   - providing assurance with respect to corporate social responsibility matters;
   - audit or assurance with respect to reports for regulators of financial institutions;
   - providing certification with respect to compliance with tax regulations to the extent this is required by law;
   - other statutory duties in relation to audit work.

c. Non-audit services include[14]:
   1) services entailing conflict of interest in all cases:
      a) expert services not related to the audit, tax consultancy, general management consultancy and other advisory services;

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[10] *To a maximum of 10% of the audit fee; see below in this memo.*

[11] *See Article 10.1 and 10.3 of the draft Regulation.*

[12] *See Article 10.4 of the draft Regulation.*

[13] *See Article 10.2 of the draft Regulation.*

[14] *See Article 10.3 of the draft Regulation.*

b) administrative services and the preparation of financial statements;
c) design and implementation of internal control or risk management in relation to the financial statements and advice on risk;
d) valuation services, providing fairness opinions and contribution-in-kind reports;
e) actuarial and legal services;
f) design and implementation of financial information systems for financial enterprises;
g) activities for internal audit services;
h) broker or dealer, investment adviser, or investment banking

2) services which may entail conflict of interest:
a) human resources services, including the recruitment of senior management (permitted after approval by the audit committee);
b) providing comfort letters for investors in the context of the issuance of securities (permitted after approval by the audit committee);
c) design and implementation of financial information systems for listed companies (permitted after approval by the regulator);
d) due diligence services and assurance services in the context of a financial or corporate transaction (permitted after approval by the regulator).

The European Commission reserves the right to make changes or have changes made to the lists of audit-related services and non-audit services as a result of any new developments.[15]

Changes compared to the current situation in the Netherlands

With regard to the combination of statutory audit work and non-audit services, the current independence rules include a number of specific instructions and prohibitions for audit firms which audit PIEs. Furthermore, the rules are mainly based on general conceptual framework that is based on an assessment of threats and safeguards to mitigate threats. The current independence rules do not contain any lists, exhaustive or otherwise, of services that must be considered as audit-related services or non-audit services. With regard to the combination of statutory audit work and non-audit services, the European Commission proposals contain more unequivocal and restrictive instructions and prohibitions instead of the current conceptual framework.

Conclusion

a. In its report 'Incentives for Audit Quality' of 6 October 2011, the AFM has already stated its support for clear, unequivocal and more restrictive regulation on the issue of independence. From the perspective of the users of financial statements, the AFM thus endorses the principle that clear instructions and prohibitions in this area are preferable to the existing conceptual framework. The AFM has moreover recommended that when designing stricter independence rules, a distinction should be made in the services provided by audit firms, by separating the services into two main categories:

1) services designed to provide assurance regarding the information provided by the audit client for external users of this information, and
2) services for the audit client itself.

[15] *See Article 10.6 of the draft Regulation.*

The permission to conduct statutory audits and (specifically stated) audit-related services and the prohibition of combining audit work with (specifically stated) non-audit services for an audit client which is a PIE are in line with this recommendation.

A limited number of non-audit services remain permitted in exceptional cases after approval by the audit committee or after approval by the regulator. The AFM advocates a situation in which exceptions to the general prohibition are put before the audit committee, which can assess the independence of the audit firm. Generally speaking, the AFM also advocates a greater role for the audit committee with regard to the independence of the audit firm. Mandatory approval by the audit committee, for non-audit services to be provided in addition to the statutory audit by the same audit firm, would be consistent with this principle. Regarding the other service 'design and implementation of financial information systems', the AFM is not at this stage convinced by the distinction that is made between financial enterprises, for which this service is prohibited, and listed enterprises, for which this service is permitted subject to the regulator's prior approval. Since the design and implementation of financial information systems is clearly a different activity than the conduct of statutory audits, it would seem logical to prohibit this other service entirely, regardless of the type of audit client for which the service is provided. Regarding non-audit services relating to due diligence work and assurance services in the context of a financial or corporate transaction, the AFM notes that it would also be possible to submit these non-audit services to the audit committee for approval and to notify the regulator accordingly. This would allow for attention to be devoted particularly to the safeguards in place to mitigate any threats to independence. The regulator can then take additional measures if it sees reason to do so.

b. The activities designated as audit-related services in the draft Regulation are those whereby the auditor adds assurance to information for the external users of this information. The AFM is of the opinion that these activities can indeed be considered as related to the statutory audit, and therefore can normally be carried out in combination with the statutory audit.

c. The activities designated as non-audit services in the draft Regulation are mostly those whereby the auditor advises or provides services to the audit client or the management thereof. The AFM is of the opinion that these activities can indeed be considered as non-audit services, and that they should not be provided in combination with statutory audit work to the same audit client.

4.3 Hiving off non-audit services

Proposal by the European Commission

a. Large audit firms that carry out statutory audits for a large number of *large* PIEs must completely hive off the provision of their non-audit services from their organisation, and henceforward may provide statutory audits and audit-related services only. This applies to the entire network to which the audit firm belongs. This means that if an audit firm belongs to a network whose member firms collectively realise more than €1500 million in revenue from statutory audits within the EU, and if they earn more than one third of their total revenue from statutory audits of large PIEs, the audit firm may not provide any non-audit services or be connected (through capital holdings or voting rights) to an entity that provides non-audit services.[16]

[16] *See Article 10.5 of the draft Regulation.*

b. 'Large PIEs' are defined as[17]:
   - the 10 largest issuers of shares in the Member State (based on market capitalisation at year-end) and all issuers of shares whose average market capitalisation over the past three years is higher than €1 billion;
   - all credit institutions, insurers, payment institutions, electronic money institutions and investment firms with a balance sheet total of more than €1 billion;
   - all undertakings for collective investment in transferable securities and EU alternative investment funds with total assets under management on the balance sheet of more than €1 billion.

Changes compared to the current situation in the Netherlands

The current independence rules in the Netherlands do not contain any obligation for large audit firms to hive off their non-audit services from their organisation. According to our initial estimation, the proposed separation and termination of all non-audit services by the largest audit firms will not apply in the Netherlands. None of the audit firms in the Netherlands would appear to earn more than one third of its revenue from statutory audits of *large* PIEs. For the Dutch audit firms, the proposed rules at this stage constitute only a 'ceiling' which will form an incentive to continually diversify the client portfolio on the basis of client size.[18]

Conclusion

a. While the AFM supports the potential benefits of an 'audit-only' audit firm whereby the firm exclusively conducts statutory audits and audit-related services and does not provide non-audit services, it is not convinced at this stage that a complete separation and termination of non-audit services by the large audit firms is necessary. A full separation and termination of such services could increase the options available to large enterprises for the selection of an independent audit firm. It could also increase the quality of statutory audits by creating an unequivocal profile for the auditor with full focus on the quality and innovation of the audit and pure price formation. The independence of the audit firm could, however, also be safeguarded, and potential threats to independence at PIEs mitigated, by separating the conduct of the statutory audit from the provision of non-audit services to the PIE in question without hiving off the provision of all other services within the audit firm. Furthermore, a mandatory hiving off of non-audit services could negatively affect the European integration of audit firms, which is raising the quality standards. If indeed one or a limited number of member firms in a network meet the above criteria, the network can decide to completely hive off these member firms rather than separate all its non-audit services. The AFM is therefore not convinced of the need for such a far-reaching and arbitrary measure at this stage.

b. The new definition of 'large PIEs' divides audit clients into three categories: non-PIEs, PIEs and large PIEs. The distinction appears to be designed to set specific rules for the Big Four firms in order to limit their market position. The AFM is not convinced of the necessity or the added value of incorporating competition issues in the draft Regulation at this stage, and thus does not support the introduction of a new category of audit clients.

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[17] *See Article 4 of the draft Regulation.*

[18] *The European Commission has indicated that according to its estimation only the largest audit firms in Germany, Spain and the United Kingdom will meet the proposed criteria.*

4.4 Fees for statutory audits and audit-related services

Proposal by the European Commission

a. The fees for audit-related services provided to a PIE audit client shall not exceed 10% of the fee paid by the audited client for the statutory audit.[19]

b. If the total fees received by an audit firm from a PIE exceed 20% (or 15% in two successive years) of the audit firm's total revenue, this must be disclosed to the audit committee of the audit client. The audit committee shall consider whether a quality control review should be conducted by another audit firm prior to the issuance of the audit report.[20]

c. If the total fees received by an audit firm from a PIE exceed 15% in two successive years of the audit firm's total revenue, this must be disclosed to the regulator. The regulator shall then decide whether the audit firm may continue to conduct the statutory audit for an additional period which in any case shall not exceed two years.[21]

Changes compared to the current situation in the Netherlands

Current regulation in the Netherlands does not include any provision regarding the maximum revenue that may be earned from the conduct of audit-related services. Audit-related services are provided by audit firms to their PIE audit clients on a relatively frequent basis. The audit-related services provided include the audit or review of interim statements, the review of reports for the prudential regulator and other mandatory statutory audits, such as audit reports attached to issue prospectuses, contribution-in-kind reports, audit reports accompanying mergers and demergers, and audit reports for grants and subsidies. Moreover, the current independence rules do not include any specific percentages with regard to determining the financial dependence on a PIE audit client. In our estimation, none of the large PIE audit firms in the Netherlands have (or could acquire) individual PIE audit clients that would account for more than 15-20% of their total revenue. This situation would be more likely to occur at smaller PIE audit firms with only a limited number of audit clients.

