

## **Thematic review of non-PIE audit firms**

### **Part 1: NBA firms**

**11 July 2013**

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## **The Netherlands Authority for the Financial Markets (AFM)**

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The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. The AFM promotes the conscientious provision of financial services to consumers and supervises the honest and efficient operation of the capital markets. Our aim is to improve consumers' and the business sector's confidence in the financial markets, both in the Netherlands and abroad. In performing this task the AFM contributes to the prosperity and economic reputation of the Netherlands.

## **Contact**

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

## Contents

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|   |  |    |
|---|--|----|
| 1 | Introduction   | 4  |
| 2 | Drastic measures needed to bring the quality of audits by NBA firms up to standard | 6  |
| 3 | Thematic review  | 12 |
|   | 3.1 <i>Background</i>  | 12 |
|   | 3.2 <i>The thematic review</i>   | 13 |
|   | 3.3 <i>The review process</i>  | 13 |
| 4 | The audit market for NBA firms   | 18 |
|   | 4.1 <i>Size of the NBA firms</i>   | 18 |
|   | 4.2 <i>Features of the audit practice at NBA firms</i>                             | 21 |
| 5 | Findings of the review   | 23 |
|   | 5.1 <i>Quality of the statutory audits</i>   | 23 |
|   | 5.2 <i>Shortcomings in statutory audits</i>  | 29 |
|   | 5.3 <i>Quality of financial reporting</i>  | 45 |
|   | 5.4 <i>Shortcomings in financial reporting</i>                                     | 46 |
| 6 | Further development of the thematic review   | 51 |
|   | 6.1 <i>Actions in relation to shortcomings</i>                                     | 51 |
|   | 6.2 <i>Assessment and follow-up of action plans</i>                                | 52 |
|   | 6.3 <i>Dialogue with the sector and sector-wide improvements</i>                   | 53 |
|   | Appendix 1: Tables in section 4  | 55 |
|   | Appendix 2: Sample questions for root cause analysis                               | 57 |

## 1 Introduction

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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 the 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.<sup>1</sup> 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 conducting statutory audits, audit firms provide many other services to their clients. 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 perform quality assessments, on the NBA’s behalf, of audit firms that are 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,<sup>2</sup> which contain agreements regarding cooperation in the

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<sup>1</sup> Section 1 subsection 1 item 1 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”.

<sup>2</sup> 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 carried out

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 cooperative agreements 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 NBA firms with a non-PIE licence. These firms conduct statutory audits exclusively of enterprises that are not designated as being of public interest. These firms conduct just over 5% of all the statutory audits in the Netherlands. Of the total revenue arising from statutory audits, 2% goes to NBA firms. In addition to carrying out statutory audits, the NBA firms earn on average approximately 90% of their revenue from the provision of other services.<sup>3</sup> The AFM expects to publish a report in relation to its review of the SRA firms at the end of 2013.

The Audit Firms Supervision Act [*Wet toezicht audit firms*, 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 NBA 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 30 NBA firms. Section 4 presents a brief analysis of the market, with information on the size of the NBA firms and the nature of the audit practice at these firms. Section 5 presents 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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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.

<sup>3</sup> For further information on the size of the NBA firms and other features of their audit practice, see Section 4 of this report.

## **2 Drastic measures needed to bring the quality of audits by NBA firms up to standard**

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The AFM's conclusion is that a large number of NBA firms with a non-PIE licence will have to take drastic measures in order to bring the quality of their statutory audits up to the required standard. Based on the file reviews at 30 NBA firms, the AFM has formed an impression of the quality of the statutory audits conducted by NBA firms with a non-PIE licence. The conduct of the statutory audits at the audit clients of these 30 NBA firms was of insufficient quality in 79% of the cases. The AFM expects this quality problem to apply to the entire group of NBA firms with a non-PIE licence.

The NBA plays an important part in supporting the NBA firms and their external auditors in implementing the required quality improvements. The AFM considers that sector-wide measures are needed to encourage a radical improvement in quality at NBA firms. The AFM will initiate a constructive dialogue with the NBA and thus contribute to the formulation of these measures.

### **Quality of statutory audits and financial reporting is not satisfactory**

The AFM identified serious shortcomings in 50 of the 63 statutory audits by 30 NBA 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 58 of the 78 financial statements it assessed.

In table 1, the AFM classifies the quality of the 63 statutory audits it assessed into four categories, with the statutory audits in category 1 being of the highest relative quality and the statutory audits in category 4 the lowest:

| <b>Category</b> | <b>Number of<br/>statutory audits</b> | <b>Assessment</b> | <b>Remarks</b>  |
|-----------------|---------------------------------------|-------------------|---|
| 1               | 13 (21%)                              | Adequate          | No serious shortcomings.  |
| 2               | 13 (21%)                              | Inadequate        | Inadequate audit procedures conducted regarding specific items.   |
| 3               | 21 (33%)                              | Inadequate        | Some audit procedures conducted, however very basic audit techniques either not or incorrectly applied. |
| 4               | 16 (25%)                              | Inadequate        | No or very few audit procedures conducted, mainly administrative and compilation work only.             |

*Table 1. Quality of 63 statutory audits assessed in four categories.*

The AFM notes that the quality of the statutory audits conducted by the 30 NBA firms assessed (non-PIE licence holders) is lower than that of the statutory audits conducted by PIE licence holders. The percentage of statutory audits qualified as 'inadequate' in previous AFM reviews in 2010 was 63% at the Big 4 audit firms and 74% at the other nine PIE audit firms in early 2013.<sup>4</sup> The shortcomings in the statutory audits at the NBA firms assessed were, however, different in nature. The shortcomings at the PIE audit firms mostly concerned specific areas of the statutory audit (category 2 in table 1). However with respect to the statutory audits conducted by NBA firms, in 58% of the cases basic audit techniques were not used or applied incorrectly, or few or no audit procedures were conducted at all.

### **Quality of the external auditor is the main distinguishing feature**

The AFM assessed 21% 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 responsible external auditor, the audit firm, the statutory audit and the audit client concerned. The review of the NBA firms shows that the size of the client portfolio of the individual auditor and of the audit firm and the size of the audit clients are not related to the quality of the statutory audits conducted. Statutory audits conducted by larger NBA firms, by auditors who carry out a greater number of audits or audits conducted for larger audit clients are thus not necessarily of better quality.

The AFM did, however, qualify a statutory audit as 'adequate' more frequently in the following cases:

- the external auditor had been registered as an auditor relatively recently;
- the audit client operates in a sector that is relatively straightforward for audit purposes, such as trade;
- the audit opinion concerns a disclaimer of opinion; or
- an engagement quality control review (EQCR) had been carried out on the statutory audit.

The AFM concludes from the above that it is mainly the quality of the person who acts as the external auditor that determines the quality of the statutory audit. Auditors who have relatively recently been registered as auditors appear to have a fuller understanding of audit standards and reporting regulations. Auditors tend to select training and courses they take as part of their mandatory permanent education that relate mainly to adjacent professional areas (such as tax, company law, management), while they devote little or no time to keeping their knowledge and expertise regarding auditing and reporting up to standard. External auditors can deliver adequate quality more frequently when a relatively simple statutory audit is involved. For instance, if the audit client is a trading company and therefore its business is relatively straightforward from an audit perspective. Or because the

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<sup>4</sup> 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.

external auditor issues a disclaimer of opinion and does not have to conduct any system-related procedures in order to deliver an opinion regarding the operation of the internal controls. Moreover, an independent engagement quality control reviewer can bring a less diligent external auditor or a less diligent audit up to standard and improve the quality of the statutory audit prior to the issuance of the audit opinion.

### **The AFM expects NBA firms to take action**

The AFM has sent a written report to the 30 NBA firms informing them of the actions the AFM expects them to take. The AFM has requested the 28 NBA firms (93%) 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.

At 24 of the NBA firms reviewed (80%), the number of statutory audits qualified by the AFM as ‘inadequate’ is so great and the shortcomings identified are so serious that the AFM has requested these firms to carry out a root cause analysis. In a root cause analysis, the audit firm itself investigates whether the shortcomings identified by the AFM have occurred more frequently and what the causes of the shortcomings were. During its review, the AFM expressly asked each of these 24 firms to seriously consider the question of whether they are able to bring their audit practice up to the required level of quality or whether it would be better for them to cease performing statutory audits. 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 action plan will contain measures that firstly will rectify the shortcomings in the statutory audits identified by the AFM and secondly prevent shortcomings from occurring (or reoccurring) in the statutory audits the firm conducts in future.

