

# **Report on the AFM inspection of statutory audits of housing corporations**

**12 December 2012**

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## **The Netherlands Authority for the Financial Markets**

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The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. 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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## Structure

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Section 1 of this report describes the background to the inspection of the quality of the conduct of statutory audits of housing corporations. This section also describes the purpose of the inspection, and the procedure used by the AFM in the inspection. Section 2 states the AFM's conclusions and recommendations on the basis of the findings of the inspection. The findings of the inspection are listed in Section 3. Section 4 outlines the follow-up work after completion of the inspection, and the status of the incident investigation into the statutory audits of Vestia.

The Audit Firms Supervision Act [*Wet toezicht accountantsorganisaties*, or Wta] prohibits the AFM from publishing confidential information that it has obtained in the course of its supervision. The Wta however does permit the AFM to use this confidential information as the basis for general statements, as long as these cannot be traced to individual persons or audit firms. For this reason the findings of this inspection are presented in this report on an anonymous basis, and are not shown for each Big 4 audit firm.

# 1 Introduction

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## 1.1 Background

On 16 May 2012 the AFM announced that it would conduct an inspection at the four largest audit firms (Deloitte Accountants B.V. (Deloitte), Ernst & Young Accountants LLP (Ernst & Young), KPMG Accountants N.V. (KPMG) and PricewaterhouseCoopers Accountants N.V. (PwC), hereinafter 'the Big 4 audit firms') with regard to the quality control of the audits of the financial statements of housing corporations.

The direct reason for this inspection was the public concern that arose regarding the quality of audits of housing corporations as a result of the problems at Stichting Vestia Groep (Vestia) and the results of the stress test of the Central Fund for Public Housing [*Centraal Fonds Volkshuisvesting*, or CFV] in March 2012<sup>1</sup>. Serious liquidity shortages existed at Vestia and other housing corporations as a result of margin calls on derivatives positions, and questions were asked with regard to the correct recognition of derivatives transactions in the financial statements and the audits thereof.

The AFM has conducted an incident investigation regarding the audit of the 2010 financial statements of Vestia, and as a result of this has submitted a disciplinary complaint to the Disciplinary Court for Auditors against the external auditor responsible for the statutory audit for the 2010 financial year. The incident investigation of the 2009 financial statements of Vestia is not yet completed. This report describes the findings of the wider inspection that the AFM carried out at the Big 4 audit firms regarding the audit of the financial statements of housing corporations. The findings of the incident investigation conducted by the AFM into the Vestia financial statements for 2009 and 2010 have been left out of consideration.

In 2011 there were a total of 389 housing corporations operating in the Netherlands, leasing a total of almost 2.6 million units (see Table 1). The financial statements of more than 77% of these housing corporations were audited by the Big 4 audit firms. Measured by the number of units leased, the Big 4 audit firms have a market share of more than 90% in the housing corporation sector.

<i>2011 financial year</i>	<b>Number of housing corporations</b>		<b>Number of units leased</b>	
Deloitte	132	(33.9%)	790,652	(30.4%)
Ernst & Young	60	(15.4%)	324,959	(12.5%)
KPMG	32	(8.2%)	535,171	(20.6%)
PwC	77	(19.8%)	716,975	(27.6%)
<b>Total Big 4</b>	<b>301</b>	<b>(77.4%)</b>	<b>2,367,757</b>	<b>(91.1%)</b>
Nine other audit firms	88	(22.6%)	231,915	(8.9%)
<b>Total</b>	<b>389</b>	<b>(100%)</b>	<b>2,599,672</b>	<b>(100%)</b>

Table 1. Figures taken from the report 'Market share of audit firms in the housing corporation sector – 2011 financial year', August 2012, CFV.

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<sup>1</sup> See: 'Stress test of liquidity risk at year-end 2011 based on the derivatives portfolios at 162 housing corporations', 30 March 2012, *Centraal Fonds Volkshuisvesting*

The stress tests of the CFV in March and June 2012 revealed that in addition to Vestia, a further eight (in March) and four (in May) housing corporations failed the stress tests. All of these housing corporations were audited by the Big 4 audit firms.

Since December 2009, and with retroactive effect to 1 July 2009, the audits of the financial statements of housing corporations have been designated as statutory audits. This designation was the result of consultation between the CFV, the Ministry of Housing, Communities and Integration, and the Ministry of Finance, from which it was concluded that the size and function of housing corporations were of such social importance that supervision of the quality of the auditing of housing corporations would be desirable.

The financial position of housing corporations and the reporting of this information has been an item of major public concern for quite some time. Important aspects in this respect are the leadership style and governance structure, the vulnerability to fraud and unethical behaviour, the size and valuation of strategic land holdings, and the use of financial instruments, such as derivatives.

It is not the case that the AFM has not paid any attention to the audit of housing corporations in the past. The AFM has also considered the auditing of housing corporations in its previous regular inspections of the Big 4 audit firms as part of its focus on the valuation of immovable property. The AFM reported on this inspection in its report of 1 September 2010<sup>2</sup>. At the time, at the instigation of the AFM, one or more of the Big 4 audit firms conducted an internal review of the quality of the auditing of municipalities and housing corporations, because the AFM had concerns regarding the quality of the audits in the public sector<sup>3</sup>.

## 1.2 Purpose and implementation of this inspection

The AFM's supervision is designed to encourage audit firms to monitor their own quality themselves. The Wta expressly states that the directors of audit firms have responsibility for this. The purpose of this inspection was to establish the extent to which the Big 4 audit firms had discharged their own responsibility to safeguard and evaluate the quality of the statutory audits of housing corporations. In its inspection, the AFM observed:

- how the Big 4 audit firms safeguarded the quality of the statutory audits of housing corporations; and
- how the Big 4 audit firms themselves evaluated the quality of the statutory audits of housing corporations.

