

Compliance with transitional provision for separation of audit and advisory services

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The Netherlands Authority for the Financial Markets

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1 Introduction

The Dutch Senate adopted the new Accountancy Profession Act (*Wet op het accountantsberoep*, or 'Wab') on 11 December 2012. This Act took effect on 1 January 2013. It also introduces two new provisions in the Audit Firms Supervision Act (*Wet toezicht accountantsorganisaties*, or 'Wta') that are intended to improve the safeguards of the independence of audit firms conducting statutory audits of public interest entities (PIEs). PIEs are listed companies, banks and insurers.

The first new provision in the Wta concerns the mandatory firm rotation, and states that an audit firm may not conduct a statutory audit of a PIE for more than eight consecutive years (Section 23 sub c Wta). This means that after eight years a PIE must appoint a different audit firm to carry out its statutory audit. The provision takes effect on 1 January 2016.¹ In practice therefore, a transitional period of three years applies.

The second new provision in the Wta introduces a prohibition of providing both audit services and other services to PIEs (known as 'separation of audit and advisory services') (Section 24b Wta). This prohibition took effect together with a transitional provision on 1 January 2013.

This report concerns the investigation by the AFM of how the Big 4 audit firms (Deloitte Accountants B.V., Ernst & Young Accountants LLP, KPMG Accountants N.V., PricewaterhouseCoopers Accountants B.V., including their network members in the Netherlands) have dealt with the prohibition on the provision of other services in addition to audit services to PIEs and in particular the related transitional provision.

2 The importance of an independent auditor

In its report 'Incentives for Audit Quality' of 6 October 2011, the AFM drew attention to the importance of independence for an audit firm and for external auditors. An audit opinion rendered by an external auditor increases the reliability of financial reporting and contributes to confidence in this reporting. An audit opinion is only of value to the users if the audit is conducted by an auditor who is independent. The users, including investors, must be able to have confidence that the auditor has been objective and critical, that he has carried out his work adequately and that he has not allowed his activities and opinion to be influenced by other than purely professional considerations. The auditor must be independent not only in fact (independence in practice), he must also avoid any suggestion that he might not be independent (independence in appearance).

In the above-mentioned report, the AFM also addressed the threat to independence that arises from the 'coincidence of services': the situation in which an audit firm provides other services to an audit client as well as the statutory audit of the financial statements. The provision of non-audit services increases the contradictory interests inherent in the auditor's work. On the one hand, the external auditor has to take an objective and critical attitude towards his audit client in order to be able to fulfil his public duty towards the users of the client's financial statements. On

¹ Decree of 13 December 2012, regarding establishment of the date the Accountancy Profession Act takes effect, *Bulletin of Acts and Decrees* 2012 681

the other hand, the auditor wants to serve his client as well as possible and provide satisfaction in order to obtain or retain the audit engagement.

The contradiction arises because the audit firms are commercial organisations. They are paid by the organisations they audit (their audit clients) and compete with each other in order to obtain and retain audit engagements. The provision of non-audit services increases this inherent contradiction.

In its report of 6 October 2011, the AFM stated its support for clear, unambiguous and more restrictive regulation with regard to independence, including the separation of auditing and advisory services. This is now implemented with the introduction of the prohibition on the provision of both audit services and other services to PIEs.

3 Statutory regulation for the separation of audit services and other services

As a result of an amendment to the Wab submitted to the House of Representatives on the separation of audit services and other services, Section 24b has been added to the Wta. This Article states:

An audit firm conducting statutory audits of a public interest entity shall not provide other services to this entity in addition to audit services.

This prohibition means that an audit firm (including its network members in the Netherlands²) may not simultaneously provide audit services and other services to a client which is a PIE.

A transitional provision with reference to the prohibition is included in Section 86a, and reads as follows:

Section 24b shall not apply to activities for which the auditor or the audit firm was engaged prior to the taking effect of the Accountancy Profession Act until two years after the date on which the Accountancy Profession Act takes effect.

