Thematic review of non-PIE audit firms

Part 2: SRA firms

26 November 2013

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The Netherlands Authority for the Financial Markets (AFM)

The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. We promote the fair and conscientious provision of financial services to consumers and private investors, as well as professional and semi-professional parties. We supervise the fair and efficient operation of the capital markets. Our aim is to improve consumers' and companies' confidence in the financial markets, both in the Netherlands and abroad. In performing this task, the AFM contributes to the stability of the financial system, the economy and the reputation and prosperity of the Netherlands.

Contact

Further information on the supervision of audit firms is available on the AFM website (www.afm.nl) under Professionals > Audit firms. Specific questions regarding this report may be put by e-mail to wta@afm.nl or by surface mail to the Netherlands Authority for the Financial Markets, attn. the Audit Firms Supervision Division, P.O. Box 11723, 1001 GS Amsterdam, or by telephone to (020) 797 2000.

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1 Introduction

In 2013, the Netherlands Authority for the Financial Markets (the AFM) carries out a thematic review of audit firms licensed to carry out statutory audits of companies and institutions not designated as public interest entities (PIE). The purpose of the thematic review is to gain a reliable impression of the quality of the statutory audits conducted by non-PIE audit firms.

The AFM supervises audit firms that perform statutory audits. A statutory audit is an audit of the financial reporting of an enterprise for public use that is specifically designated as a statutory audit in the Audit Firms Supervision Act (*Wet toezicht accountantsorganisaties*, or 'Wta'). This concerns the audit of financial statements of medium-sized and large companies, municipalities, provinces and various financial enterprises, for instance. A distinction is made between the statutory audit of organisations known as PIEs and other enterprises and institutions (non-PIEs). PIEs are listed companies, banks and insurers.[1] In order to conduct statutory audits, an audit firm must have obtained a licence from the AFM: a PIE licence if the audit firm also carries out statutory audits of PIEs and a non-PIE licence if the audit firm only conducts other statutory audits.

In addition to the conduct of statutory audits, audit firms provide many other services to their customers. For example, they conduct voluntary audits, they accept review and compilation engagements, they provide administrative and tax-related services and business consultancy services. The AFM does not supervise these other services.

A further distinction within the group of non-PIE firms is made between NBA firms and SRA firms. The Netherlands Institute of Chartered Accountants (*Nederlandse Beroepsorganisatie van Accountants*, or 'NBA') has a system for assessing the quality of audit firms. The Association of Chartered Accountants (*Samenwerkende Registeraccountants en Accountants-Administratieconsulenten*, or 'SRA') is accredited by the NBA to carry out quality assessments, on the NBA's behalf, of audit firms affiliated to the SRA (SRA firms). In the case of the remaining firms, these assessments are conducted by the NBA itself. In this report, these firms are referred to as 'NBA firms'. The AFM has established cooperative agreements with the NBA and the SRA in covenants,[2] which contain agreements regarding cooperation in the

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[1] *Section 1 subsection 1 item l of the Wta defines public interest entities as follows: "1°. a legal person established in the Netherlands under Dutch law whose securities are admitted to trading on a regulated market as referred to in Section 1:1 of the Financial Supervision Act [Wet op het financieel toezicht]; 2°. a credit institution having its registered office in the Netherlands as referred to in Section 1:1 of the Financial Supervision Act which has been granted a licence under that Act; 3°. a central credit institution having its registered office in the Netherlands as referred to in Section 1:1 of the Financial Supervision Act which has been granted a licence under that Act; 4°. as reinsurer, life insurer or non-life insurer having its registered office in the Netherlands as referred to in Section 1:1 of the Financial Supervision Act which has been granted a licence under that Act; 5°. an enterprise, institution or public body forming part of one of the categories designated pursuant to Section 2".*

[2] *See the newsletters "Covenant between the NBA and the AFM regarding the assessment of audit firms" of 6 September 2012 and "AFM concludes new supervisory covenant with the SRA" of 13 December 2011 on the website of the AFM. The SRA has*

field of quality assessment and the use that the AFM wishes to make of the findings of the quality assessments by the NBA and the SRA.

The thematic review is consistent with the covenants with the NBA and the SRA. The AFM is assessing the quality of selected statutory audits by means of file reviews at a total of 50 non-PIE audit firms: 30 NBA firms in the first half of 2013 and 20 SRA firms in the second half of 2013.

This report presents the AFM's findings from its assessment of the quality of the statutory audits conducted by 20 SRA firms with a non-PIE licence. On 11 July 2013, the AFM published a report of its review of 30 NBA firms. This report on the review of the SRA firms has the same structure as the report on the NBA firms, and its content is largely the same.

The 265 SRA firms with a non-PIE licence perform a total of 27% of all the statutory audits in the Netherlands of companies that are not public interest enterprises. 12% of the total revenue from statutory audits goes to SRA firms. In addition to performing statutory audits, the SRA firms on average earn around 90% of their revenue from the provision of other services.[3]

The Audit Firms Supervision Act [*Wet toezicht accountantsorganisaties*, or 'Wta') prohibits the AFM from publishing confidential information that comes into its possession as part of its supervisory duties. The Wta however does permit the AFM to use this confidential information to make generic statements as long as these cannot be traced to individual persons or audit firms. For this reason, the key findings of this review are presented in anonymous form where necessary and not individually for each SRA firm.

Section 2 of this report contains a summary of the main findings and the general conclusion of the AFM. Section 3 describes the background and the process followed for the thematic review and in particular of the review conducted by the AFM at 20 SRA firms. Section 4 presents a brief analysis of the market, with information on the size of the SRA firms and the nature of the audit practice at these firms. Section 5 states the AFM's findings with respect to the quality of the statutory audits and the quality of the financial reporting. This section also includes more detailed information regarding the shortcomings identified by the AFM in its assessment of the statutory audits and the financial reporting. Finally, Section 6 describes the subsequent steps following the report of the findings.

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carried out assessments of statutory audits on the basis of the original covenant of 28 September 2006. The NBA has been carrying out assessments of statutory audits since 2013.

3 For further information on the size of the SRA firms and other features of their audit practice, see Section 4 of this report.

2 Drastic measures also needed at the SRA firms to bring audit quality up to standard

The AFM notes that most SRA firms have made efforts to improve the quality of their statutory audits in recent years. At the same time, the AFM has to conclude that these efforts have so far not been adequate, since the quality of the statutory audits performed is not yet at a satisfactory level. Based on the file reviews at 20 SRA firms, the AFM has formed an impression of the quality of the statutory audits conducted by SRA firms with a non-PIE licence. The conduct of the statutory audits at the audit customers of these 20 SRA firms was of insufficient quality in 81% of the cases. The AFM expects this quality problem to apply to the entire group of SRA firms with a non-PIE licence.

Quality of statutory audits and financial reporting is not satisfactory

The AFM identified serious shortcomings in 38 of the 47 statutory audits by 20 SRA firms with a non-PIE licence it has assessed. The quality of these statutory audits is qualified as 'inadequate'. The external auditors who were responsible for the adequate conduct of these statutory audits failed to obtain sufficient and appropriate audit evidence with respect to items of material significance for the financial statements and in relation to the financial statements as a whole in order to be able to substantiate their audit opinion. The AFM furthermore concludes that the financial reporting was not of sufficient quality in 49 of the 61 financial statements it assessed (80%).

In table 1, the AFM classifies the 47 statutory audits it assessed into four quality categories. Category 1 concerns the statutory audits assessed as 'adequate'. These are statutory audits for which the AFM did not find any serious shortcomings in the elements it assessed. Categories 2, 3 and 4 concern the statutory audits for which the AFM identified serious shortcomings and which are therefore classified as 'inadequate'. A distinction is made on the basis of the nature of the shortcomings that led to an assessment of 'inadequate', with the statutory audits in category 2 being of relatively better quality and those in category 4 being of the lowest quality.

Category	**Number of statutory audits**	**Assessment**	**Remarks**
1	9 (19%)	Adequate	No serious shortcomings.
2	17 (36%)	Inadequate	Inadequate audit procedures with regard to specific aspects.
3	17 (36%)	Inadequate	Some audit procedures conducted, however very basic audit techniques either not or incorrectly applied.
4	4 (9%)	Inadequate	No or very few audit procedures conducted, mainly administrative and compilation work only.

Table 1. Quality of 47 statutory audits assessed in four categories.

The AFM notes that with regard to the nature of the shortcomings, the quality of the statutory audits conducted by the 20 SRA firms assessed (non-PIE licence holders) is slightly higher than that of the statutory audits conducted by the 30 NBA firms previously assessed. The difference between the percentages of the statutory audits assessed as 'adequate' at the SRA and NBA firms (19% and 21% respectively) is not so pronounced, it is more notable in the nature of the shortcomings. The percentage of SRA firms at which the AFM concluded that little or no audit work had been conducted was lower (9% compared to 25% in category 4). However, with respect to the statutory audits conducted by SRA firms, in 45% of the cases basic audit techniques were not used or applied incorrectly, and in a number of cases few or no audit procedures were conducted at all. For the NBA firms, this percentage was 58%. As is the case with the NBA firms, the quality of the statutory audits conducted by the 20 SRA firms assessed is lower than the quality of the statutory audits performed by PIE licensees. The percentage of statutory audits found to be 'inadequate' in previous AFM reviews was 63% at the Big 4 audit firms in 2010 and 74% at the other nine PIE audit firms at the beginning of 2013.[4] The shortcomings at the PIE audit firms mostly related to specific elements of the statutory audit (category 2 in table 1).

Importance given to the audit is a contributing factor to quality

The AFM assessed 19% of the statutory audits it reviewed as 'adequate'. The AFM also identified the features distinguishing these 'adequate' audits from the 'inadequate' audits. We considered the features of the external auditor responsible, the audit firm, the statutory audit and the audit client concerned.

In cases where the statutory audit was considered to be important by both the audit client and the audit firm, the AFM was more likely to assess the quality of the audit as 'adequate'. The AFM indeed noted that in cases where the external auditor's experience was that the audit client considered the statutory audit to be important and did not exert pressure with respect to the audit fee, these audits were more likely to be of adequate quality. Furthermore, the AFM was more likely to assess audits as 'adequate' if the conduct of statutory audits represented a significant proportion of the business of the audit firm in question. This is shown by the fact that these audit firms conduct more than 15 statutory audits and less frequently perform compilation engagements for their audit clients. Lastly, the AFM was more likely to assess a statutory audit as 'adequate' if the external auditor had registered in the auditors' register relatively recently.

Efforts by SRA firms to raise quality are still inadequate

Most SRA firms have made efforts to improve the quality of their statutory audits in recent years, mainly through becoming familiar with the professional and other information provided by the SRA and the use of specific tools for the audit.

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4 *See the newsletters "AFM reviews point to need for fundamental improvements to audits" of 1 September 2010 and "Fundamental improvements initiated at nine medium-sized audit firms after AFM review" of 21 March 2013 respectively.*

A number of new practical guides were made available by the SRA to SRA firms in the first half of 2013. In the first quarter of 2013, the SRA published guides for the auditing of property, IT and the going-concern assumption. These guides are available on the member section of the SRA website and can be accessed by all affiliated SRA firms. Furthermore, the SRA has informed the SRA firms regarding the AFM's thematic review, in addition to the information provided by the AFM. In April, the SRA published a guide titled "A visit to the AFM in relation to the Thematic Reviews" and in June, it organised an information meeting for the 20 SRA firms that had been selected.

During the AFM's review, it became apparent that in approximately 70% of the statutory audits assessed, an audit approach had been taken that involved the use of sector-specific check-lists and working schedules available in digital form. These tools force an external auditor to go through the most important phases of an audit. The AFM noted that the design of many statutory audits could be classified as reasonable to good *in principle*. However, the performance of the audit activities *in practice* was characterised as 'inadequate' by the AFM in many cases.

The AFM notes that the efforts referred to above have not been sufficiently effective. The quality of the statutory audits performed is not up to standard. In the performance of a statutory audit, quality depends mainly on the professional expertise and competences and the professionally sceptical attitude of the external auditor. This means that the overall quality of a statutory audit that is designed well or reasonably well in principle ultimately depends on the audit activities that are carried out and the way in which the external auditor inspects unusual items or inconsistencies he encounters in the course of these activities. In the statutory audits assessed, the AFM established that there were shortcomings both in the audit activities performed and the follow-up. Although in several audits the external auditors performed many audit activities in relative terms, these activities did not provide enough appropriate audit evidence. The AFM moreover is of the opinion that the considerations and conclusions show that the external auditor did not adopt an attitude of sufficient professional scepticism.[5] External auditors were for instance not adequately alert to audit evidence that conflicted with other audit evidence obtained, and were not sufficiently alert to circumstances that required audit work in addition to the 'standard' work that had been planned.

The AFM expects SRA firms to take action

The AFM has sent a written report to the 20 SRA firms informing them of the actions the AFM expects them to take. The AFM has requested the 18 SRA firms (90%) for which at least one statutory audit has been qualified as 'inadequate' to rectify the shortcomings identified in these statutory audits. This means that the external auditor must still obtain sufficient and appropriate audit evidence, and must evaluate their original opinion regarding the financial statements as a whole and possibly revise this.

[5] *An explanation of what is meant by an attitude of professional scepticism is given in sections A18-A22 of COS 200.*

Secondly, the AFM has requested these firms to carry out a root cause analysis. In a root cause analysis, the audit firm itself inspects whether the shortcomings identified by the AFM have occurred more frequently and what the causes of the shortcomings were. During the review, the AFM expressly asked each of these 18 firms to consider carefully whether the firm would be able to bring its audit practice up to the required quality standard. If the firm in question sees possibilities for improving the quality of its statutory audits, it will prepare an action plan based on its root cause analysis. In its action plan, the audit firm will state the measures that firstly will rectify the shortcomings in the statutory audits identified by the AFM, and secondly prevent shortcomings occurring (or reoccurring) in the statutory audits the firm conducts in future.

