Report on general findings regarding audit quality and quality monitoring

1 September 2010

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Foreword

The Netherlands Authority for the Financial Markets (*Autoriteit Financiële Markten*, or AFM) promotes fairness and transparency within financial markets, thereby promoting investor confidence in these markets. One of the AFM´s duties is to enforce the rules for auditors of annual financial statements. The market should be able to rely on the proper conduct of audits.

In the context of its ongoing supervision, the AFM completed regular inspections at Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers (the Big 4 audit firms) in 2009 and the first half of 2010. In addition, the AFM undertook incident investigations at these firms. This report exclusively sets out the findings of reviews completed by the AFM prior to 1 September 2010, with the exception of the credit crisis reviews, on which the AFM reported on 3 December 2009.

The Big 4 firms serve the largest portion of the market, performing around 60% of the number of statutory audits in the Netherlands and more than 90% of the number of statutory audits at public-interest organisations. The Big 4 firms account for around 80 percent of total revenue from statutory audits in the Netherlands.

Contact

For more information regarding the supervision of audit firms, please visit the AFM’s website (www.afm.nl) under Professionals > Audit Firms. Any specific questions you may have after reading this report, can be raised via our e-mail (wta@afm.nl), or in writing to Netherlands Authority for the Financial Markets, Attn Audit Firm Supervision Division, P.O. Box 11723, 1001 GS Amsterdam, or by telephone +31 (0) 20 797 2000.

1 Introduction

1.1. Background

In its report on the general findings regarding the credit crisis review of 3 December 2009, the AFM announced that its regular inspections in 2009 would focus on the completed statutory audits of the 2008 annual financial statements of financial sector companies, and companies in the construction/real estate and automotive sectors. As a consequence of the financial crisis, there is considerable public interest in the financial position and performance of financial sector companies. The decline in liquidity in several financial markets has made the valuation of financial assets more judgmental, at a time when companies may be under heavy pressure to present their financial position and performance in the most favourable light possible. The economic crisis greatly affected the financial performance in the construction/real estate and automotive sectors, making refinancing more problematic if not impossible, thereby creating greater going concern risks than usual. In such circumstances, auditors have to be especially alert and sceptical in conducting their audits, at all times having a due regard for the interests of the users of the financial statements.

In 2009 and the first half of 2010, the AFM undertook and completed seven incident investigations. The AFM undertakes incident investigations based on both incident reports from audit firms and signals, for example, from the press.

At our meeting with the audit firms licensed to audit public-interest organisations on 1 July 2010, the AFM presented its provisional generic findings from its ongoing supervision inspections in 2009. At the meeting, the AFM set out its most important and prevalent findings relating to the following:

– The audit firm’s duty of care.
– Insufficient professional scepticism on the part of the external auditor.
– Inadequate audit evidence.
– Insufficient audit documentation.
– Insufficient audit work when relying on procedures carried out by others (other auditors, experts, internal audit department).
– Insufficient audit work on the internal control structure including tests of controls.
– Insufficient involvement of the external auditor.
– Insufficient safeguards for the system of audit quality control (quality monitoring), including the role of compliance officers and the system of internal reviews.
– Insufficient records of the engagement quality assessor’s considerations regarding quality control reviews of audit engagements; and
– Insufficient records of infringements and measures taken.

The AFM also raised the possible causes of the deficiencies at this meeting with the audit firms licensed to audit public-interest organisations (*organisaties van openbaar belang*, or OOBs).

1.2. Overview of the AFM’s inspection process

Since the end of September 2007, the Big 4 firms reviewed have been licensed by the AFM and therefore fall under the AFM's ongoing supervision. They must demonstrate that they meet the requirements under and pursuant to the Act on the Supervision of Audit Firms (*Wet toezicht accountantsorganisaties*, or Wta) on a continuous basis. The AFM conducts inspections to establish to what extent audit firms comply with the regulations governing them. During the process of obtaining their licence, audit firms demonstrated that the design of their quality control systems complied with the requirements under and pursuant to the Wta. As part of the licensing process, the AFM carried out high-level tests of the effective operation of the quality control systems based on a limited number of audits. The AFM’s ongoing supervision generally focuses on the effective operation of the firms’ quality control systems. As part of our ongoing supervision, the AFM reviews audits to assess the effective operation of the firms’ audit quality systems. The AFM uses a risk-based approach in selecting specific aspects of quality control systems and audits for review.

A completed inspection results in a draft inspection report setting out the AFM's provisional findings. Before including these provisional findings in the draft report, the facts are discussed with the auditors directly involved. The draft report is then sent to the audit firm for the purpose of agreeing on the facts, and the firm is given an opportunity to respond. The AFM evaluates the firm’s response, which is followed by a final inspection report including, in addition to the firm's response, the AFM’s conclusions and view. The firm’s response may result in certain provisional findings of the AFM being deleted or changed. The AFM may take enforcement action where necessary, ranging from informal measures, including a discussion with the firm with a view to imposing standards and a warning letter, to formal measures under the Wta, including issuing an instruction, imposing an order for incremental penalty payments, or an administrative penalty. The AFM may also decide to institute disciplinary proceedings against an external auditor before the Disciplinary Court for Auditors.

