



## Quality of PIE audit firms

Findings of the assessment of the implementation and embedding of improvement programmes at PIE audit firms and the inspection of the quality of statutory audits at the Big 4 audit firms

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## The Dutch Authority for the Financial Markets

The AFM is committed to promoting fair and transparent financial markets.

As an independent market conduct authority, we contribute to a sustainable financial system and prosperity in the Netherlands.

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## 1 Summary

Between May 2016 and May 2017, the AFM carried out a thematic review (hereinafter assessment) of the implementation and embedding of the improvement measures and the change aimed for (hereinafter, the implementation and embedding of the improvement programme) at eight PIE audit firms. These include the Big 4 audit firms Deloitte, EY, KPMG and PwC and four other PIE audit firms Accon, BDO, Baker Tilly Berk and Mazars. The AFM has assessed the extent to which these PIE audit firms have been successful in implementing and embedding improvements in the areas of control, behaviour and culture and internal supervision, known as the pillars. Grant Thornton, which is also a PIE audit firm, was not included in the assessment in 2016. The AFM concluded that Grant Thornton had not made sufficient progress in addressing the points of concern in the assessment in 2015 of the design of the change and improvement measures to enable an assessment of the implementation and embedding of the improvement programme. In the period from year-end 2015 to June 2017, the AFM also carried out a regular inspection at the Big 4 audit firms in order to determine whether these audit firms had been able to ensure that the quality of the statutory audits performed in 2015 and 2016 was safeguarded. By publishing the results in a single report, the AFM aims to give a broader picture of both the progress of the improvement programme at the PIE audit firms and the quality of the statutory audits by the Big 4 audit firms that it has inspected.

Based on the findings, the AFM concludes that the improvement programme at the PIE audit firms is progressing too slowly and that the quality of the inspected statutory audits by the Big 4 audit firms is not satisfactory.

The eight PIE audit firms have not fully met the expectations for 2016 for the implementation and embedding of the improvement programme with respect to the pillars control, behaviour and culture and internal supervision. Deloitte, KPMG and PwC have made more progress with respect to the pillars behaviour and culture and internal supervision and on the item of root cause analyses in the pillar control than the other five PIE audit firms. Deloitte, KPMG and PwC made more progress in 2016 on realising a quality-oriented culture, by the board of directors setting an example with respect to behaviour, by making quality a decisive factor in the appraisal and remuneration policy of the partners and by deepening the root cause analyses. Therefore, the AFM is positive regarding the focus and commitment shown by these PIE audit firms in the implementation and embedding of the improvement programme. The other five assessed PIE audit firms (EY, Accon, BDO, BTB and Mazars) have achieved limited results and progress in the implementation and embedding of the improvement programme. This concerns both the changes to information systems and management procedures, such as the embedding of the 'in control cycle regarding quality' and the strengthening of the root cause analyses, as well as the change to behaviour and culture, such as making quality a decisive factor in the remuneration model for the partners. They have accordingly not shown sufficient focus or commitment to the implementation and embedding of the improvement programme.

The number of statutory audits performed that are qualified as 'inadequate' at each of the Big 4 audit firms is too high, similar to the previous regular inspection in 2014. The AFM qualified 19 of the 32 inspected statutory audits as 'inadequate': 3 at Deloitte, 4 at PwC and 6 at KPMG and EY. The quality safeguards at these audit firms have failed to prevent or detect this in a timely manner. The AFM notes that the most common deficiencies in the inadequately performed statutory audits are similar in nature to those identified in the previous regular inspection. The deficiencies in the inadequately performed statutory audits are of such severity that the AFM concluded that the audit opinions with respect to the financial statements are issued without sufficient audit evidence to support the opinion. In the inadequately performed statutory audits, the statutory auditors did not test relevant items, elements or assertions within the inspected material parts of the audit or their audit procedures with respect to these items were inadequate. Among other things, the deficiencies concern testing the operating effectiveness of internal controls inadequately and performing of tests of details and substantive analytical procedures inadequately. The critical evaluation of audit evidence was also inadequate. The findings are similar to the conclusions of the International Forum of Independent Audit Regulators (IFIAR), which concluded in its most recent report of March 2017<sup>1</sup> that the percentage of inspected audits with significant findings continued to be unacceptably high.

The AFM takes the view that the PIE audit firms have to make a more determined effort to change and to give permanently safeguarding audit quality the highest priority. This means maximum focus and commitment of resources to the improvement programme in order to bring about the necessary sustainable improvement and at the same time ensuring that additional measures are taken to safeguard the quality of statutory audits in progress and to be performed in the near future.

The audit firms are responsible for permanently safeguarding the quality of statutory audits. The Netherlands Institute of Chartered Accountants (NBA) and the Monitoring Committee Accountancy also have an important role and will have to continue to strictly monitor and encourage the improvement measures. The AFM will continue to exert pressure on the audit firms to meet the requirements for the quality of statutory audits and implement change more expeditiously. The AFM will appropriately intervene in this respect, which could mean interventions may vary per PIE audit firm. Among other things, the AFM will address the items where change has stayed behind in its subsequent assessments. The AFM will moreover intensify its supervisory efforts with respect to the other PIE audit firms, among other things by conducting inspections of the quality of statutory audits at these organisations.

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<sup>1</sup> See the IFIAR report of 3 March 2017 '2016 Inspection Findings Survey' available [here](#). The survey is a collection of the reported findings of 36 international supervisors between 30 June 2015 and 30 June 2016 with respect to the six largest international audit firms.

## 2 The AFM assessed the implementation and embedding of improvement programmes at PIE audit firms and inspected the quality of statutory audits at the Big 4 audit firms

In recent years, it has become clear that a fundamental change is required in order to improve the quality of statutory audits<sup>2</sup>. Based on its regular inspection at the Big 4 audit firms<sup>3</sup> in 2013 and 2014<sup>4</sup>, the AFM concluded that there were structural deficiencies in the quality of statutory audits and that reforms were needed.

The public, which includes investors, banks, creditors, financial analysts and consumers, should be able to rely on the opinions issued by auditors. An audit firm must ensure<sup>5</sup> that its statutory auditors carry out sufficient procedures to support the opinion that the financial statements present a true and fair view of the assets and the result of the company being audited and that the public interest is given a central priority in the performance of statutory audits. The audit opinion of a statutory auditor provides assurance with respect to the financial statements and contributes to the confidence placed in the financial statements by a large group of users. The audit is thus important for the fair and transparent functioning of markets and statutory auditors therefore have an important public role. Statutory audits are performed in a system that features inherent incentives to place other interests above the public interest, such as commercial or personal interests. Among other things, these inherent incentives stem from the fact that the auditor is paid by the company whose financial statements he audits, the fact that that quality of the statutory audit is insufficiently visible and the auditor's business or earnings model.

Partly as a result of the disappointing results of the regular inspection in 2013 and 2014, the PIE audit firms<sup>6</sup> and the NBA acknowledged the urgency<sup>7</sup> of sustainably improving the quality of statutory audits. In recent years, the PIE audit firms have taken various measures designed to safeguard the quality of statutory audits. Important among these measures were the 53 measures

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<sup>2</sup> A statutory audit is an audit of the financial reporting of a company on behalf of the public that is specifically designated as a statutory audit in the Audit Firms Supervision Act (Wet toezicht accountantsorganisaties, the Wta). It concerns the audits of financial statements of medium-sized and large companies, municipalities, provinces and various financial enterprises.

<sup>3</sup> The Big 4 audit firms are: Deloitte Accountants B.V. (Deloitte), Ernst & Young Accountants LLP (EY), KPMG Accountants N.V. (KPMG) and PricewaterhouseCoopers Accountants N.V. (PwC).

<sup>4</sup> See the AFM report of 25 September 2014 '[Findings of the inspection of quality of statutory audits at the Big 4 audit firms](#)'.

<sup>5</sup> Under Section 14 Wta, audit firms must ensure that the statutory auditors they employ or who are affiliated to them meet the requirements of or pursuant to Section 3.2 Wta (duty of care). This also covers the rules of professional competence, which among other things require compliance with the Further Regulations on Auditing and Other Standards

<sup>6</sup> PIE audit firms are audit firms licensed to perform statutory audits of Public Interest Entities (PIE). PIEs are listed legal entities, banks, insurers and reinsurers. In addition to the Big 4 audit firms Deloitte, EY, KPMG and PwC, the other PIE audit firms are: Accon avm controlepraktijk B.V., BDO Audit & Assurance B.V., Baker Tilly Berk N.V., Grant Thornton Accountants and Adviseurs B.V. Mazars Paardekooper Hoffman Accountants N.V. (Mazars).

<sup>7</sup> See the response from the NBA board of 25 September 2014 to the report 'In the Public Interest'.

in the report 'In the Public Interest' by the 'Future of the Accountancy Profession' working group (the NBA measures)<sup>8</sup> to improve the audit quality and auditor independence. An independent Monitoring Committee Accountancy was set up to monitor progress with respect to the implementation of these improvement measures in the sector.<sup>9</sup> In addition, in January 2017 the large and medium-sized firms established a joint Public Interest steering group in cooperation with the SRA (Samenwerkende Registeraccountants and Accountants-administratieconsulenten) and the NBA, which with its 'Change Agenda Audit'<sup>10</sup> aims to give further impulse to improving audit quality. The legislature has also followed up on a number of previous proposals for legislation from the AFM that may contribute to the necessary changes. A parliamentary bill on additional measures for audit firms was submitted to the House of Representatives in February 2017. It is expected that this will lead to a legal requirement for statutory auditors and audit firms to remediate statutory audits<sup>11</sup> in 2018. Furthermore, a suitability test for current and new board members and supervisory board members will be introduced and a supervisory board for PIE audit firms will become compulsory.

The AFM's supervision of audit firms aims to contribute to audit firms improving the quality of their statutory audits and making this improvement last. The supervisory approach therefore consists firstly of the regular inspection of the quality of statutory audits and secondly of urging the implementation of improvement measures in order to improve the quality of statutory audits. Internationally, the AFM is leading with this approach.

In 2014, there was a focus on measures concerning aspects such as behaviour and culture and governance. It is too soon to expect that the effect of the entirety of these measures will be fully visible in the quality of the statutory audits performed. At the same time, the audit firms need to ensure that the audit opinions issued are adequately substantiated at all time, not only in the medium to longer term. It is the AFM's public and statutory duty to assess whether the trust placed by the public in these audit opinions is justified. Two years after the improvement programmes were intensified<sup>12</sup>, 2016 was a suitable moment to assess the extent to which the PIE audit firms had responded to the urging of the AFM, supported by politicians and the NBA, to more consistently ensure the quality of statutory audits and bring about a sustainable improvement.

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<sup>8</sup> See the NBA report of 25 September 2014 '[In the Public Interest](#)'.

<sup>9</sup> The Monitoring Committee Accountancy monitors the implementation, operation and effects of the proposed NBA measures, identifies any uncertainties, omissions and imbalances and makes recommendations for possible additions and amendments. See [the Monitoring Committee Accountancy website](#).

<sup>10</sup> See the NBA newsletter of 16 June 2017 '[Change agenda audit](#)'.

<sup>11</sup> The obligation to remediate concerns a new obligation for audit firms and statutory auditors to remediate deficiencies in the performance of statutory audits and in the quality control system.

<sup>12</sup> After previous inspections of the quality of statutory audits by the AFM, the PIE audit firms announced that they had introduced improvement measures and that they would continue to do so. In response to the AFM's regular inspection in 2013 and 2014, urging from the politicians and the sector plans, the PIE audit firms acknowledged the urgency of rapid change and intensified their improvement programmes.

The AFM accordingly conducted a thematic review and a regular inspection. In the period May 2016 to May 2017, it conducted an assessment of the implementation and embedding of the improvement programme at eight PIE audit firms. The AFM assessed the extent to which these PIE audit firms had successfully implemented and embedded the improvement programme and the extent to which they had met the expectations for 2016<sup>13</sup> with respect to the pillars control, behaviour and culture and internal supervision. In the period from the end of 2015 to May 2017, the AFM also carried out a regular inspection at the Big 4 audit firms to determine whether these audit firms had been able to safeguard the quality of the inspected statutory audits that were performed in 2015 and 2016.

This report presents the AFM's findings. By publishing the outcomes in a single report, the AFM aims to present a broader picture of both the progress of the improvement programmes at the PIE audit firms and the quality of the inspected statutory audits by the Big 4 audit firms. The Big 4 audit firms collectively perform around half of the statutory audit engagements and nearly 90 per cent of the PIE audit engagements. The other PIE audit firms collectively perform around 15 per cent of the statutory audit engagements. The AFM reports its conclusions and findings publicly and transparently. The firm-specific conclusions and findings<sup>14</sup> will enable the users of financial statements, such as investors and creditors, to acquire an understanding of how the audit firms concerned compare to each other. This information can also be used by supervisory boards, and especially audit committees, for the selection and evaluation of their statutory auditors.

#### *Structure*

In section 3, the AFM describes its vision regarding the sustainable improvement of quality and the findings of its inspection and thematic review, how the PIE audit firms reflect on these findings and the actions considered by the AFM to be necessary. Section 4 contains the findings of the thematic review of the implementation and embedding of the improvement programme at the PIE audit firms assessed, and section 5 contains the findings of the regular inspection of the quality of statutory audits by the Big 4 audit firms. Section 6 describes the methodologies used. The main conclusions and findings per PIE audit firm are presented separately in part 2 of the report.<sup>15</sup> The responses from the PIE audit firms are available on the AFM website.<sup>16</sup>

Reference to persons such as the statutory auditor using the masculine form 'he' or 'his' etc. of course also include the feminine equivalent.

A list of the abbreviations used in this report is included in appendix 3.<sup>17</sup>

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<sup>13</sup> See appendix 1 in [part 3](#) of this report.

<sup>14</sup> See [part 2](#) of this report.

<sup>15</sup> See [part 2](#) of this report.

<sup>16</sup> See the [AFM website](#).

<sup>17</sup> See [part 3](#) of this report.

### 3 PIE audit firms must change more expeditiously

This section describes the AFM's vision with respect to sustainable improvement of the quality of statutory audits and the findings of its inspections. It also describes how the PIE audit firms themselves reflect on these findings and the actions the AFM deems necessary.

In response to the assessment of the design of the change and improvement measures in 2015<sup>18</sup>, the AFM noted that the PIE audit firms were working seriously on change and improving the preconditions in order to improve the quality of their statutory audits and thereby act more in the public interest. A sound implementation and embedding of the improvement programme is an essential basis for the sustainable improvement of the quality of statutory audits. The necessary improvement can only be achieved if there is focus and serious commitment to the objective of the changes, by prioritising quality and creating a quality-oriented culture. The partners, as well as the board of directors and the supervisory board need to be committed<sup>19</sup>. Despite the fact that there is a need for fundamental change in the sector and accomplishing this will take time, the audit firms also need to ensure that any audit opinion with respect to financial statements issued by auditors are adequately substantiated, so that continued public confidence in these audit opinions can be justified.

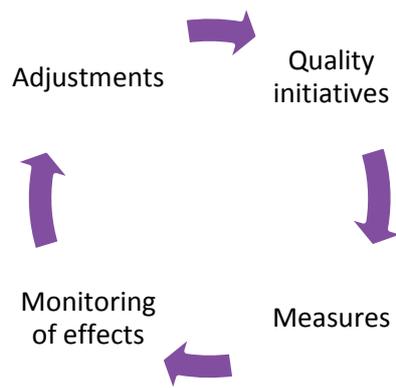
It is important that the audit firms implement a coherent set of measures at all levels within the system in which an auditor exercises his profession. After its previous regular inspection at the Big 4 audit firms, the AFM recommended measures designed to strengthen governance, create a quality-oriented culture, internalise the level of quality<sup>20</sup>, deepen root cause analyses and increase transparency with respect to quality. An effective 'quality circle' is also needed for sustainable control of the quality of the statutory audits performed (figure 1). This means that an audit firm has to have insight with respect to quality and the factors that positively and negatively affect the quality delivered (quality-contributing and quality-hampering factors), that it develops initiatives based on that insight to improve quality, that it takes measures in connection with the developed initiatives, that it monitors whether these measures are having the desired effect and makes adjustments if quality is inadequate. It is important that when gaining insight into the quality-contributing and quality-hampering factors, attention is also paid to the vulnerabilities in the system in which statutory audits are performed.

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<sup>18</sup> See the AFM report of 15 October 2015 '[Dashboard 2015: Change and improvement measures](#)'.

<sup>19</sup> The PIE audit firms have a structure in which the statutory auditors are usually also shareholders (or partners). The shareholder in Accon is a foundation (Stichting). The statutory auditors are employed by Accon. These statutory auditors are also referred to as partners in this report.

<sup>20</sup> This means that the statutory quality standard is recognised within the organisation and seen as the desired and necessary level of quality.



*Figure 1 The quality circle*

The means that an audit firm can use to gain insight into quality and the quality-contributing and quality-hampering factors and to identify what are known as ‘audit quality indicators’ include the conduct of internal quality reviews, root cause analyses and cultural surveys. The effectiveness of measures designed to improve and embed quality depends among other things on the degree to which audit firms have a culture that encourages quality-oriented behaviour, by rewarding desirable behaviour and sanctioning undesirable behaviour, through the firm’s ‘tone at the top’ and setting a good example. Effective governance at an audit firm, including a critical and competent supervisory board, also contributes to achieving the necessary quality improvement.

In its assessment of the implementation and embedding of the improvement programme, the AFM focused on the above items, grouped into three pillars: control, behaviour and culture and internal supervision. The AFM also inspected whether the Big 4 audit firms safeguarded the quality of the statutory audits performed in 2015 and 2016 in practice. For this purpose, the AFM selected 32 statutory audits and inspected whether there were deficiencies in the selected material elements of these audits that were of such significance to indicate that the audit opinions issued by the statutory auditors were not adequately substantiated. The AFM also inspected the quality safeguards regarding these statutory audits, such as the internal quality review and the Engagement Quality Control Review (EQCR).

## The improvement of quality at the PIE audit firms is too slow

Based on the outcome of its assessment, the AFM concludes that the implementation and embedding of the improvement programme at the PIE audit firms is progressing too slowly and that the quality of the inspected statutory audits at the Big 4 audit firms is not satisfactory. The findings underlying this conclusion are shown in figures 2 to 4 below. Firstly, the AFM explains the findings of the assessment of the improvement programme at the PIE audit firms and secondly the findings of the inspection to whether the Big 4 audit firms had been able to ensure that the quality of the statutory audits performed was safeguarded. The AFM presents these findings in more detail in sections 4 and 5.



