

Report on AFM inspection of the quality of audit and system of quality control and quality monitoring at nine PIE licence holders

21 March 2013

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

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Reading guide

Section 1 of this report describes the background to the inspection of the quality of the conduct of statutory audits and the system of quality control and quality monitoring at nine PIE licence holders. This concerns all PIE licence holders with the exception of the Big 4 audit firms on which a report was already published on 1 September 2010. This section also describes the purpose of the inspection, the manner in which the AFM conducted the inspection, and the inspection process. Section 2 states the AFM's conclusions and recommendations on the basis of the findings of the inspection. Section 3 discusses the factors that affect quality. Section 4 of this report presents a summary of the main findings from the inspection. Section 5 describes the quality measures that the PIE licence holders have taken as a result of the AFM's findings.

The Audit Firms Supervision Act [*Wet toezicht accountantsorganisaties*, or *Wta*] prohibits the AFM from publishing confidential information that it has obtained during the course of its supervision. The *Wta* however does permit the AFM to use this confidential information as the basis for general statements, as long as these cannot be traced to individual persons or audit firms. For this reason, the key findings from this inspection are presented in this report on an anonymous basis, and are not shown for each individual PIE licence holder.

Contact

You can find more information on the supervision of audit firms on the website of the AFM (www.afm.nl) under Professionals > Audit firms. Do you have any specific questions as a result of this report? If so, please send an email to wta@afm.nl, or a letter to The Netherlands Authority for the Financial Markets, for attention of the Audit Firms Supervision Division, P.O. Box 11723, 1001 GS Amsterdam, or phone +31 (0)20 797 2000.

1 Introduction

1.1. Background

This report contains the AFM's findings from the regular inspections conducted by the AFM in 2011 and 2012 at nine audit firms that have a licence that also extends to performing statutory audits at public interest entities (PIE licence holders)¹. The regular inspections were conducted at the following nine PIE licence holders:

- Accon avm controlepraktijk B.V.
- Baker Tilly Berk N.V.
- BDO Audit & Assurance B.V.
- Grant Thornton Accountants en Adviseurs B.V.
- HLB Schippers Beheer N.V.
- HLB van Daal & Partners N.V.
- Maatschap PKF Wallast
- Mazars Paardekooper Hoffman Accountants N.V. and
- SMA Accountants N.V.

The nine inspected PIE licence holders have received a licence from the AFM and are therefore under the continuous supervision of the AFM. The AFM Monitor of 2012 shows that the nine inspected PIE licence holders collectively conduct approximately 15% of the total number of statutory audits in the Netherlands. They conduct some 9% of the total number of statutory audits at PIEs and about 15% of the total number of statutory audits at non-PIEs.²

Number of statutory audits

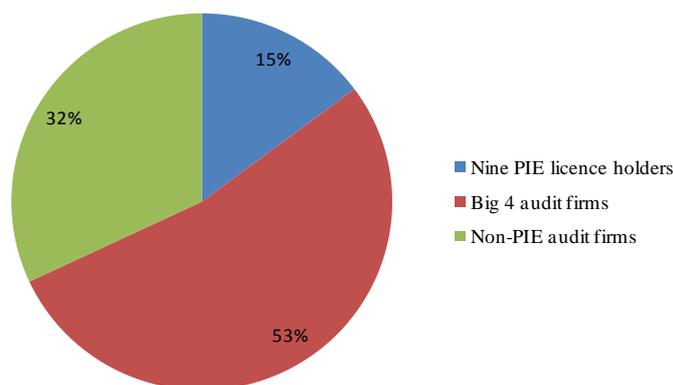


Figure 1: Distribution of number of statutory audits among audit firms

¹ Public Interest Entities (PIEs): listed companies, credit institutions and insurers. Where this report talks of 'audit firm' or 'PIE licence holder', this usually also means the Dutch entities of the network to which the audit firm belongs.

² The Big 4 audit firms (Deloitte Accountants B.V., Ernst & Young Accountants LLP, KPMG Accountants N.V., and PricewaterhouseCoopers Accountants N.V.) collectively conduct some 91% of the total number of statutory audits at PIEs and some 51% of the total number of statutory audits at non-PIEs. The non-PIE audit firms collectively conduct some 34% of the total number of statutory audits at non-PIEs.

The amount of the audit engagements at the PIE audit clients of these nine PIE licence holders is about four times smaller than those at the PIE audit clients of the Big 4 audit firms.³ It also appears from the most recent transparency reports of the nine PIE licence holders that this group of PIEs comprises some 38% of insurers and some 62% of listed companies. These listed companies are mainly investment vehicles of large non-PIE companies that have issued transferable bonds. The AFM Monitor of 2012 shows that the nine PIE licence holders had a share of some 10% of the total revenue from statutory audits in the Netherlands.

Revenue from statutory audits

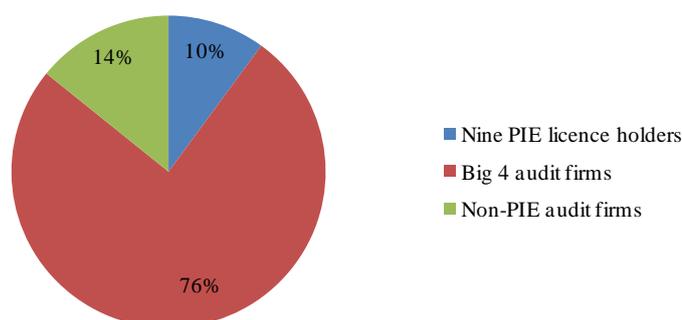


Figure 2: Distribution of revenue from statutory audits among audit firms

In conducting the regular inspections at the nine PIE licence holders, the AFM has assessed the quality of the audits and the system of quality control and quality monitoring at all the PIE licence holders. The AFM commenced its inspections at the Big 4 audit firms. During recent years, the AFM has conducted a number of regular and thematic reviews at these audit firms. In 2008, the AFM conducted a thematic review as a result of the credit crisis, and reported on this on 3 December 2009.⁴ Then the AFM conducted regular reviews in 2009 and reported on these on 1 September 2010.⁵ During the first half of 2011, the AFM conducted its ‘Incentives for audit quality’ thematic review at all PIE licence holders and reported on this on 6 October 2011.⁶ Finally, on 11 December 2012, the AFM issued a report as a result of a thematic review at the Big 4 audit firms into the quality control of the audit of the financial statements of housing corporations.⁷

³ Measured at the average revenue from statutory audits that the audit firms have charged their audit clients. The nine PIE licence holders realised some € 33,000 revenue from statutory audits for each PIE audit client, whereas the Big 4 audit firms realised an average revenue of some € 141,000 for each PIE audit client. Source: AFM Monitor of 2012.

⁴ Report of general finding of credit crisis review, 3 December 2009.

⁵ Report of general findings concerning quality of audit and quality monitoring, 1 September 2010.

⁶ Incentives for Audit Quality. An exploratory study, 6 October 2011.

⁷ Report on the AFM inspection of statutory audits of housing corporations,, 11 December 2012.

1.2. Development of number of PIE licence holders since introduction of *Wta* (Audit Firms Supervision Act)

There are currently 13 PIE licence holders listed in the register of the AFM. This is five audit firms less than the number of audit firms from which the AFM received the licence application in 2007. Two audit firms converted their application to a non-PIE licence application. The AFM rejected the licence application from another audit firm, because it did not meet the requirements set by the *Wta* for a PIE licence holder. Until recently, Baker Tilly Berk B.V. was a PIE licence holder, but had the licence withdrawn due to a change in its organisational structure. The statutory audits were performed by licence holder Baker Tilly Berk N.V. Licence holder Extendum Audit B.V. converted the licence in the summer of 2012 from a PIE licence to a non-PIE licence, and terminated its engagement with the PIE audit client. Finally, it is noteworthy that HLB Schippers Beheer N.V. and BDO Audit & Assurance BV entered into a strategic partnership with effect from 1 January 2013, which must lead within a few years to a full integration of HLB Schippers Beheer N.V. into BDO Audit & Assurance B.V.

1.3. Purpose and implementation of this inspection

1.3.1. Purpose of the inspection

In its supervision, the AFM encourages audit firms to safeguard the quality of their audits. Audit firms must demonstrate continuous compliance with the requirements of and pursuant to the Audit Firms Supervision Act (*Wta*). The AFM conducts reviews to determine the extent to which audit firms comply with the laws and regulations applicable to them. During the licence granting process, the audit firms demonstrated that they were organised to meet the requirements of and pursuant to the *Wta*, and at that time the AFM assessed the operation of the system of quality control on the basis of a limited number of audits. In its continuous supervision, the AFM wants to identify the quality of the audits. On the basis of a risk analysis, the AFM determined which (parts of the) audits and aspects of the system of quality control and quality monitoring would be involved in the inspection. These are explained in sections 1.3.2. and 1.3.3.

1.3.2. Inspection of audits

The AFM included a total of 47 audits concerning financial years 2009, 2010, and 2011, the majority of which concerned 2011, in the inspection of the quality of the audit. These concerned 12 audits at PIEs and 35 audits at non-PIEs (Table 1).

Number of audits at PIEs	12
Number of audits at non-PIEs	35
Total	47

Table 1: Number of inspected audits at PIEs and non-PIEs

The 47 audits relate to companies in the financial sector, construction/property sector, and in manufacturing, trade, and a few other sectors. The AFM especially focused its inspection on the **financial⁸ and construction/property** sectors. The specific reporting requirements mean that there is an increased risk of shortcomings in the financial statements due to the risks of fraud and integrity issues, and the valuation problems in these sectors. Because not all the PIE licence holders' audits were conducted in the financial and construction/property sectors, the AFM has also selected audits from other sectors for its inspection. Table 2 shows the distribution of the number of audits among the various sectors. The construction and property sectors are merged, because the selected audit clients in many cases perform activities in both sectors.

