Incentives for Audit Quality

An exploratory review

6 October 2011

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Netherlands Authority for the Financial Markets (AFM)

The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. 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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Foreword

The Netherlands Authority for the Financial Markets (Autoriteit Financiële Markten, or AFM) promotes the fair and efficient functioning of capital markets, thereby supporting investor confidence in these markets. The AFM's duties include the enforcement of the rules for auditors auditing annual financial reports. The market has to be able to rely on the proper performance of such audits.

As part of its ongoing supervision of audit firms, the AFM conducted a thematic review on incentives for audit quality during the first six months of 2011. Our review covered all fifteen audit firms whose license includes the performance of statutory audits for public interest entities (PIE licensees).[1] This report sets out the results of our thematic review.

This report is set out under the following sections. Section 1 sets out the background and purpose of our thematic review and outlines the source of the information used in our review. Section 2 provides an overview of our conclusions and recommendations. Section 3 provides information on our review process and the scope of our thematic review. Section 4 provides the results of our review by theme, broken down into several topics. Section 5 provides a summary of the improvements in policies and procedures that audit firms have implemented or announced in relation to matters set out in this report. Finally, section 6 describes the future developments in the public discussion about incentives. Appendix 1 to this report provides a summary of the laws and regulations governing independence and the appointment, appraisal, remuneration and sanctioning of external auditors. Appendix 2 provides a comprehensive overview of the types of other services that one or more PIE licensees provided to their audit clients.[2]

Contact

For more information about the supervision of audit firms, please visit the AFM´s website (www.afm.nl/en.aspx) under professionals> Audit firms. Any specific questions you may have after reading our report can be raised via email (wta@afm.nl), or in writing to the Financial Markets Authority, Attn. Audit Firms Supervision Division, P.O. Box 11723, 1001 GS Amsterdam, The Netherlands or by telephone on +31 (0)20 797 2000.

1 'Public interest entities' (PIEs) include listed companies, credit institutions and insurers. 'Audit firm' and 'PIE licensee' as used in this report often include the Dutch parts of the network to which the audit firm belongs.

2 Audit client within the meaning of Article 1.1(e) of the Supervision of Audit Firms Act (Wet toezicht accountantsorganisaties, or Wta). 'Audit client' as used in this report often includes third parties affiliated with the audit client.

1 Introduction

1.1 Background

The AFM´s Report on general findings regarding audit quality and quality control monitoring[3] of 1 September 2010 announced that the AFM´s oversight in 2011 would focus on financial and other incentives for audit quality within audit firms. Following the findings of the above report, the AFM decided to undertake its thematic review ´Incentives for Audit Quality´ covering all PIE licensees.

Audit firms by nature are organisations with commercial interests. At the same time, audit firms are subject to various statutory and regulatory requirements pertaining to the quality of their services, creating tension for auditors. Discussions in the Dutch Parliament on this subject described this tension as follows: "*The public function of the auditor´s report requires that audits and the resulting auditor´s reports are of a high quality. Audit firms are for-profit organisations competing with each other to offer and provide their services. The statutory quality requirement leaves room only for competition on efficiency aspects of the performance of audits. There is a certain tension between these different interests or objectives.*"[4]

The AFM´s review of financial and other incentives for audit quality focused on two themes: the independence of audit firms and external auditors, and the appointment, appraisal, remuneration and sanctioning of external auditors.

Being able to make objective judgements requires external auditors and audit firms to be independent of their audit clients. The intended users of auditor's reports, i.e., society at large, and the external auditor's client are not one and the same. Auditors must not let their professional judgement be impaired by bias, conflicts of interest or undue influence.[5] If auditors allow this to happen, there is a risk that society at large will have little or no confidence in the quality of audits and the resulting auditor's reports. By being independent, the external auditor shows society at large that he can perform an audit engagement objectively and with integrity. It is therefore necessary that, when conducting an audit, the auditor demonstrates fairness, honesty and integrity, and avoids conflicts of interest. Independence is not an end in itself but a means to ensure and demonstrate the integrity and objectivity of external auditors. It is essential that society at large has an understanding of the independence of external auditors and audit firms. This is crucial to maintaining and safeguarding public confidence in the reliability of financial statements and the function of external auditors. An auditor should not be involved in an audit if there are financial, business, employment or other relationships with an audit client that a reasonable and informed third party having knowledge of all relevant information would consider unacceptable.

Independence involves both independence 'in fact' and independence 'in appearance'. Being independent in fact (reflecting an auditor's state of mind) means that the external auditor must be objective towards the individual audit client. Being independent in appearance (reflecting an auditor's actions) requires audit firms and external auditors to avoid all facts and circumstances pointing to a situation where the objectivity of the external auditor or the audit firm may be compromised. Threats

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3 'Audit' as used in this report refers to the statutory audit within the meaning of Article 1.1(p) of the Wta.

4 Explanatory Memorandum to the Supervision of Audit Firms Decree of 16 August 2006, Bulletin of Acts, Orders and Decrees no. 380, 2006, page 32.

5 See Article A-100.4(b) of the Dutch Code of Conduct Regulation for accountants (Verordening Gedragscode, or VGC).

to independence fall into the following categories: self-interest, advocacy, familiarity, intimidation and self-review.

In addition, it is important that there are sufficient incentives within audit firms that promote the quality of audit work, i.e., incentives triggering external auditors to conduct high-quality audit work. This could be achieved by making audit quality an important evaluation criterion in the appointment, appraisal, remuneration and sanctioning of external auditors.

Independence and the appointment, appraisal, remuneration and sanctioning of external auditors are areas that fall within the scope of the AFM's statutory ongoing supervision responsibilities, requiring inspections of PIE licensees once every three years. Partly due to the fact that these issues are high on the agenda of, among others, regulators, professional bodies, interest groups of users and legislators, both in the Netherlands and abroad, it is now important to further examine these areas. With a view to improving the quality of audits, the AFM aims to contribute to the public debate on these areas by providing a better understanding of the incentives for audit quality.

1.2 The purpose of the review

The aim of the AFM's thematic review was to gain an understanding of how independence and the appointment, appraisal, remuneration and sanctioning of external auditors are addressed in practice. Our review was exploratory in nature, and did not focus on assessing the level of compliance with laws and regulations, or identifying specific violations.

The fact that external auditors are paid by their audit clients puts pressure on external auditor independence. The position of the auditor in relation to his audit client and to investors and other users of financial reports is the subject of national and international discussions. This review did not deal with that position. Our review focused on the following situations where there may be a threat to the auditor independence[6]:

- a combination of statutory audit and other services;
- business relationships with audit clients;
- long-term relationships with audit clients;
- financial interests in audit clients;
- family and close personal relationships with audit clients;
- sponsor relationships with and gifts to audit clients;
- gifts from audit clients;
- entering into an employment relationship with an audit client;
- employment relationships with audit clients, or management or supervisory positions at audit clients.

The AFM examined the incentives playing a role in the appointment, appraisal, remuneration and sanctioning of external auditors and, in particular, whether and to what extent the quality of statutory audits plays a role. The AFM´s aim was to gain an understanding of:

- the nature and size of the population of external auditors;
- the way in which the audit firms have implemented their policy regarding the appointment, appraisal, remuneration and sanctioning of external auditors (design and operation);

[6] *Some of these relationships are included in the Further regulations on auditor independence (Nadere voorschriften onafhankelijkheid openbaar accountant).*

- the evaluation criteria used to appoint, appraise and remunerate auditors;
- the way in which audit firms impose sanctions on external auditors in case of violations and other offences;
- the relationship between any sanctions imposed on auditors and their appraisal and remuneration.

Our review was exploratory in nature. Our findings are generally used as an input into the AFM´s risk-based supervision, and can provide the basis for further inspection by the AFM.

1.3 Source of the information

The information presented in this report is based on the information provided to the AFM by the audit firms following the AFM´s request to provide such information. Some audit firms did not have certain information systematically available in the form requested by the AFM. In such cases, audit firms made specific requests to their external auditors to provide the information requested, or collected this information, manually or otherwise.

2 Conclusions and Recommendations

2.1 Conclusions

Inherent tension

Audit firms are organisations with commercial interests. They are paid by the organisations being audited (audit clients) and they compete with each other to win and retain audit business. This set-up creates inherent tension for auditors. On the one hand, the external auditor must adopt an objective and sceptical attitude towards his audit client in order to serve the public interest of the users of the audit client's financial statements. On the other hand, the auditor aims to provide the best possible service to that audit client in order to win or retain the business of the client. To gain a better understanding of this area of inherent tension, the AFM's review explored auditor independence and the appointment, appraisal, remuneration, and sanctioning of external auditors.

2.1.1 The appointment, appraisal, remuneration and sanctioning of external auditors

The AFM's review highlighted that the extent to which PIE licensees have incorporated the quality of their statutory audits in the appointment, appraisal, and remuneration of external auditors varied among audit firms. In addition, our review brought to light differences in the way PIE licensees have formalised and documented the quality of statutory audits as an evaluation criterion. However, the majority of PIE licensees demonstrably considered audit quality aspects when appointing, appraising and remunerating their external auditors. This is evident from the 46 cases reviewed by the AFM, two of which are included in this report for illustrative purposes. Examples of quality aspects include the results of engagement quality control reviews (EQCR)[7], internal audit file reviews and other quality reviews which were conducted in the past year, credits obtained in the context of continuing professional development, identified violations, and any disciplinary matters.

In addition, ten PIE licensees had a sanctions policy in place focused on taking appropriate disciplinary and other action against external auditors violating internal or external rules. PIE licensees imposed approximately 100 sanctions in total against external auditors in 2010. Our report includes two examples of PIE licensees imposing sanctions on external auditors.

Commercial aspects

The appraisal end remuneration of external auditors involves both quality aspects and commercial aspects. Such commercial aspects include entrepreneurship, new business development, profit contribution and cross-selling results, i.e., the sale of other services to audit clients. In the course of its review, the AFM was not able to determine how much weight was given to commercial aspects relative to quality aspects.

2.1.2 Independence

Why an auditor must be independent

[7] *An EQCR is a review of a statutory audit by an auditor who is not involved in the performance of that audit, to assess whether the external auditor could reasonably have come to the opinion expressed in the auditor's report to be issued. An EQCR is mandatory for all PIE licensees, on the basis of the Supervision of Audit Firms Decree. For non-PIE licensees, an EQCR is conducted if certain internal criteria are met.*

An auditor's report provides assurance and contributes to the confidence in financial reporting. An auditor's report is only of value to users if the audit is conducted by an independent auditor. Users must be confident that the auditor has been objective and sceptical, that he has carried out sufficient work, and that he has not let his work or judgement be influenced by other than technical considerations. The auditor must not only be actually independent (independence in fact), but must also avoid the perception that he may not be independent (independence in appearance).