In the case of only two NBA firms (7%), the AFM does not expect any direct action since it did not identify any serious shortcomings in the statutory audits performed by these firms. Actually, this concerned statutory audits that led to a disclaimer of opinion or for which the audit client was a trading company. Naturally, these firms will also be expected to continue to strive to maintain their quality at the desired level.

### **Limited effect on the audit market**

While approximately 180 NBA firms possess a non-PIE licence and around 210 external auditors work for these firms, the conduct of statutory audits is not the principal business of these firms in most cases. 73% of the NBA firms perform at most five statutory audits; 26% of the NBA firms actually make no use of the licence whatsoever. The NBA firms which do perform statutory audits serve a limited part of

the audit market: they account for barely 5% of all statutory audits and thereby generate only 2% of the total revenue from statutory audits.

For many audit clients, the statutory audit is an additional service to other services taken, such as administrative and tax-related services, that completes the total package of services they purchase from their auditor. For these audit clients, the statutory audit is of relatively little importance. The NBA firms appear to see their licence primarily as enabling them to offer a total service package to these audit clients. The added value of these statutory audits is, in view of the numerous shortcomings regarding the quality of the audit, therefore very limited.

#### **Drastic measures needed: improve or perhaps even stop**

The AFM appeals to all NBA firms to review the quality of their statutory audits and to take appropriate action. The AFM expects that some NBA 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 from 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 EQCRs of statutory audits.

For the majority of the NBA firms however, the AFM is aware that quality-improving measures such as adjustments to internal procedures and taking courses will not be sufficient to bring the quality of statutory audits up to a satisfactory level. The shortcomings at these firms are so serious that the improvements needed are probably not feasible in the short term. This concerns situations in which the external auditors in question have failed to carry out any audit at all although they think that they have, or they have failed to apply very basic audit skills or have applied them incorrectly. The AFM expects that these firms will have to take more drastic measures, including deregistration from the register of the AFM of poorly functioning external auditors. For audit firms with only a single or a limited number of external auditors, this means that they will have to consider the most extreme measure to prevent the repetition of quality issues, namely the cessation of performance of statutory audits and requesting the AFM to withdraw their licence. They can then concentrate fully on their other services, which already account for approximately 90% of their revenue. In view of the limited impact of the NBA firms on the audit market, the AFM does not expect problems to occur as a result of a possible transfer of statutory audits to other audit firms. For a small number of firms, the situation is so dire that the AFM will contact these firms in the near future to discuss the question of whether retention of their licence is still appropriate.

#### **Assessment and follow-up of action plans**

The AFM will assess the action plans it receives in the third quarter of 2013. 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. Should this dialogue not lead to the desired outcome, the AFM will conduct further investigation and move to the imposition of formal enforcement measures if necessary. These measures may include withdrawal of the licence, submission of a complaint to the Disciplinary Court for Auditors or imposition of an administrative fine. The enforcement measure to be used will be determined in each case on the basis of a consideration of effectiveness and legal feasibility in accordance with our enforcement policy.

If, in the AFM's view, 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 NBA firms on the basis of the covenant in collaboration with the NBA<sup>5</sup> and among other things will establish whether implementation of the action plan has led to an improvement in the quality of the statutory audits. Should the performance of statutory audits still not be up to standard, the AFM can as yet consider the imposition of formal enforcement measures.

### **Sector-wide improvements needed**

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. This dialogue can contribute to the formulation of sector-wide measures that will achieve an improvement in quality.

One of these sector-wide measures is the introduction of mandatory PE programmes for all auditors working in the profession in 2014. The NBA announced this requirement on 21 June 2013.<sup>6</sup> There are three elements to the requirement: (i) a course focusing on communication skills to increase the auditor's signalling function, (ii) a knowledge test focusing on relevant regulation (including the Further Regulations for Audit and Other Standards [*Nadere voorschriften controle- en overige standaarden*, or NVCOS]) and (iii) discussion of an audit file with a mentor. The AFM endorses the need for this mandatory PE so that basic knowledge and skills in relation to auditing and reporting can be regularly refreshed and embedded. The AFM furthermore expects the sector to embrace the quality improvement programme announced by the NBA for the exchange of knowledge and experience in relation to quality and quality control.

Another measure is to increase the standards required in the basic accountancy qualification. Advisory committees at both the Committee for final accountancy

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<sup>5</sup> See the newsletter "Covenant NBA and AFM on the testing of audit firms" of 6 September 2012 on the website [www.afm.nl](http://www.afm.nl).

<sup>6</sup> See the newsletter "NBA presents mandatory PE programmes for improvement in signalling function and audit quality" of 21 June 2013 on the website [www.nba.nl](http://www.nba.nl).

qualifications [*Commissie eindtermen accountantopleiding*, or CEA] and the Netherlands Institute of Chartered Accountants [*Nederlandse Beroepsorganisatie van Accountants*, or NBA] have published reports containing recommendations for a new model for the accountancy qualification. The current qualification does not appear to be still adequate for daily practice, whereby auditors are mostly either employed in the SME sector or work for larger clients such as PIEs. The AFM takes the view that training could be brought more into line with practice, with more attention devoted to specialist areas such as the audit of semi-public or public institutions, financial institutions and IT environments.

As part of the covenant with the NBA, other assessments will also be made in 2014 at NBA 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.

#### **Review of SRA firms**

The AFM will also review the quality of the statutory audits performed by 20 SRA firms in the third quarter of 2013, and will publish the findings of this review at the end of the year. The AFM calls on the SRA firms to take note now of the findings of the review of the NBA firms and to take proactive measures where necessary.

### **3 Thematic review**

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#### **3.1 Background**

The Audit Firms Supervision Act [*Wet toezicht audit firms*, 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 investigation, the AFM granted a non-PIE licence to 463 audit firms on 29 September 2008.<sup>7</sup> 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.<sup>8</sup> 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<sup>9</sup>, 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 clients. This applies to the management of these audit clients, but also for

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<sup>7</sup> See the report "Licensing under the Audit Firms (Supervision) Act leads to quality improvement" of 29 September 2008.

<sup>8</sup> 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.

<sup>9</sup> 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.

external parties such as suppliers, creditors, shareholders, banks, the Tax & Customs Administration, and also De Nederlandsche Bank if a pension fund 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 NBA firms. At the end of 2013, the AFM expects to publish its report on the review of the SRA firms. Finally, the AFM will enter into 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.<sup>10</sup> 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.

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<sup>10</sup> 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>.

This consists of 30 NBA firms and 20 SRA firms.<sup>11</sup> The thematic review will be carried out in a consistent manner at all 50 firms selected.

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 purpose of the selection, the AFM divided the firms into three 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 61% of the NBA firms conduct either no statutory audits or not more than three statutory audits, the AFM limited the number of firms in this category to approximately 40% of the selection. The relatively larger NBA firms are therefore somewhat more heavily represented in the AFM's selection.

Table 2 shows for each category the number of NBA 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 NBA firms | Selected NBA firms |
|-------------------------------------|-------------------------|---------------|--------------------|
| 0                                   | 81 (18%)                | 48 (26%)      | 0 (0%)             |
| 1-3                                 | 102 (23%)               | 64 (35%)      | 12 (40%)           |
| 4-10                                | 113 (25%)               | 45 (25%)      | 11 (37%)           |
| > 10                                | 151 (34%)               | 25 (14%)      | 7 (23%)            |
| Total number of firms               | 447 (100%)              | 182 (100%)    | 30 (100%)          |
| Total number of statutory audits    | 6,854                   | 1,012         | 360                |

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

### 3.3.2 Information request

The AFM notified the 30 NBA firms selected that they had been selected for review at the end of 2012. 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 of the most recent audit opinion;
- the amount of the statutory audit fee;
- the name of the external auditor; and
- the office from which the audit was conducted;
- whether activities performed by experts or other auditors were used for the purpose of the audit; and
- whether an engagement quality control review (EQCR) or an internal review had been conducted of the audit.

