



AFM report on audit committees

The role of audit committees in selecting the external auditor and monitoring the external audit

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Reading guide

This report presents the outcomes of the further exploratory review (hereafter: review) of the Dutch Authority for the Financial Markets (AFM) of the role of audit committees in selecting the auditor/audit firm (hereafter: auditor) and monitoring the audit.

This report consists of seven parts:

- (1) Introduction
- (2) General observations
- (3) Specific observations on the selection process
- (4) Specific observations on the monitoring process
- (5) The role of the AFM regarding audit committees
- (6) Methodology
- (7) Outreach

In the highlighted text blocks, we refer to the applicable laws and regulations and we give recommendations on the topics of the review.

1. Introduction

The AFM is committed to high-quality audits and external reporting. Audit committees are an important link in the relationship between the supervisory board, the company, the auditor and the shareholders. As such, they play an important role in improving the quality of audits and external reporting.

In its [AFM Agenda 2020](#), the AFM announced a review of how audit committees of Dutch Public Interest Entities (hereafter: PIEs) fulfil their roles in selecting the auditor and monitoring the audit. In addition, we continued the dialogue with audit committees and organised a [webinar](#) on this topic. By sharing the outcomes of this review, the AFM aims to contribute to the audit committees' understanding and fulfilment of their responsibilities.

The methods used in this review were: (i) an online survey; (ii) a review of documents regarding the selection and monitoring processes; and (iii) interviews (see section 6).

Section 2 lists the topics to which the same ('overall') general observations apply for the vast majority of the audit committees in our review. The observations in sections 3 and 4 vary between the audit committees in our review.

In this report, we refer to EU Audit Regulation 537/2014 as 'AR'; to the (Dutch) Decree on Audit Committees as 'BIAC' (Besluit instelling auditcommissie); to the Audit Firms Supervision Act as 'Wta' (*Wet toezicht accountantsorganisaties*); and to the Dutch Corporate Governance Code as 'CGC'.

2. General observations

Our review has led us to the following four general observations. Two are generally positive and two others are related to room for improvement. We refer to the questions in the [online survey](#) as 'Q'.

2.1. Audit committees are more in charge

Compared to the outcomes of our [review in 2015](#), we identified a positive trend towards audit committees taking greater charge of the selection process. The audit committee is responsible for the selection process organised by the PIE (art. 16(3) AR). In practice, the selection process is carried out by a *selection committee*. 92% of PIEs that recently changed auditors indicated that the selection committee was chaired by the chairman of the audit committee or a member of the supervisory board/audit committee (Q38). In 2015, this was 79%. Another 4% indicated that the selection committee was chaired by the CFO, and 4% indicated that it was chaired by the majority shareholder.

The audit committee in charge of selection process

Recommendation

- ✓ The chairman and majority of the selection committee are audit committee members.

Laws and regulations

- ✓ The audit committee validates the report with conclusions of the selection committee on the selection process (art. 16(3)(e) AR).
- ✓ Separately, the audit committee sends its recommendation to appoint an auditor to the supervisory board. This recommendation contains two choices and a duly justified preference for one of them (art. 16(2) AR).

2.2 Sufficient relevant knowledge is available

According to the audit committee chairs we interviewed, there was generally sufficient relevant knowledge available among the interviewed audit committee members. All audit committee members we interviewed indicated that one or more members of the audit committee were a 'financial expert'. According to the BIAC, at least one member shall be an expert in the field of financial reporting or audit of the financial statements (art. 2(3) BIAC).

Financial expertise within the audit committee

Recommendation

- ✓ The audit committee gives appropriate meaning to the desired expertise of financial reporting and audit of the financial statements within the audit committee and includes this in the charter of the audit committee.

2.3 Monitoring of the audit quality and independence of the audit(or) can be enhanced

Based on interviews and documents, we found that the monitoring role of almost all audit committees could be enhanced by (a) challenging the auditor during the different phases of the audit; (b) monitoring the follow-up of the management letter by management; and (c) taking into account reports on audit quality in the monitoring and evaluation of the auditor. These topics will be presented in more detail in section 4.

The audit committee is responsible for monitoring the independence of the audit(or) (and cannot rely on the audit firms' independence process alone, as was observed during our review). We noted that various annual reports (reports of the supervisory board) made reference to non-audit services or the approval thereof (e.g. pre-clearance for several tax services). Audit committees need to be aware of concurrence of non-audit services, as this is prohibited.