Requirements and prohibitions

The AFM's review shows that, where requirements and prohibitions are set out in the independence rules, external auditors and audit firms generally comply with such rules. The rules do not allow financial interests in audit clients, employment relationships with audit clients, nor auditors holding management or supervisory positions at such clients. In addition, external auditors conducting PIE audits must observe a seven-year rotation period. Audit firms are required to ensure that such rules are complied with. Partners and staff are required periodically, annually in most cases, to complete an independence statement which is reviewed and followed-up by the independence officer or department. Firms with a large number of listed audit clients have policies and systems for central registration of financial interests in listed audit clients. They identify prohibited financial interests and take action on any violations of the rules. Some firms periodically review the reliability of the information provided by their partners and staff in their independence statements and in the central register of financial interests, using the partners´ and employees´ own records.

Independence assessment

The current auditor independence rules include hardly any explicit requirements and prohibitions for other situations occurring in practice that pose a threat[8] to auditor independence. This concerns, in particular, the provision of services other than statutory audits to audit clients, business or sponsor relationships with audit clients, and long-term relationships with non-PIE audit clients. In such situations, the external auditor and the audit firm are required to perform an independence assessment in accordance with a prescribed conceptual framework. This means, in fact, that external auditors and audit firms conduct a self-assessment of their independence by identifying and evaluating threats and taking measures to safeguard their independence where necessary, with the rules leaving ample room for judgement.

As a consequence of using a self-assessment framework, assessments carried out in similar situations vary among external auditors and audit firms and so do the outcomes of such assessments. This was evident from the 78 cases reviewed by the AFM, fifteen of which are included in this report for illustrative purposes. The assessment inconsistencies related to:

- identification of all existing and potential threats to independence in a given situation;
- the evaluation of such threats;
- the choice of the situation-specific safeguards to mitigate or eliminate potential threats; and
- the decision not to enter into a certain relationship with an audit client or to discontinue an existing relationship.

As noted above, independence assessments carried out by external auditors and audit firms and their outcomes vary. As a consequence, users of the financial statements and auditor's reports do not know what independence entails in specific situations. Users rely on the framework applied by an individual auditor, or the firm that employs him or with which he is affiliated. This does not mean that

[8] The threats to auditor independence are fall into the following categories: threats resulting from self-interest, self-review, advocacy, familiarity, and intimidation.

the assessment would not be correct. Nevertheless, due to a lack of uniform standards for independence assessments and, as a consequence, their subjective nature, the outcomes of such assessments give ample room for judgement. To ensure that assessments are carried out consistently and their outcomes are more generally accepted, clearer and more restrictive standards are required.

The PIE licensees indicated that engagements to provide other services are not undertaken if they would lead to unacceptable threats to independence. The AFM´s review has not resulted in a clear understanding of the number of situations where PIE licensees had declined requests to perform other services.

Examples

To review auditor independence, the AFM’s thematic review focused on 171 audit clients in total where audit firms carried out statutory audits in combination with other services of some significance. The fifteen examples included in this report are therefore not representative of the total population of audit clients of the PIE licensees.

2.2 Recommendations

For the benefit of the users of financial statements, the AFM supports clearer, unambiguous and more restrictive rules for auditor independence and the appointment, appraisal, remuneration and sanctioning of external auditors.

The Netherlands Institute of Chartered Accountants (Nederlandse Beroepsorganisatie van Accountants, or NBA) in November 2010 issued a plan of action ("Lessons Learned from the Credit Crunch") for the profession. As a measure to improve audit quality, this action plan proposes to make quality the main evaluation criterion for the appraisal and remuneration of auditors serving audit clients, and prohibiting commercial incentives such as revenue and cross-selling as evaluation criteria for remuneration. The AFM believes that a clear quality criterion should be developed and included as a requirement in the professional regulations. The NBA has already published a proposal to amend the Dutch Audit Firms Regulation.

The AFM´s review shows that clear requirements and prohibitions can reduce the risk of undesirable dependencies. Such rules are easier to apply, and reduce the risk of inconsistent application. This does not take away from the fact that self-assessment continues to play an important role in ethical issues. Given that clear requirements and prohibitions are more effective, the AFM supports the position of the Minister of Finance, who prefers clear requirements and prohibitions in this area over the existing conceptual framework, which is based on threats to independence and safeguards against such threats.[9] The AFM recommends that, when developing stricter independence rules, the services provided by audit firms are split into two main categories:

1) services aimed at providing assurance on information provided by the audit client for the benefit of external users of this information, and
2) services for the benefit of the audit client itself.

[9] The Minister of Finance has raised this point of view in his combined reaction of 13 September 2011 to the evaluation of the Supervision of Financial Reporting Act, the vision on audit, and the reaction to Mr. Plasterk´s Initiative Memorandum.

In addition, the AFM believes that it is important that the above categories are clearly defined, eliminating any room for judgement. The AFM believes that the drafting of such stricter independence rules should be the subject of a comprehensive public consultation.

Given the importance of independence, any violations of independence rules should be considered explicitly in the appraisal and remuneration of auditors.

3 Execution of the thematic review

In the first six months of 2011, the AFM carried out a thematic review involving all fifteen PIE licensees, including the Big 4 firms and eleven other PIE licensees[10]. Those fifteen PIE licensees conduct statutory audits of both PIE audit clients and non-PIE audit clients. The AFM´s review extended to both categories of audit clients. The PIE licensees serve a majority of the audit market, carrying out approximately 72 percent of the approximately 21,500 statutory audits in the Netherlands, representing approximately 87 percent of total fees from statutory audits in the Netherlands.[11] PIE licensees employ about 40 percent of all external auditors in the Netherlands carrying out statutory audits.[12] The size of the fifteen PIE licensees varies. Figure 1 provides an analysis of the relative size of the fifteen PIE licensees based on the number of statutory audits they conduct. One of the other PIE licensees is a firm that in substance is part of another PIE licensee.[13] That is why, in the remainder of this report, we refer to fourteen PIE licensees. Two of the other PIE licensees have a business model which involves working with so-called affiliated offices (other audit firms, auditing and bookkeeping services providers).[14]

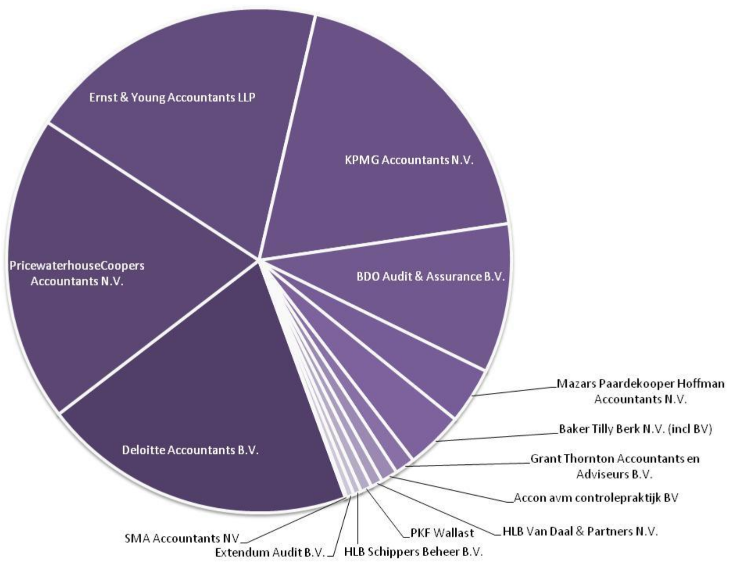

Figure 1. Analysis of the size of the fourteen PIE licensees based on the number of statutory audits carried out (source: AFM Monitor Audit firms 2010)

The AFM has the statutory duty to monitor compliance with the provisions set by or pursuant to the Audit Firms Supervision Act (Wet toezicht accountantsorganisaties, or Wta) and, in particular, the provisions relating to independence, the system of quality control and the quality assurance policies (including the policy regarding the appointment, appraisal, remuneration and sanctioning of external auditors).

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10 Accon avm controlepraktijk B.V., Baker Tilly Berk (N.V. and B.V.), BDO Audit & Assurance B.V., Extendum Audit B.V., Grant Thornton Accountants en Adviseurs B.V., HLB Van Daal en Partners N.V., HLB Schippers Beheer B.V., Mazars Paardekooper Hoffman Accountants N.V., PKF Wallast and SMA Accountants N.V.

11 Source: AFM Monitor Audit firms 2010.

12 Source: AFM Monitor Audit firms 2010.

13 Baker Tilly Berk B.V. (affiliated with Baker Tilly Berk N.V.).

14 SMA Auditors N.V. and Extendum Audit B.V.

The aim of the AFM's thematic review was to gain an understanding of how independence and the appointment, appraisal, remuneration and sanctioning of external auditors are addressed in practice. Our review was exploratory in nature, and did not focus on assessing the level of compliance with laws and regulations, or identifying specific violations. However, our review highlighted a number of issues, particularly related to the adequacy of standards. The results in this report should be viewed in this light.

The thematic review 'Incentives for Audit Quality' consisted of five phases:

1. *General information request*

   The AFM made a general request for information to the PIE licensees relating to the period 1 January 2009 to 31 December 2010, requesting the following information:

   - the nature and extent of the situations[15] where there may be a threat to auditor independence (for the entire audit client base);
   - any violations of independence rules and/or complaints about independence related to audit clients;
   - further details about the external auditors registered on 31 December 2010;
   - the extent to which quality is incorporated in the appointment, appraisal, remuneration and sanctioning of external auditors;
   - the nature and extent of sanctions against external auditors.

2. *Specific information requests*

   Based on an analysis of the information provided by the PIE licensees following our general information request, the AFM requested additional specific information for further inspection.

   To review auditor independence, the AFM made a selection for further inspection – based on the nature and extent of threats to independence in 2009 and 2010 – of 171 audit clients in total, comprising 43 (25%) PIEs and 128 (75%) non-PIEs. The audit clients selected were audit clients with whom the audit firm or the external auditor had a relationship that could threaten their independence. Figure 2 provides an analysis of the selected audit clients by firm type (Big 4 firm or other PIE licensee) and by type of client (PIE or non-PIE). The AFM requested specific information for all 171 audit clients about combinations with other services, for 47 audit clients about existing business relationships, and for 15 audit clients about the sponsor relationships that had been reported. Regarding the other situations listed in Section 1.2, the AFM requested specific information from an average of nine audit clients. This specific information included audit file papers, independence assessments, time sheet information, invoices, contracts and reports.

[15] The requested information related to the following: financial interests, business relationships, employment and secondment relationships, staff entering employment with audit clients, management and supervisory positions, family or close personal relationships, combinations of statutory audits and other services provided, gifts from audit clients, gifts to audit clients, sponsoring, and long-term relationships.