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<sup>11</sup> 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 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 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 impression 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. Where possible, the AFM 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 clients active in construction, financial and other services and real estate. In total, the AFM has assessed the quality of 63 statutory audits. Table 3 shows the distribution of these statutory audits across the industry sectors in which the audit clients are active.

| <b>Sector</b>                | <b>Number of statutory audits assessed</b> |
|------------------------------|--|
| Construction                 | 16   |
| Financial and other services | 20   |
| Real estate                  | 1  |
| Trade                        | 23   |
| Production                   | 3  |
| <b>Total</b>                 | <b>63</b>                                  |

Table 3. Statutory audits assessed by sector.

The AFM has informed the 30 NBA 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 that were 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 these meetings 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, the AFM checked prior to the file review whether the financial reporting met the applicable reporting standards in a number of specific respects. This enabled the AFM to obtain an impression of the quality of reporting by SMEs. 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.<sup>12</sup> 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. A high quality auditor distinguishes himself in this area from a colleague with less aptitude for auditing.<sup>13</sup>

In addition, the AFM selected one or more of the other aspects listed above for further review. The choice of aspects partly depended on the sector in which the audit client operates and was made on the basis of professional judgement. The aspect of 'construction contracts' was for instance only relevant to audit clients in the sectors of construction and production. For the aspect 'measurement of assets', the most relevant item was chosen on the basis of the sector: property, debtors or

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<sup>12</sup> See paragraph 5.1 for the exception.

<sup>13</sup> See paragraph 5.2.1 for a further description of the complexity of auditing (the completeness of) revenue recognition.

inventory. 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 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 NBA firms 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. The external auditors could also decide to be accompanied by either the manager or the audit leader from their audit team. 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 regulations.

After conclusion of the file review, the supervisors inform the external auditor regarding 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.<sup>14</sup>

### **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.

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<sup>14</sup> An account of the experience of some external auditors regarding the review process of the AFM can be found in Accountancy News no. 2 of 1 February 2013

## 4 The audit market for NBA firms

This section contains information on the size of NBA firms.<sup>15</sup> 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 NBA firms are compared to the data from the SRA 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 NBA firms based on the discussions the AFM has held with the firms concerned.

### 4.1 Size of the NBA 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 40% of the non-PIE licensees are NBA firms and 60% are SRA 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 NBA firms serve only a limited part of the audit market in the Netherlands. They perform relatively few statutory audits, and thus generate relatively little revenue from this activity and the external auditors working for these firms perform a relatively low number of statutory audits per person.

#### 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 NBA firms perform only 5% of the total number of statutory audits in the Netherlands.

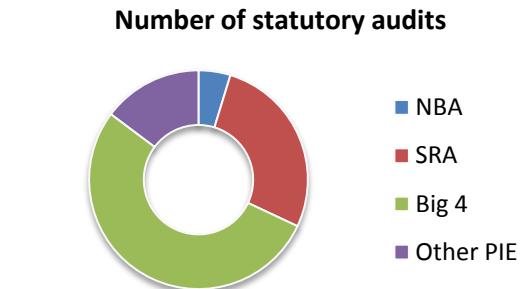


Figure 1

<sup>15</sup> 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 regulations. 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 audited the information provided to verify that it is reliable.

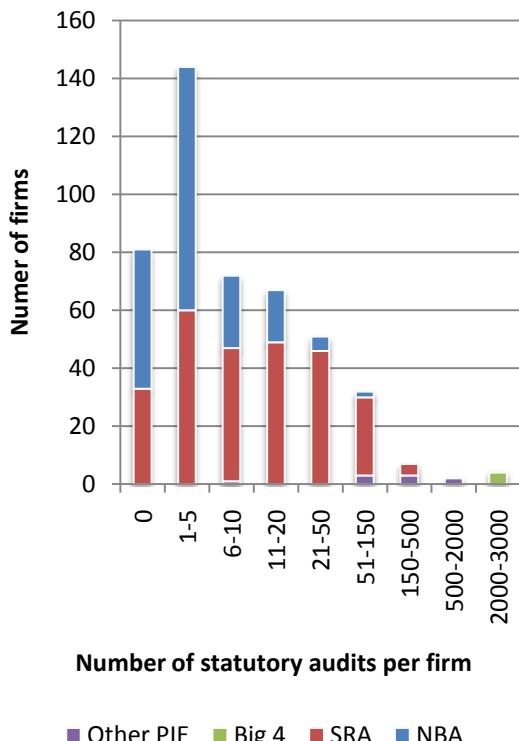
Per firm, the NBA firms perform on average fewer statutory audits than the SRA firms. Only 27% of the NBA firms perform more than five statutory audits. For the SRA firms, this figure is 65%. Figure 2 shows how many firms conduct a certain number of statutory audits.

#### 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: 2% for the NBA firms and 12% for the SRA firms (see figure 3).

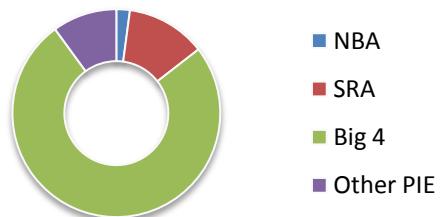
The audit practice of non-PIE audit firms is significantly smaller than that of PIE audit firms measured by revenue generated. Non-PIE audit firms earn around 10% of their total net revenue from the conduct of statutory audits, while for the PIE audit firms this figure is nearly 40%. There is, however, little difference between the relative size of the audit practice at NBA firms and SRA firms. Furthermore, the average revenue per statutory audit for both NBA and SRA 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 statutory audits per firm**



*Figure 2*

**Revenue from statutory audits**



*Figure 3*

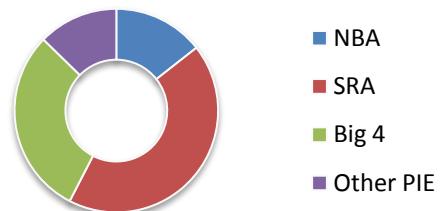
### Number of external auditors

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

At approximately 77% of the NBA firms that perform statutory audits, the external auditors perform on average between one and five statutory audits per person, while at nearly 57% of the SRA firms that perform statutory audits, the external auditors perform on average more than five statutory audits per person. Figure 5 shows at how many firms the average number of statutory audits per external auditor falls into one of the stated categories.

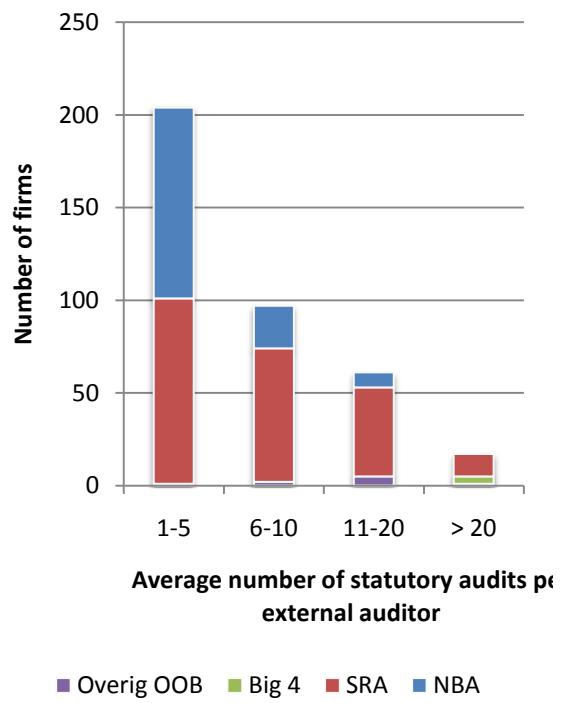
The 30 NBA firms selected give a reasonably good representation of the entire group of NBA firms that conduct statutory audits. While around 73% of the NBA firms perform five statutory audits at most (and none in some cases), the AFM has limited the number of firms in this category to approximately 53% of the selection and thus has selected a relatively higher number of larger NBA firms. These 30 selected NBA firms performed a total of around 360 statutory audits, for which 52 external auditors were responsible. They generated approximately €43 million in total net revenue and around €6 million from the performance of statutory audits. The average revenue per statutory audit is the same as that of the other non-PIE audit firms (€17,000).

**Number of external auditors**



*Figure 4*

**Average number of statutory audits per external auditor**



*Figure 5*

#### **4.2 Features of the audit practice at NBA 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 NBA firms regarding their views of the sector and their view of the future for their firm.