The AFM initially identified the quality measures introduced by the Big 4 audit firms in order to safeguard the quality of the statutory audits of housing corporations. In particular, the AFM wished to establish whether the problems at Vestia had led the Big 4 audit firms to introduce additional measures to safeguard the quality of statutory audits for the 2011 financial year. For this purpose, the AFM took note of documentation relating to the quality control systems at these audit firms, and consulted with the responsible officers at these firms. This gave the AFM

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<sup>2</sup> *The AFM Report on General Findings Regarding Audit Quality and Quality Control Monitoring of 1 September 2010.*

<sup>3</sup> *The AFM only supervises those audits designated in the Wta as statutory audits. The audits of provinces, municipalities and housing corporations are designated as statutory audits. The audits of other organisations are not.*

the opportunity to re-evaluate the systems of quality control and monitoring at these audit firms. In its report of 1 September 2010, the AFM concluded that the quality monitoring at several Big 4 audit firms was inadequate in certain respects, as a result of which the safeguards, which had been designed to ensure that the audit opinions issued were correct and sufficiently substantiated, were inadequate.

Secondly, the AFM assessed the findings of the internal file reviews that the Big 4 audit firms had themselves conducted into the quality of the statutory audits of housing corporations that they had performed. The AFM has taken note of the findings of the ongoing and completed file reviews, and the reports of these reviews, and has consulted with those conducting the reviews. The AFM has thus formed an impression of the effectiveness of the quality control measures that have been introduced.

In order to assess whether the internal file reviews had been conducted in a sufficiently critical manner, the AFM itself assessed at least one audit file for a housing corporation at each Big 4 audit firm, with specific attention to the audit of derivatives. The AFM has discussed the results of its own inspection with the external auditors responsible, and has compared these results with the results of the internal file reviews by the individual Big 4 audit firms. These inspections enabled the AFM to form an impression of the actual quality of the statutory audits of housing corporations and the elements where this quality was not satisfactory.

The AFM's inspection was focused on the quality measures introduced by the Big 4 audit firms themselves in order to safeguard the quality of the statutory audits of housing corporations. This means that neither the AFM nor the Big 4 audit firms have reviewed every individual statutory audit of a housing corporation in its entirety.

## 2 Conclusions and recommendations

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### 2.1 Conclusions

The AFM notes that the Big 4 audit firms have paid increased attention to the quality of statutory audits of housing corporations for the 2011 financial year, and in particular to the auditing of derivatives. To the extent that the Big 4 audit firms had not done so already, they have taken additional quality measures to safeguard the quality of these statutory audits, as a result of the publicity in relation to the problems at the housing corporation Vestia. The quality measures introduced by the Big 4 audit firms vary in terms of the nature, intensity and point in time at which they were introduced. The differences are due to the fact that the application of quality measures is specific to each firm and depends on the quality of the external auditors and the extent to which the culture of the organisation encourages quality.

As part of their quality measures, the Big 4 audit firms carried out various forms of internal file reviews, both before and after issuance of the audit opinion, including engagement quality control reviews (EQCRs) and internal, additional and interim reviews. Depending on the quality of the external auditors and the effectiveness of other quality measures, the Big 4 audit firms identified shortcomings in the conduct of statutory audits of housing corporations in these internal file reviews. The nature and seriousness of the shortcomings vary per audit firm. As a result of these shortcomings, the Big 4 audit firms considered whether additional audit activities or other quality measures were necessary in order to safeguard the quality of the statutory audits for the 2011 financial year.

Based on the file reviews that the AFM had conducted itself, the AFM concluded that three of the Big 4 audit firms had carried out the internal file reviews in a sufficiently critical manner, and had taken appropriate measures where needed. They had therefore obtained a reasonable degree of certainty that the quality of statutory audits of housing corporations was adequate, whereby there is, however, still no guarantee that further shortcomings would not occur at all in the conduct of statutory audits of housing corporations or in the financial statements of housing corporations. In the case of one of the Big 4 audit firms, the AFM is conducting a further review of the quality of these internal file reviews, since the AFM's own evaluation of the audit does not correspond to the evaluation of the audit firm concerned.

Table 2 shows the AFM's conclusions per Big 4 audit firm in anonymous form.



<b>Audit firm</b>	<b>Conclusion</b>
A	This audit firm recognised the need for specific quality measures to safeguard the quality of statutory audits of housing corporations at an early stage, in other words, before the public had become aware of the problems at Vestia. The preventive quality measures, the quality of the external auditors and the culture of this audit firm contributed to the fact that no material shortcomings were identified by this audit firm in its internal file reviews.
B	This audit firm recognised the need for specific quality measures to safeguard the quality of statutory audits of housing corporations at an early stage, in other words before the public became aware of the problems at Vestia. In order to proactively support the quality of its external auditors, this audit firm considered a relatively large number of quality measures to be necessary. This audit firm identified several shortcomings in its file reviews and introduced additional quality measures, in order to be able to safeguard the quality of the statutory audits for the 2011 financial year.
C	This audit firm recognised the need for measures, and the fact that it needed to introduce serious quality measures in order to be able to safeguard the quality of the statutory audits for the 2011 financial year, at a relatively late stage, in other words, after the public had become aware of the problems at Vestia.
D	This audit firm has introduced quality measures to safeguard the quality of statutory audits of housing corporations. Since the AFM's own assessment of the audit differs from the assessment made by the audit firm in question, the AFM is conducting a further inspection at this audit firm with regard to the quality of the internal file reviews.

*Table 2* Conclusions per Big 4 audit firm

#### *Quality measures*

In this inspection, the AFM distinguished four categories of quality measures implemented at organisational level, which are designed to safeguard the quality of the statutory audits of housing corporations. The AFM identified certain risks associated with these quality measures, in addition to the benefits thereof.

