

Financial Reporting Council  
Mr S. Haddrill  
8th Floor 125 London Wall  
EC2Y 5AS LONDON  
United Kingdom

Date 2 September 2015  
Our reference MeBk-15081941  
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Subject AFM response to FRC consultation of  
Audit Firm Governance Code

Dear Mr Haddrill, *Dear Stephen*

The Netherlands Authority for the Financial Markets (AFM) has read with great interest FRC's consultation document "Audit Firm Governance Code: A review of its implementation and operation". We appreciate the opportunity to respond to this document and to provide you insights into the discussion of audit firm governance that is currently taking place in the Netherlands. We hope that these insights can help you in strengthening the Code.

This response is structured as follows. We will first provide background information on the discussion on the governance of audit firms in the Netherlands (section 1). Section 2 deals with some interesting obligations for audit firms as proposed in the Additional Measures for Audit Firms Bill, which are to an extent similar or equivalent to the principles included in the Code. We end with some concluding remarks in the third section.

## 1. Background

The AFM is responsible for supervising the operation of the financial markets. This means that the AFM supervises the conduct of the entire financial markets sector. Within this broad mandate, we are the responsible regulator in the area of audit on the basis of the Audit Firms Supervision Act (*Wet toezicht accountantsorganisaties, Wta*). This means that the AFM licenses and supervises audit firms that carry out statutory audits in the Netherlands.

On September 25, 2014 the AFM released a report on the inspection findings of statutory audits and the quality control and monitoring by the four largest audit firms, the so-called Big 4 (Deloitte, EY, KPMG and PwC).<sup>1</sup> The AFM concluded that the quality of statutory audits performed by the four largest audit firms had insufficiently improved since 2010.<sup>2</sup> The number of statutory audits deemed 'inadequate' by the AFM was (again) too high. The most common deficiencies related to the tests of controls, the substantive procedures and the external auditor's critical assessment of obtained audit evidence. Because the identified deficiencies are structural in nature, the AFM

<sup>1</sup> AFM, *Results of the inspection of the quality of statutory audits at the Big 4 audit firms*, 25 September 2014.

<sup>2</sup> In the first round of regular inspections, the AFM concluded in the final inspection reports that on average in 52 per cent of the reviewed statutory audits the external auditors failed to obtain sufficient and appropriate audit evidence: AFM, *Report on general findings regarding audit quality and quality monitoring*, 1 September 2010.

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believes that the governance of audit firms has played a decisive role in these outcomes. Therefore, we proposed a number of recommendations leading to fundamental reform and cultural change with the aim of improving audit quality in the Netherlands. The recommendations focused on strengthening governance (in particular the professionalisation of the executive board and the establishment of an independent supervisory board), creating a quality-oriented culture with a focus on the public interest, ensuring the legal level of quality, and increasing the transparency of quality. On the same date of the publication of the AFM's report, the professional body NBA proposed improvements for the entire audit sector in its report 'In the public interest'.<sup>3</sup> The measures mentioned in that report are not only targeting the level of individual audits, but also touch upon audit firm governance.

In October 2014, the Minister of Finance expressed his support for fundamental reform of the audit sector and announced that he had started a legislative procedure with the aim of implementing the AFM's recommendations into legislation. This procedure takes place next to the legal developments as a result of the implementation of the new EU Audit Directive and, to the extent necessary, the EU Audit Regulation. The EU legislative package also brings about important changes to the regulatory environment of audit firms and auditors. On July 7, 2015, the Minister started a public consultation procedure for the Additional Measures for Audit Firms Bill (*Wetsvoorstel Wet aanvullende maatregelen accountantsorganisaties*). We have submitted a public response to the Bill in which we expressed our strong support for the additional measures proposed.<sup>4</sup> We expect the Bill to enter into force in the summer of 2016.

We should point out, however, that the Bill is subject to modifications as a result of the public consultation procedure and the Parliamentary debate that should take place in 2016.

## 2. The Audit Firm Governance Code from a Dutch perspective

The AFM agrees with the FRC that the purpose of the Code – and thus the governance of audit firms – should primarily lie in the promotion of high quality statutory audits, in the public interest and in accordance with law and regulation. We believe that the aspects dealt with in the Audit Firm Governance Code – leadership, values, independent non-executives (INEs), operations, reporting and dialogue – are the right ones for increasing the quality of audits and audit firms overall. Focusing on the two most significant changes that the Code has brought about in the United Kingdom – the appointment INEs and the dialogue between audit firms and shareholders in listed companies – the AFM observes that in the Netherlands we move towards similar obligations for audit firms in the near future. The Additional Measures for Audit Firms Bill includes an obligation for audit firms that audit public interest entities (PIEs<sup>5</sup>) to establish an independent supervisory board on the highest level of its organisation. In the

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<sup>3</sup> Summary in English: Future Accountancy Profession Working Group, *In the public interest: measures to improve the quality and independence of the audit in the Netherlands (summary and measures)*, October 2014.

<sup>4</sup> The AFM's response can be found here: <<https://www.internetconsultatie.nl/aanvullendemaatregelen/reactie/34e12a1c-21df-48d6-92db-85aee3e0aa92>> (last visited on 17 August 2015).

<sup>5</sup> In short, public interest entities (PIEs) in the Netherlands are Dutch listed entities on a regulated market, banks and other credit institutions and insurance companies. On June 29, 2015 the Minister of Finance announced that Government intends to designate the following institutions as public interest entities, in addition to those mentioned above: grid operators, large pension funds, scientific

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second place, it introduces a suitability test for individual members of the executive boards and supervisory boards, as well as the collective executive boards and supervisory boards of audit firms. And in the third place, the Bill includes the possibility for the AFM to share its entity specific findings and conclusions directly with the audit committees of audited PIEs in order to increase the transparency and stimulate dialogue between audit firms and the public interest entities.