Conclusion

a. The AFM endorses the principle of the European Commission that audit firms should only provide services to audit clients that do not threaten their independence. Non-audit services that form a threat to independence should in principle not be provided in addition to the statutory audit to the same audit client. The services designated by the European Commission as audit-related are, like the statutory audit itself, designed to provide assurance with regard to information supplied by the audit client for external users of this information. This is contrary to non-audit services, which are provided for the audit client itself. The AFM thus sees no risks to independence as a result of the performance of such audit-related services to the same PIE audit client in advance. The AFM is not convinced at this point of the necessity or added value of limiting the fees for audit-related services in terms of percentage. Moreover, a comment can be made regarding the practical feasibility of this percentage limitation: the Regulation contains no

[19] *See Article 9.2 of the draft Regulation.*

[20] *See Article 9.3 of the draft Regulation.*

[21] *See Article 9.3 of the draft Regulation.*

further definition of what exactly constitutes the “fees for the statutory audit”. From our supervision it appears that in practice this is dealt with differently.

b. The AFM supports the setting of clear, unequivocal and more restrictive regulation regarding the issue of independence. The proposed rules with regard to the financial dependence on one PIE audit client are consistent with this view. The comment can, however, be made that the proposed percentages only relate to the financial dependence of the audit firm as a whole. Previous scandals, such as that involving Enron and Arthur Andersen, show that the financial dependence of one part of the audit firm, for instance a branch or an individual auditor, can be significant[22]. Similar rules at the branch level of the audit firm and mandatory regular rotation of the auditor could contribute to the prevention of financial dependence on one audit client.

c. The AFM advocates a situation in which the assessment of whether a long-term financial dependence can continue should be made by the audit committee as an independent third party rather than by the audit client. The AFM is not convinced at this stage of the need to make this subject to the prior approval of the regulator. It is also possible to make this situation subject to approval by the audit committee and to notify the regulator that approval has been granted. The regulator can then take additional measures if it sees reason to do so.

4.5 Other issues relating to independence

Proposal by the European Commission

a. The other provisions relating to independence in the draft Regulation include a prohibition on, among other things, taking financial interests in or receiving money, gifts or favours from contract parties, and taking key employment positions at audit clients within a period of two years (for external auditors and key audit partners) or one year (for other employees) after performing an audit.[23] Furthermore, the fee charged for audit work at PIEs may not depend on the result of a transaction or the result of the activities performed (contingent fees).[24]

b. Prior to the acceptance or continuation of an engagement to conduct a statutory audit at a PIE, audit firms must assess whether all the regulations – regarding quality control, personnel, time and resources, appointment of the external auditor, rotation periods and the integrity of the PIE – have been complied with, and whether threats to independence exist. If independence is affected by threats of self-review or self-interest, the statutory audit may not be conducted. If independence is affected by threats of advocacy, familiarity or intimidation, the audit firm must apply safeguards to mitigate these threats.[25]

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[22] *Enron was a large audit client of the audit firm Arthur Andersen. However, the revenue earned by Arthur Andersen from the audit of Enron was less than 15-20% of Arthur Andersen's total revenue. Enron, however, accounted for a significant proportion of the audit revenues earned by the branch of Arthur Andersen where the audit of Enron was conducted, and was in fact the only audit client of the individual auditor who issued the audit report.*

[23] *See Articles 7 and 8 of the draft Regulation.*

[24] *See Article 9.1 of the draft Regulation.*

[25] *See Article 11.1 and 11.2 of the draft Regulation.*

Changes compared to the current situation in the Netherlands

The provisions with regard to financial interests, employment at audit clients and the prohibition of contingent fees are already included in the current independence rules in the Netherlands. One of the new features is the explicit prohibition on receiving money, gifts or favours from contract parties. The assessments prior to the acceptance or continuation of an engagement to perform a statutory audit of a PIE are broadly speaking similar to the provisions that are already included in current Dutch legislation and regulation. However, this legislation and regulation does not describe any situations in which an engagement must be refused, while the draft Regulation contains a prohibition of the acceptance of engagements whereby a real or potential threat of self-review or self-interest is identified.

Conclusion

a. The AFM supports the setting of clear, unequivocal and more restrictive regulation regarding the issue of independence. The proposed rules are consistent with this stance. However, the AFM is not convinced at this point that the prohibition relating to money, gifts and favours should only concern the *receipt* thereof and not also the *granting* thereof. In its thematic inspection 'Incentives for quality', the AFM notes that auditors and audit firms also give money, gifts and favours to audit clients, for instance in the form of sponsoring, marketing and client relation management.

b. The AFM supports the proposed restriction in comparison with the existing rules, whereby an audit firm is prohibited from performing a statutory audit of a PIE if its independence is affected by threats of self-review or self-interest. With regard to threats to independence in the form of advocacy, familiarity or intimidation however, the draft Regulation allows the possibility of applying safeguards to mitigate these threats and still to conduct the statutory audit. This begs the question of what safeguards would be truly effective in completely removing the threats to independence, in both practice and appearance.

4.6 Appointment of the audit firm and compulsory rotation

Proposal by the European Commission

a. The General Meeting of Shareholders (GMS) of a PIE is responsible for the appointment of an audit firm to conduct the statutory audit.[26] The audit committee of the PIE shall submit a recommendation to the administrative or supervisory body of the PIE that contains at least two alternative audit firms and shall express a duly reasoned preference for one of them. If the matter concerns the reappointment of the same audit firm as the one currently or previously appointed, the audit committee shall, in its recommendation, take into consideration the published findings and conclusions of the regulator with regard to the audit firm. The audit committee shall be responsible for the selection of audit firms to be considered as candidates for this recommendation. The European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) will issue further guidelines regarding the criteria for this selection procedure. For instance, at least one proposal must be invited from an audit firm that earns less than 15% of its total audit revenue from large PIEs. The regulator will prepare a list of all audit firms with details

[26] *See Article 37 of the Directive.*

of their revenue each year for the purpose of this selection. In the event that the matter concerns the reappointment of an audit firm, the audit committee shall take into consideration the findings and conclusions in the reports published by the regulator regarding the audit firm in question in its proposal. The proposal by the administrative or supervisory body of the PIE to the GMS regarding the appointment of the audit firm shall also include the recommendation of the audit committee. In the case of banks and insurers, the proposal must be submitted to the prudential regulator, which shall have a right of veto. Clauses that limit the choice of an audit firm are prohibited, and must be notified to the regulator if they are nonetheless proposed.[27]

b. The appointment of an audit firm shall be for more than one year, and the initial engagement must be for at least two years. The appointment of the audit firm may only be extended once. The maximum term of the combined engagements shall not exceed six years (or nine years in the case of a joint audit). A period of at least four years shall then elapse before the same audit firm may be appointed again. In exceptional cases the PIE may request permission from the regulator to reappoint the audit firm for a third term that may not exceed two years (or three years in the case of a joint audit).[28]

c. A newly appointed audit firm shall receive a handover file from its predecessor, and shall be given access to the additional reports to the audit committee and any information that has been provided to the regulator.[29]

d. The external auditor (or key audit partner) shall cease their participation in the statutory audit after seven years. They may not participate in the statutory audit again for a period of at least three years. The audit firm shall additionally establish a gradual rotation mechanism with regard to the other members of the audit team.[30]

Changes compared to the current situation in the Netherlands

The provision that the audit firm shall be appointed by the GMS is already established in Dutch legislation. The Dutch Corporate Governance Code moreover states that this shall occur on the basis of a nomination by the supervisory board, based on a recommendation to the supervisory board by the audit committee and the management. The draft Regulation defines the role of the audit committee more fully and more explicitly, and includes a description of the procedure for the selection of audit firms and the tendering process for the audit engagement. Current Dutch legislation and regulation does not contain any provisions regarding the term (either minimum or maximum) of appointment of an audit firm. The implementation of a maximum term for the total period of the engagement will introduce a system of rotation of firms that will be new for the situation in the Netherlands. Dutch legislation and regulation already includes a seven-year rotation period for external auditors, although the interim period that must elapse before they may participate in the statutory audit again is currently two years rather than the three-year period that is proposed.