The financial figures of Dutch companies for the period 2009-2011 show that the audit clients of non-PIE audit firms are clearly 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 the PIE audit firms are on average larger. There are hardly any differences between the audit clients of NBA firms and those of SRA firms.

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

For many audit clients, the performance of the statutory audit is a supplement to other services such as administrative and tax-related services that make up the total service package that they purchase from their audit firm. 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. The larger audit clients, clients mostly funded by a bank, which form part of a national or international group or not-for-profit organisations, are more inclined to see the statutory audit as adding value. The NBA firms appear to see their licence mainly as allowing them to offer a total service package and enabling them to retain staff, and to operate internships for practical accountancy training.

In the discussions with the AFM, the NBA firms cited various threats to their audit practice: price pressure and competition from medium-sized and large audit firms, the fact that most audits are not profitable, the threat of discontinuity of audit and other clients and the difficulty of attracting and retaining competent staff. Several NBA firms also considered the increasing complexity of regulations to constitute a threat, and are more frequently engaging the services of external consultants to deal with this.

The AFM also asked the NBA firms to describe their ambitions for the future of their audit practice. Around half of the 30 NBA firms reviewed had an ambition to expand their audit practice. About a third of the firms reviewed thought they would maintain their current status. A limited number of firms expected to cease the conduct of statutory audits in the near future or had no concrete vision regarding their audit practice.

## **5 Findings of the review**

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This section describes the findings of the assessment made by the AFM of 63 statutory audits by the 30 selected NBA firms and 78 audited financial statements of audit clients of these NBA firms. Paragraph 5.1 describes the AFM's conclusion regarding the quality of the 63 statutory audits it assessed. This paragraph also lists the features of the statutory audits that are qualified as 'adequate' or 'inadequate'. Paragraph 5.2 gives a summary of the content-related shortcomings identified by the AFM in the statutory audits it assessed. Paragraphs 5.3 and 5.4 then describe the AFM's conclusion regarding the quality of the financial reporting of 78 non-PIE audit clients and the content-related shortcomings identified by the AFM in this financial reporting.

### **5.1 Quality of the statutory audits**

The AFM identified serious shortcomings in 50 of the 63 statutory audits assessed of 30 NBA firms with a non-PIE licence. 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, 79% of the total number of statutory audits assessed, as 'inadequate'.

In table 4, the AFM classifies the quality of the 63 statutory audits assessed into four categories, with the statutory audits in category 1 being of the highest relative quality and those in category 4 the lowest:

| Category | Number of statutory audits | Evaluation | Remarks   |
|----------|----------------------------|------------|---|
| 1        | 13 (21%)                   | Adequate   | No serious shortcomings.  |
| 2        | 13 (21%)                   | Inadequate | Inadequate audit procedures with regard to specific aspects.  |
| 3        | 21 (33%)                   | Inadequate | Some audit procedures conducted, however very basic audit techniques either not or incorrectly applied. |
| 4        | 16 (25%)                   | Inadequate | No or very few audit procedures conducted, mainly administrative and compilation work only.             |

*Table 4. Quality of 63 statutory audits assessed classified into four categories.*

The AFM qualified at least one statutory audit as 'inadequate' at 28 NBA firms (93%). There were only two NBA firms (7%) where the AFM did not identify serious shortcomings. In fact this concerned statutory audits that led to a disclaimer of opinion or for which the audit client was a trading company.

As stated in section 3, in its assessment of the 63 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.<sup>16</sup> 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 purpose, 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 regarding 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 this information 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 any material misstatements.

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. For example, the AFM focused on the audit of the revenue recognition in 62 of the 63 statutory audits assessed (98%).<sup>17</sup> In 48 of these 62 statutory audits (77%), the AFM found shortcomings with respect to the audit of the revenue recognition. The AFM identified serious shortcomings in 50 of the 63 statutory audits it assessed (79%). Paragraph 5.2 describes the shortcomings in each focus element.

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<sup>16</sup> 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."

<sup>17</sup> 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.

| Focus element                    | Number of statutory audits with this focus element<br>(% of total of 63 statutory audits) | Number of statutory audits with shortcomings in this focus element<br>(% of number of statutory audits with this focus element) |
|----------------------------------|---|---|
| Revenue recognition              | 62 (98%)  | 48 (77%)  |
| Construction contracts           | 19 (30%)  | 16 (84%)  |
| Measurement of assets            | 46 (73%)  | 24 (52%)  |
| Use of work of auditor's experts | 7 (24%)   | 4 (57%)   |
| Going-concern assumption         | 29 (46%)  | 10 (35%)  |
| Total                            | 63 (100%)   | 50 (79%)  |

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 30 NBA 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 63 statutory audits it assessed as 'adequate' or 'inadequate', the AFM investigated which of the following features were related to the quality of the statutory audit:<sup>18</sup>

- Features of the external auditor responsible:
  - How many statutory audits in total does the external auditor perform?
  - Is the external auditor a registered accountant (RA) or an accounting consultant (AA)?
  - 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 in total 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?
  - Has the external auditor or the audit firm provide compilation services to the audit client in addition to the statutory audit?

<sup>18</sup> The AFM tested for each feature to see whether the feature had a significant connection ( $\alpha = 10\%$ ) with the quality of the statutory audit (adequate or inadequate). Pearson Chi2 tests, t tests and Pearson correlation tests were conducted for this purpose.

- 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 price of the statutory audit?

Four features appear to be significantly related to the quality of the statutory audit.<sup>19</sup>

#### **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 63 statutory audits assessed were performed by 44 external auditors, of whom 17 were entered as an RA or an AA in the accountants' register in 2000 or later; 27 were already entered in the accountants' register prior to 2000.<sup>20</sup> Table 6 shows for the 63 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. 33% 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 14%.

| Quality of statutory audit | Registered in 2000 or later | Registered prior to 2000 | Total     |
|----------------------------|-----------------------------|--------------------------|-----------|
| Adequate                   | 7 (33%)                     | 6 (14%)                  | 13 (21%)  |
| Inadequate                 | 14 (67%)                    | 36 (86%)                 | 50 (79%)  |
| Total                      | 21 (100%)                   | 42 (100%)                | 63 (100%) |

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

#### **The statutory audit has been subjected to an EQCR**

The AFM concludes that an EQCR contributes to increasing the quality of the statutory audits performed and is therefore an important tool in the quality control systems of audit firms. Table 7 shows the statutory audits for which an EQCR was conducted prior to issuance of the audit opinion. An EQCR was conducted on a total of 27 of the 63 statutory audits (43%). 33% of these 27 statutory audits with an EQCR were ultimately assessed by the AFM as 'adequate', while only 11% of the 36 statutory audits with no EQCR were assessed by the AFM as 'adequate'. Although an

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<sup>19</sup> The results of the statistical tests were significant for these features, suggesting that these links can be expected to apply to all NBA firms.

<sup>20</sup> 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.

EQCR provides no guarantee at all that the audit is of sufficient quality, this procedure does make a contribution.

| <b>Quality of statutory audit</b> | <b>EQCR conducted</b> | <b>No EQCR conducted</b> | <b>Total</b> |
|-----------------------------------|-----------------------|--------------------------|--------------|
| Adequate                          | 9 (33%)               | 4 (11%)                  | 13 (21%)     |
| Inadequate                        | 18 (67%)              | 32 (89%)                 | 50 (79%)     |
| Total                             | 27 (100%)             | 36 (100%)                | 63 (100%)    |

Table 7. Connection between quality of statutory audits and the conduct of an EQCR

#### **The audit client operates in a ‘straightforward’ sector**

The AFM concludes that statutory audits for audit clients that are trading companies are more straightforward than audits for clients in other sectors, and that the audit is therefore more often of adequate quality in this case. Table 8 shows the connection between the quality of the 63 statutory audits assessed and the sectors in which the audit clients operate. The AFM assessed 30% of the statutory audits of trading companies as ‘adequate’, whereas the AFM’s assessment was ‘adequate’ in only 15% of the 40 statutory audits of audit clients in other sectors.<sup>21</sup>

| <b>Quality of statutory audit</b> | <b>Trade</b> | <b>Services</b> | <b>Construction</b> | <b>Production</b> | <b>Property</b> | <b>Total</b> |
|-----------------------------------|--------------|-----------------|---------------------|-------------------|-----------------|--------------|
| Adequate                          | 7<br>(30%)   | 2<br>(10%)      | 3<br>(19%)          | 0                 | 1<br>(100%)     | 13<br>(21%)  |
| Inadequate                        | 16<br>(70%)  | 18<br>(90%)     | 13<br>(81%)         | 3<br>(100%)       | 0               | 50<br>(79%)  |
| Total                             | 23<br>(100%) | 20<br>(100%)    | 16<br>(100%)        | 3<br>(100%)       | 1<br>(100%)     | 63<br>(100%) |