- *Specialisation and monitoring of client portfolios.* The AFM endorses the quality-enhancing effects of a certain degree of specialisation by external auditors in a specific sector, such as housing corporations, or in a special subject, such as derivatives. Excessive specialisation can, however, lead to an excessive degree of familiarity with the client or the subject, and too much autonomy regarding the determination of the standards to be used. The AFM has further noted that audit firms which monitor their client portfolios on a centralised basis are in a better position to take responsibility for the quality of the conduct of individual audit assignments. This does, however, require audit firms to have adequate information regarding the features of these client portfolios and the qualities of each individual auditor.
- *Risk analysis.* Although public concern about housing corporations had already existed for several years prior to the audit of the 2010 financial statements, three of the Big 4 audit firms did not identify any housing corporation as involving a higher risk. They had not, therefore, introduced the application of certain quality measures in their audits. After the financial problems at Vestia became public knowledge, these audit firms identified several housing corporation audits as audits involving higher risk, and therefore introduced additional or different quality measures. In order to make the

correct decisions regarding the application of other quality measures, both the external auditor and the audit firm have to make a correct risk estimate for each statutory audit. While the external auditor is most familiar with the audit client, the AFM identifies a risk that an individual auditor will underestimate the risk profile of a housing corporation. This can be avoided through the involvement of the audit firm, if a centralised assessment is made from the perspective of risk management and quality of the risks in the client portfolio.

- *Audit resources.* The AFM has observed that standard audit resources specifically designed for the audit of housing corporations and derivatives do assist external auditors and their teams to conduct a good quality audit. The AFM identifies, however, an inherent risk that can be present in excessive standardisation, if the adherence to detailed prescribed standards leads to a situation in which an auditor is less critical in the conduct of his audit.
- *Review of the quality of audits and compliance with internal guidelines.* The review of the quality of audits and compliance with internal guidelines is the final phase of the quality measures: audit firms review at different times whether the external auditors have actually delivered the necessary quality and have observed internal guidelines. In the opinion of the AFM, these quality measures are only effective if they are carried out at the right times, if the file reviewer is independent and competent, if the audit firm issues clear guidelines, if a file reviewer establishes that findings are being followed up, and if the entire process is properly recorded.

All Big 4 audit firms have implemented quality measures from each of these four categories, however the measures vary for each firm in terms of the nature, the intensity and times at which they are implemented. The AFM takes the view that these quality measures will, in principle, make a positive contribution to the quality of the statutory audits of housing corporations, as long as the identified risks are sufficiently taken into account, and as long as they are appropriate to the quality of the external auditors and the culture of the organisation in question.

#### *Balance between quality measures, auditors and culture*

The quality of a statutory audit is in the first place determined by the expertise and the professionally critical attitude of the external auditor and his audit team. The external auditor is responsible for the conduct of the statutory audit. He must obtain sufficient and appropriate evidence for his opinion regarding the reliability of the audited financial statements as stated in his audit opinion. The manner in which external auditors fulfil this responsibility partly depends on the culture of the audit firm, whereby the leadership should, through the right 'tone at the top', encourage the focus on quality and should make clear the firm's expectations regarding the responsibilities of the auditors.

The Wta expressly places responsibility for the quality of the conduct of statutory audits on the audit firm and not only on the individual external auditor. Audit firms implement quality measures in order to be able to meet these responsibilities and safeguard the quality of statutory audits. A number of quality measures are prescribed by statute in general terms. Depending on the quality of their external auditors and the degree to which their culture encourages quality, the audit firms design these quality measures themselves and apply additional quality measures to a greater or lesser extent. The exact nature of this process depends on the firm concerned, and may vary in each case.

## 2.2 Recommendations

The findings from the AFM's inspection provide information on how the Big 4 audit firms have safeguarded and evaluated the quality of the statutory audits of housing corporations. These findings will enable first of all the Big 4 audit firms themselves, but also other audit firms which conduct statutory audits of housing corporations, to evaluate whether their quality measures are tailored to the quality of their external auditors and their culture to a degree that is adequate enough to be able to safeguard the quality of housing corporation audits. The AFM expects the audit firms to also apply these quality measures to other statutory audits in both the private and public sectors. The AFM moreover calls for attention to application of these measures in audits involving other public and semi-public sectors, such as the audits of educational and health-care institutions. If the quality of the external auditors or the culture give reason to impose heavy quality measures, the AFM considers it likely that this will lead to a vulnerable and expensive balance. In the medium and longer term, an audit firm can safeguard the quality of statutory audits more effectively by increasing at the basis the quality of its external auditors and, through the use of the right 'tone at the top', encouraging a quality-oriented culture.

Audit firms that themselves identify shortcomings in the conduct of statutory audits will have to analyse what the reason for these shortcomings is, before they can impose the right quality measures. Understanding the quality of their external auditors and the degree to which their culture encourages quality is essential for this. The AFM is confident that audit firms will indeed conduct this evaluation and analysis, and the AFM will assess the results of this as part of its ongoing supervision.

Furthermore, the findings of the inspection enable the users of the financial statements of housing corporations, such as regulators, banks, creditors and other stakeholders, to ask critical questions regarding the quality control system of the audit firm and the audit. The AFM therefore recommends these users to take note of the findings of this inspection.

## 3 Findings of the inspection

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### 3.1 System of quality control and monitoring

The AFM has identified the quality measures that have been introduced by the individual Big 4 audit firms in order to safeguard the quality of the statutory audits of housing corporations.

The quality measures can be ranked in four categories:

- Specialisation and monitoring of client portfolios
- Risk analysis
- Audit resources
- Review of the quality of audits and compliance with internal guidelines

#### 3.1.1 Specialisation and monitoring of client portfolios

Specialisation within the audit means that an auditor primarily focuses on the conduct of audits within a certain sector (for example, the public sector) or of certain organisations (such as housing corporations). Table 3 contains information on the number of external auditors in relation to the number of housing corporations.

<i>2011 financial year</i>	<b>Big 4 audit firms</b>
Number of housing corporations	301
Number of external auditors	50
Average number of housing corporations per external auditor	6
Lowest number of housing corporations per external auditor	1
Highest number of housing corporations per external auditor	32

*Table 3.* Figures from the CFV, 2011 financial year

One Big 4 audit firm has a high concentration of housing corporation audits with a limited number of auditors. The external auditors of this Big 4 audit firm conduct on average ten statutory audits of housing corporations, while the external auditors of the other three Big 4 audit firms conduct on average five or six statutory audits of housing corporations. At these three Big 4 audit firms there is less intentional specialisation and concentration. One Big 4 audit firm operates on the principle that an external auditor should audit at least five housing corporations, although this principle is not applied rigidly in practice. The housing corporations sector group at this organisation is responsible for the allocation of engagements to external auditors as well as the allocation of the team complement at auditor and manager level.