The transitional provision is explained in the note to the amendment. This states: *'With regard to activities for which the engagement has already been made, prior to the effective date and for which the audit firm has a contractual obligation, existing engagements may be performed until two years after the date on which the Accountancy Profession Act takes effect.'*³

This text clearly expresses the intention of the transitional provision: audit firms are not required to cancel contracts for services other than audit services that had already been concluded prior to the taking effect of Section 24b Wta as a result of the changed legislation, as long as they are carried out within two years.

² See the NBA Alert 27 of December 2012 for explanation.

³ House of Representatives, 2011-2012 33 025, no. 18.

4 Rationale for investigation by the AFM

In December 2012, the AFM received a signal from a PIE. From this signal, it emerged that the audit firm conducting the statutory audit of the financial statements of this PIE had, in the light of the new statutory regulation, strongly urged the PIE to conclude a contract for the provision of non-audit services before 1 January 2013. The conclusion of a contract before 1 January 2013 would mean that these services could continue to be provided for a further two years under the transitional provision.

The AFM's view is that such behaviour contradicts the intention of the transitional provision. The transitional provision is intended to allow the prohibition of the provision of other services in addition to audit services to take effect on 1 January 2013, and to allow work being performed under existing contracts to be completed.

It is not intended to actually permit the provision of non-audit services to PIE audit clients until 1 January 2015. If this had been the case, the legislator could have established a later effective date, as it did with respect to mandatory firm rotation. This interpretation of the meaning of the transitional provision has also been confirmed by the statement of the Minister of Finance in the House of Representatives on the matter. In his answer to questions, he stated: *"A transitional provision of two years does indeed apply, however the amendment is effective immediately, and therefore from then on other activities are no longer permitted, other than the completion of existing advisory engagements. This is what the two-year period is for."*⁴

The abovementioned signal was reason for the AFM to initiate an investigation into how the Big 4 audit firms are dealing with the prohibition of the provision of other services in addition to audit services to PIEs and the associated transitional provision. The investigation was limited to the Big 4 firms since they conduct the vast majority of PIE audits. They account for 98 percent of the total revenue from statutory audits to PIEs and conduct 91 percent of statutory PIE audits.⁵ In addition to audit services, the Big 4 firms can offer numerous other services to their audit clients. These include tax consultancy, services relating to the design and implementation of financial information systems and corporate finance services such as due diligence services, advice on mergers and acquisitions and business succession.

5 The investigation

The AFM's investigation focused on the question whether the Big 4 audit firms had concluded new contracts for the performance of non-audit services for PIE clients prior to 1 January 2013 other than in the context of other activities already in progress, and had thereby acted in contradiction to the intention of the Act.

The AFM accordingly requested the firms to provide a list of the contracts for non-audit services concluded with PIE clients in the period of 1 November to 31 December 2012. The AFM then reviewed how the lists had been compiled and how the firms had ensured that their list was

⁴ Actions 2012-2013, no. 9, item 4, p.37, meeting date: 27-11-2012, Senate

⁵ Data from the Monitor 2012 of the AFM.

accurate and complete. In addition, the AFM made a selection from the lists of contracts on the basis of the description of the activities, the date on which the contract was concluded and the question of whether an existing or a new contract was involved. The AFM requested copies of the actual contracts selected.

From the selected contracts, the AFM assessed the nature of the service agreed, whether the activities had been specified and the start and end dates of the contracts in question. In particular, the AFM assessed whether the nature of the activities gave a specific reason for the activities to fall under the transitional provision for the established contract term.

Moreover, the AFM assessed how the firms had ensured that they were in compliance with the new legislation. It conducted interviews with various persons, including the compliance officer, the independence officer and the policy-makers at the Big 4 firms. It also assessed the documentation on acceptance of the engagement and the monitoring of independence, as well as the internal communication within the firms regarding the new legislation.