Monitoring independence by the audit committee

Laws and regulations

- ✓ EU and Dutch independence rules prohibit non-audit services (art. 5 AR, art. 24b Wta and art. 2(2)(e) BIAC).

2.4 Transparency to shareholders needs improvement

A full 90% of survey respondents endorsed the importance of transparency towards shareholders regarding the selection process (Q10a). However, none of the seven PIEs in our document review had sent at least two choices (with the names of the audit firms) with a duly justified preference for one of them upfront to the general meeting of shareholders, which is not in line with the AR. Instead, only the name of the preferred audit firm was included in the proposal to the shareholders. Improvements should be made by audit committees in this regard.

Transparency selection process to shareholders

Laws and regulations

- ✓ The proposal to the shareholders of the appointment of the auditor shall contain:
 - at least two choices and the duly justified preference for one of them on the part of the audit committee (art. 16(2)(5) AR);
 - a justification if the proposal differs from the preference of the audit committee (art. 16(5) AR).

Recommendation

- ✓ A summary of the selection process is included in the proposal to the shareholders as well.

3. Specific observations on the selection process



Section 3 describes our observations on three elements of the auditor selection process (see the figure above), based on the applicable laws and regulations.

3.1 Observations on fair and transparent selection

3.1.1 Tender documents are not always sent to all audit firms participating in the selection process

A total of 88% of the respondents of the survey indicated that they send a request for proposal (tender documents or RfP) to two or more audit firms (in line with the AR) (Q33). From our document review of seven PIEs regarding the selection process, we noticed that tender documents were not always sent to *all* audit firms who participated in the selection process. Two PIEs (out of seven) invited their current audit firm and one new audit firm to tender. In those two cases, the current audit firm received an oral invite to participate – instead of tender documents – with the argument that the auditor was already familiar with the organisation and type of audit, and the audit committee was already familiar with the auditor.

A due and effective tender process

Laws and regulations

- ✓ Tender documents are sent to all audit firms participating in the selection process (at least two) (art. 16 (2)(3)(b) AR).
- ✓ If the current audit firm is involved in the selection process, it shall receive the tender documents as well to assure a fair and transparent process and the use of transparent and non-discriminatory selection criteria (art. 16 (3)(b) AR).

Recommendation

- ✓ Allow the participating auditors to speak with the current auditor in order to gain a better insight into the type of audited entity and type of audit before they submit their response.

3.1.2 Preselection is not always substantiated and non-discriminatory

Preselection is the (informal) process in which the selection committee decides which audit firms will be invited to tender and which firm(s) will not be. Based on documents and interviews with seven PIEs, we observed that the preselection of audit firms is substantiated most of the time (e.g. missing necessary expertise or global spread/presentation) (five out of seven), although sometimes not. In those cases (two out of seven) the selection committees focussed on the Big 4 semi-automatically, leaving out the other PIE audit firms.

Preselection

Recommendation

- ✓ The preselection of audit firms is substantiated with justified and non-discriminatory arguments.

3.1.3 Mixed picture for anticipation of sufficient choice

While 17% of the respondents of the survey do not expect to have at least two options when selecting a new audit firm (Q31), around 20% of the respondents of the survey indicated they had already taken measures to assure sufficient choice in the future. Around 80% of the respondents indicated they had not taken measures yet, with half of them mentioning that rotation is more than a couple of years ahead.

Measures to assure a sufficient choice of audit firms

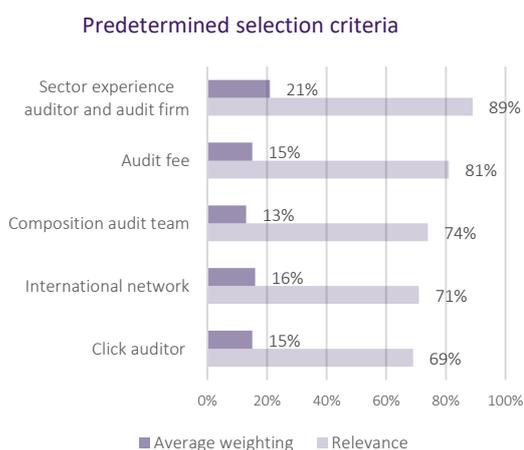
Recommendations

- ✓ Take timely measures to assure a sufficient choice of audit firms in the future, for example with a sunset clause for advisory work – i.e. a clause stipulating that non-audit services are automatically scaled down and eventually ceased after a certain point in time.
- ✓ Actively monitor all offered/purchased services of audit firms.
- ✓ Assure that there is no reward for audit firms – e.g. in the form of more non-audit work – if they refuse to respond to a tender proposal.
- ✓ Involve as many PIE audit firms as possible in the selection process to stimulate competition on audit quality between them.