Financial	Construction/ Property	Manufacturing	Trade	Other⁹	Total
10	14	4	8	11	47

Table 2: Distribution of number of audits among sectors

The AFM also included the topic **continuity** in its inspection of the selected audits. The results can be under pressure in nearly all the sectors due to the financial and economic crisis, and refinancing can be more difficult, if not seemingly impossible. This is illustrated, for example, by the number of bankruptcies that occurred in these sectors in 2011.¹⁰

In particular, the AFM assessed whether the external auditor obtained sufficient and appropriate audit evidence on which to base his auditor's opinion. In the assessment of selected audits, the AFM, where relevant and appropriate, included the following issues:

- Did the external auditor perform sufficient audit procedures with respect to the completeness of the revenue?
- Did the external auditor perform sufficient audit procedures with respect to the existence and the measurement of the following statement of financial position items, depending on size and sector of the audit client?
 - Property
 - Financial assets
 - Investments
- Did the external auditor perform sufficient audit procedures with respect to the recognition of income and expenses from construction contracts?
- Did the external auditor perform sufficient audit procedures with respect to the going concern assumption (COS 570)?
- Did the external auditor, as a group auditor, adopt an active and critical attitude towards (foreign) auditors that were engaged, and did he thus obtain assurance that he could rely on the audit procedures performed by these other auditors (COS 600)?
- Did the external auditor adopt an active and critical attitude towards any expert engaged by himself or by the audit client (COS 620 and COS 500.8), or towards a service organisation engaged by the

⁸ These mainly concerned audits at insurers, usually regional mutual insurance companies, and pension funds.

⁹ The other sectors are IT, services, transport, automotive, the agricultural sector and the printing sector.

¹⁰ For the number of bankruptcies, see: D&B Failure Statistics – Total 2011, Dun & Bradstreet B.V. to be found via: <http://www.dnb-nederland.nl/dnb-service/failurestatistics>.

audit client (COS 402), and did he thus obtain assurance that he could rely on the work of this expert or service organisation?

The AFM assessed the conduct of the audit by the external auditor on material aspects. This means that the supervisors of the AFM inspected the audit file together with the external auditor. The supervisors asked questions about how the auditor has audited the financial statements, how the auditor arrived at specific positions, and how the auditor documented his considerations and decisions. The AFM did not assess the entire audit file, but focused on two to three pre-selected focus areas. These focus areas depended on the typology of the audited company, but always involved the key items of the financial statements. The auditor had also frequently identified a significant risk for these items.

1.3.3. Inspection of system of quality control and quality monitoring

The policymakers of the nine PIE licence holders are responsible for monitoring the quality of the audits performed by their audit firm. In addition to assessing audits, the AFM therefore focuses attention on the system of quality control and quality monitoring in its regular inspections. In this context, the AFM pays particular attention to the engagement quality control review (EQCR), the regular internal review, and the supervision of compliance with the laws and regulations by the policymakers and the compliance officer.

The AFM did not assess the entire system of quality control and quality monitoring, but mainly focused on parts of the system of quality control and quality monitoring in which special risks have been identified by the AFM. The AFM also spoke with policymakers, compliance officers and other people involved, as well as independently inspecting the documentation concerning the system of quality control and quality monitoring.

1.4. From inspection to final inspection report

An inspection conducted at a licence holder results in a confidential report that contains the preliminary findings of the AFM. Before these preliminary findings are included in the report, the AFM checks the facts with the directly involved external auditors, the policymakers and the compliance officer. In this context, the AFM presents the facts obtained during the inspection. Furthermore, the AFM states, in the opinion of the AFM, whether these facts may or may not have led to violations of standards. The report with preliminary findings is sent to the audit firm for the purpose of checking the facts. The audit firm is then given the opportunity to respond. The AFM requests the audit firm to take appropriate (recovery) measures in response to the preliminary findings, where applicable, to redress any violations in the past and prevent repetition in the future. The AFM assesses the response of the audit firm and then sends a report containing its final findings. The response from the audit firm can lead to the cancellation or modification of any preliminary findings of the AFM. The AFM only includes the serious findings in the report of findings. These are the findings in which the external auditors have obtained insufficient and inappropriate audit evidence concerning the financial statements as a whole to be able to substantiate their auditors' opinions. The less serious findings that the AFM identified during its inspection are fed back verbally to the PIE license holders and the external auditors involved. The findings in this public report are based on the findings contained in the final confidential reports. In this context, the AFM has ensured that the findings are not traceable to the nine PIE license holders and their audit clients.

2 The nine PIE licence holders are working on fundamental improvements

An audit aims to strengthen the extent to which the intended users of the financial statements of an audit client can rely on the accuracy and completeness of these financial statements, with justifiable confidence, and use them for making their decisions. The auditor's opinion must be substantiated by sufficient and appropriate audit evidence to justify the opinion that the financial statements give a true and fair view, and that the disclosures included are sufficient and understandable. The external auditor expresses this in his opinion that the financial statements give a true and fair view of the amount and composition of the equity, the result, the liquidity, and the solvency.

Fundamental improvements essential

The AFM has established that in the inspected audits of all nine PIE licence holders, there were serious shortcomings, which meant that the quality of the audit as a whole was inadequate. All nine PIE licence holders that were inspected have therefore failed in their duty of care. The AFM encountered serious findings in 35 of the 47 audits that it assessed. These findings show that the external auditors obtained insufficient and inappropriate audit evidence concerning the financial statements as a whole to be able to substantiate their auditors' opinions. Although the auditor, in his auditor's report, declares his opinion that the audit evidence obtained was sufficient and appropriate to enable substantiation for the provision of his opinion, in approximately 74% of the audits assessed by AFM the external auditors did not obtain sufficient and appropriate audit evidence. This means that it is uncertain whether the financial statements of the audit clients involved are free from material errors. The shortcomings in audit quality occurred in all the sectors inspected. These are similar to the shortcomings that the AFM previously encountered at the Big 4 audit firms and on which the AFM reported publicly in 2009 and 2010. The AFM has asked the nine PIE licence holders to take appropriate recovery measures with respect to the audits concerned in its findings, and to take improvement measures to prevent these shortcomings from occurring again in the future. It is the responsibility of the external auditors themselves to assess whether the already issued auditor's reports on the financial statements should be adjusted.

Nine PIE licence holders are implementing quality measures

The nine audit firms realise that possessing a PIE licence entails obligations. During recent years, these audit firms have therefore already taken measures to improve the quality of their audits. These measures include, for example, the centralisation of the audit practice, the rolling out of an improved audit approach on the basis of the new audit standards in effect since 15 January 2011, and the central monitoring of the results of the engagement quality control reviews (EQCRs) and regular internal reviews. However, these quality measures do not yet appear to be working well enough.

From the discussions that the AFM has conducted with the nine PIE licence holders, it appears that they are prepared to take far-reaching quality measures. In this context, the AFM has requested the audit firms to make a thorough analysis of the causes that underlie the shortcomings in the quality of the audits inspected by the AFM. The AFM also calls on the nine PIE licence holders to pay additional attention to the conduct of the people who are involved in the conducting of an audit. The AFM believes that this analysis must serve as a basis for the quality measures that the nine PIE licence holders take to reinforce a corporate culture that is focused on high-quality audits with a matching tone at the top. The nine PIE licence holders have currently started to implement more far-reaching quality measures in their firms. See section 5 of this report.

In the consultation with the nine PIE licence holders on 20 March 2013, in which the AFM presented its inspection findings, the AFM asked the audit firms to pay additional attention to factors that could

improve the quality of the audits. The AFM specifically identified the tone at the top, including the company culture, the system of quality control and quality monitoring, and the quality of the external auditor. The AFM believes that more attention to these factors within audit firms will have a favourable effect on the quality of the audit. There are also several environmental factors, including perceived 'price pressure' and the training of auditors and continuous education, which could have effects on the quality of the audits.

The AFM has conducted discussions to share standards with the policymakers of the nine PIE licence holders. During 2013, the AFM will closely monitor the implementation of the recovery measures and the quality measures of the PIE licence holders.

Conclusions

The AFM's inspections identified differences between the nine PIE licence holders in both the severity and the possible causes of the quality problems. Table 3 presents these differences between the nine PIE licence holders. The comparisons between the various PIE licence holders are identified, on an anonymous basis, in terms of the tone at the top, the system of quality control and quality monitoring, the quality of the external auditor, and the percentage of inspected audits with serious findings as a percentage of the total number of inspected audits. A "+" in the table means that the audit firm concerned scores better than the other PIE licence holders. A "-" means that the audit firm concerned scores lower than the other PIE licence holders.

PIE licence holder	Tone at the top	System of quality control and quality monitoring	Quality of external auditor	Inspected audits with serious findings as a percentage of the total number of inspected audits
1	+	+	+	50%
2				51% to 99%
3				51% to 99%
4				51% to 99%
5			-	51% to 99%
6		+	-	100%
7	-			100%
8	-	-	-	100%
9	-	-	-	100%

Table 3: Differences between the nine PIE licence holders

On the basis of its inspection, the AFM has identified that the differences in the tone at the top between the nine PIE licence holders is reflected in the manner and the intensity with which the leadership encourages quality-oriented thinking and acting within their firm. Explicitly rewarding the conducting of high-quality audits in audit firms can encourage the quality-oriented behaviour of auditors.

Furthermore, the quality of the external auditors within a firm is generally the determining factor for the quality of an audit conducted. The external auditors, who were responsible for the audits with which the AFM had serious findings, all showed an inadequate professional critical attitude in conducting the audits. The AFM considers this to be a serious matter, because a professional critical attitude of an auditor largely determines the quality of an audit. In addition, external auditors do not always have the requisite knowledge and experience that are required for the audits for which they are responsible. Moreover, not all the external auditors demonstrate sufficient involvement in the conducting of the audits for which they are responsible.

The nine firms surveyed generally have a sufficiently well-designed system of quality control and quality monitoring, but the system operates inadequately. The AFM has the impression that the audit firms set the 'bar' for the quality of their audits at too low a level. In 22 of the 31 selected audits, approximately 70%, in which the nine PIE licence holders had performed EQCRs, the AFM had serious findings regarding the audit. In these cases, the EQCR was therefore unable to prevent the fact that the auditor's opinion was substantiated with insufficient audit evidence. In 12 of the 16 selected audits, approximately 75%, in which the nine PIE licence holders had performed a regular internal review, the AFM also had serious findings regarding the audit. In these cases, the audit firms were therefore unable to afterwards detect that the auditor's opinion was substantiated with insufficient audit evidence. The AFM considers this a serious cause for concern.

Finally, the AFM considers that the quality control system of the nine PIE licence holders must force more external auditors to engage experts for their audit, if necessary, including IFRS experts, valuation experts, and IT experts. This applies both for experts available within the audit firm and for external experts.