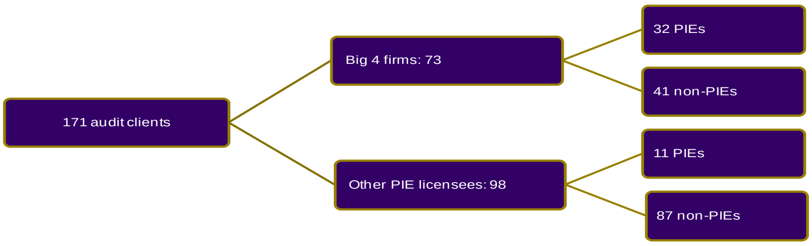

Figure 2. Analysis of selected audit clients by firm type and type of client

In addition, the AFM requested further information from the PIE licensees about the appointment, appraisal, remuneration and sanctioning of the 865 external auditors employed by the PIE licensees and registered with the AFM on 31 December 2010. This information included the records with the considerations involving appointments, appraisal, remuneration and sanctions.[16] Figure 3 sets out an analysis of the number of external auditors by PIE licensee. The AFM performed a high-level review of the documentation of the PIE licensees with respect to concrete appointments, appraisals, remuneration and sanctions in the period 2009 to 2010, and then selected specific examples for further inspection.

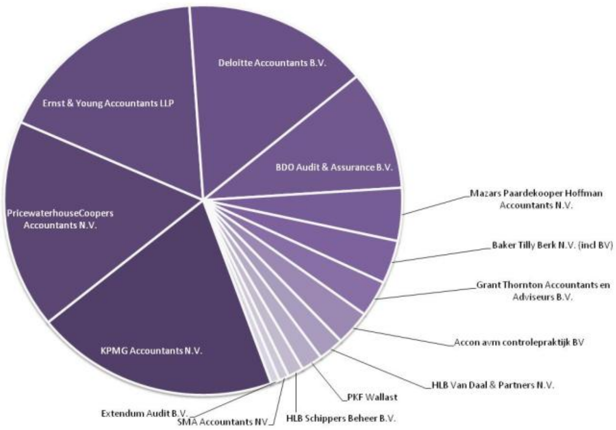

Figure 3. Analysis of the number of external auditors by PIE licensee selected for review

3. *On-site inspection*

The AFM conducted on-site inspections at all PIE licensees to gain an understanding of how external auditors and audit firms had dealt with threats to their independence and how they had dealt with the appointment, appraisal, remuneration and sanctioning of external auditors. In addition, the AFM discussed with the relevant officials of the PIE licensees how the information provided to the AFM had been prepared. The AFM also discussed the applicable internal policies and procedures with them. Furthermore, during on-site inspections, the AFM reviewed all

[16] *The AFM's review was aimed at all registered external auditors, even if these external auditors were not actually responsible for conducting statutory audits, and in that sense were 'inactive'. Approximately 86 percent of the external auditors in 2010 were actually responsible for conducting statutory audits. At the Big 4 firms, about 91 percent of the registered external auditors were active as such; for the other PIE licensees, this was approximately 74 percent.*

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relevant relationships between the audit firm or auditor and the selected audit clients. The AFM performed a high-level review of the information pertaining to the appointment, appraisal, remuneration and sanctioning of external auditors, including documents from personnel files and records of violations.

4. *Written confirmation of information with audit firms*

The AFM confirmed with the PIE licensees the accuracy and completeness of the factual information gathered in the course of its review. Firstly, the written confirmation included a description of the AFM's general observations regarding independence and the appointment, appraisal, remuneration and sanctioning of external auditors. Secondly, the confirmation included a summary of the concrete cases reviewed by the AFM in more detail and selected as illustrative examples. This involved a total of 78 case studies relating to independence and 46 case studies relating to the appointment, appraisal, remuneration and sanctioning of external auditors. The AFM requested the PIE licensees to inform the AFM of any changes to the audit firm's quality control system, or any other measures taken as a result of our review. The written exchanges between the AFM and the PIE licensees are confidential and are not publicly available.

The examples in Chapters 4 and 5 have been derived from actual situations encountered at PIE licensees and reviewed by the AFM in the course of its thematic review. The case studies were confirmed with the individual PIE licensees and have been included for illustrative purposes.

5. *Public report*

The AFM presented the preliminary findings of its thematic review during a meeting with the PIE licensees on 5 September 2011. This was followed by a discussion of our findings with the NBA. The anonymised results of our thematic review are included in this report, which is available on the AFM´s website.

4 Results by theme

4.1 Appointment, appraisal, remuneration and sanctioning

On 31 December 2010, 865 auditors in total were employed by or affiliated with PIE licensees and registered as external auditors with the AFM, including 603 auditors working at the Big 4 firms and 262 auditors working at other PIE licensees. About 91 percent of the registered auditors working at the Big 4 firms were active as such. For the other PIE licensees, this was about 74 percent.

At most PIE licensees, the role of external auditor is performed at various job levels within the audit firm. Many external auditors are partners. But there are also external auditors holding the position of, for example, director or executive director, or audit manager or senior audit manager. Partners are shareholders or co-owners of their audit firms, while other external auditors are often employed by the audit firm. Approximately 67 percent of the external auditors were audit firm partners (Big 4 firms: 71%; other PIE licensees: 58%).

4.1.1 Appointment

The PIE licensees in 2010 appointed 66 auditors to the position of external auditor, and removed 66 auditors registered as an external auditor from the AFM´s register.

The appointment as an external auditor may be directly linked to an appointment to a particular position, but can also be a separate decision. Ten PIE licensees made appointments via a separate decision.

Audit quality played a role in the appointment of external auditors at all PIE licensees. However, the extent to which this was formalised varied. Of the fourteen PIE licensees, ten based their decisions on information available within the organisation. This included results from internal quality reviews, engagement quality control reviews, recorded violations and other relevant information. Four firms specifically ensured that potential candidates for the position of external auditor were included in internal quality reviews, making sure that relevant information was available prior to the appointment decision. At least ten PIE licensees collected this information, insofar available, accompanied by a recommendation from the compliance officer and/or the person responsible for the audit firm´s professional practice department. One PIE licensee allowed newly appointed external auditors to perform statutory audits on 'low risk' audit clients only. Another firm provided additional guidance and training for new external auditors. Four PIE licensees took standard quality measures after the appointment of external auditors, i.e., audit files of newly appointed external auditors being included in engagement quality reviews, or in periodic internal quality reviews.

Example 1 illustrates a situation where audit quality played a clear role in the appointment of an external auditor.

Example 1: Appointment as an external auditor
Early 2010 an audit manager was appointed as an external auditor by the responsible director on the proposal of the compliance officer. The compliance officer’s proposal was based on his inquiry, which considered the following:

- Theoretical training - the compliance officer´s report noted that the manager had completed the training for registered accountant.
- Practical training - the report noted that, since 2006, the manager had been involved in audit engagements of various sizes and in various business sectors. In addition, the report included the audit manager´s time spent conducting audits in 2008 and 2009, referring to the various sectors in which the manager had worked. The inquiry also noted that the manager had served as an audit senior accountant and as a second auditor. Based on this information, the compliance officer concluded that the manager had been sufficiently involved in carrying out audit engagements in 2008 and 2009 and had performed his work in roles of sufficient seniority.
- Views of other external auditors – the report noted that the compliance officer had, in general terms, made inquiries with two external auditors regarding the suitability of the audit manager as an external auditor. Both external auditors had responded positively.
- Inquiry into the practical execution of audit engagements - the report noted that the assessment of the practical execution of an engagement was somewhat difficult because the audit manager´s work had been carried out under the responsibility of other external auditors. The assessment of the quality of practical execution consisted of a file review and an interview regarding the preparation and planning for the engagement selected for file review. Based on that, the compliance officer concluded that the manager had sufficient knowledge of the practical execution of audit engagements, was able to apply the firm´s audit methodology sufficiently, and that he exercised sufficient professional scepticism, appropriate for an external auditor.

4.1.2 Appraisal

Twelve PIE licensees combined the appraisal of external auditors with the overall performance appraisal of the respective persons in their role as a partner, director or executive director, audit manager or senior audit manager at the audit firm. The role of external auditor was therefore not separately assessed. Five PIE licensees used an almost uniform evaluation system for external auditors, regardless of their position within the audit firm (partner or non-partner).

At seven PIE licensees, the form of appraisals of external auditors depended on the position of the person involved. Whilst non-partners were appraised often using fixed procedures and standardised forms, the appraisal of partners was usually relatively unstructured. One PIE licensee appraised all partners in their office on a joint basis rather than on an individual basis. In the past year, two PIE licensees did not systematically appraise the performance of their external auditors.

The PIE licensees appraised the overall performance of their external auditors in terms of various achievements and skills. The extent to which PIE licensees consistently included audit quality, and particularly the input of, for example, the audit firm´s compliance officer or professional practice department in the appraisal of external auditors varied from firm to firm. Four PIE licensees considered audit quality implicitly and in general terms in the appraisal of external auditors. However, other PIE licensees measured, recorded and demonstrably included more concrete audit quality aspects in the appraisal of external auditors. Such concrete quality aspects included the results of engagement quality control reviews, internal file reviews and other quality reviews carried out in the past year, credits obtained in the context of continuing professional development, any identified violations, and any disciplinary matters. Three firms have set up a central and systematic system for collecting all quality aspects relevant to the appraisal of each external auditor. Such records also provide an overview of the quality of external auditors, enable comparison between individuals, and can also provide a basis for company-wide measures. One firm gives ´compliments´ designed to reward activities with a positive contribution to audit quality, such as providing training or providing support to colleagues on complex engagements. These ’compliments’ are also included in the appraisal of external auditors.

However, the AFM found that, in some cases, audit quality deficiencies identified by a few PIE licensees had not been taken into account in the appraisal of the external auditors concerned. Example 2 illustrates a situation where this occurred.

Example 2: Appraisal of an external auditor
In 2009 the audit firm concerned imposed a sanction on an external auditor. The person concerned had not carried out sufficiently detailed audit procedures in the 2007 statutory audit of an audit client. The sanction comprised an internal coaching programme. The audit firm´s board subsequently ordered file reviews of three 2008 statutory audits carried out under the responsibility of the auditor. These reviews highlighted areas for improvement in two of the three audits. Based on their findings, the firm’s reviewers concluded that the audit file documentation of key elements of the audit (adequate understanding of the company, sufficient audit evidence supporting the auditor’s report) required improvement. One of the specific findings was that in one case, the auditor concerned had initially issued an auditor’s report on the balance sheet only, rather than an unqualified auditor’s report on the financial statements. Subsequently, the auditor revoked the auditor’s report on the balance sheet and then issued an unqualified auditor’s report on the financial statements. The results of the file review were reported to the board of the audit firm mid-2010. However, the results were not reflected in the external auditor´s 2010 appraisal form.