3.2 Observations on selection based on quality

3.2.1 Selection criteria are not always based on quality

The respondents to the survey were asked to indicate the selection criteria they used most. The figure below shows the top five most common criteria included in the selection procedure (in light purple). Furthermore, this figure shows the average weighting of that selection criterion according to the respondents in the survey (in dark purple) (Q30).



These top-five criteria are relevant criteria, although not all necessary relating to audit quality (refer to the selection criteria mentioned below).

Selection criteria that (may) relate to audit quality

Recommendation

- ✓ Involve criteria that (may) relate to audit quality, for example:
 - Involvement and professionalism of the auditor (% , hours)
 - Involvement of specialists (% , hours)
 - Quality ratings of internal quality reviews (IQR)
 - Reports from oversight bodies (e.g. AFM, PCAOB)
 - Experience of the auditor in the sector
 - Composition of the audit team

The audit committees' most frequently used sources of information regarding the quality of the recently appointed auditor (Q35) were: (i) references from fellow supervisory board members; (ii) references from the management/board of the company; and (iii) an analysis of the audit proposals received.

With regard to the criteria above, we observed - especially in the interviews - that the audit committees paid particular attention to a sufficient involvement of the auditor (lead partner) and specialists.

Regarding 'audit fee' (price) as a selection criterion, our observation was that audit committee members consider the price of the audit services to be less or slightly less important compared to other criteria: it only comes into play when there is no clear preference for one of the candidates. However, 16% of the survey respondents indicated that the audit fee was decisive in selecting the current auditor (Q41). Furthermore, the interviews showed that fee discussions are generally held after the selection procedure is finished and audit committees generally do not participate in these discussions. This raises questions about whether the audit committee is sufficiently involved in setting the agreed fee, which may influence partner and/or specialist involvement, the scope and/or the materiality level of the audit.

Regarding a professional connection with the auditor ('click'), we observed from the documents and interviews that a professional and personal 'click' with the auditor (and its team) becomes more important in the last part of the selection process compared to other selection criteria.

Obtaining insight in the connection with the auditor

Recommendation

- ✓ Do a workshop together to explore the 'click', i.e. a good connection between the audit committee and the auditor.

3.2.2 The use of inspection reports can be improved

It is the responsibility of the audit committee to consider public inspection reports from the AFM during the selection process (art. 16(3)(e) AR). However, the survey indicated that the audit committees who recently changed auditor made very limited or no use of inspection reports from oversight bodies and internal quality review reports by the audit firm (Q35). This was confirmed by our document review. However, the survey indicated that over 70% of the respondents were aware of the existence of those reports (Q24). The audit committees struggle with the use of AFM reports in their specific role. See also section 5, The role of the AFM regarding audit committees.

Guidance can help to articulate the selection criteria as objectively as possible and help the audit committee in their role in this regard. Examples of such guidance include the international guidance published by [IOSCO](#), the [Financial Reporting Council](#) and the [Public Company Accounting Oversight Board](#).

3.2.3 The use of selection criteria is not always clear

Evaluation of the auditors must take place in line with predefined criteria (16(3)(e) AR). Although the chosen predetermined selection criteria seemed relevant and mostly related to quality, the actual use of these selection criteria varied. In our document review, we observed that only one PIE out of seven had prepared a clear evaluation document in which the auditors were rated (evaluated) on the predefined criteria with substantive arguments in favour or against. In the other six cases, our observations included: points awarded on each criterion, but without any underlying arguments; evaluation in line with the predefined selection criteria, but also other selection criteria (not predefined), e.g. 'click' and price were given more weight; or criteria that were not always fully applied in the evaluation documents we reviewed.