The preparation of a final inspection report involves a due process that requires a substantial amount of time, particularly in view of the need to hear the views of the auditor and the audit firm views to get the facts right and the assessment of the additional information provided by the firms to the AFM during the process. The lead time from the start of a regular inspection to the completion of the final inspection report is on average one year. The AFM’s inspection reports are confidential.

1.3. Scope of the review

1.3.1. Regular inspections

The regular inspections for 2009 focused on the quality of audits and quality monitoring at the Big 4 firms.

The AFM’s regular audit quality inspections completed before 1 September 2010 included 46 audits in total , 22 of which were audits of OOBs[1] and 24 of which were audits of non-OOBs (table 1).

	Regular inspections
Number of audits of OOBs	22
Number of audits of non-OOBs	24
Total	46

Table 1

Audit quality

The AFM’s reviews of the 46 audits of 2008 financial statements covered financial sector companies and companies and institutions in the construction/real estate, automotive and other sectors, including housing corporations and municipalities. Table 2 gives an analysis of the number of audits by sector.

[1] *Public-interest organisations are listed companies, banks and insurers.*

Financial	Construction/Real Estate	Automotive	**Other**	**Total**
11	19	8	8*	46

Table 2

* The AFM's reviews also included audits of housing corporations and municipalities. At the instigation of the AFM, one or more of the Big 4 firms have conducted an internal review of the quality of the audits of municipalities and housing corporations. This involved several dozens of audits. The AFM has evaluated the results of these reviews in the context of its supervision.

The AFM's reviews did not cover all aspects of the audits of the selected companies and institutions. Its inspections were designed to answer the following questions:

- Does the audit firm ensure that the external auditor takes responsibility for the conduct of the statutory audit and also is he able to fulfil this responsibility?
- Does the audit firm ensure that the external auditor conducts the audit in a structured manner, using an adequate audit approach, and documents the audit work in the audit file?
- Does the audit firm ensure that the external auditor of the financial statements assesses whether the general accounting policy regarding going concern is appropriate?
- Does the audit firm ensure that the external auditor, when acting as group auditor, is actively involved and exercises professional scepticism with regard to other foreign and non-foreign auditors engaged and thereby obtains assurance that he can rely on audit work carried out by these other auditors?
- Does the audit firm ensure that the external auditor obtains adequate audit evidence with regard to the existence and valuation of the following balance sheet items:
    - financial assets (financial sector)
    - work in progress (construction sector/municipalities)
    - vehicles (automotive sector)
    - property (real estate sector)
- Does the audit firm ensure that the external auditor obtains adequate audit evidence with regard to completeness of revenue recognition?

The AFM independently took note of relevant documents in audit files, and spoke to, among others, directors, compliance officers and the external auditors responsible for audit files under review, as well as other members of audit teams. The level of detail the AFM went into when conducting its reviews varied from audit to audit. The level of detail in each case was to some extent determined by the structure of the company and the resulting design of the audit. In the case of multinational companies, the audits of the group companies concerned were mostly conducted by foreign auditors. The source documents showing the audit work carried out are usually not on file with the Dutch group auditor. These documents can only be found in the files of the foreign auditors. This means that the level of detail reached by the AFM in its test of the audits for these companies was more limited than in cases where the audits were carried out in full by Dutch auditors only.

Quality monitoring

In addition to reviewing audits, the AFM's regular inspections paid attention to the design and effective operation of the system of quality control with regard to the following aspects:

- quality monitoring, where appropriate, the work carried out by the compliance officer;
- periodic internal quality reviews of completed audit assignments (internal quality review);
- engagement quality assessments (EQAs);
- internal evaluations of quality control systems;
- recording of infringements.

The AFM’s reviews focusing on internal quality reviews included 23 audits relating to the 2008 financial year. The AFM’s reviews focusing on EQAs included 37 audits relating to the 2007 and 2008 financial years. The EQA is required for audits of OOBs. In general, audit firms auditing non-OOBs carry out an EQR for high-risk clients. Selected of the audit files was based on the risk profile of the audit engagement and the results of the EQA or internal quality review. Table 3 gives an analysis of the number of audits selected per type of review focus.

	Review of internal review	**Review of EQA**	**Total**
Number of audits	23	37	60

Table 3

The AFM included other topics, including the work carried out by the compliance officer, in its regular audit quality reviews (table 2).

1.3.2. Incident investigations

The AFM undertook and completed seven incident investigations at several Big 4 firms before 1 September 2010. Two of these reviews focused on audits of OOBs and five on audits of non-OOBs (table 4). The AFM notes that none of these incidents had been reported, while the AFM believes that they should have been reported. The AFM issued its Interpretation on incident reporting to the audit firms in mid-2010. Our interpretation aims to alert audit firms to the importance of rapid incident reporting to the AFM, given that incidents can damage confidence in the audit firm and the financial markets. The interpretation was published on the AFM’s website. As a result of this interpretation, the AFM expects audit firms to report incidents more quickly and the number of incident reports to increase.

	Incident investigations
Number of audits of OOBs	2
Number of audits of non-OOBs	5
Total	7

Table 4

Table 5 gives an analysis of the number of audits included in incident investigations per sector.