In the case of only two SRA firms (10%), the AFM does not expect any direct action since it did not identify any serious shortcomings in the statutory audits performed by these firms. Naturally, these firms will also be expected to continue to strive to maintain their quality at the desired level.

Increase in quality is needed

The AFM appeals to all SRA firms to review the quality of their statutory audits and to take appropriate action. In view of the significance of the SRA firms to the audit market, the AFM considers a sector-wide increase in quality to be necessary. Most SRA firms consider the performance of statutory audits as an important activity. The 281 external auditors who work at 265 SRA firms with a non-PIE licence perform in total around 27% of the statutory audits in the Netherlands, and account for 12% of the total revenue from statutory audits. 65% of the SRA firms perform more than five statutory audits per year.

The AFM expects that most SRA firms will be able to bring the quality of their statutory audits up to the required level. They will most likely take the right measures to rectify the shortcomings and prevent further shortcomings occurring in future. We expect these measures to focus mainly on improving the audit skills and the professional scepticism of the external auditors. The external auditors can subsequently be kept ‘sharp’ by conducting independent and critical engagement quality control reviews of statutory audits. Moreover, external auditors need to bring and keep their professional expertise up to standard by means of permanent education.

The AFM is aware, however, that for a limited number of SRA firms additional quality-improving measures to bring the quality of the statutory audits up to standard will not be possible. These firms should consider ceasing to perform statutory audits in order to avoid repetition of quality problems.

Assessment and follow-up of action plans

The AFM will assess the action plans it receives in the first quarter of 2014. If in the AFM's view the firm is taking measures that are expected to raise its statutory audit practice to the necessary level of quality, a further file review will be conducted in 2014. The intention here is to assess whether the measures have indeed had the desired effect on quality. These file reviews will be conducted by the AFM at the SRA firms on the basis of the covenant in collaboration with the SRA[6], and among other things will establish whether implementation of the action plan has led to the necessary improvement in the quality of the statutory audits. Should the performance of statutory audits still not be up to standard, the AFM can consider the imposition of formal enforcement measures.

If on the basis of its review and the action plans received the AFM takes the view that a firm is not in a position to perform decent quality statutory audits, it will in the first instance enter into a dialogue with the firm in question, including raising the question of whether retention of the firm's licence is still appropriate. This dialogue may lead to further investigation by the AFM and the imposition of formal enforcement measures if necessary. These include the issuance of an instruction, the imposition of an order for incremental penalty payments or an administrative fine, the submission of a complaint to the Disciplinary Court for Auditors, or, in the most extreme cases, withdrawal of the licence. The enforcement measure imposed will be determined for each firm on the basis of our enforcement policy.

Sector-wide improvements needed

In the meantime, the AFM holds a constructive dialogue with the sector, including the non-PIE audit firms and their advisers, the professional organisations and their assessors. The intention is that this dialogue will contribute to the formulation of sector-wide measures that will achieve an improvement in quality. The AFM has the strong impression that the sector is now aware that the statutory audits being performed are not of sufficient quality and that sector-wide improvements are needed.

The SRA offers the opportunity to its affiliated firms to take the course "Learning lessons from the AFM's thematic reviews (non-PIE firms)".[7] This course explains the AFM's findings and conclusions and deals with the subsequent measures to improve quality. The NBA has announced a mandatory PE subject relating to audit quality for all public auditors.[8] A review is also underway to determine how the training of auditors can be better formulated.

As part of the covenant with the SRA, other assessments will also be made in 2014 at SRA firms that have not been included in the AFM's thematic review. Among other things, it will be established whether the shortcomings described in this report also apply to these other firms.

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6 *See footnote 2.*

7 *See https://www.sra.nl/educatie/eocu-lessen-trekken-uit-afm-themaonderzoeken-(niet-oob-kantoren).*

8 *See http://www.nba.nl/Voor-leden/Permanente-educatie/Verplicht-PE-onderwerp-20142015/*

3 Thematic review

3.1 Background

The Audit Firms Supervision Act [*Wet toezicht accountantsorganisaties*, or 'Wta'] took effect in 2006. Since then, the AFM has supervised all audit firms which perform audits of financial statements for public use (statutory audits). In order to conduct statutory audits, an audit firm must have obtained a licence from the AFM. Audit firms which were already performing statutory audits in 2006 were allowed to make use of a transitional arrangement and continue to perform these audits until the AFM had made a final decision regarding their licence application. A total of 699 audit firms applied for a non-PIE licence under the transitional arrangement.

After two years of inspection, the AFM granted a non-PIE licence to 463 audit firms on 29 September 2008.[9] For approximately a third of these 463 audit firms, the AFM attached one or more items of attention or assumptions to the licence. Nearly 34% of the 699 applicants did not receive a licence, since they could not or did not wish to meet the requirements pursuant to the Wta. The majority of this group of applicants withdrew their licence application themselves. The AFM rejected the licence application in the remaining cases. At the beginning of 2013, there were 447 audit firms in possession of a non-PIE licence.

After the licensing period, the AFM's review process focused initially on audit firms with a PIE licence. These PIE audit firms conduct the majority of all statutory audits of non-PIE clients in the Netherlands. They are also responsible for the auditing of the financial statements of all PIEs (listed companies, banks and insurers). The AFM has published its findings as a result of these reviews.[10] These reviews enabled the AFM to obtain an impression of the quality of the statutory audits conducted by PIE audit firms.

To complete its understanding of the quality of the performance of statutory audits in the Netherlands, the AFM is conducting a thematic review in 2013 of the quality of the statutory audits performed by non-PIE audit firms. Non-PIE audit firms perform statutory audits of enterprises in the SME sector[11], but also of larger companies that are not listed on the stock exchange.

Various parties rely on the opinion of the auditor regarding the financial statements of non-PIE customers. This applies to the management of these audit customers, but also for external parties such as suppliers, creditors, shareholders, banks, the Tax &

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9 *See the report "Licensing under the Audit Firms Supervision Act leads to quality improvement" of 29 September 2008.*

10 *Report of general findings in relation to the credit crisis review of 3 December 2009, Report of general findings on the quality of audits and quality control of 1 September 2010, Report on incentives for quality of audit of 6 October 2010, Report on statutory audits of housing corporations of 12 December 2012, Report on quality of audits and quality control and monitoring systems at nine PIE licence-holders of 21 March 2013 and Report on compliance with transitional arrangement for separation of audit and advice of 27 March 2013.*

11 *Subject to certain conditions, small companies can make use of an exemption for the audit of the financial statements. In this case no statutory audit is conducted.*

Customs Administration, and also *De Nederlandsche Bank* if a pension fund or pension administrator is involved. These parties must be able to have confidence that the auditor's opinion regarding the financial statements has been reached from an independent standpoint, that the auditor has applied professional scepticism in the conduct of the audit and that the audit file provides sufficient substantiation for the auditor's opinion. The financial statements have to be reliable, and contain sufficient relevant information to form the basis for decisions.

3.2 The thematic review

The purpose of the thematic review is to obtain an accurate impression of the quality of the statutory audits conducted by non-PIE audit firms. In its thematic review, the AFM focuses primarily on assessing the quality of the statutory audits conducted by means of file reviews at selected NBA and SRA firms. In addition, the AFM assesses the quality of the financial reporting that has been audited by the selected auditors. If the AFM assesses the quality of the statutory audits as 'inadequate', it will request the audit firm in question to conduct a root cause analysis and to formulate an action plan. This should mean that the external auditors rectify the shortcomings identified in their audits and that they avoid shortcomings in future. The AFM publishes the findings of the file reviews in a generic report. This contains the findings from the file reviews at the SRA firms. The AFM published its findings from the file reviews at the NBA firms on 11 July 2013. Finally, the AFM holds a dialogue with the sector on the basis of this thematic review in order to draw broad-based attention to its findings and motivate the sector to adopt the sector-wide measures that are needed.

3.3 The review process

3.3.1 Selection of firms

In order to gain an impression of the quality of statutory audits by non-PIE firms, it is impossible in practical terms and moreover not necessary to include all 447 non-PIE licensees in the review. The AFM has therefore made a selection.

Among the non-PIE licensees, there are 81 firms that do not perform any statutory audits.[12] These firms have been excluded from the selection. The AFM selected 50 firms from the group of 366 non-PIE audit firms that do perform statutory audits. This consists of 30 NBA firms and 20 SRA firms.[13] The thematic review will be carried out in a consistent manner at all 50 firms selected.

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12 A provision was added to the Wta in the Financial Markets Amendment Act 2014 submitted to the House of Representatives for approval on 17 May 2013 giving the AFM the power to revoke a licence if the licensee makes no use of the licence for a period of 36 months. See https://zoek.officielebekendmakingen.nl/kst-33632-2.html.

13 On the basis of the covenants with the AFM of 28 September 2006 and 13 December 2011, the SRA has been conducting reviews of SRA firms, and has thus assessed the quality of the statutory audits, over several years. Until 2013, the NBA had not assessed the quality of statutory audits at NBA firms, it had limited its assessments to the other activities of these firms. For this reason, the AFM included more NBA firms than SRA firms in its selection.

The firms selected for the thematic review were chosen so that the selection represents a reasonable cross-section of the entire group of NBA firms and SRA firms. For the selection of the SRA firms, the AFM divided the firms into categories on the basis of the number of statutory audits they perform. The AFM then selected certain firms from each category on the basis of a risk analysis, and certain firms at random. Although around 48% of the SRA firms conduct more than 10 statutory audits, the AFM increased the number of firms in this category to 65% of the selection. The relatively larger SRA firms are therefore somewhat more heavily represented in the AFM's selection.

Table 2 shows for each category the number of SRA firms falling in that category and the number selected by the AFM for its review.

Number of statutory audits per firm	**All non-PIE audit firms**	**All SRA firms**	**Selected SRA firms**
0	81 (18%)	33 (12%)	0 (0%)
1-5	144 (32%)	60 (23%)	4 (20%)
6-10	71 (16%)	46 (17%)	3 (15%)
11-20	67 (15%)	49 (18%)	4 (20%)
21-50	51 (11%)	46 (17%)	4 (20%)
> 50	33 (7%)	31 (12%)	5 (25%)
Total number of firms	447 (100%)	265 (100%)	20 (100%)
Total number of statutory audits	6.854	5.842	920

Table 2. Selected firms by category of number of statutory audits.

3.3.2 Information request

The AFM notified the 20 SRA firms selected that they had been selected for review at the end of May 2013. The AFM requested each firm to provide a list of all the statutory audits that the firm conducts, stating the following for each statutory audit:

- the business of the audit client;
- the essence and date of the most recent audit opinion;
- the date on which the audit file was closed;
- the amount of the statutory audit fee;
- the name of the external auditor;
- the office from which the audit was conducted; and
- whether the audit included the use of work of auditor's experts or other auditors; and
- whether an engagement quality control review (EQCR) or an internal review had been conducted of the audit.

The AFM used this information for the selection of the statutory audits it wished to review.

3.3.3. Selection of statutory audits

In its thematic review, the AFM concentrated primarily on the assessment of the quality of the statutory audits conducted by means of file reviews. The number of statutory audits selected by the AFM from each firm depends on the size of the audit practice at the selected firm. If a firm performs more than 50 statutory audits, the AFM has in principle selected five statutory audits for review. In principle, the AFM has assessed four of these five audits. The fifth audit was the reserve. This audit was only assessed if the four audits assessed did not present a consistent picture of the quality of the conduct of audits at the firm in question. If a firm performs 50 statutory audits or less, the AFM has selected three audits and assessed two. The third audit was therefore the reserve. For firms that perform only one or two statutory audits, the AFM selected and assessed all the statutory audits conducted.

In its selection of the statutory audits to be assessed at each firm, the AFM used various criteria. Firstly, the AFM selected statutory audits that had recently been completed. In most cases, these concerned audits for the 2012 financial year. Where possible, the AFM moreover wished to review audits performed by several external auditors and to focus mainly on external auditors who perform a relatively large number of statutory audits. The AFM also focused particularly on audits in sectors that were especially affected by the financial crisis, since there are frequently special items of attention for the audit in these sectors. Accordingly, and where possible, the AFM selected audits of customers active in construction, financial and other services and property. The AFM selected a total of 61 statutory audits and assessed the quality of 47 statutory audits. Table 3 shows the distribution of these statutory audits across the sectors in which the audit clients are active.

Sector	Number of statutory audits assessed
Construction	15
Financial and other services	11
Property	1
Trade	19
Production	1
Total	47

Table 3. Statutory audits assessed by sector.

The AFM has informed the 20 SRA firms regarding which statutory audits were selected and requested them to submit the audited financial statements of the selected audit clients for the purpose of the review of the quality of the financial reporting.

3.3.4 Information meeting

The AFM invited the external auditors responsible for the statutory audits selected and a limited number of team leaders or firm partners to attend an information meeting regarding the thematic review. The AFM explained the review at this meeting and gave the participants the opportunity to ask questions.

3.3.5 Financial reporting review

While the principal focus of the thematic review was on assessing the quality of the statutory audits performed, for the first time the AFM included a systematic assessment of the quality of the financial reporting in this review. For all the clients selected, prior to the file review the AFM checked whether the financial reporting met the applicable reporting standards in a number of specific respects. The AFM accordingly reviewed the audited financial statements and where necessary obtained oral explanations from the external auditor responsible during the file review. This enabled the AFM to obtain an impression of the quality of the reporting. The major findings of the review were passed on to the external auditor during the file review.