Evaluation of auditors in the selection process

Laws and regulations

- ✓ The evaluation of the auditors is fair and transparent and in line with the predefined selection criteria in the tender documents (art. 16(3)(e)(f) AR).

Recommendation

- ✓ Evaluation is based on quality and consists of substantive arguments in favour and against.

3.3 Observations on the audit committees' responsibility for the selection process

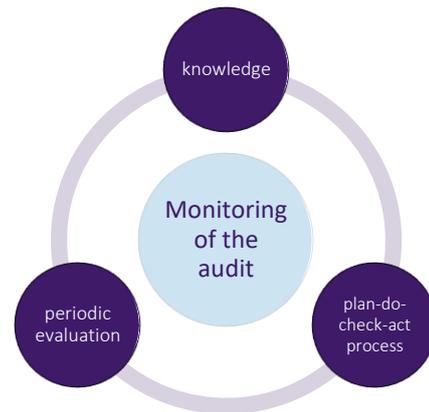
As stated above, audit committees have taken more of a leading role in the recent selection process compared to our review in 2015. Still around 11 % of the survey respondents indicated that, according to the selection procedure, management is leading the process (Q29). In 12% of recent auditor changes, the audit committee was not part of the selection committee (Q36). 19% of the respondents indicated that management established the procedure for the selection process (Q28).

Audit committee role versus management role

Laws and regulations

- ✓ The audit committee is responsible for establishing the selection procedure (art. 2(2)(f) BIAC).
- ✓ The audit committee is responsible for the selection process (art. 16(3)AR).
- ✓ The audit committee takes note of the observations of management (1.6.1 CGC).
- ✓ The role of management does not go beyond facilitating the process (1.6.3 CGC).

4. Specific observations on the monitoring process



Section 4 describes our observations on three elements of the monitoring process of the audit (see the figure above), based on the applicable laws and regulations.

4.1 Observations on knowledge regarding the audit

Aside from the overall observation that sufficient knowledge is available within the audit committees generally, we noted during the interviews that some audit committee chairs explicitly mentioned the need for more IT experience within the audit committee. It is important to keep up to date with relevant developments, for example by discussing relevant incidents in the audit committee.

Keeping knowledge up to date

Recommendation

- ✓ Discuss relevant incidents in the outside world (e.g. relating to fraud) in the audit committee with your auditor and ask critical questions, especially if the company is exposed to similar risks. Which audit procedures does the auditor perform to mitigate these risks?

4.2 Observations on the plan-do-check-act process

4.2.1 There are many contact moments with the auditor

Monitoring of the audit is a plan-do-check-act process. We observed that such processes are in place. A majority of respondents indicated that the audit committee had at least one or more formal meetings with the auditor without the presence of management (Q19c). On the other hand, the survey also indicated that 27% of the respondents/audit committees still do not have a formal meeting with the auditor without the presence of management (1.7.4 CGC) (Q19c). However, audit committee chairs have several informal contact moments with the auditor during the year. These 'one-on-ones' without management are mostly held more than once a year (Q19e).

These private one-on-ones were mentioned in several interviews as a good practice. Sometimes these sessions take place prior to and/or after each audit committee meeting.

4.2.2 The work of the auditor is perceived as important

Moreover, we observed in the interviews that audit committee chairs perceived the work of the auditor as important. The auditor is seen as the audit committees' eyes and ears. The audit committee wants to hear of signs of possible weaknesses in IT systems or fraud. Sometimes the discussions with the auditor go beyond the audit itself, taking in such topics as the perceived work culture and spirit in the workplace and the tone at the top. This was mentioned in more than half of the interviews. Furthermore, we observed that the audit committee chairs perceived the quality of the Big 4 as a given. Such a perception of quality could lead to too much trust and a lack of critical attitude towards the auditor. Some audit committee chairs mentioned that the professionalism of the person of the auditor is of greater importance than the name of the firm.

4.2.3 Extent of discussions with the auditor is unclear

During our review, it was difficult to obtain an insight into the extent of the (interactive) discussions between the audit committee and the auditor. Nevertheless, the AFM noted that monitoring of the audit sometimes seemed to focus more on process and less on audit quality. See the figures in paragraph 4.3.

4.2.4 The follow-up of the management letter could be monitored more closely

We noted from interviews and documents that in some cases the findings of the auditor seemed to be unchanged over the years. Again, it was difficult to obtain an insight into the audit committees' work regarding the follow-up of the management letter during this review.