Because the appraisal of a person in his role as an external auditor generally coincides with the overall performance appraisal of that person in his role as a partner, director or executive director, audit manager or senior audit manager, twelve of the fourteen PIE licensees included commercial aspects in the appraisal of external auditors. These aspects are defined in terms of entrepreneurship, commercial attitude, personal profit contribution, fees, margin, work in progress, write-downs of accounts receivable, billable hours, write-downs of work in progress, new business, organic growth in existing customer business, fee growth from new customer business, cross-selling (selling other services) and productivity. In the course of this inspection, the AFM was not able to determine how much weight was given to commercial criteria relative to quality aspects.

4.1.3 Remuneration

Nearly all PIE licensees, except for two firms, determined the remuneration of their external auditors in a way that is linked to the position held by their auditors. Partner remuneration mainly comprises their share in the firm´s profits, whilst the remuneration of non-partners usually comprises the auditor´s salary.

Twelve PIE licensees had a remuneration policy where the remuneration of external auditors was to a greater or lesser extent variable. Total partner remuneration was linked to total profits made. Partners at a majority of the PIE licensees shared in the profits earned on other services. Depending on seniority or the achievement of agreed targets, including commercial performance (comparable with the commercial aspects involved in the appraisal of auditors), partners were awarded more or less profit credits determining the level of their individual total remuneration. The variable remuneration of non-partners was usually in the form of a bonus.

Half of the PIE licensees based the remuneration of their external auditors in part on the performance appraisal of their external auditors. For the other half this was not the case. In the case of three PIE licensees, a negative audit quality assessment had a direct negative impact on the remuneration of the external auditors involved.

In addition, the AFM occasionally found that external auditors with an 'average' quality score and a 'very good' score on commercial performance had received a bonus, whereas external auditors scoring 'very good' on quality, but 'average' on commercial performance had not received any additional remuneration.

4.1.4 Sanctioning

Ten PIE licensees used a sanctions policy including disciplinary and other measures against external auditors violating internal or external rules. These measures include mandatory participation in training or other forms of education, cutting the variable component of remuneration, demotion (from partner to non-partner), imposing a warning, reprimand or suspension, imposing a ban on acting as an external auditor (including revocation of the auditor´s registration with the AFM) and the annulment of the employment, affiliation or management agreement with the respective external auditors. In 2010 the PIE licensees imposed approximately 100 sanctions in total on external auditors.

The AFM found that some PIE licensees had not demonstrably taken recorded violations or sanctions into consideration in the appraisal and remuneration of external auditors. In those cases, the technical qualities of the external auditor were rated 'very good' or the external auditor received a financial bonus, despite violations or sanctions.

Example 3 illustrates a situation where the audit firm recorded the external auditor’s violations in the register of violations, and then imposed sanctions on this external auditor.

Example 3: Sanctioning of an external auditor

The external auditor, a partner of the audit firm, headed one of the audit firm’s local offices.

The 2010 register of violations included the following violations by the auditor:

– The external auditor issued the auditor’s report accompanying an audit client´s financial report prepared for publication purposes prior to completion of the engagement quality control review (EQCR).
– The external auditor dated and issued the auditor’s report before completion of the audit concerned and before all audit evidence had been obtained (NV COS 700.52). The external auditor issued the auditor’s report prior to completion of the EQCR (Article 21 of the Audit Firms Supervision Decree). The quality control reviewer had explicitly indicated to the auditor that the file still did not meet the requirements.
– Exceeding the 60-day period for finalisation of the audit file.
– Insufficient evidence in audit file to support rotation selection.
– Inadequate audit file documentation.

The compliance officer reported the external auditor to the audit firm’s board referring to the first two of the above violations with a view to applying the sanction rules to the auditor concerned. One of the compliance officer´s grounds was that the external auditor had repeatedly violated the rules. The compliance officer requested the board in writing to evaluate the case considering the sanction rules and to impose an appropriate sanction, taking into account earlier violations.

The audit firm´s board in 2010 gave a written warning to the external auditor. The board urged the external auditor in writing to adhere to the applicable legal requirements and/or current policies, procedures and technical quality requirements. A repeat violation would be followed by a more severe sanction or an additional sanction. The letter showed that the external auditor had acknowledged his failure to apply the relevant rules adequately and had indicated that he would take measures (the senior manager involved was transferred from the firm´s audit practice to the compilation practice; an experienced manager from the audit practice was transferred to the local office concerned). In addition, the external auditor assured the audit firm´s board that such violations would not occur in the future. The audit firm’s board also concluded that the local office´s audit practice needed to be further strengthened to ensure audit quality. That is why the board encouraged the transfer of a second audit practice manager to the external auditor’s local office.

4.2 Independence

The following section provides the results of our review of auditor independence covering 2009 and 2010.

4.2.1 Combinations of statutory audit and other services

An audit firm is not allowed to carry out statutory audits of PIE audit clients if, at any time during the previous two years, it compiled the financial statements of the client concerned, or, during the financial year to be audited, it keeps or has kept the accounting records or sets up or has set up the audit client's accounting records (Article 23 of the Wta). In addition, the NBA´s Further regulations on auditor independence (Nadere voorschriften onafhankelijkheid, or NVO) set out some combinations of services resulting in unacceptable threats to independence. Where this is the case, the audit firm is not allowed to provide the other services. Such unacceptable threats are:

- Valuation services with a direct material impact on the financial statements of the audit client and where valuation requires a significant degree of judgement.
- Certain corporate finance services, including recommending, or trading in, equity or debt instruments following equity or debt offerings of an audit client, or underwriting such offerings, or performing transactions on behalf of an audit client.
- Certain legal services, including acting on behalf of the audit client in the resolution of a dispute relating to matters that may reasonably be expected to have a material impact on the financial statements of the audit client.
- Certain activities concerning the design and implementation of financial or other information systems generating information that will eventually be included in the audit client's financial statements.
- Certain services related to the recruitment of staff for key financial and administrative positions at PIE audit clients.

And there is the general rule that the external auditor may have no involvement in the audit client´s decision-making process.

In situations that are not prohibited or regarded as unacceptable, the auditor is required to carry out a self-assessment to evaluate whether he is independent. Where the external auditor identifies a threat to his independence that is other than clearly insignificant, he should at least apply adequate safeguards to eliminate the threat or mitigate it to an acceptable level. This can also imply that he does not undertake the work requested. The NVO set out the following safeguards for auditors:

- segregation of roles and responsibilities between the audit engagement and the other services provided to the audit client or a third party affiliated with the audit client;
- consultation with the independence officer responsible for independence issues within the audit firm;
- consultation with an independent auditor from outside the audit firm itself, or obtaining advice from the professional body;
- review of the audit work performed by an audit partner who is not involved in that audit engagement or those other services provided to the audit client or a third party affiliated with the audit client.

The AFM reviewed the extent to which the PIE licensees had carried out statutory audits in combination with the provision of other services to audit clients, or third parties affiliated with the audit client. Other services to audit clients varied in nature. All PIE licensees performed other services to audit clients, including both PIE and non-PIE audit clients. The services provided to PIE clients are usually approved by the audit committees of those audit clients. The size of other services is largely dependent on the audit client´s policies in this area. In the first instance, the audit firm and/or the external auditor have to determine whether the other services are allowed by the regulations. Then it is up to the audit committee to determine whether provision of these services complies within the company's policies.

Article 10 of the Audit Firms Supervision Decree (Besluit toezicht accountantsorganisaties, or Bta) requires audit firms to distinguish, in their client records, between statutory audit fees and the fees for other services rendered. The professional regulations distinguish between assurance engagements (including statutory audits), assurance-related engagements, and other engagements. Practice guideline 1107 (level of fees) distinguishes between assurance engagements and other services. Due to a lack of common definitions in the Bta, the professional regulations and the practice guidelines, audit firms can classify their services in various ways.

The client records of the PIE licensees showed that the fees for other services as a percentage of total fees from audit clients varied widely across the PIE licensees and across individual audit clients. The share of the fees charged for other services for each PIE licensee ranged from zero to 62 percent of total fees from audit clients. Approximately 50 percent of the total fees of the PIE licensees charged to their audit clients were fees for statutory audits carried out by the PIE licensees themselves. Overall, the other 50 percent of the fees related to other services. These other services cannot simply be classified as non-assurance or non-assurance-related engagements, given that they include other audits and audit-related services not being statutory audits. The AFM was not able to determine, on a consistent basis, the share of fees from other audits and assurance-related services in total fees charged.[17]

However, the information provided to the AFM by the Big 4 firms showed that fees from other services relative to total fees ranged from 15 to 30 percent for PIE audits, and from 23 to 45 percent for non-PIE audits.[18]

The AFM has established that PIE licensees provided the following services to both PIE and non-PIE audit clients:

- other assurance engagements, i.e., in addition to statutory audits;
- accounting services, including preparing financial statements, keeping accounting records and payroll administration[19];
- design and implementation of financial information systems;
- valuation services, including making assumptions regarding future developments, the use of certain methods and techniques and the combination of both to calculate a certain value or range of values for an asset, liability or an activity as a whole;
- services in the area of internal controls, including advising on and implementing internal control procedures;

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17 *In addition, the fee information in the client account records was not consistent with the breakdown of auditor fees included in the audit clients´ financial statements. The latter also includes the use of any foreign auditors, regardless whether they are from the same network. The billing method for international auditors' fees and the way the PIE licensees account for such fees in their Dutch client account records varied per PIE licensee, thus affecting the size and relative size of the different service categories.*

18 *The percentages supplied by the Big 4 firms are not fully comparable. This is because the fee information of some of the Big 4 firms did not include their fees from network entities and third parties affiliated with audit clients. The Big 4 firms used different definitions for the category 'other assurance engagements'.*

19 *Not at PIE audit clients.*

- legal services, including assisting an audit client in legal disputes;
- services related to recruiting senior managers for an audit client;
- interim management;
- corporate finance services, including due diligence investigations, advice on mergers, acquisitions and business succession;
- tax services, including preparing corporate tax and sales tax returns and advising on tax structures.

The PIE licensees interpreted 'other assurance engagements' in different ways and, as a consequence, included different services in this category. Some PIE licensees included one or more of the above other services in their other assurance engagement category.

Appendix 2 of this report provides a comprehensive overview of the types of other services provided by one or more PIE licensees to their audit clients. This overview is based on the information obtained from the PIE licensees.

The decision to provide other services is subject to the conceptual framework in the NVO. In this context, nine PIE licensees used a so-called 'pre-approval' procedure. This means that, prior to the PIE licensee or other network entities entering into an engagement to provide other services to audit clients, the PIE licensee must first determine whether 1) such an engagement is acceptable given the required independence; and 2) what safeguards may be necessary to ensure independence. At six of the aforementioned nine PIE licensees, the responsibility for these decisions rested ultimately with the external auditor. At the other three PIE licensees, this responsibility rested with someone other than the external auditor (the compliance officer or another person within the organisation).