Financial	Construction/Real Estate	Automotive	**Other**	**Total**
2	3	-	2	7

Table 5

Details of incident investigations:

- One investigation related to an audit client with a going concern problem following the bankruptcy of a subsidiary. The external auditor failed to inform the public in a timely manner by renouncing his unqualified audit opinion on materially misstated financial statements when the company involved failed to issue a directors' statement about the financial statements being seriously deficient in presenting a true and fair view[2]. The external auditor also predated essential audit documents in his audit file. Although the audit was considered to be a high-risk engagement and the audit firm's policymaker responsible for professional technical expertise was aware that the external auditor had not renounced the unqualified audit opinion, the management of the audit firm was insufficiently active and sceptical in the way it supervised compliance with the quality control system and laws and regulations by the external auditor. It did not set the requisite example, and therefore failed to create the right 'tone-at-the-top'.
- Three investigations followed independence issues relating to audit forms' policymakers and co-policymakers. One of these investigations involved a case where the auditor's independence was unacceptably threatened by holding prohibited financial interests in the audit client or a related third party. In this particular case, a co-policymaker who was part of the audit firm's chain of command was involved. Although the audit firm discovered this incident by itself, it failed to take action to remedy the independence threat. In addition, the client's audit committee had not been adequately informed about the threat to independence within the meaning of section 24a, subsection 3 of the Wta. One or more investigations involved an audit firm failing to take adequate measures to remedy the appearance of dependence regarding an audit because it did not, or did not adequately, make clear the threat to its independence and any measures taken to an 'objective, reasonable and informed third party'.
- One investigation followed statements in the press about suspected fraudulent acts regarding real estate transactions by employees of professional real estate investors. The AFM investigated to what extent the audit of the property' asset and the associated income and expense in the audit client's financial statements had been conducted in accordance with the NV COS.[3] The external auditor did not exercise sufficient professional scepticism, in that he

[2] *A directors' statement within the meaning of section 362, subsection 6 of Book 2 of the Netherlands Civil Code.*
[3] Further regulations regarding audit and other standards *(Nadere voorschriften Controle- en overige standaarden* or *NVCOS).*

failed to adequately recognise the risk of fraud, and failed to perform sufficient specific audit procedures designed to address the fraud risk.

- One investigation followed clear indications of fraud at an audit client. The AFM investigated how the audit firm and the external auditor had dealt with the indications of fraud. The external auditor did not exercise sufficient professional scepticism, and he failed to obtain adequate audit evidence regarding the indications of fraud. The audit firm's policymakers failed to take adequate action to address the indications of fraud.
- One investigation followed the early termination of the audit engagement by the audit client in connection with the audit client's integrity. The client had withheld audit evidence. The audit firm´s internal quality review found that the external auditor had incorrectly issued an unqualified audit opinion, given that the financial statements were not free from material misstatement. The audit client then was not prepared to make a directors' statement pursuant to section 393 subsection 6 of Book 2 of the Netherlands Civil Code. The audit firm itself ultimately filed a statement with the Chamber of Commerce renouncing its issued unqualified audit opinion. The audit firm then took measures against the external auditor. Neither the infringement nor the measures taken were recorded in the register of infringements in a timely manner, not being recorded until one and a half years later. The register also contained insufficient information regarding the substance of these measures, which is a violation of the requirements in section 24, subsection 1 of the Decree on the Supervision of Audit Firms (*Besluit toezicht accountantsorganisaties*, or Bta).

As a result of the incident investigations carried out, the AFM has had discussions with the firms with a view to imposing standards and/or has sent warning letters where appropriate. In several cases the AFM intends to take formal enforcement action.

The AFM received seven reports of incidents from some Big 4 firms in the period from 1 July 2009 to 1 September 2010. The AFM has now acted upon, or is still dealing with, these incident reports. As at 1 September 2010, the AFM was engaged in four incident investigations relating to the real estate sector and the financial sector. The AFM notes that an incident report was made in only one of these cases.

2 Incentives for audit quality required

Compared with the AFM´s inspections in 2008, it would appear that the quality of the audit has since been given a higher priority by the Big 4 firms. Awareness at the Big 4 firms has clearly improved, as has their readiness to take action to enhance their quality control and monitoring systems in order to improve the quality of their audits. Partly as a result of the AFM's supervision therefore, progress has been made in these areas.

At the same time, the findings at case level show that audits at several Big 4 firms still had systemic deficiencies in the period under review as a result of which audit quality was inadequate. The extent to which these deficiencies occurred, however, varies per office and per audit. This means that there are differences in audit quality across the audit practices reviewed.

The AFM's review findings show that too many external auditors with regard to certain areas did not meet, or did not adequately meet, applicable standards relating to the conduct of audits. The AFM identified relevant weaknesses in 29 of the 46 audits (63 percent) reviewed in the context of its regular audit quality inspections. In addition, there were deficiencies in audit quality across all sectors of audit clients reviewed. The deficiencies were therefore not restricted to the financial sector; they also occurred in other sectors such as construction/real estate, the automotive sector and the public sector (municipalities and housing corporations). The findings that the AFM presented in its report on the general findings regarding the credit crisis review of 3 December 2009 thus occurred more widely and more systemically.

The AFM's review findings highlight various causes of deficiencies in audit quality at several Big 4 firms. The AFM found cases where audit firms had not reacted appropriately to signals and indications relating to audit quality or the quality of the EQAs carried out, or to the fact that an unqualified audit opinion should possibly not have been issued. The measures taken by the audit firms were inadequate in some cases and were implemented too late in many cases. This means in some cases that audit firms accepted audit quality falling short within their own organisation, and did not take appropriate action against infringements of the rules by their employees. In addition, the public was not always informed in a timely manner when this was indeed necessary. As a consequence, audit firms failed to adequately fulfil their duty of care regarding the quality of audits.