The AFM recognises the benefits of a certain degree of specialisation, because this means that the auditor will have more knowledge of the sector, and thus will recognise the potential risks and problems at an audit client more readily and can design his audit more effectively. This also applies to the statutory audits of housing corporations.

In addition to the benefits of specialisation, the AFM identifies the following risks:

- *Familiarity.* A specialist auditor or group of specialist auditors can become so familiar and involved with the sector and the organisations that they audit, that they lose their

independent and critical perspective. It is therefore important that specialists also continue to follow developments and risks outside the sector.

- *Establishment of standards.* Specialists frequently act relatively autonomously, whereby they themselves can determine the standards that apply for a proper audit. Without an assessment by others outside the specialist group, in order to establish that these standards are in fact correct, there is a risk that the specialists will assume that they are conducting proper audits and will confirm each other's views in this respect, while actually their audits will not be of sufficient quality. It is therefore important that regular objective assessments are made by others from outside the specialist area, in order to establish whether the standards used are still adequate to meet the current requirements for the conduct of a proper audit.
- *Time pressure.* One risk of far-reaching specialisation, which is certainly also applicable to the audits of housing corporations, is the fact that as a result of specific regulations these audits all have to be conducted during the same time period. This may mean that an external auditor who is auditing many housing corporations may be under too much time pressure to be able to give the necessary attention to each audit. The AFM considers that the actual involvement of external auditors in the audits conducted under their management is crucial for the quality of the audit process.

The Big 4 audit firms deal differently with the monitoring of the client portfolios of their external auditors. One Big 4 audit firm conducts an analysis at central level, once a year, of the nature, size and composition of the client portfolios of external auditors as a whole, by establishing for instance whether these auditors have the required expertise. One of the considerations is to establish that the diversification across different sectors is not excessive. This should, for instance, prevent a situation in which an external auditor's knowledge of a business sector is inadequate.

The AFM observes that audit firms which monitor – at a central level – whether the team composition is appropriate for each client and whether the size and composition of the client portfolio is appropriate for each external auditor, are better positioned to take responsibility for the quality of the conduct of individual audit engagements than organisations which do not do this and which leave these matters to the individual auditors. In order to be able to assume this responsibility at central level, adequate information – on the qualities of each individual auditor, the risk profile of the individual audit engagements, and the workload involved in each engagement – must be available at this level. It is moreover important that a shared vision exists within the organisation regarding the minimum amount of time that an external auditor should personally spend on conducting an audit.

### 3.1.2 *Risk analysis*

Auditors and audit firms make an estimate of the risks associated with statutory audits. They assign a risk classification to each individual audit engagement. This risk classification is important in connection with the requirements set for the expertise of the audit team and the manner in which the quality of the audit will be monitored. Engagements involving higher risk will therefore usually qualify for an engagement quality control review. This means that, prior to the issuance of the audit opinion, the quality of the audit will be assessed by an auditor that is not involved in the audit.

At all the Big 4 audit firms, the risk profile of a statutory audit of a housing corporation will in the first instance be assessed by the external auditor, who will also assign an (initial) risk classification at engagement level. Since it is the external auditor that should have the most knowledge of the audit client, it is clear that the external auditor should be primarily responsible for assessing the risk associated with a particular engagement. In this connection, the AFM notes that there is a risk that an individual auditor will underestimate the risk profile of a housing corporation, for example because:

- he does not himself have a good understanding of the risks, such as the more general risks associated with the economic climate or the sector as a whole;
- he overestimates his own competence; or
- a higher risk profile will involve additional quality measures and therefore additional expenses, which may not be accounted for in the audit fees agreed with the client.

At all the Big 4 audit firms, acceptance and continuation of engagements with increased risk does not happen only on the initiative of the external auditor. The Big 4 audit firms have tasked one or more persons with special responsibility for quality and/or risk management, in order to assess the risk classification selected by the external auditor. These persons have to approve the risk classification before actual acceptance or continuation can occur.

The AFM considers the involvement of the audit firm to be an important factor in preventing the risk that the risk classification might be too low. The Big 4 audit firms have initiated automated procedures for this purpose. With respect to these automated procedures, the AFM identifies a risk that approval will be treated as a formality, and that it will be granted more or less automatically, without all the information relevant to the decision being actually made available and evaluated.

The Big 4 audit firms differ with respect to the question of whether they review the total portfolio of audits and each auditor's portfolio from a central position, and from a risk management and quality perspective.

One Big 4 audit firm regularly evaluates the specific risks associated with its client portfolio, including the housing corporations sector. These risks are identified and also serve as items of attention in the assessment of and decision regarding the continuation of current audit engagements. At the end of 2010, this organisation also consulted with all the external auditors who audit housing corporations, and an assessment was made to establish whether the risk profile should be updated. This organisation conducted a further numerical analysis in November 2011 and held further discussions with all the external auditors in order to maintain awareness of developments in the risk profiles.

Another Big 4 audit firm also regularly evaluates the specific risks by means of portfolio consultations and has established whether risk had increased, by means of a one-off measure in the form of a quick scan of housing corporations that lease more than ten thousand units. Three of the Big 4 audit firms discuss the portfolio with each auditor separately once a year.

Table 4 shows the percentage of the statutory audits of housing corporations designated by the Big 4 audit firms as involving higher risk. This shows that the Big 4 audit firms identified more risks associated with the conduct of statutory audits of housing corporations in 2011 than it did

in 2010. In 2010, three of the Big 4 audit firms did not designate any housing corporation audit as involving higher risk, while in 2011 every Big 4 audit firm qualified at least a number of housing corporation audits as risky. One Big 4 audit firm designated all housing corporation audits as risky in 2011.