In accordance with the NVO, the PIE licensees are required to include the following safeguards to ensure their independence:

- separate teams, with the audit team not being involved in other services and vice versa;
- conducting engagement quality control reviews or equivalent reviews;
- pre-approval of other services by the audit committee of an PIE audit client;
- involving of a second auditor in statutory audits;
- In the case of a secondment to an audit client, the engagement letter has to set out that the secondee will act under the responsibility of the audit client and therefore will not make any management decisions himself.

The PIE licensees indicated that they decline engagements to provide other services where this leads to unacceptable threats or other than clearly insignificant threats that cannot be mitigated or eliminated by safeguards. The AFM's review has not resulted in an understanding of the number of situations where the PIE licensees had declined engagements.

The AFM selected 171 audit clients on the basis of the provision of combinations of services and carried out an initial assessment. From the sample of 171 audit clients selected, the AFM included 46 case studies as examples in its firm-specific reports. These 46 case studies are based on situations reviewed in detail by the AFM. The following examples 4 through 9 are indicative of situations encountered by the AFM. These are situations where the external auditor and the audit firm had to conduct an independent assessment within a prescribed conceptual framework. This means that the external auditors and audit firms in fact conducted a self-assessment of their independence by identifying and evaluating threats and, where necessary, applying safeguards to ensure their independence. The rules for this procedure leave ample room for judgement. As a consequence of applying the conceptual framework, external auditors and audit firms facing similar situations did not always carry out the same assessment or arrive at the same conclusion.

The below examples illustrate primarily the application of the conceptual framework. Examples 4, 5 and 6 also illustrate, in particular, the role of the audit client´s audit committee. Example 6 further describes safeguards applied by the audit firm regarding the secondment of staff to the audit client. Example 7 illustrates a situation where the external auditor excluded tax work for the audit client from his independence assessment. Example 8 illustrates a situation where the safeguard of separate teams was not effective. Example 9 describes the safeguards applied by an audit firm regarding internal control procedures.

Example 4: Other services provided to a PIE audit client

The audit firm carried out the statutory audit of a PIE audit client and provided other services to that audit client. The total 2009 and 2010 statutory audit fees were more than €2.5 million and total fees from other services were more than €6.5 million in the same period. Other services consisted primarily of support in connection with special projects, including:

- various due diligence services;
- vendor assistance work related to business plans;
- special purpose audits, i.e., re-verifying year-end financials to be included in a draft prospectus;
- review of a draft prospectus;
- review of accounting issues identified by the audit client’s management; and
- secondment of staff.

The audit firm classified its support as audit-related services. To carry out the special projects, the audit client hired both advisors of the audit firm and other advisors. The external auditor reviewed the accounting issues identified by the audit client’s management and advised the audit client´s management board. The audit client´s supervisory board took note of this. Partly based on these accounting recommendations by the auditor, the audit client´s management board examined alternative scenarios, terminated the active special project and launched a new special project. The audit firm was hired to carry out some of the above services in this new project as well.

The audit firm reported to the audit client’s management board and supervisory board the following fees charged for the year in which the projects took place: audit services (more than €3.5 million), audit-related services (more than €5 million), tax services (more than €0.5 million) and other services (more than €0.5 million). The audit firm also disclosed that more than €5 million related to services provided in the context of the audit client’s projects. The audit client´s audit committee approved all other services provided by the audit firm to the audit client.

The external auditor included his independence assessments for 2009 and 2010 in the relevant audit files. Regarding any self-review threat, the external auditor referred to the memos he had prepared for each project prior to commencement of service. The purpose of these memos was to determine in advance what safeguards he should apply to ensure independence. Before the commencement of the projects, the external auditor submitted the memos on the services and safeguards to the audit firm’s professional practice department and independence officers. They advised positively regarding the auditor undertaking the services for these projects. The auditor’s memos did not go into the fees from the statutory audit relative to the fees from other services. The safeguards applied included:

- Services were not allowed to commence before approval by the external auditor and the audit committee of the audit client (pre-approval);
- The services were to be provided by separate teams and separate engagement letters; and

– Periodic reporting to the audit committee and the supervisory board of all engagements approved by the audit committee including related fees.

The external auditor´s independence assessment concluded that the independence test - after applying the above safeguards - had not resulted in threats to the independence and objectivity of the audit firm or the auditor himself. He also concluded that there were no independence threats to be reported to the audit client's supervisory bodies. The auditor's independence assessment also noted that the fee ratio of statutory audits and audit related services versus other services did not result in threats to the independence of the audit firm or himself.

Example 5: Outsourcing of work by a PIE audit client to the audit firm

The audit firm carried out the statutory audit of a PIE audit client and provided other services to the audit client. The statutory audit fees in the period October 2008 through September 2010 totalled approximately €3.2 million and fees from other services in the period January 2009 to September 2010 totalled approximately €2.4 million. Other services included a long-term outsourcing project related to pension transfers.

The audit committee of the audit client adopted a guideline on hiring the audit firm for non-audit services, prohibiting total fees from non-statutory audit services in any year to exceed 50 percent of the audit firm´s annual budget. The guideline set out that exceeding this threshold triggered approval by the audit client's audit committee of the non-audit services to be provided by the audit firm. In addition, the audit committee approved separately the outsourcing of pension value transfer activities for a period of two years.

Because this concerned a PIE audit client, the firm appointed a quality control reviewer for the statutory audit.

The audit client reported to the audit firm that the non-statutory audit services contracted out exceeded the 50 percent fee threshold for accountancy services and terminating the outsourcing contract. The audit client would outsource the services to another party or carry out the work itself. In the end, there were various reasons preventing the termination of the services that year. One year later the audit client discussed with the audit firm the fee ratios and the cost of the outsourcing process. As an alternative, the audit firm proposed outsourcing work abroad resulting in a fee reduction by 25 percent. The audit client did not approve this alternative and confirmed to the audit firm that the contract would be terminated in 2010. The termination eventually became effective in 2011.

The audit firm's 2010 report to the audit client's management board, the supervisory board and the audit committee noted that the consulting services, excluding the services related to pension transfers in 2009, amounted to 20 percent of the audit fee. The report also noted that the fees for services related to the annual financial statements totalled €1.8 million and the fees for consulting services, including work on pension transfers, totalled €1.9 million. According to the external auditor's report, the audit firm was independent of the audit client.

The audit firm's 2011 report to the audit client's management board, the supervisory board and the audit committee noted that, in 2010, the fees from consulting services, excluding the services related to pension transfers, were 31 percent of the audit fee. The report also noted that the fees for services related to the financial statements were €1.9 million and the fees for consulting services, including work on pension transfers, were €1.4 million. According, to the external auditor's report, the audit firm was independent of the audit client.

Example 6: corporate finance services to a PIE audit client

The audit firm carried out the statutory audit of a PIE audit client and provided other services to that audit client. The 2009 statutory audit fees were more than €10 million and fees from other services were approximately €6.5 million. Other services consisted of approximately €1.5 million from corporate finance services regarding restructuring and reorganisation. To provide these services, the audit firm seconded staff to the audit client. The external auditor's independence assessment set out that he had applied sufficient safeguards to mitigate the threats to independence to acceptable levels, namely:

- The assignment was awarded after prior approval by the audit client´s CFO and audit committee;
- The audit firm reported its engagements to the audit committee on a quarterly basis;
- The interim staff had no management duties and their work was performed under the responsibility of the audit client;
- The audit firm would play no role in preparing financial agreements, designing and implementing processes and controls, or preparing budgets;
- The audit client was responsible for making decisions related to the project; and
- The audit firm would not provide legal advice and would not represent the audit client in legal disputes.

Example 7: Tax services to a non-PIE audit client

The audit firm carried out the statutory audit of a non-PIE audit client and provided other services to that audit client. The statutory audit fees for 2009 and 2010 totalled approximately €250,000 and fees from other services totalled approximately €1.5 million, including about €1 million related to other tax advice. The audit firm indicated that the tax advice services related to corporate tax, dividend tax and income tax compliance services and corporation tax, income tax and sales tax advice, including discussions with tax authorities. The external auditor´s independence assessment did not take into account these tax activities.

Example 8: Other services to a non-PIE audit client

The audit firm carried out the statutory audit and provided other services to that audit client. The statutory audit fees for 2009 and 2010 totalled approximately €65,000 and fees from other services exceeded €400,000. Other services included support in verifying and processing transactions in the accounting records; the compilation of financial statements; payroll administration services, tax advice and issuing assurance reports relating to contracted-in staff. The external auditor's independence assessment concluded that there were no threats to the independence of the audit firm or the auditor himself. The external auditor's assessment also concluded that independence was sufficiently safeguarded because he believed the audit budget was realistic and because safeguards had been applied such as the physical separation of the teams conducting the audit engagements and the teams performing the other services. In addition, the audit firm had applied the safeguard of involving a second auditor in the statutory audit.

According to the external auditor, the members of the audit team, separated from the other teams, carried out audit work only. However, time sheets in 2009 and 2010 showed that three members of the audit team had been involved in providing other services.

Example 9: Internal control services for a non-PIE audit client

The audit firm carried out the statutory audit of a non-PIE and provided other services to that audit client. The fees from statutory audits over the years 2009 and 2010 totalled approximately €400,000 and fees from other services totalled approximately €800,000. Other services included support in performing internal control procedures.

The nature of the internal control procedures to be performed was agreed in individual engagement letters, and included determining the population subject to the internal control procedures; determining and drawing the sample; following up on the external auditor's findings; and evaluating the findings of the internal control procedures performed. The timesheets of the audit firm showed that the audit team members had been involved in performing internal control procedures on the basis of the internal control plan. The engagement letter noted that the audit firm's employees would not perform management duties and would not have and/or exercise any decision-making powers. In addition, the engagement letter noted that the internal control procedures were performed under the responsibility of the audit client.

The external auditor submitted a consultation request – as required by the audit firm – to the body monitoring compliance with the independence requirements related to the fee level of the other services. As a follow-up, the external auditor and the audit firm recorded that they would apply the following safeguards to maintain independence:

- ensuring that employees responsible for carrying out other services would not participate in the audit team;
- incorporating an assessment of the adequacy of the audit fee ensuring that sufficient time and qualified staff are allocated to the audit and to ensure that technical guidelines and quality safeguards are observed;
- prior to performing the work, documenting the communications with the audit client´s supervisory body on the subject;
- ensuring the use of separate job numbers in the client records of the audit firm;
- performing a quality review of the statutory audit by an auditor entirely independent of the audit; and
- providing a copy of the independence assessment to colleagues involved in providing other services.

4.2.2 Business relationships with audit clients

The NVO set out that business relationships are acceptable provided such relationships are established in the normal course of business and do not pose a more than insignificant threat to independence. The NVO do not explicitly set out any prohibited business relationships.

The AFM reviewed whether the PIE licensees had business relationships with audit clients or third parties affiliated with audit clients related to:

- developing, renting out, handing over or transferring property;
- granting or taking up loans, and
- supplying goods or services with a single or annual value in excess of €100,000.

