

## Interpretation of Wta Sections 16 and 16b

**In short** – This interpretation provides further guidance on the principles enshrined in Sections 16 and 16b of the Dutch Audit Firms Supervision Act (Wta). The requirements in these sections ensure that Auditors occupy a central position in the audit firm, so that they can act at all times in accordance with the public interest. In that regard, Auditors must have a decisive influence in the audit firm.

*This document has been drafted in the Dutch language and translated into English. In the event of inconsistency or discrepancy between the Dutch version and the English version of this publication, the Dutch version shall prevail.*

# Contents

<b>1.</b>	<b>Introduction</b>	<b>3</b>
<b>2.</b>	<b>Provisions of the Wta that directly impact the design of investment structures</b>	<b>4</b>
<b>3.</b>	<b>Principles applied</b>	<b>5</b>
	3.1 All executive board decisions fall under day-to-day policy	5
	3.2 Majority voting right	5
	3.3 Investment protection measures	6
<b>4.</b>	<b>Interpretation</b>	<b>7</b>
<b>5.</b>	<b>Examples</b>	<b>9</b>
<b>6.</b>	<b>Legal framework</b>	<b>11</b>

# 1. Introduction

The value that society attributes to the auditor's objective judgement is of great importance for the functioning of the economy. When taking decisions, market participants must be able to rely on the view that companies present of their financial position and on the opinion issued by an auditor on the fairness of that view. Providing assurance for society by issuing opinions on the fairness of presented financial information is a core public function of the auditor.<sup>1</sup>

In addition to this core public function, audit firms are also undertakings with commercial objectives and compete with one another. That gives rise to pressure. Pressure from shareholders and pressure from the audited companies. There is a certain tension between the core public function and the commercial objectives. This tension is one of the reasons why audit quality needs to be guaranteed in law. The legal guarantee of quality leaves room for competition only in terms of the efficiency of performance.<sup>2</sup>

An increasing number of audit firms have attracted external investors in recent years. Sections 16 and 16b of the Wta set preconditions for audit firms with regard to such investments. These provisions are important in ensuring that auditors can practise their profession independently and in accordance with the rules of conduct and professional practice. These sections aim to ensure that auditors occupy a central position within the audit firm, at both executive board and shareholder levels. Auditors are thus able to fulfil their responsibility to act in the public interest and offer counter pressure against the financial incentives of external investors.

Given the importance of consistent application of legal requirements by all audit firms, the AFM explains the meaning of two sections of the Wta, Sections 16 and 16b, in this interpretation. This interpretation is based on applicable legislation.

## Interpretation outlines principles and expectations

An interpretation by the AFM is a written policy statement setting out the AFM's view of applicable legislation and regulations it supervises. Through its contacts with market participants and the legal profession, the AFM identifies subjects requiring interpretation. In such interpretations the AFM aims to explain the standard in accordance with European and national legislation and legislative history.

The AFM expects audit firms to design their structure in accordance with the principles enshrined in applicable legislation. Those principles are set out in this interpretation.

In this context, when establishing investment structures, audit firms assess whether such structures actively enable them and the statutory auditors employed by or associated with them to fulfil their responsibility to act in the public interest. Given their public role, audit firms and auditors subject to rules of conduct and professional practice may be expected to interpret legislation in a way that does justice to the interests that the legislation aims to protect.

## Any questions?

If you have any questions about this interpretation and its application, please contact the AFM by e-mail at [wta@afm.nl](mailto:wta@afm.nl).

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<sup>1</sup> House of Representatives, 2003/2004, 29 658, no. 3, pp. 1 and 2.

<sup>2</sup> Bulletin of Acts and Decrees, 2006, no. 380, p. 32.

## 2. Provisions of the Wta that directly impact the design of investment structures

Section 16 of the Wta states that an audit firm's day-to-day policy must be determined in majority by audit firms, audit offices or natural persons complying with the rules on the professional competence of statutory auditors to be specified pursuant to Section 25 of the Wta or equivalent rules. If the audit firm's day-to-day policy is determined by two persons, at least one of those persons must comply with these rules.

Under Section 16b of the Wta, the majority of the voting rights in an audit firm must be held by audit firms, audit offices or natural persons complying with the rules on the professional competence of statutory auditors to be specified pursuant to Section 25 of the Wta or equivalent rules.

For the sake of brevity in the discussion in this interpretation of these sections of law, the term **'Auditors'** is used to mean 'audit firms, audit offices and natural persons complying with the rules on the professional competence of statutory auditors to be specified pursuant to Section 25 of the Wta or equivalent rules'. An audit firm is deemed to mean the undertaking or institution to which the AFM has granted a licence under Section 6 of the Wta.