<b>Housing corporation audits designated as involving higher risk</b>	<b>Number of Big 4 audit firms</b>	
	<i>2010</i>	<i>2011</i>
100%	0	1
10-20%	1	1
2-3%	0	2
None	3	0
Total	4	4

*Table 4. Risk classification of housing corporation audits*

In the opinion of the AFM, the audit firms that assess the nature and extent of risks in sectors from a broad perspective, and use the findings to assess, compare and adjust the individual risk classifications, have an important tool at their disposal to safeguard the quality of individual audits. It is important that this assessment is made from the perspective of quality safeguards and risk management, and not wholly or partially from a commercial perspective. Classification as higher risk entails the imposition of additional quality requirements on the audit, and may for instance mean that an EQCR must be performed. This means that greater expense will be involved in an audit of a client classified as higher risk.

### *3.1.3 Audit resources*

Audit firms can safeguard the quality of the statutory audits by facilitating and providing audit resources to their external auditors, such as relevant information and specific audit tools.

All the Big 4 audit firms inform their auditors regarding current developments via electronic newsletters and employ a standard audit methodology that is supported by an electronic file.

All the Big 4 audit firms also have a housing corporation sector group that disseminates information on the sector. At all the Big 4 audit firms, this sector group provides audit resources designed for housing corporations, either in collaboration with the professional practice department or not, such as working schedules, checklists, audit reporting models and sample texts: sample reports and standard texts that can be used in the auditor's report to the client's management and supervisory boards.

At one of the Big 4 audit firms, the sector group produces an annual sector-specific initial risk analysis of items that may be the focus of the audit. This audit firm also issues central guidelines in relation to the audits to be conducted, such as the compulsory performance of audit measures with respect to specific risk areas, including positions in derivative instruments and the consequences of the economic crisis, and the reporting of these matters in a memorandum in the audit file. Another guideline concerns the compulsory involvement of specialists in the audit of complex derivatives portfolios.

Two of the Big 4 audit firms initiated a centralised approach at the beginning of 2012 for the audit of derivatives, including the proactive use of specialists in the field of derivatives by audit teams.

The AFM has observed that standard audit resources specifically designed for the audit of housing corporations assist external auditors and their teams to conduct a good quality audit. The AFM also notes, however, that standardisation involves a risk if following these standards leads to a situation where an auditor adopts a less critical attitude in the conduct of his audit. This may occur, for instance, with the use of checklists, whereby the auditor does not have to document his own specific considerations, he simply has to check prewritten conclusions. The AFM's supervision is also designed to determine whether statutory audits are properly conducted in terms of substance, and whether sufficient audit certainty is obtained.

#### *3.1.4 Review of the quality of audits and compliance with internal guidelines*

The quality measures described above support the external auditors in the conduct of good quality statutory audits. The review of the quality of audits and compliance with internal guidelines is the final phase of these quality measures. Audit firms review at different times whether the external auditors have actually delivered the necessary quality and have observed the internal guidelines. The audit firm may, on the basis of these findings, implement recovery or improvement measures as necessary. These reviews can take place before the external auditor issues his audit opinion, or afterwards.

##### *Prior to issuance of audit opinion*

The review of the quality of the audit and compliance with internal guidelines can take place either during the conduct of the audit or prior to issuance of the audit opinion. The quality measures used by the Big 4 audit firms are the interim review, the engagement quality control review (EQCR) and the assessment of specific elements of the audit by specialists.

An interim review is an assessment during the conduct of the audit, usually focused on one specific item of attention or theme. An audit can be updated if necessary in a timely manner, that is, before the external auditor issues his audit opinion, as a result of an interim review. The follow-up of the improvement measures agreed as a result of the interim review is established by the EQCR. One Big 4 audit firm has conducted interim reviews of approximately 29% of the statutory audits of housing corporations. The focus of these reviews was on the correct and complete recognition and disclosure of financial instruments. The reviews led to adjustments to the audit where this was necessary. The Big 4 audit firm evaluated the findings from the interim reviews and conducted a causal analysis in order to provide the best possible orientation for future quality initiatives.

Two of the Big 4 audit firms distinguish two types of EQCR: the normal EQCR, on the basis of the requirements set for an EQCR by the Audit Firms Supervision Decree [*Besluit toezicht accountantsorganisaties*, or Bta], and the limited EQCR, in which a limited number of elements of the audit is assessed immediately prior to issuance of the audit opinion. Compared to a limited EQCR, in a normal EQCR the quality reviewer conducts his evaluation to a greater extent during the conduct of the audit. The other two Big 4 audit firms use only the normal EQCR. The decision as to whether or not an EQCR will be conducted for the audit of a housing



corporation usually depends on the risk classification that has been assigned. An EQCR is only conducted in cases designated as higher risk.

One Big 4 audit firm conducts at least a limited EQCR of all statutory audits, regardless of the risk classification. This organisation carried out either an EQCR (approximately 17%) or a limited EQCR (approximately 83%) of every housing corporation audit for the 2011 financial year. The records of the conduct of the EQCRs and limited EQCRs are internally assessed for signals of individual quality and in the wider context of overall quality. The analyses are placed on the agenda for discussion with the management board of the audit firm on a monthly basis.

Three Big 4 audit firms did not conduct any EQCRs of housing corporation audits for the 2010 financial year. After the risk classification was increased, EQCRs were conducted for the 2011 financial year. One Big 4 audit firm conducted an EQCR for approximately 3% of its housing corporation audits. Another Big 4 audit firm conducted an EQCR of approximately 2% of its housing corporation audits and a limited EQCR of approximately 5% of these audits. One Big 4 audit firm increased the risk profile of all housing corporation audits, and thus conducted an EQCR of all its housing corporation audits. The team composition of all audit teams for housing corporations was thereby assessed as well. Changes were made where necessary, and reinforcements were provided in the form of specialists in the field of derivatives. Additional training was also provided. These activities led to the correction of errors in the 2011 financial statements of some audit clients.

In addition to the EQCR, two Big 4 audit firms engaged a team of internal treasury specialists to assess the 2011 financial statements of housing corporations with complex derivatives positions.

#### *After issuance of the audit opinion*

The review of the quality of the audit and compliance with internal guidelines can also be conducted after the issuance of the audit opinion. Here the Big 4 audit firms distinguish between regular internal reviews, additional reviews and incident investigations. If during the conducting of a review after the issuance of an audit opinion it emerges that there are serious shortcomings in the audit, recovery measures are required. The auditor must, in this case, perform the necessary audit activities in order to obtain adequate and appropriate audit information, and in many cases will have to return to the audit client.