Recommendations

The AFM calls on the nine PIE licence holders to start a discussion in the sector concerning the specific interpretation of the factors identified in this report that can improve the quality of the audits and, in doing so, to also involve the environmental factors that were identified, such as price pressures and education of the auditors. The AFM also recommends that the clients involved, and their supervisory boards, should request the audit firm that conducts their auditing to provide them with the findings from the confidential AFM report that are relevant to that firm. This would enable them to be better informed in conducting the discussion with their auditors concerning the quality of the audit.

The AFM also recommends that other audit firms take note of the findings of this inspection. The AFM considers it important that the audit firms regularly perform a review of the quality of their audits. This means that it is essential that they obtain insight into the quality of their external auditors, the quality measures, and the degree to which their company culture encourages quality. They should also carry out a thorough analysis of the causes, such as behavioural aspects, which underlie any shortcomings in the quality of the audits or of the firm in general. When this insight has been obtained, the audit firms can proceed to take the necessary corrective and improvement measures that will have a quality improvement effect on the firm.

Regarding the education of auditors, the AFM makes the recommendation to the NBA that an external auditor be obliged to spend a part of the continuous education on bringing up to standard, maintaining or strengthening his audit skills, depending on his knowledge and experience, and the nature of his audit practice. The audit skills should not only include knowledge of audit methodology, but also the communication skills that are needed to discuss errors in the audited figures and defects in the ao/ic with the audit client.

Finally, the AFM recommends that the users of financial statements take note of the findings of this inspection. The findings enable the users of financial statements to ask critical questions about the audit conducted, and the system of quality control and quality monitoring of the nine PIE licence holders. The inspection can thus be a source of inspiration for them in enabling them to be critical towards their auditor, with the ultimate goal of ensuring that the quality of audits in the Netherlands is improved.

3 Factors that affect the quality

Various factors affect the quality of an audit. An important factor in this respect is the quality of the external auditor: his professional critical attitude, knowledge and experience, and his involvement in the audit. However, the experience and expertise of the other members of the audit team also play an important role. The external auditor is responsible for the conduct of the statutory audit. He must obtain sufficient and appropriate substantiation for his opinion regarding the reliability of the audited financial statements as stated in his auditor's report. How the external auditor fulfils this responsibility partly depends on the culture of the audit firm, in which the leadership should, through the right 'tone at the top', encourage the focus on quality and should make clear the firm's expectations regarding the responsibilities of the auditors.¹¹

3.1. Tone at the top

A good **tone at the top** assumes a demonstration of exemplary behaviour, showing that policymakers and other members of management (hereinafter: leadership) of the audit firm attach primary importance on a good quality of audits. They have an eye for what is needed to achieve a good quality within the firm and will therefore take the necessary measures to achieve that goal, and they radiate – in word and deed – the conviction that quality is important. A proper tone at the top also requires that the leadership of an audit firm is exemplary of the principle that auditors – in their thoughts and actions – do not focus on the client's thinking as main priority, but on the audit itself. Society, the external user of the information, is ultimately the primary stakeholder, and not the audit client. The exemplary behaviour of the leadership encourages (external) auditors to demonstrate the same behaviour in the performance of their duties.

The exemplary behaviour of the leadership has a significant influence on the **company culture** of the audit firm. The culture of a firm determines the behaviour of auditors. The individual auditor is often faced with the following dilemma. On the one hand, the external auditor must be objective and critical towards his audit client to be able to conduct a high-quality audit. On the other, the auditor wants to serve the same audit client as well as possible, in order to obtain or retain the engagement. The more often that commercial factors play a decisive role within an audit firm, the more pressure there is on providing quality in conducting the audit. There may be an area of tension present between revenue targets, cost reduction measures and the delivery of a high-quality audit. In such cases it is important that the leadership within the audit firm uses the right tone to manage their employees within this area of tension. Concessions regarding quality – which might undermine the trust that society places in the judgment of the auditor, must be prevented. A quality-oriented company culture will also be reflected in the appointment, appraisal and remuneration policy of an audit firm. The AFM believes that explicitly

¹¹ The AFM has previously stated this concept in the report resulting from the AFM inspection of statutory audits at housing corporations of 11 December 2012 (pages 10 to 11).

rewarding the conducting of high-quality audits in audit firms can encourage the quality-oriented behaviour of auditors.¹²

On the basis of its inspections, the AFM notes that the nine PIE licence holders differ from each other in their tone at the top. This is reflected in the manner and the intensity with which the leadership encourages quality-oriented thinking and acting within their firm. One PIE licence holder scored better compared to the other audit firms, and three PIE licence holders score worse compared to the others.

The tone at the top of the audit firm must encourage the external auditors to give more substance than currently to their responsibility in conducting audits. This responsibility should be the most important factor for external auditors, which intrinsically motivates them to conduct high-quality audits. This responsibility does not always appear to be felt by external auditors that audit non-PIE audit clients. At these clients, the external auditor often operates without a force field of segregation between ownership and management, with shareholders who do not provide the management themselves from within their ranks, and with a supervisory board (SB) and audit committee¹³ who, from their financial interest, or supervisory role, have an interest in a qualitatively well conducted audit. External auditors often have to deal with directors of non-PIE audit clients, particularly in a situation where the ownership is in the hands of a director and major shareholder, who attaches less importance to a high-quality audit of the financial statements from a financial interest or supervisory role. This is because the quality of the financial reporting is sufficiently familiar to them. They attach more importance to the advisory role of the auditor, and make use of the expertise of the external auditor in the preparation of the financial statements.

However, there are often also stakeholders other than the owner of a company that the auditor must not forget. For example, a true and fair view of the financial position and results of a company are important for the Tax and Customs Administration, banks, credit institutions and creditors (creditors of the company). Furthermore, with their auditor's report, external auditors contribute to the confidence that society has in the financial-economic system. By conducting audits, external auditors can increase the quality of the financial reporting and improve compliance with the laws and regulations, and in doing so, for example, can also possibly detect fraud. In this role, therefore, auditors have an important responsibility in conducting audits, both within the PIE segment as well as within the non-PIE segment. Consequently, especially also within the non-PIE segment, the tone at the top is of great importance in preventing individual auditors from becoming too enmeshed with the interests of the audit client.

The AFM expects the leadership of the nine PIE licence holders to create a behavioural change within their firms. This behavioural change must lead to the emergence of a quality-oriented company culture. They must constantly encourage quality in their decision-making despite other factors, such as commercial results. They must express this through their exemplary behaviour in both words and deeds. The AFM believes it is important that audit firms develop their vision of quality in the quality policy of their audit firm, and that they render accountability to society for this policy in their transparency report. The AFM considers the transparency report to be important for every audit firm with a PIE licence.¹⁴

¹² The AFM has previously adopted this position in the report 'Incentives for quality of audit' of 6 October 2011.

¹³ Decree of 26 July 2008 on implementation of Section 41 of Directive no. 2006/43/EG of the European Parliament and the Council of the European Union of 17 May 2006 concerning the statutory audits of financial statements and consolidated financial statements, to amend the Directives no. 78/660/EEC and no. 83/349/EEC of the Council of the European Communities and including withdrawal of Directive no. 84/253/EEC of the Council of the European Communities.

¹⁴ The transparency report is not statutorily mandatory for PIE licence holders that do not conduct any audits at PIEs.

3.2 System of quality control and quality monitoring

The *Wta* expressly places responsibility for the quality of the conduct of statutory audits on the audit firm, and not only on the individual external auditor. Audit firms implement **quality measures** in order to be able to meet these responsibilities and safeguard the quality of statutory audits. A number of quality measures are prescribed by statute in general terms. Audit firms have a system of quality control with which they safeguard the compliance with laws and regulations. Their quality monitoring enables them to ensure that the system of quality control is permanently and consistently operational. To achieve this, it is important that leadership has a view of the actual quality of the audits conducted and, if necessary, can promptly make adjustments for any problems that arise in the firm. Depending on the quality of their external auditors and the degree to which the company culture encourages quality, the audit firms develop these quality measures themselves and apply additional quality measures to a greater or lesser extent. The exact nature of this process depends on the audit firm concerned, and may vary in each case.

On the basis of its inspections, the AFM observed that the nine PIE licence holders that were inspected do generally have a sufficiently well-designed system of quality control and quality monitoring, but that the system operates inadequately. The nine PIE licence holders differ from each other with respect to the effectiveness of the system of quality control and quality monitoring, whereby the AFM also notes that none of the nine PIE licence holders has set the bar for quality at an adequate level (see below). Two PIE licence holders score better compared to the others, and three PIE licence holders score worse than the others.

It follows from the inspections of the AFM that all nine PIE licence holders have a procedure to determine whether external auditors have delivered the required quality in conducting the audit and whether they have complied with the internal quality guidelines in doing so. All the PIE licence holders have a procedure in which they determine this before the external auditor issues his auditor's report (EQCR)¹⁵ and seven PIE licence holders do so also after the auditor's report has been issued (regular internal review). The quality and depth of these quality measures is generally inadequate (see section 4.2.) The AFM considers this a serious cause for concern.

There are several possible causes that can be identified for the operational failure of the quality measures. The AFM has the impression that the audit firms set the 'bar' for the quality of their audits at too low a level. In its inspections, the AFM checks whether the external auditors have conducted their audits at the level of the *Wta* (Audit Firms Supervision Act) and *Bta* (Audit Firms Supervision Decree) and the code of conduct and professional rules that auditors have mutually agreed (e.g. in the *VGC* [professional code of conduct] and the auditing standards as included in the NV COS [based on the International Auditing Standards]). Foreign supervisory authorities also conduct checks against a comparable 'bar'. The inspections of the AFM show that the nine PIE licence holders sometimes do identify shortcomings in audits in EQCRs and regular internal reviews, but label these in the overall opinion as 'not sufficiently serious/material' and then arrive at an overall opinion of 'adequate'. The AFM emphasises that it is important that auditing firms raise the bar to a higher level in their reviews. The bar that the PIE licence holders use within their firms is, after all, the quality standard that is used for audits.

It is also important that external auditors become much more aware of the 'bar' or quality standard than they currently are. They have learned in their training how a proper audit must be conducted and how the

¹⁵ The EQCR is mandatory for audits at PIEs and as designated by the audit firm for non-PIEs.

auditing standards must be applied. The awareness of the quality standard can be an incentive for auditors to increase their knowledge and experience through education and training courses. The audit firms could take more initiative in the area of education and training courses for external auditors in the firm, and could implicitly or explicitly reward the following of these courses. This could encourage external auditors to choose quality because they see that this is valued by the firm. At the same time it is important to sanction auditors who commit violations. The sanctions could be targeted at improvement (following a course, or the use of a second auditor), reduction in pay and limiting the opportunities for promotion, or even the striking off of an external auditor from the AFM register. It is the choice of the audit firm to determine what mix of positive and negative reward elements in its firm will contribute most effectively to the improvement of the quality of the audits and the promotion of the desired company culture.