3.3.6 Selection of focus aspects in the statutory audits

The AFM did not assess the complete statutory audit, it focused on a number of specific aspects. Those aspects were selected that require particular attention by the auditor given the industry sector concerned. In its thematic review, the AFM focused on the following aspects of the audit:

- completeness of the revenue recognition (including IT);
- construction contracts;
- measurement of assets;
- use of work of auditor's experts;
- going-concern assumption.

With the exception of one audit, the AFM assessed every statutory audit with respect to how the external auditor had audited the completeness of the revenue recognition.[14] The AFM chose this aspect of the audit because the audit of the completeness of the revenue recognition seems to be a difficult area for many auditors.[15]

In addition, the AFM selected one or more of the other aspects listed above for further review. The choice of aspect partly depended on the sector in which the audit client operates and was made on the basis of a professional judgement. The aspect of 'construction contracts' was for instance only relevant to audit clients in the sectors of construction. For the aspect 'measurement of assets', the most relevant item was chosen on the basis of the sector: property, debtors, inventory or financial non-current assets. If the measurement of property was selected as the focus element, the AFM also assessed how the external auditor made use of the work of an auditor's expert. If the audit client's financial reporting or the audit file show that the audit client's financial position is weak, the AFM also assessed how the external

14 *See paragraph 5.1 for the exception.*

15 *See paragraph 5.2.1 for a further description of the complexity of auditing (the completeness of) revenue recognition.*

auditor audited the going-concern assumption. The AFM also remained alert to any other serious shortcomings in all the audit files.

3.3.7 File reviews

The AFM assessed the statutory audits performed by each selected SRA firm in all cases on one day at the AFM's office in Amsterdam. The external auditors responsible for the selected audits were invited to attend the review, and were allowed to choose a colleague to accompany them. The external auditors brought their audit files to the AFM.

A file review by the AFM is interactive: the AFM requests the external auditor to explain the parts of the audit selected by the AFM using his audit file. By means of question and answer, the supervisors of the AFM form an impression of the audit procedures performed and an opinion regarding the quality of the audit. It is up to the external auditor to demonstrate on the basis of the audit file that the audit opinion he has issued is adequately substantiated and that the statutory audit has been performed in accordance with the audit standards and other legislation and regulation.

After conclusion of the file review, the supervisors discuss the facts observed during the review with the external auditor, their assessment of the quality of the statutory audit and the financial statements and their expectations with respect to follow-up actions by the external auditor and the firm.

3.3.8 Written reporting

For reasons of diligence, after the review each firm received a report stating the AFM's findings with regard to the audit files and the financial statements reviewed in writing. Should there be other information that was not raised during the review but which puts the AFM's findings in a different light, the firm has four weeks in which to inform the AFM accordingly.

4 The audit market for SRA firms

This section contains information on the size of SRA firms.[16] This information relates to matters including the number of licensees, the number of statutory audits, the revenue achieved by these firms, the number of external auditors involved and the size of the audit clients. The data from the SRA firms are compared to the data from the NBA firms and the PIE audit firms (both the Big 4 firms and others). The quantitative data from this section is presented in tabular form in Appendix 1. Furthermore, a description is presented of the nature of the audit practice at SRA firms based on the discussions the AFM has held with the firms concerned.

4.1 Size of the SRA firms

At the beginning of 2013, a total of 460 audit firms held a licence pursuant to the Wta: 13 of these firms may also audit PIEs, and 447 may only audit non-PIEs. Around 60% of the non-PIE licensees are SRA firms and 40% are NBA firms. Not all the Wta licensees actually perform statutory audits: 366 firms (82%) actually perform statutory audits. Over 26% of the NBA firms and 12% of the SRA firms do not actually need a licence.

The SRA firms serve a significant proportion of the audit market in the Netherlands. They perform more than a quarter of the total number of statutory audits, they earn nearly €100 million in revenue from this activity and the majority of the external auditors engaged by these firms perform more than five statutory audits each.

Number of statutory audits

The non-PIE licensees together account for nearly 32% of all statutory audits, approximately 6,850 of the 21,400 audits per year. Figure 1 shows the share in the total number of statutory audits for each category of licensees (NBA firms, SRA firms, Big 4 and other PIE audit firms). The SRA firms perform around 27% of the total number of statutory audits in the Netherlands.

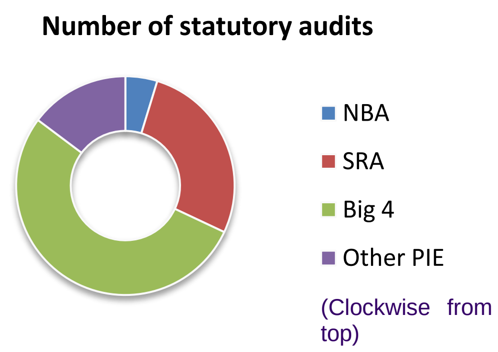

Figure 1

16 *This information originates from the AFM Monitor of Audit Firms 2012. The Monitor is one of the supervisory instruments used by the AFM in the conduct of its continuous supervision of audit firms. It is a questionnaire whereby audit firms provide information to the AFM each year that the AFM needs to conduct its supervisory duties effectively and efficiently. The audit firms thereby contribute to the objectives of the legislation and regulation. The AFM uses this information to obtain knowledge regarding individual audit firms, but also regarding all licensed audit firms collectively. The Monitor 2012 was completed by the audit firms in the period November/December 2012. The figures presented are based on information provided by the audit firms to the AFM. The AFM has not analysed the information provided to verify that it is reliable.*

The SRA firms perform more statutory audits on average per firm than the NBA firms. Approximately 65% of the SRA firms perform more than five statutory audits. This figure for the NBA firms is only 27%. All the PIE firms perform more than five statutory audits per firm. Figure 2 shows how many firms conduct a certain number of statutory audits.

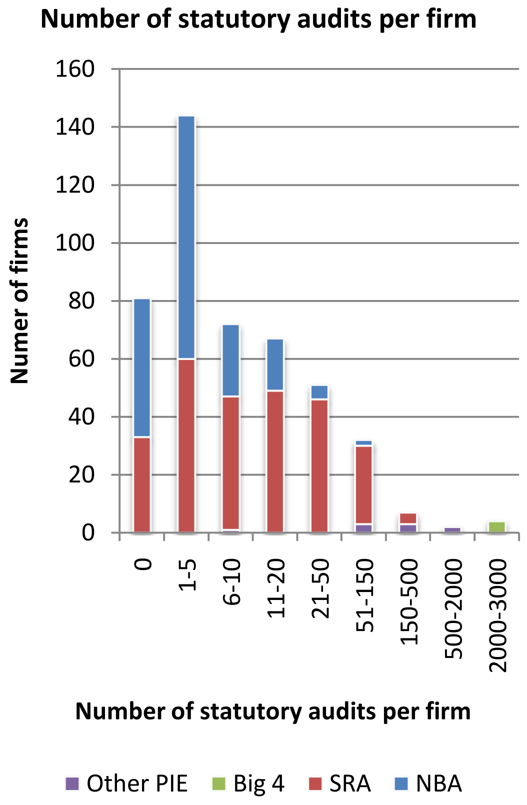

Figure 2

Revenue from statutory audits

The non-PIE audit firms account for approximately 14% of the total revenue generated by all Wta licensees collectively from the conduct of statutory audits: 12% for the SRA firms and 2% for the NBA firms (see figure 3).

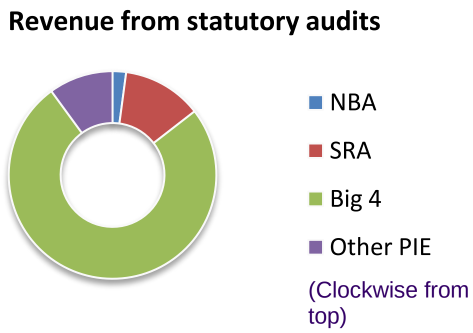

Figure 3

The audit practice at non-PIE audit firms is significantly smaller than at the PIE firms in terms of revenue generated. Non-PIE audit firms earn around 10% of their total net revenue from the performance of statutory audits (SRA firms: 10%, NBA firms: 8%), compared to nearly 40% for the PIE audit firms. The average revenue per statutory audit for both SRA and NBA firms is the same (approximately €17,000) and lower than the average revenue per statutory audit at the Big 4 and other PIE audit firms (around €53,000 and €26,000 respectively).

Number of external auditors

Overall, the approximately 21,400 statutory audits are conducted under the responsibility of 1,464 external auditors. 632 (43%) external auditors were engaged by an SRA firm, and 211 (14%) by an NBA firm. Figure 4 shows the distribution of the total number of external auditors across the SRA and NBA firms and the Big 4 and other PIE audit firms.

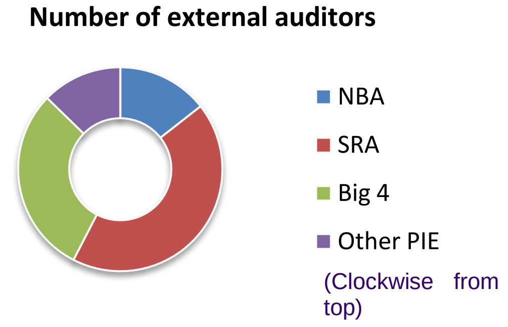

Figure 4

At almost 57% of the SRA firms that conduct statutory audits, the external auditors on average perform more than five statutory audits each. This figure for the NBA firms is only 23%. Figure 5 shows at how many firms the average number of statutory audits per external auditor falls into one of the stated categories.

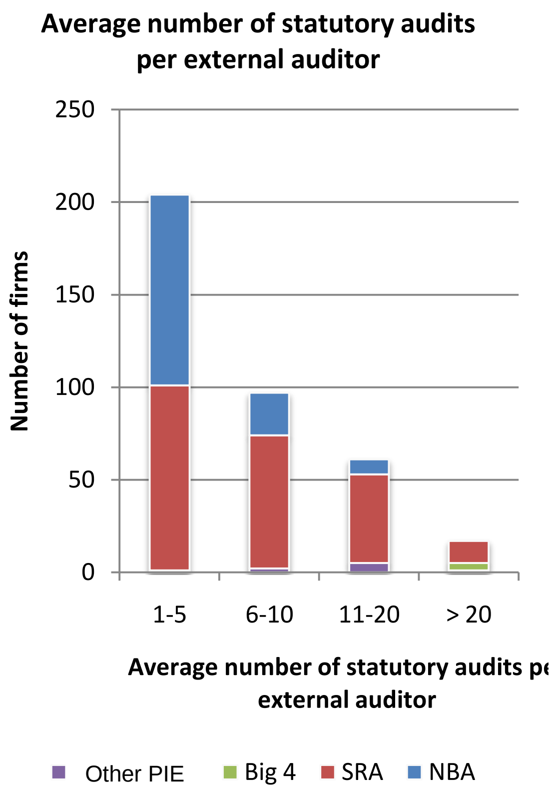

Figure 5

The 20 selected SRA firms are a reasonable cross-section of the entire group of SRA firms that perform statutory audits. While around 14% of the SRA firms that perform statutory audits conduct more than 50 statutory audits, the AFM has expanded the number of firms in this category to 25% of the selection and therefore the selection includes more relatively larger SRA firms. These 20 SRA firms selected perform a total of around 920 statutory audits, for which 73 external auditors were responsible. They generated approximately €171 million in total net revenue, and around €14 million from the performance of statutory audits.

4.2 Features of the audit practice at the SRA firms

In addition to its file reviews, the AFM has reviewed the general financial details of audit clients in the non-PIE sector and held discussions with the selected SRA firms regarding their views of the sector and their view of the future for their firm.

The financial figures for Dutch companies in the period 2009-2011 show that the audit clients of non-PIE audit firms are significantly smaller than the audit clients of the PIE audit firms. These audit clients are for instance significantly smaller in terms of operating income, operating result, balance sheet total, equity, employees, shareholders, associate investments and gross profit. The audit clients of PIE audit firms are on average larger. The differences between the audit clients of the SRA firms and of the NBA firms are however negligible.

Based on its discussions with the SRA firms, the AFM has gained an impression of the attitude of the audit clients of these firms to the statutory audit and how these SRA firms see their own future.

For several SRA firms, the performance of statutory audits forms the basis of being able to offer a total service package to clients. They prefer to profile themselves as a ‘full-service’ firm, and the statutory audit is considered to be an important element of this. 65% of the SRA firms selected have a separate department for their audit activities. The larger audit clients, clients mostly funded by a bank, which form part of a national or international group or not-for-profit organisation, are more inclined to see the statutory audit as adding value. The 20 SRA firms reviewed have stated that they have the impression that the audit client considered the audit to be important in around 70% of the 47 statutory audits assessed. In these cases, they did not experience pressure from the client regarding the fee for the audit.

For audit clients with a director and major shareholder and clients that are mainly funded with equity, such as family businesses, the statutory audit is usually seen as a ‘necessary evil’ . These clients do not place much value in the statutory audit. This does not alter the fact that other parties in society, such as suppliers, creditors, employees and the Tax & Customs Administration, do consider a statutory audit to be of real value.

The AFM also asked the SRA firms to describe their ambitions for their audit practice in future. Over half of the 20 SRA firms reviewed expressed the ambition of increasing their audit practice. The other firms thought that they would maintain their audit practice at its current level. Some of these firms said they had no specific growth targets, or that they did not see potential for growth in the current economic climate. None of the 20 SRA firms reviewed expected to cease performing statutory audits in the near future.