All four audit firms have a system of regular internal reviews whereby at least one audit file of each auditor is evaluated once every three or five years. These internal reviews are not oriented to themes or sectors. In addition, internal reviews are conducted if there is reason to do so, such as in the context of the inspection by the AFM or in the event of incidents. These internal reviews also involved the audit files of housing corporations for the 2010 and 2011 financial years. All Big 4 audit firms assessed the quality of one or more housing corporation audits during their regular internal reviews. Three Big 4 audit firms assessed the audit files of housing corporations in an additional review, either in the context of the AFM's inspection or otherwise. Lastly, three Big 4 audit firms assessed one or more housing corporation audits because an incident had occurred.

The findings of the reviews conducted by the Big 4 audit firms with regard to the quality of the statutory audits of housing corporations performed by them are described in section 3.2.

### *Key issues*

The AFM has identified a number of key issues in relation to the reviews of the quality of statutory audits of housing corporations:

- *Timeliness.* As mentioned above, the quality review can be conducted prior to the issuance of the audit opinion by means of interim reviews, EQCRs and/or assessments by specialists, so that adjustments can still be made during the audit process. If the file review is conducted at the last possible moment prior to issuance of the audit opinion, there is a risk that there will not be enough time to carry out additional audit activities or draw other conclusions. This risk will increase if the audit client believes that for all practical purposes the audit is complete and the findings have already been discussed with the client. It is therefore important that file reviews are conducted at one or more suitable moments during the conduct of the audit, after which additional or restorative audit activities are still possible.
- *Independence and competence of the reviewers.* An effective review of quality requires that audit firms appoint suitable persons (reviewers) to conduct the file reviews. A suitable reviewer is in the first place independent and not involved in the audit he is reviewing, so that he will not hesitate to give an honest and objective opinion regarding the quality of the audit. The second requirement for a suitable reviewer concerns competence. This does not necessarily mean that he must be a specialist in the field of housing corporations. There is of course a danger that the reviewer and the reviewed are well acquainted, come from a similar culture and will tend to take their own conduct of housing corporation audits as the standard and thus fail to notice in their findings points that they themselves would have missed or carried out less effectively. It is precisely the critical and open-minded view of a relative outsider that can be of assistance in arriving at a proper assessment of the quality of the audit and the compliance with procedures.
- *Guidelines of the audit firm.* The guidelines provided by the audit firm must clearly state the expectations with regard to the file review: what exactly should the reviewer do, what should he especially look for, how much time does he have available, what is the required level of quality for the audit file, how should the findings be recorded and communicated to the external auditor, and how should reports be provided to the audit firm.
- *Follow-up of findings.* In order for the internal file reviews to be effective, it is essential that a reviewer also establishes that the additional activities have actually been performed and explicitly establishes that the audit has thereby been conducted at the required level. In the case of interim reviews or EQCRs, this must occur before the audit opinion is issued.
- *Documentation.* The records of the file reviews are an important source of information for the audit firm, as long as they contain adequate substantive information, and not simply checklists with boxes to be ticked. The individual records provide information on the quality of the conduct of one specific audit by one specific auditor, and the measures that have to be taken at engagement level to safeguard the quality of the audit. The records can also be viewed collectively. Collectively, they provide a picture of the performance of an external auditor with respect to several audit files, or of the total quality of the whole audit practice. This overall picture can be reason to initiate a further review of the performance of individual auditors or specific groups of auditors. The overall analysis also provides information on which elements of the audit have

been satisfactory and which have not. This information may be reason for the audit firm to devote additional attention to these elements in newsletters or training courses, for instance, or to adjust its quality control system.

### **3.2 Findings of file reviews**

As mentioned in section 3.1.4, the Big 4 audit firms have themselves conducted file reviews on their own initiative as a result of market developments and at the request of the AFM. These file reviews were conducted both before and after the external auditor had given his audit opinion. The file reviews concerned EQCRs, interim reviews and the assessment of specific elements of the audit by specialists in the form of internal and additional reviews and incident investigations respectively. The number of statutory audits of housing corporations that were reviewed and the scope and depth of the file reviews varied per Big 4 audit firm. The Big 4 audit firms did conduct a file review for all housing corporations that failed the stress tests of the CFV in 2012. All the file reviews focused to a greater or lesser extent on the audit of derivatives in the financial statements of housing corporations.

The AFM has noted the findings of these file reviews and in addition has itself assessed at least one audit file at each Big 4 audit firm. The AFM's focus hereby was on the audit of derivatives.

Various examples of audit measures that made a positive contribution to the quality of the statutory audits were identified in the file reviews. Besides these measures that improved quality, there were, however, also shortcomings identified in the conduct of statutory audits of housing corporations. These shortcomings were assessed in accordance with the relevant quality procedures of the audit firms, and measures were taken where necessary to repair the shortcomings and prevent repetition thereof in future.

Since file reviews are conducted on a selection of audit files with a specific focus on particular risk areas, there is no overall (re)assessment of all the activities and conclusions of the external auditor. The file reviews thus provide a reasonable degree of certainty regarding the quality of the statutory audits conducted, but do not provide a full guarantee that no other shortcomings may exist.

Some examples of quality-enhancing audit measures, shortcomings and follow-up activities are given below. The examples are taken from the findings of the file reviews conducted by the Big 4 audit firms for the 2010 and 2011 financial years. These examples will enable the audit firms to compare their own file reviews with those of other firms and to (re)evaluate the findings of these file reviews where necessary. This information may also be reason for regulators of housing corporations and other stakeholders to ask critical questions regarding the auditing of housing corporations.

### 3.2.1 *Quality-enhancing audit measures*

In their file reviews, the Big 4 audit firms identified certain measures that positively contributed to the quality of the statutory audits of housing corporations.