A second possible reason for the failure of the quality measures to achieve the desired effect is that the nine PIE licence holders involve insufficient numbers of audits in the performance of EQCRs and regular internal reviews. The reason can also be that they do not apply the correct selection for these reviews because, in the opinion of the AFM, they have identified too few audits, or the wrong audits, as higher risk. Audit firms set their own assessment criteria on the basis of which they proceed to perform the EQCRs with non-PIE audits. Perhaps these assessment criteria lead to the failure to perform EQCR's in cases in which this would be desirable, e.g., in cases of audits with an increased risk profile. In addition, the inspections of the AFM show that two of the nine PIE licence holders perform no regular internal reviews of statutory audits. The regular internal review is specifically designed to check whether the external auditor has complied with the applicable laws and regulations when conducting his audit. It is therefore a useful management tool for an audit firm.

3.3 Quality of the external auditor

The inspections of the AFM show that a proper **quality of the external auditor** is the basis for a proper quality of the audit. If this basis is not present, it is almost impossible for audit firms with additional quality measures, such as EQCRs and regular internal reviews, to conduct high-quality audits. The AFM has observed that the nine PIE licence holders differ from each other in terms of the quality of the external auditors whom the AFM has assessed. At one PIE licence holder, the external auditors score better compared to the other audit firms. At four PIE licence holders, the external auditors score worse compared to the others.

Factors that determine the quality of the external auditor are:

- professional scepticism;
- knowledge and experience;
- involvement in the audit.

The auditor's **professional scepticism** is an important factor in the quality of an audit. If audits are not conducted with sufficient professional criticism, there is a greater risk that material errors will not be detected in the financial statements and that the external auditor will inadequately substantiate the auditor's report. Professional scepticism means that, among other things, the auditor critically assesses the value of audit evidence obtained. He must be alert to audit evidence that is inconsistent with, or raises questions about, the reliability of documentation, the answers to questions asked, and other information obtained from the management of the entity and the bodies charged with governance. He must discuss this with the audit client. When gathering audit evidence, the auditor must not rely only on corroborative audit evidence, but must also consider whether there could be any conflicting information in existence. The auditor will therefore not only rely on information obtained from the audit client, but must also involve as many external sources as possible in his audit.

On the basis of its inspections, the AFM has observed that the external auditors responsible for the audits with which the AFM had serious findings, all showed an inadequate professional scepticism in conducting the audits. The AFM consider this to be serious, because the professional scepticism of an auditor largely determines the quality of an audit. The AFM notes that the degree of lack of professional scepticism, however, differs between the external auditors and also for each PIE licence holder. For instance, the AFM observed quality problems in relatively simple audits at several PIE licence holders and saw the findings on basic aspects of the conduct of the audit. In these cases, the professional scepticism of the external auditor had serious shortcomings. At other PIE licence holders, the shortcomings mainly concerned the more complex audits and exceptional details in the audit. Although the professional scepticism was equally inadequate, this did not concern the basic aspects. In addition, at all nine PIE licence holders it appeared external auditors in some cases perform no audit work where they should be doing this, or that they perform too few activities.

Another important factor that affects the quality of the external auditor is his **knowledge and experience**. The knowledge and experience should be consistent with the nature and activities of the audit client, and varies for each sector and industry (such as SMEs, government, construction/property, and the financial sector). Some audits are more complex in nature than others. Before accepting the engagement from a potential audit client, the audit firm must assess whether they have an external auditor who can properly audit this audit client. If the case involves an audit team that is conducting an audit at a PIE, heavier experience requirements apply to this team – as a whole or to individual members – than those in an audit at a non-PIE. The nine PIE licence holders, in the context of their duty of care, must always determine whether there is sufficient knowledge and experience in their external auditors and audit teams for the specific audits they conduct. The leadership of an audit firm must make an estimate as to whether an external auditor and an audit client fit together in terms of knowledge and experience. This can cause an audit firm to decide to change the external auditor or members of audit teams at audit clients, and even to take leave of the audit client if there is a reason to do so. In addition, this inspection report can provide the audit firm with insight into the areas in which the audit firm and its employees must sharpen their knowledge and skills in order to remain up-to-date on laws and regulations.

On the basis of its inspections, the AFM determined that not of all the external auditors have the necessary knowledge and experience required for the audits for which they are responsible. An external auditor will not always possess the necessary expertise himself, in areas other than financial reporting or auditing, in order to adequately substantiate his auditor's opinion. In such cases he will have to engage the services of an expert. In the opinion of the AFM, the quality control system of the nine PIE licence holders must force more external auditors to engage experts for their audit, if necessary, including IFRS experts, valuation experts, and IT experts. This applies both for experts available within the audit firm and for external experts.

A third factor, finally, which affects the quality of an external auditor, is his **involvement in the audit**. The AFM considers the actual involvement of external auditors in the audits conducted under their management as a crucial element for the quality of the audit process. For proper involvement in the audits, it is important that external auditors have the right focus on the audit and are motivated to conduct it well. The external auditor has an important role to fulfil in the risk analysis, the audit plan, the performance of audit procedures, the assessment of the findings, and the formulation of the final opinion. The AFM has established that at some PIE licence holders, the external auditors have extensive knowledge of the audit client, but little knowledge of the actual audit procedures performed. In these cases, many audit procedures are performed by less experienced staff, often without prompt adjustment by the external auditor. This creates the risk that they will perform insufficient or inappropriate

procedures to enable substantiation of the auditor's opinion. At a later time in the audit, this cannot be repaired, or it will be difficult to do so. The external auditor will therefore have to spend a lot of time on coaching and on-the-job training of his staff in the audit team in order to mitigate this risk. He has to set an example for the less experienced staff, and he must ultimately assume the full responsibility for the audit.

3.4 Environmental factors

The nine PIE licence holders have to deal with environmental factors that affect the quality of audits. Audit firms experience the so-called **price pressure** in the acquisition and retention of engagements. This occurs naturally in a competitive auditors market. However, price pressure is problematic if it leads to the reflex to spend fewer hours than necessary on conducting a proper audit. The AFM expects audit firms to always conduct high-quality audits, regardless of the accuracy of the preliminary calculation in terms of commitment of hours. After all, they conduct the audits for the benefit of society, which will be unimpressed by commercial considerations between auditor and audit client. Audit firms must therefore in advance, or during the audit, ensure that audit teams have sufficient time, resources and manpower to conduct high-quality audits, even if this entails exceeding the budget agreed with the audit client. It is the audit firm's responsibility to determine the budget for which they can conduct a high-quality audit and the audit clients for whom they will or will not provide that service.

Another environmental factor, finally, that may affect the quality of audits is the **education of auditors**. The education consists of two parts: the auditor's training and the continuous education. The training to become an auditor is currently being discussed. Both the Accounting Programme Exit Qualifications Committee (*Commissie eindtermen accountantsopleiding* - CEA) and the Netherlands Institute of Chartered Accountants (*Nederlandse Beroepsorganisatie van Accountants* - NBA) have issued advisory committee reports that contain recommendations for a new model for the auditor's education. The current education model – with which both the Dutch Chartered Accountant (*Registeraccountant* - RA) and the Accounting Consultant (*Accountant-Administratieconsulent* - AA) are trained to be an auditor permitted to conduct audits without being able to specialise specifically – no longer appears to be adequate. The AFM believes that the theoretical basis of the education, subject to the above recommendations, provides an adequate level, but the coordination with practice could be improved further. During the theoretical education, students receive a general education, but there is relatively little attention paid to specialised areas, such as the auditing of municipalities, complex derivatives, banks, and IT systems. Both the theoretical and the practical education are inadequately designed for these areas.

The AFM expects an external auditor to fulfil his continuous education requirements largely by taking courses focused on auditing. The AFM wonders whether audit firms sufficiently ensure that the continuous education of their external auditors provides the proper material interpretation, and whether the training on the job, also with relatively few more specialised audits, offers sufficient guarantees for a good quality of the audit if specialist knowledge is required. The AFM suggests that the NBA and the CEA should consider the extent to which they can play a significant role in this context. The AFM recommends that an external auditor should be obliged to spend a part of the continuous education on bringing up to standard, maintaining or strengthening his audit skills, depending on his knowledge and experience and the nature of his audit practice. The audit skills should not only include knowledge of audit methodology but also communication skills that are needed to discuss errors in the audited figures and defects in the ao/ic with the audit client.

4 Findings of the inspection

4.1. Quality of the audits

4.1.1. General

The AFM assessed 47 audits in the context of its regular inspections at the nine PIE licence holders. The assessment of the AFM concerned material items in the financial statements. The AFM observed that the opinions of auditors on the financial statements as a whole, in 35 of the 47 audits inspected (approximately 74%), were inadequately substantiated by audit evidence. The AFM makes a distinction between audits with serious findings, in which the auditor's opinion on the financial statements as a whole is insufficiently substantiated, and audits with findings, but which are less serious. The AFM has reported in writing to the nine PIE licence holders concerning the audits with serious findings. With regard to the audits with less serious findings, the AFM did not report in writing, but verbally informed the external auditors and policymakers about the nature and extent of these findings. The audits with regard to which the AFM had less serious findings were of adequate quality. These findings vary from insufficient control of documentation to insufficient audit evidence in some parts of some files. In the remainder of this report the AFM discusses only the serious findings in more detail.

Table 4 provides an overview of the AFM's findings. It contains a breakdown of the findings in the sectors with increased risk of shortcomings in the financial reporting (financial and construction/property). The AFM discovered serious findings in all of the 15 audits selected in the construction/property sector. With respect to the audits in the financial sector, serious findings were discovered in half of the selected audits.

	All sectors	Financial sector	Construction/property sector	Other sectors
Number of audits selected	47	10	15	22
Number of audits with serious findings	35 ¹⁶	5	15	15
Number of audits with less serious findings	12	5	0	7

Table 4: Summary of findings on audits

Table 5 provides an overview of the AFM's findings broken down into findings that relate to audits of PIEs (listed companies and unlisted insurers) and audits of non-PIEs. The AFM selected 12 audits at PIEs. This is approximately 12% of all the audits that the nine PIE licence holders conduct at PIEs.