6 Findings of the investigation

The Big 4 audit firms concluded a total of 277 contracts for non-audit services to PIEs for which they also conduct statutory audits between 1 November and 31 December 2012. The number of contracts varies per firm.⁶ The AFM selected 82 of these 277 contracts (approximately 20 per firm) for further assessment.

The AFM's investigation found that all Big 4 audit firms had concluded contracts for non-audit services that in the opinion of the AFM should not be covered by the transitional provision. This concerns a total of 52 of the 82 contracts that were further assessed, which:

1. were concluded at the end of 2012;
2. mostly expire at the end of the period of the transitional provision, in other words on 31 December 2014; and
3. do not or not exclusively concern existing activities to be completed in view of the mostly general description of the activities.

The AFM therefore qualifies these 52 contracts as 'open contracts' that should not fall under the transitional provision. The AFM was not able to form a similar opinion with regard to other more specific contracts, since the contract administration and the contracts themselves did not provide clear information regarding the actual start date of a non-audit service or the intention behind the conclusion of the contract. The AFM is thus making no judgement with regard to the total number of contracts (277) concluded by the Big 4 firms.

Of the 52 open contracts, 25 percent concern contracts for various activities, such as corporate finance-related work including due diligence and human capital. The other 75 percent concern contracts in relation to tax. These are open contracts for tax returns, tax advice and consultancy.

⁶ The number of contracts per big 4 firm varies between 11 and 38 percent of the total number of contracts.

The audit firms stated that their PIE clients required time to transfer their tax affairs to a different tax consultancy organisation outside the audit firm's network. They also stated that some tax-related activities were logically provided by the firm's tax consultancy division, for instance the preparation of the tax return for 2012.

The AFM understands this point. However it would have expected the newly concluded contracts to be focused on running down the service and transferring it to a different tax consultancy organisation. And, that the new contracts would clearly state the activities that would necessarily fall under the transitional provision and the date on which these activities would be completed. Simply extending the broad-based consultancy relationship until the end of the transitional period is not in line with the intention of the transitional provision.

The audit firms moreover referred to the short time period between adoption of the Act by the Senate on 11 December 2012 and the effective date of Section 24b of 1 January 2013. The AFM, however, takes the view that the firms could have anticipated this new legislation at an earlier stage. The amendment to introduce the prohibition of non-audit services was actually adopted by the House of Representatives in February 2012. Reference was also made to the AFM with regard to the concurrent regulation on mandatory firm rotation for the conduct of statutory audits. As soon as a PIE appoints a different audit firm to conduct its statutory audit the coincidence of services that threatens the auditor's independence no longer applies. In this case termination of the consultancy relationship is not necessary. The AFM acknowledges this argument, as long as it is clear that the PIE will change its audit firm before 31 December 2014.

7 Conclusions

Based on its activities, the AFM concludes that in the case of 52 of the contracts it has investigated there is no specific reason as a result of the nature of the activities described in these contracts for the activities to fall under the transitional provision for the established contract term. The AFM has the impression that all of the Big 4 firms have initially interpreted the transitional provision to mean that any contract for non-audit services for PIE audit clients concluded prior to 1 January 2013 falls under the transitional provision. The AFM further has the impression that the 52 contracts it has investigated were concluded immediately prior to 1 January 2013 in order to prolong the consultancy relationship with the audit client for as long as possible.

The AFM's conclusion therefore is that the firms have not acted in the spirit of the Act. This is a disappointment to the AFM, since it expects audit firms to take their social responsibility seriously. The AFM concludes that the firms have not adequately ensured compliance with the new legislation, at least as far as the transitional provision contained therein is concerned.

Furthermore, the AFM takes the view that the audit clients that entered into these contracts have not adequately considered the meaning of the independence of their auditor. It is an important duty of supervisory boards and audit committees in particular to oversee the

independence of the external auditor.⁷ The AFM has the strong impression that these contracts are assessed and approved in advance by the supervisory board or audit committee of the audit client in only a very limited number of cases.