Follow-up of the management letter

Recommendations

- ✓ Ensure management responds adequately and timely to issues in the auditor's management letter.
- ✓ Consider to provide more transparency about the work of the audit committee in this regard towards the supervisory board and shareholders.

4.3 Observations on periodic audit(or) evaluations

4.3.1 The use of inspection reports could be enhanced

The figures in this paragraph indicate the top five most and least common elements in the audit evaluation.

In paragraph 3.2.2, we mentioned the limited use of public inspection reports for the aim of selection.

Most used input – Auditor monitoring



To a lesser extent the same applies to the use of these reports to monitor and evaluate the audit(or). The survey indicated that over 70% of the audit committees were familiar with public (e.g. AFM/PCAOB) and/or firm-specific reports on the current auditor (Q24), and over 70% discussed those reports in the audit committee when relevant (Q25), although these reports were used less often in the most recent periodic evaluation of the audit(or) (Q27). The audit firm is required to send the inspection report of the AFM to the related PIE (art. 48a(7) Wta). In those cases, a discussion does take place between the audit committee and the auditor. Only 25% included firm-specific reports of supervisory

Least used input – Auditor monitoring



authorities in their most recent evaluation of the audit(or) (20% included generic reports). The same applies to the use of IQRs: only about 9% included IQRs in the evaluation of the audit(or) (Q27). In the interviews, some audit committee chairs stated that the public AFM reports were either too generic or too specific to use them directly to monitor and evaluate the audit(or) (see also section 5).

Use of external reports (related to audit quality)

Laws and regulations

- ✓ AFM reports are taken into account when monitoring and evaluating the audit (2(2)(d) BIAC).

Recommendation

- ✓ Consider involving other relevant reports in the monitoring and evaluation as well (IQR, PCAOB).

5. The role of the AFM regarding audit committees

With the review and webinar, we also explored what the AFM could do to strengthen and support audit committees in their role.

We received valuable input which will be taken into consideration, such as the suggestion from audit committees to engage each other more frequently about specific topics, such as after the publication of AFM inspection reports. They indicated their need for a better understanding of inspection reports for their own role. For instance, how can an inspection report support the audit committee during selection and monitoring, for example by suggesting questions the audit committee could ask the auditor in response to such a report?

The audit committees expressed appreciation for the outreach and dialogue by the AFM during the seminar (2019) and recent webinar (2020) and called for sharing good practices. The AFM intends to continue the dialogue with audit committees in the coming years.

With this report, the AFM provides additional guidance that audit committees can use when selecting and monitoring the audit(or).

To enhance the dialogue between the AFM and to support audit committees in their role, the AFM website has a specific information page for [audit committees](#). Among other things, this web page contains useful links and a further explanation of the role of the AFM regarding audit committees.

6. Methodology

The AFM conducted a review on how audit committees of Dutch PIEs perform their roles in the selection and monitoring of the audit(or).

The methods and scope of the review were:

- (i) an online survey among nearly 100 audit committee chairs of Dutch PIEs (listed on the Amsterdam stock exchange), in response to which we received 64 completed questionnaires in July 2020;
- (ii) a review of documents regarding the selection process from from a group of seven PIEs (which changed auditor since 2017) and a review of documents regarding the monitoring process from a group of 10 PIEs (chosen randomly);
- (iii) interviews held with 13 audit committee chairs, two auditors and one CFO. The interviews involved 13 PIEs which delivered the aforementioned documents.

The aggregated results of the survey are accessible via this [link](#).

In the review, we took into consideration the applicable laws and regulations:

- (i) EU Audit Regulation 537/2014 ([AR](#)) (especially art. 16 on the selection process)
- (ii) The Dutch Decree on Audit Committees ([BIAC](#))
- (iii) The Audit Firms Supervision Act ([Wta](#))
- (iv) The Dutch Corporate Governance Code ([CGC](#))

We shared and discussed the preliminary outcomes of the review during [a webinar](#) for audit committees on 1 December 2020 and refined the outcomes and views for this report.

7. Outreach

In order to improve our external communications, we would like to hear from you. Please share your views on this report. We invite you to fill out [our survey](#), which should take no more than two minutes to complete.

If you have any other questions or remarks, you can reach out to the AFM by email at wta@afm.nl.



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