The importance of the aforementioned provisions lies in the need for an auditor to be able to practise his profession independently and in accordance with the rules of conduct and professional practice. This is of fundamental importance for promoting public trust in the reliability of statutory auditors' reports. Auditors and users of auditors' reports benefit from justified, stable and widely shared trust in the functioning of the profession. It also follows from the rules of conduct and professional practice that auditors have an important responsibility to act in the public interest. The majority requirements in Sections 16 and 16b of the Wta ensure that Auditors occupy a central position in the audit firm, so that they can act at all times in accordance with the public interest.

## 3. Principles applied

The following principles are applied in determining whether the requirement is met that the day-to-day policy of the audit firm is determined in majority by Auditors and the majority of voting rights in an audit firm are held by Auditors.

### 3.1 All executive board decisions fall under day-to-day policy

The natural persons responsible for the day-to-day management of the audit firm are considered to be policy makers. All the decisions they take fall within the determination of day-to-day policy, as referred to in Section 16 of the Wta. Policy makers are deemed to include, in any case, the persons who formally hold the position of executive director of the audit firm.

In the case of a sole proprietorship, the owner is the sole executive director and hence the policy maker. In the case of a partnership or other form without legal personality, this depends on the contractual agreements between the parties involved and their implementation in practice. If they have agreed with each other in writing that the audit firm will be managed by one or more of them, the latter persons are in any case formally executive directors and hence policy makers. If one or more persons act as such, they are also deemed to be policy makers. If the parties involved have not made written arrangements, all persons who are parties to the agreement are formally executive directors. In the case of a form of organisation having legal personality (such as a private limited company (B.V.), public limited company (N.V.), foundation, cooperative or association), at least those who are formally registered as executive directors in the commercial register are deemed to be policy makers.

Natural persons who do not formally hold the position of executive director but have de facto the day-to-day management of the audit firm are also deemed to be policy makers.

### 3.2 Majority voting right

#### Interpretation of the term 'voting rights' is independent of legal form

Section 16b of the Wta is not tailored to one or more specific legal forms but to audit firms regardless of their legal form. In the Wta, an 'audit firm' is deemed to be an undertaking or institution, or an organisation in which such undertakings or institutions are associated with each other, whose purpose is to perform statutory audits. This includes companies, partnerships and sole proprietorships, as well as other collaborative structures. In this interpretation, the term 'voting rights' is therefore not interpreted solely on the basis of, for example, a voting right attached to the ownership of shares in a company. It is also deemed to include voting rights that may be exercised by voting rights holders in bodies of other collaborative structures, such as a meeting of members or a meeting of partners.

#### Decisive influence of Auditors in the audit firm

Since Section 16b of the Wta applies to any licensed collaborative structure that performs statutory audits on a commercial basis, the 'voting right' must be interpreted as the ability to exert influence in the audit firm. Since the majority of voting rights in an audit firm must be held by Auditors, it follows that Auditors therefore have a *decisive* influence in the audit firm in the exercise of those voting rights. This is in accordance with Section 16 of the Wta, which states that an audit firm's day-to-day policy must be determined in majority by Auditors. Auditors must thus always have a decisive influence in an audit firm.

### **Both the formal and material structures lead to decisive influence for Auditors**

From the perspective of decisive influence, agreements regarding the exercise of voting rights on decisions concerning the audit firm also fall within the scope of application of Section 16b of the Wta. This concerns not only the formal granting of voting rights (for example in articles of association) but also material implementation (e.g. through voting agreements). In other words, structures must not be used to restrict the voting rights granted to the Auditors if, as a result, the Auditors effectively no longer have decisive influence. Examples include approval rights and qualified majorities in decision making.

### **Auditors exert decisive influence on all decisions relating to the audit firm**

The requirement in Section 16b of the Wta is formulated in general terms and draws no distinction between policy areas. The requirement that Auditors exert decisive influence in an audit firm therefore applies to all decisions of voting rights holders relating to the audit firm.

### **Voting rights may be held indirectly and directly**

Auditors may hold voting rights indirectly. The question arising in these types of situations is which persons can exert influence on the audit firm. To answer this, it is necessary to look through the structure to the ultimate party that indirectly holds voting rights in the audit firm. In audit firms, within the group of persons who can exert influence, Auditors must exert decisive influence.

## **3.3 Investment protection measures**

The European legislature has not chosen to exclude investments by parties other than Auditors. The chosen legal wording provides scope to prioritise the interests of independence and professional competence. On the other hand, it is too risky for third parties wishing to invest in an audit firm if the investment cannot be protected to some extent. Against this background, the AFM provides scope for basic investment protection measures relating to the continuity and identity of the audit firm. In this regard, reference is made to section 4.9 of this interpretation.