5 Findings of the review

This section describes the findings of the review conducted by the AFM of 47 statutory audits by the 20 selected SRA firms and 61 audited financial statements of audit clients of these SRA firms.[17] Section 5.1 states the AFM's conclusions with respect to the quality of the 47 statutory audits assessed. This paragraph also lists the features of the statutory audits that are qualified as 'adequate' or 'inadequate'. Section 5.2 gives a summary of the content-related shortcomings identified by the AFM in the statutory audits it assessed. Sections 5.3 and 5.4 then describe the AFM's conclusion regarding the quality of the financial reporting of 61 non-PIE audit clients and the content-related shortcomings identified by the AFM in this financial reporting.

5.1 Quality of statutory audits

The AFM identified serious shortcomings in 38 of the 47 statutory audits by 20 SRA firms with a non-PIE licence it has assessed. These shortcomings relate to the fact that the external auditors who were responsible for the adequate performance of the statutory audits failed to obtain sufficient and appropriate audit evidence regarding the financial statements as a whole in order to substantiate their audit opinion. The AFM accordingly qualified these 50 statutory audits, 81% of the total number of statutory audits assessed, as 'inadequate'.

In table 4, the AFM classifies the 47 statutory audits it assessed into four quality categories. Category 1 concerns the statutory audits assessed as 'adequate'. These are statutory audits for which the AFM did not find any serious shortcomings in the elements it assessed. Categories 2, 3 and 4 concern the statutory audits for which the AFM identified serious shortcomings and which are therefore classified as 'inadequate'. A distinction is made on the basis of the nature of the shortcomings that led to an assessment of 'inadequate', with the statutory audits in category 2 being of relatively better quality and those in category 4 being of the lowest quality.

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17 See also paragraph 3.3.3, which explains that the AFM selected a number of statutory audits as 'reserves'. The financial statements for these reserve audits were also assessed.

Category	Number of statutory audits	Assessment	Remarks
1	9 (19%)	Adequate	No serious shortcomings.
2	17 (36%)	Inadequate	Inadequate audit procedures with regard to specific aspects.
3	17 (36%)	Inadequate	Some audit procedures conducted, however very basic audit techniques either not or incorrectly applied.
4	4 (9%)	Inadequate	No or very few audit procedures conducted, mainly administrative and compilation work only.

Table 4. Quality of 47 statutory audits assessed in four categories.

The AFM qualified at least one statutory audit as 'inadequate' at 18 SRA firms (90%). There were only two SRA firms (10%) where the AFM did not identify serious shortcomings.

As stated in section 3, in its assessment of the 47 statutory audits selected the AFM focused on two or more of the following aspects:

- revenue recognition (including IT);
- construction contracts;
- measurement of assets;
- use of the work of auditor's experts; and
- going-concern assumption.

The AFM assessed whether the external auditor had obtained 'sufficient and appropriate audit evidence' with respect to each of these aspects.[18] In the performance of an audit, the auditor's objective is to form an opinion regarding the question of whether the financial statements meet the reporting regulations in all material respects. For this, the auditor must obtain a reasonable degree of certainty regarding the question of whether the financial statements as a whole do not contain material misstatements that are the result of fraud or errors. The auditor obtains this certainty by gathering sufficient and appropriate audit evidence. Audit evidence includes information from the financial administration on which the financial statements are based, or other information from the audit client or from third parties. Sufficient and appropriate audit evidence is needed to substantiate the auditor's opinion and the auditor's statement. The term 'adequate' is the measure for the quantity of the audit evidence. The term 'appropriate' is the measure for the quality of the audit evidence. Quality means that the audit evidence is relevant and reliable, so that it provides real substantiation for the auditor's opinion. With this audit evidence, the external auditor has grounds for his opinion that the capital and result presented in the audit client's financial statements do not contain material misstatements.

18 *In other words, the AFM established whether there was a contravention of NV COS 200 'General objectives of the independent auditor, as well as the performance of an audit in accordance with the Standards', paragraph 17: "In order to obtain a reasonable degree of certainty, the auditor must obtain adequate and appropriate audit evidence so as to reduce the audit risk to an acceptably low level, thus enabling the auditor to draw reasonable conclusions on which he can base his opinion."*

Table 5 presents an overview of the focus elements, and states the number of statutory audits for which the area in question was selected and the number of cases in which the AFM established that the external auditor had not obtained sufficient and appropriate audit evidence with respect to this area. The AFM identified serious shortcomings in 38 of the 47 statutory audits it assessed (81%). For example, the AFM focused on the audit of the revenue recognition in 46 of the 47 statutory audits assessed (98%).[19] In 36 of these 46 statutory audits (78%), the AFM found shortcomings with respect to the audit of the revenue recognition. Section 5.2 describes the shortcomings in each focus element.

Focus element	**Number of statutory audits with this focus element (% of total of 47 statutory audits)**	**Number of statutory audits with shortcomings in this focus element (% of number of statutory audits with this focus element)**
Revenue recognition	46 (98%)	36 (78%)
Construction contracts	17 (36%)	13 (77%)
Measurement of assets	28 (60%)	15 (54%)
Use of work of auditor's experts	4 (9%)	3 (75%)
Going-concern assumption	14 (30%)	5 (36%)
Total	47 (100%)	38 (81%)

Table 5. Number of statutory audits with focus elements and number of statutory audits with shortcomings in these focus elements.

To obtain an impression of the quality of the statutory audits performed by the 20 SRA firms selected, the AFM focused mainly on establishing serious shortcomings in the audit. Less serious shortcomings were shared orally with the external auditors concerned during the review, and are not included in this report.

5.1.1. Features of adequate and inadequate statutory audits

After the AFM qualified the 47 statutory audits it assessed as 'adequate' or 'inadequate', the AFM inspected which of the following features were related to the quality of the statutory audit:[20]

- Features of the external auditor responsible:
  - How many statutory audits does the external auditor perform?
  - Is the external auditor a registered accountant (RA) or an accounting consultant (AA)?

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19 *For one statutory audit for which the external auditor issued a disclaimer of opinion due to the lack of a properly functioning administrative organisation and internal control system, the AFM's supervisors chose to focus on elements other than revenue recognition.*

20 *The AFM tested for each feature to see whether the feature had a significant connection (α = 10%) with the quality of the statutory audit (adequate or inadequate). Pearson Chi2 tests, t tests and Pearson correlation tests were conducted for this purpose. The AFM also tested these features using a multivariate regression analysis.*

- In which year was the external auditor entered in the accountants' register?
- Features of the audit firm:
  - Has the audit firm previously been subject to a file review by the AFM?
  - How many statutory audits does the audit firm perform?
- Features of the statutory audit:
  - Has the statutory audit been subjected to an EQCR?
  - Was the EQCR conducted by a quality assessor from outside the audit firm?
  - What is the substance of the audit opinion issued?
  - Did the external auditor use an electronic or a hard-copy audit file for his audit?
  - Did the external auditor or the audit firm provide compilation services to the audit client in addition to the statutory audit?
- Features of the audit client concerned:
  - What is the size of the audit client (balance sheet total, revenue, result, number of employees)?
  - In what sector does the audit client operate?
  - Does the audit client value the statutory audit and the audit opinion?
  - Did the audit client put pressure on the external auditor or the audit firm to reduce the fee for the statutory audit?

The following four features appear to have a significant relationship to the quality of the 47 statutory audits assessed.[21]

The external auditor was entered in the accountants' register in the year 2000 or later

The AFM concludes that external auditors that have been more recently entered in the accountants' register more frequently perform audits that are of adequate quality. The 47 statutory audits assessed were performed by 41 external auditors, of whom 17 were entered as an RA or an AA in the accountants' register in 2000 or later; 23 were already entered in the accountants' register prior to 2000.[22] Table 6 shows for the 47 statutory audits assessed whether these were conducted by an external auditor entered in the accountants' register in 2000 or later, or an external auditor that was already entered prior to 2000. The table shows that a total of 21 statutory audits were conducted by an external auditor who was entered in the accountants' register in 2000 or later. 29% of these audits were qualified as 'adequate'. This percentage is clearly higher than the percentage of 'adequate' statutory audits performed by an external auditor who was already entered in the accountants' register prior to 2000, which is 12%.

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21 The results of the statistical tests were significant for these features, suggesting that these links can be expected to apply to all SRA firms.

22 The year 2000 has no specific significance in itself, however, this is the point at which the difference between adequate and inadequate quality is clearly significant.

Quality of statutory audit	Registered in 2000 or later	Registered prior to 2000	Total
Adequate	6 (29%)	3 (12%)	9 (19%)
Inadequate	15 (71%)	23 (88%)	38 (81%)
Total	21 (100%)	26 (100%)	47 (100%)

Table 6. Connection between quality of statutory audits and year of entry in the accountants' register (before or since 2000)

The audit firm performs at least 15 statutory audits

The AFM concludes that the statutory audits it qualified as 'adequate' have all been performed by audit firms that perform a total of 15 statutory audits or more. 8 of the 20 SRA firms reviewed perform fewer than 15 statutory audits. The 14 statutory audits by these 8 firms assessed by the AFM were all qualified as 'inadequate'. 12 of the 20 SRA firms assessed perform at least 15 statutory audits. The AFM assessed 33 statutory audits performed by these firms, and qualified 9 of them (27%) as 'adequate'.

Quality of statutory audit	At least 15 statutory audits	Fewer than 15 statutory audits	Total
Adequate	9 (27%)	0	9 (19%)
Inadequate	24 (73%)	14 (100%)	38 (81%)
Total	33 (100%)	14 (100%)	47 (100%)

Table 7. Relationship between the quality of statutory audits and the number of statutory audits performed by the audit firm (fewer than 15 or at least 15)

The audit firm does not carry out compilation work for the audit client

The AFM concludes that audit firms that do not carry out compilation work for their audit clients in addition to performing the statutory audit are more likely to carry out statutory audits of adequate quality. During the file reviews, the AFM asked the external auditors responsible whether they, or other employees of the audit firm, also carried out compilation work for the audit client in question. From these interviews, we established that compilation work had been carried out by the audit firm in addition to the statutory audit in 20 of the 47 cases assessed (43%). The compilation work was carried out by either the external auditor himself, members of the audit team, or employees not involved in the statutory audit. Only 5% of the statutory audits performed by audit firms that also provided compilation work were assessed as 'adequate', whereas 30% of the statutory audits performed by audit firms that had not also carried out compilation work were assessed by the AFM as 'adequate'.

Quality of statutory audit	Compilation	No compilation	Total
Adequate	1 (5%)	8 (30%)	9 (19%)
Inadequate	19 (95%)	19 (70%)	38 (81%)
Total	20 (100%)	27 (100%)	47 (100%)

Table 8. Relationship between quality of statutory audits and the concurrence of statutory auditing with compilation work

The audit client values the statutory audit and does not exert pressure on the audit fee

The AFM concludes that in cases where the audit client considered the statutory audit to be important and did not exert pressure with respect to the audit fee, these audits were more likely to be of adequate quality. During the file reviews, the AFM asked the external auditors responsible to describe their impression of the value placed on the statutory audit by the audit client. The AFM also asked the external auditors if they had experienced pressure from the audit client regarding the audit fee. The external auditors concerned stated that they had the impression that the audit client considered the statutory audit to be of value and did not experience pressure with respect to the audit fee in 25 of the 47 statutory audits assessed (53%). The AFM assessed the quality of the statutory audit as 'adequate' in 36% of these cases. On the other hand, all the 22 statutory audits for which the external auditors stated that they had the impression that the audit client considered the audit to be of little or no value and at the same time exerted pressure with respect to the fee were assessed by the AFM as 'inadequate'.

Quality of statutory audit	Value/ no fee pressure	No value/ fee pressure	Total
Adequate	9 (36%)	0	9 (19%)
Inadequate	16 (64%)	22 (100%)	38 (81%)
Total	25 (100%)	22 (100%)	47 (100%)

Table 9. Relationship between quality of statutory audits and the value placed on the audit by the audit client and fee pressure experienced by the external auditor

Other features and quality of statutory audits

To the extent we have been able to establish, other features have no significant relationship with the result of the assessment of the statutory audit ('adequate' or 'inadequate') and therefore do not by definition apply to all SRA firms.[23]

In relation to the 47 statutory audits assessed, the AFM has the following observations:

- *Size of the audit client*. The audit clients whose statutory audits were qualified by the AFM as 'adequate' are not larger or smaller (in terms of balance sheet, revenue, result and number of employees) than audit clients for which the statutory audits were qualified as 'inadequate'.
- *Sector.* The AFM assessed audit files for audit clients operating in the sectors trade, services, construction, production and property. The assessment of the statutory audits performed in these sectors by the 20 SRA firms did not vary significantly.
- *EQCR.* 19 of the 47 statutory audits assessed (40%) were subjected to an EQCR. The AFM assessed only 2 (11%) of the 19 statutory audits that were subjected to an EQCR as 'adequate'.
- *Auditor's statement.* 89% of the 47 statutory audits assessed were given an unqualified audit opinion, and 11% were given a disclaimer of opinion. This

[23] *It should be noted here that the number of observations, 47 statutory audits, is relatively low for the purpose of obtaining hard and fast findings from the statistical tests used.*

proportion is the same as that for the audits qualified as 'adequate' and 'inadequate'.

- *Electronic audit file.* An electronic audit file was used in approximately 70% of the 47 statutory audits assessed. This proportion is virtually the same as that for the audits qualified as 'adequate' and 'inadequate'.

5.2 Shortcomings in statutory audits

This paragraph describes the main shortcomings in each focus element encountered by the AFM in its assessment of the 47 statutory audits. Each paragraph starts with a brief description of what may be expected of the auditor in the area in question based on general auditing principles or legislation and regulation, including the NV COS. Each paragraph then gives a summary of the procedures that the external auditor has failed to perform. Where necessary, the AFM illustrates its findings by means of examples. All these examples are derived from the AFM's review findings and therefore concern actually encountered situations. The examples relate to the audit of material aspects of the financial statements concerned.