### 2.1 *Supervisory board*

The Bill requires audit firms to have an independent system of internal supervision on the policy and daily affairs of audit firms, which shall at least include the set-up of a supervisory board. At present not all Dutch audit firms that audit PIEs have such an independent internal supervisory system. In addition, for those firms that do have such a system, many differences in the set-up and implementation can be observed. The Bill requires that the supervisory board be established at the highest level to ensure that the supervisory board can also act in relation to other parts of the network in case the day-to-day policy of the audit firm is predominantly determined in other parts of the network. Section 22a, fourth paragraph, of the Bill includes the power for the supervisory board to appoint, suspend and/or dismiss members of the executive Board of the audit firm, or of Board members of firms at the higher level of the network in case the day-to-day policy of the audit firm is predominantly determined in that other part of the network. The Bill determines that more requirements for the supervisory board shall be regulated in lower-level regulations. In our public response to the Bill, we have pointed out that in our opinion supervisory boards should consist of a majority of independent members that are not affiliated with the audit firm. In determining the independence of the supervisory board, the AFM believes that alignment should be sought with regard to the rules from the Dutch Corporate Governance Code and the NBA's Regulation regarding the Independence of Accountants in the case of Assurance Engagements (*Verordening inzake de onafhankelijkheid van accountants bij assurance-opdrachten*).

### 2.2 *Suitability test for policymakers*

Another important proposal in the Bill is the introduction of a suitability test (*geschiktheidstoets*) in which the AFM will assess the individual as well as the collective suitability of policymakers and co-policymakers of audit firms, i.e. the members of the executive and supervisory boards. We think that this matter could be particularly interesting in light of the consultation question on the role of the FRC in the appointment of INEs.<sup>6</sup>

At present, (co-)policymakers only deal with requirements regarding their trustworthiness (*betrouwbaarheid*).<sup>7</sup> The suitability test requires that (co-)policy makers are suitable with regard to the carrying out of the business of audit firms which audit PIEs. This not only includes the trustworthiness, but also the expertise, professional competence and experience of (co-)policymakers. This should ensure that board members and the board as a whole set the right priorities, have expertise with regarding to the business of the audit firm, and that the necessary competences and skills are present within the firm. A part of the suitability test concerns the expertise with respect to the system of

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policy institutions (the Royal Netherlands Academy of Arts and Sciences, the Netherlands Organization for Scientific Research and the National Library of the Netherlands), as well as the majority of housing associations.

<sup>6</sup> FRC Consultation document "Audit Firm Governance Code: A review of its implementation and operation", p. 13.

<sup>7</sup> This is the Dutch implementation of article 4 (good repute) of Directive 2006/43/EC.

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quality control within the audit firm. The suitability test is carried out by the AFM. If the AFM determines that a candidate-member of the executive or supervisory board is not suitable for the carrying out of such function, this means that the individual cannot be appointed on the executive or supervisory board of the audit firm. The AFM has already had several years of experience with suitability testing of directors, supervisory directors and other policymakers of certain financial undertakings (including, but not limited to banks, insurers, investment firms, trust offices, and pension funds).

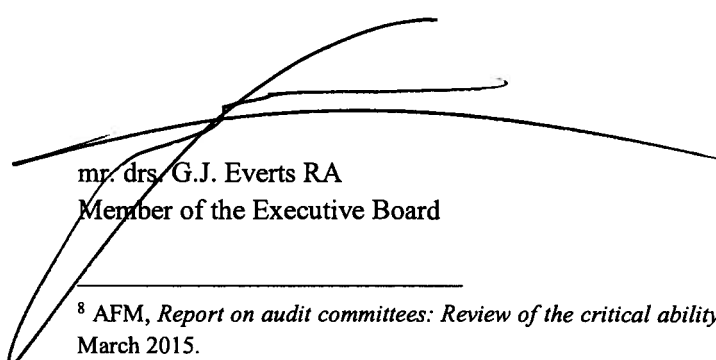
### 2.3 *Sharing of findings and conclusions with audit committees*

An important aspect in the UK Audit Firm Governance Code is the matter of dialogue: firms should reach out to listed company shareholders as well as the management of the companies and their audit committees. Important developments also take place in this area. The Bill introduces a possibility for the AFM to share the entity specific findings and conclusions of its inspections and investigations directly with audit committees (or other bodies with similar powers) of audited PIEs. While audit committees are not subject to direct supervision by the AFM, they do have our particular attention because of the ever-increasing importance attached by capital providers to the proper functioning of audit committees in the internal governance of companies. We are aware of the important role of audit committees in a system of checks and balances between audit firms, the auditor and the company (audit client) concerned. Based on an exploratory study carried out in 2014-15, the AFM expects that audit committees will have a positive influence on internal control and specifically as regards the quality of financial reporting and audits if audit committees exercise their duties with a critical attitude.<sup>8</sup> The inspection findings of the AFM are a good, reliable source of information for an effective dialogue between audit committees and audit firms and, therefore, we strongly support the introduction of this possibility.

### 3. **Concluding remarks**

We hope that we have provided the FRC some insight into the discussions of the governance of audit firms in the Netherlands. We believe that this insight may be useful for the future development of the Code. The AFM would be happy to provide any additional information. If you would like to discuss our views in further detail, please do not hesitate to contact us.

Yours sincerely,  
Netherlands Authority for the Financial Markets



mr. drs. G.J. Everts RA  
Member of the Executive Board

<sup>8</sup> AFM, *Report on audit committees: Review of the critical ability of audit committees with respect to financial reporting and audits*, March 2015.