	Total	PIEs	PIEs	Non-PIEs
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¹⁶ At one PIE licence holder, the AFM assessed audits concerning 2009 financial years. The old NV COS applied to these audits. The AFM's findings that relate to the old COS 500 ('insufficient audit evidence') are comparable with COS 200.17 (insufficient and unsuitable audit evidence).

		Listed companies	Insurers	
Number of audits selected	47	7	5	35
Number of audits with serious findings	35	5	2	28
Number of audits with less serious findings	12	2	3	7

Table 5: Overview of findings for PIEs and non-PIEs

In Table 6, the AFM links its inspection findings to the nature of the auditor's report. The AFM assessed seven audits in which the external auditor issued a disclaimer of opinion. The external auditor has had to perform as many audit procedures as possible with respect to the parts of the financial statements to which the disclaimer of opinion relates. For the parts of the financial statements to which the disclaimer of opinion does not relate, the auditor should perform a complete audit. With respect to audits with a disclaimer of opinion there is a risk that the auditor performed too few audit procedures. The AFM discovered serious findings in five of these audits. In one audit of a non-PIE audit client, the AFM has concluded that the external auditor wrongly issued a disclaimer of opinion. Important parts of the financial statements concerned were not prepared according to the applicable reporting regulations. As a result of this, the financial statements contained material misstatements and the external auditor should have issued a qualified auditor's report.

	Unqualified auditor's report	Disclaimer of opinion
Number of audits selected	40	7
Number of audits with serious findings	30	5
Number of audits with less serious findings	10	2

Table 6: Findings according to nature of auditor's report

4.1.2. *Duty of care*

The AFM found that all nine inspected PIE licence holders failed in their duty of care. The 35 audits with serious findings are actually spread across all nine PIE licence holders. The nine PIE licence holders failed to take adequate measures to ensure that their external auditors obtained sufficient and appropriate audit evidence on which to base their auditor's opinion.

4.1.3. *Auditors insufficiently substantiate their opinion on the financial statements*

In conducting an audit, the auditor has the aim of passing an opinion about whether the financial statements in all material respects meet the reporting regulations. This requires that the auditor obtains a reasonable level of assurance about whether the financial statements as a whole do not contain material misstatements resulting from fraud or errors. The auditor obtains this assurance by gathering *sufficient* and *appropriate* audit evidence.¹⁷ 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

¹⁷ This follows from the professional regulations, specifically COS 200.17: "To obtain a reasonable level of assurance, the auditor must obtain sufficient and suitable audit evidence in order to reduce the audit risk to an acceptable level, which will enable the auditor to draw a reasonable conclusion on which he can base his opinion."

parties. Sufficient and appropriate audit evidence is necessary to substantiate the opinion of the auditor and the auditor's report. 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. Quality means that the audit evidence is relevant and reliable so that this information actually constitutes substantiation for the opinion of the auditor. The external auditor uses audit evidence to substantiate his opinion that the presented equity and result in the financial statements of the audit client are free from material misstatements.

Procedures to obtain audit evidence

The auditor obtains audit evidence by performing audit procedures. COS 500 provides a summary of the different types of audit procedures: inspection, observation, external confirmation, recalculation, reperformance, analytical procedures, and inquiries. The external auditor will often combine these types of audit procedures to obtain sufficient and appropriate audit evidence. Inquiries alone do not normally provide sufficient audit evidence. The auditor will often perform a combination of tests of controls and substantive procedures to obtain audit evidence. The tests of controls are focused on the design, existence and operation of internal controls of the audit client. If the external auditor wants to rely on the internal controls of the audit client, he will use tests of controls to determine that the internal controls are operating effectively and that he can rely on them. The auditor uses substantive procedures to assess whether there are no material misstatements. Substantive audit procedures consist of detailed checks of parts of the financial statements, and substantive analytical procedures and balancing checks.

An auditor will not always possess the necessary expertise himself, in areas other than financial reporting or auditing, in order to be able to obtain the required audit evidence. In such cases an auditor will have to engage the services of an expert. This can be an expert engaged by the auditor himself, or an expert or service organisation engaged by the audit client. The auditing of complex financial instruments, such as derivatives, is usually an area for which auditors engage valuation experts, and specifically valuation experts. If an auditor engages an expert, he must assess the competence, capacities and objectivity of the expert and evaluate whether the procedures performed by the expert are satisfactory. In order to check the value of property, auditors often make use of the valuation report of an appraiser. Table 7 provides an overview of the AFM's findings in the assessment of procedures of other experts and service organisations. The table shows that, in six of the ten (60%) selected audits in which the auditor made use of other experts or service organisations, the AFM has serious findings in this area.

	Procedures of other experts or service organisations
Number of audits selected	11
Number of audits with serious findings	6
Number of audits with less serious findings	5

Table 7: Findings on other experts/service organisations

Distinction between audit evidence and audit documentation

Audit evidence must be distinguished from audit documentation. Audit documentation is the record of audit evidence in the audit file. The external auditor must document all the evidence on which he has based his opinion of the audited financial statements in an audit file, thus showing that he has conducted the statutory audit in accordance with the regulations that apply. The AFM observed that external auditors failed, in too many audits, to adequately document audit evidence in the audit file. The AFM has qualified findings regarding the lack of sufficient audit documentation in itself as less serious. However, the AFM emphasises that the external auditor, using his audit file in a clear and organised manner, must be able to provide insight into how the audit has been conducted and into the substantiation of the auditor's report. Documentation in the audit file is essential to enable the main theme of the audit to be followed. The

distinction between the audit evidence and audit information can be illustrated by means of the following hypothetical example:

Distinction between audit evidence and audit documentation

An auditor checks the correct valuation of a building, for which his planning of the audit includes using the expertise of an appraiser engaged by him. When, in the assessment of the audit file, the AFM did not find any valuation report, the auditor must demonstrate that he indeed has used a valuation report. He was able to do this because he does have a memo in the audit file that refers to the conclusion from the valuation report and he also has the valuation report in his personal mailbox. In that case, the AFM concludes that the external auditor did obtain audit evidence, but that he has not documented it properly. If, however, the auditor cannot demonstrate that he has used the valuation report, or has not performed any alternative audit procedure to check the value of the building, the AFM then concludes that the auditor has not obtained sufficient audit evidence. The fact that the audit documentation is also actually inadequate, however, is not also identified by the AFM as a separate finding.

In sections 4.1.4. to 4.1.9 inclusive, the AFM provides an explanation of the serious findings it has concerning the audit procedures. The AFM illustrates its findings by using examples. All these examples are based on aspects of the AFM's inspection findings and thus relate to real situations that were encountered. The examples relate to the audits of both PIEs and non-PIEs. All examples relate to the audit of material elements of the financial statements concerned.

4.1.4. Audit of the revenue

The AFM observed, in too many audits, that external auditors performed insufficient audit procedures with respect to the completeness of the revenue to adequately substantiate their auditor's opinion. The AFM concluded on the basis of its inspections that the insufficient audit procedures relate to the points listed below:

- Insufficient tests of controls to determine the design, existence and operation of the internal controls, including the general IT controls and application controls¹⁸, at the audit client. The procedures performed by the external auditor are usually substantive in nature. This is partly caused by insufficient knowledge about the organisation and environment of the audit client. If the auditor has planned that he would rely on an effective operation of the internal controls of the audit client, it is important that he specifies which internal controls are relevant for the audit of the completeness of the revenue. Then he must determine the operation of these relevant internal controls. However, instead of determining that the audit client has performed an internal control measure, the auditor himself often assesses one or more items in the administration. As a result of this, the auditor has only obtained assurance on these items by means of random sampling, and not on the operation of the internal control measure.
- Insufficient substantiation of why the selected items and numbers are representative for the check of the operation of the internal controls.
- Insufficient depth of the substantive analytical procedures. When performing substantive procedures, the external auditor often uses substantive analytical procedures. It is important in this context that the external auditor predetermines a sufficiently detailed expectation and that he makes

¹⁸ For an explanation, see COS 315 A96 and A97.

a more detailed examination of deviations from this expectation, provided with an adequate substantiation.

- Insufficient substantive detail procedures to ensure the completeness of the revenue. When checking the completeness of revenue, for trading and production companies links can be made to other items and flows in the financial statements, using the movement of cash and goods. The balancing check shows which records and/or files the auditor reconciles with each other. Thus, for example, the issuing from inventories must reconcile with the addition to the cost of sales. When determining which balancing to make, it is important that the external auditor thoroughly understands the actual activities of his audit client.

The above can be illustrated by the following examples from the inspection of the AFM:

General IT controls

The audit client is a non-life insurer. The non-life insurer uses a computerised system for the insurance process and the financial administration. In the audit, the external auditor assesses the general controls of the computerised system (general IT controls), including the user rights. These user rights show which powers are available to the employees of the non-life insurer in the computerised system. In this context, the external auditor's assessment includes whether adequate segregation of duties is present between key functions in the insurance process, which is important for the reliability of the information obtained from the computerised system. The audits file shows that a large number of employees of the non-life insurer have access to all the functions in the computerised system. This allows these employees to make changes into not only the policy administration, but also the claims administration, the financial administration, and the master data. The external auditor has not assessed what the risks are of these shortcomings in the general IT controls, but wrongly concludes that these general IT controls are adequately set up and operating.

Tests of controls

The audit client is a medium-sized transport company. The external auditor uses a tests of controls approach for the audit of the completeness of the revenue. To do this, the external auditor has planned to conduct a line check and a procedure test in order to determine the existence and operation of the internal controls in the sales process. The procedures performed by the external auditors, however, are by their nature substantive detail testing, because the external auditor himself has determined whether an order letter is present and whether the invoicing reconciles with the order letter. The external auditor has not determined that the transport company's internal controls are present and sufficiently effective. He could have done this by assessing whether the transport company had determined that the invoicing reconciles with the order letter. The external auditor therefore concludes incorrectly that he can rely on internal controls of the transport company in the audit of the completeness of the revenue.

In the performance of these procedures, the external auditor discovers that in 10 of the 25 assessed orders he cannot determine that orders have been fully invoiced, that the correct rate has been applied, and that the standard deviations between standard kilometres and kilometres driven remain within the norm. The external auditor has incorrectly failed to assess these exceptions in more detail.

Movement of goods

The audit client is an egg trading company, which trades in different types of eggs. The audit client frequently sells eggs of a more expensive type for a lower price due to surpluses. The external auditor recognises the risk of shifting between different egg qualities as a significant risk. This shifting risk relates to the effect that the revenue of the trading company may be recognised at too low an amount.