Table 8. Connection between quality of statutory audits and the sector in which the audit client operates

#### **The audit opinion is a disclaimer of opinion**

The AFM concludes that statutory audits that lead to a disclaimer of opinion are usually more straightforward to perform than statutory audits that lead to other audit opinions, and are therefore more frequently of adequate quality. If the auditor is not in a position to obtain sufficient and appropriate audit evidence and this information is material and significantly affects the financial statements as a whole, the auditor issues a disclaimer of opinion. In other words, the auditor does not express an opinion regarding the reliability of the financial statements. Table 9 shows the connection between the quality of the 63 statutory audits assessed and the type of audit opinion attached. From this it can be seen that half of the statutory audits in which the external auditor attached a disclaimer of opinion were assessed by the AFM as ‘adequate’, while in the case of unqualified or modified audit opinions this percentage is lower (15% and 33% respectively).

<sup>21</sup> Although 100% of the statutory audits assessed of property companies (one audit) were assessed as ‘adequate’ and 100% of the statutory audits assessed of production companies (three audits) were considered to be ‘inadequate’, the number of statutory audits assessed in these sectors is so low that no meaningful conclusions can be drawn.

One frequently occurring situation in which an auditor declines to express an opinion is when the nature of the activities and the size of the company are such that the company's internal organisation cannot be structured in an economically sound way so that the auditor can rationally obtain the required degree of certainty regarding the completeness of the revenue recognition and the items directly related to this. In this situation, an auditor can and will perform little or no tests of controls on the company's internal controls, since these internal controls are not in place, or only barely so. The audit procedures that the auditor can perform are largely substantive in nature, and usually simpler to perform than tests of controls.

| <b>Quality of statutory audit</b> | <b>Disclaimer of opinion</b> | <b>Unqualified audit opinion</b> | <b>Modified audit opinion</b> | <b>Total</b>     |
|-----------------------------------|------------------------------|----------------------------------|-------------------------------|------------------|
| Adequate                          | 4 (50%)                      | 8 (15%)                          | 1 (33%)                       | 13 (21%)         |
| Inadequate                        | 4 (50%)                      | 44 (85%)                         | 2 (67%)                       | 50 (79%)         |
| <b>Total</b>                      | <b>8 (100%)</b>              | <b>52 (100%)</b>                 | <b>3 (100%)</b>               | <b>63 (100%)</b> |

Table 9. Connection between quality of statutory audits and issuance of a disclaimer of opinion

#### **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 NBA firms.<sup>22</sup>

In relation to the 63 statutory audits assessed, the AFM has the following observations:

- *Size of the audit firm.* The AFM has expressly found no relationship between the number of statutory audits that the audit firm performs and the quality of the statutory audits assessed. In total, 21% of the statutory audits assessed were qualified as 'adequate' and 79% as 'inadequate'. This proportion is more or less identical for small (less than 5 statutory audits), medium-sized (5 to 15 statutory audits) and large (more than 15 statutory audits) NBA firms.
- *Size of the audit client.* The audit clients whose statutory audits were qualified by the AFM as 'adequate' are marginally smaller (measured by balance sheet total, revenue, result and number of employees), and possibly less complex, than audit clients whose statutory audits were qualified as 'inadequate'.
- *Number of statutory audits per external auditor.* The statutory audits qualified by the AFM as 'adequate' were performed by external auditors who on average perform just under 10 statutory audits per person. The 'inadequate' statutory audits were conducted by external auditors who performed around 7 statutory audits per person on average.

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<sup>22</sup> It should be noted here that the number of observations, 63 statutory audits, is relatively low for the purpose of obtaining hard and fast findings from the statistical tests used.

- *Combination of audit and compilation.* 23% of the statutory audits qualified by the AFM as ‘adequate’ involved compilation work by the external auditor or the audit firm. This percentage for ‘inadequate’ statutory audits was 36%.
- *External EQCR.* 27 of the 63 statutory audits assessed had been subjected to an EQCR (43%), and in 12 cases this involved a quality assessor from outside the audit firm (44%). An EQCR was conducted on 69% of the statutory audits qualified as ‘adequate’, involving an external assessor in 67% of these cases. An EQCR was conducted on 36% of the statutory audits qualified as ‘inadequate’, involving an external assessor in 33% of these cases.
- *Electronic audit file.* In 46% of statutory audits qualified by the AFM as ‘adequate’, the external auditor made use of an electronic audit file. This percentage for ‘inadequate’ statutory audits was only 26%.

## **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 63 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 regulations, 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 audit 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 and 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 62 of the 63 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 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.

| <b>Issues</b>                 | <b>Number of statutory audits with this issue<br/>(% of total of 63 statutory audits)</b> | <b>Number of statutory audits with shortcomings in this issue<br/>(% of number of statutory audits with this issue)</b> |
|-------------------------------|---|---|
| Revenue recognition           |   |   |
| • General                     | 62 (98%)  | 48 (77%)  |
| • Tests of controls           | 51 (81%)  | 40 (78%)  |
| • Automated data systems (IT) | 51 (81%)  | 32 (63%)  |
| • Substantive analysis        | 62 (98%)  | 40 (65%)  |

*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 8 of the 62 statutory audits (13%), the AFM found that the auditor had completely neglected to plan and perform audit procedures in relation to the completeness of the revenue. In the other cases in which the auditor did plan and perform these audit procedures, the AFM found other general shortcomings. In total, the AFM found serious shortcomings in relation to the audit of the revenue recognition in 77% of the statutory audits. 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;
- identify the relevant internal control measures, including segregation of functions (whereby the responsibilities for authorising transactions, recording transactions and the custody of assets are placed 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);
- 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 Tests of controls**

51 statutory audits involved the performance of tests of controls by the external auditor (81%). The AFM identified serious shortcomings in the performance of these tests of controls in 78% of these statutory audits. In approximately half of these statutory audits, the AFM considers that the audit procedures that the external auditor has qualified as 'tests of controls' were in fact 'substantive'. In these cases, the external auditor did not actually 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 accounts, the auditor must establish in his audit that the head of accounts has actually carried out this calculation. He does this by establishing the external features of the control measure, for instance the appearance of the initials of the head of accounts 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 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 from the following example from the AFM's review:

#### **Testing of internal control measures**

The audit client is a medium-sized company engaged in the production and supply of window frames, among other products. The external auditor used a tests of controls approach for the audit of the completeness of the revenue recognition. The external auditor planned a walk-through test and a test of controls in order to establish the existence and the operation of the internal control measures in the sales process. The procedures that the external auditor subsequently carried out were, however, largely substantive tests of details. The external auditor established independently that the quotation corresponded to the delivery note and the invoice in the case of 13 transactions. The only internal control measure tested by the external auditor in these tests of controls was the authorisation of the preliminary estimate. In the 13 tests of controls, however, the external auditor established that authorisation of the preliminary estimate usually did not take place. The external auditor subsequently concluded incorrectly that the most important internal control measures were operating effectively.

The following example illustrates a situation in which the AFM concluded that the external auditor had performed adequate tests of controls:

#### **Good practice: Testing of internal control measures**

The audit client is a professional football club. The external auditor identified the completeness of the revenue from sponsoring (by means of advertising boards in the stadium) as a significant risk. The external auditor used a tests of controls approach for the audit of the completeness of this revenue. The external auditor planned a walk-through test and a test of controls in order to establish the existence and the operation of the internal control measures in the sales process. These procedures focused on the testing of the internal control measure regarding the authorisation of sponsor contracts. On the basis of 25 sponsor contracts that he selected from the contracts register, the external auditor established that these had been authorised by management. The external auditor then carried out an observation on site, by means of attending a football match and counting the number of advertising boards in the stadium and comparing this number to the registration in the contracts register in order to establish whether the register was complete. The external auditor clearly documented these procedures in the audit file, and concluded that the internal control measures were operating effectively.

