



Q&A: 10 questions regarding the AFM's appeal against the ruling on the duty of care of audit firms

1. Why is the AFM appealing?

The purpose of the appeal is to obtain more clarity regarding the interpretation of the duty of care from the highest authority.

As a result of the ruling, the AFM can no longer call an audit firm directly to account due to serious shortcomings in the quality of its statutory audits of financial statements, even though these audits are of great importance to users of the financial statements, such as retail and institutional investors.

The ruling will mean that the AFM's supervision of the audit sector will be less effective, since the duty of care is the only statutory connecting factor to make the audit firm responsible for the quality of its audits of financial statements. The AFM will then only be able to hold individual auditors responsible for errors under disciplinary law. The AFM sees this as reducing its effectiveness and moreover that it fails to recognise the responsibility of the audit firms.

2. Why is it a problem if the audit firm cannot be directly called to account?

As a result of this ruling, the AFM can no longer call an audit firm directly to account due to shortcomings in the quality of its statutory audits of financial statements,

This affects all those concerned, including retail and institutional investors as important users of financial statements. The reliability of financial statements is an important public issue. Why is this?

1. Because the AFM cannot call audit firms directly to account regarding the quality of audits, while these audits are of essential importance to investors and users. They rely on these audits providing certainty, and to some extent base decisions on this. There have been several accounting scandals in the past where the accounts were not in order, with disastrous results.
2. The effectiveness of supervision could be reduced. Under the Audit Firms Supervision Act (*Wet toezicht accountantsorganisaties*, or 'Wta') the AFM has to establish once every three years that PIE audit firms comply with the law and therefore also has to scrutinise the quality of audits. If the AFM can only call individual auditors to account, our expectation is that fundamental changes at organisational level and in the sector will take much longer to materialise.
3. Individual auditors will become more vulnerable if they are called to account when they make mistakes, and not the audit firm that employs them. This could create a waterbed effect. It could create an incentive for good auditors not to want to associate themselves with more risky audits. The audit firms could also shift risks onto individual auditors.

3. What is the case brought by EY and PwC against the AFM?

The case primarily concerned the duty of care, as the AFM considered that this was violated by the four large audit firms (KPMG, Deloitte, PwC and EY).

The AFM investigated 10 audits of financial statements for 2012 and 2013 by each of these firms. Shortcomings were identified in 18 of these 40 audits, with no sufficient and appropriate audit evidence being obtained at the time the auditor's opinion was issued.

The AFM considered that this constituted a violation of the duty of care and imposed fines accordingly. EY was fined EUR 2.2 million in 2016, Deloitte EUR 1.8 million, KPMG EUR 1.2 million and PwC EUR 845,000. Deloitte and KPMG accepted the fines. EY and PwC appealed against the fines to the court. The court upheld their appeal on 20 December 2017.

4. What is the duty of care actually?

The duty of care means that the managements of audit firms must ensure that all their affiliated statutory auditors meet the standards that apply to them. The audit firm has to create conditions that ensure that the auditors it employs observe the rules.

In its supervision, the AFM uses the duty of care to link the quality of audits of financial statements by individual auditors to the responsibility of the audit firms to which they are affiliated.

5. Why did the court uphold the appeal by EY and PwC?

To impose the fine, the AFM believed it was able to demonstrate that EY and PwC had violated their duty of care by showing that multiple statutory audits had not been performed adequately. The court ruled that violation of the duty care could not be established solely on the basis of shortcomings in statutory audits. The court did not rule on the findings themselves.

The court stated that shortcomings in the audit procedures of the statutory auditors could indicate inadequate compliance with the duty of care by the audit firm. This, however, was not in itself sufficient to conclude that the audit firm had been negligent with respect to its duty of care. According to the court, this required the establishment of a personal and direct culpability on the part of the audit firm.

Based on the strict requirements that have to be set for the furnishing of evidence of the violation and the grounds for imposing the fine, this was insufficient to establish that the AFM had demonstrated beyond reasonable doubt that there had been a violation of the duty of care by EY and PwC.

6. Why did the AFM not use another legal basis to justify the fines?

Other than the duty of care, there is no other legal basis for fining audit firms in cases where the AFM identifies serious shortcomings in the audits of financial statements. In other words, the duty of care is the only statutory connecting factor to hold audit firms responsible for the quality of audits of financial statements.

7. How does the Dutch legislation relate to legislation in other countries?

The legislation in the Netherlands differs from legislation in other countries in two respects that are relevant to this ruling. The Netherlands is the only country that has a statutory duty of care. In addition, supervisory agencies in other countries may take direct enforcement action against both the statutory auditor and the audit firm in cases where they identify shortcomings in the performance of a statutory audit. On the basis of this ruling, it would appear that holding audit firms directly responsible for shortcomings in statutory audits is in principle not (or no longer) possible.

8. How is the AFM developing its approach to supervision?

The AFM has been supervising audit firms since 2006, and its approach to supervision has been constantly developing over the past 10 years.

This ruling concerns cases from 2012 and 2013 and the AFM has further developed its approach since that time. And we will continue to do so, as the sector is also changing. The effectiveness of our supervision is the priority, with the aim of improving the quality of audits of financial statements. These serve an important public interest. Enforcement is not the only instrument in this respect. The AFM is increasingly focusing on influencing culture and behaviour at audit firms. This broad approach will continue to be the guiding principle in the further development of our supervision. The dialogue with investors, audit committees and audited companies regarding quality, structure and culture will be further intensified.

9. What will the AFM do during the appeal?

During the appeal, the AFM will accept the court's ruling in any current and future enforcement decisions. In addition, the AFM will consult with the Ministry of Finance regarding how this ruling relates to the objectives of the legislature when it introduced the duty of care in 2006 and the consequences of the court ruling. There will also be discussion of whether the law needs to be evaluated on this point.

10. How does the AFM supervise the quality of statutory audits of financial statements?

The AFM has been supervising audit firms since 2006. Its approach to this supervision has developed constantly over the past 10 years. The AFM takes a broad approach to its supervision.

- Since 2015, we have been measuring the changes realised by audit firms and our attention is increasingly focused on conduct and culture at the audit firms. It is therefore important to remember that this case concerns an investigation in 2012 and 2013.
- We look at the end result: the quality of the audit of the financial statements.
- We also influence the 'system' within which audit firms operate. Regulation in the Netherlands has been tightened since 2013 at the AFM's request (the report Incentives for Quality). On this basis, the mandatory audit firm rotation and the separation of audit and advisory services have been further developed in regulation. Executive directors will also soon be tested for suitability. This will help to continually improve the 'system', or more accurately the structure within which auditors do their work.

In addition, our supervision is continually developing. It is also important to devote attention to the entire ecosystem of the audit of financial statements, including the roles that companies and audit committees can play in this regard.