*Figure 2 Findings of assessment of the implementation and embedding of improvement programmes at eight PIE audit firms and GT<sup>21</sup>*

The PIE audit firms did not meet the expectations for 2016 with respect to the implementation and embedding of the improvement programme. They accordingly failed to meet the AFM's expectation for 2016 and they are falling behind with respect to achieving the medium to long-term objectives for improving and sustainably safeguarding the quality of their statutory audits.

The least good results realised by the eight PIE audit firms were on the items of the pillar control. The 'in control cycle on quality' is still not adequately embedded in the organisation of most of the PIE audit firms. The same applies to the conduct of root cause analyses with sufficient depth and the responding to the findings of the culture surveys. In the pillar behaviour and culture, most of the PIE audit firms have ensured that quality is a decisive factor in the policy regarding the appraisal, remuneration and promotion of employees. The fact that quality is not a decisive factor in the remuneration of the partners at the majority of the assessed PIE audit firms is a cause for concern. The best results were achieved in the pillar internal supervision. The assessed PIE audit firms have expeditiously formed a supervisory board and most of them have a supervisory board that is critical towards the board of directors and the organisation with respect to quality and the policy decisions that the board of directors takes. The AFM takes a positive view regarding the focus and commitment shown by Deloitte, KPMG and PwC in the implementation and embedding of the improvement programme. These firms made more progress in 2016 with respect to the

<sup>21</sup> This figure shows the extent to which the expectations for 2016 were met. The level is based on the degree to which the expectations for 2016 regarding the elements of the pillars were met. The qualifications on the ten elements were used to determine the level.

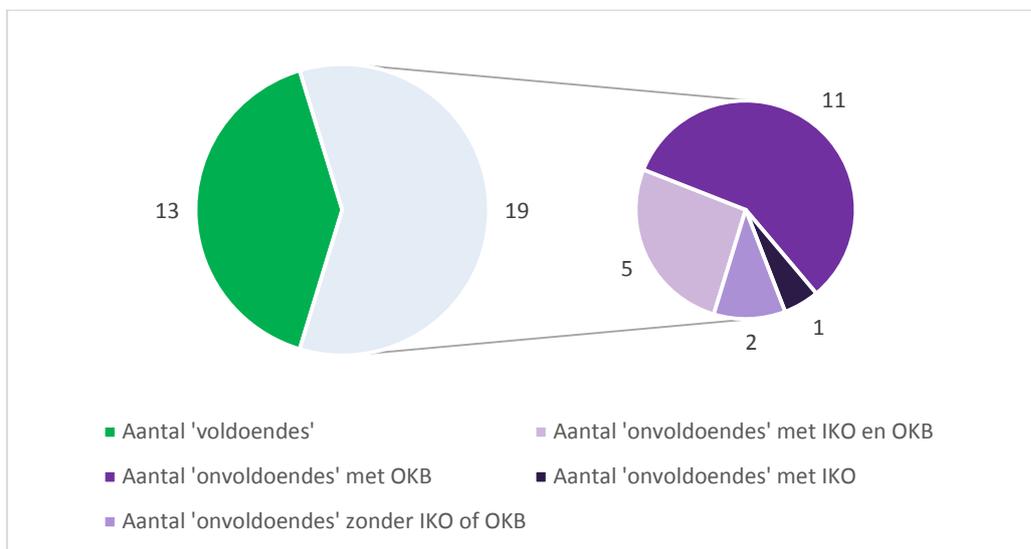
pillars behaviour and culture and internal supervision, and on the item of root cause analyses in the pillar control than the other five assessed PIE audit firms. Deloitte, KPMG and PwC have made more progress, for example, on realising a quality-oriented culture, by the board of directors setting an example with respect to behaviour, by making quality a decisive factor in the appraisal and remuneration policy of the partners and by deepening the root cause analyses. Section 4 presents a detailed explanation and description of some good practices with respect to these elements.

Figure 3 below presents a summary of the qualifications on the items of the three pillars at the eight PIE audit firms.



Figure 3 Summary of the qualifications on the elements of the three pillars

From its regular inspection at the Big 4 audit firms, the AFM concludes that the number of inadequately performed statutory audits<sup>22</sup> is too high at each of the Big 4 audit firms, as was the case in the previous regular inspection. The quality safeguards at these audit firms have failed to prevent or detect this in a timely manner. The outcomes regarding the 32 inspected statutory audits (13 'adequate' and 19 'inadequate') are shown in figure 4 below, showing which of the inadequate statutory audits concerned the quality safeguards known as the internal quality review (IQR) and the engagement quality control review (EQCR).



*Figure 4 Outcomes of inspection of the quality of inspected statutory audits by Big 4 audit firms (first circle) with the 'inadequate' statutory audits divided into audits with and without the IQR and EQCR quality safeguards<sup>23</sup> (second circle)*

The most common deficiencies in the inadequately performed statutory audits are similar in nature to those identified in the previous regular inspection. Professional competence at audit firms therefore either has to be improved or applied more effectively. The outcomes of the inspection of the quality of statutory audits performed also generally correspond to the outcomes of audit regulators in other countries. In its most recent report, IFIAR concludes that internationally the percentage of inspected audits with significant findings continues to be unacceptably high. The IFIAR report shows that 42 per cent of the inspected audits of listed PIEs ('public interest entities') included one or more significant findings.

<sup>22</sup> This concerns the inspected statutory audits that the AFM qualified as 'inadequate'. How the AFM determines this qualification is explained in section 6.2.4.

<sup>23</sup> In section 5.2, the AFM addresses the fact that these quality safeguards at the Big 4 audit firms failed to prevent or detect the deficiencies in the statutory audits that were performed inadequately.

## The PIE audit firms emphasise that embedding changes takes time

The AFM has asked the PIE audit firms to reflect on the findings of the inspection and on the connection between the improvement measures and the quality of the statutory audits performed. All PIE audit firms acknowledge generally that the implementation and embedding of the improvement programme will contribute to sustainably safeguarding the quality of statutory audits. The audit firms recognise the connection, but most of them stress that embedding the changes in the area of behaviour and culture will take time and that therefore the effects of the improvement measures are not yet fully visible in the quality of the statutory audits. Certain other PIE audit firms also state that they believe the time between the finalising of the design of the improvement programme and the assessment of the implementation and embedding is too short. Despite the efforts already made on the various items, all PIE audit firms recognise that their firms still can and must evolve to a greater or lesser extent.

## The outcomes of the inspections call for action by the sector

On the one hand, it is too soon to state that the improvement programmes, NBA measures and the new legislation to be implemented will not lead to the desired effect in the medium to long term. The effects of improvement measures relating to aspects such as behaviour and culture and governance may not yet be fully visible in the quality of statutory audits performed. The AFM will at this stage not make any new recommendations regarding additional legislation and regulation. On the other hand, the PIE audit firms have not shown to a greater or lesser extent the results that could have been expected of them at this stage regarding both the implementation and embedding of the improvement programme and the quality of the statutory audits performed. The AFM takes the view that the PIE audit firms have to change more expeditiously and that the sustainable safeguarding of the quality of statutory audits should have the highest priority. Utmost attention and deployment of resources to the improvement programme is meant in order to achieve the necessary sustainable improvement, and at the same time making an effort to ensure that additional measures are taken to safeguard the quality of the statutory audits to be performed both now and in the short term.

The AFM accordingly holds the PIE audit firms to their previous commitments to do everything to achieve fundamental changes. This means that the PIE audit firms need to apply increased urgency and decisiveness to drawing attention and resources in order to achieve their medium to long-term objectives for a sustainable improvement of quality. The AFM expects this in any case with respect to all items of the pillars control, behaviour and culture and internal supervision, and to all elements of the quality circle as described above. Insight into the level of quality delivered and awareness of the root causes that lead to deficiencies in audits within the audit firm are essential in order to be able to take the necessary improvement measures that will effectively improve the quality of the statutory audits performed. In particular, the AFM wishes to draw the attention of audit firms to:

- developing of management information on quality, for instance from IQRs, EQCRs and root cause analyses;

- improving professional expertise and proper application thereof;
- identifying the root causes of the level of quality delivered and the factors that enhance and limit quality (the 'audit quality indicators');
- measuring and monitoring the effects of improvement actions, including the effect on the quality of the statutory audits performed;
- encouraging desirable behaviour and a quality-oriented culture by interventions on leadership, the setting of a good example by the board of directors and the partners, and a policy with respect to appraisal, remuneration, appointment and sanctions for partners in which quality has a central priority;
- taking additional measures directly at the level of the statutory audit engagements in order to continuously safeguard the quality of all statutory audits performed. These measures, which may be temporary in nature and in addition to those measures that are focused more on the medium to long term, may for instance include the coaching of statutory auditors during the performance of audits, additional IQRs before the issuance of audit opinions, and an (interim) critical evaluation of the client portfolio in relation to the available time, people and resources.

The AFM wishes to emphasise that the audit firms are responsible for permanently safeguarding the quality of their statutory audits. The NBA and the Monitoring Committee Accountancy also have an important role and have to continue to strictly monitor and promote the improvement measures. It is also important that the sector explores other potential measures, for instance in relation to the business or revenue model, in case the current measures fail to achieve the desired effect. The steering group In the Public Interest has made a start on this with its 'Change Agenda Audit'. The supervisory boards of audit clients can also contribute to change by continuing to hold a dialogue on quality with their auditors.<sup>24</sup> The AFM will continue to draw attention internationally to the expected changes focused on improving and sustainably safeguarding quality, since the challenges in the sector are not restricted to the Netherlands.

#### The AFM will continue to urge the audit firms to change more expeditiously

The AFM will continue to exert pressure on the audit firms to meet the requirements for the quality of statutory audits and implement change more expeditiously. The AFM will apply appropriate interventions in this respect that may vary per audit firm. Encouraging the desired (behavioural) changes is part of the consideration of what type of intervention will be appropriate. The AFM will also include the items where change has stayed behind in its subsequent thematic reviews. The AFM will in addition intensify its supervisory efforts with respect to the other PIE audit firms, including carrying out an inspection of the quality of the statutory audits performed by these organisations. Specifically, the AFM will assess the implementation and embedding of the improvement programme at GT. The AFM will also intensify its dialogue with the supervisory boards of the PIE audit firms. The AFM will consider

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<sup>24</sup> See also the IFIAR publication 'Audit Committees and Audit Quality: Trends and Possible Areas for Further Consideration' of April 2017 available at the [IFIAR website](#).

whether enforcement on the basis of the current inspections is appropriate. In addition, the findings, as well as other supervisory information, may be included in the upcoming suitability tests for board members and members of the supervisory board of PIE audit firms.

## 4 The implementation and embedding of the improvement programmes at the assessed PIE audit firms is proceeding too slowly

This section describes the outcomes of the assessment carried out by the AFM into the implementation and embedding of the improvement programmes at eight PIE audit firms.

The AFM assessed the implementation and embedding of the improvement programme at eight PIE audit firms in 2016<sup>25</sup>. In 2014, the sector committed to implementing the measures to improve the quality and independence of audits included in the NBA report 'In the Public Interest'. These measures form the basis for the medium to long-term objectives for improving and permanently safeguarding the quality of statutory audits established by the AFM in 2015. These objectives<sup>26</sup> were shared with the sector in 2015 and are the basis for the AFM's assessments in 2015 and 2016 of the design and implementation and embedding of the improvement programme with the aim of improving the quality of statutory audits. The outcomes of the assessment in 2016 are shown in a dashboard.

GT is not included in the 2016 assessment. The AFM had concluded that GT had not adequately addressed the items of attention with respect to the design of the change and the improvement measures from the 2015 assessment in order to enable an assessment of the implementation and embedding of the improvement programme.

An explanation of the three pillars is provided below, followed by the conclusions of the assessment and the dashboard.

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<sup>25</sup> These are Deloitte, EY, KPMG, PwC, Accon, BDO, BTB and Mazars.

<sup>26</sup> See appendix 2 in [part 3](#) of this report.

The implementation and embedding of the improvement programme is assessed on the basis of three pillars

The implementation and embedding of the improvement programme is assessed on the basis of three pillars: control, behaviour and culture and internal supervision (figure 5).

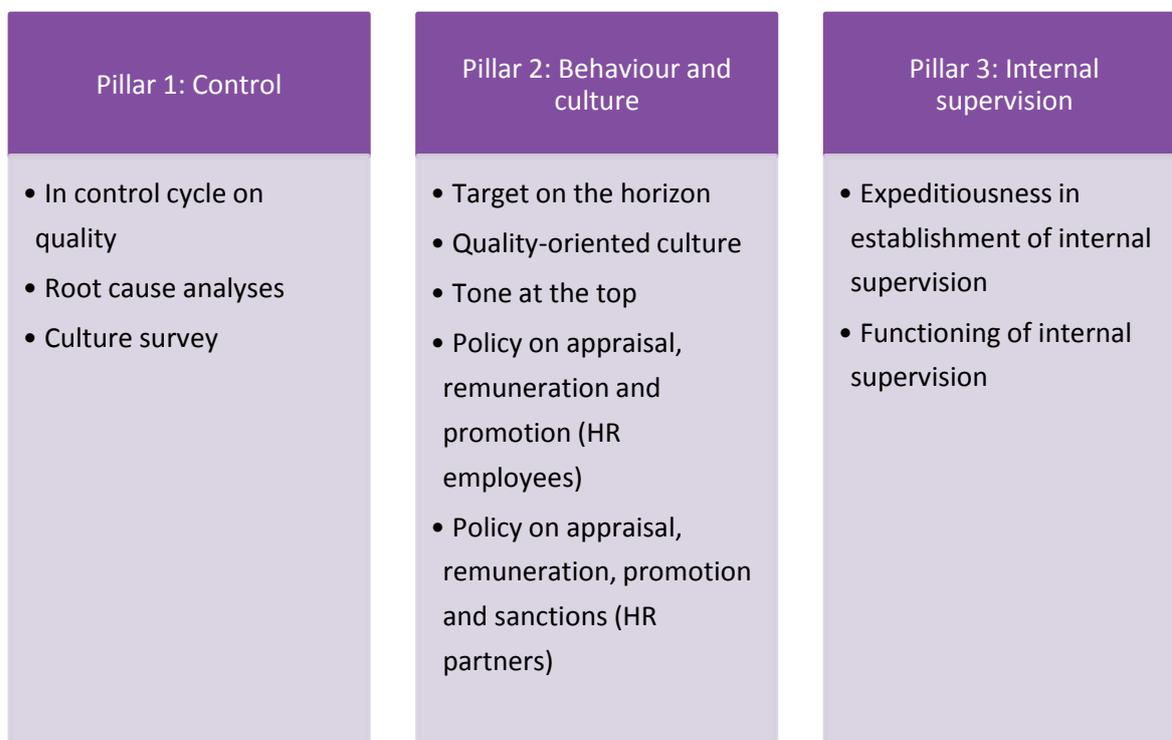


Figure 5 Pillars

For each pillar element, the AFM has assessed whether the eight PIE audit firms met the expectations for 2016<sup>27</sup> for the implementation and embedding of the improvement programmes. The expectations for 2016 were based on the medium to long-term objectives. They are established on the basis of legislation and regulation and the (problem) analyses and proposals for improvement as described in the NBA report 'In the Public Interest' and the recommendations of the AFM in past years as a result of its inspections. The expectations for 2016 were ambitious and reflect the ambition of the sector to implement the measures stated in the report 'In the Public Interest' expeditiously. The expectations indicate what was necessary in 2016 regarding the implementation and embedding of the improvement programme in order to be able to achieve the medium to long-term objectives after the design of the change and improvement measures as assessed in 2015<sup>28</sup>. These expectations were shared with the assessed PIE audit firms when the assessment was announced.

To assess whether the expectations had been met, the AFM held (group) interviews with various people at various levels in the organisation. Use was also made of various sources of information,

<sup>27</sup> See appendix 1 in [part 3](#) of this report.

<sup>28</sup> See section 6.1.1 for an explanation of the formulation of the expectations for 2016 and the medium to long-term objectives.

such as documents, minutes of meetings and personnel files (HR files). The AFM qualified each pillar element in words based on the number of expectations that were or were not met for an element. The qualifications used are: 'in line with expectation', 'nearly in line with expectation', 'short with expectation' and 'well short with expectation'. The methodology and the method to qualify each pillar elements were described in section 6.1.

#### *Pillar 'control'*

The board of directors of an audit firm significantly influences quality of statutory audits, since the board of the organisation manages the organisation based on its vision and mission and the associated quality objectives. The board of directors designs the quality control system in line with these objectives, propagates this system and monitors it as to safeguard the quality of statutory audits. Therefore, information that provides insight into the various aspects that contribute to the quality of statutory audits is needed. Regarding the pillar control, the AFM assessed:

- how the board of directors directs the audit firm with respect to quality and how it thereby practically shapes the in control cycle on quality;
- how the audit firm applies two relevant instruments for the control of the audit firm in practice and uses them to direct the firm: the culture survey and the root cause analyses.

#### *Pillar 'behaviour and culture'*

The culture of an organisation affects what people consider to be important or what people believe is considered to be important. People ascribe significance to events in interaction, and thereby select the events that they consider to be important. This creates patterns of behaviour: 'This is how we do this here'. Culture is thus an important determinant of behaviour, and vice versa. The effectiveness of the measures designed to improve and safeguard quality depends significantly on the extent to which audit firms have a quality-oriented culture. Regarding the pillar behaviour and culture, the AFM assessed:

- the extent to which employees feel engaged with the mission, vision, strategy and core values of the audit firm (target on the horizon);
- how the organisation encourages its employees to show the desired behaviour that reflects the quality-oriented culture;
- how the board of directors and the partners contribute to a quality-oriented culture through the 'tone at the top' and setting an example;
- the extent to which employees and partners are encouraged to display the desired behaviour by the policy with respect to appraisal, remuneration, promotion and sanctions (HR employees and HR partners).

#### *Pillar 'internal supervision'*

Among other things, an effective internal supervisory body (the supervisory board) ensures that the board of directors of the audit firm is continually aware of its obligation to meet public

expectations regarding the delivery of statutory audits of good quality in the public interest. The supervisory board thereby contributes to safeguarding the necessary level of quality. Regarding the pillar internal supervision, the AFM assessed:

- the degree of expeditiousness in the establishment of internal supervision;
- how the supervisory board fulfils its duty of keeping the board of directors aware of its obligations in practice and the exercise of the powers assigned to the supervisory board.