However, the external auditor did not perform the planned procedures 'audit of the movement of goods for each egg type' and 'analytical review of the revenue and margin for each egg type'. The external auditor did however perform a movement of goods and margin analysis at total level. Nevertheless, these procedures at total level do not provide the external auditor with audit evidence about the revenue for each egg type and he cannot discover the shifts between egg types. With the procedures the external auditor has performed, he has not obtained any audit evidence about the significant 'shifting danger' risk or about the completeness of the revenue recognised.

Analytical review

The audit client is a trading company in collected textiles. The audit client processes the collected textiles to produce different products with different profit margins. The trading company grants discounts to customers and creates waste in its processing. For the audit of the completeness of the revenue, the external auditor performs a substantive analytical review on the basis of the total amount of revenue and on the basis of the ledger. However, the external auditor has obtained insufficient audit evidence from this analytical review. The external auditor has specified no predetermined expectations, and has determined no acceptable difference/audit gauge for the data involved in the analytical review. In addition, the external auditor performed the analytical review at too high an aggregated level, which means he obtained no insight into the various product groups, the discounts granted, and the recognised waste. With these procedures, the external auditor cannot detect any material errors in the revenue recognition, whereas these could have become evident from more detailed analytical reviews.

4.1.5. Audit of the property

To obtain audit evidence about the existence, the ownership and the valuation of property, auditors will generally perform substantive procedures. The AFM observed, in too many audits, that external auditors performed insufficient audit procedures with respect to the existence, the ownership and the valuation of property to adequately substantiate their auditor's opinion. In order to check the valuation of property, external auditors often use an expert (appraiser) engaged by the auditor or by the audit client. If an auditor engages an expert or makes use of the procedures of an expert who has been engaged by the audit client, he must assess the competence, capacities and objectivity of the expert, and evaluate whether the procedures performed by the expert are satisfactory. The AFM concluded on the basis of its inspections, that the insufficient audit procedures relate to the points listed below:

- Obtaining information without actually performing audit procedures. Inquiries alone do not normally provide sufficient audit evidence.
- Inadequate assessment of the reasonableness of the audit client's estimates, including internal estimates, of the value.
- Inadequate assessment of the expertise and independence of the appraiser engaged by the audit client.
- Insufficient evaluation of whether assumptions and methods used by the appraiser are reasonable and relevant.
- Insufficient evaluation of the source data used by the appraiser, in order to determine whether these are accurate and complete.
- Insufficient performance of procedures aimed at identifying impairments. The AFM would actually expect this in the light of the financial and economic crisis. For the valuation of property, the external auditor must check the fair value. This is possible by using, for example, valuation reports, leases, and return calculations. External auditors are insufficiently critical concerning indications of impairments, such as a much lower value according to the Immovable Property Tax Act value (WOZ value).

- Insufficient performance of audit procedures regarding existence and ownership of property. In order to determine that the property exists and is owned by the audit client, an auditor can consult land register details, *WOZ* tax assessments, or any other relevant information that shows the existence and (economic) ownership.

The above can be illustrated by the following examples from the inspection of the AFM:

Valuation expert/objectivity

The audit client is a property company that uses an external appraiser for the valuation of its investment properties. The external auditor has doubts about the objectivity of this appraiser because the current directors of the audit client recently worked with this appraiser. The external auditor concludes nevertheless, and without substantiation, that the objectivity of the appraiser is adequate.

Valuation expert/assumptions

The audit client is a non-life insurer that values its office building at a fair value of approximately € 1 million. This value is based on a valuation from an appraiser engaged by the non-life insurer. The external auditor has reconciled the valuation in the financial statements. However, the external auditor has not assessed the reasonableness of the assumptions and method used by the appraiser. Thus, the external auditor has not, for example, obtained insight into how the value was determined and whether the basic data used for this are correct. The valuation report also provides no insight into this. In addition, the external auditor has the *WOZ* value available as an indication of the value of the building. This *WOZ* value amounts to approximately € 0.3 million. However, the external auditor has performed no procedures to assess the difference between the appraised value and the *WOZ* value. After the AFM had made its findings known, the external auditor performed more detailed audit procedures. These procedures showed that the appraiser had used incorrect assumptions. Due to the inaccuracy in the valuation, there was an issue of an overvaluation of the office building. The external auditor concluded that, if he had been aware of this anomaly at the completion of his audit, he would have issued a qualified auditor's report (if this anomaly had not been adjusted). The non-life insurer adjusted the error in the financial statements of the new financial year. The external auditor informed DNB about this situation¹⁹.

Obtaining information

The audit client is a construction company with investment properties and land holdings. The external auditor has identified significant risks concerning the existence, ownership and the valuation of the investment properties and land holdings. The external auditor has performed insufficient audit procedures, because he only obtained information from the management of the audit client concerning the existence, ownership and valuation of the investment properties and the land holdings. The external auditor has therefore not independently performed procedures to check the information obtained. Therefore the external auditor has not assessed aspects including the issue of whether there was any impairment concerning the valuation of the investment properties and the land holdings. The latter was actually important because the construction company had acquired strategic land holdings, whereby the management was speculating on a change to the zoning plan. Discussions with the management revealed,

¹⁹ Pursuant to Section 3:88 Wft and the practice guideline 1104, the statutory obligations of the auditor who audits the financial statements of a financial enterprise or a pension fund.

however, that there are indications that these zoning plan changes are no longer expected. This means that these land holdings are probably valued too high.

4.1.6. *Audit of construction contracts*

The AFM observed, in too many audits, that external auditors performed insufficient audit procedures, with respect to the recognition of income and expenses for construction contracts, to adequately substantiate their auditor's opinion. Construction contracts involve projects contracted by third parties, whereby the execution of such projects are still 'in progress' on the statement of financial position date and usually extend over more than one reporting period, such as buildings under construction and other infrastructural work. Companies often recognise the income and expenses of these projects in proportion to the work completed. This method of recognition, with interim profit taking during the execution of the project, is also called the 'percentage of completion' method. This method can only be applied if the company can reliably determine the phasing and interim income provisions. The reporting guidelines (RJ guideline 221) contain detailed elaboration of the specific conditions which must be met for the application of this method. If this condition is not met, interim profit recognition is not allowed and the profits can only be recognised when a project is completed. Regardless of the method applied, anticipated losses must be recognised immediately in the income statement.

The AFM concluded on the basis of its inspections that the insufficient audit procedures relate to the points listed below:

- Insufficient assessment as to whether, in applying the percentage of completion method, the company can indeed determine the interim profits reliably, and whether this complies with the requirements as stated in reporting guideline RJ 221. This assessment is important because of the effect of the selected method on the presented equity and result.
- Insufficient assessment of the reasonableness of accounting estimates made by the audit client on the amount of the interim profit taking from construction contracts.
- Insufficient assessment concerning the question of whether account has been taken of loss-making projects, whether actually expected or not, also including the assessment of whether costs are accounted for on the correct project. With a view to possible loss-making projects, the external auditor must also specifically determine whether costs are accounted for on the correct project. There is always the risk that, to avoid having to take losses, costs actually related to loss-making projects are recognised on profitable projects.

The above can be illustrated by the following examples from the inspection of the AFM:

Interim profit taking/unreliable determination of results

The audit client is a construction company with projects in earthworks, road works, and hydraulic engineering. The construction company recognises the income and expenses of these projects using the percentage of completion method. The external auditor has identified the fact that the interim results on the projects cannot be reliably estimated, among other reasons because the internal control is limited, and because the preliminary and subsequent costing calculations for each project are missing. Nevertheless, he concludes, without substantiation, that interim profit-taking using the percentage of completion method is permitted.

Degree of progress

The audit client is a construction company with major infrastructure projects. The construction company recognises the income and expenses of these projects using the percentage of completion method

according to the degree of progress of the projects. The construction company's financial statements define how the degree of progress is determined. According to the financial statements, the degree of progress is determined on the basis of the costs incurred for the project on the statement of financial position date in relation to the total expenses expected to be spent on the project. The external auditor has neglected to determine whether the construction company has actually determined the degree of progress in this manner. During the AFM's inspection, on the basis of the documentation in the audit, the external auditor should have noted that the construction company did not determine the degree of progress in the manner defined in the financial statements. Instead, the construction company actually determined the degree of progress on the basis of the instalments invoiced to the client on the statement of financial position date in relation to the expected total of the instalments to be invoiced for the project. However, this method is not suitable for determining the degree of progress. Because the external auditor had not performed any audit procedures concerning the degree of progress, he had not previously detected this.

Shifting risks

The audit client is a steel construction company with approximately 100 construction projects. The external auditor had identified a significant risk concerning the accuracy of the construction contracts. This included the question of whether the project costs were recognised on the correct projects. To mask losses, the steel company could have an interest in shifting the costs of loss-making projects to profitable projects. The external auditor did not perform any audit procedures to assess the accuracy of the project costs, with the exception of performing a 'corroborative review'. However, the external auditor could not identify the specific procedures he performed in this 'corroborative review'. According to the verbal explanation of the external auditor, he had determined, using this 'corroborative review', that the internal control on the working hours implemented by the workshop manager was operating effectively. This is insufficient, however, because it is not clear how the external auditor determined this, and thus no audit evidence was obtained about the other costs such as material costs. The external auditor did not obtain sufficient audit evidence about the operation of this internal control measure.

4.1.7. Audit of the financial assets

The AFM observed, in too many audits, that external auditors performed insufficient audit procedures with respect to the existence and the valuation of financial assets to adequately substantiate their auditor's opinion. To assess the value of financial assets, the auditor will generally perform substantive procedures, for example, to determine that the financial assets are adequately presented and disclosed in the financial statements. The auditing of complex financial instruments, such as derivatives, is usually an area for which auditors engage experts, and specifically valuation experts. If an auditor engages an expert or makes use of an expert who has been called in by the audit client, he must assess the competence, capacities and objectivity of this expert and evaluate whether the procedures performed by the expert are satisfactory. The AFM's report of 11 December 2012 on the statutory audits at housing corporations includes examples of situations in which the external auditor did not obtain sufficient and appropriate audit evidence with respect to derivatives.²⁰ In conducting the inspections at the nine PIE licence holders, the AFM encountered similar findings. The AFM concluded on the basis of its inspections that the insufficient audit procedures relate to the points listed below:

²⁰ See footnote 7.