5.2.1 Revenue recognition

For most companies, the recognition of the revenue from its business operations is one of the most important items in the financial statements. For the auditor, the recognition of revenue is one of the most important parts of his audit. This is not only because of the importance of the revenue to the audit client, it is also because in many cases the auditing of revenue recognition is not a simple matter.

When auditing the revenue recognition, an auditor must act on the assumption that there are risks of fraud in the revenue recognition, since fraudulent financial reporting is usually associated with intentional reporting of incorrect or incomplete revenue. For instance, in case of theft, black money or money laundering. This risk of fraud is moreover a significant risk, namely a risk that the reporting contains a material misstatement and this therefore requires special attention during the audit.

Depending on the circumstances and apart from the most obvious forms of fraud, a company's revenue may be shown as too high as a result of the reporting of fictitious revenue, whether temporarily or not, or as too low as a result of revenue being shifted to a subsequent reporting period or not included in the administration at all. In his audit of the revenue recognition therefore, the auditor has to audit both the correctness of the recognition ("Was the revenue as reported in the financial statements actually realised?") and the completeness of the recognition ("Has all the revenue realised been recognised in the financial statements?"). In many cases, substantive procedures are the most suitable means of auditing the correctness of the revenue recognition, and tests of controls are the best way to audit completeness.

In his audit, an auditor can perform both tests of controls and substantive procedures in order to obtain audit evidence, and will usually combine these two methods. The tests of controls concentrate on the design, existence and operation of internal control measures at the audit client. If the external auditor wishes to base findings on the audit client's internal control measures, he will have to establish by means of tests of controls that the internal control measures operate effectively and that he can rely on them. Substantive audit procedures consist of detailed checks of parts of the financial overview and substantive analysis of figures, including coherence tests. The auditor thus assesses whether the financial statements contain material misstatements.

With regard to significant risks, it is usually not possible or practically feasible to obtain sufficient and appropriate audit evidence by means of substantive analysis alone. In these cases, the entity's internal control measures that relate to these risks are relevant to the audit and the auditor must review the measures and establish that they operate effectively.

The AFM designated the audit of revenue recognition as a focus element in 46 of the 47 statutory audits assessed (98%). The shortcomings in these statutory audits relate to the following issues:

1. General
2. Tests of controls
3. Automated data systems (IT)
4. Substantive numerical analysis

Table 10 presents an overview of the issues assessed by the AFM in the context of its assessment of the audit of the revenue recognition, and shows the number of statutory audits for which the issue in question was relevant and the number of statutory audits in which the AFM identified serious shortcomings. These shortcomings are elaborated further below.

Focus elements	**Number of statutory audits with this focus element (% of total of 47 statutory audits)**	**Number of statutory audits with shortcomings in this focus element (% of number of statutory audits with this focus element)**
Revenue recognition		
• General	46 (98%)	31 (67%)
• Tests of controls	46 (98%)	28 (61%)
• Automated data systems (IT)	46 (98%)	29 (63%)
• Substantive numerical analysis	46 (98%)	34 (74%)

Table 10. Number of statutory audits with focus elements and number of statutory audits with shortcomings in these focus elements.

5.2.1.1 General

In the first place, the shortcomings identified by the AFM in the audit of revenue recognition relate to general features of this audit. In most of the 46 statutory audits (96%), the AFM found that the auditor had scheduled audit activities with respect to the completeness of the revenue recognition. In 67% of the statutory audits assessed however, the AFM found general shortcomings in relation to the execution of these scheduled activities. In these cases, the external auditor failed (among other things) to:

- assess whether there was a risk of fraud or other risks regarding the completeness of the revenue recognition;
- check that the revenue concerns the reporting period in question and has not been shifted to a different period ('cut-off');
- establish that the financial statements, including the disclosures, are in accordance with the system of financial reporting; or
- follow up his findings with respect to revenue recognition adequately.

5.2.1.2 Test of controls

In 46 of the statutory audits (98%), the external auditor planned to conduct tests of controls. In 61% of these statutory audits, the AFM found serious shortcomings in the conduct of these tests of controls. In 79% of the statutory audits featuring shortcomings with respect to the tests of controls, the external auditor failed to establish the internal control measures that were relevant to his audit, including the separation of functions.[24]

In more than half of the statutory audits with shortcomings with respect to tests of controls, the AFM is of the opinion that the audit work qualified by the external auditor as 'tests of controls' were in fact 'substantive procedures' in nature. In these cases, the external auditor actually did not test the internal control measure itself, he only tested the result of the internal control measure. If for instance the control measure consists of a recalculation of the total amount of a sales invoice by the head of the administration, the auditor must establish in his audit that the head of the administration has actually carried out this calculation. He does this by establishing the external feature of the control measure, for instance the appearance of the initials of the head of the administration on the sales invoice. If the auditor only recalculates the sales invoice himself, he only obtains certainty regarding the sale by means of sampling, he does not obtain certainty regarding the operation of the internal control measure.

Other failures by external auditors established by the AFM concern the following:

- testing of the adequate and continuous operation of the relevant internal control measures, since they have only established the *design* of the internal

24 Separation of functions refers to the placement of the responsibilities for authorising transactions, recording transactions and the custody of assets with different persons within the company, in order to limit the possibilities for anyone involved to make errors in the normal course of their duties or to commit fraud by keeping transactions hidden.

control measure and have not carried out adequate tests of controls to be able to form an opinion regarding the *operation* of the control measure;
- including the findings of the tests of controls conducted in the planning of the substantive procedures still to be performed;
- evaluate whether, despite the lack of internal control measures at the audit client, they were able to obtain sufficient and appropriate audit evidence in order to be able to issue an unmodified audit opinion.

The above shortcomings can be illustrated by the following example from the AFM's review:

Tests of controls
The audit client is a medium-sized company that leases building and demolition machinery, and employs service personnel. The external auditor stated that his audit plan would include tests of controls in order to check the completeness of the income from leasing and that he would base this on the control measures in the leasing process. He assessed the various stages in the leasing process by means of a walk-through test and identified the most important internal control measures for which he wished to establish that they had operated continually throughout the year. One of these measures concerned the internal control measure designed to ensure that all the lease days stated in the daily records were actually invoiced to the lessees. In his audit of 30 lease contracts, the external auditor established that the number of lease days in the daily records was equal to the number of lease days invoiced. By making his own reconciliation between the daily records and the invoices, the external auditor only established that this reconciliation was correct in 30 cases. The external auditor however failed to establish whether the *internal control measure* designed to ensure that this reconciliation applies was also operating satisfactorily. He completely failed to establish how this reconciliation was actually made: for instance, whether it was made by an employee or by an application control in the automated system. The external auditor had thus not carried out any tests of controls, he had conducted a substantive procedure. One cannot conclude that an internal control measure is operating and can be relied upon on the basis of a substantive procedure.

5.2.1.3 Automated data systems (IT)

At many companies, transactions are generated, recorded, processed and reported by means of automated data systems. In this case, transactions are recorded electronically and not in paper documentation. The internal control measures that are relevant to an audit of the financial statements of such companies therefore often involve automation elements as well as manual elements. These internal control measures relating to automated data processing consist of firstly general IT controls and secondly specific application controls.[25]

If an auditor wishes to rely on the internal control measures of a company that uses automated data processing to a significant extent, he will have to test both the

25 *For further definition of general IT controls and application controls, see COS 315 paragraphs A96 and A97.*

general IT controls and the application controls. This in principle concerns 'standard' tests of controls, whereby the auditor obtains information on the internal control measures and then tests them with regard to design, existence and operation.[26]

Automated data processing however involves specific risks for a company's internal control system, and in the testing of these internal controls the auditor will only be able to rely to a limited extent on paper documentation. Most of the information will have to be obtained from electronic records.

The AFM has established that the company's internal control measures are to a large extent automated in 46 of the 47 statutory audits assessed (98%). In 63% of these cases, the external auditor has, in the opinion of the AFM, devoted inadequate attention to these automated data systems. The external auditors actually have failed to include the general IT controls and the application controls in their audits, while they have stated that they have relied on the data from this automated environment. They also failed to perform other procedures in order to establish the reliability of the data from this automated environment. For instance, this applies to the audit of the separation of functions in the automated system: the auditor must establish which persons are authorised to access the system and the nature of their authorisation (established in competence tables), whether these authorisations correspond to the necessary separation of functions within certain processes and whether the separation of functions has applied throughout the year. For this purpose, the auditor will concentrate on testing the design, existence and operation of the application controls with respect to the separation of functions. The auditor must also establish that the authorisations cannot be changed without justification ('change management') and how the management of the automated system is organised. For this, the auditor reviews the general IT controls. In several cases, the AFM established that the external auditor failed to conduct any audit procedures on the above points.

The next example illustrates a situation in which the AFM concluded that the external auditor had performed adequate procedures with respect to the automated data system:

***Good practice:* 'Super users' identified as a risk**

The audit client is a service provider, and its administration and internal control measures are to a large extent automated. In his audit plan, the external auditor had decided he wished to make use of these automated systems. His assessment of the general IT controls revealed that there were two 'super users' at the company. These were system users with rights enabling them to transcend several organisational separations of functions and thus were able to perform various conflicting roles within the system. The external auditor established the risks associated with the breach of the separation of functions and what effect this had on his other audit procedures. As a result of this observation, the external auditor performed specific audit procedures to establish that these 'super users' in any case had not been able to enact payments on the company's behalf or to approve the time sheets of

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26 *In addition, pursuant to Article 2:393 (4) BW the auditor must state his findings with respect to the reliability and continuity of the automated data processing in his report to the supervisory board and the management.*

employees. The external auditor moreover reduced the other risks to an acceptably low level by means of substantive analysis of the figures.

5.2.1.4 Substantive numerical analysis

A substantive analytical procedure is one of the audit procedures that an auditor may use to obtain sufficient and appropriate audit evidence. When conducting an analytical procedure, an auditor evaluates financial information through analysis of plausible relationships among various financial and non-financial data.

Analytical procedures may be used at various stages of the audit. Under an *initial* analytical procedure, an auditor for instance will make general comparisons between the figures for the current financial year with those of the previous financial year in order to gain an impression of the current financial situation. The *concluding* analytical procedure at the end of the audit assists the auditor in forming a final conclusion regarding whether the financial overviews are consistent with the auditor's opinion of the entity. With *substantive* analytical procedures, the auditor conducts more detailed analyses in order to obtain sufficient and appropriate audit evidence regarding a specific item or movement in the financial statements.

For instance, an auditor can compare the financial information from the audit client with:

- comparable information from previous reporting periods;
- results expected by the audit client, such as budgets or forecasts, or expectations of the auditor himself; or
- similar information from the sector.

The auditor may also consider connections as part of his analytical procedure, for example:

- between elements of financial information that the auditor expects to display a predictable pattern on the basis of experience of the company, such as gross margin rates;
- between financial information and relevant non-financial information, such as the wages and salary expenses compared to the number of employees.

The auditor may use various methods for the conduct of analytical procedures. These vary from simple comparisons to complex studies using advanced statistical techniques. In any case, before making comparisons, the auditor has to form an expectation regarding the result of the comparison and decide which differences require further inspection. He then evaluates the differences found and inspects further in order to either explain the differences or have them adjusted.

In all 46 statutory audits for which the AFM identified the audit of revenue recognition as a focus element, the AFM also considered the conduct of substantive analytical procedures (including audits of relationships). The AFM identified serious shortcomings regarding the performance of these substantive analytical procedures in 74% of these statutory audits. In these cases, in the opinion of the AFM the auditor has usually conducted only a general initial or concluding analytical procedure without the more detailed substantive analytical procedure that was needed. In these cases, the external auditor failed (among other things) to:

- formulate expectations with regard to his analytical procedures;
- test the explanations of the differences identified provided by the audit client against underlying documentation;
- make connections between the data relevant to the company in question.

The exact analytical procedures that an auditor may perform for the audit of a company's revenue recognition depend to a large extent on the specific sector of the company or the nature of its business. A trading company earns its money in a different way than a service provider, for example. The AFM identified serious shortcomings in the conduct of sector-specific substantive analytical procedures in 74% of the statutory audits of trading companies and in 64% of the statutory audits of service providers.[27] With regard to trading companies, among other things the external auditor failed to:

- involve the movement of money and goods with a review of the inventory and the cash as a closing item in his audit;
- involve variations in the connections such as discounts, take-up of bonuses and different sale prices in his audit;
- conduct substantive analytical procedures and in particular the analysis of margins in sufficient detail.

Among other things, the external auditors of the service providers failed to:

- make a connection between service and service in return, such as the analysis of the expected and actual positions with respect to total hours and agreements on commissions;
- involve an analysis of the indirect hours compared to the direct hours in his audit;
- conduct substantive analytical procedures and in particular the analysis of hours registration and income in sufficient detail.

The following example illustrates a situation in which the AFM concluded that the external auditor had performed adequate procedures with respect to the substantive numerical analysis:

***Good practice:* Substantive numerical analysis**

The audit client is a medium-sized company that produces cutting machines for industrial purposes. To conclude the audit of the completeness of the revenue recognition, the external auditor decided to audit the movement of money and goods. The audit client, however, had not kept a record of the movement of money and goods. The external auditor *himself* then decided to create a record of the movement of money and goods in order to obtain sufficient certainty regarding the completeness of the revenue recognition in an efficient way. The opening and closing balances of the movement of money and goods were reconciled by the

27 *In the only statutory audit of a production company, no serious shortcomings were identified in the conduct of the sector-specific analytical procedures. In the only statutory audit of a property company, the serious shortcomings in the conduct of the analytical procedures were mostly general in nature and not sector-specific. The analytical procedures in the statutory audits of construction and production companies mostly related to the audit of construction contracts. Construction contracts was a specific focus element in the AFM's review, and is dealt with in paragraph 5.2.2.*

external auditor with the inventory.