### Change is an intensive process

The implementation and embedding of the proposed changes is an intensive process, since it is a combination of taking actions with respect to various aspects of an organisation (direction, behaviour, processes, decisions), monitoring the effects of the various actions and continuous adjustment to these actions. Change demands focus and commitment of resources in order to achieve the desired results and bring about sustainable improvement. The PIE audit firms were expeditious in the formulation of their improvement plans in 2015. For 2016, the AFM expected that the PIE audit firms had achieved results with respect to the implementation and embedding of the improvement programme. These results are necessary in order to achieve the medium to long-term objectives.

### **The AFM takes the view that the implementation and embedding of improvement programmes at the PIE audit firms is progressing too slowly.**

The dashboard below (figure 6) shows that none of the assessed PIE audit firms met all the expectations for 2016. Insufficient results were achieved with respect to managing quality by the board of directors, the monitoring of the effects of the actions taken and establishing a desired quality-oriented culture and the change of behaviour associated with this.



*Figure 6 Dashboard 2016 Outcomes of the assessment of the implementation and embedding of improvement programmes at eight assessed PIE audit firms and GT<sup>29</sup>*

<sup>29</sup> This figure shows the extent to which the expectations for 2016 were met. The level is based on the degree to which the expectations regarding the pillar elements were met. The qualifications on the 10 elements were used to determine the level using a scale from 1 to 4.

Three audit firms (Deloitte, PwC and KPMG) have made more progress than the other five assessed PIE audit firms. The AFM is positive regarding the focus and commitment shown by these firms to the implementation and embedding of the improvement programme in 2016. The strong focus of the board of directors of Deloitte on directing quality contributes to the effective conversion of plans into actions. The board of directors could make better use of the dialogue with partners and employees. KPMG has intensified its managing of quality, but so far the change has not led to an adequate change in behaviour and culture. PwC has made progress on achieving a quality-oriented culture. PwC is action-oriented, but greater attention needs to be given to monitoring the actions taken. The other five PIE audit firms (EY, Accon, BDO, BTB and Mazars) fell short or well short with the expectations for 2016 on most of the pillar elements. They have achieved limited results on the three pillars and have not made satisfactory progress, concerning both the changes to information and other systems and management processes and the change of behaviour and culture. They have not always shown the focus or commitment needed to achieve the expectations for 2016.

In section 4.1 to 4.3, the AFM discusses the extent to which the assessed PIE audit firms met the expectations for 2016 for each pillar and the differences observed between the assessed PIE audit firms. The AFM notes that the board of directors has insight into the current culture, that the information for directing towards quality is inadequate and that the effects are not adequately monitored (see section 4.1). The AFM also notes that the board of directors is setting an example by its behaviour and that more commitment is needed to encourage desirable behaviour (see section 4.2). Lastly, the AFM notes that the supervisory boards are showing their countervailing power, that they could be more effective and that supervision of the policy on quality is inadequate (see section 4.3). The AFM also provides some good practices<sup>30</sup> from its assessment. An overview of the qualifications on the pillar elements for each assessed PIE audit firm is provided in the firm-specific conclusions and findings in the second part of this report<sup>31</sup>.

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<sup>30</sup> Good practices are practical examples from specific PIE audit firms regarding elements of the pillars that show how audit firms can interpret the implementation and embedding of the expectations for 2016. These good practices can inspire other audit firms to achieve further improvement. Alternative interpretations that are appropriate to the specific features of the audit firm concerned are also possible.

<sup>31</sup> See [part 2](#) of this report.

#### 4.1 Control: the board of directors has insight into the current culture, the information for managing quality is inadequate and the effects are not adequately monitored

Control	Spread		
- In control cycle on quality	6	1	1
- Root cause analyses	4	2	2
- Culture survey	1	4	3

Table 1 Qualifications for the pillar control<sup>32</sup>

On the pillar control, most of the assessed PIE audit firms fell short or far short of the expectations for 2016 on the elements in control cycle on quality, root cause analyses and culture survey. The extent to which the expectations were met varied between the assessed PIE audit firms.

##### 4.1.1 In control cycle on quality

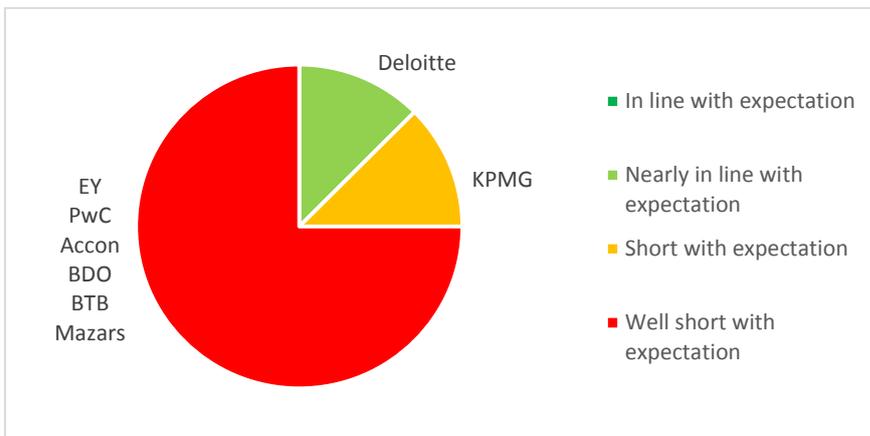


Figure 7 In control cycle on quality<sup>33</sup>

Most of the assessed PIE audit firms fell short or far short of the expectations for 2016 on the element in control cycle on quality because the available information did not provide adequate insight into the various aspects that contribute to the quality of statutory audits. The boards of directors of the assessed PIE audit firms therefore lack a structured insight into the status with respect to the realisation of strategic quality objectives, including a quality-oriented culture. In addition, most of the assessed PIE audit firms do not sufficiently manage quality and the

<sup>32</sup> The distribution shows the allocation of the qualifications across the eight assessed PIE audit firms.

<sup>33</sup> The expectations and qualifications are included in appendix 1 in [part 3](#) of this report.

monitoring of the effects of the actions taken is inadequate. This is explained in more detail below.

### The available information gives inadequate insight into the quality objective in most cases

The AFM has assessed whether the boards of directors of the assessed PIE audit firms have the relevant information in order to be able to give direction regarding the in control cycle on quality. Among other things, this means that information is available with respect to quality, the culture inside the organisation and insight in factors that en or hamper audit quality, for example from root cause analyses, IQRs, EQCRs, incidents, reviews by regulators, culture surveys and information from HR policies. Deloitte and KPMG have initiated processes whereby they have relevant information available. They have insight into the various aspects that contribute to quality and the change with respect to the quality of statutory audits. The other PIE audit firms (EY, PwC, Accon, BDO, BTB and Mazars) do not have sufficient information to obtain this insight.

In order to be able to control, information is needed that relates to the status of the organisation with respect to the strategic quality objectives as well as information that is useful for taking (policy) decisions. Deloitte and KPMG have both. This is not the case at the other assessed PIE audit firms (EY, PwC, Accon, BDO, BTB and Mazars). These firms do not have adequate insight into their status with respect to the strategic quality objectives. The main purpose of the available information is to account for the quality control processes implemented or on the activities of the departments that support quality. This information is not sufficiently suitable for taking policy decisions.

### Inadequate managing of quality and inadequate monitoring of the effects of actions taken

It is the duty of the board of directors to establish, on the basis of the available information, the status of the audit firm with respect to the formulated quality objectives and then to take decisions in order to provide additional or adjusted managing of quality objectives. It is also a duty of the board of directors to ensure that these decisions are implemented. The boards of Deloitte and PwC are well equipped to take action and intervene in order to enhance quality. At KPMG, the discussion of the status of the audit firm with respect to the quality objectives takes place in a forum set up for that purpose with representatives of professional and management positions, but as a result there is less formal direction by the board of directors. The other PIE audit firms (EY, Accon, BDO, BTB and Mazars) lack a proactive attitude by the boards of directors with respect to managing quality. Managing quality usually takes place on an incidental basis as a result of incidents or reports on IQRs. In addition, half of the PIE audit firms (EY, BDO, BTB and Accon) do not always assign the highest priority to quality in their vision and mission and therefore also not in the implementation of policy in the organisation. At some PIE audit firms (EY, BDO and BTB), the statutory auditors are also given a great deal of liberty in the implementation and embedding of the intended quality objectives, meaning there may be differences in results and it is less certain whether the desired effects will be consistently achieved.

## Inadequate insight into the effect of actions taken

Almost all assessed PIE audit firms (EY, KPMG, PwC, Accon, BDO, BTB and Mazars) do not have adequate insight into the effects of actions taken. Attention by the board of directors to this issue and the tools to measure effectiveness are lacking. Adjustments to direction can be made on the basis of these findings where necessary. Deloitte is the only firm to adequately monitor the progress and impact of actions and quality initiatives and important policy decisions. PwC uses a culture monitor to gather information on behaviour and culture and thus gain insight into the effect of interventions with respect to behaviour.

### Good practice Deloitte: Plan-Do-Check-Act cycle

Deloitte applies the 'Plan-Do-Check-Act' cycle for directing its quality agenda. This is based on the Audit Quality Plan, with the initiatives the organisation takes with respect to improving quality. This is a dynamic document that is adjusted at the monthly meetings of the Audit Quality sub-committee of the board of directors. A board package is prepared for these meetings with information on the progress of the quality initiatives in place. This information concerns both substance and the process itself and provides insight into the actions taken and the recurring issues from the existing information. This also leads to proposals for board decisions. The board package thus provides insight into the progress of the implementation of actions and monitors the effects of significant board decisions.

### Good practice PwC: culture monitor

The culture monitor at PwC is an example of the gathering of information with respect to behaviour and culture. This integrates the findings of the various reviews of behaviour and culture and analyses of recurring issues. This enables PwC to identify attention items and priorities.

## 4.1.2 Root cause analyses

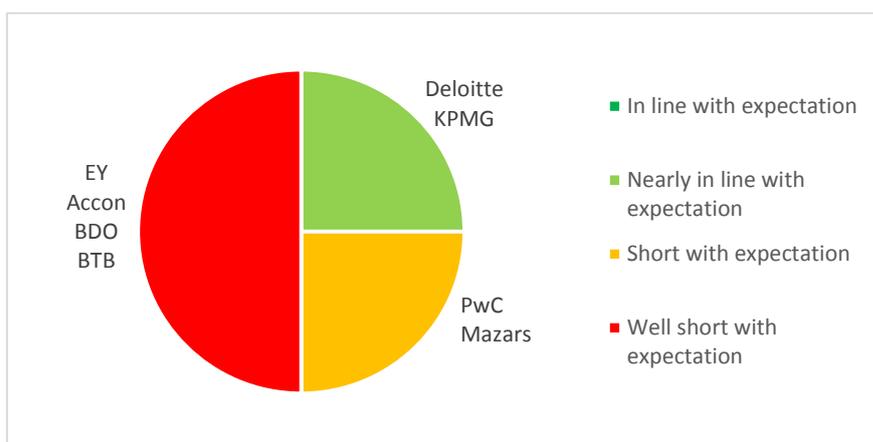


Figure 8 Root cause analyses<sup>34</sup>

Most of the assessed PIE audit firms fall short or well short of the expectations on the element root cause analyses, because inadequate examination is made of the root causes that contribute or hamper audit quality. Furthermore, PIE audit firms do not apply sufficient specific behaviour expertise in their analyses. Root cause analyses moreover generally apply to the statutory auditor and individual audits, meaning that no organisation-wide causes are identified. In addition, there is little attention from the board of directors at most PIE audit firms to the outcomes of the root cause analyses and the monitoring of actions initiated. This is explained in more detail below.

### Causes that contribute and hamper audit quality not adequately identified

Root cause analyses in response to statutory audits in which the quality is either inadequate or adequate that are carried out at statutory auditor level and at organisation level provide insight into the factors that contribute and hamper audit quality. This insight may be useful in determining the actions needed to achieve the formulated quality objectives. The AFM has assessed whether the PIE audit firms perform root cause analyses in which the above aspects are in any case involved, and whether the analyses are performed in accordance with the formulated policy and procedures. Half of the assessed PIE audit firms (Deloitte, KPMG, PwC and Mazars) carry out their formulated policies and their analyses are carried out at both statutory auditor and organisation level. At EY, Accon and BTB, the policy is inadequate in certain respects and/or the policies are not implemented in practice. EY, Accon and BTB have for example carried out only a few root cause analyses and only with respect to individual audits. PwC could improve the execution of the process. This improvement concerns various aspects such as the timeliness of the analyses, the availability of input and the documentation of the process and the outcomes. BDO has not formulated a policy regarding the above-mentioned aspects and thus has not met any of the established expectations with respect to the element root cause analyses. Since this firm has not formulated and implemented a policy, it is not included in the explanation below.

<sup>34</sup> The expectations and qualifications are included in appendix 1 in [part 3](#) of this report.

## Behavioural expertise not often employed

KPMG and PwC employ behavioural expertise in their root cause analyses. Deloitte, EY, Accon, BTB and Mazars do not, meaning there is a risk that the causes relating to behaviour and culture are not adequately identified. This could mean there is no direction in relation to the strengthening of desirable behaviour.

### Good practice KPMG: root cause analyses

At KPMG, the 'Audit Quality Issues Council' (AQIC) is responsible for initiating and carrying out root cause analyses. In addition to its analyses, the AQIC proposes actions to address identified causes and thus improve the quality of the statutory audits. The AQIC includes persons responsible for the audit firm, HR, the professional practise department and advisory. For performing root cause analyses a competent independent team which possesses knowledge of both the audit process and behaviour and culture is used. KPMG applies a methodology in which 'soft controls' are considered in addition to the causes in the performance of audits. To apply the analysis methodology effectively, the analysts are trained to carry out the root cause analyses in areas including that of behaviour and culture.

### Limited discussion by the board of directors of the outcomes of the root cause analyses

Discussions of the quality of the root cause analyses performed and the repeating root causes can enable the board of directors to take appropriate action, for instance by intervening in processes and behaviour. The boards of Deloitte, EY and PwC have discussed the quality of the root cause analyses performed, the outcomes and the repeating root causes identified. At KPMG, the follow-up of outcomes takes place in the same forum as the performance of root cause analyses. The discussion of the outcomes takes place in this forum, which includes both representatives from professional practice and the board of directors, and the board of directors is kept informed. This means that there is less discussion by the board of directors of the outcomes of the root cause analyses performed. The minutes of board meetings at the other PIE audit firms (Accon, BTB and Mazars) show that there is only limited discussion of the performance and outcomes of root cause analyses.

### Inadequate monitoring of actions taken as a result of root cause analyses

Deloitte and KPMG have initiated processes and systems, for instance using key performance indicators, to monitor the effects of actions taken on the basis of the outcomes of the root cause analyses. PwC regularly evaluates the status of the actions taken as a result of the root cause analyses and whether the desired effect is achieved. The other assessed PIE audit firms that carry out root cause analyses (EY, Accon, BTB and Mazars) do not have adequate insight into the effects of actions taken as a result of the root cause analyses.

### 4.1.3 Culture survey

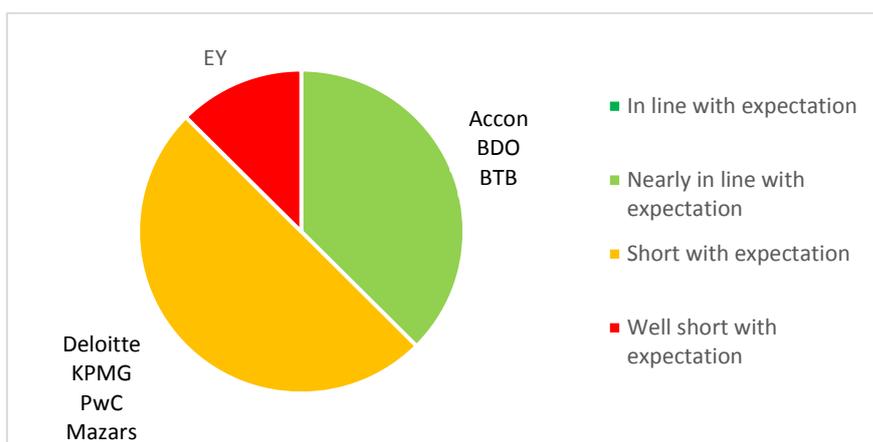


Figure 9 Culture survey<sup>35</sup>

Most of the assessed PIE audit firms fell short or well short of the expectations for the element culture survey, since culture surveys have not been structurally embedded in the organisation, in terms of either continuity of the surveys or follow-up of the findings of surveys conducted. This is explained in more detail below.

#### Culture surveys provide insight into the extent to which the culture is quality-oriented

Regarding managing quality, a culture survey provides insight into the status of the audit firm with respect to the realisation of objectives that are part of the quality-oriented culture. The assessed PIE audit firms did follow-up on the need to devote more attention to behaviour and culture by carrying out a culture survey. Nearly all the PIE audit firms, with the exception of EY, have performed a culture survey with the involvement of an expert party. EY initiated an organisation-wide culture survey during the assessment period, but no findings were as yet available. These culture surveys are designed to measure the extent to which the culture is quality-oriented. Among the PIE audit firms that conducted such a survey, a representative share of each function group of the audit firm was involved.

#### Culture survey not adequately translated into action

The findings of the culture surveys are discussed with the employees and by the board of directors. At nearly all assessed PIE audit firms, the discussion at board level of the findings of the survey was inadequate, since the discussion did not lead to decisions being taken with respect to the actions needed to achieve desirable behaviour. The boards of Accon, BDO and BTB formulated an action plan in response to the culture survey regarding how they would follow up the survey.

#### Structural follow-up survey of culture in the organisation

<sup>35</sup> The expectations and qualifications are included in appendix 1 in [part 3](#) of this report.

Most of the assessed PIE audit firms (Deloitte, Accon, BDO, BTB and Mazars) have decided to carry out such a culture survey on a regular basis, for instance by deciding that a similar measurement of culture will take place every one or two years to enable monitoring of developments.

#### Inadequate monitoring of actions with respect to behaviour and culture

None of the assessed PIE audit firms that carried out a culture survey monitors the effects of the actions and interventions as a result of the survey. PwC has decided that the findings of the survey will be part of the culture monitor developed by PwC to measure the effect of interventions on behaviour. BDO has also designed a plan for monitoring the effects, for instance by holding mini-surveys.