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[27] *See Article 32 of the draft Regulation.*

[28] *See Article 33.1 to 33.3 of the draft Regulation.*

[29] *See Article 33.5 of the draft Regulation.*

[30] *See Article 33.4 of the draft Regulation.*

Conclusion

a. The AFM is an advocate of a prominent role for the audit committee in the selection and appointment of an audit firm. The AFM also supports a transparent tendering procedure as described in the draft Regulation. The AFM endorses the added value of a clear evaluation of the quality of the audit firm by the audit committee, which also takes account of the findings and conclusions by the regulator. Regarding the obligation in the tendering process to request at least one proposal from an audit firm that earns less than 15% of its total audit revenue from large PIEs, some comments are appropriate. The most important issue in the tendering process is that several realistic and competitive proposals are included, regardless of the size of the audit firms concerned. Additional safeguards need to be considered in order to ensure that proposals are in fact realistic. Furthermore, in all probability in the Netherlands there will be no audit firms that earn more than 15% of their total audit revenue from large PIEs[31], so that this obligation will have no relevance in practice.

b. The AFM recognises the risks associated with a long-term relationship between an audit firm and a PIE audit client. A fresh view of the audit can be very cleansing and clarifying. The risks of familiarity or trust can be mitigated by ensuring a prominent evaluative role for the audit committee, and through mandatory periodic rotation of the audit engagement. Allowing the appointed audit firm to participate in the tendering process at the end of its first term of engagement can provide an important incentive for quality. The audit committee will in this case evaluate the experiences gained with this audit firm, and take the findings and conclusions of the regulator into consideration. If these are favourable, the audit firm can be rewarded by being reappointed. Ultimately the AFM considers it in the interest of audit quality that the length of the relationship between the audit firm and the PIE should not be such that this becomes a threat to the audit firm's independence. A total combined engagement period of up to six years therefore appears to be reasonable. The AFM is, however, not convinced at this stage of the need to limit the total engagement period to six years *in all cases*. From a public point of view, striving for a more long-term relationship by the best quality audit firm may be beneficial, especially if alternatives are not available, and if an open tendering process and a critical assessment have been carried out. Furthermore, the AFM is not supportive of joint audits (see paragraph 4.7). An extension of the maximum combined engagement period from six to nine years would therefore not apply.

c. The AFM supports the principle that adequate information should be provided by the outgoing audit firm to the incoming audit firm. If the incoming audit firm is provided with all the audit information and considerations of its predecessor that are relevant to the conduct of the statutory audit, this would be an improvement to the current situation.

d. The seven-year rotation period for external auditors is already implemented in Dutch legislation. The draft Regulation would extend the interval period from two to three years and introduce a gradual rotation procedure for the other members of the audit team. The AFM questions the usefulness of this tightening of the rotation requirements for external auditors, since the introduction of the mandatory audit firm rotation will already entail the rotation of the external auditor and the entire audit team.

[31] *See also paragraph 4.3.*

4.7 Joint audits

Proposal by the European Commission

Member states may decide in certain cases that a minimum number of auditors or audit firms shall be appointed for the audit of a PIE, and may establish rules in relation to the collaboration between the auditors or audit firms concerned.[32] Joint audits are therefore not compulsory on the basis of the draft Regulation, but may be made compulsory by the Member State concerned.

Changes compared to the current situation in the Netherlands

Current Dutch regulation does not contain any obligation or other provisions with reference to joint audits.

Conclusion

The AFM does not support compulsory joint audits. In a joint audit, tasks and activities are in practice divided, meaning that neither of the parties has a complete overview and neither of them bears full responsibility for quality control of the audit as a whole. The AFM sees potential risks with regard to quality if none of the engaged audit firms has a complete overview of the statutory audit, whereby full responsibility cannot be univocally allocated to one external auditor. The argument by the European Commission that joint audits lead to better audits because of the 'four-eyes' principle is not at this stage convincing, since the draft Regulation does not contain a provision to ensure that the two parties in a joint audit check each other's work. The possibility for Member States to decide unilaterally whether or not to make joint audits compulsory is not consistent with the principle of the draft Regulation, which states that the same rules should apply for the whole European Union in order to promote one internal market for audit services. A mandatory tendering procedure (see paragraph 4.6) means that new entrants to the market for statutory audit work will get a fair chance. This means that an artificially collective conduct of the statutory audit is not necessary.

4.8 Reports by audit firms

Proposal by the European Commission

a. The outcome of a statutory audit of a PIE must be stated in two reports[33] by the audit firm: the audit report[34] and the report to the audit committee[35].

   The content of the audit report that is published will be extended to include an explanation of the methodology used – in particular the way in which the balance sheet has been directly verified and how much has been based on system and compliance testing, the level of materiality applied, the key areas of risk of material misstatement in the financial statements, a determination as to whether the statutory audit was designed to detect fraud, and in the case of an audit report with a qualified opinion, an adverse opinion or a disclaimer of opinion, the reason

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[32] *Article 32.9 of the draft Regulation.*

[33] *See Article 21 of the draft Regulation.*

[34] *See Article 22 of the draft Regulation.*

[35] *See Article 23 of the draft Regulation.*

for such an opinion. The audit report must also explain any variation in the weighting of substantive and compliance testing when compared to the previous year.

The audit firm must also prepare a report for the audit committee. This report must provide more detailed information on the audit works conducted, on the situation of the enterprise as such (such as the continuity of the business operations) and on the findings of the audit, accompanied by the necessary explanations. This report shall be provided to the audit committee, the management of the PIE and also to the regulator on request. The report shall however not be made generally available to the public.

b. Audit firms shall provide a list to the regulator each year of all the PIEs they have audited, stating the revenue generated from them.[36] The audit firm shall also report to the regulator in the event of[37]:
   - Material breaches of legislation and regulation specifically applying to the PIE in question;
   - A threat to the continuity of the PIE;
   - The audit firm's intention to issue an other that clean audit opinion.

c. Audit firms must publish an audited set of financial statements each year, and notify the regulator accordingly. These financial statements must include at least an income statement in which the revenue is classified according to audit revenue from PIEs, audit revenue from non-PIEs and revenue from audit-related services. Financial and other information should also be included regarding the network to which the audit firm belongs. [38]

   In addition, audit firms must publish a transparency report each year, and must inform ESMA and the regulator accordingly. The transparency report shall contain the elements that are already included in Article 40 of the SAD[39]. The following additional elements shall also be included:
   - A description of policy regarding the rotation of key audit partners;
   - A corporate governance statement, if the audit firm earns more than one third of its revenue from statutory audits of large PIEs.

Changes compared to the current situation in the Netherlands

The audit report is extended, and will have to contain more information regarding the statutory audit conducted. The draft Regulation introduces the presentation of a formal annual report to the audit committee and prescribes the minimum information this report must contain. There are various rules currently in place that prescribe the issues on which the audit firm must communicate with the audit committee (or the supervisory board). In practice, audit firms already include several items mentioned in the draft Regulation in the management letter that is also provided to the audit committee. The duty of audit firms to notify the regulator of breaches or irregularities at a PIE client already apply for financial enterprises. The draft Regulation extends this notification requirement to include all PIEs. Furthermore, the draft Regulation makes it mandatory for audit firms to issue audited financial statements, and extends the scope of the transparency report in certain respects.

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[36] *See Article 29 of the draft Regulation.*

[37] *See Article 25 of the draft Regulation.*

[38] *See Article 26 of the draft Regulation.*

[39] *This article will actually be deleted from the SAD and introduced into the draft Regulation.*

Conclusion

a. The AFM supports additional information being provided (in the audit report) to the users of the financial statements, regarding matters such as the audit process and the independence of the auditor and the audit firm. With regard to the exact scope of the information that must be included in the audit report, our view is that this should be linked to the information needed by the users of the financial statements. It is important that this information is relevant, understandable, correct and complete. The AFM also endorses the provision of adequate information to the audit committee. We approve of the explicit inclusion of the possibility for the regulator to request a copy of the report to the audit committee (the management letter) from the audit firm.

b. The AFM has no objection to the provision by audit firms of a full list of PIE clients to the regulator. Notification to the regulator in the event that exceptional circumstances at a PIE audit client are identified by the audit firm is currently to a large extent already implemented in the Netherlands for financial enterprises. The AFM supports the extension of this notification requirement to include all PIEs. One question that could be raised is that it is not entirely clear *which* regulator has to be notified: the regulator responsible for the audit firm, or the regulator of the PIE, or both. To avoid misunderstanding, it would appear to be sensible to refer to the AFM with respect to this obligation in addition to the existing obligation for financial enterprises to notify the Dutch central bank (De Nederlandsche Bank or DNB).

c. The AFM supports increased transparency regarding the audit firms themselves, and thus also the mandatory publication of the financial statements of audit firms and the extension of the scope of the transparency report. This information will enable decisions taken with regard to services provided by audit firms to be based on more objective criteria that will moreover include the quality of the statutory audits.