5.2.2 Construction contracts

Of the 47 statutory audits reviewed, 17 audit clients (36%) perform projects for third parties. These engagements are normally in progress on the balance sheet date and usually extend over more than one reporting period, such as buildings under construction or other infrastructure works. Specific reporting regulations apply to construction contracts that must be specifically considered by the auditor in his audit.

Companies often recognise the income and expenses of these projects pro rata to the works completed. This method, involving the taking of interim profit during the performance of the project is also known as the percentage of completion method. This method may only be used if the company can reliably establish the phasing and interim profit calculations. The financial reporting guidelines (DASB Guideline 221) give further details of the conditions that must be met in order for this method to be applied. If these conditions are not met, interim recognition of profit is not permitted and profit may only be recognised on completion of the project. Regardless of the method applied, expected losses must be recognised directly in the income statement.

The AFM identified serious shortcomings in 13 of the 17 statutory audits in which the external auditor audited construction contracts (77%). In these cases, the external auditor for example failed to:

- establish the relevant internal control measures, including:
  - the separation of functions;
  - the monitoring of the progress of the projects taking account of the budgeted and actual costing for each project;
  - the process associated with the contracts (fixed contractual sum, cost-plus basis);
- reconcile the project administration and the ledger;
- establish that the number of projects for which revenue is recognised is correct;
- conduct audit procedures regarding inconsistencies in relationships, such as the relationship between the work in progress (recognised under inventory) and the related job-time/shop-time;
- conduct analytical procedures, including the analysis of the income compared to previous years, analysis of figures in comparison to budgeted and actual costing and the associated margins on projects in sufficient detail;
- establish that the item construction contracts consists of the balance of actual project costs, allocated profit, recognised losses and instalments already invoiced;
- assess whether the recognition of income and expense from construction contracts in the income statement is in accordance with Guideline 221 ‘Construction Contracts’ of the Dutch Accounting Standard Board (DASB),

whereby the external auditor has not established (per individual project) whether:

  - the result can be reliably estimated;
  - the payment for the work and any additional work has been contractually agreed;
  - the costs needed to complete the project have been reliably determined;
  - the degree of completion as at balance sheet date has been reliably determined;
  - the costs have been allocated to the correct projects (risk of misallocation);
  - the expected losses have been directly expensed in the income statement;

- establish that the treatment of construction contracts in the financial statements is not in accordance with DASB Guideline 221 'Construction Contracts'.

From its discussions with external auditors during the reviews, the AFM concludes that external auditors do not have adequate knowledge of the specific guidelines applying to the reporting of construction contracts. It also emerged from these discussions that clients prefer to recognise profits in the interim rather than on project completion. The reporting guidelines, however, specifically state that interim recognition is only permitted if the result can be reliably estimated. Generally speaking, this is the case if the company can provide a good estimation of the project's degree of completion, for instance by clear phasing, and the total costs have also been reliably estimated by means of sound budgeted costing. In a relatively large number of the statutory audits reviewed by the AFM, it emerged that the external auditor was not able to establish whether the audit client's administrative organisation was adequate to make a reliable interim estimate of the result from construction contracts. For example, due to the lack of budgeted and actual costing. In these cases the audit client is not permitted to recognise interim profit under the financial reporting guidelines. In many cases, the AFM concludes that the external auditor has failed to establish adequately whether the reporting guidelines have been correctly complied with.

The above shortcomings can be illustrated by the following example from the AFM's review:

Measurement of construction projects

The audit client is a construction company that is mainly active in residential and non-residential construction. The external auditor identified a significant risk that the item of construction projects had not been measured correctly. In its revenue recognition and the measurement of the construction contracts, the audit client had chosen to recognise interim profits. The external auditor however failed to assess whether interim profit recognition was permissible under DASB Guideline 221.

Additionally, the external auditor did not adequately assess the reliability of the amounts of profit on construction contracts to be recognised as estimated by the audit client. The external auditor did establish that these estimates reconciled with the progress reports prepared by the audit client, but he did not assess whether the information in these reports was reliable. The external auditor moreover attempted to assess the historical reliability of these estimates by comparing the estimates at the end of the previous financial year with the actual results realised in the subsequent financial year. The external auditor received explanations of the identified differences from the audit client, but failed to test whether these explanations were satisfactory.

5.2.3 Measurement of assets

After the audit of revenue recognition, the audit of the measurement of assets is the most frequently occurring focus element in the AFM's review. The AFM considered the audit of the measurement of assets in 60% of the statutory audits it assessed. Depending on the sector and the nature of the audit client's business, other assets were relevant to the assessment. Table 11 presents a summary of the statutory audits in which the AFM designated the measurement of assets as a focus element, divided into the various types of asset:

- immovable property and other property, plant and equipment;
- debtors;
- inventory;
- financial non-current assets.

The table also shows the percentage of the statutory audits with this focus element for which the AFM has identified serious shortcomings. In total, in 54% of these statutory audits the external auditors failed in the opinion of the AFM to obtain sufficient and appropriate audit evidence in relation to the measurement of the assets in question. The specific shortcomings for the various asset types are described in the paragraphs below.

Focus element	**Number of statutory audits with this focus element (% of total of 47 statutory audits)**	**Number of statutory audits with shortcomings in this focus element (% of number of statutory audits with this focus element)**
Measurement of assets	28 (60%)	15 (54%)
• Measurement of immovable property/property, plant and equipment	8 (17%)	3 (38%)
• Measurement of debtors	9 (19%)	6 (67%)
• Measurement of inventory	10 (21%)	7 (70%)
• Measurement of financial non-current assets	2 (4%)	2 (100%)

Table 11. Number of statutory audits with focus elements and number of statutory audits with shortcomings in these focus elements.

5.2.3.1 Measurement of immovable property and other property, plant and equipment

The AFM reviewed the audit of the measurement of property, plant and equipment in 8 statutory audits (17% of the total number of statutory audits assessed). This concerned statutory audits of companies in various sectors (trade, property, and service provision). In four cases the property, plant and equipment consisted of immovable property, and in the other four cases, of other property, plant and equipment.

Under the reporting regulations, the measurement of immovable property depends on the use of the property by the company concerned. In half of the cases, the property concerned land and business premises for the audit client's own use. In the other half of the cases the company owned the property with the intention of leasing it commercially.

The AFM identified serious shortcomings in relation to the audit of the measurement of immovable property or the other property, plant and equipment in 3 of the 8 statutory audits (38%). In one of these statutory audits, the external auditor completely neglected to plan and conduct audit procedures in relation to the measurement of the property, plant and equipment. The shortcomings occurring in more than one statutory audit concerned the external auditor's failure to:

- establish the accuracy of the investments and depreciation, and the resultant carrying amount of the property;
- establish whether there were indications of impairment;
- establish the accuracy of the information used to calculate the market value;
- take the WOZ value into consideration in the assessment of the fair value;
- establish that the financial statements and the disclosure were in accordance with the applicable reporting regulations.

The above shortcomings can be illustrated by the following example from the AFM's review:

Measurement of property, plant and equipment
The audit client is a service provider in the shipping industry: pleasure cruises and transport. The company's property, plant and equipment consists mainly of ships: pleasure craft and freighters. The ships are carried at current value. This means for this company that the ships are carried in the statement of financial position at replacement value at the time of revaluation or at the value in use, if this is lower than the replacement value. The replacement value is calculated by the company on the basis of valuations by recognised valuers. The company had valuations of the value of its freighters made for the financial year. This showed that the current replacement value of these freighters did not differ from the carrying amount in the statement of financial position. No revaluation was therefore necessary. On the basis of this valuation, the external auditors concluded that no valuations were necessary for the measurement of the pleasure craft. Without further substantiation, the external auditor wrongly concluded that the lack of a change in value of the freighters also applied to the pleasure craft.

5.2.3.2 Measurement of debtors

The measurement of the item debtors is in principle determined by the receivables the company has on customers that have purchased goods or services on account, taking account of the risk that some receivables cannot be collected. The AFM reviewed the audit of the measurement of debtors in 9 statutory audits (19% of the total number of statutory audits assessed). This concerned statutory audits of 7 trading companies and 2 service providers.

In 6 of these 9 statutory audits (67%) the AFM identified serious shortcomings in relation to the audit of the measurement of debtors. In one of these statutory audits, the external auditor completely neglected to plan and conduct audit procedures in relation to the measurement of the debtors item. In the other 5 audits, the shortcomings related to the fact that the external auditor had failed to establish the adequacy of the provision for non-performing debtors. The external auditor had in fact failed to check whether debtors had paid in the new reporting period ('review of after-date payments') or to carry out other audit work to obtain audit evidence regarding the measurement of debtors.

The above shortcomings can be illustrated by the following example from the AFM's review:

Measurement of debtors
The audit client is a service provider in the ICT industry. In his audit, the external auditor identified the provision for uncollectible receivables as a significant risk. He had planned to carry out a review of after-date payments to establish that cash payments had actually been received for the receivables outstanding at the closing date in the new financial year. The external auditor assessed whether bank receipts had been entered in the financial administration for the receivables outstanding at the closing date in the new financial year. This turned to be the case for all the receivables open at the closing date. However, with these activities the external auditor had only established that the receivables at closing date had been removed from the administration in the new financial year. He failed to check whether cash payments had actually been received in the audit client's bank account. He actually did not involve bank statements in his audit activities, nor did he assess whether bank receipts had been correctly applied by other means.

5.2.3.3 Measurement of inventory

The measurement of a company's inventory is partly determined by the type of inventory, whether it be raw materials and additives, semi-manufactured products, finished products or trading goods, and the extent to which the inventory has become obsolete (and is therefore worth less). The AFM assessed the audit of the measurement of inventory for 10 statutory audits (21% of the total number of statutory audits assessed). These included 11 trading companies and 1 production company.

In 7 of these 10 statutory audits (70%) the AFM identified serious shortcomings in relation to the audit of the measurement of inventory. The shortcomings in these statutory audits mainly concerned the external auditor's failure to:

- conduct a stock-take of the available inventory (including any goods on consignment);
- make a reconciliation between the inventory recorded and the inventory stated in the financial administration as at closing date;
- establish the accuracy of the prices and rates used for the calculation of the measurement: in particular, this concerns the prices and rates used taking account of discounts and any additional costs, including credit penalty mark-ups and transport charges;
- assess the adequacy of the provision for obsolete inventory, whereby the external auditor failed to:
    - determine the inventory turnover rate;
    - determine the age of the inventory on the basis of the stock list and the stock-take conducted;
    - determine whether account had been taken of all foreseeable losses.

The above shortcomings can be illustrated by the following example from the AFM's review:

Measurement of inventory of passenger vehicles

The audit client is a company that sells and repairs passenger vehicles. The external auditor had identified the measurement of the inventory of passenger vehicles as a significant risk for his audit. The vehicles present at the company fell into four categories:

1. new vehicles owned by the company and available for sale ('trading inventory');
2. new vehicles owned by third parties (such as suppliers) and available for sale ('consignment inventory');
3. new vehicles owned by the company but financed externally, and available for sale; and
4. vehicles on the company's land for the purpose of repairs, and thus not available for sale.

For his audit of the measurement of the inventory of passenger vehicles, the external auditor chose to conduct audit work solely for the trading inventory and the externally financed inventory. By not performing any audit activities for the consignment inventory and the vehicles under repair, the external auditor wrongly failed to obtain audit evidence in order to be able to establish the completeness of the inventory, and to be able to establish whether all the vehicles present were reported in the correct categories and therefore that the inventory had been correctly measured.

5.2.3.4 Measurement of financial non-current assets

The AFM assessed the audit of the measurement of financial non-current assets for 2 statutory audits (4% of the total number of statutory audits assessed). This concerned the item ‘investments’ as reported by two service providers in the funeral insurance business.

In both these statutory audits (100%) the AFM identified serious shortcomings in relation to the audit of the measurement of financial non-current assets. The shortcomings in these statutory audits mainly concerned the external auditor’s failure to:

- assess the acceptability and consistency of the accounting policies chosen for the investments;
- establish whether the accounting policy actually applied corresponds to the accounting policy disclosed in the financial statements;
- assess whether the annual statements the audit client says it has received from the bank are reliable and useful for his audit;
- establish whether the measurement of the investments is subject to impairment.

5.2.4 Using the work of auditor’s experts

An auditor does not always possess the necessary expertise in areas other than financial reporting or auditing to be able to obtain the audit evidence he needs. In these cases, the auditor will use the work of an auditor’s expert. This happens for instance in case of complex measurement issues, for instance the measurement of immovable property. If an auditor uses the work of an auditor’s expert, among other things he must establish that the expert is objective and has expertise, and evaluate whether the expert’s work is adequate.

The AFM has established that the external auditor had used the work of an auditor’s expert in four statutory audits in which the measurement of immovable property was the focus element in the file review. In these cases, the external auditor used a report from a valuer for the measurement of immovable property. In three of these statutory audits the AFM identified serious shortcomings regarding the use of the valuer’s report (see also table 5), where the external auditor failed to:

- assess the valuer’s work;
- establish the numerical accuracy of the valuation; and
- evaluate whether the valuer’s work was adequate.

Without carrying out these procedures, the external auditor cannot make use of the valuer’s work. If the external auditor himself has also not carried out any additional procedures to audit the measurement of the immovable property, he has not obtained sufficient and appropriate audit evidence on which to base his opinion regarding the measurement of the immovable property.