## 4.2 Behaviour and culture: the board of directors sets an example, but encouraging desirable behaviour requires more commitment

Behaviour and culture	Spread		
- Target on the horizon	4	1	3
- Quality-oriented culture	2	3	1 2
- Tone at the top	2	2	3 1
- HR employees	3	3	2
- HR partners	4	2	2

Table 2 Qualifications for pillar behaviour and culture<sup>36</sup>

Regarding the pillar behaviour and culture, most of the assessed PIE audit firms fell short or well short of the expectations with respect to the elements target on the horizon, quality-oriented culture and contribution to the policy on appraisal, remuneration, promotion and sanctions of the partners to the quality-oriented culture (HR partners). On the element tone at the top, half of the assessed PIE audit firms met or nearly met the expectations. On the element contribution to the policy on appraisal, remuneration, promotion and sanctions of the employees to the quality-oriented culture (HR employees), most of the assessed PIE audit firms met or nearly met the expectations. The extent to which the expectations were met varied between the assessed PIE audit firms.

<sup>36</sup> The distribution shows the allocation of the qualifications across the eight assessed PIE audit firms.

### 4.2.1 Target on the horizon

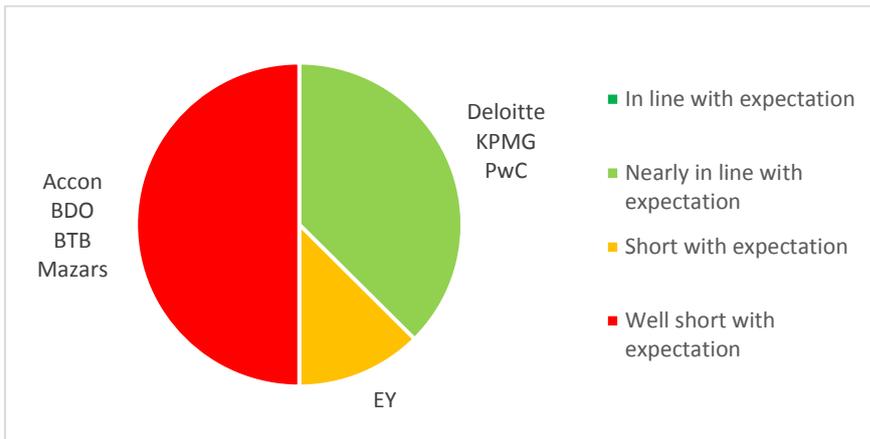


Figure 10 Target on the horizon<sup>37</sup>

Most of the assessed PIE audit firms have a mission, vision and strategy (target on the horizon) that is quality oriented, is known by the employees and that strives to do more than simply comply with legislation and regulation. However, most of the assessed PIE audit firms have not or not yet succeeded in translating their mission, vision and strategy into daily practice. This is explained in more detail below.

#### The target on the horizon is known by the employees

At all assessed PIE audit firms, the target on the horizon sets a higher objective than simply complying with legislation and regulation. Half of the audit firms (Deloitte, KPMG, PwC and Accon) have included quality improvement in this element. In addition, the employees at half of the audit firms (Deloitte, EY, KPMG, PwC) are aware of what the target on the horizon is.

<sup>37</sup> The expectations and qualifications are included in appendix 1 in [part 3](#) of this report.

## Translating the target on the horizon into actual desirable behaviour by employees is inadequate

The extent to which a change can succeed depends in part on the extent to which the target on the horizon is clearly translated into desirable behaviour by the employees, so that this provides them with adequate direction and is actionable.

None of the assessed PIE audit firms have succeeded in effectively translating their target on the horizon into actual desirable behaviour by their employees. As long as it is not clear what exactly is expected of an employee, or the employees are not adequately called to account in this respect, there will be little motivation for an employee to display different behaviour. All audit firms have a code of behaviour which includes the competences expected of their employees. But this has not or not yet led to these audit firms succeeding in translating the target on the horizon into actual desirable behaviour by their employees, so that the majority of the employees understand what the target on the horizon means for them. The employees cannot therefore properly understand the expected competences in order to apply them in daily practice.

### 4.2.2 Quality-oriented culture

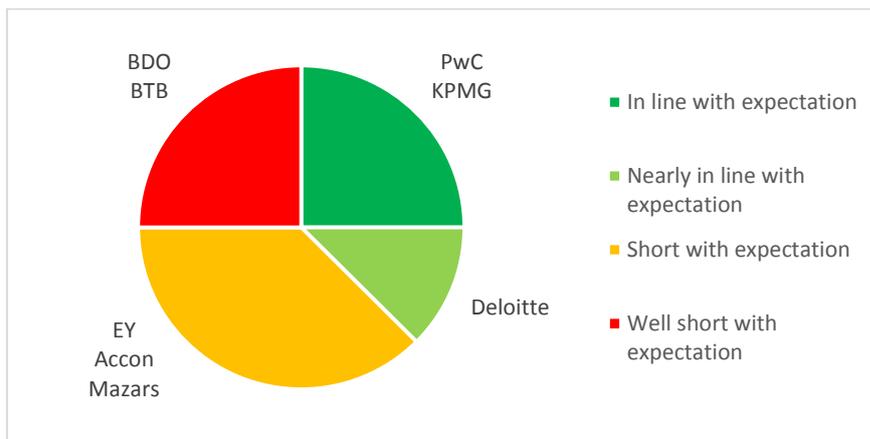


Figure 11 Quality-oriented culture<sup>38</sup>

Most of the assessed PIE audit firms are not taking adequate action to encourage behaviour that supports quality. The employees cannot specify what the audit firm is doing to encourage them to display desirable behaviour. At most of the assessed PIE audit firms, the employees do not adequately experience the urgency of change. This is explained in more detail below.

<sup>38</sup> The expectations and qualifications are included in appendix 1 in [part 3](#) of this report.

Interventions deal with systems and processes, but more attention is needed for intervention with respect to leadership and competences

To ensure that employees act in line with the target on the horizon formulated by the audit firm it is important that interventions are made on the hard side in the systems and processes, but also on the softer side, in relation to behaviour and leadership. To achieve a change, it is important that the various interventions are combined into an integrated approach. Half of the PIE audit firms (EY, KPMG, PwC and Mazars) are taking sufficient action to strengthen leadership and encourage behaviour by employees that contributes to quality. Examples of actions taken include the encouraging of feedback in the organisation, dilemma sessions with employees, dialogue sessions on how issues are dealt with between employees and with audit clients. These interventions are important to create a culture of giving feedback and learning from each other so that the quality of statutory audits improves.

Good practice PwC: dialogue sessions

PwC has introduced the programme 'Moments that matter' in order to encourage a change of behaviour among employees and partners. This programme contributes to the dialogue on ways of expected behaviour between employees and also between employees and audit clients. PwC has supported this programme with various resources, whereby the dialogue sessions are experienced by the employees as most important. In these dialogue sessions, actors portray familiar working situations in which those present can intervene. The employees experience mutual discussion of difficult working situations as important.

Most audit firms (Deloitte, KPMG, PwC, Accon, BDO and Mazars) have intervened adequately in systems and processes and strengthening professional expertise. The employees are able to cite many of these interventions. Examples include: coaching of statutory auditors in the performance of the statutory audit, standardisation of the audit process, more attention to the risk profile of the client and the available resources in the client acceptance and continuation process, making certain working programmes mandatory and developing the knowledge of employees.

The employees experience inadequate urgency for change

It is important that the employees feel the urgency to actually change in order to realise the change at the audit firm. At most of the assessed PIE audit firms (EY, Accon, BDO, BTB and Mazars), the employees do not adequately experience the urgency of change. At two audit firms (EY and Mazars) the employees recognise that the sector has to undergo a major change, but the urgency to implement or formulate the change facing their own organisation is lacking. At three assessed audit firms (Deloitte, KPMG, PwC), the employees adequately understand the urgency of change.

### 4.2.3 Tone at the top

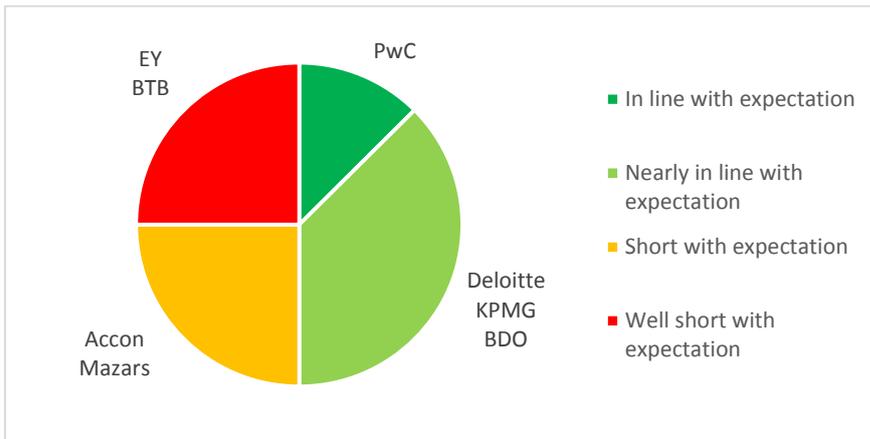


Figure 12 Tone at the top<sup>39</sup>

Although the board of directors at most of the assessed PIE audit firms has a tone at the top that reflects the organisation's mission, vision, strategy and core values, the employees do not adequately experience this tone at the top from the partners<sup>40</sup> in the organisation. This is explained in more detail below.

#### Boards of directors express a quality-oriented culture in both tone and behaviour

The tone of the board of directors and the examples set by the board of directors significantly influence what issues are considered as important by the employees. This concerns not only what the board of directors says; the main issue is that the actions by the board of directors is in accordance with the message that is communicated. Most of the assessed audit firms (Deloitte, KPMG, PwC, BDO, Accon and Mazars) have a board of directors that expresses a quality-oriented culture in its communications and behaviour that reflects the mission, vision, strategy and core values of the audit firm. At half of the assessed audit firms (Deloitte, KPMG, PwC, Accon), the employees also experience this reflection in practice.

At the Big 4 audit firms, the boards are leading the process of realising a quality-oriented culture. It is essential that the board of directors of the Dutch holding company<sup>41</sup> supports this change of culture and sets the right priorities in this respect. In addition, the message communicated has to be unequivocal and supported by the behaviour of both the board of directors of the Dutch holding company and the board of directors of the licensee. At three of the Big 4 audit firms (Deloitte, KPMG and PwC), there is a consistent message focused on quality improvement that is

<sup>39</sup> The expectations and qualifications are included in appendix 1 in [part 3](#) of this report.

<sup>40</sup> Most of the assessed PIE audit firms have a structure in which the statutory auditors are usually the shareholders (or partners). The shareholder in Accon is a foundation (Stichting). The statutory auditors are employed by Accon. These statutory auditors are also referred to as partners in this report.

<sup>41</sup> The natural persons responsible for determining daily policy of the hierarchically highest entity in the network located in the Netherlands that influences the policy of the audit firm.

supported by both the board of directors of the Dutch holding company and the board of directors of the licensed firm.

The employees at BDO, BTB and Mazars indicate that they do not have adequate understanding with respect to the tone and behaviour of the board of directors. The board of directors is remote and the daily management is provided by the office management (the partners at the office at which they work). The employees also experience differences in culture between offices. These three audit firms have now introduced a change from a decentralised structure to a centralised structure in which the board of directors plays a greater role in the direction of the offices.

The partners support the message of the board of directors in communication and behaviour, but the employees do not adequately recognise this

The partners at the assessed PIE audit firms are important with respect to the expression of the mission, vision, strategy and core values of the audit firm and displaying the type of behaviour that reflect this. Although the partners at most of the PIE audit firms (Deloitte, KPMG, PwC, BDO and Mazars) express the quality-oriented culture that reflects the mission, vision, strategy and core values of the audit firm, the employees do not recognise this in all cases. At most of the audit firms (Deloitte, EY, KPMG, Accon, BTB and Mazars), the employees do not adequately experience that the majority of the partners have a tone at the top and show behaviour in line with the mission, vision, strategy and core values of the audit firm.

The employees cite various issues that vary per audit firm, such as:

- Although the employees experience that the partners spend more hours with the audit team, they experience less the partners act on softer aspects such as dealing with feedback, being open to criticism and putting themselves in a vulnerable position.
- The employees experience a top-down direction from the board of directors and indicate that some partners may be less motivated to express the change. As a result, the employees experience variations in direction between partners and between offices.
- The employees indicate that the partners are managed on the basis of several targets, whereby the partners may set different priorities with respect to what is most important to achieve. There is therefore a variation in the tone at the top of the partners.
- The employees experience that the partners make their own choices and set priorities, possibly due to inadequate direction of the partners by the board of directors.
- From the surveys conducted by the assessed PIE audit firms, it appears that in the experience of the employees there is a difference between what the partners say that they do and what they actually do. In other words, the message is not consistent.

#### 4.2.4 Policy on appraisal, remuneration, promotion - HR employees

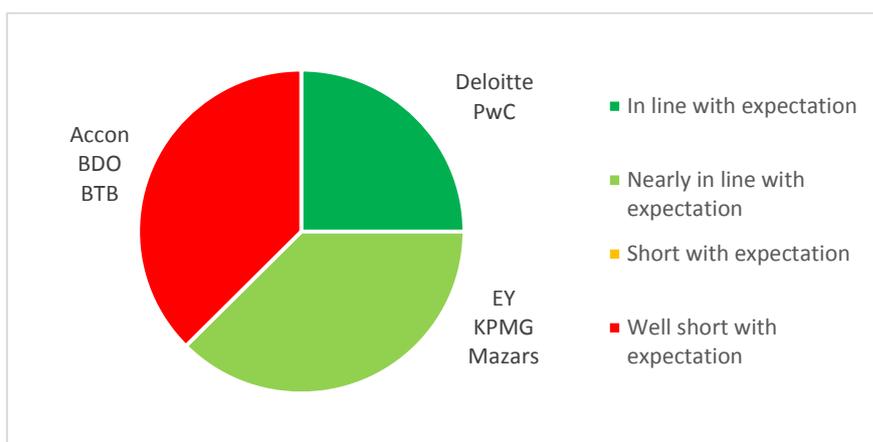


Figure 13 Policy on appraisal, remuneration, promotion - HR employees<sup>42</sup>

At most of the assessed PIE audit firms, quality is a decisive factor in the policy on appraisals, remuneration and promotion of employees. However, most assessed PIE audit firms have not adequately ensured that the employees recognise this policy in practice. This is explained in more detail below.

#### Quality aspects such as professional quality and coaching of employees are adequately included in the appraisal process

Most of the assessed PIE audit firms (Deloitte, EY, KPMG, PwC and Mazars) have an appraisal policy in which quality is a decisive factor. These audit firms apply a broad definition of quality that includes both professional quality and the guidance and coaching of employees. At three audit firms (Deloitte, EY and PwC), the employees recognise this in practice. At the other two audit firms (KPMG and Mazars), the AFM was not able to test during its assessment period whether the employees recognise that quality is a decisive factor in the appraisal process, since the appraisal process was changed after the appraisal round in 2016. At three audit firms (Accon, BDO and BTB), quality is not a decisive factor in the appraisal process and their employees do not recognise that quality is a decisive factor in the application of policy in practice.

#### Quality is decisive in the remuneration of employees

At most of the assessed PIE audit firms (Deloitte, EY, KPMG, PwC and Mazars), quality is a decisive factor in the remuneration of employees and this is recognised by the employees. At these audit firms, the employees receive little or no salary increase if their quality is assessed as inadequate. Quality is also a decisive factor in the variable remuneration. At three audit firms (Deloitte, EY and KPMG), no variable remuneration is allocated if the employee is assessed as inadequate with respect to quality. At three audit firms (Accon, BDO and BTB), quality is not a decisive factor in the remuneration of the employees or employees do not sufficiently recognise this.

<sup>42</sup> The expectations and qualifications are included in appendix 1 in [part 3](#) of this report.

## Various policies on promotion varies at the assessed PIE audit firms

Half of the assessed PIE audit firms (Deloitte, KPMG, PwC and Mazars) use quality as a decisive factor in their policy on promotion of employees and employees experience that this is the case. The other half of the audit firms (EY, Accon, BDO and BTB) do not use quality as a decisive factor with respect to promotion. The reason why quality is not a decisive factor varies per organisation, for instance:

- Personal development is a decisive factor for promotion.
- Quality is important and according to the audit firm must be up to standard for a promotion, but it is not the decisive factor.
- The test of professional knowledge and skills for promotion to manager is not sufficiently robust.
- The promotion process and the reasons for promotion are not properly documented, meaning that it is impossible to see whether quality is a decisive factor.

## Managers are adequately facilitated in the application of HR policy

Most of the audit firms (Deloitte, EY, KPMG, PwC, Accon and Mazars) facilitate managers adequately in the application of HR policy. They do this for instance by giving managers training on the appraisal process of employees. This training covers both the process and the substance of the appraisal process, including aspects relating to competences. Some of the audit firms also facilitate the process with an assessment in which the appraisal of employees is benchmarked (known as a peer comparison).

### 4.2.5 Policy on appraisal, remuneration, promotion and sanctions - HR partners

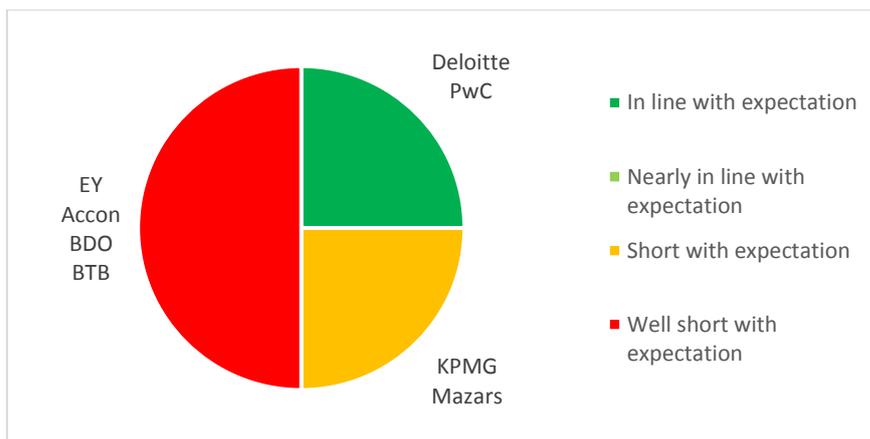


Figure 14 Policy on appraisal, remuneration, promotion and sanctions - HR partners<sup>43</sup>

<sup>43</sup> The expectations and qualifications are included in appendix 1 in [part 3](#) of this report.

At most of the assessed PIE audit firms, quality is not a decisive factor in the appraisal process and remuneration of the partners. In addition, quality is not a decisive factor in the appointment of partners. This is explained in more detail below.