It is also important that the AFM can supervise the power structure laid down for an investment and its implementation in practice. For example, Section 17 of the Wta states that the audit firm's formal or de facto control structure must not impede the proper supervision of compliance with the provisions of or pursuant to the Wta. Given the many possible ways in which a power structure can be designed, and the importance of ensuring that the formal or de facto power structure does not, in theory or in practice, impede the proper supervision of compliance with Sections 16 and 16b of the Wta, there is an additional interest in only providing scope for basic investment protection measures.

## 4. Interpretation

The principles set out above lead to the following interpretations:

1. Auditors must have a decisive influence in an audit firm in the exercise of voting rights.
2. The day-to-day policy of an audit firm must be determined in majority by Auditors. The majority is interpreted on the basis of both the number of persons and the weight of their voting rights; in other words, Auditors must have a decisive influence on day-to-day policy.
3. If the day-to-day policy of the audit firm is determined by two persons, at least one of them must be an Auditor, and the voting rights granted to the Auditor must never weigh less heavily than those of the other policy maker who is not an Auditor.

### Approval rights

4. In the context of the subject matter of this interpretation, a right of approval exists if the policy makers or voting rights holders of an audit firm, in connection with a decision or type of decision, require the consent of a third party (i.e. other than the body that is in principle authorised to take the decision) and there is no mandatory approval right prescribed<sup>3</sup> by law.

In principle, approval rights undermine the decisive influence that Auditors are required to have in the exercise of voting rights and determination of day-to-day policy. An approval right granted by voting rights holders or policy makers to a third party and enabling the latter to block the decision results in the majority of policy makers or the majority of voting rights holders no longer having decisive influence with regard to that decision or type of decision. If such decisions can be blocked by the third party, they are in violation of Sections 16 and 16b of the Wta.

5. Furthermore, apart from the permitted exceptions stated in section 4.9, the decisive influence of Auditors can only be overridden by approval rights if these are exercised by independent persons and bodies, in line with the rationale for introducing an internal supervisory body for certain types of audit firms. These persons or, in the case of a body, the members of that body, must satisfy the same independence requirements as those applying to members of the mandatory internal supervisory body as referred to in Section 22a of the Wta and Article 34c of the Audit Firms Supervision Decree (Bta). These persons and members of the body must be guided by the interests of the audit firm and its associated undertaking and by the public interest in guaranteeing the quality of statutory audits.
6. This means that – in addition to the permitted exceptions stated in section 4.9 – approval rights may also be granted to (i) the internal supervisory body when an audit firm has a system of independent internal supervision established in accordance with the requirements of Section 22a of the Wta and (ii) persons who, or other bodies whose members, meet the same independence requirements as those applicable to members of the mandatory internal supervisory body.
7. For the sake of completeness, it should be noted that granting approval rights or other powers to third parties may result in these third parties exerting significant influence on the day-to-day management of the audit firm and thereby qualifying as co-policy makers of the audit firm.

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<sup>3</sup> See, for example, Article 2:239(6) of the Dutch Civil Code or the works council's right of consent as referred to in Section 27 of the Works Councils Act.

These third parties may even qualify as de facto policy makers if they are granted such broad instruction and/or approval rights that they effectively determine the audit firm's day-to-day policy from a de facto and/or legal position of power. This means that audit firms must take these third parties into account when determining whether the provisions of Section 16 of the Wta are fulfilled.

### **Qualified majorities**

8. In the context of the subject matter of this interpretation, a qualified majority exists if the policy makers or voting rights holders of an audit firm, in connection with a decision or type of decision, need more than a simple majority and there is no mandatory qualified majority prescribed by law. Having regard to Sections 16 and 16b of the Wta, qualified majorities must not result in Auditors no longer having a decisive influence within the audit firm in the exercise of voting rights and determination of day-to-day policy. If decisions can be blocked by non-Auditors, they are in violation of Sections 16 and 16b of the Wta. Details of permitted exceptions can be found in section 4.9.

### **Investment protection measures relating to continuity and identity**

9. Against the background of the need for basic measures to protect the investment, the AFM permits a limited number of exceptions to the principles enshrined in law as described in sections 4.4 (approval rights) and 4.8 (qualified majorities), to the extent that they relate to the continuity or identity of the audit firm. Non-Auditors may require that their consent be obtained for the following decisions:
  - a. Cessation of activities and/or dissolution of the audit firm;
  - b. Application for bankruptcy or suspension of payments by the audit firm;
  - c. Legal merger of the audit firm;
  - d. Legal demerger of the audit firm;
  - e. Conversion of the audit firm;
  - f. Change in the nature of the organisation as an audit firm; and
  - g. Amendment to the audit firm's articles of association, to the extent that such amendment prejudices the consent requirements set out above under points a to f.