Other causes are insufficient professional scepticism exercised by the external auditor, insufficient involvement of and direction provided by the external auditor and experienced audit team members, and inadequate quality monitoring. The AFM presented these causes at its meeting with the audit firms licensed to audit public-interest organisations.

The AFM takes the view that a fundamental change in behaviour is needed in order to adequately address the deficiencies in audit quality. This will require an extensive internal analysis of causes by these firms, followed by appropriate measures to deal with the situation. The AFM observes that at several Big 4 firms, the 'tone-at-the-top' and its impact on the firm's culture regarding quality could be improved. The senior people at the audit firm, the firm´s policymakers and co-policymakers and the external auditors in charge of audit teams, set an important example in this respect. They will have to take the initiative in order to bring about the necessary change in culture at the audit firms. In this context, the AFM notes that the supervisory boards and audit committees of audit clients can also make a contribution to improving audit quality. For example, they can draw attention to the quality of the audit by asking their own auditor for the AFM's review findings or by initiating a discussion on issues raised. The AFM is not allowed to share its findings with audit clients due to its duty of confidentiality.

3 Summary of principal findings

3.1. Findings at the level of quality monitoring

The important pillars underpinning the monitoring of audit quality are the EQA, the internal quality review and the compliance function. Monitoring of audit quality fell short at a number of the Big 4 firms. As a consequence, there were insufficient safeguards ensuring that the audit opinions issued or to be issued were correct and adequately supported.

3.1.1. Engagement quality assessment (EQA)

The EQA is legally required and is one of the most important instruments to monitor the quality of statutory audits. The external auditor may only issue his audit opinion after the engagement quality assessor has determined that the audit procedures performed by the external auditor were adequate to support the audit opinion. The conduct of an EQA involves a test of the quality of the statutory audit conducted, and the audit is remedied where necessary before the audit opinion is issued, pursuant to the provisions in sections 18, 19 and 20 of the Bta.

The AFM's reviews showed that the EQA was insufficiently sceptical or detailed at several Big 4 firms. The AFM identified deficiencies in audits which the engagement quality assessor had not identified. Our reviews also found that the engagement quality assessor's considerations had been inadequately documented. Audit files often contained a checklist which was initialled by the assessor, thereby confirming that the EQA had been carried out. This approach resulted in inadequate documentation of the assessor´s considerations, making it impossible to verify or reconstruct the assessor´s judgment. As a consequence, the audit firm would be less likely to see any reason to perform additional procedures or to repeat some or all of the procedures conducted by the auditor in order to remedy existing uncertainties before issuing an audit opinion. Finally, the reviews showed that some of the Big 4 firms had not established adequate criteria to determine which non-OOB audits should be subject to an EQA.

3.1.2. Internal quality review

Internal quality reviews are audit quality reviews of selected completed audits carried out by audit firms. The internal quality review primarily focuses on whether the audit opinion in question was issued correctly and is supported by sufficient audit evidence. Each internal quality review results in a conclusion (grade) as to whether and to what extent the applicable laws and regulations have been complied with and the quality control system has been applied.

The inspections carried out by the AFM showed that the system of internal quality reviews at some Big 4 firms was open to improvement. The internal quality reviews had been carried out without sufficient professional scepticism or in insufficient detail. As a consequence, not all relevant findings with regard to the selected audits were identified and documented. The AFM also found that, due to inadequate documentation, quality reviews conducted in such cases could not be sufficiently verified or reconstructed. As a consequence, the considerations underpinning the grade of an audit were often not clear. In addition, the AFM has found that there was no analysis of causes in such cases, both at the level of the audit engagement and at the level of the audit firm. The AFM also found that in such cases appropriate measures had not been taken to a sufficient extent to remedy deficiencies in the conduct of audits and to ensure that the deficiencies in question would not occur in the future. Finally, it would appear that external auditors often obtained a 'pass' score based on the firms' grading systems even when the audit, or parts thereof, had not been conducted in accordance with laws and regulations. This means that audit firms create an impression that non-compliance with laws and regulations is permissible to a certain extent, reducing the incentive for external auditors to improve audit quality.

3.1.3. Compliance Officer

Compliance officers play an important role in controlling the risk of audit firms and their staff not complying with laws and regulations. Ultimately, the compliance officer contributes to audit quality and the management of the audit firm's reputational risk. In this capacity the compliance officer is an important contact for the audit firm's policymakers, and for the AFM as regulator. This is a provision of section 23, subsections 1 and 2 of the Bta.

The AFM's reviews show that at some Big 4 firms the role of the compliance officer focused too much on formalities, lacking in substance. The AFM's reviews show that at some Big 4 firms the compliance officer did not always review the information obtained from the EQA and the internal quality review.

3.2. Findings at the level of audits

3.2.1. General

The AFM reviewed 46 audits in the context of its regular inspections of audit quality and seven audits in the context of its incident investigations. Table 6 gives an analysis of the outcome of reviews per review type.