4.9 Role of the audit committee

Proposal by the European Commission

Every PIE must have an audit committee (with certain exceptions).[40] The duties and powers of the audit committee in the draft Regulation are broadly the same as those in the SAD.[41] An audit committee shall consist of non-executive members of the administrative body and/or members of the supervisory body of the PIE and/or members appointed by the GMS. A majority of the members and the chairman shall be independent. At least one member shall have competence in auditing, and another member in accounting and/or auditing. The members of the audit committee as a whole shall have competence that is relevant to the sector in which the PIE operates. The audit committee monitors the financial reporting process, the effectiveness of the internal controls, the internal monitoring and risk management and the work of the audit firm that conducts the statutory audit, and informs the management and the supervisory body of the audit client accordingly.[42] The audit committee may give its approval for the provision of certain non-audit services (such as services in

[40] *See Article 31 of the draft Regulation.*

[41] *Deze bepalingen worden overigens verwijderd uit de SAD en geïntroduceerd in de ontwerpverordening.*

[42] *See Article 24 of the draft Regulation.*

relation to human resources and comfort letters to accompany share issues).[43] The audit committee is moreover responsible for the tendering procedure for the assignment of the audit engagement to an audit firm.[44]

Changes compared to the current situation in the Netherlands

The draft Regulation increases the role of the audit committee and sets stricter (statutory) requirements with regard to its independence, competence and involvement with the PIE.

Conclusion

The AFM supports such an increased role for the audit committee in the activities of the audit firm (including the evaluation of certain threats to independence). Indeed, if the management of the PIE (and in particular the CFO) have primary responsibility for the direction of the external auditor and the selection of the audit firm, this can create a conflict between the independence of the auditor and his or her interests as a contractor of the audited entity. If, however, the direction and selection of the audit firm are the responsibility of the audit committee, as proposed in the draft Regulation, the auditor will be in a better position to take a professional-critical attitude when conducting the audit, and to arrive at an independent opinion. In this regard it is essential that there is complete transparency with respect to the various positions held by the members of the audit committee, for instance at other PIEs, and the relationships they have with (other) audit firms in these positions. There is also the question of whether sufficient capacity is available to be able to meet the stricter competence requirements for at least two members of the audit committee.

4.10 Conduct of the statutory audit

Proposal by the European Commission

The draft Regulation contains various provisions that should safeguard the quality of the conduct of the statutory audit of a PIE, including[45]:

- the scope of the audit (focused on the presentation of a true and fair view and compliance with reporting standards, not on the future viability or the efficiency or effectiveness of the audit client);
- the professional scepticism of the auditor (especially with reference to the audit of estimates of fair values, the amortisation of goodwill and other intangible assets, and the future cash flows relevant to the consideration of continuity of the entity);
- the appointment of at least one external auditor (key audit partner) with sufficient resources to carry out his or her work, who is actively involved in the conduct of the statutory audit;
- the external auditor shall spend sufficient time on the audit and shall make adequate resources available to his or her employees;
- the keeping of records of cases in which the Regulation is not respected;
- the consultation with external experts;
- the maintenance of client account records;
- the minimum content of an audit file;
- the registration of complaints regarding the conduct of statutory audits;

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[43] *See Article 10 of the draft Regulation.*

[44] *See also paragraph 6.6.*

[45] *See Articles 14-20 of the draft Regulation.*

- the registration of incidents, measures being taken and notifications to the regulator;
- the notification of fraud or other irregularities to the audit client and to the appropriate bodies if the measures taken by the audit client are inadequate;
- the responsibility of the group auditor for compilation of audit files and the provision of information to the regulator;
- the engagement quality control review of statutory audits at PIEs;
- the use of international auditing standards.

Changes compared to the current situation in the Netherlands

The above provisions regarding the conduct of statutory audits are already to a large extent implemented in Dutch legislation and regulation.

Conclusion

The AFM is of the opinion that the current legislation and regulation with respect to the conduct of statutory audits, and therefore also the proposed provisions in the draft Regulation, are in principle adequate.

4.11 Quality control

Proposal by the European Commission

The draft Regulation includes provisions making it mandatory for an audit firm to have policy and procedures to ensure that it has (among other things) the following: independent and objective external auditors, a controlled and sound conduct of its business, effective quality controls, personnel with appropriate knowledge and experience, outsourcing of audit functions that are of adequate quality, measures to deal with threats to independence, standards for the conduct of statutory audits, and policy and procedures for coaching and evaluating employees, organising the structure of audit files, dealing with incidents, the remuneration of employees, quality monitoring and the evaluation of the system of quality controls. Compliance with these provisions must be proportionate to the size and complexity of the activities of the audit firm.[46]

Changes compared to the current situation in the Netherlands

The majority of these provisions are currently already implemented in Dutch legislation and regulation and are equivalent to the rules with regard to the independence of the audit firm and the external auditor, the quality control system, quality monitoring and the controlled and sound conduct of the firm's business. A few of the elements in these provisions are new for the Netherlands:

1. *Remuneration.* The provision that the remuneration of employees may not be related to the revenue earned by the audit firm from the audit client is currently not explicitly included in Dutch legislation and regulation. Performance-related remuneration, salaries and promotion are however cited as indicators of the mandatory quality policy of audit firms.
2. *Outsourcing.* Current Dutch legislation and regulation contains no provisions in relation to the outsourcing of audit activities. Such outsourcing may not detract from the quality of the statutory audit and may not affect the responsibility of the audit firm towards the audit client.

[46] *See Article 6 of the draft Regulation.*

3. *Quality control.* The provision that responsibility for the system of quality control within an audit firm must rest with a person who qualifies as an external auditor is currently not explicitly included in Dutch legislation and regulation.
4. *Proportionality.* The provision that compliance with these quality control provisions should be proportionate to the size and complexity of the activities of the audit firm is currently not explicitly included in Dutch legislation and regulation.

Conclusion

The AFM is of the opinion that the current legislation and regulation with respect to quality control, and therefore also the proposed provisions in the draft Regulation, are in principle adequate. Regarding the remuneration of employees, the AFM also refers to the NBA's Action Plan 'Lessons from the Credit Crisis' published in November 2010. This includes the following measure: "Quality as the most important principle for the assessment and remuneration of auditors at audit clients; prohibition of commercial incentives such as revenue and cross selling as criteria for remuneration". In its report 'Incentives for audit quality' of 6 October 2011, the AFM stated its support for a clear and standardising expression of this measure in the regulations for the profession, whereby quality shall indisputably prevail above any form of commercial incentive. The provisions in relation to the outsourcing of audit activities that are new for the situation in the Netherlands are expected to make an additional contribution to ensuring the quality of statutory audits. With regard to the provision that responsibility for the quality control system must rest with a person who is qualified as an external auditor, the AFM notes that while this can constitute a positive incentive for quality, it should not detract from the collective responsibility of the management of an audit firm for the quality control system as a whole. The explicit inclusion of the provision that compliance with the quality control provisions should be proportionate to the size and complexity of the activities of the audit firm clarifies the fact that more can be expected from larger and more complex audit firms with regard to compliance with the quality control provisions.

4.12 Confidentiality

Proposal by the European Commission

a. Auditors and audit firms shall not invoke the rules on confidentiality if this prevents the application of the Regulation.[47]

b. In the context of a group audit, audit firms may disclose audit information to the group auditor in a third country.[48]

Changes compared to the current situation in the Netherlands

The provision in a. ensures that national legislation and regulation does not impede the application of the Regulation. The provision in b. provides an exception to the confidentiality rules that is already included in current Dutch legislation and regulation.

Conclusion

The AFM has no objection to these proposals.