Eleven PIE licensees maintained such business relationships with a total of 126 audit clients, including 21 PIE audit clients. The business relationships of PIE licensees with audit clients included the development of office space, insurance, banking services, legal services, business loans, IT, car leasing, cleaning and business archive management. Business relationships were usually undertaken by the board of the audit firm with the support of a central purchasing department.

The AFM initially reviewed business relationships involving 47 audit clients. From this sample of 47 audit clients the AFM included 14 case studies as examples in its firm-specific reports. These 14 case studies are based on situations reviewed in detail by the AFM. The following examples 10 through 15 are indicative of situations encountered by the AFM. These are situations where the external auditor and the audit firm had to conduct an independence assessment within a prescribed conceptual framework. This means that the external auditors and audit firms in fact conducted a self-assessment of their independence by identifying and evaluating threats and, where necessary, applying safeguards to ensure their independence. The rules for this procedure leave ample room for judgement. As a consequence of applying the conceptual framework, external auditors and audit firms facing similar situations did not always carry out the same assessment or arrive at the same conclusion.

The following examples illustrate primarily the application of the conceptual framework. Examples 10 and 11 also illustrate, in particular, those situations where a business relationship is assessed at a central level within the audit firm. Example 12 illustrates a situation where the external auditor's independence assessment did not include the business relationship concerned. Example 13 illustrates a situation where the audit firm carried out a reassessment of the business relationship with an audit client. Example 14 illustrates a situation where the external auditor included a business relationship in his independence assessment, but did not perceive it as a threat to his independence. Finally, example 15 illustrates a situation where the audit firm, based on the significance of the business relationship, decided not to put itself forward for re-appointment as the external auditor of the audit client.

Example 10: Business services

The audit firm performed the statutory audit of a PIE audit client. The total 2009 and 2010 statutory audit fees in the Netherlands were more than €10 million and the fees from other services were in excess of €3.5 million. In the same period, the company provided services to the audit firm to an amount exceeding €13 million. These services were provided under a five-year framework agreement that had been agreed to at the audit firm's board level in 2006. Under the audit firm's internal guideline, the purchasing department and the independence officers were required to assess whether the terms of the agreement were similar to the terms offered by other service providers. The audit firm selected this service provider because, at that time, it was in fact the only provider who met all the audit firm's requirements. In addition to the proven quality of the service, other considerations in selecting the provider included past experience with the provider and the savings offered by this provider of more than € 2 million on an annual basis.

The framework agreement stipulated that the company would ensure that its services would be provided to the audit firm at market conditions. The agreement included the option of performing, from time to time, a test to review whether services were provided at market conditions. This test was conducted late 2010 by an independent expert. The independent expert concluded that the prices charged were "on average consistent with market rates".

The external auditor included his independence assessment for 2009 and 2010 in the audit file. Upon completion of the statutory audits in 2010 and 2011, the external auditor sent an independence letter to the company's audit committee addressing the following: pre-approval by the Supervisory Board, the internal independence procedure, partner rotation, the services provided by the company to the audit firm, the audit fees and his conclusion regarding the independence of the audit firm and himself. The external auditor´s independence assessment referred to the internal rules on entering into and maintaining business relationships and to the business relationship with the audit client recorded centrally and evaluated by the audit firm´s independence officers. The external auditor concluded that the business relationship did not threaten his independence. The power to establish and maintain business relationships with audit clients was restricted to the audit firm´s purchasing department and was separate from the professional services provided by the external auditor.

Example 11: Legal services

The audit firm performed the statutory audit of a law firm, a non-PIE audit client. The statutory audit fees for the years 2009 and 2010 totalled approximately €250,000 and fees from other services were approximately €150,000. More than 80 percent of those other services were audit-related services. During that same period the law firm provided legal services to the audit firm worth approximately €2.2 million. The legal services were related to the following areas:

– potential notices of liability;
– advice on the legal structure of the audit firm; and
– other services (advice on possible violations of laws and regulations, and communications with regulators).

The audit firm recorded and assessed the business relationships at a central level. It concluded that, due to the separation between the purchasing department and the professional services provided by the external auditors, there was no threat to auditor independence. The external auditor´s independence assessment took into account the business relationship between the audit firm and the law firm by referring to the relevant chapter in the audit firm´s internal independence rules, and his confirmation that such a relationship was strictly separate from the performance of his statutory task.

Example 12: IT services

The audit firm performed the statutory audit of a listed PIE audit client providing IT solutions. The statutory audit fees for the years 2009 and 2010 totalled approximately €215,000. During this period the IT company provided IT-related services to the audit firm totalling approximately €1.9 million related to the IT maintenance of the client records during the period 1 April 2008 to 31 December 2010. The external auditor did not include the business relationship in his independence assessments for 2009 and 2010.

Example 13: Banking services

The audit firm performed the statutory audit of a bank, a PIE audit client. The statutory audit fees for 2009 and 2010 totalled more than €1.5 million. The audit firm maintained several business relationships with this bank, relating to a loan taken out by the audit firm, a bank guarantee facility, a rent guarantee facility and various current accounts. The audit firm’s finance agreements with the bank totalled tens of millions of euros. In addition, the partners of the audit firm took out loans with the bank.

The independence assessment underlying the external auditor’s decision to continue the statutory audit engagement into 2010 did not include his business relationships with the bank, since this assessment took place on a central level within the audit firm. The audit firm assessed and recorded centrally each business relationship individually. This assessment took place at the inception of the various business relationships during the period 2006-2007. The business relationships were deemed acceptable on an individual basis because they were transacted at market conditions and rates. Reflecting on new developments in society, the audit firm in November 2010 decided to initiate a reassessment. The reassessment, which took into account the accumulation of business relationships, showed that the total financing agreements with this bank were nearly 30 percent of total shareholders´ equity of the audit firm. The reassessment, performed at on overall level, resulted in the audit firm deciding to refinance the loan and contract the guarantee with non-audit clients.

Example 14: Office renovation

The audit firm performed the statutory audit of a construction company, a non-PIE audit client. The statutory audit fees for 2009 and 2010 totalled approximately €55,000. The construction company in the past had built one of the audit firm´s offices. The audit firm in 2009 requested the construction company to renovate that office. The audit firm did not issue an invitation to tender to other parties. The construction company billed almost €2 million to the audit firm. The audit firm hired a third party expert to negotiate the price of the renovation. In 2010 the same construction company also renovated the private residence of the external auditor responsible for carrying out the statutory audit of the construction company, with a cost of approximately €30,000. The external auditor had requested multiple quotes for this renovation. The external auditor´s independence assessment took into account both the office renovation and the renovation of his private residence by the audit client. However, the external auditor did not consider this combination of services to be a threat to his independence.

Example 15: Development and lease of office space

The audit firm performed the statutory audit of a property developer, non-PIE audit client. The statutory audit fees for 2009 and 2010 totalled more than €100,000. The audit firm had had a business relationship with the developer for a number of years following the development of office space for the audit firm. As part of the development project, the developer and the audit firm entered into cooperation agreements for the lease of the new office space to be developed. The cooperation included lease arrangements that were laid down in lease agreements becoming effective after the handover the office space. The planned office space was sold to an investor prior to the handover of the property. The lease arrangements between the property developer and the audit firm included incentives granted to the audit firm. These incentives were laid down in agreements separate from the lease agreements. For part of the office space, the incentives included a lease amount discount and the transfer of net lease obligations relating to existing office space. Serving as a security for the developer meeting its obligations under the agreed incentives, it was agreed that, until the time of handover, the developer was required to:

– provide a bank guarantee to the audit firm;
– establish a second mortgage in favour of the audit firm; and
– pledge all issued shares of a legal project entity to the audit firm.

It was also agreed that, if the handover deadline of office space was exceeded, the project developer would be required to pay a fine and to reimburse the audit firm for any double lease expenses. To ensure payment of any fine or compensation, the developer was required to deposit with a civil-law notary an amount in favour of the audit firm. A calculation made by the external auditor showed that a substantial proportion of the developer’s profit expectations over several years were based on the development of office space for the audit firm.

The AFM´s review showed that the external auditor’s independence assessment had taken into account the business relationship related to the project development. However, the independence assessment did not include the bank guarantee, mortgage, pledge of shares or the deposit in favour of the audit firm. The external auditor did not regard the business relationship as an unacceptable independence threat, partly because the arrangements regarding limited lease amount discounts and incentives were agreed in the normal course of business, the various transactions were business transactions and the project development work for the audit firm had a limited impact on the project developer´s results. The external auditor noted the following safeguards in his independence assessment:

- the audit firm's management and support department were responsible for the office accommodation policy , strictly separated from the audit team;
- for confidentiality purposes, the audit file was secured by access security; and
- the relationship and the reporting line between the external auditor and the project developer's Advisory Board.

The audit firm communicated to the audit client that it would not be available for re-appointment as external auditor due to the possible perception of a threat to independence. The most important reason for this was the increase in the significance of the business relationship.

4.2.3 Long-term relationships with audit clients

A long-term relationship with an audit client is deemed to exist if auditors, including external auditors, quality reviewers and senior managers, regularly and over a long period of time, are involved in the execution of an engagement at the same audit client. Article 24 of the Wta prohibits an audit firm from allowing an external auditor to be responsible for the same audit engagement with a PIE audit client for a period longer than seven years. After such an engagement, the external auditor may not perform statutory audits for this audit client for two years. In the case of non-PIE audit clients, there is no prescribed maximum period for statutory audit engagements. However, paragraph 3.3 of the NVO includes a preference to apply the same procedures as those applicable for PIE audit clients. In addition, the Dutch professional body of chartered accountants, NIVRA, has issued practice guide 1106 to provide further guidance regarding this standard, setting out that a long-term relationship poses a potential threat to independence that can be mitigated by applying safeguards. Possible safeguards include internal rotation, the engagement quality control review, or a review of a different nature.

The AFM assessed whether there were any cases at PIE licensees where the external auditor had been involved in conducting a statutory audit for more than seven years. Generally, all PIE licensees complied with the seven-year rotation period for external auditors responsible for conducting statutory audits of PIE audit clients. In cases where audit firms themselves had identified a violation of the rules, sanctioning followed. However, situations involving long-term relationships (i.e., longer than seven years) between the external auditor and non-PIE audit clients occurred regularly. The AFM's review showed that for approximately twelve percent of non-PIE audit clients of PIE licensees, the external auditor had been responsible for conducting the statutory audit for more than seven years. The AFM has not made a full assessment to what extent PIE licensees had mitigated this potential threat to independence by applying sufficient safeguards.

The AFM also assessed whether there were PIE licensees with external auditors conducting statutory audits who – after the termination of their activities for that audit – had continued to carry out their work within a period covering two continuous financial years after such a termination. According to the information provided by the PIE licensees, there had been no violations of this rule.