	Regular inspections	**incident investigations**	**Total**
Number of audits selected	46	7	
Number of audits of financial sector companies	11	2	13
Number of audits with findings	29	7	36
Number of audits with finding 'inadequate audit evidence'	25	3*	28
Number of audits with no findings	17	-	17

Table 6

*Three investigations focused on the independence of the audit firm, and one investigation focused on the registration of infringements and did not focus therefore on inadequate audit evidence.

In 29 of the 46 audits which the AFM reviewed in the context of its regular inspections, the AFM identified the following deficiencies at some Big 4 firms, but not necessarily in all 29 audits:

- The external auditors based their audit opinion on inadequate audit evidence. The following deficiencies identified by the AFM fall into this category:
  - External auditors did not exercise sufficient professional scepticism when obtaining and assessing audit evidence.
  - The procedures conducted by external auditors were insufficient with regard to the existence and valuation of financial assets, work in progress, vehicles and property in the balance sheet.
  - The procedures conducted by external auditors were insufficient with regard to the assessment as to whether there were indications of fraud or of other infringements of laws and regulations.
  - The procedures conducted by external auditors were insufficient when relying on procedures carried out by another auditor, internal audit department or expert.

- External auditors did not carry out tests of internal controls where they should have done so.
- The procedures carried out by external auditors were insufficient to assess whether the going concern assumption made by the entity's management was acceptable.
- The procedures carried out by external auditors were insufficient with regard to the completeness of revenue.
- External auditors did not evaluate identified audit differences in relation to the audit opinion issued or their evaluation was insufficient.

- The external auditor responsible for the engagement was insufficiently involved in conducting the audit to be able to fulfil his responsibility for the overall quality of the audit engagement he undertook.
- The external auditors did not include all the relevant audit evidence in their audit files.

<u>Findings in the financial sector</u>

The AFM identified relevant deficiencies in certain areas of eight of the eleven audits it reviewed (more than 70 percent) relating to financial sector companies. The financial sector companies operate in banking, insurance and the pension sector. In the case of five audits, the AFM concluded that the audit evidence obtained by the external auditor was inadequate. In the case of three of these five audits there was insufficient audit evidence regarding the audit of the valuation of financial assets at fair value and the associated disclosures in the financial statements. In the other two cases, there was insufficient audit evidence regarding the evaluation of the internal control structure and tests of internal controls and regarding the assessment of procedures performed by another auditor, the internal audit department or experts. In three of these five audits, the required active involvement and professional scepticism of the group auditor were also insufficient. One audit was deficient in the assessment of the independence of the external auditor when accepting the engagement. Finally, two other audits involved external auditors who were insufficiently involved in conducting the audit to fulfil the responsibility for the overall quality of the audit.

In our previous review the AFM identified relevant deficiencies in certain areas in eleven of the eighteen audits it had reviewed, partly associated with inadequate audit evidence concerning the valuation of financial assets at fair value and the associated disclosures. Both reviews lead the AFM to conclude that more than 60 percent of the audits of financial sector companies selected by the AFM had relevant deficiencies in certain areas.

<u>Findings in other sectors</u>

The deficiencies in the audits relating to companies or institutions in the construction/real estate, automotive and public sectors related mainly to inadequate audit evidence and insufficient involvement of the external auditor in conducting the audit to be able to fulfil his responsibility for the overall quality of the audit.

3.2.2. Professional scepticism and duty of care

The AFM considers it a serious matter that in too many cases the external auditors based their opinion on inadequate audit evidence and also exercised insufficient professional scepticism. Maintaining professional scepticism means that the auditor objectively assesses the value of the audit evidence obtained, being alert to audit evidence that is in conflict with, or raises questions regarding, the reliability of documentation, answers to questions and other information obtained from the directors of the entity and its governance bodies. It also means that the auditor does not base his audit solely on information obtained from the audit client, but that he also uses external sources as much as possible. In addition, it is important that when gathering audit evidence the auditor does not base his work solely on audit evidence supporting the audit client´s financial reporting. He should also establish whether there is audit evidence which conflicts with the audit client´s financial reporting. In that case, the auditor has to carry out additional audit work to obtain adequate audit evidence. The findings of the AFM show that in 25 of the 46 audits reviewed by the AFM as part of its regular inspections, the audit evidence obtained did not provide sufficient assurance to support the audit opinion issued (inadequate audit evidence). The risk that the assets and results as presented in the audit client's financial statements contained material misstatements was therefore insufficiently addressed. Although the external auditor states in the audit opinion that he is of the opinion that the audit evidence he has obtained is a sufficient and suitable basis for his assessment and that the audit was performed in accordance with Dutch law, it appears that in 25 of the 46 audits reviewed the audit evidence gathered was insufficient.

The AFM found that some of the four Big 4 firms failed to fulfil their duty of care under section 14 of the Wta by taking the necessary measures to ensure that statutory audits are conducted with the requisite professional scepticism, as required by paragraph 15 of COS 200.

The following paragraphs illustrate deficiencies encountered by the AFM in the audit files reviewed, dealing with:

- Audit evidence (3.2.3.)
- Involvement of the external auditor (3.2.4.)
- Audit documentation (3.2.5.)