- Insufficient determination that there are derivative financial instruments (derivatives) at the audit client, and insufficient knowledge of RJ 290 (reporting guidelines for financial instruments). This means that there were no audit procedures performed in the audit with respect to derivatives.
- Insufficient performance of audit procedures with respect to the valuation of derivatives.
- Insufficient determination of whether the strict conditions for application of cost hedge accounting were complied with.
- Insufficient performance of audit procedures regarding indications of impairment of financial assets.
- Insufficient performance of audit procedures relating to the design and operation of the internal control of a service organisation engaged by the audit client, in the event that the external auditor relies on procedures performed by a service organisation (COS 402).

The above can be illustrated by the following examples from the inspection of the AFM:

Service organisation

The audit client is a non-life insurer that makes use of a service organisation, an asset manager, for the administrative processing of the investments and the execution of investment transactions. The non-life insurer receives a report from the auditor of the service organisation on the design and operation of the internal controls of the service organisation. The external auditor of the non-life insurer makes use of this report for the audit of the investments. This report shows major findings with respect to the internal control of the service organisation. It also appears that the auditor of the service organisation did not include some asset management activities of the service organisation in his review. The external auditor did not assess whether these findings and exception were relevant for him. In addition, the external auditor did not assess whether the service organisation's auditor was sufficiently expert and independent, and whether the service organisation's auditor included the internal controls in his audit that were relevant to the external auditor. The external auditor therefore did not assess whether he could use the report to obtain sufficient assurance concerning about the recognised investments and investment income.

Interest rate swaps

The audit client is a transport company. The transport company has contracted three interest rate swaps. The negative value of these swaps, as at the statement of financial position date, amounts to approximately € 0.3 million. The financial statements of the transport company contain no disclosures on these interest rate swaps. It is unknown whether the interest rate swaps were recognised in the statement of financial position. According to the reporting regulations, not recognising these swaps in the statement of financial position is only possible if the transport company makes use of cost hedge accounting. The external auditor did not determine whether the transport company applied cost hedge accounting and whether the transport company met the strict conditions for applying cost hedge accounting. It is possible that the negative value of the interest rate swaps is incorrectly not recognised in the statement of financial position, whereas this has a material effect on the equity and the result of the transport company. The external auditor has therefore not performed any audit procedures to determine whether the swaps have been properly recognised in the financial statements.

4.1.8. Assessment of procedures of other auditors.

External auditors must adopt an active and critical attitude with respect to procedures performed by other auditors. The external auditors have to delve into the issues and the specific risks associated with this, then must provide focused instructions for it and must themselves determine that the procedures performed by other auditors have been performed in a sufficiently critical manner, and that the correct conclusions have been drawn on the basis of the findings. In Table 8 below, the AFM has summarised its

findings concerning the application of COS 600. In 6 of the 21 selected audits (approximately 28%), the AFM discovered serious findings in the cases where the external auditors rely on procedures performed by other auditors (in the context of the group audit).

	COS 600
Number of audits selected	21
Number of audits with serious findings	6
Number of audits with less serious findings	15

Table: Findings on COS 600

The AFM concluded on the basis of its inspections that the insufficient audit procedures relate to the points listed below:

- Insufficient assessment by the external auditor of whether he, in his role of group auditor, is able to obtain sufficient audit evidence to substantiate his auditor’s opinion.
- Inadequate risk analysis of the group as a whole to determine which risks there are or can be identified in the various group entities.
- Insufficient involvement as group auditor in carrying out the risk analysis of the auditors of the group entities.
- Insufficient specific instructions to the auditors of the group entities.
- Insufficient assessment of procedures performed by auditors of group entities and insufficient evaluation of their findings for the auditor’s opinion.

The above can be illustrated by the following examples from the inspection of the AFM:

Assessing adequacy of procedures performed

The audit client is a business service provider. The audit client has a subsidiary in another EU country that contributes 10% of the consolidated revenue. The external auditor has deemed this group entity in the country concerned as significant, and makes use of a foreign auditor to obtain sufficient assurance on this group entity. For this purpose, the external auditor instructs the foreign auditor to conduct a regular full scope audit. However, the documentation received by the external auditor from the foreign auditor shows that the foreign auditor did not conduct a full scope audit, but that he conducted a limited review that only consisted of obtaining information and performing an analytical review. The external auditor independently examined the specification of the construction contracts of the foreign group entity and conducted an interview with a Board member of this group entity. Nevertheless, the external auditor obtained insufficient assurance concerning the reliability of the annual figures of the foreign group entity. With the procedures performed, which largely consisted of making inquiries, the auditor did not obtain sufficient assurance concerning the absence of material errors or concerning the operation of significant internal controls.

4.1.9. Assessment of the going concern assumption

When a company has prepared its financial statements on the basis of a going concern assumption, a company indicates that it can continue its operations in the foreseeable future. An external auditor will need to obtain audit evidence regarding the appropriateness of the management’s use of this going concern assumption. In Table 9, the AFM provides an overview of the findings concerning the going concern assumption. In three of the twelve selected audits (25%), the AFM noted serious findings observed when the external auditors assess whether the continuity of the operations assumed by the management of the entity is acceptable.

	Going concern assumption
Number of audits selected	12
Number of audits with serious findings	3
Number of audits with less serious findings	9

Table 9: Findings on going concern assumption

The AFM concluded on the basis of its inspections that the insufficient audit procedures relate to the points listed below:

- Insufficient audit procedures to determine whether the going concern assumption of the audit client has been correctly applied or whether there are indications that can create doubts about the ability of an audit client to maintain its continuity. If the auditor, on the basis of audit evidence obtained, has doubts, he should determine what the consequences of these are for his auditor’s report.
- Insufficient audit procedures in the event that there are negative indications regarding the going concern assumption. The external auditor does not always adequately assesses the management’s estimates, assumptions underlying the forecasts, agreements with external financiers, future order book, liquidity and solvency of the audit client.

The following example from the AFM’s inspection illustrates serious findings that the AFM has noted:

Indications of reasonable doubt

The audit client is a medium-sized construction company that prepared its financial statements on the basis of the going concern assumption. The external auditor recognises the risk that the construction company has insufficient liquidity. The external auditor had a discussion about this with the legal adviser of the construction company. The report of this discussion shows that the legal adviser has assessed the bankruptcy risk of the construction company. According to this assessment, it follows that the construction company has several subsidiaries where difficulties have arisen with respect to collecting receivables from these subsidiaries, and that a potential bankruptcy of one of the subsidiaries could put the continuity of the construction company at risk. The external auditor concludes solely on the basis of these procedures that the continuity of the construction company is not at risk, without providing more detailed substantiation for this conclusion. The external auditor has therefore not performed more detailed audit procedures, such as analysing the latest available interim financial statements, assessing the financing agreements of the subsidiaries, and assessing the forecasts of the subsidiaries.

4.2. System of quality control and quality monitoring

The AFM’s inspections show that the system of quality control and quality monitoring at all nine inspected PIE licence holders has components with shortcomings. This means that these audit firms do not adequately safeguard the assumption that the auditor’s reports issued or to be issued are accurate and sufficiently substantiated. Sections 4.2.1. and 4.2.2. explain the key findings of the AFM at the level of the system of quality control and quality monitoring.

4.2.1. The design and operation of the system of quality control and quality monitoring

The system of quality control contains all the procedures, standards and descriptions of an audit firm for the purpose of compliance with the laws and regulations. In many cases the system of quality control is described in a (digital) manual. The quality monitoring has the purpose of ensuring that the system of

quality control is complied with within the audit firm. One condition for this is that the system of quality control can be checked and that it operates in manner that can be reconstructed, so that people within the audit firm who are responsible for quality assurance – as well as the AFM - can check whether the system also works or has worked in practice.

Design of the system of quality control

The AFM's inspections showed that several PIE licence holders have included no or insufficiently clear procedures, standards and descriptions in their system of quality control for the following topics:

- The assessment criteria for performing an engagement quality control review (EQCR) with statutory audits that the audit firm conducts at non-PIE audit clients. These are not always sufficiently specific, which means that when checking against the criteria in similar cases, the use of an EQCR may sometimes be decided upon and sometimes not.
- The recording of all the relevant considerations that are made on the basis of the EQCR findings.
- The closing and archiving of electronic files and hard copy files. The absence of a procedure means that files cannot be closed at a date that is not later than two months after signing of the auditor's report.
- The conducting of the audit of derivative financial instruments (derivatives). The absence of a standard for the auditing of derivatives and the availability of specialist knowledge means that external auditors, in several audits, pay insufficient attention to the proper recognition and presentation of derivatives in the financial statements of the audit client.
- The requesting of the necessary advice from other professionally competent people by external auditors for the purpose of conducting the statutory audit (consultation procedure). The situations in which external auditors are obliged to request advice are (too) limited and insufficiently specific. This means there is not similar consultation in similar cases.
- The mandatory engagement of IT expertise in specific circumstances.

Safeguarding the compliance with the system of quality control

The AFM's inspections showed that several PIE licence holders have insufficiently safeguarded the assumption that the internal procedures are complied with in relation to the following topics:

- The application of the standard for conducting statutory audits. Compliance with the standard is an important safeguard which ensures that external auditors conduct the audit in accordance with rules for professional competence. A standard provides guidelines for the external auditor for the correct application of the auditing standards. Auditors have neglected to perform required audit procedures by not applying the standard.
- The requesting of the necessary recommendations from other professionally competent people by external auditors for the purpose of conducting the statutory audit. Audit firms do not – or insufficiently – ensure that effective advice is sought in situations in which they have prescribed this.
- The performance of EQCRs. Audit firms do not assess quality and depth of the EQCRs in a manner that can be checked and reconstructed.
- The performance of regular internal reviews. Audit firms do not or insufficiently monitor whether instructions on the audit that are provided by internal reviewers are actually followed up in the audit of the next financial year.
- The procedures of the compliance officer. The compliance officer monitors the compliance with regulations set by and pursuant to the *Wta*, and performs the procedures that are required for this monitoring. Audit firms do not monitor – or insufficiently monitor – the assumption that compliance officers perform the relevant procedures.

Evaluation of the system of quality control

The audit firm is statutorily obligated to evaluate the system of quality control each year and – as a result of this evaluation – to take measures to adjust the system if necessary. The AFM’s inspections showed that four PIE licence holders have not adequately evaluated their system of quality control.