- *Special attention.* Several file reviews show that the external auditor responsible for the conduct of the statutory audit had devoted special attention to subjects of great importance in the case of housing corporations: land holdings, immovable property, financial instruments (including derivatives) and rental income. The audit of derivatives contracts is for instance designated by various external auditors as a significant risk, for which specific audit measures were employed in order to establish that these derivatives contracts have been correctly accounted for.
- *Specific audit resources.* Several audit teams used specific task schedules and checklists in the statutory audits of housing corporations that reflect the specific risks associated with housing corporations and whereby sector expertise in connection with, for example, specific legislation and regulation can be applied.
- *Experts.* Lastly, various audit teams engaged experts with specific knowledge of the audit of derivatives.

### 3.2.2 *Shortcomings*

One Big 4 audit firm identified only a number of immaterial shortcomings as a result of the conduct of its internal file reviews, and no material shortcomings. The other Big 4 audit firms identified both material and immaterial shortcomings in a number of audit files.

- *Inadequate analysis of risk.* The external auditor must identify the risks, and estimate whether or not the financial statements contain material misstatements. He must then design and implement appropriate audit measures to reflect these risks, and thereby obtain adequate and appropriate audit information with regard to these risks. One Big 4 audit firm established that the external auditor had incorrectly assessed certain risks as low in a number of audit files. In some audits, the audit measures did not adequately reflect the risks that had been identified: either the sample of the substantive procedures in relation to financial instruments was too limited in size, or the conduct of the tests of controls was not consistent with the planning thereof.
- *Insufficient or inappropriate audit evidence.* In order to obtain sufficient certainty regarding the accuracy and completeness of the derivatives recorded in the administration of a housing corporation, the auditor must obtain sufficient and appropriate audit evidence by employing a range of audit resources. He will have to obtain knowledge of the design and existence of the internal controls at the housing corporation. If he conducts his audit focused on tests of controls, the auditor will then have to test the operation of these internal controls. He will moreover have to check the opening positions, movements and closing positions of the derivatives by means of position confirmations or valuation statements from banks, for instance.

Three Big 4 audit firms have, to a greater or lesser extent, established that in some statutory audits the external auditor did not obtain sufficient or appropriate audit evidence with regard to the positions in derivatives. These Big 4 audit firms actually

identified shortcomings in both the audit files and the financial statements of the housing corporations.

Shortcomings in audit files:

- In some audit files, the external auditor has only documented the fact that the derivatives are correctly recognised in the financial statements on the basis of cost-price hedge accounting. The external auditor has, however, failed to obtain sufficient audit evidence, because he has not analysed the derivatives, he has not tested whether the cost-price hedge has been effective, and he has not obtained any documentation regarding the cost-price hedge and included this in the audit file. This means that the external auditor has not assessed whether the conditions that must be met for the application of cost-price hedge accounting have indeed been met.
- Some audit files include documents relating to the general risk analysis and events occurring after the balance sheet date, which contain clear indications of possible differences in items such as the liquidity position and the size of available facilities<sup>4</sup>. The external auditor has not apparently followed up these indications and therefore has not obtained sufficient audit evidence regarding these items.
- Position confirmations and valuation statements are more reliable if the auditor obtains them directly from a source independent of the housing corporation, such as a bank. In one statutory audit, the external auditor obtained the confirmations of the market value of the derivatives positions from the housing corporation. In some other statutory audits, the external auditor failed to ask for any position confirmations or statements at all. In one single case the external auditor did request position confirmations, but these were not related to his audit of the derivatives.
- As an alternative to requesting position statements from an independent source, the external auditor can also audit the market value by using a valuation model. Use was made of such a valuation model in one statutory audit of a housing corporation, and the auditor used the output of a computer application with a specific module for derivatives from an external supplier. The external auditor did, however, fail to assess whether the value of the derivatives had been calculated correctly.

Shortcomings in financial statements:

- Several Big 4 audit firms reassessed the financial statements of housing corporations and identified shortcomings that apparently were not noticed by the external auditor, or the person conducting the EQCR (where applicable). Regarding the information in relation to the recognition of derivatives in the financial statements, and more specifically the application of cost-price hedge accounting, these audit firms identified some cases in which relevant information was missing: the use of derivatives, the use of cost-price hedge accounting, the market value of the derivatives or the relevant risks, such as the existence of margin call requirements, were not reported in the financial statements. The responsible external auditors had not noticed these

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<sup>4</sup> The size of available facilities is the amount that a housing corporation can borrow in any one year. The size of this amount depends on the housing corporation's projected cash flow and funding requirement.

omissions in the financial statements or addressed them in their audit activities.

- In one set of financial statements, cost-price hedge accounting had not been properly applied in the recognition of derivatives. An interest-rate swap had incorrectly been recognised under financial fixed assets and long-term liabilities in the balance sheet, and had been recognised at the 'notional value', meaning the value of the underlying assets, thus inflating the balance sheet. The interest-rate swap should have been measured at cost, therefore nil. While the total amount did not exceed the quantitative materiality threshold used, it did exceed the 'correction criterion' used in this audit. The external auditor should therefore have identified and evaluated this difference.
- *Materiality threshold set too high.* For purposes of efficiency, when planning and conducting a statutory audit an auditor applies the concept of materiality. This means that the auditor plans and performs his audit activities in a manner designed to detect misstatements in the financial statements which, if not adjusted, could lead to different decisions being made by the users of the financial statements. The lower the materiality threshold is set, the greater the audit activities that the auditor must perform in order to be able to detect relevant misstatements. It may be necessary to reduce the materiality threshold for special transaction flows, account balances or disclosures if smaller misstatements in these items could influence the economic decisions of the user.

One Big 4 audit firm established that the materiality threshold was set too high in several statutory audits of housing corporations. Setting the materiality threshold too high is a particularly risky approach. The result is that in the course of the audit less or even no attention will be devoted to items that are smaller than the materiality threshold. If derivatives are recognised in the financial statements under cost-price hedge accounting, the derivatives have no value in the balance sheet and therefore fall below the auditor's materiality threshold. The external auditor in question had incorrectly set the materiality threshold on the basis of the housing corporation's total assets. Housing corporations have very high total assets due to their sizeable property portfolios that in comparison to other companies bear no relation to their results or their core activities (rental income). A normal materiality consideration is not appropriate if cost-price hedge accounting is used.