### **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 of specific application controls.<sup>23</sup>

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 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.<sup>24</sup>

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 51 of the 63 statutory audits assessed (81%). 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 segregation 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 segregation of functions within certain processes and whether the segregation 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. 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 purpose, 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 above shortcomings can be illustrated by the following example from the AFM's review:

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<sup>23</sup> For further definition of general IT controls and application controls, see COS 315 paragraphs A96 and A97.

<sup>24</sup> 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.

### **IT in the audit**

The audit client is a retailer, and uses an ERP system for its inventory management and cash register. The external auditor failed to conduct any procedures to assess the general IT controls and the application controls in the ERP system, including the segregation of functions, even though he fully relied on the information and lists in this ERP system.

The following 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: Audit of segregation of functions in the automated environment***

The audit client is a small non-life insurer<sup>25</sup> that uses an ERP system in which inter alia data on insured persons and claims are recorded. The external auditor has qualified the automated environment as 'complex' and planned procedures in relation to the general IT controls and the application controls in the automated environment. In relation to the audit of the segregation of functions, the external auditor established that the functions of policy acceptance, claim settlement, collection and administration were segregated. For this, the external auditor established by means of inspection of the competence tables in the ERP system that the employees of the non-life insurer only have rights to one of the functions. The external auditor then audited the log files in the ERP system from 1 January to 31 December in order to establish that no impermissible breaches of the segregation of functions in the ERP system occurred during the financial year.

#### ***5.2.1.4 Substantive analytical procedures***

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. As part of 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.

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<sup>25</sup> This is a small mutual insurance company that applies specific exemptions so that it does not qualify as a PIE.

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 to perform 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 investigation. He then evaluates the differences found and investigates further in order to either explain the differences or have them adjusted. In all the 62 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 65% of these statutory audits. In these cases, in the opinion of the AFM the auditor has merely conducted 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 57% of the statutory audits of trading companies and in 80% of the statutory audits of service providers.<sup>26</sup> With regard to trading companies, among other things the external auditor failed to:

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<sup>26</sup> In the only statutory audit of a property company, no serious shortcomings were identified in the conduct of the sector-specific analytical procedures. 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.

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

#### **Substantive analytical procedure**

The audit client is a personnel BV (private limited company). All employee expenses are recognised in this company and charged on to other group companies. In view of the audit client's activities, salary costs are an important item in the financial statements. For the purpose of the audit of the salary costs, the external auditor established that the financial administration and the salary administration were mutually consistent, he conducted a substantive analytical procedure and reviewed the ledger for inconsistencies. The analytical procedure concerned the comparison of salary costs in the year under review in totals, per month and per FTE against these figures for previous years. From this numerical analysis it emerged that the salary costs had risen in comparison to previous years. However, the external auditor had not formed any expectation regarding the trend in salary costs and had not set a threshold above which differences would have to be explained. The external auditor, moreover, failed to check the explanations offered by the client regarding the rise in salary costs, for instance with reference to the collective employment agreement and the changes in the workforce.

#### **5.2.2 Construction contracts**

The 16 construction companies and the 3 production companies whose statutory audits were assessed by the AFM carry out projects on the instructions of 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 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 16 of the 19 statutory audits in which the item construction contracts was audited by the external auditor (84%). In these cases, the external auditor for example failed to:

- establish the relevant internal control measures, including:
  - the segregation 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 DASB Guideline 221 ‘Construction Contracts’, 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’.

The AFM identified a relatively large number of serious shortcomings in the audit of 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 and the total costs have also been reliably estimated by means of 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 whether the reporting guidelines have been correctly complied with.

The next example illustrates a situation in which the AFM concluded that the external auditor had followed adequate procedures with respect to construction contracts:

***Good practice: Construction contracts***

The audit client is a medium-sized construction company that carries out civil and non-residential construction projects. The audit client's administrative organisation is limited. The external auditor therefore concluded that he could not obtain sufficient certainty regarding the completeness of the income and that he could not go further than issuing a disclaimer of opinion. In addition, on the basis of the audit client's administrative organisation the external auditor concluded that it was not possible to make a reliable estimate of the interim result from construction contracts. The profit is recognised by the client for each project on project completion (percentage of completion method with zero profit estimate). For virtually all projects, the external auditor then reconciled the contractual sum recognised with the underlying contract. Following this, for the same projects the external auditor audited the costs incurred on the basis of the invoices received and the timesheets. For projects delivered to the principal, the client had received a report. For these projects, the external auditor checked the recognised profit, in other words the difference between the contractual sum and the costs incurred.

***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 70% 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.

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 52% 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<br>(% of total of 63 statutory audits) | Number of statutory audits with shortcomings in this focus element<br>(% of number of statutory audits with this focus element) |
|---|---|---|
| Measurement of assets   | 44 (70%)  | 23 (52%)  |
| • Measurement of immovable property/property, plant and equipment | 16 (25%)  | 10 (63%)  |
| • Measurement of debtors  | 18 (29%)  | 9 (50%)   |
| • Measurement of inventory  | 12 (19%)  | 5 (42%)   |

Table 11. Number of cases with focus elements and number of cases with shortcomings regarding 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 16 statutory audits (25% of the total number of statutory audits assessed). This concerned statutory audits of companies in various sectors (trade, property, services and production). In 15 cases the property, plant and equipment consisted of immovable property, and in one case 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 most cases, the property concerned land and business premises for the audit client's own use. In two cases the company owned the property with the intention of leasing it commercially. In one case, the property was an investment.

The AFM identified serious shortcomings in relation to the audit of the measurement of immovable property or the other property, plant and equipment in 10 of the 16 statutory audits (63%). 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 over a quarter of these 16 statutory audits concerned the fact that the external auditor had failed to:

- assess whether there was a risk of fraud or other risks regarding the measurement of the property;
- assess the acceptability of the accounting principles selected for measurement of the property;
- establish whether there were indications of impairment;
- take the WOZ (Valuation of Immovable Property Act) value into consideration in the assessment of the fair value;
- assess the Land Registry data, WOZ statements or any other relevant information (in the current year or in previous years) evidencing the existence of the property and its economic ownership.

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

#### **Measurement of immovable property**

The audit client is a medium-sized company involved in waste collection and recycling. Business premises and land for the company's own use are recognised in the balance sheet in an amount of €3.6 million. These business premises and land are measured at current value and depreciation is applied on a straight-line basis. The disclosures in the financial statements state that the current value is determined on the basis of valuations by a valuer. The appraised value according to the valuation report is however €0.5 million higher than the value recognised in the financial statements. The external auditor failed to assess the reasonableness of the assumptions and methods used by the valuer and to assess the significance of the audit difference for his opinion.

#### **5.2.3.2 Measurement of debtors**

The measurement of the item debtors is in principle determined by the receivables the company has on clients 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 18 statutory audits (29% of the total number of statutory audits assessed). This mainly concerned statutory audits of service providers, trading companies and one construction company.

In 9 of these 18 statutory audits (50%) the AFM identified serious shortcomings in relation to the audit of the measurement of debtors. In two 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 cases, the shortcomings concerned the fact that the external auditor had failed to:

- assess whether there was a risk of fraud or other risks regarding the measurement of the debtors item;
- establish the adequacy of the provision for default by debtors. Among other things, the external auditor neglected to:
  - check whether debtors had paid in the new reporting period (review of after-date payments);

- establish whether any debtors had become bankrupt and assess the related documentation;
- establish whether there were indications that debts had been outstanding for a lengthy period (age of outstanding items analysis);
- establish that the financial statements, including the disclosures, are in accordance with the system of financial reporting;
- follow up the findings of his audit.

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

#### **Measurement of debtors**

The audit client is a wholesaler of iron and metal products with revenue of approximately €20 million. At year-end 2011 the audit client had outstanding receivables from debtors totalling €3 million. The external auditor planned to audit whether the debtors had paid at the end of February (review of after-date payments). The external auditor selected 10 debtors from the sub-administration at year-end 2011 and checked whether they had paid on the basis of the client's bank statements. By means of these procedures, the external auditor established that €120,000 had been received after the balance sheet date. The external auditor failed to verify a substantial part of the payments by the debtors in the first two months of 2012 (€1 million) on the basis of the bank statements and to carry out procedures in relation to the debtors who had not yet paid at the beginning of 2012.