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[47] *See Article 12 of the draft Regulation.*

[48] *See Article 13 of the draft Regulation.*

4.13 National regulators of audit firms and PIEs

Proposal by the European Commission

a. Every Member State should designate a regulator to carry out the supervisory duties associated with the draft Regulation. A different regulator may be designated for the supervision of compliance with the provisions relating to the appointment of audit firms for PIEs (including the provisions for audit committees). The regulator must have sufficient capacity, expertise and resources. The Member States should inform each other, EBA, EIOPA and ESMA as to which regulator(s) they have designated. ESMA will maintain a publicly available list of these regulators.[49]

b. The regulator should be independent[50], have adequate powers (such as the power to access any documentation, demand information from any person, carry out on-site inspections, request records of telephone and data traffic with the permission of the courts, refer matters for criminal prosecution and engage experts)[51], process personal data in accordance with the directive on the protection of personal data[52] and observe the principles of confidentiality[53] (although information can be exchanged with institutions such as ESMA[54] and other regulators[55]).

Changes compared to the current situation in the Netherlands

The draft Regulation would not appear to entail any changes regarding the supervision of audit firms in the Netherlands: the AFM can continue to take responsibility for the supervision of audit firms. Regarding the supervision of compliance with the provisions by PIEs, some of the aspects of this supervision are currently the responsibility of DNB (as the prudential regulator for financial enterprises) and some are the responsibility of the AFM (as the conduct regulator for financial enterprises). There would not currently appear to be a regulator in the Netherlands with explicit responsibility for overseeing listed companies, for instance regarding the question of whether they have an adequate audit committee. As things currently stand, the regulators in the Netherlands would appear to have sufficient powers to meet the requirements of the draft Regulation.

Conclusion

The AFM has no objection to these proposals, especially since they are largely already implemented in the Netherlands. We do see a need for a regulator to be explicitly designated as responsible for supervision of the provisions not currently subject to supervision in the Netherlands with sufficient powers, including enforcement powers, for this purpose.

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49 See Article 35 of the draft Regulation.

50 See Article 36 of the draft Regulation.

51 See Article 38.1 to 38.4 of the draft Regulation.

52 See Article 38.6 of the draft Regulation.

53 See Article 37 of the draft Regulation.

54 See Article 55 of the draft Regulation.

55 See Articles 48 and 57 of the draft Regulation.

4.14 Inspections of PIE audit firms

Proposal by the European Commission

a. The regulator shall carry out independent quality assurance reviews (inspections) of audit firms that audit PIEs every three years. Certain activities shall be carried out by the regulator independently, and may not be delegated to a professional association or body:
    a. approval and amendment of inspection methodologies (manuals, methodology, inspection programmes);
    b. approval and amendment of inspection reports and follow-up reports;
    c. approval and assignment of individual supervisors (or inspectors) for each inspection.

   Individual inspectors must be independent, have the appropriate professional education and experience, may not be employed in public practice, may not have worked for the audit firm to be inspected in the previous two years, and shall declare not to have any conflicts of interest.

   An inspection shall include at least:
    a. a review of the quality control system;
    b. compliance testing of procedures and a review of audit files of PIEs, whereby at least a significant proportion of the audit files are selected on the basis of an analysis of the risk that the statutory audit of the financial statements has not been conducted adequately;
    c. an assessment of the most recent transparency report.

   The inspector shall discuss his or her findings and conclusions with the audit firm. Recommendations shall be followed up by the audit firm within a reasonable period and in any case within 12 months. The main conclusions of the inspection will be recorded in a report.[56]

   In addition, a regulator must have mechanisms in place for the conduct of specific investigations with a view to detecting, correcting and preventing inadequate conduct of statutory audits.[57]

b. The regulator shall continually monitor developments in the market and produce reports to ESMA, EBA and EIOPA every two years on the following issues[58]:
    a. the risks arising from high market concentration, including the demise of audit firms with significant market share, the disruption in the provision of statutory audits in a specific sector, and the overall stability of the financial sector;
    b. the need to adopt measures to remove these risks.

c. The regulator shall request the six largest audit firms within the Member State to establish a contingency plan containing information on the degree of liability of each partner within the audit firm and the degree to which liability can extend to other audit firms within the same network. The contingency plans shall be submitted to the regulator, however the plans will not have to be approved or endorsed by the regulator.[59]

Changes compared to the current situation in the Netherlands

The requirements set in the draft Regulation have already been included in a recommendation by the European Commission[60] and are largely already implemented in Dutch legislation and regulation. The

[56] *See Article 40 of the draft Regulation.*

[57] *See Article 41 of the draft Regulation.*

[58] *See Article 42 of the draft Regulation.*

[59] *See Article 43 of the draft Regulation.*

requirements regarding the substance of an inspection are also already mostly implemented. The final responsibility for the regulator is defined more precisely. Since the European regulator ESMA, EBA and EIOPA have only recently been incorporated, the provisions with respect to the submission of information to these institutions have not yet been implemented in Dutch legislation and regulation. The requirement for the six largest audit firms to prepare a contingency plan is also new in the Dutch situation.

Conclusion

a. The provisions in the draft Regulation regarding the conduct of inspections are largely in line with current practice in the Netherlands. In this model the regulator is obliged to conduct an inspection of PIE audit firms every three years (and of non-PIE audit firms every six years). While these periods certainly provide a safeguard, they also form a limitation in the degree of supervision. The regulator has less discretion with regard to conducting inspections of some audit firms more or less frequently on the basis of risk or impact-driven supervision. In practice it can now be the case that, as a result of the mandatory terms, the regulator is forced to conduct inspections of audit firms with an extremely low risk profile, and thus has less capacity available for the inspection of audit firms with a high risk profile.

   Regarding the review of audit files, the AFM notes that it is not entirely clear whether this means only that the selection of a significant proportion of the audit files must be based on a risk analysis, regardless of the total number involved. For its inspections, the AFM already selects the audit files largely on the basis of a risk analysis. If, on the other hand, this also means that a significant *number* of audit files must be selected for an inspection, further clarification will be needed to establish the quantity of audit files that qualifies as 'significant'. The AFM is of the opinion that the risk-driven selection of audit files for an inspection and the average number of audit files reviewed[61] provides sufficient information for the formation of an opinion with regard to compliance with relevant legislation and regulation, and the quality of the statutory audits conducted.

b. The monitoring of the market described here can be carried out by the AFM to the extent that this relates to the continuity and quality of the statutory audits conducted. To the extent that such monitoring concerns the degree of competition in the audit profession in the Netherlands, this is a task for the NMa (the Netherlands Competition Authority) and not for the AFM. It is not clear whether the draft Regulation is intended to include such a role for competition authorities.

c. The obligation to prepare a contingency plan arises from the assumption that the largest audit firms can constitute a systemic risk. It is assumed that the failure of one of these audit firms would entail consequences for the overall stability of the financial market. The continuity of these audit firms is important for the proper operation of the financial markets, specifically the continuity in current and future statutory audits. It is therefore a good thing if the largest audit firms have made preparations to deal with a failure of continuity. The raising of temporary or permanent external funding can offer a solution if a threat to continuity arises. This could prevent a collective 'migration' of employees to one or more audit firms, forced by the governance

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[60] *Commission Recommendation of 6 May 2008 on external quality assurance for statutory auditors and audit firms auditing public interest entities (notified under document number C(2008) 1721) (2008/362/EC)`.*

[61] *The AFM reviews approximately 10 to 15 audit files during a regular inspection at a Big Four audit firm.*

structure of external auditors who are partners and/or owners of the audit firm. The draft Directive caters for this possibility, as long as sufficient safeguards are in place to prevent conflicts of interest between the shareholders of audit firms and PIEs. Indeed, for the practical application of this provision regarding the preparation of a contingency plan, a parallel can be drawn with the so-called 'living wills' that are prepared by banks.

4.15 Reports by the regulator

Proposal by the European Commission

The regulator shall be transparent, and shall publish the following documents[62]:

- an annual activity report;
- an annual work programme;
- a report on the overall results of the quality assurance system during a year, including information on recommendations made, follow-up thereon, supervisory measures taken and penalties imposed;
- the findings and conclusions of individual inspections.

Changes compared to the current situation in the Netherlands

In the current situation in the Netherlands, the AFM publishes an annual activity report, an annual plan and a general report of its inspection findings. Due to the current confidentiality rules, the AFM cannot publish the findings and conclusions of individual inspections, apart from administrative fines.