3.2.3. Audit evidence

External auditors should obtain sufficient audit evidence to be able to draw reasonable conclusions to support the audit opinion, as stipulated in the professional standards (COS 500). The AFM has established that in too many cases opinions were not supported by sufficient audit evidence. External auditors exercised insufficient professional scepticism when obtaining and assessing audit evidence. This is shown by the following examples from the AFM's reviews:

<u>Audit of items in the balance sheet and income statement</u>

Audit of acceptability of the going-concern assumption
The audit client is a parent company of a group of companies in the automotive sector. On the date on which the external auditor signed his audit opinion, there was insufficient audit evidence available in the audit file to support his opinion on the financial statements. Information was lacking on refinancing, impairment tests, inventory (vehicles) and tax. This meant that the external auditor did not have sufficient audit evidence to assess whether the assumption made by the entity's board of directors that the business was a going concern was acceptable. Moreover, the EQA had not yet been completed at the time when the audit opinion was signed and refinancing conditions had not yet been finalised.

Audit of valuation and disclosure of financial assets
The audit client is a Dutch-based financial sector parent company of a group of companies. One of the Dutch-based business units manages the financial assets of several Dutch entities which are included in the audit client's consolidated financial statements. The financial assets were directly impacted by the credit crisis. The AFM's review showed that the external auditor had obtained inadequate audit evidence regarding the classification of investments as 'available for sale'. The external auditor also failed to obtain adequate audit evidence regarding the various indications that there might not be an active market

and the consequences thereof for determining the fair value of the investments and the correctness of the relevant disclosures in the financial statements. As a consequence, the external auditor did not obtain adequate audit evidence regarding the correctness of the valuation methods used (active market or valuation technique) to determine the fair value of the investments and the correctness of the accounting treatment chosen and of the disclosures in the financial statements.

Audit of revenue

The audit client is an intermediate holding company established in the Netherlands and active in the automotive sector. The external auditor's audit file regarding the audit of the accuracy and completeness of a material portion of the revenue contained only records of analytical reviews performed at the level of the financial statements. The audit file did not contain any other records providing audit evidence with regard to this part of total revenue. Analytical reviews do not constitute sufficient audit evidence to support an opinion on the accuracy and completeness of revenue.

Audit of work in progress

The audit client is a construction company. The external auditor did not assess whether the audit client met the conditions for application of the percentage of completion method in the allocation of profit from construction contracts. Furthermore, the external auditor failed to analyse and test the method used by the audit client for determining the percentage of completion of work in progress using an independent estimate, for instance based on an inspection. As a consequence, the external auditor did not obtain sufficient audit evidence to enable him to draw reasonable conclusions regarding work in progress to support his audit opinion.

Opinion on regularity

The audit client is a large municipality. For municipalities, the external auditor not only provides an opinion in his auditor's statement on the true and view presented by the financial statements, but also a separate opinion on their regularity. Because of this the external auditor must perform specific audit procedures, including obtaining an overview of the specific regulation and identifying associated risks, in order to enable specific audit work to be carried out. The AFM found that such specific audit work had not been carried out. Nevertheless the external auditor issued a positive opinion on the regularity of the financial statements.

Audit of valuation of building land

The audit client is a large municipality. The financial statements stated that the building land inventory was valued at acquisition cost or production cost. If the market value is lower than acquisition cost or production cost, the carrying amount must be written down to this lower market value. The market value of "building land not put into operation" partly depends on the purpose of the land in question. In the audit file, there was no documentation showing that the book value of the inventory had been tested against the market value. Neither was there any documentation in the audit file showing that the external auditor had obtained audit evidence concerning the purpose of the building land not put into operation.

Audit work when relying on work carried out by other auditors, the internal audit department or experts

External auditors should be actively involved and should exercise professional scepticism regarding audit work carried out by others. The external auditor should gain a good understanding of the issues and the associated risks. He should issue specific instructions and establish that the other party carrying out audit work has exercised sufficient professional scepticism and that the right conclusions have been drawn on based on the audit findings. The AFM found that in too many cases, the audit work carried out by external auditors was insufficient when reliance was placed on audit work carried out by others. This might involve other foreign auditors (in the context of group audits), the internal auditor's role and experts. This is illustrated by the following examples from the AFM´s reviews:

Audit work carried out by the group auditor in the audit of a tax holding company

The audit client is a tax holding company established in the Netherlands with a great number of international subsidiaries and a listing on a foreign stock exchange. The foreign auditor is part of the same network as the Dutch group auditor. The external auditor in the role of group auditor issued an unqualified audit opinion regarding the audit client's consolidated financial statements. The group auditor's involvement was however limited to signing the audit opinion regarding the consolidated financial statements. The audit file showed that the group auditor had not carried out the tasks necessary to obtain sufficient audit evidence, meaning that the procedures carried out by the other auditor were considered to be sufficient for the purposes of the group auditor. The group auditor did not himself establish that the audit had been properly conducted by assessing the foreign auditor's work; he trusted that the quality of work was sufficient. Furthermore, the group auditor had no contact with the client, had no influence on the risk analysis, planning and conduct of the audit and spent only a very limited number of hours on the engagement. Since the external auditor had no significant involvement in the audit of the financial statements of the tax holding company, he should not have acted as group auditor.

Use of the internal audit department

The audit client is a financial sector company established in the Netherlands with offices abroad. For some of his work, the external auditor relied on procedures conducted by the audit client's internal audit department (IAD). However, the external auditor failed to assess the quality of the IAD's procedures. The external auditor seems not to have evaluated the procedures carried out by the IAD or to have carried out independent audit procedures to establish himself that the procedures carried out by the IAD were sufficient for his own purposes. The external auditor therefore failed to obtain sufficient audit evidence to support his opinion.