#### **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 12 statutory audits (19% of the total number of statutory audits assessed). Since these audits were of 12 trading companies, this concerned inventory of trading goods in all cases.

In 5 of these 12 statutory audits (42%) the AFM identified serious shortcomings in relation to the audit of the measurement of inventory. In one of these statutory audits, the external auditor completely neglected to plan and conduct audit procedures in relation to the measurement of inventory. In the other cases, the shortcomings concerned the fact that the external auditor had failed to:

- conduct a stock-take of the available inventory (including any goods on consignment);
- include the findings of the stock-take in the measurement of the inventory;
- 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 from the following example from the AFM's review:

#### **Measurement of inventory of passenger vehicles**

The audit client is a car dealership which measures its inventory of used passenger vehicles (€0.5 million and approximately 80 vehicles) at the cost of acquisition or the net sale proceeds if lower. The external auditor stated that the measurement of the inventory of used vehicles was a significant risk. The external auditor planned to audit which part of the inventory of used vehicles had been sold after the balance sheet date in order to check the accuracy of the measurement of the used vehicles as at the balance sheet date (review of after-date payments). For this, the external auditor compared the sale price on the invoice for 10 vehicles with the measurement in the accounts as at the balance sheet date. However, the external auditor failed to audit the value of a substantial proportion of the used vehicles, for instance by means of a comparison with a vehicle price list as at 31 December. Furthermore, the audit procedures showed that the 10 vehicles that were sold after 31 December were sold for a lower sum than the amount at which they were carried as inventory in the balance sheet as at 31 December. This could have been an indication that the measurement of the inventory of used passenger vehicles in the balance sheet as at 31 December was too high. The external auditor failed to further investigate this potential overvaluation.

#### **5.2.4 Using the work of an auditor's expert**

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

- establish the valuer's objectivity and expertise;

- assess the valuer's work; and
- evaluate whether the valuer's work was adequate.

Without carrying out these procedures, the external auditor actually 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.<sup>27</sup>

As stated in table 5, in 29 of the 63 statutory audits assessed (46%) the AFM found reason to investigate 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.<sup>28</sup>

In 10 of these 29 statutory audits (35%) the AFM identified serious shortcomings in relation to the audit of the going-concern assumption. In half of these cases, the

<sup>27</sup> *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.*

<sup>28</sup> *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'.*

external auditor completely neglected to plan and conduct audit procedures in relation to the going-concern assumption. In one of these five cases, the AFM noted that the external auditor originally intended to issue an audit opinion including a paragraph explaining the uncertainty regarding the continuity of the audit client. At the audit client's request however, the external auditor replaced this explanation with a standard unmodified audit opinion with no explanatory paragraph. The AFM did not find any additional audit procedures that removed the original doubts regarding continuity.

In the other five statutory audits in which the AFM found serious shortcomings, among other things the external auditors failed to:

- assess the estimate of the audit client's management regarding continuity (in two statutory audits);
- assess the assumptions on which the budget or the cash forecasts were based that supported the going-concern assumption (in four statutory audits); and
- assess the audit client's funding structure, including the bank agreements and the cash position (in four statutory audits).

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.

#### **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 29 (46%) 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:

- carry out procedures for risk analysis, state all the (significant) audit risks and conduct adequate audit procedures as a result of the initially identified material risks;
- carry out procedures to determine the degree of materiality;
- carry out procedures for the formulation of audit programmes and working programmes;
- obtain all relevant audit evidence before the date of the audit opinion attached to the financial statements;
- adequately record considerations, findings and conclusions as a result of the audit;
- comply with requirements under NV COS 600 if he uses the work of another auditor, whereby the external auditor in particular failed to assume undivided responsibility for the direction, supervision and conduct of the audit engagement of the group;

- consider whether long-term shortcomings in the audit client's internal controls that led to him issuing a disclaimer of opinion with regard to the financial statements over several years and the management's refusal to take action in this respect should have had consequences for his continued acceptance of the engagement, his assessment of the management's integrity and his assessment of the risks, including the risk of fraud;
- state the name of the licensed audit firm in its articles of association (rather than the trading name) with the signature attached to the audit opinion.

### **5.3 Quality of financial reporting**

In addition to its assessment of the statutory audits, the AFM also assessed 78 financial statements<sup>29</sup> and thereby formed an impression of the quality of the financial reporting by the audit clients of NBA firms. The AFM's conclusion regarding the quality of the financial reporting on this basis is that quality was adequate in approximately 26% of the cases, and inadequate in 74% of the cases.

In all the 78 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 report of the company management or the reports of the directors and the supervisory board, the cash flow statement, 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 report of the company management 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 report of the company management does not contain all the new items

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<sup>29</sup> 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.

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 78 audit clients of NBA 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 treatment of construction contracts, the measurement of inventory, the continuity of the company, the report of the company management or the annual report, the cash flow summary, changes to accounting policies and the correction of errors. Paragraph 5.4.2 lists the other shortcomings identified by the AFM.

### **5.4.1 Shortcomings in focus elements**

#### **5.4.1.1 Construction contracts**

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 income statement does not show the change in construction contracts, or the sub-total of the net revenue and the change in construction contracts.
- 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.

#### **5.4.1.2 Measurement of inventory**

In its assessment of the 78 financial statements selected, the AFM found that the method used to measure inventory was only clearly stated in a limited number of cases (for example, FIFO or LIFO). Approximately 20% of the financial statements did not provide a specification either in the disclosure relating to the inventory recognised in the balance sheet.

#### **5.4.1.3 Company continuity**

In its assessment of the 78 financial statements, the AFM had expected in 6 cases to see at least a further disclosure regarding the company's continuity and the associated explanatory paragraph from the auditor in the audit opinion. The AFM actually found such a disclosure in only two cases.

#### **5.4.1.4 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.<sup>30</sup>

Of the 78 financial statements assessed by the AFM, 23 (nearly 30%) contained no directors' report. Of the 55 reports that the AFM was able to assess in terms of content, only 11 (20%) included a risk paragraph and 4 (7%) mentioned price, liquidity or market risk. Only in 2 cases (4%) did the report include a description of the management of risks associated with financial instruments. In the opinion of the AFM, many of the financial statements were very limited in scope and did not contain the analyses and items required by law.

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

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<sup>30</sup> 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.

#### **Financial instruments in the directors' report**

To the extent relevant, the company management must disclose its use of financial instruments in its directors' report. Financial instruments are all agreements whereby one party obtains a financial asset and another party assumes a financial liability or equity instrument. Financial instruments concern both 'primary' financial instruments, such as receivables, payables and shares, and derivative financial instruments, such as options, futures and swaps.

The management of company X included the following statement in its directors' report: "X BV does not possess financial instruments. Indeed, the management intends to dispose of the investment portfolio in the coming year." While the annual report does mention financial instruments, this passage is factually incorrect. Not only the shares in the investment portfolio, but also the company's debtor and creditor items, are financial instruments.

#### **5.4.1.5 The cash flow statement**

Although the obligation to include a cash flow statement in the financial reporting arises only from the DASB Annual Financial Reporting Guidelines and is not included in the Civil Code, the AFM found a cash flow statement in 58 of the 78 financial statements it assessed (74%). However, the AFM also noted that these cash flow statements do not meet the legal requirements in all respects:

- In approximately 17% of cases, the cash flow statement did not include comparative figures for the previous financial year;
- In approximately 35% of cases, the cash flow statement included items in the investment and financing cash flows that are not cash flow items;
- In approximately 33% 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.
- In 16 of the 18 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 balance sheet.

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

#### **Non-cash flow items in the cash flow statement**

Company Y BV is in financial difficulties, and has had part of its debt remitted as part of a debt restructuring. The company will convert this debt into equity. Y BV has also incorrectly recognised this conversion in its cash flow statement. A conversion of debt to equity does not involve a transfer of cash. It is simply an accounting measure that does not belong in the cash flow statement.