Conclusion

The AFM supports this extension to the possibilities to increase its own transparency, since in practice we see a huge need for increased transparency (both at the audit firm subject to supervision, and from the public). Regarding the transparency with respect to findings and conclusions from individual inspections, we wish to make two comments. First, the AFM foresees a further increase in the juridification of the supervisory process if firm-specific findings and conclusions are published. Audit firms are already expressing anxiety regarding excessive transparency with respect to their actual quality in the light of the effects on reputational risk, which delays effective enforcement and the self-correcting capacity. Second, even more than is currently the case, there will be debate regarding every word and example cited in individual reports that are published. In such a situation, the AFM considers it inevitable that its ability to simply state its findings will be compromised. This dilutes the distinction between a report concerning an audit firm and the decision to impose an administrative fine. Particularly the latter is an important enforcement measure for the AFM that cannot be rashly replaced by a mere public report of findings.

4.16 Enforcement

Proposal by the European Commission

a. The Member States shall set rules on enforcement measures and inform ESMA regarding these rules (and amendments thereto).[63] The draft Regulation contains an Annex listing the offences

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[62] *See Article 44 of the draft Regulation.*

[63] *See Article 61 of the draft Regulation.*

that can be committed by auditors, audit firms and PIEs. The regulator must be able to impose at least the following administrative measures and sanctions for these offences[64] that must be published without delay[65] (Member States may also allocate additional powers):

a. an order;
b. a publication stating the nature of the offence on the regulator's website;
c. a temporary prohibition of the conduct of statutory audits by the audit firm or external auditor;
d. a statement that the audit report does not meet the requirements of the draft Regulation;
e. a temporary ban on directors of audit firms or PIEs;
f. financial penalties:
    i. of up to twice the profit gained or loss avoided as a result of the offence;
    ii. of up to €5,000,000 for natural persons;
    iii. of up to 10% of the total revenue in the previous financial year for legal persons.

In the determination of the amount of the sanction and the type of analysis, regulators must take the following into consideration[66]:

a. the gravity and duration of the offence;
b. the degree of responsibility (or culpability) of the persons concerned;
c. the financial strength of the person concerned;
d. the importance of the profit gained or loss avoided as a result of the offence;
e. the degree of cooperation with the regulator;
f. previous violations.

Regulators and other legal institutions shall inform ESMA regarding the penalties imposed on an annual basis. ESMA shall publish this information in an annual report.[67]

b. The Member States must initiate effective mechanisms to encourage reporting of offences to the regulator.[68] These shall in any case include:
    a. specific reporting procedures;
    b. appropriate protection for persons who report potential or actual offences;
    c. protection of personal data;
    d. procedures to ensure that both sides of the argument are heard.

Changes compared to the current situation in the Netherlands

The draft Regulation contains new and more extensive enforcement measures than those currently available to the AFM (including in the area of publication, the form and amount of penalties, the temporary prohibition of acting as an external auditor or a (co) policymaker of a PIE audit firm). The aspects that should be taken into consideration in the determination of the amount and type of the penalty to be imposed are already included in the current enforcement policy of the AFM. The protection of personal data and the principle that both sides of the argument should be heard are already implemented in the Netherlands.

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64 *See Article 62 of the draft Regulation.*

65 *See Article 64 of the draft Regulation.*

66 *See Article 63 of the draft Regulation.*

67 *See Article 67 of the draft Regulation.*

68 *See Article 66 of the draft Regulation.*

Conclusion

a. The AFM has no objections to the extension of the enforcement measures and the reporting of penalties imposed to ESMA.

b. The AFM supports mechanisms that encourage the reporting of offences to the regulator and that protect the person who makes such a report. This enables the regulator to become aware of offences at an earlier stage and to take suitable measures in good time.

4.17 Cooperation and European regulation of audit firms

Proposal by the European Commission

a. Where necessary, regulators shall cooperate with regulators from other Member States[69], for example with regard to the contingency plans of audit firms[70], whereby the principle of the home Member State shall be respected[71], information shall be mutually exchanged[72] and duties may be delegated to other regulators (without transfer of final responsibility)[73]. In order to encourage cooperation between regulators in the conduct of inspections, either singly or collectively, colleges of regulators may be incorporated. In such cases, the regulator of the home Member State shall in principle take the leading and facilitating role.[74]

b. Cooperation between regulators shall be organised within the framework of ESMA. ESMA shall create a permanent internal committee for this purpose which will take over the duties of the European Group of Auditors' Oversight Bodies (EGAOB) and will work with EBA and EIOPA. ESMA shall advise regulators regarding matters that involve this Regulation. ESMA shall contribute to cooperation between EU regulators and regulators from third countries.[75] ESMA shall also cooperate with international organisations and bodies concerned with international auditing standards.[76] ESMA shall moreover, after consultation with EBA and EIOPA, issue guidelines with respect to[77]:
    a. common standards on the content and presentation of the audit report;
    b. common standards on the content and presentation of the report to the audit committee;
    c. common standards for the supervisory activities of the audit committee;
    d. common standards and best practices for the content and presentation of the transparency report;
    e. common standards and best practices for the gradual rotation mechanism for the members of audit teams;

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[69] *See Article 45 of the draft Regulation.*

[70] *See Article 52 of the draft Regulation.*

[71] *See Article 47 of the draft Regulation.*

[72] *See Article 48 of the draft Regulation.*

[73] *See Article 54 of the draft Regulation.*

[74] *See Article 53 of the draft Regulation.*

[75] *See Articles 57-59 of the draft Regulation.*

[76] *See Article 60 of the draft Regulation.*

[77] *See Article 46.1 to 46.3 of the draft Regulation.*

f. common standards and best practices regarding the grounds for dismissal of an audit firm;
g. enforcement practices and activities to be conducted by regulators;
h. common standards and best practices for conducting inspections and investigations, in particular with reference to the varying size and scope of the activities of audit firms and the corresponding quality standards, policy and procedures of audit firms within a network;
i. procedures for the exchange of information;
j. procedures and modalities for cooperation in cases of collective inspections;
k. the operational functioning of the colleges of regulators.

In addition, EBA, EIOPA and ESMA shall collectively issue guidelines with respect to the types of enforcement measures and penalties, and the amounts of penalties to be imposed in individual cases within the national statutory framework.

c. ESMA shall publish a number of reports (20XX being the year in which the draft Regulation takes effect)[78]:
    a. In 20XX + 2 years: an evaluation of the structure of the audit market on the basis of a study of the influence of Member States' civil liability systems on the structure of the audit market (which shall be presented in a report by the Commission one year later);
    b. In 20XX + 4 years: a report every two years on the application of the Regulation after consultation with EBA and EIOPA;
    c. In 20XX + 4 years: a report on a study to establish the degree to which the regulators in the Member States are sufficiently empowered and have adequate resources to carry out their tasks;
    d. In 20XX + 6 years: a report on changes in the structure of the audit market, changes in the patterns of cross-border activities and an interim assessment of the improvement in audit quality;
    e. In 20XX + 12 years: an evaluation of the effect of this Regulation.

d. ESMA shall introduce a voluntary European quality certificate for audit firms that conduct statutory audits of PIEs. This quality certificate will be issued by ESMA to audit firms which meet requirements as yet to be determined (based on audit quality and the experiences of regulators) against payment of a cost-effective fee.[79]

Changes compared to the current situation in the Netherlands

The draft Regulation encourages and regulates the further cooperation between regulators and introduces an important coordinating role for ESMA.

Conclusion

a. The AFM supports increased (regulated) cooperation between regulators where this is necessary and effective. Colleges of regulators are already informally active in the supervision of audit firms with cross-border activities and corresponding organisational structures. This cooperation between regulators contributes to more efficient and effective supervision of these audit firms and avoids overlapping and repetition of supervisory inspections.

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[78] *See Article 46.4 and 46.5 of the draft Regulation.*

[79] *Zie artikel 50 van de ontwerpverordening.*

b. The AFM supports the creation of a coordinating and harmonising role for ESMA. It should be noted in this context that this should not lead to a limitation of the regulator's discretionary powers (for instance with regard to the type or amount of an enforcement measure or penalty).

c. The AFM has no objection to the proposal that ESMA should evaluate compliance with the Regulation and the status of the audit market and produce a report on these matters.

d. The AFM sees no added value in the introduction of a voluntary quality certificate (in addition to the PIE licence that is issued by the AFM) and therefore does not support this proposal.