Five PIE licensees monitored compliance with the seven-year rotation period for PIE audit clients at a central level.

Two audit firms implemented a mandatory rotation period for non-PIE audit clients, in both cases a period of ten years. Three PIE licensees had policies or procedures including safeguards with regard to relationships with non-PIEs, such as a mandatory engagement quality control reviews or a compulsory second review of the financial statements. Example 16 illustrates a situation where an audit firm implemented these safeguards.

Example 16: Long-term relationship

The audit firm conducted the statutory audits of a pension fund and the pension administration organisation of the pension fund, both non-PIE audit clients. Whilst the pension fund and the pension administration organisation were separate legal entities, their statutory audits were handled jointly by the audit firm.

An auditor had acted as the pension fund’s external auditor since 2007 and had also been part of the audit team of the pension administration organisation since 2000. In the 2009 and 2010 independence assessments, the external auditor labelled the pension administration organisation's position as a threat to his independence. With respect to this threat to independence, the external auditor applied the following safeguards to maintain his independence:

– adding a sceptical signing partner to the audit team in 2006;
– adding a sceptical manager to the audit team in 2007; and
– having a quality control review conducted by an auditor who was completely independent of the audit team.

4.2.4 Financial interests in audit clients

Financial interests include, for example, direct or indirect equity interests, holding or trading securities, or accepting pension rights or other benefits. Contractual agreements to acquire a financial interest or derivatives thereof (e.g. stock options, futures) are also financial interests. When auditors or their family members hold a direct financial interest in an audit client, there is an unacceptable threat to independence. Indirect financial interests are acceptable only under certain circumstances.

The AFM assessed whether PIE licensees had any financial interests in audit clients (or third parties affiliated with audit clients). The AFM was not able to obtain a complete overview of the magnitude of these financial interests. In most cases, the PIE licensees only gave the AFM insight into the number of prohibited financial interests that they had identified themselves. During the inspection period under review, four PIE licensees identified a limited number of prohibited financial interests, followed by them taking appropriate action.

The PIE licensees with a large number of listed companies as audit clients ensure that partners and staff have no financial interest in such audit clients. They have policies setting out which persons are prohibited from having a financial interest in a listed audit client. These policies go beyond the requirements laid down in the NVO. These include in any case the persons that are involved in, or can influence, the conduct of the audit. In addition, these PIE licensees have systems in which partners and certain employees are required to record their financial interests. Such systems produce alerts highlighting prohibited interests. These alerts are followed up by a central support department responsible for safeguarding the independence of external auditors and the audit firm (Independence Department). Prohibited financial interests have to be sold, and the persons involved are sanctioned as appropriate.

All PIE licensees required their partners and staff to periodically, at least annually, complete an independence statement, confirming that no prohibited financial interests are held. The completed statements are reviewed by the independence officer. Six PIE licensees periodically tested the reliability of the independence statements and the records of financial interests in the central system, if applicable, using the records kept by the respective partners and certain staff members themselves.

All PIE licensees required the external auditor and audit team members to confirm in the audit file that they were independent of the audit client, and did not hold financial interests in that audit client.

4.2.5 Family and close personal relationships with audit clients

Family relationships are relationships with family members and close relatives. The AFM assessed whether, at PIE licensees, any family or close personal relationships existed with audit clients or third parties affiliated with audit clients. The external auditor is prohibited from conducting an audit for an audit client where a family member holds or held a position with influence over the financial statements (for example, by holding a senior management position, holding a financial interest or maintaining a business relationship).

The AFM´s review of the PIE licensees included an assessment whether there were family or close personal relationships with audit clients (or third parties affiliated with audit clients). Six PIE licensees reported a total of about 30 family and close personal relationships to the AFM. One PIE licensee did not provide any information.

All PIE licensees periodically ask their partners and staff to confirm through an independence statement that there are no family or close personal relationships threatening their independence. The external auditor and audit team members are also required to include a confirmation to that effect in the audit file. The PIE licensees did not have a central register of family or close personal relationships.

4.2.6 Sponsor relationships with and gifts to audit clients

Sponsor relationships and gifts to audit clients are not prohibited. Similarly, certain sponsor relationships and gifts to audit clients are not identified as an unacceptable threat to independence in the NVO.

The AFM assessed whether PIE licensees had sponsor relationships with audit clients with a cost value exceeding €5,000.[20] Eight of the fourteen PIE licensees reported a total of 30 sponsor relationships with audit clients including one PIE audit client. A sponsor relationship includes financially supporting, or bearing the cost of, an event in return for promoting the brand name of the audit firm. Twelve PIE licensees sponsored one or more organisations and/or events, including a national sailing event, professional soccer organisations, a music hall, a sports venue or events such as conferences, sailing competitions or golf clinics. They also invited audit clients to attend events such as concerts and sporting events.

The AFM initially reviewed sponsor relationships with fifteen audit clients. From the sample of fifteen, six case studies were included as examples in the firm-specific reports to the firms concerned. A

[20] *This threshold amount has been determined by the AFM. It is not based on laws and regulations.*

number of sponsorship agreements included details about the services to be provided by the audit firm to the sponsored organisation. Examples 17 and 18 illustrate situations where this occurred. In such situations, the external auditor and the audit firm are required to perform an independence assessment in accordance with a prescribed conceptual framework. This means, in fact, that external auditors and audit firms conducted a self-assessment of their independence by identifying and evaluating threats and taking measures to safeguard their independence where necessary, with the rules leaving ample room for judgement. As a consequence of using a self-assessment framework, assessments carried out in similar situations varied among external auditors and audit firms and so did the outcomes of such assessments.

Example 17: Sponsoring sports venue

The audit firm sponsored a sports venue, a non-PIE audit client. From October 2008 to September 2010, the statutory audit fees totalled €101,000 and the fees from other services were €248,000. An agreement required the audit firm to pay an annual fee of €120,000 to the audit client in return for renting a space with seating, and special rights, including a right to advertise, and an exclusive right to provide services such as auditing, tax and financial advisory services at market prices. The external auditor did not identify the sponsor relationship as a potential threat to his independence.

According to a memorandum to the AFM the audit firm had applied the following safeguards to mitigate the appearance of dependence arising from the sponsor relationship:

- the sponsorship agreement was substantially similar to sponsorship agreements offered to other parties and did not give rise to doubts about its business nature;
- the sponsorship agreement was separate from the audit engagement letter of the audit;
- the sponsorship agreement was entered into by the board of the audit firm without involvement of the external auditor; and
- The external auditor did not act as a host or hostess of the space with seating.

Example 18: Sponsorship of a professional football organisation

One of the auditor´s non-PIE clients was a professional football organisation. The audit firm also acted as a sponsor of that professional football organisation. The statutory audit fees in 2009 and 2010 were approximately €78,000 and the fees from other services were approximately €37,000. As a part of the audit fee negotiations, the audit firm agreed to conduct the statutory audits for €30,000 in combination with the placement of an advertising billboard of the audit firm representing a value of €5,000, the latter to be billed separately. The audit firm did not advertise during the period 2009-2010. Furthermore, the external auditor, a director of the audit firm, entered into two sponsorship agreements on behalf of the audit firm. The first sponsorship agreement allowed the audit firm to use a number of stadium seats. Under the second agreement, the audit firm sponsored the professional football organisation through a billboard. According to the audit firm´s accounting records, it set off the second billboard against the outstanding invoice for the statutory audit of the professional football organisation.

The external auditor took into account the sponsor relationship in his independence assessment in 2010 and concluded that independence was sufficiently safeguarded and that there were no threats to fundamental principles of professional ethics.

The AFM also reviewed whether PIE licensees had made gifts to audit clients or third parties affiliated with audit clients. 34

A total of nine PIE licensees set a threshold, ranging from €25 to €1,500, with respect to the permissibility of making gifts to audit clients. One PIE licensee determined that staff may only offer gifts of a symbolic nature. The PIE licensees generally did not consider invitations to attend events sponsored by the audit firm, shared dinners and Christmas hampers as gifts to audit clients.

Four of the aforementioned nine PIE licensees had a procedure requiring prior approval for gifts above the set limit, providing them with an overall overview of such gifts to audit clients. Six PIE licensees in total reported to the AFM that they had made about 50 gifts to audit clients above their set limits.

4.2.7 Gifts from audit clients

Accepting gifts from audit clients is not prohibited, and the NVO and Chapter B1-260 VGC do not classify the acceptance of gifts as an unacceptable threat to auditor independence.

The AFM reviewed whether PIE licensees had received gifts from audit clients or third parties affiliated with audit clients.

Twelve PIE licensees had a regulation stipulating the extent to which gifts from audit clients are permissible. Some of these PIE licensees always required a notification or approval of gifts received, whereas other audit firms did so only in the case of gifts above a certain threshold. Ten PIE licensees in total set a threshold, ranging from €25 to €1,500, to decide whether gifts received from audit clients are allowed or not. One PIE licensee determined that staff were only allowed to receive gifts of a symbolic nature. Another PIE licensee did not allow any gifts to be received. Nine PIE licensees had a mandatory reporting system for receiving gifts from clients, providing them with a central overview of the gifts received from audit clients. Two PIE licensees in total reported to the AFM a total of approximately ten gifts from audit clients above their set limits.

4.2.8 Entering into an employment relationship with an audit client

Partners of audit firms with a key role in the audit engagement are required to observe a cooling-off period of two years before taking on a key management position with an audit client.

The AFM assessed whether there were any employment relationships of partners or staff of PIE licensees with audit clients or third parties affiliated with audit clients. The AFM´s review highlighted 75 employment relationships involving eight PIE licensees with 69 audit clients, including ten PIE audit clients. Approximately 50 percent of the persons reported to the AFM as having entered into an employment relationship with an audit client, or a third party affiliated with an audit client, had been a member of the audit team. They included both external auditors and other staff. The employment relationships mostly involved financial management positions at audit clients.

Eight PIE licensees had policies and procedures requiring partners and staff to report any intended employment relationships with audit clients of the audit firm. In addition, their policies and procedures usually included a removal from the audit of the person involved once the appointment becomes known, and a review of the person´s last work.

4.2.9 Employment relationships with audit clients, and management and supervisory positions at audit clients

Regarding employment relationships, an external auditor is not allowed to be employed by an audit client or by a third party affiliated with an audit client. He must ensure that other persons with influence over the outcome of the audit engagement do not have an employment relationship either. In addition, the external auditor may not hold any management or supervisory function, be it active or passive, at an audit client or a third party affiliated with an audit client.

The AFM reviewed whether there were any employment relationships with audit clients or management or supervisory positions being held at audit clients or third parties affiliated with audit clients by the PIE licensees. None of the PIE licensees reported any employment contracts. Furthermore, it appeared that there were virtually no instances of external auditors holding a management or supervisory position, be it active or passive. In the few cases where a management or supervisory position had been held, be it active or passive, the person in question gave up that position and the audit firm took disciplinary measures.