### Quality is not a decisive factor in the application of the policy on appraisal and remuneration for partners

At most of the assessed PIE audit firms (EY, KPMG, Accon, BDO, BTB and Mazars), quality is not a decisive factor in the appraisal and remuneration of the partners. These PIE audit firms use this instrument to a limited extent to provide direction with respect to the desired quality-oriented behaviour. Quality is a factor that has to be up to standard, but it does not contribute to the appraisal. In addition, the assessed PIE audit firms do not always apply a definition of quality that includes both professional quality and the guidance and coaching of employees.

Policies on appraisal and remuneration vary between these audit firms. Three audit firms remunerate the partners equally on the basis of profits (BDO, BTB and Mazars). Two audit firms (BDO and Mazars) conduct an appraisal of each partner. This appraisal does not have any significant effect on the remuneration of the partner concerned. The board of directors of these audit firms may reduce the remuneration in case of inadequate quality at its discretion. At BDO, there are no observations regarding the application of the appraisal process and remuneration in practice, since the appraisal period in 2016 was not completed. At one audit firm (BTB), there is no individual appraisal of the partners; there are only interviews held with the partners regarding the conduct of business at the office. At three audit firms (EY, KPMG and Accon), quality is a factor in the appraisal process of the partners, but this is not a decisive factor in all cases. The statutory auditors of Accon are employed and receive a salary, however it is not clear how important quality is in practice in comparison to the growth and productivity targets in the application of the policy on the appraisal and remuneration of the statutory auditors. At EY and KPMG, inadequate quality leads to a lower appraisal, however good quality does not lead to a higher appraisal. At both of these audit firms the appraisal has a relatively limited effect on the remuneration.

At two audit firms (Deloitte and PwC), quality is a decisive factor in the appraisal process and remuneration of the partners. The boards of directors at both of these audit firms use quality as a factor in the appraisal process and remuneration of the partners.

#### Good practice Deloitte: partner appraisal process

Quality is a decisive factor in the appraisal process of the partners at Deloitte. Deloitte has linked the targets for the partners to its quality agenda. In addition, the partners experience that the progress and appraisal interviews are dominated by the partner's contribution to the quality agenda. Positive quality performance is rewarded in the appraisal process and there are also consequences in case of deficiencies with respect to quality. An example of a positive quality performance is making a contribution to the quality agenda or conducting high quality EQCRs. Deloitte has a Quality Performance Dashboard, in which the quality achievements and deficiencies of each partner are recorded. The National Professional Practice Director, the Director of Independence and the Ethics Officer provide input to this Dashboard. Furthermore, the appraisal policy states that no weight will be allocated to achieving commercial targets if the partner is negatively assessed with respect to quality. The partners are assessed on a four-point scale: 'does not meet expectations', 'does not meet some expectations', 'meets expectations', 'exceeds expectations'. If the assessment on quality is lower than 'meets expectations', the overall assessment will not be higher than 'does not meet some expectations'.

#### Various policies on promotion varies at the assessed PIE audit firms

At three audit firms (Deloitte, KPMG and PwC), quality is a decisive factor in the appointment of partners. At three other assessed PIE audit firms (EY, BDO and BTB), quality is not a decisive factor in the appointment of partners in practice. These audit firms include a certain number of positive results from IQRs as a condition in their appointment policy, but in the application of this policy they do not adequately consider the information on the professional quality of the person concerned in individual cases. At two audit firms (Accon and Mazars), there are no observations regarding the application of the appointments policy in practice, since these firms did not make any appointments in the assessment period.

The sanctions policy does not adequately contribute to the promotion of a quality-oriented culture

At most of the assessed audit firms (EY, KPMG, Accon, BDO, BTB), the sanctions policy does not adequately contribute to the promotion of a quality-oriented culture at the audit firm. To promote a quality-oriented culture, it is important that there is a good balance between learning from mistakes and sanctioning undesirable behaviour. It is important that the sanctions policy can also contribute to encouraging desirable behaviour as well as its punishment aspect. These audit firms are having difficulty in finding this balance. At three audit firms (Deloitte, PwC and Mazars), the sanctions policy is formulated so that it also encourages desirable behaviour and thus contributes to promoting a quality-oriented culture.

#### 4.3 Internal supervision: the supervisory board is critical, its impact could be greater and its supervision of the policy on quality is inadequate

Internal supervision	Spread	
- Expeditiousness	1	7
- Functioning	3	5

*Table 3 Qualifications for the pillar internal supervision<sup>44</sup>*

On the pillar internal supervision, nearly all the assessed PIE audit firms fulfil the expectations with respect to expeditiousness in setting up a supervisory board. Regarding the element of the operation of the internal supervision, more than half of the assessed PIE audit firms nearly meet the expectations. The extent to which the expectations were met varied between the assessed PIE audit firms.

<sup>44</sup> The distribution shows the allocation of the qualifications across the eight assessed PIE audit firms .

### 4.3.1 Expediency establishment of internal supervision

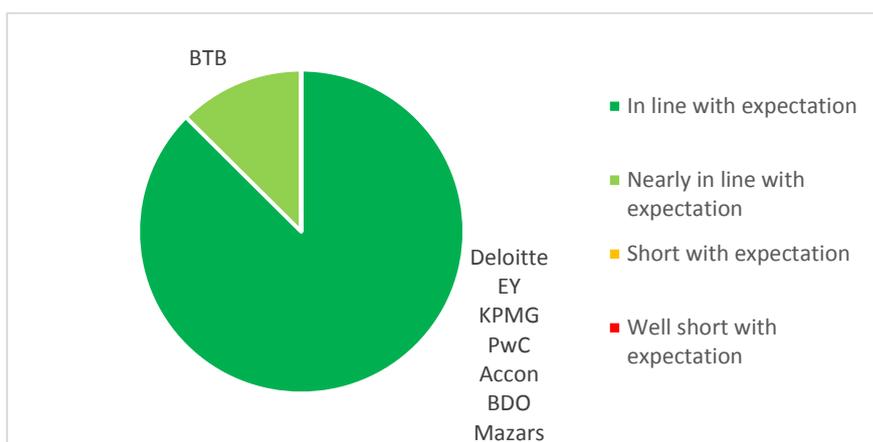


Figure 15 Expediency and establishment of internal supervision<sup>45</sup>

Nearly all the supervisory boards of the assessed PIE audit firms have expeditiously followed an introductory programme and quality is an important agenda item for all supervisory boards.

The supervisory boards have been set up and have followed an introductory programme expeditiously

The assessed PIE audit firms have supervisory boards of which all or some members are external. This has strengthened the governance structure. The new members have followed an introductory programme, among other things to become better acquainted with the audit firm. One important aspect in establishing a supervisory board is that the supervisory board sets its own agenda. Nearly all supervisory boards (Deloitte, EY, KPMG, PwC, Accon, BDO and Mazars) have set an agenda in which quality is clearly featured. At BTB the annual agenda is determined by formal matters and issues arising from the statutory authority and items formulated by the board of directors. The supervisory board of BTB does not determine these items proactively. The quality policy and the quality-oriented culture as well as the objectives that BTB has with respect to quality have only been limitedly discussed.

<sup>45</sup> The expectations and qualifications are included in appendix 1 in [part 3](#) of this report.

### 4.3.2 Functioning of internal supervision

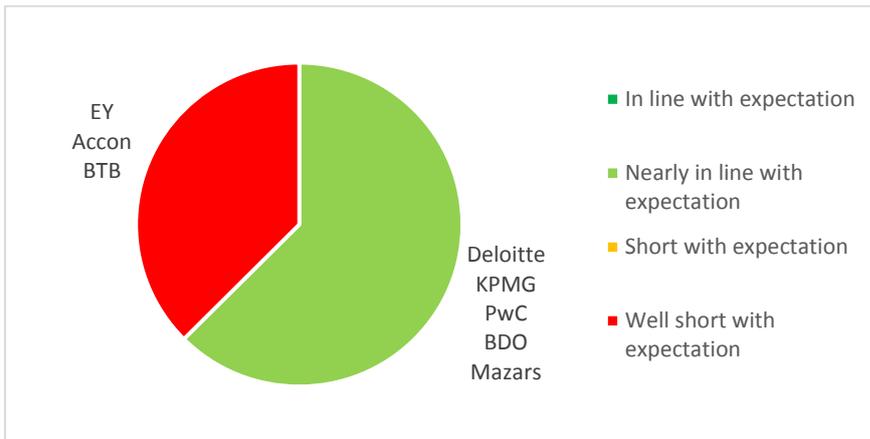


Figure 16 Functioning of internal supervision<sup>46</sup>

More than half of the assessed PIE audit firms nearly meet the expectations regarding the functioning of the supervisory boards, since the supervisory boards have defined their role in the organisation, they exercise their authorities and generally fulfil their role of setting an example. There is room for improvement with respect to the critical view, since the critical questions are mostly reflective in nature. These questions lead to a lesser extent to interventions with respect to the decisions made by the board of directors regarding the quality policy. In addition, the supervision of the quality policy and how the board of directors lead with respect to quality and the policy choices made in this context is not adequate. This is explained in more detail below.

#### Differences in the rate at which the role in the organisation is defined

The functioning of the internal supervisory body covers several aspects. Firstly, it is relevant to establish whether the supervisory board has a role that is appropriate to the organisation. Most of the supervisory boards of the assessed PIE audit firms (Deloitte, EY, KPMG, PwC, BDO and Mazars) have a clear view as to how they wish to define the role in the organisation. Most of the supervisory boards are aware that they have an important public role and that they have to actively supervise the decisions and actions of the board of directors of the audit firm and the statutory auditors. The supervisory board at Accon has intentionally chosen a role which requires a more active involvement and visibility of the internal supervisor than usual. The supervisory board thus to some extent acts like a board of directors at this audit firm. The supervisory board at BTB has not yet developed a collective view as to how it wishes to define its role.

#### Authorities are exercised

Secondly, the functioning of the supervisory board concerns the use of the authorities that contribute to promoting the quality of statutory audits, for example the authority to approve the appointment and dismissal of the partners at the licensee. The supervisory boards are aware of

<sup>46</sup> The expectations and qualifications are included in appendix 1 in [part 3](#) of this report.

their authorities and have exercised them in practice. In most cases, this concerns the authorities in relation to approval of policies on investment or remuneration, or partner appointments.

### Supervisory boards take various approaches to setting an example

Thirdly, the functioning of the supervisory board concerns the view of the supervisory board regarding what quality means for the organisation, how it expresses this view to the board of directors and the statutory auditors and calls them to account with respect to tone and setting a good example when necessary. Most supervisory boards (at Deloitte, KPMG, PwC, Accon, BDO and Mazars) have a good idea of what quality means for their audit firm. They promote this view in the organisation. Various examples show that the supervisory boards of Deloitte, KPMG, PwC, BDO and Mazars have called the board of directors and the statutory auditors to account regarding their tone and setting a good example. The supervisory boards of BTB and EY are able to show the actions taken by the organisation to improve the quality of statutory audits. These supervisory boards do not have a clear view of what quality means for their audit firm, in the sense of what they are working towards, and what the target on the horizon is in practical terms. These supervisory boards have virtually no examples of how they have expressed the importance of quality in their contacts with the board of directors or the partners.

### Keeping the board of directors aware means more than asking critical questions

The functioning of the supervisory board also concerns keeping the board of directors aware of its duty to meet the expectations of society, focused on continuously giving the public interest central priority. Keeping the board aware in any case means asking critical questions. The examples show that the supervisory boards of Deloitte, KPMG, BDO and Mazars are critical with respect to quality and the public interest. In addition, the critical questions asked are impactful and have led to changes to policy decisions by the board of directors. The supervisory boards of EY and PwC also have various examples showing that they are critical with respect to quality and the public interest. However, the critical questions were less effective in leading to changes besides issues for which there was actually a statutory authority. The supervisory boards of Accon and BTB are critical on various aspects, such as the direction of the organisation or the formal powers, but there are fewer examples in which the supervisory board has been critical with respect to issues affecting the quality of the statutory audits and the public interest.

### Supervision of the quality policy is not adequate in practice

Keeping the board aware of its obligations also means that the supervisory board substantively discusses the quality policy with the board of directors and how the board of directors provides managing quality. Supervisory boards are fulfilling their role of supervision of quality policy to a limited extent. Half of the supervisory boards (Deloitte, EY, KPMG and PwC) have discussed the quality policy, but a more in-depth discussion between the supervisory board, the board of directors and the organisation is needed for proper supervision of the policy decisions by the board of directors with respect to quality. The supervisory boards of Deloitte, EY, KPMG and PwC receive various reports relating to quality and these are extensively discussed. These supervisory

boards however devote less time explicitly discussing the quality policy and the policy decisions made by the boards of directors with respect to managing quality. In some cases, this is due to over-full agendas or the lack of good or cohesive information received by the supervisory board. The other supervisory boards (at Accon, BDO, BTB and Mazars) have not adequately discussed the quality policy and the choices made for managing quality in their meetings. These supervisory boards thus have no insight into the quality policy and issues and do not provide enough countervailing power to the choices made by the board of directors. Approval of the quality policy is one of the formal authorities of the supervisory board.

## 5 The quality of the statutory audits by the Big 4 audit firms is still not yet up to standard

This section describes the outcomes of the regular inspection at the Big 4 audit firms.

The AFM inspected a total of 32 statutory audits in its regular inspection in 2015 and 2016. The AFM inspected 8 statutory audits at each Big 4 audit firm, half of which were for the 2014 financial year and half for the 2015 financial year. In particular, the AFM inspected whether the statutory auditor obtained sufficient and appropriate audit evidence<sup>47</sup> on which to base his opinion with respect to the financial statements<sup>48</sup>. In its inspection, the AFM focused on material elements in the statutory audit. If the statutory auditor has not obtained sufficient and appropriate audit evidence for a material elements, he has not obtained sufficient and appropriate audit evidence on which to base his opinion with respect to the financial statements as a whole. In such cases, the AFM qualifies the performance of the statutory audit as 'inadequate'. In other cases, the AFM qualifies the performance of the statutory audit as 'adequate'<sup>49</sup>.

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<sup>47</sup>Audit evidence is, for example, information from the financial accounts on which the financial statements are based, or other information from the audit client or from third parties. Sufficient and appropriate audit evidence is necessary to substantiate the opinion of the auditor. The qualification 'adequate' refers to the quantity of audit evidence. The qualification 'appropriate' refers to the quality of the audit evidence. Quality means that the audit evidence is relevant and reliable so that this information actually constitutes substantiation for the opinion of the auditor.

<sup>48</sup> This means that the AFM has established whether the statutory auditor has complied with paragraph 17 of Further Regulations on Auditing and Other Standards 200 (NV COS 200) 'General objectives of the independent auditor, as well as the performance of an audit in accordance with the Standards': "To obtain a reasonable level of assurance, the auditor shall obtain sufficient and appropriate audit evidence in order to reduce the audit risk to an acceptably low level, thus enabling the auditor to draw a reasonable conclusion on which he can base his opinion."

<sup>49</sup> This does not exclude the possibility that there may be serious deficiencies in elements of the inspected focus areas or in other elements of the statutory audit not inspected by the AFM. This qualification therefore does not constitute a general opinion by the AFM as to whether the statutory auditor had obtained sufficient and appropriate audit evidence on which to base his opinion with respect to the financial statements as a whole.

The AFM qualified 19 of the 32 inspected statutory audits<sup>50</sup> as ‘inadequate’. The outcomes per audit firm are shown in table 4 below:

	Deloitte	EY	KPMG	PwC	Total	2014 financial year	2015 financial year
Number of ‘adequate’ statutory audits	5	2	2	4	13	4	9
Number of ‘inadequate’ statutory audits	3	6	6	4	19	12	7
Total inspected audits	8	8	8	8	32	16	16

*Table 4 Outcomes of the inspected statutory audits*

In cases where the statutory auditors have failed to obtain sufficient and appropriate audit evidence with respect to material elements in the audit and the statutory audit is therefore ‘inadequate’, this means there are serious deficiencies in the procedures. In most cases, these deficiencies concern both the tests of controls and the substantive audit procedures and the critical evaluation of audit evidence. An EQCR was carried out on 16 of the ‘inadequate’ statutory audits prior to issuance of the audit opinion, and an IQR was carried out on 6 of the ‘inadequate’ statutory audits after completion of the audit engagement.

**The AFM takes the view that the quality of the statutory audits by the Big 4 audit firms is still not yet up to standard**

The AFM notes that the number of inadequately performed statutory audits is once again too high, as it was in the previous regular inspections of the Big 4 audit firms (see section 5.1). Several of the inadequately performed statutory audits involved quality safeguards which failed to prevent or detect that the statutory auditors had not adequately substantiated their opinion with respect to the financial statements (see section 5.2). The deficiencies identified by the AFM in the ‘inadequate’ statutory audits are moreover similar to those identified in the previous regular inspections in 2013 and 2014. Both the elements for which relatively the most frequent serious deficiencies were identified and the nature of the most frequent deficiencies generally correspond (see section 5.3).

<sup>50</sup> The principal conclusions and findings per Big 4 audit firm are shown separately and are available on the AFM website. See [part 2](#) of this report.

## 5.1 The number of inadequately performed statutory audits is once again too high

Since the introduction of the Audit Firms Supervision Act (Wta), the AFM has conducted three regular inspections of the Big 4 audit firms. In the current inspection, the AFM concludes that in 19 of the 32 inspected statutory audits the external auditors had not obtained sufficient and appropriate audit evidence<sup>51</sup> to substantiate their opinion with respect to the financial statements as a whole. In the previous regular inspection in 2013 and 2014, the AFM noted that the statutory auditors had failed to obtain sufficient and appropriate audit evidence in 18 of the 40 inspected statutory audits. In the final reports of the regular inspection in 2009 and 2010<sup>52</sup>, this applied to 24 of the 46 inspected statutory audits.

The total number of inadequately performed statutory audits in the inspection is too high. The number of 'inadequate' audits varies per Big 4 audit firm and is also too high for each firm. The 32 inspected statutory audits were not selected on the basis of a statistical sample, meaning that the outcomes of the inspection cannot be projected to include all the statutory audits performed by the Big 4 audit firms. The outcomes of the inspection show that there are deficiencies in the majority of the inspected statutory audits that are of such significance that an audit opinion has been issued without adequate substantiation of the opinion with respect to the financial statements, that in these cases the statutory auditors had failed to comply with professional standards<sup>53</sup> and that the quality safeguards at the audit firms did not operate adequately. The issuance of an audit opinion that is not adequately substantiated is a serious matter, since the public should be able to have justified confidence on the audit opinions issued. The audit firms must therefore ensure that the auditors working for them comply with laws and regulations and that the quality of the statutory audits performed is safeguarded. Since there were several inadequately performed statutory audits at each of the Big 4 audit firms, the AFM concludes, consistent with its previous regular inspection, that the number of inadequately performed statutory audits in total and at each Big 4 audit firm is too high.