5.2.5 Going-concern assumption

In principle, a company's financial reporting is based on the assumption that the company will be able to continue its business operations in the foreseeable future. Among other things, this going-concern assumption by the company's management determines how assets and liabilities are formulated and presented in the reporting. It is the responsibility of the external auditor to obtain sufficient and appropriate audit evidence: firstly, to be able to assess whether this assumption is indeed appropriate in the case of the company concerned, and secondly, in order to conclude whether there is significant uncertainty regarding the company's continued existence. If use of the going-concern assumption is not appropriate or there is significant uncertainty regarding the company's continuity, the external auditor will state this in his audit opinion.[28]

As stated in table 5, in 14 of the 47 statutory audits assessed (30%) the AFM found reason to inspect whether and to what extent the external auditor had assessed the going-concern assumption. For example, the following events or circumstances referred to in the audit client's financial reporting or the external auditor's audit file could have been a reason to include an assessment of the going-concern assumption as a focus element of the audit:

- the audit client has suffered significant operating losses or the value of its principal assets has fallen significantly;
- the audit client has a negative operating cash flow or negative values for key financial ratios, which could lead to capital requirements not being met;
- there are fixed-maturity loans whose maturity date is approaching and there is no realistic prospect of renewal or repayment, or the audit client is not in a position to meet the conditions of the loan agreements;
- key members of the audit client's management have left the company and have not yet been replaced.[29]

In 5 of these 14 statutory audits (36%) the AFM identified serious shortcomings in relation to the audit of the going-concern assumption. In one case the external auditor completely neglected to plan and carry out audit procedures with regard to the going-concern assumption. In the other four statutory audits in which the AFM encountered serious shortcomings, the external auditors failed (among other things) to:

- consider whether there was reasonable doubt with respect to continuity;
- assess the estimate of the audit client's management with respect to continuity;
- assess the assumptions on which the budget or the cash forecasts were based that supported the going-concern assumption; and
- assess the audit client's funding structure, including its bank covenants and cash position.

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[28] *The lack of any reference to uncertainty regarding continuity in the audit opinion may not however be seen as a guarantee of the company's ability to continue in operation.*

[29] *This list is not exhaustive, and moreover the existence of one or more of these elements does not always mean that there is a significant uncertainty regarding the audit client's continuity. Further examples of events or circumstances that, separately or collectively, may raise doubts regarding the going-concern assumption are given in paragraph A2 of NV COS 570 'Continuity'.*

By not making these assessments, the external auditor did not obtain sufficient and appropriate audit evidence in order to be able to form an opinion with regard to the going-concern assumption used by the audit client.

The next example illustrates a situation in which the AFM concluded that the external auditor had performed adequate audit activities with respect to the going-concern assumption:

***Good practice*: assessment of the going-concern assumption**
The audit client is a company whose cash position at closing date is a cause for concern. The external auditor devoted attention to the company's continuity during each stage of his audit. At the start of his audit, he identified the company's continuity and the possibility it could not meet the financial ratios required by its bank as a significant risk for his audit. Despite its worrying cash position at closing date, the company's management was convinced of its ability to continue its business operations. The management asserted that the going-concern assumption was appropriate on the basis of new credit and facility agreements with its bank, an adequately filled order book for the near future and positive forecasts for its result and cash flow. The external auditor assessed these assertions with professional scepticism, questioned whether the arguments underlying the assertions were sufficient to assume that the business operations could continue, and made adequate record of this in his audit file. Furthermore, he insisted that the company management should include a clear disclosure of the company's cash position in its financial statements. Such a disclosure improves the users' insight into the company's financial position.

5.2.6 Other audit shortcomings

In addition to the focus elements selected in advance for which the findings are stated above, the supervisors at the AFM remained alert to the existence of any other serious shortcomings in all the statutory audits they assessed. In 22 (47%) of the statutory audits, they encountered serious shortcomings in parts of the statutory audit that fell outside the focus elements of the AFM's review. The number of other shortcomings per statutory audit varies from one to five. The following shortcomings were found in two or more statutory audits and relate to situations in which the external auditor failed to:

- clearly describe, substantiate and consistently apply the audit method chosen (primarily tests controls or substantive procedures) in the audit;
- carry out audit procedures designed to establish the existence of the debtors;
- record his deliberations, findings and conclusions with respect to the audit systematically and in mutual context in the audit file;
- state the reasons why the issuance of a disclaimer of audit opinion was the appropriate choice;
- close and archive the audit file in due time.

5.3 Quality of financial reporting

In addition to its assessment of the statutory audits, the AFM also assessed 61 financial statements[30] and thereby formed an impression of the quality of the financial reporting by the audit clients of SRA firms. The AFM's conclusion regarding the quality of the financial reporting on this basis is that quality was adequate in 20% of the cases, and inadequate in 80% of the cases.

In all the 61 audits originally selected, the AFM checked whether the audited financial reporting met the relevant reporting standards with regard to the following focus elements: the treatment of construction contracts, the measurement of inventory, the continuity of the company, the directors' report or the annual report, the cash flow summary, changes to accounting policies and the correction of errors.

The AFM designates the quality of the financial reporting as 'inadequate' in the following situations:

- if the financial statements do not show what the company is actually doing, for example if it is not clear whether there are works or construction contracts or not;
- if no attention is paid to the going-concern assumption, while the financial statements contain indications that there could be doubts regarding continuity;
- if no directors' report or cash flow statement is included;
- if the cash flow statement contains gross inaccuracies, such as the recognition of non-cash flow items in the financing cash flow or the investment cash flow, or failure to include comparative figures;
- if other shortcomings are found in the reporting that obscure the information on the capital and the result.

The AFM notes that in many cases, the shortcomings in the financial reporting concern reporting regulations that have been changed relatively recently. For instance, the directors' report does not contain all the new items that must be included, and the reporting in relation to construction contracts does not satisfy the new regulations that apply here.

The most important shortcomings identified by the AFM in the financial reporting of the 61 audit clients of SRA firms are described in paragraph 5.4.

5.4 Shortcomings in financial reporting

Paragraph 5.4.1 states the shortcomings found by the AFM in relation to the selected focus elements: the directors' report or the annual report, the cash flow statement, the treatment of construction contracts, changes to accounting policies and the correction of errors, and the continuity of the company. Paragraph 5.4.2 lists the other shortcomings identified by the AFM.

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30 *See also paragraph 3.3.3, which explains that the AFM selected a number of statutory audits as 'reserves'. The financial statements for these reserve audits were also assessed.*

5.4.1 Shortcomings in focus elements

5.4.1.1 The directors' report

In the directors' report accompanying the financial statements, the company's management presents a balanced and complete analysis of the situation as at balance sheet date, the developments during the financial year and the results, in accordance with the size and complexity of the legal entity and the group companies. This analysis usually contains both financial and non-financial performance indicators, including environmental and personnel-related matters. The directors' report also describes the principal risks and uncertainties with which the entity is faced.[31]

Of the 61 financial statements assessed by the AFM, 14 (23%) contained no directors' report at all. In the 47 directors' reports the AFM was able to assess in terms of substance, in the AFM's opinion the following analyses and items that are required by law were missing:

- a description of the status and expected developments with respect to investment (40%), workforce (53%) and financing (60%);
- a paragraph on risk (64%);
- a description of price, liquidity and market risk (64%); and
- a description of the management of risk associated with financial instruments (81%).

5.4.1.2 The cash flow statement

Although the obligation to include a cash flow statement in the financial reporting arises only from the Annual Financial Reporting Guidelines issued by the Dutch Accounting Standard Board and is not included in the Civil Code, the AFM found a cash flow statement in 55 of the 61 financial statements it assessed (90%). However the AFM also noted that these cash flow statements do not meet the legal requirements in all respects:

- In approximately 16% of cases, the cash flow statement did not include comparative figures for the previous financial year;
- In approximately 62% of cases, the cash flow statement included items in the investment cash flows that are not cash flow items;
- In approximately 38% of cases, the cash flow statement included items in the financing cash flows that are not cash flow items;
- In approximately 24% of cases, there was no reconciliation between the cash flow statement and the balance sheet in the financial statements with regard to the movement in cash;

31 *Article 2:391 BW states the information the management of a legal entity must provide in its annual report. In 2005 this article was expanded to include the obligation to include information on matters including financial instruments and the company's risk management.*

- In 17 of the 20 cases in which the financial statements included exchange-rate differences, these differences were included in the operating cash flow in the cash flow statement, rather than in the reconciliation between the cash flow statement and the statement of financial position.

The above shortcomings can be illustrated by the following example from the AFM's review:

Non-cash flow items in the cash flow statement

1. The company measures its property, plant and equipment at current value. A recent valuation revealed that the current replacement value was higher than the carrying amount. The company therefore revalued its property, plant and equipment, however it incorrectly recognised this revaluation as an investment cash flow in the financial statements. Revaluations do not generate cash flows.
2. Company A has provided a long-term loan to Company B. Company A has recognised this loan in its financial statements under financial non-current assets. When Company B went bankrupt, Company A wrote the loan off because it was no longer collectible. Company A incorrectly presented the write-off of the loan as an incoming investment cash flow in its cash flow statement. Write-offs do not generate cash flows.

5.4.1.3 Construction contracts

The processing, measurement and presentation of construction contracts is governed exclusively by the Guidelines issued by the Dutch Accounting Standard Board (DASB), and is not covered by the Civil Code. The AFM found 19 cases in which companies recognised income and expenses from construction contracts on behalf of third parties. In its assessment of the financial reporting, the AFM found shortcomings in the majority of financial statements featuring construction contracts. The shortcomings concern the following:

- The method used to determine the percentage of the works completed is either not stated, or is not correct;
- The income statement does not state the income from construction contracts;
- In the notes, information on the cumulative total of the recognised project income, the total advance payments received, the sums retained by the project principals, the costs capitalised for services not yet provided and a breakdown of the item of construction contracts into debit and credit items is missing.

In 2008 the Dutch Accounting Standards Board published a new Guideline 221 with respect to construction contracts. The AFM has established in numerous cases that this new guideline is not (or not fully) observed and that construction contracts are still being reported according to the old reporting regulations.

The above shortcomings can be illustrated by the following example from the AFM's review:

Determining the percentage of completion

The percentage of completion of a construction contract can be determined in various ways. The company chooses the method whereby the percentage of completion of the construction contract can be reliably determined. Depending on the nature of the contract, the following methods may be used:

- the project expenses incurred until the closing date in relation to the budgeted project expenses;
- inspection of the part of the project that has been completed; or
- completion of a physically distinguishable part of a project.

In several financial statements the AFM found a statement that the percentage of completion is determined on the basis of invoiced instalments. This method is expressly not stated in the Annual Financial Reporting Guidelines issued by the DASB and in case of arrears in the invoicing will lead to an incorrect result being reported.

5.4.1.4 Changes to accounting policies and correction of errors

The AFM noted that one set of financial statements included a change to accounting policies, and four included a correction of errors. The four financial statements in which errors were rectified did not meet the requirements applying to the correction of errors. In three cases, the type of the error was not clearly stated. In one of the financial statements in which fundamental errors were corrected, the correction was not correctly presented in the result and was incorrectly applied directly to equity, the comparative figures were not adjusted and the correction of the fundamental error was not applied in the right financial year.

5.4.1.5 Measurement of inventory

In its assessment of the 61 financial statements selected, the AFM found that the method used to measure inventory was only clearly stated in 21% of cases (for example, FIFO or LIFO). Approximately 4% of the financial statements did not provide a specification in the disclosure relating to the inventory recognised in the statement of financial position.

5.4.1.6 Company continuity

In its assessment of 61 financial statements, in 4 cases the AFM would in any case have expected to see a further disclosure with respect to the company's continuity. This disclosure was actually provided in these cases.

5.4.2 Other shortcomings in financial reporting

In addition to the shortcomings found in relation to the focus elements, the AFM also found shortcomings in the financial reporting with regard to the principle for determining the result, the use of financial statements templates and the publication of the financial statements.

5.4.2.1 The principle for determining the result

The way in which a company determines its result in its financial reporting depends among other things on the business of the company concerned. In around 23% of the cases, the AFM found that the principle for determining the result was not appropriate to the company's business.

The above shortcomings can be illustrated by the following example from the AFM's review:

Reporting of income by a child care facility
The AFM found the following policy with regard to the recognition of income in the financial statements of a company providing child care. "Income from the sale of goods is recognised in the income statement if all material entitlements to economic benefits as well as all material risks relating to the goods are transferred to the buyer, the amount of the income can be reliably determined and receipt of the income is likely."

This policy would not appear to apply to the actual business of the company, which actually provides a service in the form of child care.

5.4.2.2 The use of financial statements templates

Specific templates are prescribed for the structure and classification of the financial statements, in particular the statement of financial position and the income statement. Dutch legal entities are free to choose a template that they must use consistently thereafter. The income statement presents income and expense items separately. This division is made either on the basis of the nature of the income and expense items (known as the income statement by nature) or on the basis of the function of the income and expense items for the entity (known as the income statement by function). The AFM notes that 65% of the financial statements it assessed wrongly apply a sort of hybrid model, in which the income statement is initially presented by function and then later by nature. However, this leads to incorrect figures being stated in particular for the items 'cost of sales' and 'gross profit or loss on sales/gross margin'.