8 Follow-up

The AFM has put the findings of its investigation to each Big 4 firm and invited it to give its views on the matter. The investigation's findings have been discussed with the Netherlands Institute of Chartered Accountants (the NBA). The AFM has issued an urgent appeal to the firms to review all the contracts they concluded immediately prior to 1 January 2013 and to terminate those contracts that do not reflect the intention of the legislation or restrict them to performance of the activities that are reasonably still necessary. The AFM considers this to be an appropriate solution to ensure compliance with Sections 24b and 86a Wta.

In their response to the findings of the report, the audit firms have indicated either that they have already taken the necessary measures or that they will do so.

Response from the audit firms

The four audit firms do not recognise the description of the situation as presented by the AFM in this report. They take the view that they and their network members have applied the transitional provision in good faith and in accordance with the Act. They say that they have acted in the interests of both their clients and the public, and moreover that they have paid attention to the importance of independence for their audit activities. Three of the audit firms stated that they considered that interpretation of the Act was not unambiguous and that a dialogue between the parties involved was needed in order to obtain clarity.

Measures

The AFM has issued an urgent appeal to the audit firms as follows:

1. to assess or reassess all the contracts concluded immediately prior to 1 January 2013; and
2. to either terminate contracts that are not in accordance with the intention of the legislation, or to restrict them to performance of the activities that are still reasonably necessary.

All the audit firms state that they have assessed all the contracts in question. Three audit firms have reassessed the contracts that the AFM qualified as 'open'. This has led to the conclusion that the contracts will be terminated or amended, or that no further action is necessary. One audit firm states that it has followed a diligent process and therefore sees no reason to reassess these contracts at this stage, however states that it is devoting its efforts towards a careful transfer to a new service provider as soon as possible.

All the Big 4 firms have stated that they will actively monitor all other activities performed in addition to audit services for PIEs.

⁷ Section 21a Wta sets regulations with respect to the obligation for PIEs to appoint an audit committee or another body with similar duties. The responsibilities of the audit committee or comparable body include "the assessment and monitoring of the independence of the external auditor or audit firm, with particular attention to the provision of ancillary services to the audited entity".

The AFM is pleased to note that the Big 4 firms have indicated that they have either withdrawn or will not implement contracts that clearly contradict the intention of the transitional provision.

The AFM will monitor the actions of the Big 4 firms and also monitor compliance by these firms with the prohibition.

The AFM considers it important that the findings of this investigation to safeguard independence will be followed up in the very near future, since it wishes to avoid a situation in which its future reviews of the quality of PIE audits by the Big 4 firms in the period 2013-2014 would be forced to conclude that in specific audits the auditors at the audit firms had not been independent. The AFM furthermore expects supervisory boards and audit committees to play an active part in engaging in discussions with their auditor in order to ensure that the audit conducted is independent.

Dialogue

The AFM will enter into a constructive dialogue with the audit firms with regard to the findings for which there is as yet no consensus. One of the findings of the AFM's investigation is that the Big 4 firms had made different decisions regarding the activities that could fall under the transitional provision.

In addition, the AFM will enter into a broad dialogue regarding the clear interpretation of the prohibition and the transitional provision. The AFM will thus strive to achieve a consistent interpretation and compliance with the new legislation, which is designed most of all to protect the public interest.

There is also a debate among auditors as to the activities that should be qualified as audit services, for instance whether specific activities that have been agreed have to be considered as part of audit services. There is also discussion of the question of whether the prohibition of the provision of non-audit services to a PIE audit client should not be restricted to the Dutch audit firm and its network members in the Netherlands but should also apply to the foreign parts of the audit firm's network.

The AFM is consulting with the NBA on both these issues. The AFM considers it important that the NBA and the individual audit firms decide on an interpretation that reflects the spirit of the legislation.

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