5 Proposals – Amendments to the Directive

5.1 Scope of the Directive

Proposal by the European Commission

a. The rules relating to audit firms that audit PIEs and the supervision thereof are included in the Regulation (see paragraph 4 above). This means that Articles 22, 25 and 27 to 30 SAD no longer relate to PIE audit firms unless the Regulation expressly states otherwise. Articles 32 to 36 SAD ('public oversight and regulatory arrangements between Member States – and the regulatory area') only apply to PIE audit firms to the extent that supervision of compliance relates to the approval and registration of external auditors and audit firms.

b. The definition of 'statutory audit' in Article 2 SAD will be changed to cover situations where Member States impose an obligation on small undertakings to have their financial statements audited, as well as those situations where an obligation to have the financial statements audited is imposed by the EU. If a small undertaking voluntarily decides to have its annual reporting audited, this audit shall also qualify as a statutory audit.

c. The definition of 'public-interest entity' (PIE) in Article 2 SAD will be changed. See paragraph 4.1 of this memo.

d. The following definitions will be added: small undertakings and medium-sized undertakings, home Member State, and host Member State.

Changes compared to the current situation in the Netherlands

The extension of the definition of a statutory audit in particular will have significant consequences for the situation in the Netherlands. While Dutch legislation and regulation does not contain any obligation for small companies to have their accounts audited, many such audits are conducted in the Netherlands on a voluntary basis. These audits are moreover conducted by audit firms that under the current definition do not conduct statutory audits and therefore do not hold (and are not required to hold) a licence from the AFM. The proposed extension to the definition of statutory audit will mean that more audit firms will come under supervision.

Conclusion

a. The AFM endorses the desirability of clear and consistent rules for PIE audit firms within the European Union. This can be achieved by means of a Regulation. It can also be noted that the

fact that such a Regulation deals with sensitive issues will not expedite the decision-making process.

b. This proposal will likely lead to a huge increase in the number of statutory audits in the Netherlands. The AFM does not univocally support the proposed amendment. The inclusion of voluntary audits could improve clarity in the market. At the same time, it must be prevented that the typical segment of small companies will come under supervision of the AFM due to this rule.

c. We refer to the conclusion in paragraph 4.1.

d. The AFM has no objection to the addition of these definitions to the SAD.

5.2 Access to the audit market

Proposal by the European Commission

a. Member States will no longer be permitted to require that a majority of the voting rights or capital in an audit firm is held by auditors or audit firms.[80] The only requirement will be that a majority of the day-to-day policymakers at audit firms must be professionally qualified.

b. The draft Directive introduces a 'European passport' for audit firms.[81] This means that audit firms may provide their services in other Member States, on condition that the external auditor is approved in the host Member State. The host Member State registers such an audit firm from another Member State on the basis of evidence of registration in the home Member State.

c. The draft Directive introduces a 'European passport' for external auditors.[82] An external auditor may provide services in other Member States on a temporary or occasional basis. Articles 5 to 9 of the Directive on the Recognition of Professional Qualifications[83] in this case apply to this free professional practice. This also means that the external auditor shall notify the regulator in the host Member State of the service he or she is providing in advance, or afterwards in urgent cases. If an external auditor wishes to practice in another Member State on a permanent basis, the Member State shall offer the external auditor a choice of either an aptitude test or an adaptation period of up to three years. The regulators in the Member States will have to cooperate more closely in the area of training of auditors, also from the point of view of consistency of the requirements for the aptitude test and the adaptation period. To the extent that the convergence of requirements relates to the statutory audits of PIEs, they will also have to cooperate with ESMA.[84]

Changes compared to the current situation in the Netherlands

Based on the current legislation, a majority of the voting rights in an audit firm must be held by audit organisations, audit firms or statutory auditors. This requirement will be scrapped. Furthermore, on

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80 *See Article 1 (3)(b) of the draft Directive (Article 3 SAD).*

81 *See Article 1(4) of the draft Directive (new Article 3b SAD).*

82 *See Article 1(4) of the draft Directive (new Article 3a SAD).*

83 *PB EC L 255, p. 22.*

84 *See Article 1 (7) of the draft Directive (Article 14 SAD).*

the basis of current legislation, audit firms with a licence from the AFM may only conduct statutory audits in the Netherlands. If they wish to extend provision of their audit services into another Member State, they will have to be registered in that Member State, which requires a substantive assessment. This principle applies throughout the EU. The draft Directive introduces a European passport whereby registration in another Member State occurs on the basis of proof of registration in the home Member State and therefore without a substantive assessment. Lastly, the draft Directive brings the provision for the admission of individual statutory auditors in line with the Directive on the Recognition of Professional Qualifications.

Conclusion

a. The proposed rules will liberalise access to capital for audit firms, since a majority of ownership and control no longer has to be held by auditors or audit firms. The AFM has no objection to this liberalisation of the rules. It is however important that the day-to-day management of the audit firm is conducted by persons who have sufficient knowledge and understanding of statutory audits and the tasks and methods involved in this process.

b. The draft Directive makes it easier for audit firms to access the audit market in Europe. A European passport encourages cross-border mobility of auditors and audit firms and the existence of pan-European audit firms. Moreover, a European passport also means that the AFM will have to rely on the system of supervision and enforcement in other Member States. However it is currently the case in many Member States that the SAD in its present form has not been fully or uniformly applied (for example, with regard to the integrity test of policymakers). At this stage, the AFM therefore does not consider that it can rely on the supervision in these Member States in advance.

c. From the point of view of consistency and the free exchange of persons and services, the AFM supports the harmonisation of the admission of external auditors with the requirements in the Directive on the Recognition of Professional Qualifications. In the conduct of statutory audits, knowledge of the specific national legislation and regulation in the host Member State as well as knowledge of the harmonised international auditing standards is needed (in the case of the Netherlands, this concerns the Dutch Civil Code, the Money Laundering and Terrorist Financing (Prevention) Act (the Wwft), the fiscal legislation and specific rules regarding professional conduct). An external auditor conducting statutory audits on a temporary or occasional basis in another Member State does not have to undergo an aptitude test or an adaptation period. An external auditor who wishes to practice in another Member State on a permanent basis does have to undergo this process. This would not seem to be consistent with the principle that the external auditor must be sufficiently qualified to conduct statutory audits in accordance with the prevailing (national) legislation and regulation. In the case of temporary or occasional statutory audits, the necessary expertise would have to be otherwise available in the audit team in order to comply with the prevailing legislation and regulation in the Member State concerned.

5.3 Auditing standards

Proposal by the European Commission

The Member States will be obliged to ensure that audit firms and external auditors conduct statutory audits in accordance with international auditing standards.[85] International auditing standards in this respect refers to the International Standards on Auditing (ISAs) and the associated other statements and standards that form part of the Clarity Project of the International Federation of Accountants (IFAC) to the extent these are relevant to the statutory audit. Subject to conditions, the Member States may only make audit activities or requirements that are additional to the international auditing standards obligatory if this is the result of specific national statutory requirements that relate to the scope of the statutory audit of financial statements. Member States will no longer be able to exclude international auditing standards or parts thereof.

Changes compared to the current situation in the Netherlands

In the Netherlands, the professional body NBA has already fully implemented the ISAs in the Further Regulations for Audit and Other Standards [Nadere voorschriften controle- en overige standaarden, or NVCOS]. These regulations do not contain any additional standards, nor do they exclude any international standards, and only refer to specific national legislation and regulation in certain explanatory paragraphs.

Conclusion

The AFM supports the mandatory application of the (Clarified) ISAs, because this will bring about (further) harmonisation of statutory audits in Europe. However, adequate governance regarding the formulation of the ISAs is an important consideration.[86]

5.4 Supervision of non-PIE audit firms

Proposal by the European Commission

a. The competent authority (or regulator) is (ultimately) responsible[87] for the approval and registration of external auditors and audit firms[88], the quality assurance system[89], the approval of rules governing professional conduct, continuing education and investigative and disciplinary systems[90]. The competent authority may only delegate tasks to other authorities or bodies (such as professional bodies) that relate to the approval and registration of external auditors and audit firms. This may only occur under strict conditions and the other Member States must be informed

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85 *See Article 1 (12) of the draft Directive (Article 26 SAD).*

86 *See for instance the conclusions of the Monitoring Group in the report "Review of the IFAC Reforms – Final Report" published on 8 November 2010.*

87 *See Article 1 (15)(a) of the draft Directive (Article 32(4) SAD).*

88 *See Article 1 (3)(a) of the draft Directive (Articles 3 and 15 SAD).*

89 *See Article 1 (14)(a) of the draft Directive (Article 29 SAD). The specific requirements for quality assurance regarding audit firms that audit PIEs are stated in the draft Regulation.*

90 *See Article 1 (15)(a) of the draft Directive (Article 32 SAD).*

accordingly[91]. The explicit possibility that professional bodies may be designated as competent authorities will be scrapped.[92]

b. The requirements placed on the competent authority will be tightened:
   - Professional practitioners may not be involved in the management of the system of public oversight.[93] The possibility for Member States to allow a minority of the management of the system of public oversight to consist of professional practitioners will be scrapped.
   - Sufficient resources shall be made available for the initiation and conduct of investigations.
   - The competent authority shall have the power to demand information from any person, to interview persons for this purpose and inspect the documentation of the external auditor and the audit firm and make copies thereof.