Use of the procedures of an EDP auditor

The audit client is a financial enterprise established in the Netherlands. The external auditor used the services of an EDP auditor for the audit in order to conduct an assessment of the automated environment, including the design and existence of general IT controls, within the audit client. The EDP auditor did not perform specific procedures because he considered them to be outside the scope of his review. The EDP auditor advised the external auditor to carry out additional substantive audit procedures. The external auditor however failed to carry out these additional audit procedures. In addition, the EDP auditor drew conclusions regarding the operation of the audit client's IT environment on the basis of information received without carrying out audit procedures to establish whether this information was correct. The external auditor then failed to take appropriate measures or carry out additional procedures himself. As a consequence, he failed to obtain sufficient audit evident regarding the audit client's IT environment.

The active involvement and professional scepticism required of the group auditor is required pursuant to section 15a of the Decree on the Supervision of Audit Firms, the professional standards (COS 200, COS 315) and the specific professional standards relating to the use of other auditors (COS 600). The active involvement and professional scepticism required of an external auditor who relies on the procedures carried out by the internal audit department or experts is also set out in the professional standards COS 610 and COS 620.

<u>Study and evaluation of the internal control structure including tests of controls</u>

If the external auditor relies on the audit client's internal controls to ensure that revenue is fully accounted for, he has to carry out tests of internal controls in order to establish that the internal controls operate effectively and that he can rely on them. This requirement is set out in the professional standards (COS 330). The AFM has established that in too many cases the external auditor failed to actually test internal controls. This is illustrated by the following examples from the AFM's reviews:

Testing of internal controls regarding a mortgage portfolio
The audit client is a listed financial sector company. The external auditor carried out a walkthrough test as part of the study and evaluation of the internal control structure to establish the existence of the internal controls. The external auditor concluded that the design and existence of the internal controls for the mortgage portfolio had been assessed. The audit documentation did not show which internal controls the external auditor established the existence of, nor did the audit file support the conclusion that the design and existence of the internal controls regarding the mortgage portfolio had been assessed. Neither was it apparent how the external auditor tested the effective operation of the internal controls. As a consequence, the external auditor obtained inadequate audit evidence concerning the existence and effective operation of the internal controls regarding the mortgage portfolio.

Approval of accounts receivable write-offs
The audit client is a listed company. According to the audit approach, the external auditor relied on the internal control that accounts receivable write-offs are approved by qualified company officers. The audit file did not show that the external auditor carried out audit procedures to test the design, existence and effective operation of the write-off approval procedure. As a consequence, the external auditor failed to obtain adequate audit evidence to enable him to rely on the aforementioned internal control.

Infringements of laws and regulations

Dealing with indications of non-compliance with laws and regulations
The audit client is a construction company. During the audit the external auditor had indications of non-compliance of competition law, in this case concerning price-fixing agreements (as referred to in the Parliamentary inquiry into fraud in the construction sector). The external auditor did not identify these indications as such and failed to conduct a more detailed review as required in the professional standards (COS 250). At the instigation of the AFM, a more detailed review has now been conducted. This review shows that it is likely that the company actually failed to comply with competition law.

3.2.4. Involvement of the external auditor

The lead engagement partner must assume responsibility for the overall quality of each audit engagement he undertakes. To be able to fulfil this responsibility, he must be sufficiently involved at significant phases and points during the audit. Evidence of this involvement must be included in the audit file, as set out in the professional standards (COS 220). The AFM has established that in too many cases external auditors failed to take adequate responsibility for the conduct of audits. This is illustrated by the following example from an AFM review:

Involvement of the external auditor
The audit client is a relatively large municipality. There were significant deficiencies in the audit. The audit file did not show that the external auditor had reviewed the contents of the audit file or that he had established that adequate audit evidence had been obtained to make the final judgments supporting the

audit opinion issued. In addition, the file showed that various documents had been signed off by the senior audit manager instead of the external auditor after the date of the audit opinion.

3.2.5. Audit documentation

The audit file should enable the external auditor to provide clear and accessible information on how his audit was conducted and the supporting evidence for the audit opinion. This requirement is set out in the professional standards (COS 230) and section 11 of the Decree on the Supervision of Audit Firms. Documentation in the audit file is essential to show that an adequate audit has been conducted. The AFM has established that in too many cases, external auditors did not include all the required audit evidence in the audit file. Due to the absence of sufficient audit documentation, in some cases, the central theme of the audit can only be established with the help of a verbal explanation from the external auditor. This is shown by the following example from a review carried out by the AFM:

Missing records of important meetings
The audit client is a listed company with foreign business units. The Dutch group auditor provided insufficient documentation of discussions with the audit client and the foreign auditor on important issues, and also failed to provide this documentation on a timely basis. The audit file contained an agenda for the closing meeting with the management of the audit client. The audit file also contained an agenda for a meeting between the group auditor and the foreign auditor regarding important issues. In both cases, there were no records showing that the meetings actually had taken place, who had been present, what items had been discussed and what the main outcomes had been.

4 Responses from the Big 4 firms to the AFM's findings

The AFM has made its draft and final inspection reports available to the Big 4 firms under review. The responses from the Big 4 firms indicate that they are taking or have already taken steps to a greater or lesser extent as a result of the AFM's findings. These steps lead the AFM to infer that some of the Big 4 firms have recognised the need for improvement. However, the AFM has found that a number of the Big 4 firms have implemented measures to improve or remedy their internal quality monitoring only in response to the AFM's review findings.