5.4.2.3 Publication of the financial statements

In principle, financial statements should be published by means of filing with the Chamber of Commerce within just over seven months[32] after the end of the financial

32 The financial statements must in principle be prepared within five months of the end of the financial year, and must be submitted to the general meeting of shareholders within two months. The general meeting of shareholders is not legally obliged to year. Only in extraordinary circumstances can the general meeting of shareholders grant additional time to the company management for the preparation of the financial statements. The additional time granted may not be more than 6 months, so that the maximum period permitted for filing comes to 13 months after the end of the financial year.[33]

Virtually all the financial statements assessed by the AFM had also been filed with the Chamber of Commerce. Nine companies have not (or not yet) filed their financial statements at the Chamber of Commerce. Four of these nine financial statements relate to a financial year closing on 31 December 2011.

The filed financial statements are made publicly available on average six months (185 days) after the close of the financial year. The AFM has the following remarks concerning these filed financial statements:

- In 13 cases, the period between the general meeting of shareholders and the filing at the Chamber of Commerce is more than 8 business days. The law obliges companies to file their financial statements at the Chamber of Commerce within 8 business days after the financial statements are adopted by the general meeting of shareholders;
- In 4 cases, the date of the audit opinion is after the date of the general meeting of shareholders. The audit opinion should, however, be included in the Other Data section of the financial statements that are submitted to the general meeting of shareholders. The general meeting of shareholders cannot adopt financial statements if an audit opinion is required by law and the meeting has no knowledge of the audit opinion;[34]
- In 11 cases, the period between the date of the audit opinion and the date of the general meeting of shareholders was more than two months. Submission of financial statements to the general meeting of shareholders within two months of preparation is a statutory requirement;
- 10 financial statements were filed later than 7 months after the close of the financial year. In other words, these companies used the option of postponement. The AFM seriously doubts whether all these cases actually involved the ‘extraordinary circumstances’ that are required to justify postponement, and considers it likely that the companies see the postponement option as a formality that can be taken for granted.

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adopt the financial statements submitted, however it usually does so. The financial statements must be filed within eight days. After a period of 13 months, a company must file whatever is available at that time immediately.

33 See Article 2:394 (3) BW.

34 Not adopting the financial statements may have consequences for matters such as the distribution of the profit of the legal entity, the repurchase of the entity’s own shares and the submission of the financial statements to the works council.

6 Further course of the thematic review

With its assessment of 47 statutory audits by 20 SRA firms, the AFM has formed an impression of the state of affairs at part of the non-PIE audit firms. The actions the AFM expects to see taken by the 20 SRA firms assessed are listed in paragraph 6.1. Paragraph 6.2 describes how the AFM will assess and follow up the action plans prepared by the SRA firms. In conclusion, paragraph 6.3 explains the intentions of the AFM in the dialogue it will initiate with the sector.

6.1 Actions in relation to shortcomings

The AFM has listed the actions it expects to see taken in the written reports it has sent to the 20 SRA firms. Table 12 presents a summary of the actions the AFM expects the 20 SRA firms it assessed to take, and the number of firms to which these actions apply.

Action	Number of firms
No action necessary	2 (10%)
Rectification of shortcomings, root cause analysis and action plan	18 (90%)

Table 12. Actions in relation to shortcomings

If the AFM did not identify any shortcomings in the quality of the statutory audits during its review, no action by the firm in question is required. This was the case for 2 of the 20 SRA firms (10%). Naturally, these firms must also continue to strive to maintain their quality at the desired level.

If the review shows that the quality of one or more of the statutory audits were inadequate, the firm in question must take action. The AFM has first requested the 18 SRA firms (90%) for which at least one statutory audit has been qualified as ‘inadequate’ to rectify the shortcomings identified in these statutory audits. This means, if the file review revealed that the audit evidence obtained was insufficient or inappropriate, the external auditor concerned still has to obtain sufficient and appropriate audit evidence and must repeat the process of forming an opinion with regard to the financial statements as a whole. This may mean that the external auditor will have to return to the audit client and that the new opinion may differ from the previously issued audit opinion. This could mean that the auditor will have to change his audit opinion, and that the audit client will have to amend its financial statements.

Secondly, the AFM has requested these firms to carry out a root cause analysis. In a root cause analysis, the audit firm itself inspects whether the shortcomings identified by the AFM occur more frequently, and what the causes of the shortcomings are (or the firm instructs an external party to inspect the matter). The AFM has sent a number of sample questions to the SRA firms that can be used as the basis for the root cause analysis (see Appendix 2 to this report).

During the review, the AFM expressly asked each of these 18 firms to consider carefully whether the firm would be able to bring its audit practice up to the required quality standard. If the firm in question sees possibilities for improving the quality of its statutory audits, it will prepare an action plan based on its root cause analysis. The firms have been given three months to formulate an action plan and submit this to the AFM.

An action plan includes:
- a description of the root cause analysis;
- the measures designed to rectify the shortcomings in the statutory audits identified by the AFM;
- the measures that will prevent shortcomings from occurring in statutory audits in future.

Depending on the causes identified by the audit firm for the shortcomings found by the AFM, it is important that measures are taken that will remove these causes and thereby prevent repetition of the same shortcoming in future. The measure may concern improvement to the audit firm's quality control system, such as its standard audit approach or its consultation procedure. It may also be necessary to no longer allow poorly performing auditors to continue to act as external auditors and to remove them from the public register of the AFM. The most extreme measure an audit firm may have to take in order to prevent repetition is to cease performing statutory audits and to request the AFM to withdraw the firm's licence.

In its action plan, the audit firm should also describe for each measure:
- exactly what the measure involves;
- when the measure will be implemented and completed;
- who is responsible for the measure;
- how the audit firm will monitor the progress of the measure; and
- how the audit firm will evaluate the effectiveness of the measure.

6.2 Assessment and follow-up of action plans

The AFM will assess the action plans it receives in the third quarter of 2014, and will review them in general terms. In other words, the AFM will assess whether the measures taken to repair the inadequately performed statutory audits are adequate. The AFM will also consider whether the measures designed to improve quality formulated on the basis of the root cause analysis should in principle lead to adequate performance of statutory audits in future. The AFM will inform the firms of its opinion and how it wishes to see matters proceed further.

If the AFM considers, based on the review and the action plans received, that the firm does have the potential to raise its statutory audit practice to the necessary level of quality, a further file review will be conducted in 2014. The intention here is to assess whether the measures have indeed had the desired effect on quality. These file reviews will be conducted by the AFM at the SRA firms in cooperation with the

SRA on the basis of the covenant. Among other things, the file reviews will establish whether the implementation of the action plan has led to the necessary improvement in the quality of statutory audits. Should the performance of statutory audits still not be up to standard, the AFM may as yet impose formal enforcement measures.

If on the basis of its review and the action plans received the AFM takes the view that a firm is not in a position to perform high-quality statutory audits, it will in the first instance enter into a dialogue with the firm in question, including raising the question of whether retention of the firm's licence is still appropriate. This dialogue may lead to further investigation by the AFM and the imposition of formal enforcement measures if necessary. These include the issuance of an instruction, the imposition of an order for incremental penalty payments or an administrative fine, the submission of a complaint to the Disciplinary Court for Auditors, of, in the most extreme cases, withdrawal of the licence. The enforcement measure imposed will be determined for each firm on the basis of our enforcement policy.

6.3 Dialogue with the sector and sector-wide improvements

The AFM believes that the quality problem affects the entire group of SRA firms with a non-PIE licence, and calls on these firms to review the quality of their statutory audits and take measures accordingly. The AFM moreover wishes to enter into a constructive dialogue with the sector, including the non-PIE audit firms and their advisers, the professional organisations and their assessors. The intention is that this dialogue will contribute to the formulation of sector-wide measures that will achieve an improvement in quality. The AFM will discuss the possible causes of the shortcomings identified and the various sector-wide measures designed to remove these shortcomings with the boards of the NBA and the SRA. The AFM will speak to the advisers of non-PIE audit firms and the assessors of the professional organisations regarding what the AFM understands by 'the right level' of quality of statutory audits.

The SRA now offers the opportunity to its affiliated firms to take the course "Learning lessons from the AFM's thematic reviews (non-PIE firms)".[35] This course explains the AFM's findings and conclusions and deals with the subsequent measures to improve quality. The NBA has announced a mandatory PE subject relating to audit quality for all public auditors.[36] A review is also underway to determine how the training of auditors can be better formulated.

As part of the covenant with the SRA, other assessments will also be made in 2014 at SRA firms that have not been included in the AFM's thematic review. Among other things, it will be established whether the shortcomings described in this report also apply to these other firms.

35 See https://www.sra.nl/educatie/eocu-lessen-trekken-uit-afm-themaonderzoeken-(niet-oob-kantoren).

36 See http://www.nba.nl/Voor-leden/Permanente-educatie/Verplicht-PE-onderwerp-20142015/

Appendix 1: Tables in section 4

The information in the tables below originates from the AFM Monitor of Audit Firms 2012. The Monitor is one of the supervisory instruments used by the AFM in the conduct of its continuous supervision of audit firms. It is a questionnaire whereby audit firms provide information to the AFM each year that the AFM needs to conduct its supervisory duties effectively and efficiently. The audit firms thereby contribute to the objectives of the legislation and regulation. The AFM uses this information to obtain knowledge regarding individual audit firms, but also regarding all licensed audit firms collectively. The Monitor 2012 was completed by the audit firms in the period November/December 2012. The figures presented are based on information provided by the audit firms to the AFM. The AFM has not analysed the information provided to verify that it is reliable.

Table 13 states the number of audit firms licensed by the AFM to perform statutory audits and the number of statutory audits they perform.

Category of licensees	**Number of licensees**	**Number of licensees with statutory audits**	**Total number of statutory audits**	**Average number of statutory audits per licensee**
Non-PIE audit firms	447	366	6,854	19
SRA	265	232	5,842	25
(20 in sample)	(20)	(20)	(920)	(46)
NBA	182	134	1,012	8
PIE audit firms	13	13	14,574	1,121
Big 4	4	4	11,410	2,853
Other PIE	9	9	3,164	352
Total	460	379	21,428	57

Table 13. Number of licensees per category and number of statutory audits

Table 14 shows the total amount of net revenue the Wta licensees realised for their services. It also states the amount of revenue derived specifically from the conduct of statutory audits. Lastly, the average revenue per statutory audit is stated.

Category of licensees	**Total net revenue (x €1m)**	**Revenue from statutory audits (x €1m)**	**Revenue from statutory audits/total net revenue**	**Average revenue per statutory audit (x €1,000)**
Non-PIE audit firms	1,144	117	10%	17
SRA	981	100	10%	17
(20 in sample)	(171)	(14)	(8%)	(16)
NBA	163	17	10%	17
PIE audit firms	1,752	690	39%	47
Big 4	1,465	609	42%	53
Other PIE	287	81	28%	26
Total	2,9	807	28%	38

Table 14. Total net revenue and revenue from statutory audits

Table 15 shows the number of external auditors involved in the conduct of the statutory audits as stated in table 13.

Category of licensees	**Number of external auditors involved in statutory audits**	**Number of statutory audits per external auditor**
Non-PIE audit firms	843	8
SRA	632	9
(20 in sample)	(73)	(13)
NBA	211	5
PIE audit firms	621	23
Big 4	435	26
Other PIE	186	17
Total	1,464	15

Table 15. Number of external auditors and number of statutory audits per auditor.

Appendix 2: Sample questions for root cause analysis

Sample questions that can be used by audit firms to examine whether the shortcomings identified by the AFM occur more frequently and what the causes of the shortcomings are:

1. Are the findings exceptional in nature, or do they also occur in:
    a. other statutory audits performed by the same external auditor(s)?
    b. statutory audits in a specific industry sector (such as construction, property, financial sector)?
    c. statutory audits by other external auditor(s) at your organisation?

   To answer this question, your organisation will itself have to assess the quality of a number of other statutory audits. You may also have this assessment made by someone outside your organisation.
2. Has your organisation accepted engagements to conduct statutory audits from audit clients for which it is difficult to perform a high quality statutory audit? This may for instance be due to specific features of the clients in question, such as an inadequate administrative organisation and system of internal controls, limited interest from the management in a critical audit, or a business culture that is ethically questionable.
3. Do the auditors acting on behalf of your organisation as external auditors possess adequate specific knowledge and experience (including of the industry sector) to carry out statutory audits they are involved in properly?
4. Do the other employees at your organisation who are involved in the conduct of statutory audits possess adequate specific knowledge and experience to perform their procedures properly?
5. Are the budgets made available to your external auditors (in terms of both time and money) adequate for statutory audits to be performed properly?
6. Are the budgets made available to your external auditors (in terms of both time and money) adequate for statutory audits to be performed properly? By the term 'adequate audit resources', the AFM means, among other things, a standard audit approach with adequate specific working programmes, formats, manuals and internal guidelines that safeguard the quality of the conduct of statutory audits.
7. Do your external auditors have sufficient possibilities to obtain advice from experts if necessary (either an internal expertise centre or external experts) and do they make adequate use of these consultation facilities?
8. Does your organisation conduct engagement quality control reviews (EQCRs) on enough statutory audits and on the right statutory audits, and are these EQCRs conducted with sufficient rigour?
9. Does your organisation include a sufficient number of statutory audits in the evaluation of your quality control system (through regular internal reviews)?
10. Do you, as the management (and policy-makers) of your organisation, adequately promote the principle that statutory audits must be performed to a high level of quality, and do you create a culture that encourages quality orientation in both principle and practice? Is quality a central priority in your organisation's vision and mission, in your organisation's manuals, in your internal training courses,

and is this reflected in the evaluation and remuneration of your auditors and other employees?

11. Have the findings of this review by the AFM been included in previous reviews, including the licensing process, other reviews by the AFM or other institutions? If so, you should include these instances in your root cause analysis.

The Netherlands Authority for the Financial Markets (AFM)
T +31(0)20 797 2000 | F +31(0)20 797 3800
Postbus 11723 | 1001 GS Amsterdam

www.afm.nl

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