#### **5.4.1.6 Changes to accounting policies and correction of errors**

The AFM established that one set of financial statements included a change to accounting policies, and two included a correction of errors. With regard to the presentation of the change to accounting policies, the AFM noted that this did not explain the difference between the previous and the new accounting policies, nor did it explain the effect of the change on the result and on individual items. In one of the financial statements in which fundamental errors were corrected, the correction is not correctly presented in the result, the comparative figures were not adjusted and the correction of the fundamental error was not applied to the right financial year.

#### **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 30% of the cases, the AFM found that the principle for determining the result was not appropriate to the company's business. In 11 financial statements (14%) it was not possible to make this assessment, as the financial reporting gave no indication of the nature of the business of the companies concerned.

##### **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 balance sheet 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 over half 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<sup>31</sup> after the end of the financial 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.<sup>32</sup>

Virtually all the financial statements assessed by the AFM had also been filed with the Chamber of Commerce. The filed financial statements were made publicly available on average nine months (272 days) after the close of the financial year. More than 60% of the financial statements were filed later than seven 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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<sup>31</sup> *In principle, the financial statements must be prepared within five months of the end of the financial year, must be adopted within two months after preparation and filed within eight days after adoption.*

<sup>32</sup> See Article 2:394 (3) BW.

## **6 Further development of the thematic review**

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In its assessment of 63 statutory audits at 30 NBA firms, the AFM has gained an impression of the conduct of some of the non-PIE audit firms. The AFM will assess the quality of the statutory audits conducted by 20 SRA firms in the third quarter of 2013 and expects to publish a generic report on this at the end of 2013, thus completing its review of the quality of the statutory audits conducted by non-PIE audit firms. At the same time, the AFM expects to see action taken by the NBA firms with respect to the shortcomings that have been identified. The actions the AFM expects to see taken by the 30 NBA 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 NBA 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 30 NBA firms. Table 12 presents a summary of the actions the AFM expects the 30 NBA firms it assessed to take, and the number of firms to which these actions apply.

| Action                              | Number of firms |
|-------------------------------------|-----------------|
| No action necessary                 | 2 (7%)          |
| Correction of shortcomings          | 28 (93%)        |
| Root cause analysis and action plan | 24 (80%)        |

*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 applies to 2 of the 30 NBA firms (7%). Incidentally, this concerned statutory audits that led to a disclaimer of opinion or for which the audit client was a trading company. Naturally, these firms must also continue to make efforts 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 requested the 28 NBA firms (93%) for which at least one statutory audit has been qualified as 'inadequate' to repair 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.

At 24 of the NBA firms reviewed (80%), the number of statutory audits qualified by the AFM as ‘inadequate’ is so great and the shortcomings identified are so serious that the AFM has requested these firms to carry out a root cause analysis. In a root cause analysis, the audit firm itself investigates 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 investigate the matter). The AFM has sent a number of sample questions to the NBA firms that can be used as the basis for the root cause analysis (see Appendix 2 to this report).

During its review, the AFM expressly asked each of these 24 firms to seriously consider the question of whether they are able to bring their audit practice up to the required level of quality or whether it would be better to cease performing statutory audits. 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 and action plan and submit this to the AFM.

An action plan includes:

- a description of the root cause analysis;
- the measures designed to repair the shortcomings in the statutory audits identified by the AFM;
- the measures that will prevent shortcomings 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 2013, 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 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. Should this dialogue not lead to the desired outcome, the AFM will conduct further investigation and move to the imposition of formal enforcement measures if necessary. These measures may include withdrawal of the licence, submission of a complaint to the Disciplinary Court for Auditors or imposition of an administrative fine. The enforcement measure to be used will be determined in each case on the basis of a consideration of effectiveness and legal feasibility.

If in the AFM's view 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. The AFM will conduct the file reviews at the NBA firms in cooperation with the NBA. Should the performance of statutory audits still not be up to standard, the AFM can as yet impose formal enforcement measures.

### ***6.3 Dialogue with the sector and sector-wide improvements***

The AFM, moreover, wishes to engage in a constructive dialogue with the sector in the second half of 2013, including the non-PIE audit firms and their advisers, the professional organisations and their assessors. This dialogue can contribute to the formulation of sector-wide measures that will achieve an improvement in quality.

One of these measures is the introduction by the NBA of mandatory PE programmes for all practitioners in the audit profession in 2014<sup>33</sup>. This requirement has three elements: (i) a course focusing on communication skills to increase the auditor's signalling function, (ii) a knowledge test focusing on relevant regulations (including the Further Regulations for Audit and Other Standards [*Nadere voorschriften controle- en overige standaarden*, or NVCOS]) and (iii) discussion of an audit file with a mentor. The AFM endorses the need for this mandatory PE so that basic knowledge and skills in relation to auditing and reporting can be regularly refreshed and embedded. The AFM furthermore expects the sector to embrace the quality improvement programme announced by the NBA for the exchange of knowledge and experience in relation to quality and quality control.

Another measure is to increase the standards required in the basic accountancy qualification. Advisory committees at both the Committee for final accountancy

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<sup>33</sup> See the newsletter "NBA presents mandatory PE programmes for improvement in signalling function and audit quality" of 21 June 2013 on the website [www.nba.nl](http://www.nba.nl).

qualifications [*Commissie eindtermen accountantopleiding*, or CEA] and the Netherlands Institute of Chartered Accountants [*Nederlandse Beroepsorganisatie van Accountants*, or NBA] have published reports containing recommendations for a new model for the accountancy qualification. The current qualification does not appear to be still adequate for daily practice, whereby auditors are mostly either employed in the SME sector or work for larger clients such as PIEs. The AFM takes the view that training could be brought more into line with practice, with more attention devoted to specialist areas such as the audit of semi-public or public institutions, financial institutions and IT environments.

As part of the covenant with the NBA, other assessments will also be made in 2014 at NBA 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.

## **Appendix 1: Tables in section 4**

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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, which the AFM needs to perform its supervisory duties effectively and efficiently. The audit firms thereby contribute to the objectives of the legislation and regulations. 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.

| <b>Category of licensees</b> | <b>Number of licensees</b> | <b>Number of licensees with statutory audits</b> | <b>Total number of statutory audits</b> | <b>Average number of statutory audits per licensee</b> |
|------------------------------|----------------------------|--|---|--|
| Non-PIE audit firms          | 447                        | 366  | 6,854                                   | 19   |
| SRA                          | 265                        | 232  | 5,842                                   | 25   |
| NBA<br>(30 in sample)        | 182<br>(30)                | 134<br>(30)                                      | 1,012<br>(360)                          | 8<br>(12)  |
| PIE audit firms              | 13                         | 13   | 14,574                                  | 1.121  |
| Big 4                        | 4                          | 4  | 11,410                                  | 2.853  |
| Other PIE                    | 9                          | 9  | 3,164                                   | 352  |
| <b>Total</b>                 | <b>460</b>                 | <b>379</b>                                       | <b>21,428</b>                           | <b>57</b>  |

*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<br>(x €1 mln) | Revenue from statutory audits<br>(x €1 mln) | Revenue from statutory audits/total net revenue | Average revenue per statutory audit<br>(x €1,000) |
|-----------------------|---------------------------------|---|---|---|
| Non-PIE audit firms   | 1,144                           | 117   | 10%   | 17  |
| SRA                   | 981                             | 100   | 10%   | 17  |
| NBA<br>(30 in sample) | 163<br>(43)                     | 17<br>(6)                                   | 10%<br>(14%)                                    | 17<br>(17)  |
| PIE audit firms       | 1,752                           | 690   | 39%   | 47  |
| Big 4                 | 1,465                           | 609   | 42%   | 53  |
| Other PIE             | 287                             | 81  | 28%   | 26  |
| <b>Total</b>          | <b>2,896</b>                    | <b>807</b>                                  | <b>28%</b>                                      | <b>38</b>   |

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   |
| NBA<br>(30 in sample) | 211<br>(52)  | 5<br>(7)  |
| PIE audit firms       | 621  | 23  |
| Big 4                 | 435  | 26  |
| Other PIE             | 186  | 17  |
| <b>Total</b>          | <b>1,464</b>   | <b>15</b>                                       |

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

## **Appendix 2: Sample questions for root cause analysis**

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Sample questions that can be used by audit firms to investigate 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 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 performance 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 audit resources provided to your external auditors 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 policymakers) 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 in your root cause analysis.

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Amsterdam, July 2013