- *Inadequate use or assessment of experts.* An auditor will not always possess the necessary expertise himself, in areas other than financial reporting or auditing, in order to be able to obtain sufficient and appropriate audit evidence. In such cases an auditor will have to engage the services of an expert. The auditing of complex financial instruments, such as derivatives, is usually an area for which auditors engage (valuation) experts. If an auditor engages an expert, he must assess the competence, capacities and objectivity of the expert and evaluate whether the activities performed by the expert are satisfactory.

Two Big 4 audit firms identified shortcomings with respect to the engagement of (valuation) experts for the statutory audit of housing corporations. In some statutory audits no expert was engaged, although this should have been the case, as derivatives were involved. The audit files in question, moreover, contain no arguments as to why an expert was not necessary. In other statutory audits for which an expert was

engaged, the auditor failed to adequately assess the competence, capacities, objectivity and activities of the expert that was engaged.

- *Insufficient involvement of the external auditor.* In order to be able to take responsibility for the general quality of the statutory audit, an external auditor must be sufficiently involved at the right times in the conduct of the statutory audit. He cannot delegate the entire audit process to his audit team, or only conduct a review of the all the work carried out at the end of the audit.

In their assessment of the audit files of housing corporations, three Big 4 audit firms found examples where a responsible external auditor was not sufficiently involved in the statutory audit, was involved at too late a stage, or was not present for the relevant elements of the audit.

- *Inadequate documentation.* The external auditor must document all the evidence on which he has based his opinion of the audited financial statements in an audit file, thus showing that he has conducted the statutory audit in accordance with the regulations that apply. This documentation supports the direction, planning and conduct of the audit and makes it possible to assess the quality of works performed at a later stage.

All the Big 4 audit firms found shortcomings in the audit files of housing corporations in relation to the documentation of the audit of derivatives. These shortcomings included the lack of relevant documents in the audit file, such as derivatives contracts, statements from third parties and standard bank statements. Furthermore, in some audit files the records of the considerations and conclusions of the external auditor with respect to the effectiveness of the cost-price hedge, the materiality of any ineffectiveness of the cost-price hedge and the completeness of the derivatives portfolio were missing. Some records were moreover sloppy or inconsistent with other documentation.

- *Other shortcomings.* In their file reviews, the Big 4 audit firms also identified certain other shortcomings, such as one external auditor who appeared not to be sufficiently aware of the required quality level, a failure to use the facilities of the quality control system to request advice or support, and an audit budget that was possibly inadequate for the conduct of a statutory audit of a housing corporation.

### 3.2.3 Follow-up of the findings of the file reviews

The AFM has established that all the Big 4 audit firms have evaluated the findings of the file reviews that they conducted, and have taken measures where necessary.

In the opinion of the Big 4 audit firms, no radical measures were needed with regard to many of the audit files of housing corporations because, according to one or more of the Big 4 audit firms:<sup>5</sup>

1. A large number of housing corporations do not use derivatives;
2. A number of housing corporations do use derivatives, but do not take speculative positions, swaptions or other more complex derivatives;

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<sup>5</sup> The AFM leaves the question of whether this opinion is accurate entirely to the Big 4 audit firms.

3. In the case of most housing corporations, the findings have no consequence for the treatment in the financial statements;
4. The situation usually concerns old derivatives contracts for which no margin call obligations are included, so that liquidity risks are limited for positions held to maturity and the audit commitment with regard to capital and result could be limited by the nature of the items to establishing that the items associated with the existing contracts had been reported correctly and that the disclosure requirements had been met;
5. Due to the use of cost-price hedge accounting, the current values and movements in value of derivatives did not affect the capital and the result, and because the current values were of less significance in the case of a housing corporation than would be the case for instance in a trading situation, one did not have to conclude from the findings of the file reviews that material misstatements had been made or that the audit opinions had not been adequately substantiated.

Nevertheless, the Big 4 audit firms acknowledged to a greater or lesser extent that there was a need to take measures, including the following:

1. In cases where the file reviews were conducted prior to the issuance of the audit opinion for the 2011 financial statements, the observations could still be followed up individually. The external auditor could therefore have consulted the professional practice department regarding matters such as the accuracy and completeness of disclosures, or the provisional or final recognition of certain transactions in the draft financial statements;
2. If misstatements in the financial statements were identified during the file reviews, it should be assessed whether these are material and should be corrected, either without delay or in the subsequent financial year. This led to improvements and adjustments to comparative figures in some of the 2011 financial statements;
3. External auditors and audit teams have been requested to improve their documentation of the audit of derivatives;
4. The sector groups for housing corporations and the professional practice department of the audit firm will take measures to ensure consistent quality in the statutory audits of housing corporations.

#### *3.2.4 File review by the AFM*

At each Big 4 audit firm, the AFM also conducted its own independent review of the audit file of a housing corporation, in order to establish whether the internal file reviews had been effective. At three Big 4 audit firms, the file reviews by the AFM confirmed the findings of the internal file reviews that these Big 4 audit firms had themselves conducted. At one Big 4 audit firm, the finding of the AFM's own review differed from the assessment of the audit firm in question. The AFM is conducting further inspection at this audit firm into the quality of its internal file reviews.



## 4 Follow-up

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In its supervision of the Big 4 audit firms, whereby the AFM is in contact with these organisations on an ongoing basis, the AFM will assess the extent to which these audit firms have followed up the findings of its inspection.

At one Big 4 audit firm the AFM is conducting an additional inspection into the quality and effectiveness of its internal file reviews.

As a result of the publicity surrounding Vestia, the AFM immediately started an incident investigation into the audit of Vestia's financial statements for the financial years 2009 and 2010 at the beginning of February 2012. In an incident investigation, the AFM performs its own detailed investigation of the conduct of a specific statutory audit. The focus of the incident investigations into the audits of Vestia is on the audit of the positions in derivative instruments. In October 2012 the AFM filed a disciplinary law complaint with the Disciplinary Court for Auditors against the auditor who conducted the audit of Vestia's financial statements for 2010.

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Amsterdam, December 2012