## 5. Examples

### Approval right

Auditors hold a majority of the voting shares in an audit firm. A shareholders' agreement has been concluded with a minority shareholder who is not an Auditor, stating that this minority shareholder's prior approval is required for the adoption or amendment of the annual budget.

Decisions on the adoption and amendment of the budget pertain to the audit firm and do not qualify as a basic investment protection measure within the meaning of section 4.9. By granting such an approval right, the minority shareholder can block decisions, as a result of which Auditors no longer exercise a decisive influence on this decision. Such an approval right can only be granted to and exercised by a person or body satisfying the same independence requirements as those applicable to members of a mandatory internal supervisory body (sections 4.1, 4.4 and 4.5).

### Body with approval rights

An audit firm wholly owned by a holding company has an internal supervisory body with three members which is not mandatory under Section 22a of the Wta. Consideration is given to granting this body approval rights that do not qualify as basic investment protection measures within the meaning of section 4.9. One of the members is on the executive board of the holding company and another works for a company that holds a minority interest (with voting rights) in the holding company concerned. These two persons do not meet the same independence requirements as those applying to members of a mandatory internal supervisory body. This means there is no scope to grant the respective (non-basic) approval rights to this body (sections 4.5 and 4.6).

### STAK structure

A trust office foundation (STAK) has been placed between a holding company and the audit firm. This STAK holds the shares in the audit firm and has issued depositary receipts to the holding company.

The executive board of the STAK exercises the voting rights in the audit firm. To comply with Section 16b of the Wta, the majority of the members of the executive board of the STAK are Auditors. The holding company and its shareholders do not hold approval or appointment rights that prejudice the independent exercise of voting rights by the STAK executive board.

If the depositary receipt holders only hold economic rights and do not exert any direct or indirect decisive influence on decisions pertaining to the audit firm, this situation is permitted. This means that they likewise have no decisive influence on the appointment, suspension or dismissal of executive directors of the STAK or the audit firm. In that case, the STAK structure is compatible with Sections 16 and 16b of the Wta.

### Determination of strategy

Determining the audit firm's strategy is the responsibility of the executive board of the audit firm and forms part of the day-to-day policy. In a group structure, a holding company can adopt an overarching group strategy. Such a strategy can provide direction, but it must not lead to the executive board of the audit firm no longer having any formal or de facto decisive influence with regard to the audit firm's policy and strategy. The executive directors of the audit firm remain independently responsible for determining the strategy and policy of the audit firm.

**No majority voting right despite agreements**

An audit firm has five direct or indirect shareholders, of whom two are Auditors and three are non-Auditors. It is stipulated in a voting rights agreement that non-Auditors will not exercise their voting rights on decisions pertaining to the audit firm.

Despite this agreement, Auditors do not hold the majority of voting rights in the audit firm. The waiver of voting rights by non-Auditors does not alter the voting right ratios. This structure therefore does not comply with Section 16b of the Wta.

**Material structure must lead to decisive influence**

It follows from Section 16b of the Wta that Auditors must have a decisive influence in the audit firm when exercising voting rights. The day-to-day policy makers in an audit firm (all Auditors) are to vote on a proposal to wind down a profitable but risky client portfolio. The external investor makes clear to the day-to-day policy makers on several occasions that this winding down is contrary to his wishes and threatens consequences. Out of fear of the pressure being exerted, almost all Auditors decide not to vote for the proposal after all. There is an informal hierarchy that prevents the Auditors from feeling free to exercise their voting rights in a manner consistent with their own professional judgement. This is an example of a situation in which Auditors do not have decisive influence. This does not comply with Sections 16 and 16b of the Wta.

## 6. Legal framework

### **Section 16(1) of the Audit Firms Supervision Act**

The audit firm's day-to-day policy is determined in majority by audit firms, audit offices or natural persons complying with the rules on the professional competence of statutory auditors to be specified pursuant to Section 25 or equivalent rules. If the audit firm's day-to-day policy is determined by two persons, at least one of those persons must comply with these rules.

### **Section 16b of the Audit Firms Supervision Act**

The majority of voting rights in an audit firm are held by:

- b. Audit firms;
- c. Audit offices; or
- d. Natural persons who comply with the rules on the professional competence of statutory auditors to be specified pursuant to Section 25 or equivalent rules.

### **Section 17 of the Audit Firms Supervision Act**

The formal or de facto control structure of the audit firm must not impede the proper supervision of compliance by the audit firm with the provisions laid down in or pursuant to this Act.