All PIE licensees monitored the compliance with the aforementioned prohibitions via the annual independence statements. Five PIE licensees also maintained records of secondary positions.

4.2.10 Violations of the independence rules

All PIE licensees monitored compliance with independence rules. Compliance is monitored, for example, by conducting engagement quality control reviews, internal quality reviews, evaluations of the independence statements and internal pre-approval procedures. In 2009-2010 ten PIE licensees recorded violations of independence rules. The number of reported offences per PIE licensee was between zero and ten. The violations related to prohibitions and to violations of internal procedures. Audit firms often followed up on infringements and imposed sanctions where appropriate.

4.2.11 Complaints about independence

The information that the PIE licensees provided to the AFM showed that virtually none of the PIE licensees had received any internal or external complaints relating to the independence of the audit firm or external auditor in relation to audit clients. The audit firms partly based this information on the records kept following the publication of the complaints and whistleblower regulations.

5 Improvements in policies and procedures

In the course of our thematic review and the written process of agreeing on the factual information, the PIE licensees indicated to what extent they had improved, or intended to improve, their policies and procedures relating to independence and to the appointment, appraisal, remuneration and sanctioning of external auditors.

The majority of the PIE licensees have already implemented or announced improvements in policies and procedures in relation to both themes. Regarding independence, most of the changes are aimed at improving central records, including client records, for identifying potential threats to independence, and at improving procedures for independence assessments and the records thereof. Regarding the appointment, appraisal, remuneration and sanctioning of external auditors, the changes are aimed primarily at making sure that quality aspects are taken into account more consistently, explicitly and/or prominently in the appraisal and remuneration of external auditors.

6 Future developments

The AFM will contribute to the public discussions held in the Netherlands and internationally by sharing this review's outcome. In discussion with the Ministry of Finance and the NBA, a consultation process will be started in the autumn of 2011 relating to, inter alia, the independence issue. In 2012 the NBA will further implement its Plan of Action "Lessons Learned from the Credit Crunch" of November 2010, containing proposals related to the themes of independence and the appointment, appraisal and remuneration of directors and auditors. The NBA is also working on a revision of its Code of Conduct Regulation for accountants (VGC) and the Further regulations on auditor independence (NVO) in connection with the revised Code of Ethics of the International Ethics Standards Board for Auditors (IESBA). The European Commission is expected to publish some concrete legislative proposals in late 2011 following its Green Paper ' Audit Policy: Lessons from the Crisis' of 13 October 2010.

Appendix 1 Legal context

Independence

The Audit Firms Supervision Act (Wet toezicht accountantsorganisaties, or Wta) lays down two main standards regarding independence (Articles 19 and 25a of the Wta). For specific areas, they are expanded on in the Audit Firms Supervision Decree (Besluit toezicht accountantsorganisaties, or Bta), the Audit Firms Regulation (Verordening Accountantsorganisaties, or VAO) and the Further regulations on auditor independence (Nadere voorschriften onafhankelijkheid, or NVO). The explanatory notes describe the principles underlying these independence rules.

The Wta and Bta contain a number of specific independence requirements and prohibitions for audit firms auditing PIEs. They relate to certain combinations of services (Article 23 of the Wta), long-term involvement of the external auditor and the audit firm (Article 24 of the Wta) and the annual confirmation of independence to the audit committees of audit clients, setting out all services provided by the audit firm other than the statutory audit (Article 24a of the Wta). Other specific requirements and prohibitions applying to all audit firms include the requirement to ensure that external auditors annually confirm their independence to the audit firm or report threats to their independence (Article 28 of the Bta), and that statutory audit fees are not dependent on other services to the audit client (Article 29 of the Bta). In addition, the Act includes an obligation for the audit firm and the external auditor to assess their independence when accepting or continuing an engagement and to record the outcome of this assessment in the audit file (articles 12 and 13 of the Bta).

The NVO provide a general conceptual framework for the independence of auditors and audit firms that is largely based on IFAC´s international regulations. The conceptual framework provides guidance on applying the fundamental principles underlying the professional ethics for auditors. In the context of statutory audits, this framework applies to any person within the network who, based on a certain circumstance, is in a position from which he can influence the results of that audit engagement. The conceptual framework leaves room for the auditor to apply, to a greater or lesser degree, judgement. The auditor's assessment shall take into account the different people involved who, besides himself, can influence the audit engagement, and he has to identify all possible and existing threats to his independence. The NVO expand on the conceptual framework by including a number of specific prohibitions and unacceptable threats to deal with several possible threats to auditor independence. If there are relationships between an auditor or audit firm and an audit client from which an objective, reasonable and informed third party would conclude that they can threaten the independence of the audit firm or the auditor, the audit firm and auditor must implement measures to safeguard their independence and record such measures. A threat is addressed by eliminating or mitigating it. If this is not possible, Articles 19(1) and 25a(1) of the Wta set out that the audit engagement, or any involvement therein, has to be declined or terminated.

The NIVRA has issued two relevant practical guidelines that give registered auditors further guidance about applying the independence standards laid down in the professional regulations. They are practical guideline 1106 (internal rotation, non-PIEs) and practical guideline 1107 (size of fees). These publications do not have the status of professional regulations.

Appointment, appraisal, remuneration and sanctioning of external auditors

Article 8(1) of the Bta sets out that an audit firm must have a policy on quality that takes these topics into consideration. Discussions in the Dutch Parliament noted the following: "[the policy on quality] reflects the audit firm's views on the way it aims to maintain and improve, where necessary, quality-oriented thinking and acting by the audit firm. *The policy on quality encompasses everything with a determining influence on quality-oriented thinking and acting within the audit firm and, as such, is broader than the system. The policy on quality could address, for example, the [....] appraisal, remuneration and promotion [...]. In addition, the most important aspects or elements can be identified in the policy on quality, which are then elaborated on in, inter alia, the procedures and measures contained in the quality control system".*[21] Given the intention of the legislature as reflected in discussions in the Dutch Parliament, the general provision that an audit firm has to have a policy on quality means that a policy on quality also covers appointment (promotion), appraisal (performance review) and remuneration (salary) of, among others, external auditors.[22] In case of weaknesses in the quality of the conducted audits or the failure to comply, or comply sufficiently, with laws and regulations by external auditors, the audit firm is required to implement measures, including sanctions, against its partners and staff and record such measures (Article 24 of the Bta).

21 Explanatory Memorandum to the Supervision of Audit Firms Decree of 16 August 2006, Bulletin of Acts, Orders and Decrees no. 380, 2006, page 32.

22 See also chapter 6 of the Wta license guide on the AFM´s website.

Annex 2 Comprehensive overview of the nature of other services

The following types of services were provided by one or more firms to statutory audit clients in the period 1 January 2009 to 31 December 2010.

Other assurance engagements

- Voluntary audit of annual financial statements and/or audit of annual financial statements pursuant to the articles of association
- Review of annual financial statements
- Audit of year-end financials for consolidation purposes
- Audit of financial statements similar to annual financial statements
- Prospectus
- Auditor´s report on contribution in kind information
- Auditor's report on insured interest information
- Auditor's report on merger information
- Special-purpose audit engagements (circulation information, revenue information, etc.)
- Other assurance engagements, namely:
  - Audit of a balance sheet only
  - Forward-looking financial information
  - Tenders
  - Auditor´s report on subsidy information
  - Auditor´s report on compensation information
  - Review of interim figures
  - Auditor's report on portfolio simulation
  - Auditor´s report on circulation information
  - Auditor´s report on revenue information

Accounting Services

- Compilation of annual and interim financial statements
- Preparation of forecasts, budgets and liquidity calculations (including assistance and advice)
- Support in preparing the annual report and choosing of accounting policies (IFRS, Dutch GAAP, U.S. GAAP)
- Supporting and/or assisting an audit client in keeping its accounting records
- Payroll administration services (including implementation and support of payroll administration)
- Other accounting services

Design and implementation of a financial information system

- Design of a financial information system (including advice)
- Implementation of a financial information system (including advice)
- Review of a financial information system (including advice)

Valuation services

- Valuations of specific assets or liabilities
- Valuations of an entire organisation

- Other valuation services, namely:
    - Assistance in valuation of shares

Services in the area of internal controls

- Design of the internal control structure, including the planning and control cycle, accounting processes, internal controls, etc. (including advice)
- Review or evaluation of the internal control system (including response)

Legal services

- Acting in a dispute (including a dismissal case, labour dispute, other dispute)
- Acting in tax proceedings
- Drafting and reviewing contracts, agreements and minutes
- Corporate law advice (establishment, liquidation, securities offerings, mergers, etc.)
- Labour law advice
- Tenancy law advice
- Intellectual property advice
- Other legal services, namely:
    - Upon request, staff scholarship fund
    - Divorce of owner-manager
    - Legal demerger establishing a tax-exempt investment institution
    - European workers council

Services related to recruiting senior staff for an audit client

- Arranging recruitment of senior staff
- Recruitment of key personnel

Interim management

- Carrying out interim management assignments (including financial, board and control positions)
- Hiring out staff (including secondment)

Corporate finance services

- Corporate finance services in the areas of:
    - Supporting mergers and acquisitions
    - Business succession and transfer
    - Due diligence investigations
    - Transaction financing and corporate financing
    - Strategy development and determination
    - Business planning & coaching
    - Corporate recovery
    - Restructuring and reorganisation
    - Investment decisions
    - New business
    - Performance improvement
    - Balance sheet optimisation

Tax Services

- Advice on:
  - Compiling tax returns
  - Pension and retirement plans
  - Gift and inheritance tax
  - Financial and estate planning
  - International tax
  - Optimization of tax position of international structures
  - Transfer pricing
  - Advance Tax Rulings and Advance Price Agreements
  - Mergers and acquisitions
  - Expat
- Other tax advice, namely:
  - 0% VAT ruling
  - Random depreciation
  - Interest box payroll tax
  - Reviewing and appealing against tax assessments
  - VAT - foreign equity interest
  - Consequences of exchange rate results
  - Other tax advice
  - VAT - private car use
  - VAT - services
  - Sales tax
  - Dividend pay-out
  - Corporate income tax
  - Employee benefits
  - Cash repatriation

Other services:

- Support in the preparation of the annual financial statements (from trial balance to annual financial statements)
- Corporate governance advice
- Forensic investigations
- Litigation support
- Support and advice on CSR reporting
- Providing training and courses
- Risk management
- Compliance
- IT Audit & advice
- Subsidy advice
- Other, namely:
  - Secretarial support activities
  - Financial and business advice
  - Budgeting and budgets
  - Enterprise planning
  - Pension advice
  - Reorganisations
  - Bankruptcy investigation
  - Personnel issues and HR advice

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Amsterdam, 6 October, 2011