Engagement Quality Control Reviews (EQCRs)

The EQCR is a significant statutorily stipulated instrument that must monitor the quality of the statutory audits conducted. The EQCR is mandatory for audits at PIEs and for audits at non-PIEs designated by the audit firm. The external auditor must not issue his auditor’s report until after the EQCR reviewer has determined that the audit procedures performed by the external auditor have been sufficient to substantiate the auditor's report. By performing an EQCR, the quality of the statutory audit is monitored and, where necessary, the audit can be adjusted before the auditor’s report is issued.

The AFM’s inspections showed that several PIE licence holders have insufficiently recorded the considerations of the EQCR reviewer. On the basis of the internal procedure of one of these audit firms, an EQCR reviewer is only required to record the considerations for a negative assessment. At another firm, a substantiation of the opinion is required in all cases, but in practice a positive assessment by the EQCR reviewer is not substantiated. In this manner, the full opinion of the EQCR reviewers cannot be checked or reconstructed. It also appears that external auditors at several PIE licence holders have dated the auditor’s report earlier than after the EQCR has been completed, if it is required.

Table 10 makes a link between the nature of the findings on the audits and the question of whether or not an EQCR has been performed for these audits. In 22 of the 31 selected audits (approximately 70%), in which the nine PIE licence holders performed an EQCR, the AFM had serious findings in the audit. In these cases, the EQCR was therefore unable to prevent the auditor’s opinion from being substantiated with insufficient audit evidence. In its inspections, the AFM discovered shortcomings in the audit that the EQCR reviewers did not identify. This means that the EQCRs performed were insufficiently critical and were performed with insufficient depth.

	EQCR	Regular internal review	EQCR and regular internal review	Neither
Number of audits selected	31	16	9	9 ²¹
Number of audits with serious findings	22	12	6	7
Number of audits without serious findings	9	4	3	2

Table 10: Overview of EQCR and regular internal review

²¹ Three audit files had a quick scan or external review performed on them. These quality measures do not have the status of EQCR or regular internal review.

Regular internal reviews

One of the instruments that can be used in the evaluation is to conduct a regular internal review of conducted and completed audit engagements. The regular internal review is designed to check whether the external auditor has complied with the applicable laws and regulations in the conducting of his audit. In this review, the audit firm regularly assesses one or more audit files of its auditors. The AFM's inspections showed that two PIE licence holders neglected to conduct regular internal reviews for statutory audits.

Table 10 above makes a link between the nature of the findings on the audits, and whether or not a regular internal review had been performed for these audits. In 12 of the 16 selected audits (approximately 75%), in which the nine PIE licence holders performed a regular internal review, the AFM also had serious findings in the audit. In these cases, the audit firms were therefore unable to afterwards detect that the auditor's opinion was substantiated with insufficient audit evidence.

Closing of audit files

Not later than two months after the signing of the auditor's report, an external auditor must have placed all the information and documents in the audit file and have closed the audit file. This rule is to prevent changes being made in the file after completion of the statutory audit. The audit procedures must be fully carried out and documented before the auditor's report is issued. Within audit firms, the electronic file is leading, and the safeguards are usually arranged around this file. Several PIE licence holders did not ensure that hardcopy files were closed in good time. This occurs because the system of quality control does not include a procedure that safeguards this.

4.2.2. The monitoring of compliance by the policymakers and the compliance officer.

Audit firms that conduct statutory audits at PIEs are required to appoint a compliance officer and a deputy. The compliance officer has an important role in controlling the risk that the audit firm and its employees will not comply with laws and regulations. In this way he contributes to the quality of the audits and the controlling of the reputation risk for the audit firm. The compliance officer is therefore an important contact person for the policymakers and for the AFM as supervisory authority. The audit firm is required to appoint a deputy compliance officer.

The AFM's inspections showed that one PIE licence holder had not appointed any deputy compliance officer. Furthermore, at several PIE licence holders it became evident that the policymakers did not let themselves be sufficiently informed by the compliance officer. Thus there were no written reports in which the compliance officer presented reports for his activities. This means the policymakers are not fully informed about the operation of the system of quality control.

5 Quality measures of PIE licence holders

The nine PIE licence holders recognise the need to implement fundamental improvements in their firms. The AFM has asked the nine PIE licence holders to take appropriate recovery measures with respect to the audits concerned in its findings, and to take improvement measures to prevent this occurring again in the future. From the discussions that the AFM has conducted with the nine PIE licence holders, it appears that they are prepared to take far-reaching quality measures. In this context, the AFM has asked the audit firms to make a thorough analysis of the causes that underlie the shortcomings in the quality of the audits inspected by the AFM. During 2013, the AFM will closely monitor the implementation of the recovery measures and the quality measures of the PIE licence holders.

Sections 5.1. to 5.3 inclusive describe the measures that the nine PIE licence holders have included in the repair and improvement plans which they have sent to the AFM in response to the findings of the AFM. These measures are focused on improving the tone at the top, including the company culture, the system of quality control and quality monitoring, and the quality of the external auditor. The AFM believes that more attention to these factors within audit firms will have a favourable effect on the quality of the audit.

5.1. Measures to improve the tone at the top

Soon after completion of the AFM's inspections at their audit firms, the policymakers of the nine PIE licence holders proceeded to draw recovery and improvement plans. The plans have been sent to the AFM. It is important that these plans clearly show that the policymakers recognise **the importance of quality** within their firm and focus their measures on this. The AFM has also noticed this in the discussions it has conducted with the policymakers. The policymakers have stated they want to be **more involved** in the conducting of audits within their firm.

Two PIE licence holders have determined that the quality of the audits will play a more important role in the **assessment of external auditors**.

5.2. Measures for improving the system of quality control and quality monitoring

Five of the nine PIE licence holders are implementing adjustments in their **audit practice** or are exploring the opportunities to do so with a view to improving the quality of their audits. They are doing this, including by taking one or more (and usually a selection) of the following measures:

- The concentration of the audit practice, by clustering locations from which statutory audits can be conducted.
- The strengthening of the staffing of the audit practice.
- The completion of statutory audit engagements.
- The performance of quantitative and qualitative analyses of engagement portfolios, team building, hours spent, and types of clients/sectors.
- The improvement of the standard for conducting (statutory) audits.
- The establishment of the role of secondary auditor who is permitted to conduct audits, in order to support the external auditor in an audit.

Seven of the nine PIE licence holders are implementing adjustments in **the procedures, descriptions and standards** as contained in the system of quality control. These adjustments relate to topics including the following:

- The alignment of the quality manual with the applicable laws and regulations and the practice of the audit firm.

- The inclusion or adjustment of the procedures for closing and archiving of hard copy files and electronic files.
- The expansion of the number of mandatory consultation times, meaning that – when necessary – advice is requested from other professionally competent people by external auditors.

Six of the nine PIE licence holders are strengthening the **EQCR procedure** or examining the possibilities for this. They are adapting their system of quality control and quality monitoring to ensure that the EQCRs are performed with more quality and depth. They are doing this in various ways, among other things by taking one or more (and usually a selection) of the following measures:

- Revising the EQCR questionnaires.
- Tightening up the requirements set for EQCR reviewers.
- Providing training and instructions to EQCR reviewers.
- Conducting annual evaluation interviews with EQCR reviewers.
- Centrally identifying topics or risk areas to which EQCRs must relate.
- Centrally assessing the EQCR findings before the external auditors issue auditor's reports.
- Centrally monitoring compliance with the EQCR procedure.

Eight of the nine PIE licence holders are adapting their system of quality control and quality monitoring to ensure that the **regular internal reviews** are performed with more quality and depth on completed audits. They are doing this, including by taking one or more (and usually a selection) of the following measures:

- Revising the review questionnaires.
- Conducting regular internal reviews on a systematic basis.
- Conducting regular internal reviews on specific aspects or themes of an audit.
- Conducting annual evaluation interviews with internal reviewers.
- Revising the normalisation and weighting of the findings of regular internal reviews.
- Centrally assessing the findings of reviews prior to feeding these back to the external auditors.

Five of the nine PIE licence holders are **strengthening the role of the compliance officer** or exploring the possibilities for this. They are doing this, including by taking one or more (and usually a selection) of the following measures:

- Strengthening the staffing of the departments of compliance and professional practice.
- Reporting by the compliance officer to the policymakers on compliance with the EQCR procedure.
- Strengthening the supervision of the procedures that the compliance officer and his staff perform.
- Appointing a deputy compliance officer.

Three of the nine PIE licence holders will also undertake an annual **evaluation of the system of quality control**.

Two PIE licence holders are taking measures relating to the **sanctions policy**. They are doing this by taking the following measures:

- The recording of any file infringements that are detected in the regular internal reviews in the violations registration.
- The introduction of a sanctions policy for the entire firm.

5.3. Measures to improve the quality of the external auditor

Seven of the nine PIE licence holders have themselves conducted an **assessment of their audits**. They have taken the following measures:

- Internally assessing – in a comprehensive manner – all the audits that the AFM inspected or with which the AFM had serious findings. With respect to these audits, the PIE licence holders have taken recovery measures, such as performing additional audit procedures to still obtain sufficient and appropriate audit evidence or repair the financial statements.
- Reviewing the AFM findings that are possibly of a systematic nature within the client portfolio ("oil slick effect"), for example with regard to cost hedge accounting and the recognition of financial instruments in the financial statements.
- Ensuring that the audit client has adjusted the financial statements.

Six of the nine PIE licence holders have taken **measures against the external auditor** who was responsible for the conducting of an audit assessed by the AFM. This concerns the following measures:

- Conducting an interview with the external auditor about his professional scepticism and the maintaining of an appropriate distance from the audit client.
- Issuing of a written warning to the external auditor.
- Striking off one or more external auditors from the public register of the AFM.
- Providing instructions to one or more external auditors that they need to have sufficient involvement in the conducting of the audit.

Five of the nine PIE licence holders are investing in increasing the **knowledge and skills** of their external auditors. They are doing this by taking the following measures:

- Providing training courses and professional practice meetings for external auditors.
- Issuing practical guidelines, including those relating to professional scepticism, the planning phase, the valuation of property, and cost hedge accounting.

Three of the nine PIE licence holders are taking measures to increase the **involvement of the external auditor** in the conducting of audits. They are doing this by taking the following measures:

- The tightening up of the requirements imposed on the external auditor and his audit team and the more precise definition of his duties and responsibilities.
- The mandatory attendance of the external auditor at important discussions with the members of his audit team concerning the audit.

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