Changes compared to the current situation in the Netherlands

Whereas in the SAD reference is made to a quality assurance system and a system of public oversight in which various institutions or organisations can be designated as a competent authority, the draft Directive places full responsibility for the entire supervisory process on a single competent authority (the regulator). In the situation in the Netherlands, this would mean that some activities for which the professional bodies or the Minister of Finance are currently responsible would become the responsibility of the AFM, including continuing education and the approval of rules governing professional conduct. Moreover, the draft Directive explicitly states that the management and organisation of periodic inspections of non-PIE audit firms shall be the responsibility of the regulator and no longer the responsibility of a professional body.[94] In the current Dutch situation the AFM already formally holds ultimate responsibility for the overall supervision of all audit firms that conduct statutory audits. In practice however, a significant part of the activities associated with regular inspections of non-PIE audit firms are conducted by the SRA on the basis of a covenant.[95]

The approval and registration of auditors in the Netherlands is a phased process. The professional bodies are responsible for the admission to the market of registered accountants [*registeraccountants*, or RA] and Accounting Consultants [*Accountants-Administratieconsulenten*, or AA] who meet the requirements of the SAD[96]. Subsequently, on the basis of the Dutch legislation, an external auditor with responsibility for the conduct of statutory audits must in all cases be either an RA or an AA with authority to provide certification. The AFM maintains a public register of external auditors. This phased approval and registration process will continue to be possible with the proposed powers of delegation in the draft Directive.

The (stricter) requirements imposed on the competent authority (or regulator) are already largely implemented in Dutch legislation and regulation. The extension to the responsibilities and duties of

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[91] *See Article 1(16) of the draft Directive (new Article 32a SAD).*

[92] *See Article 1 (3)(a)(ii) of the draft Directive (Article 3(2) SAD).*

[93] *See Article 1 (15)(b) of the draft Directive (Article 32(3) SAD).*

[94] *Indeed, it would seem that professional practitioners could have a role to play in the* conduct *of such regular inspections of non-PIE audit firms. This does not apply to the regular inspections of PIE audit firms, which must be conducted by the regulator and by individual supervisors who are not engaged in public practice.*

[95] *A similar covenant is expected to be signed with the NBA as soon as the NBA is actually legally incorporated and established.*

[96] *These admission requirements are implemented in the Registered Accountants Act (WRA) and the Accounting Consultants Act (WAA).*

the regulator will however have to entail the provision of additional resources to the regulator so that these responsibilities and duties can be met.

Conclusion

a. The AFM is not entirely convinced at this stage of the need to impose full responsibility for the entire public oversight system on a single competent authority (in this case, the AFM). Since the professional bodies are currently already responsible for the approval and registration of auditors, and as a result of the power of delegation are expected to remain so, it would appear logical for these professional bodies to also remain responsible for the continuing education of auditors.

   The AFM is indifferent towards the question which organisation should have the authority to approve the professional conduct rules formulated by the professional bodies. In practice this already takes place in good harmony between the Minister of Finance and the AFM.

   If the AFM has to assume responsibility for the management and organisation of regular inspections of non-PIE audit firms, this will require significant additional resources. The AFM sees a practical alternative in the current situation whereby the AFM takes full responsibility for the entire public oversight system and the SRA (and also the NBA in due course) organises and conducts the regular inspections on the basis of a covenant. The AFM will then use the findings of these inspections in the fulfilment of its responsibilities.

b. From the perspective of consistency throughout the EU, the AFM supports the explicit inclusion of these requirements for the competent authority, including the related powers, in the draft Directive.

5.5 Rules for the statutory audit of SMEs

Proposal by the European Commission

The Member States shall ensure that the degree to which the auditing standards are applied to medium-sized enterprises is proportionate to their scale and complexity.[97] The Member States may request the professional bodies to provide guidance on the proportionate application of the auditing standards. In conducting its supervision, the regulator must take account of the proportionate application of the auditing standards. This also applies if Member States make the statutory audit of small enterprises compulsory.[98] If Member States apply rules for the conduct of a limited review of the financial statements of small enterprises, the Member States are not obliged to make this subject to the auditing standards.

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[97] *See Article 1(20) of the draft Directive (new Articles 43a and 43b SAD).*

[98] *In a recent draft Directive from the Commission, small enterprises were exempted from the obligation to have a statutory audit of their financial statements conducted (see Article 34 of the draft Directive COM (2011) 684 final, 25.10.2011). Member States may indeed still impose this requirement. The compulsory audit continues to apply to medium-sized enterprises. If a small or a medium-sized enterprise is a PIE, the specific requirements in the Regulation apply.*

Changes compared to the current situation in the Netherlands

In the Netherlands, small enterprises are exempted from the obligation to have their financial statements audited unless they are designated as a PIE. The auditing standards apply to all audit engagements, regardless of the size or complexity of the audit client. The provisions in the auditing standards, which are, for the most part, based on principles, offer the possibility of adjusting their application in practice to the size and complexity of the audit client. The NBA published a manual in October 2011 on the application of the auditing standards in the auditing of SMEs. Current Dutch legislation and regulation has no provisions with regard to the conduct of a limited review in the case of small enterprises.

Conclusion

The AFM endorses the stance of IFAC and the NBA that the current auditing standards (ISAs) can and should be applied in the audit of the financial statements of SMEs. It is important that users of the financial statements can be confident that the degree of assurance added by an auditor as a result of the conduct of an audit is the same for all audit engagements, regardless of the size or complexity of the audited entity. The AFM is also of the opinion that the auditing standards should be adjusted in practice so that the audit is appropriate to the specific features of the audited entity. The AFM therefore applies this principle of proportionality in its supervision. In the event that small enterprises no longer wish to have a voluntary audit conducted once this process also has to be considered as a statutory audit (see paragraph 5.1), a different type of engagement with a clearly defined different degree of assurance, such as a limited review, could be an alternative.

5.6 Rules regarding the supervision of audit firms in third countries

Proposal by the European Commission

In addition to provisions for audit firms that conduct statutory audits, the SAD includes rules for third-country audit entities and the supervision thereof. Third-country audit entities must register themselves in a Member State if they issue an audit report with respect to the consolidated or annual financial statements of an enterprise that is incorporated outside the European Union and whose transferable securities are admitted to trading on a regulated market in the Member State in question. This mandatory registration does not however apply if the audit client concerned has exclusively issued debt securities with a nominal value per security of at least €50,000 that were already admitted to trading on the regulated market prior to 31 December 2010. If the outstanding debt securities of the audit client concerned were admitted to trading on the regulated market after 31 December 2010, the nominal value per security that applies is €100,000.[99]

Changes compared to the current situation in the Netherlands

The exemption threshold for third-country audit entities will be increased and is consistent with the limitation of similar exemptions in other supervisory duties. The increase may mean that fewer third-country audit firms can be exempt from the obligation of registration with the AFM, since fewer audit clients will meet the exemption provision. The draft Directive otherwise contains no substantive changes in comparison to the current legislation and regulation for third-country audit entities.

[99] *See Article 1 (21)(a) of the draft Directive (Article 45(1) SAD).*

Conclusion

The AFM has no objection to the proposed increase to the exemption threshold. The AFM had however expected the draft Directive to propose more changes with regard to the supervision of third-country audit entities. The European regulators have requested the European Commission on various occasions to clarify or simplify the SAD in various respects. So far, there has been no response from the European Commission. The clarifications requested concern, among others, the following points:

- Third-country audit entities must register in all Member States of the European Union in which their audit clients have a market listing. There is no European passport. The proposals by the European Commission currently do contain a proposal for such a European passport for audit firms. If a European passport is also introduced for third-country audit entities, this would reduce the administrative burden for both the audit entities concerned and the regulatory bodies in the various Member States.
- A third-country audit entity is designated as such if its audit client is incorporated in a third country and has a market listing in a European Union Member State, regardless of the domicile of the audit firm concerned. This means that, under the current regulation, audit firms which are domiciled in a European Union Member State are also treated as third-country audit entities, and must therefore also register as a third-country audit entity in the Member State in which the audit client has a market listing. These firms also fall under the supervision of the supervisory body in that Member State. The AFM considers this situation to be undesirable.

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