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<sup>51</sup> Since the qualifications 'adequate' and 'appropriate' in relation to audit evidence are in most cases inextricably linked, in this report the AFM does not distinguish between findings relating to inadequate audit evidence and findings relating to inappropriate audit evidence. The AFM generally uses the formulation 'inadequate and inappropriate audit evidence' in its conclusion that the quality of the inspected statutory audit is qualified as 'inadequate'.

<sup>52</sup> See the AFM report of 1 September 2010 '[General findings regarding the quality of audits and quality control](#)'.

<sup>53</sup> In the performance of audit engagements, statutory auditors must observe the provisions of the Regulation on rules for professional conduct and practice for auditors (Verordening gedrags- and beroepsregels accountants (VGBA)) and the Further Regulations for Audit and Other Standards (Nadere voorschriften controle- en overige Standaarden, or NV COS).

## 5.2 The quality safeguards at the Big 4 audit firms on the inadequately performed statutory audits did not prevent or detect the deficiencies

Audit firms have a system of quality control consisting of procedures, descriptions and standards that enable the statutory auditors to do their work to the highest possible standard and thereby ensure the quality of the statutory audits. Two important safeguards in this quality control system are the engagement quality control review (EQCR) and the internal quality review (IQR). Based on its inspection, the AFM concludes that the quality safeguards EQCR and IQR performed on the statutory audits that it qualified as 'inadequate' failed to prevent or detect that inadequately substantiated audit opinions had been issued and that the IQRs in these cases had provided other information on the quality of the statutory audits performed than the external inspections of the AFM.

In an EQCR, a quality reviewer reviews prior to issuance of the audit opinion whether the statutory auditor had reasonably been able to arrive at his audit opinion. The quality reviewer is an auditor who is independent of the audit team. With an EQCR, the audit firm has a safeguard to identify serious deficiencies in the quality of the statutory audit in a timely fashion, thus prior to issuance of the audit opinion. The procedures relating to EQCRs vary between the Big 4 audit firms, for instance in the following respects<sup>54</sup>:

- The number of EQCRs performed varies from 10 to 80 per cent of the total number of statutory audits performed;
- The number of hours spent on an EQCR varies from 0.6 to 2.1 per cent of the total number of hours spent on the performance of the statutory audits;
- The number of EQCRs that a quality control reviewer has carried out on statutory audits on average varies from 2 EQCRs to 10 EQCRs.

In an IQR, the audit firm reviews, usually in cooperation with its international network, a number of completed statutory audits to establish whether these audits meet the requirements of its own quality control system and applicable legislation and regulation. The IQR is an important measure for audit firms. The audit firm obtains information on the actual quality of the statutory audits performed in order to identify the quality-contributing and quality-hampering factors and to take actions to sustainably safeguard the quality of the statutory audits. The audit firm can also thus detect deficiencies so that these can be remedied and prevented in future. The procedures relating to IQRs vary between the Big 4 audit firms, for instance in terms of the number of reviews carried out on statutory audits relating to the 2015 financial year (ranging from 22 to 38), and the aim and approach of the IQR.

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<sup>54</sup> The data relate to statutory audits for the 2015 financial year.

#### Good practice Deloitte: IQR

In 2013, Deloitte began a programme designed to intensify its IQRs ('practice reviews'), by raising the bar (setting stricter standards), increasing the number of practice reviews and using a different approach. All its statutory auditors with one or more audits have now been subject to this intensified programme. The findings of the first round of 'new style' practice reviews are more in line with the findings of external inspections. The findings of the practice reviews are important management information for the board of directors.

26 EQCRs and 11 IQRs have been conducted on the 32 inspected statutory audits. 16 of the 19 inspected statutory audits that were qualified by the AFM as 'inadequate' were the subject of an EQCR. The EQCR carried out in these cases was therefore not able to prevent an inadequately substantiated audit opinion from being issued. 6 of the 19 inadequately performed statutory audits were subjected to an IQR. In their IQRs, the audit firms qualified the performance of these 6 statutory audits with the highest possible rating of 'compliant', 'satisfactory' or 'rating 1', depending on the qualification used by the various Big 4 audit firms. In these audits, the audit firms failed to identify the deficiencies that were identified by the AFM in its inspection, or the identified deficiencies were not deemed to be material. The IQRs conducted therefore did not provide the audit firms with the same information on the quality of these statutory audits inspected as the inspection by the AFM.

### 5.3 The deficiencies identified are similar to those found in the previous regular inspection

The AFM has further analysed the findings of its inspections of the statutory audits performed in order to identify the focus areas in which it has found the fewest and the most deficiencies in relative terms and the nature of the deficiencies it found in the inadequately performed statutory audits<sup>55</sup>. The AFM has also compared the findings of these analyses with those of the previous regular inspection. The AFM notes that the deficiencies are of similar nature to those found in the previous regular inspection and that the focus areas with relatively the most deficiencies are also similar. This is explained further in sections 5.3.1 and 5.3.2 respectively.

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<sup>55</sup> In its reference to the nature of deficiencies, the AFM is referring to the type of deficiencies that led to the conclusion that sufficient and appropriate audit evidence had not been obtained with respect to the material element of the inspected statutory audit. The analysis of the deficiencies is based on the deficiencies in the inadequately performed audits reported to the audit firms. See section 6.2.5 for further explanation.

### 5.3.1 The deficiencies in the 'inadequate' statutory audits are similar in nature to those found in the previous regular inspection

At the beginning of a statutory audit, the statutory auditor assesses the risks of a material misstatement in the financial statements in order to determine the nature, timing and scope of his procedures. Risks are assessed at the level of assertions<sup>56</sup> and at the level of the financial statements as a whole. It is important that the risk assessment is a careful consideration of risk factors that either increase or diminish risk<sup>57</sup> and that the substantiation of the risk assessment does not remain limited to the statement of reasons for the absence of (significant) risks. It is also important to specify the risks rather than stating that there is a risk that a valuation may not be correct and to explicitly relate the risks to what could go wrong at the assertion level. Only in this manner can the statutory auditor design and carry out his audit procedures so that these are a response to the assessed risks at the assertion level. In any case, regardless of his risk assessment, an auditor must carry out substantive audit procedures on each material transaction flow and balance sheet item in the financial statements.

In his audit, a statutory auditor may carry out both tests of controls and substantive audit procedures in order to reduce the risk of material misstatement in the financial statements to an acceptably low level. Usually, he will combine both types of procedure in order to obtain sufficient appropriate audit evidence. In the inadequately performed statutory audits, the statutory auditors did not test relevant items, elements or assertions within the material elements of the audit or that their audit procedures with respect to these items were inadequate. In this last case, there was usually a combination of deficiencies in both the tests of controls and the substantive audit procedures. In addition, the AFM notes that the evaluation of the audit evidence obtained by the statutory auditors was not sufficiently critical. Most deficiencies found were similar in nature to those found in the previous regular inspections in 2013 and 2014. This is shown by table 5 below, which shows the most common deficiencies found by the AFM in the procedures of the inadequately performed statutory audits in its current and previous regular inspections.

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<sup>56</sup> Assertions with respect to transaction flows and events: occurrence, completeness, accuracy, cut-off, classification, presentation. Assertions with respect to account balances: existence, rights and obligations, completeness, accuracy, classification, presentation (NV COS 315.A129).

<sup>57</sup> Examples of circumstances and events that may indicate risks of a material misstatement are changes in the supply chain, development or offering of new products or services, changes of key personnel, deficiencies in internal controls (in particular deficiencies not addressed by the management) and changes in the IT environment.

No.	Description of deficiency	Regular inspection 2015 and 2016	Regular inspection 2013 and 2014
<b>Tests of controls</b>			
1	Inadequate testing of the operating effectiveness of internal controls	√	√
<b>Substantive audit procedures</b>			
2	Substantive analytical procedures not carried out adequately	√	√
3	Inadequate procedures carried out to draw conclusions regarding the entire population	√	x
4	Tests of details not carried out and scope not in line with audit methodology	x	√
<b>Critical evaluation of audit evidence</b>			
5	Estimates not adequately tested	√	√
6	Reliability of the information used in the audit is not adequately established	√	√
7	No verification of information obtained from management	√	√
8	Findings from audit procedures not adequately followed up	√	√
9	Inadequate evaluation of the procedures used in the audit that were carried out by others	√	√

*Table 5 Most common deficiencies in the regular inspection in 2015 and 2016 and in the regular inspection in 2013 and 2014<sup>58</sup>*

The AFM provides further detail of the most common deficiencies in the inspection by category below.

#### Inadequate testing of the operating effectiveness of internal controls

Audit clients have in most cases implemented controls designed to mitigate or to identify and correct risks that targets will not be achieved, including risks of a material misstatement in the financial statements. These internal controls may be either manual or automated. It may be

<sup>58</sup> √ refers to a deficiency found most often in the regular inspection, x refers to a deficiency not found most frequently by the AFM in its inspection.

efficient and effective for a statutory auditor to rely on these internal controls in his audit. If the statutory auditor intends to rely on these internal controls, he must carry out audit procedures to establish that these controls are operating effectively. First of all, he must obtain an understanding of the design of the internal controls, including by reviewing the actions carried out within the audit client, which officers carried them out and when did they carry them out, and what resources were used. In the test to establish that the internal controls are operating effectively, the external auditor must then establish that these actions were carried out, that they were carried out by the appropriate officers with the proper resources and that this has occurred consistently throughout the financial year. If the external auditor does not adequately test this operating effectiveness, he cannot rely on these internal controls and he has not obtained audit evidence from this test that the risk of a material misstatement in the financial statements has been reduced. In this case, if possible<sup>59</sup>, he has to obtain sufficient and appropriate audit evidence from his substantive audit procedures to reduce the risk of a material misstatement in the financial statements to an acceptably low level.

The most common deficiency found by the AFM in its inspection is that the procedures carried out by the external auditor inadequately tested the operating effectiveness of the internal controls. In 14 of the 19 inspected statutory audits that were qualified by the AFM as 'inadequate', the external auditor planned to rely on internal controls. With respect to these 14 statutory audits, the AFM found that almost none of the internal controls had been adequately tested for operating effectiveness by the statutory auditor and that therefore the statutory auditor could not rely on these internal controls. For example, in these statutory audits the statutory auditor:

- failed to test whether the internal control was implemented by the audit client;
- failed to test adequately whether the internal control had been implemented correctly and consistently by the audit client;
- failed to obtain adequate understanding of the design of the internal control;
- failed to evaluate adequately whether the internal control was sufficiently accurate to prevent or to identify and correct a material error in the financial statements;
- failed to adequately establish the reliability of the information that he used to test that the internal control was operating effectively;
- failed to establish that the internal control had been operating effectively throughout the financial year and based his conclusion regarding this operating effectiveness exclusively on his procedures relating to part of that financial year.

In cases where the statutory auditor had relied on the internal control but had not adequately tested whether it was operating effectively, he usually failed to obtain adequate understanding of

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<sup>59</sup> Whether this is possible depends on whether the internal controls are irreplaceable or replaceable. Irreplaceable internal controls cannot be remediated by replacement controls.

the design of the internal control and did not adequately evaluate whether the internal control was sufficiently accurate.

With respect to internal controls relating to IT systems, which consist of general IT controls and application controls<sup>60</sup>, the AFM notes that in 13 inspected statutory audits the statutory auditor concluded that he was not willing or able to rely on the audit client's general IT controls. The reasons for this were that he had already assessed or established that there were deficiencies in the automated data processing or because he considered a different audit strategy to be more efficient. Not relying or not being able to rely on general IT controls has consequences for the further procedures to be performed by the statutory auditor. If the statutory auditor does not adequately evaluate the consequences of this and does not adequately reflect this in the procedures to be performed, this will usually result in deficiencies in the audit. The reliability of the information used in the audit is then not adequately established, the operating effectiveness of automated application controls is not adequately tested and the authority of persons who have recorded transactions is not adequately tested.

### Substantive audit procedures not carried out adequately

Substantive audit procedures consist of substantive analytical procedures (including cross checks) and tests of details. The AFM found deficiencies in the performance of these substantive audit procedures. This is explained in more detail below.

#### *Substantive analytical procedures*

A statutory auditor can use a substantive analytical procedure to obtain audit evidence by establishing plausible relationships between various financial and non-financial information. When carrying out a substantive analytical procedure, a statutory auditor should develop an expectation that is sufficiently accurate and objective (and therefore appropriate) in order to compare the reported figures. He should also determine in advance at what level of variation between the expected and the reported figures that he considers further investigation to be necessary (the threshold amount). If the variance is greater than this threshold, the statutory auditor must carry out further investigation of the differences. Examples of substantive analytical procedures include margin analyses and movements of cash and goods.

The substantive analytical procedures carried out by the statutory auditor were inadequate in 11 of the 19 inadequate statutory audits. In these audits, in most cases the statutory auditor only carried out a general analytical procedure and failed to carry out the procedures necessary for a substantive analytical procedure, such as developing a sufficiently appropriate expectation, developing a threshold amount in advance and adequately investigating differences in excess of

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<sup>60</sup> General IT controls safeguard the integrity of the information and the security of data in systems and support the effective operation of application controls. Application controls are manual or automated procedures that usually operate at business process level and apply to the processing of transactions using individual applications.

that threshold amount. The statutory auditor did further investigate differences in excess of the threshold in four cases, but failed to verify the explanations received from management.

### *Tests of details*

A test of details involves a test by the statutory auditor of individual records within a financial statement line item against source documentation. Tests of details include subsequent receipts testing to establish that outstanding receivables after the closing date have been paid, checks of procurement invoices to establish that project expenses have been charged to the right project and reviewing shipping documentation to establish that a sales transaction has occurred. The statutory auditor may test the entire population or a part thereof. A selective investigation of part of the population does not provide audit evidence on the part not investigated, unless a sample has been taken.<sup>61</sup> The use of sampling in an audit is intended to enable to draw conclusions regarding an entire population on the basis of testing a sample taken from that population.

In six of the inspected statutory audits that were qualified as 'inadequate' by the AFM, the statutory auditor had drawn conclusions regarding the entire population without taking a sample.

### *Evaluation of audit evidence is not adequately critical*

When carrying out his procedures, a statutory auditor must always maintain an attitude of professional scepticism: an investigative attitude being alert to circumstances that could indicate the possibility of misstatements as a result of fraud or error and critically evaluating audit evidence. The critical evaluation of audit evidence among other things means that the statutory auditor challenges contradictory audit evidence, the reliability of documents and information obtained from the management. This applies especially to items that are to a large extent influenced by the management, such as accounting estimates. In addition, the statutory auditor has to be alert to circumstances that indicate he should carry out additional procedures, such as findings from his procedures and limitations imposed on him during his audit by management. Moreover, a statutory auditor cannot automatically assume that procedures carried out by others are appropriate if he makes use of them in his audit. Many of the AFM's findings relate to an inadequately critical evaluation of audit evidence. This is explained in more detail below.

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<sup>61</sup> The requirements of NV COS 530 'Use of samples in the audit' apply to the use of samples in order to draw conclusions regarding the sampled population.

### *Estimates not adequately tested*

Some elements in the financial statements cannot be valued precisely by the audit client and as such can only be estimated. The nature and reliability of the information available to the audit client's management to support these estimates vary to a large extent. This estimation uncertainty leads to risks in the audit. The audit standards prescribe specific procedures to address the risks associated with estimation uncertainty. One of the important considerations when auditing estimates is that the statutory auditor tests the basis for the estimate used by the management and tests how the audit client's management has made the estimate. Among other things, he evaluates the valuation method and whether the assumptions by the management that underlie the estimate are reasonable.

In 13 of the 19 inspected statutory audits qualified by the AFM as 'inadequate', the AFM found that the statutory auditors had not adequately audited the estimates. In these cases, the statutory auditor failed to test the information on which the estimate was based and had not for instance tested whether the underlying assumptions were reasonable.

### *Reliability of the information used in the audit is not adequately established*

For most audit procedures, including both tests of controls and substantive audit procedures, the statutory auditor uses information from reports, lists and databases of the audit client.

In 16 of the 19 inadequately performed statutory audits, the AFM found that the statutory auditor had not carried out sufficient procedures to establish that these reports, lists and databases were sufficiently accurate and complete to provide reliable information for his audit. For instance, the statutory auditor frequently used lists from the system without reviewing whether they were reliable, while the statutory auditor had not established that the general IT controls of that system were operating effectively or had concluded that these controls had not operated effectively. In these cases, the statutory auditor therefore assumed that these lists were reliable without conducting procedures in order to establish whether this was the case.

### *No verification of information obtained from the management*

A critical assessment of oral or written information obtained from the management of the audit client is important in order to increase the reliability of this audit evidence.

In 10 of the 19 inadequately performed statutory audits, the statutory auditors failed to verify oral information received from the management. This deficiency occurred for example in the audit of estimates, in substantive analytical procedures and in the follow-up of findings from audit procedures. For example, the statutory auditors failed to verify the following information received from the management in their audits:

- statements from the management that outstanding receivables were collectible;
- management forecasts regarding revenue in future years, for example regarding the valuation of goodwill;
- expected project expenses, expected project revenue, the degree of progress of projects and the reasonableness of the provision for losses.

### *Inadequate follow-up to findings from procedures*

In six statutory audits the AFM found that the statutory auditor had not followed up on differences revealed in his tests of details, substantive analytical procedures or tests of the operating effectiveness of internal controls. In these cases, the auditor failed to obtain an explanation for these differences, failed to adequately evaluate the materiality of these differences for his audit, or failed to adequately change his conclusion. Identified differences are often examples of contradictions between several sources of audit evidence or circumstances that could be reason to carry out additional procedures.

### *Inadequate evaluation of work performed by others and used in the audit*

In many cases, a statutory auditor will use in his audit work performed by persons who are not in his audit team, because he does not have sufficient expertise to do so, he does not have direct access to the necessary information, or because this will enhance the efficiency of the audit. Auditors accordingly use work of valuation experts, IT specialists, auditors of service organisations used by the audit client, the audit client's internal audit department or other auditors.

An important principle when using the work of others is that the statutory auditor at all times bears ultimate responsibility for forming an opinion regarding the financial statements as a whole, also if the work is carried out by other parties. He therefore has to continually evaluate whether the work performed by others provide sufficient and appropriate audit evidence. If this is not the case, the statutory auditor will have to carry out additional procedures or have additional procedures carried out by others in order to obtain this audit evidence.