Measures at the level of the audit firm (quality control and monitoring)

Some Big 4 firms have implemented or will implement the following measures:

<u>EQA</u>

- Fully centralising the process and monitoring of the EQA.
- Improving the consistency of the procedures, details and standards and adjusting the work programmes, which should result in a permanent improvement in the quality of the EQA.

<u>Internal review</u>

– Adjusting significant parts of the international procedures for internal quality reviews or tailoring the international procedures to the needs of the Dutch firm.
– Radically changing the system of internal quality reviews. Reviewers have to meet more stringent requirements, to exclude inexperienced auditors from conducting internal quality reviews. Reviewers will also no longer be responsible for reviewing their immediate colleagues' audits in their own audit practice. The reviewer's findings, the response of the external auditor and the reviewer's professional judgment, resulting in a grade, will be better documented. This means that the grade can be tested and reconstructed more easily. In addition, meetings will be organised where the reviewers run through the work programme for the internal quality reviews prior to their reviews and where they evaluate their reviews after completion, identifying any improvements. The approach is adjusted to achieve a better focus and more detail on specific issues regarding the financial statements.
– Carrying out additional reviews of the audits of some external auditors. For one of these external auditors, the entire audit portfolio has been subject to internal review. Following these reviews, at least one audit of all the other external auditors in the audit segment (public sector) concerned has been reviewed as well.
– Performing additional investigations of the outcomes of internal quality reviews of audits which have come into question, and taking remedial action at audit level, where necessary.

<u>Compliance Officer</u>

– Redesigning the compliance department with the appointment of a new compliance officer, staff increases, and further implementation of monitoring tools.
– The compliance officer taking a substance over form approach regarding compliance with rules.

<u>Registration of infringements and incidents</u>

– Introducing regulated and frequent internal meetings to discuss infringements and incidents with all departments concerned. These meetings will be followed up by a regular report to the audit firm's policymakers prepared by the compliance officer.
– Investigating fundamental errors in audits and, if classified as such, handling them as incidents.

- Further implementing an internal sanctions policy.
- Taking measures in response to infringements and incidents, such as training for those involved and conducting reviews to monitor that the necessary improvements actually take place.

Procedures and standards
- Amending certain areas of the audit approach.
- Adjusting significant internal procedures and standards within the quality control system to ensure that the audit firm and its staff comply with the laws and regulations.
- Publishing technical newsletters concerning topics such as the importance of professional scepticism, the reliability of audit evidence, the role of the group auditor, going concern considerations, auditing work in progress and independence.

Measures at the level of the audits

Measures for external auditors
- Taking measures against individual external auditors by having discussions with those external auditors failing to comply with professional standards with a view to improving their performance going forward. The issues discussed at these discussions include the necessary partner involvement, the need for adequate documentation, the necessary professional scepticism on the part of the external auditor and the requirement of the external auditor to prepare a remedial plan including improvements to be implemented and other arrangements.
- Replacing a division's officer responsible for professional technical expertise.
- In response to the feedback from individual case reviews by the AFM, remedial measures have been taken immediately in a number of audits and a full internal review has been conducted of these audits. These audits have been designated as infringements of the Wta and sanctions have been taken internally against the external auditors involved.

Redistribution of portfolios
- Redistributing audit portfolios within the public sector audit segment, because external auditors were individually responsible for too many audits.
- Analysing the size and composition of portfolios of external auditors who might be overburdened, and adjusting the portfolios where necessary.

Striking off external auditors from the AFM's register
- Striking off one or more external auditors from the AFM's public register.

5 Follow-up measures and enforcement

In addition to the measures which a number of Big 4 firms have taken or announced, the AFM’s inspection reports have urged one or more firms to implement additional measures. The AFM will monitor whether these measures are implemented in practice.

In addition, the findings of the AFM’s regular inspections and incident investigations have prompted the AFM to hold discussions with one or more of the Big 4 firms with a view to imposing standards. In such a discussion the AFM points out to an audit firm that it has failed to comply with a standard, giving an explanation of the AFM's interpretation of the standard and urging the firm to comply with the standard going forward.

In addition, in view of the abovementioned findings, the AFM plans to take formal enforcement action against one or more of the Big 4 firms reviewed. Formal enforcement measures may include an instruction, an order for incremental penalty payments or an administrative penalty. Imposing a formal enforcement measure follows a due process that requires the requisite time, particularly in view of the process to get the facts right (enquiry and response).

Finally, our findings have prompted us to submit one or more disciplinary complaints to the Disciplinary Court for Auditors against one or more external auditors employed or previously employed by one or more of the Big 4 firms reviewed.

6 Ongoing supervision inspections in 2010

Given the findings of the reviews of audit quality and quality control completed by the AFM in 2009 and the first half of 2010, the AFM expects to conduct further reviews at the Big 4 firms in the second half of 2010 and in 2011. These reviews will focus on financial incentives for audit quality within audit firms. The AFM will focus particularly on compliance with independence rules and policies regarding appraisals, appointments, remuneration and sanctions. The AFM expects to publish its review findings in 2011.

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Amsterdam, 2 September 2010