In several statutory audits, the AFM found that the statutory auditor had not adequately carried out the procedures described above, because for example he:

- failed to assess the relevance and reasonableness of the findings and conclusions of the valuation expert he used;
- did not follow up the findings of the IT specialist in relation to possible deficiencies in the audit client's automated data processing system;
- failed to perform his own procedures in order to verify the procedures by the internal audit department, failed to review the depth of the work programmes performed and failed to ask further questions regarding exceptions identified by the internal audit department; or
- failed to establish that the relevant internal controls in the processes at the service organisation used had operated effectively.

### 5.3.2 The elements of the audit with relatively the most deficiencies are generally similar to those found in the previous regular inspection

As explained in section 6, the AFM did not inspect the 32 statutory audits it inspected in their entirety, but focused on certain material elements in the audit, referred to as focus areas. Table 6 shows the most common focus areas with the number of inspected statutory audits by the AFM with respect to each focus area and how frequently the AFM concluded that the statutory auditor had not obtained sufficient and appropriate audit evidence with respect to the element in question ('inadequate').

Focus area	Regular inspection 2015 and 2016		Regular inspection 2013 and 2014	
	Number inspected	Number 'inadequate'	Number inspected	Number 'inadequate'
<b>General</b>				
Revenue	26	15	26	15
Trade receivables <sup>62</sup>	12	5		
Inventory	8	3	9	4
Intangible non-current assets (including goodwill)	7 <sup>63</sup>	1 <sup>64</sup>	8	6
Property, plant and equipment	3	0	2	0
<b>(Sector)specific</b>				
Tenders and procurement	5	5	4	2
Construction projects	4	4	5	3
Land development	3	2	3	2
Investments	3	0	6	2
(Technical) provisions	1	0	10	2
Equalisation payments	0	0	4	0
<b>Other<sup>65</sup></b>	11	3	7	3
<b>Total</b>	<b>83</b>	<b>38</b>	<b>84</b>	<b>39</b>

*Table 6 Elements of the audit inspected and related findings from the regular inspection in 2015 and 2016 and the regular inspection in 2013 and 2014*

<sup>62</sup> The 'trade receivables' focus area was included in the 'revenue' focus area in the regular inspection in 2013 and 2014. In the regular inspection in 2013 and 2014, there were two 'inadequates' in relation to the 'trade receivables' focus area.

<sup>63</sup> This includes six instances of intangible non-current assets and one instance of goodwill.

<sup>64</sup> This concerns goodwill.

<sup>65</sup> The 'other' includes the focus areas relating to the items cash and cash equivalents, loans provided, interest rate swaps, current liabilities, receivables (excluding trade receivables) and the elements business combinations, financial information for a significant group entity and potential non-compliance with regulation.

## No serious deficiencies found in the audit of investments, property, plant and equipment and intangible non-current assets (excluding goodwill)

Among the general focus areas, the AFM did not qualify the audit as 'inadequate' with respect to property, plant and equipment and intangible non-current assets (excluding goodwill) in any of the respectively three and six statutory audits it inspected. Among the (sector-)specific focus areas, the same applied to the audit of investments. The AFM did find deficiencies in the audit of intangible non-current assets and investments in its previous regular inspection.

## Revenue, trade receivables, inventory, construction projects, land development, procurement costs and tenders were relatively frequently 'inadequate'

Among the general focus areas, the AFM qualified the audit of revenue, trade receivables, inventory and construction projects as 'inadequate' relatively frequently, and among the (sector-)specific focus areas the same applied to the audit of tenders, procurement costs and land development. These focus areas are similar to the focus areas relatively most frequently identified by the AFM in its regular inspection in 2013 and 2014 as the areas in which sufficient and appropriate audit evidence had not been obtained. If sufficient appropriate audit evidence is not obtained with respect to revenue, in all 15 cases this affects the assertion of completeness, in 13 cases it affects the accuracy and in 7 cases the occurrence of revenue. The deficiencies in debtors, construction projects and land development mainly affect the valuation assertion.

The construction projects, land development, procurement costs and tenders focus areas are closely associated with the sector of the audit clients concerned. In its inspection, the AFM relatively frequently found serious deficiencies in the audits of construction companies and public and semi-public institutions. The AFM inspected four companies with projects<sup>66</sup>, and qualified all four audits as 'inadequate'. Also with respect to inspected audits of the four public and semi-public institutions, consisting of three municipalities and one recycling business, the AFM concluded in all four cases that the external auditor had failed to obtain adequate substantiation for his opinion with respect to the financial statements as a whole. The AFM also qualified a relatively large number of statutory audits in the IT/Telecom sector as 'inadequate' (three of the four inspected statutory audits). The AFM qualified relatively more statutory audits as 'adequate' in the (other) services sector (three of the four inspected statutory audits). Figure 17 shows the sectors of the inspected audit clients and the number of statutory audits qualified by the AFM as 'inadequate' in each sector.

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<sup>66</sup> Companies with projects include construction companies.

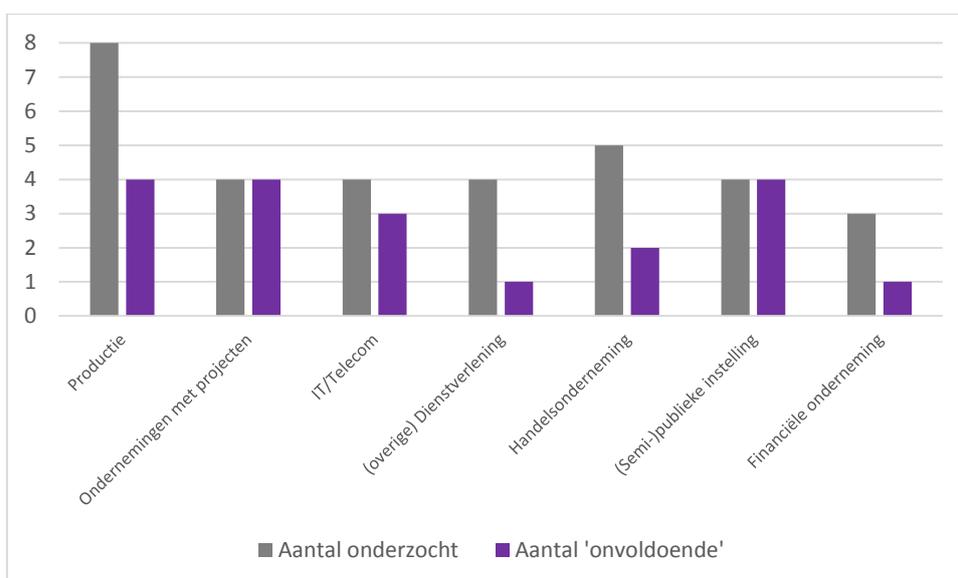


Figure 17 Number of inspected statutory audits per sector including findings

Lastly, the findings in tables 7 and 8 are divided into features of the audit arising from the AFM's selection criteria<sup>67</sup> 'market segment' and 'first or last year audit'.

Market segment	Number inspected	Number 'inadequate'
<b>PIE</b>	<b>12</b>	<b>4</b>
<b>Non-PIE</b>	<b>20</b>	<b>15</b>
Large unlisted companies <sup>68</sup>	9	7
Public and semi-public institutions	4	4
Other non-PIE	7	4
<b>Total</b>	<b>32</b>	<b>19</b>

Table 7 Inspected statutory audits per market segment

	Number inspected	Number 'inadequate'
<b>First year audit</b>	<b>5</b>	<b>2</b>
<b>Last year audit</b>	<b>5</b>	<b>4</b>
<b>Total</b>	<b>10</b>	<b>6</b>

Table 8 Inspected first year and last year audits

The AFM found relatively fewer inadequately performed audits at PIE audit clients and a relatively large number of inadequately performed audits with respect to last year audits.

<sup>67</sup> See section 6.6.2 for an explanation of the criteria used by the AFM for the selection of the statutory audits to be inspected.

<sup>68</sup> An unlisted company is considered to be large if it has revenue in excess of € 100 million.

## 6 Description of the methodologies

Section 6 describes the methodologies used. Section 6.1 describes the methodology for the assessment of the implementation and embedding of the improvement programme. Section 6.2 describes the methodology for the inspection of the quality of statutory audits at the Big 4 audit firms.

The thematic review and inspection were carried out in parallel. Publication of the results in a single report provides a broader picture of both the implementation and embedding of the improvement programmes at the PIE audit firms and the quality of the statutory audits by the assessed Big 4 audit firms.

### 6.1 Assessment of the implementation and embedding of the improvement programmes at the PIE audit firms

This section describes how the AFM designed and carried out its assessment of the implementation and embedding of the improvement programmes at the PIE audit firms.

#### 6.1.1 Objectives used by the AFM in the formulation of the expectations for 2016

##### Objectives for the medium to long term as basis for the expectations

In 2015, the AFM established medium to long-term objectives for PIE audit firms that would contribute to the improvement and sustainable safeguarding of the quality of statutory audits. These objectives were based on the (problem) analyses and proposals for improvement as described in the NBA report 'In the Public Interest' and the recommendations of the AFM in past years as a result of its inspections. These are included in appendix 2<sup>69</sup>. These medium to long-term objectives were shared with the sector in 2015 in the public report published in October 2015. The medium to long-term objectives were the basis for the expectations for 2016 with regard to the pillar elements. These expectations were shared with the assessed PIE audit firms and are included in appendix 1<sup>70</sup>.

The medium to long-term objectives concern aspects that contribute to the fulfilment of the duty of care. An adequately designed and operating quality control system, a controlled business operation and also aspects such as properly functioning governance contribute to the fulfilment of the duty of care.

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<sup>69</sup> See [part 3](#) of this report.

<sup>70</sup> See [part 3](#) of this report.

## Expectations established on the basis of legislation and regulation and principles for good governance

The expectations were established on the basis of the Audit Firms Supervision Act (the Wta) and pursuant laws and regulation with respect to the quality control system as well as the principles for good governance and supervision, such as the Dutch corporate governance code. This concerns legislation and regulation<sup>71</sup> in relation to:

- the quality control system such as: Sections 18 and 22 Wta, Sections 8 and 22 of the Audit Firms Supervision Decree (Besluit toezicht accountantsorganisaties, or Bta), the Accounting Firms Regulation (Verordening accountantsorganisaties, Section 2); and
- the ethical and controlled business operation: Section 21 Wta.

The expectations were also based on the (problem) analyses and proposals for improvement as described in the NBA report 'In the Public Interest' and the recommendations of the AFM in past years as a result of its inspections.

### Follow-up of dashboard 2015

After publication of the dashboard 2015 in October 2015, the AFM assessed whether the PIE audit firms had followed up the items of attention identified in the 2015 thematic review. In March 2016, the AFM assessed whether the underperforming PIE audit firms had adequately followed up on these items of attention in order to enable an assessment of the implementation and embedding of the improvement programme.

### 2016 assessment of the implementation and embedding of the improvement programme focused on three pillars: connection between the assessment in 2015 and 2016

The assessment in 2016 focused on the implementation and embedding of the improvement programme. The implementation and embedding of the improvement programme was assessed on the basis of three pillars: control, behaviour and culture and internal supervision. Expectations were established for each element of these pillars which the PIE audit firms had to meet in 2016 and cover most of the modules of the assessment in 2015. Many of the measures in the NBA report 'In the Public Interest' are elements of the three pillars and therefore of the assessment in 2016.

#### *Pillar 'control'*

The board of directors of an audit firm has a significant influence on the quality of statutory audits, since the board directs the firm on the basis of its vision and mission and the associated quality objectives. The board of directors designs the quality control system in line with these objectives, propagates this system and monitors it so that the quality of statutory audits is

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<sup>71</sup> The references stated here are based on the regulations as applicable on January 2016.

safeguarded. The following elements from the assessment in 2015 were included in the pillar control:

- in control cycle on quality of the organisation (part of module 1 Board of directors);
- root cause analyses (part of module 3 Quality control system);
- culture survey (part of module 2 Quality-oriented culture).

#### *Pillar 'behaviour and culture'*

The culture of an organisation affects what people consider to be important or what people believe is considered to be important. People ascribe significance to events in interaction, and consequently select the events that they consider to be important. This creates patterns of behaviour: 'This is how we do this here'. Culture is thus an important determinant of behaviour, and vice versa. The effectiveness of the measures designed to improve and safeguard quality depends significantly on the extent to which audit firms have a quality-oriented culture. The following elements from the assessment in 2015 were included in the pillar behaviour and culture:

- target on the horizon (module 7 Change);
- quality-oriented culture (part of module 2 Quality-oriented culture);
- quality-oriented vision of the board of directors and the role of the board of directors (parts of module 1 Board of directors);
- policy on appraisal, remuneration, promotion and sanctions (module 2 Quality-oriented culture).

#### *Pillar 'internal supervision'*

Among other things, an internal supervisory body (the supervisory board) ensures that the board of directors of the audit firm is continually aware of its obligation to meet public expectations regarding the performance of statutory audits of good quality in the public interest. The supervisory board thereby contributes to safeguarding the necessary level of quality. The pillar internal supervision includes the element of authorities of the internal supervisory body (part of module 4 internal supervision) from the 2015 assessment:

#### *Steps still need to be taken after 2016 to meet the medium to long-term objectives*

It is not realistic to expect the medium to long-term objectives to be met in 2016. The PIE audit firms accordingly still need to take further steps after 2016 with respect to the improvement programme in order to meet all the medium to long-term objectives. For the pillar control, examples of this include, that the board of directors has continuous and full insight regarding the quality of the statutory audits performed in its firm and the effects of the actions taken by the board of directors in order to improve the quality of statutory audits. For the pillar behaviour and culture, this concerns adequate practical demonstration of the desired behaviour in the performance of statutory audit engagements and the full embedding of a quality-oriented culture

in the organisation. For the pillar internal supervision, this concerns active supervision of the quality policy and its implementation.

### 6.1.2 Qualitative qualification to measure softer aspects

For each element of a pillar, the AFM has assessed whether the PIE audit firms met the expectations for 2016. This enables comparing of the PIE audit firms. The assessment with respect to the expectations is shown in a list with a *qualitative qualification* per element. A *qualification in words* was determined to be used. The assessment focused on the softer and not always recorded aspects of business conduct in an organisation (such as how discussions are held by the board of directors and the extent to which the employees observe a particular element of the quality-oriented culture). This means that the observations are less easy to reflect in a quantitative score. A qualification in words is given for each element of a pillar.

The qualifications used and their meanings are given in table 9.

In line with expectation	A qualification <i>in line with expectation</i> on an element is assigned if the PIE audit firm meets all the expectations for the element in question.
Nearly in line with expectation	A qualification <i>nearly in line with expectation</i> is assigned if the PIE audit firm fails to meet <i>not more than one</i> expectation for the element in question.
Short with expectation	A qualification <i>short with expectation</i> is assigned if the PIE audit firm <i>fails to meet multiple</i> expectations.
Well short with expectation	A qualification <i>well short with expectation</i> is assigned if the PIE audit firm <i>fails to meet any or multiple expectations</i> <sup>72</sup> .

Table 9 Qualifications

The AFM has detailed the above qualifications for each element of the three pillars in a table. These tables describe the qualifications on the basis of the expectations established for 2016. Appendix 1<sup>73</sup> to this report provides the expectations for 2016 and the tables for the three pillars.

<sup>72</sup> This means a greater number of expectations than for 'below expectation'.

<sup>73</sup> See [part 3](#) of this report.

### 6.1.3 Conduct of the assessment

#### The assessment was conducted on the basis of multiple sources and perspectives

The assessment was based on various information sources including documentation, minutes of meetings and interviews. The information used for the assessment originated from the audit firms, such as the various (policy) documents, HR files and minutes of meetings of supervisory directors and boards of directors (both the parent company board of directors and the board of directors of the audit firm or of the service line audit). Information was also obtained from interviews with members of the supervisory boards, boards of directors and management, partners and employees. References in section 4 of this report to how ‘the employees’ and ‘the partners’ experience and recognise certain aspects etc. are based on the observations from the interviews conducted with these persons. The use of multiple sources and perspectives reinforces the validity of this assessment. The various sources of information in the assessment were reviewed by reading, listening, analysis and reflection. Observations were collected with respect to the expectations for 2016 and qualifications were assigned. The AFM does not use absolute expectations, since audit firms are differently organised and take different approaches to developing the implementation and embedding of the improvement programme.

#### Progression of the assessment

The AFM has collected its observations with respect to the implementation and embedding of the improvement programmes at the eight PIE audit firms until the end of November 2016<sup>74</sup>. The assessment began with desk research on the basis of the information received during the assessment of the design in 2015 and during the subsequent assessment of the follow-up on the items of attention. The audit firms were also requested to provide additional information. The desk research was carried out in preparation for the interviews and the items to be discussed.

The AFM then held in-depth interviews with various persons at various levels in the firms. The interviews were held with the chair and other members of the supervisory board, the chair and other members of the board of directors of the Dutch parent entity, the chair and other members of the board of directors of the licensed firm, employees of staff departments such as the compliance officer or the officer responsible for HR, some of the partners and a number of employees. The interviews with employees were held in groups. The number of interviews at each PIE audit firm varied from 9 to 18. The STAR methodology (Situation, Task, Activity, Result) was used in these interviews to ask as many questions as possible about personal experiences, actual situations and how these were dealt with. These in-depth interviews provided additional insight into the actual behaviour of people in an organisation and therefore insight into how policies and procedures are implemented and safeguarded in practice. The findings of the internal

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<sup>74</sup> The AFM was not able to include changes to the implementation and embedding of improvement measures at the eight assessed PIE audit firms since November 2016 in this assessment.

surveys at the assessed PIE audit firms were used to gain an understanding of the extent to which the findings from the (in-depth) interviews were shared by larger groups of employees.

For the pillar behaviour and culture, information was also collected from an assessment of the HR files of the employees regarding their appraisal (approximately 10), proposed remuneration (approximately 10) and promotion (approximately 10) at each PIE audit firm. For the partners, approximately five HR files were assessed on the elements appraisal and remuneration, approximately five appointment files and approximately five sanctions at each PIE audit firm. It was ensured that the observations were spread across various functions, various regions and various appraisals and promotions. These files were assessed to establish whether the relevant expectations were met for the elements 'contribution to the policy on appraisal, remuneration and promotion by employees to a quality-oriented culture' and 'contribution to the policy on appraisal, remuneration, promotion and sanctions by partners to a quality-oriented culture'. For the assessment of the HR files of the employees and partners with respect to the assessment period, the PIE firm's HR cycle was adhered to.

The information obtained was analysed and related to the relevant expectation. A conclusion was drawn for each expectation as to whether the expectation had been met or not. A qualitative opinion was then formed after the analysis was completed.

### Firm-specific reporting

Each assessed PIE audit firm has received a report from the AFM stating the provisional conclusion and observations of the AFM. These reports are confidential. The PIE audit firms were given the opportunity to give a written response to their draft report with provisional observations. In their responses, the PIE audit firms can state that they consider the facts stated in the report to be incorrect or incomplete, stating their reasons and supported by information where necessary. The AFM has assessed the responses of the PIE audit firms. This may have led to the AFM's provisional conclusion and observations being adjusted. The AFM has included the result of this assessment in a final report and sent this to the PIE audit firms.

### Public reporting

A list of the qualifications with respect to the pillar elements applying to each PIE audit firm is included. This list is also included in the firm-specific report. Section 4 contains a summary of the facts for each pillar element for all the assessed PIE audit firms in which the PIE audit firms are mentioned. The AFM has consulted the PIE audit firms on this summary and list.

The outcomes of the assessment have been sent to the audit firms assessed. The AFM has requested the Big 4 audit firms to provide a written response. These responses can be found on the AFM website.<sup>75</sup>

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<sup>75</sup> See the [AFM website](#).

#### 6.1.4 Limitations of the assessment

The manner in which the assessment was conducted results in limitations to the conclusions that can be drawn from the outcomes. The AFM explains this further below.

The AFM has not assessed whether the improvement programme is sufficient to sustainably safeguard the quality of statutory audits

The AFM's assessment in 2016 relates to the implementation and embedding of the improvement programme at the assessed PIE audit firms. The AFM has assessed whether a vision, a policy and procedures have been implemented and are recognised and complied with in practice. The AFM did not assess the extent to which the implementation and embedding of the improvement programme has affected the actual performance of audit procedures (including the actions of employees and behaviour inside audit teams). The AFM did not form an opinion in this assessment as to whether the improvement programme is sufficient to sustainably safeguard the quality of statutory audits. The AFM also did not establish whether there are other inherent incentives present in the system that hinder the safeguarding of the quality of statutory audits.

No overall assessment conducted of all aspects of the business operation and whether the statutory requirements for the quality control system are complied with

The AFM did not carry out a complete assessment of all aspects of the business operation, the behaviour and culture and the internal supervision at the assessed PIE audit firms. Moreover it was not the purpose of the assessment to establish whether statutory requirements in relation to the quality control system as set forth in the Wta and the Bta are complied with. The assessment focused on the elements of the improvement programme. This means that certain aspects of the business operation, the behaviour and culture and the internal supervision were not part of the assessment. The observations in this report should be seen in this light. The absence of comments or remarks therefore does not imply that no other omissions could exist in aspects that are important for meeting the medium to long-term objectives.

No assessment of inherent incentives in the system

In its assessment of the implementation and embedding of the improvement programme, the AFM did not assess whether the system within which statutory audits are performed includes inherent incentives such as commercial or personal interests, including the business model that could cause the public interest not to be pivotal in performing statutory audits. This assessment does however provide additional insight in comparison to the assessment carried out by the AFM in 2011 of the incentives relating to quality in audits<sup>76</sup>. For example, whether incentives in the

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<sup>76</sup> See the report of 6 October 2011 [‘Incentives for the quality of audits’](#).

policy on appraisal, remuneration and promotion for employees and for statutory auditors contribute or hamper a quality-oriented culture.

#### Difference between the AFM dashboard and the NBA Public Interest Monitor

The NBA has published the NBA Public Interest Monitor on its website<sup>77</sup>. The NBA Monitor shows the progress on the implementation of the 53 measures in the NBA report 'In the Public Interest'. The NBA Monitor states the percentage of the measures that should be completed at the current time and the percentage of the measures in the entire improvement programme for each audit firm. The data in the NBA Monitor are entered based on a self-assessment. The PIE audit firms provide yes or no answers to indicate whether they have implemented all or part of a measure and where they stand in the improvement programme. The NBA does not perform any substantive testing.

The AFM has formed a substantive opinion regarding the implementation and embedding of many measures from the NBA report 'In the Public Interest' that are included in the pillars. The AFM has assessed whether these measures contribute to the expectations established by the AFM for the respective pillar element. As a result, the AFM's assessment is substantively different and the NBA Public Interest Monitor and the AFM dashboard cannot be compared.

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<sup>77</sup> See [the NBA website](#).

## 6.2 Inspection of the quality of statutory audits at the Big 4 audit firms

This section describes how the AFM designed and carried out its regular inspection at the Big 4 audit firms.

### 6.2.1 The regular inspection

The Big 4 audit firms have been subject to ongoing supervision by the AFM since the granting of licences to perform statutory audits. As part of this ongoing supervision, the AFM performs inspections to establish whether audit firms continuously meet the requirements in and pursuant to the Wta and thereby safeguard the quality of the statutory audits performed.<sup>78</sup> To establish this, the AFM inspects in a regular inspection the quality of a number of statutory audits performed and some elements of the quality control system. In this regular inspection, the elements of the quality control system considered were the IQR, the EQCR and the consultation procedure. In its inspection of the quality of statutory audits, the AFM inspects whether the statutory auditors have complied with professional standards in the conduct of their procedures and have obtained adequate substantiation for their opinion with respect to the financial statements. The audit firm has to ensure that its statutory auditors comply with the applicable laws and regulation, and are therefore responsible for the quality of the statutory audits performed by the statutory auditors.<sup>79</sup> The inspection of the quality of the statutory audits performed and of elements of the quality control system reveal whether the preconditions at audit firms designed to safeguard quality have been adequate and the audit firms have thus fulfilled their responsibility.

The AFM carried out the regular inspection in the period from late 2015 to the beginning of 2017. The AFM inspected the quality of statutory audits for the 2014 and 2015 financial years that were performed by the statutory auditors in the calendar years 2015 and 2016. At the end of 2015, the AFM's inspections started with what are known as 'joint inspections' with the Public Company Accounting Oversight Board (PCAOB), which are explained further below.

#### Joint inspections with the PCAOB

Under US legislation, the Dutch Big 4 audit firms are registered with the PCAOB and are therefore also subject to supervision by the PCAOB. The PCAOB conducted an inspection of all the Big 4 audit firms in the Netherlands in 2015 and 2016 as part of its supervision.<sup>80</sup> In the exercise of its supervision of the Dutch audit firms, the PCAOB cooperates with the AFM. As stipulated in Dutch

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<sup>78</sup> When referring to audit quality, the AFM means at least compliance with conduct and professional standards with respect to obtaining adequate substantiation for the opinion with respect to the financial statements and the application of an attitude of professional scepticism in the public interest.

<sup>79</sup> Under Section 14 Wta, audit firms must ensure that the statutory auditors they employ or who are affiliated to them meet the requirements of or pursuant to Section 3.2 Wta. This also covers the rules of professional competence, which among other things require compliance with the Further Regulations for Audit and Other Standards (NV COS).

<sup>80</sup> PCAOB reports: [2016 Inspection of Deloitte Accountants B.V.](#), [2015 Inspection of KPMG Accountants N.V.](#), [2016 Inspection of PricewaterhouseCoopers Accountants N.V.](#) The PCAOB had not yet published its report on EY at the time of publication of this AFM report.

law, audit firms in the Netherlands may not provide confidential information directly to the PCAOB, but the AFM may transfer this to the PCAOB on the basis of international cooperative agreements. The AFM and the PCAOB therefore carry out so-called joint inspections. The AFM has combined the joint inspections of the Big 4 audit firms with its own inspections. The AFM and the PCAOB jointly inspected both elements of the quality control system and the quality of certain statutory audits. Both audit regulators have their own responsibility to supervise the quality of auditing in their jurisdictions and therefore form their own independent opinion regarding the quality of the inspected audits based on their own set of standards. It may be the case that the findings of the two supervisors differ in nature and degree of detail.

### 6.2.2 Selection of statutory audits

The AFM requested each of the Big 4 audit firms to provide a list of all their statutory audit clients for its inspection of the quality of statutory audits. The AFM selected a total of 32 statutory audits for its inspection, half of which related to the 2014 financial year and half to the 2015 financial year. The audit opinions were issued in the period between February 2015 and June 2016. In the selection of the statutory audits to inspect, the aim was to achieve variation in market segments and other features, such as the presence of internal quality safeguards, offices of the Big 4 audit firms and first-year and last-year audits. In addition, the AFM strived to select one municipality and one financial institution at each Big 4 audit firm, partly because the impact on the public of deficiencies in these types of audit is significant and because these sectors feature particular themes in the financial statements to which the AFM expects statutory auditors to devote attention in their audits. The AFM did not base its selection on statutory audits which it had reason to believe included deficiencies.

With this approach and on the basis of a careful selection, the AFM formed an understanding of eight different statutory audits at each Big 4 audit firm, whereby the findings provide an answer to the question of whether in these cases the audit firm had ensured that its statutory auditors did obtain adequate substantiation for their audit opinions.

### 6.2.3 Selection of focus areas in the statutory audits

In the 32 statutory audits selected, the AFM focused on material elements in the audit known as the focus areas. Usually in each statutory audit two focus areas were inspected, including the related subjects or items.

The focus areas were largely determined by the nature and size of the activities of the audit client. This means that for many of the statutory audits the AFM inspected the audit of revenue and one other item in the financial statements that due its nature or size was also of material significance for the impression of the financial statements of the audit client in question. These areas included construction contracts, receivables and intangible non-current assets (including goodwill). The AFM selected more (sector-)specific audit elements for various statutory audits. These concerned mainly tenders, procurement, land developments, investments and loans provided. Many of the items selected involved an element of estimation (see section 5.3).

## 6.2.4 Conduct of the inspection

### An inspection is carried out from multiple perspectives

An inspection by the AFM is interactive. The AFM conducts interviews with the persons concerned at the audit firm for its inspection of both elements of the quality control system and the quality of statutory audits. At least two supervisors carry out the inspection, led by another supervisor. For the inspection of the quality of the statutory audit, the AFM requests the statutory auditor to explain the elements of the audit selected by the AFM on the basis of the documentation in his audit file. Based on the audit file and the explanation from the statutory auditor, the inspection team obtains insight into the procedures performed and forms a conclusion regarding the quality of the audit performed. The AFM inspects the procedures performed with respect to a focus area as a whole and bases its conclusion on the entirety of the procedures performed with respect to a focus area.

After completion of each inspection, the AFM supervisors shared their provisional conclusions and findings with respect to the selected focus areas with the statutory auditor and other representatives of the audit firm.

### Judgement by the AFM

The AFM assesses whether the statutory auditor has obtained sufficient appropriate audit evidence with respect to the focus areas selected by the AFM in accordance with the audit standards.<sup>81</sup> The statutory auditor obtains audit evidence in order to substantiate his opinion regarding the audit client's financial statements. The statutory auditor states his opinion regarding the audited financial statements in his audit report. In this report, the statutory auditor explains that he has obtained a reasonable degree of assurance regarding the question of whether the financial statements are free of material misstatements, that his opinion is based on the audit evidence he has obtained by means of his procedures, that this audit evidence is sufficient and appropriate to substantiate his opinion and that he has performed his audit in accordance with applicable laws and regulations, including the audit standards.

In its inspection, the AFM focused on material elements of the audit. If the statutory auditor has failed to obtain sufficient appropriate audit evidence for one of these material elements, this means that there is a serious deficiency in the performance of the audit. The statutory auditor in this case has not obtained sufficient appropriate audit evidence to substantiate his opinion regarding the financial statements as a whole. In these cases, the AFM qualifies the performance of the statutory audit as 'inadequate'. In other cases, the AFM qualifies the performance of the

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<sup>81</sup> Audit evidence must be both 'sufficient' and 'appropriate'. These two qualifications are intrinsically linked. The aspect 'sufficient' is the criterion for the quantity of the audit evidence. The aspect 'appropriate' is the criterion for the quality of the audit evidence. Appropriate means that the audit evidence is relevant and reliable so that this information constitutes substantiation for the opinion of the auditor.

statutory audit as 'adequate'. This does not exclude the possibility that there may be serious deficiencies in elements of the statutory audit not inspected by the AFM. A qualification of 'adequate' does not therefore constitute a general opinion by the AFM regarding the substantiation of the statutory auditor's opinion regarding the financial statements as a whole.

The AFM has implemented several internal and external quality safeguards to ensure that it forms its opinions with due care and adequate substantiation. One of these internal quality safeguards for instance is the involvement of employees outside the inspection team in the review of the responses from the audit firms to the reports of the AFM's provisional conclusions and findings. Where audit firms dispute the conclusions and findings, additional quality safeguards are implemented. Externally, the AFM for instance discusses its findings in the colleges or regulators set up for each of the Big 4 audit firms in the Committee of European Auditing Oversight Bodies (CEAOB), the cooperative arrangement for European audit regulators. The CEOAB has set up a database for the findings of inspections by European regulators.<sup>82</sup>

### Firm-specific reporting

Each Big 4 audit firm received reports from the AFM stating the AFM's provisional conclusions and findings during the inspection period. These conclusions and findings are supported with detailed information with references to audit files. These reports are confidential.

The reports of the provisional conclusions and findings state the deficiencies supporting the AFM's conclusion that sufficient appropriate audit evidence has not been obtained. Other findings were shared with the statutory auditor during the inspection. The AFM has requested the Big 4 audit firms to assess whether the deficiencies found also occur in other elements of the inspected statutory audit or in other statutory audits performed, for instance in other audits by the statutory auditor concerned or in audits in the same sector. In addition, the AFM requested the audit firms to remediate the deficiencies and to take measures to prevent these in future. In order to prevent the deficiencies occurring in future, the AFM requested the Big 4 audit firms to carry out a root cause analysis to obtain insight with regard to the factors that have contributed to an 'inadequate' or an 'adequate' statutory audit. This contributes to obtaining insight into the quality enhancing and quality limiting factors, and to the ability to take more focused measures to improve the quality of the statutory audits performed.

The audit firms have been given the opportunity to give a written response to the reports with provisional conclusions and findings. The AFM have reviewed the responses received from the audit firms. This may have led to adjustments to the AFM's conclusions and findings. The AFM has shared the outcome of this review with the Big 4 audit firms. The AFM will send a report of its final conclusions and findings to these audit firms. In this final report, the AFM will once again urge the Big 4 audit firms to share the AFM's findings and conclusions regarding a specific

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<sup>82</sup> See the document [CEAOB Inspections sub-group - Terms of reference and work plan 2016-2018](#).

statutory audit with the supervisory board (and in particular the audit committee or otherwise the body responsible for governance) of the audit client in question.

### Public reporting

The firm-specific conclusions and findings are included in part 2<sup>83</sup> of this report. A summary of the main conclusions and findings from the confidential firm-specific reports with respect to each inadequately performed statutory audit for each Big 4 audit firm has been included. All information that could be used to identify the audit client or other persons has been removed from these conclusions and findings. The AFM has consulted with the Big 4 audit firms on the content of part 2 of this report with these conclusions and findings.

The findings of the inspection have been sent to the audit firms. The AFM has requested the Big 4 audit firms to provide a written response. These responses can be found on the AFM website.<sup>84</sup>

### 6.2.5 Limitations of the inspection

The manner in which the inspection was conducted means that the conclusions that can be drawn from the findings are subject to limitations. The AFM explains this further below.

#### No statistical sample taken

The AFM inspected 32 statutory audits on the basis of pre-determined criteria (see section 6.2.2). The AFM has not taken a statistical sample and therefore has not drawn any conclusions regarding the quality of all statutory audits performed by the Big 4 audit firms. The inspection methodology also means that the findings in terms of the numbers of inadequately performed audits cannot be compared with the previous regular inspection or between audits of different financial years. The inspection methodology can also not be used to draw conclusions regarding sub-populations within the statutory audits selected, for instance comparing PIE audits with non-PIE audits.

#### No overall inspection of selected audits and quality control systems

As stated in section 6.2.1, the AFM has not inspected the entire quality control system, it has inspected elements thereof. In section 6.2.3, the AFM explained that its inspection of the performance of a statutory audit focused on a number of items and did not involve the entire statutory audit. It may therefore be the case that deficiencies exist in the elements not included by the AFM in its inspection. It may also be the case that the statutory auditor failed to obtain sufficient appropriate audit evidence in other elements of the inspected statutory audits. The

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<sup>83</sup> See [part 2](#) of this report.

<sup>84</sup> See the [AFM website](#).

findings in this report should be seen in this context. The absence of comments or remarks therefore does not mean that no other omissions exist.

### An inadequately performed audit does not mean that the financial statements are incorrect

Furthermore, the fact that a statutory audit was not adequately performed does not necessarily mean that the audited financial statements are incorrect. The financial statements may still present a true and fair view of the size and composition of the capital and the result. However, at the time of issuing his audit opinion, the statutory auditor had not obtained sufficient appropriate audit evidence to substantiate his opinion with regard to this true and fair view. The AFM did not inspect the accuracy of the audited financial statements and therefore does not express any opinion in this regard.

The AFM has requested the audit firms to remediate the deficiencies and to obtain sufficient appropriate audit evidence that the financial statements are free of material misstatements.<sup>85</sup> If the audit firm carries out adequate remediation procedures, it may emerge at a later stage whether the opinion included in the audit report was accurate or not. This does not affect the fact that at the time of issuing his audit opinion the statutory auditor had not obtained sufficient substantiation for his opinion and had therefore provided assurance to the users of the financial statements and the audit report without this being justified. The AFM has not assessed the remediation procedures in relation to its findings in this inspection.

### No further qualification of deficiencies and no analysis of adequately performed statutory audits

In section 5.3.1, the AFM reports on the nature of the deficiencies in the statutory audits inspected that were qualified by the AFM as 'inadequate'. The severity of the deficiencies that led to the conclusion that sufficient appropriate audit evidence had not been obtained to substantiate the opinion regarding the financial statements as a whole means that the statutory auditor should not have issued his opinion. Accordingly, it is not relevant whether there were one or several deficiencies and the AFM did not further qualify the deficiencies.

The AFM only reports the inadequately performed statutory audits to the firms in writing and states the basis on which it reaches its conclusion. The deficiencies reported to the audit firms are the basis for the analysis of the deficiencies provided in section 5.3.1. The AFM did not carry out an analysis of adequately performed audits or adequately performed procedures.

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<sup>85</sup> Remediation procedures are expected to be made explicitly mandatory by law in 2018 (see section 3).

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