

Foundation for Auditing Research: Addendum to the Call for Research Project
Proposals 2020

February 21st, 2020

FAR invites research projects that will look into the recommendation of the 'Monitoring Commissie (Committee) Accountancy' (MCA) and 'Commissie Toekomst Accountancysector' (Committee Future Accountancy sector - CTA). During the past few weeks (in 2020) these two committees charged with studying concerns regarding audit quality in the Netherlands published their final reports. The reports are not yet available in English, but an English summary of the CTA recommendations is included in the Appendix. Links to both reports are at the bottom of this addendum.

Both reports list recommendations, often for additional regulation or regulatory changes, that the committees think will improve audit quality in the Netherlands.

This addendum reflects recommendation 3 (translated) of the CTA: 'Academics, regulators and the accountancy profession should strive for more (scientific) research into the quality of the Dutch accountancy profession, including the factors that explain differences in audit quality'.

Indeed, results from such research would be valuable in the light academically informing public policy recommendations, like those of the CTA.

Therefore, and in addition to the 2020 Call for Research Projects dated January 31st, 2020, FAR invites research projects that will look into the MCA and CTA recommendation. This mirrors our invitation for research into accountancy sector regulation already in place: Research Program A in the current 2020 Call. Given that the recommendations here are not yet in place as regulations, this will necessitate creative research approaches. Such project proposals can be part of Research Program B: Empirical Research projects, in the current Call.

Examples of the, researchable, MCA and CTA recommendations are (for example):

- MCA 1/2: Move to annual inspections of PIE audit licensed audit firms and three-year inspections of non-PIE audit licensed audit firms
- MCA 15: Within audit firms move from profit pooling to ring fencing (in the context of audit partner remuneration).
- MCA 18: Mandate co-signing the audit report by the Engagement Quality Review partner

- MCA 29 and CTA 5: Widen the going concern concept to better reflect future client viability: more attention should be paid in the statutory audits to longer term (dis) continuity.
- CTA 6: With regard to non-financial information, the CTA recommends that it should not be reserved entirely for audit firms and that auditors are transparent about the degree of certainty that can be derived from an investigation into non-financial information.
- CTA 7 and 8: The CTA recommends further investigation into existing, alternative audit firm structure models such as audit only and joint audit; it also recommends analysis of foreign experiences with alternative structure models.
- CTA 16: The CTA recommends the responsibility of the audited entity for the design and operation of its risk management and control systems to be articulated more (cfr the 'in control statement').

Other recommendations could be relevant research topics too of course. Please take FAR's current research projects into consideration when proposing research projects.

MCA report link ('Eindrapport'):

<https://www.monitoringaccountancy.nl/nieuws-en-publicaties/>

CTA report link:

<https://www.rijksoverheid.nl/documenten/kamerstukken/2020/01/30/vertrouwen-op-controle-eindrapport-van-de-commissie-toekomst-accountancysector>

Summary of Report from the Committee on the Future of the Accountancy Sector

The auditor audits the financial statements of audited entities for public benefit purposes. The auditor performs a public task and bears a public responsibility. This justifies a comprehensive system of legislation and regulations, as well as closely independent public oversight. It also requires the auditor to feel responsible and behave accordingly.

Trust in auditors has been under pressure for some time. In order to restore that trust, the Minister of Finance set up the Committee on the Future of the Accountancy Sector from 1 January 2019. In short, the Committee has been instructed to investigate measures to sustainably improve the quality of statutory audits. This report contains the findings of the Committee's investigation.

The Committee has not ruled out any measures in advance. However, it was explicitly instructed to take account of the legal feasibility and proportionality of any recommendations. The Committee considers this to be of particular importance. Far-reaching measures, such as an intervention in the structure of the accountancy sector, require that the problem is significant and that less far-reaching measures are not sufficient. Furthermore, there must be sufficient insight into the effectiveness of proposed measures. Proposals that do not meet the proportionality bar, although they may appear decisive, are not effective.

A correct and comprehensive picture of the quality of statutory audits at different levels, based on unambiguous standards (indicators), is lacking. Looking at the results of the assessments by the supervisor and the quality assessors, the conclusion is that there is a structural problem; in recent years, the quality of statutory audits has not improved sufficiently and a significant number of statutory audits still do not (yet) meet the applicable standards. There is still a lot of work to be done.

For other levels of quality, such as the quality control system within audit firms and relevant factors for auditors to 'do the right thing', hardly any information is available. This is not acceptable in view of the importance of their public task. In order to make the quality of statutory audits more transparent and to test them in the coming years, Audit Quality Indicators (so-called AQIs) for all relevant levels should be established in the short term. These should be unambiguous, (centrally) publicly available and assessed by the regulator.

There is a gap between what society expects and what auditors can and must deliver. This damages the trust placed in auditors. Auditors need to do more about financial fraud and continuity. Non-financial information should not be fully reserved for auditors. Moreover, auditors should be transparent about the degree of assurance that can be derived from an examination of non-financial information.

There are indications that certain characteristics of the accountancy sector (the so-called structural characteristics such as, for example, the fact that an auditor is hired and paid by the organization he or she audits) can have negative consequences for the quality of statutory audits, and structural measures are conceivable that could (partly) mitigate those consequences.

Proportionality and legal feasibility require the introduction of possible structural measures and little information is available on the effectiveness of these measures. By making more use of experiences from home and abroad and experimenting with an intermediary on a limited scale, more knowledge about the effectiveness can be gained while meeting these requirements.

The governance and remuneration model of audit firms does not yet contribute to the high quality of statutory audits in all cases. The introduction of a regime inspired by the two-tier board system for PIEs and large non-PIE audit firms is desirable. In doing so, the supervisory board should be instructed to pay particular attention to the public duty and responsibility of the audit firm and to obtain approval rights for important decisions, such as those regarding profit distribution, remuneration policy - in which quality must be central - and investments.

The first steps in a culture change within audit firms have been taken but have not yet been sufficiently sustained. The cultural change must continue unabated. A certain tension between entrepreneurship and performing the public task as well as possible is inevitable; it comes down to organizing sufficient counterforce.

The profession must become and remain more attractive. In this respect, the sector is primarily responsible for providing an attractive environment for potentially joining accountants. The pressure of work, the work-life balance and a culture aimed at 'doing the right thing' at an audit firm are crucial factors in this respect.

Regarding the entire accountancy sector, there are no indications that the level of competition is too low. However, the number of audit firms with a PIE license is decreasing. That is undesirable. The stricter requirements for PIE audit firms should not unnecessarily hamper new entrants. The advantages of a government audit for public institutions do not outweigh the disadvantages; the introduction of a national auditor is therefore not logical.

Reliable (correct and complete) financial accountability is the responsibility of a chain of actors. All actors must take this responsibility and must be enabled to do so. The responsibility of the audited entity for the design and operation of the risk management and control systems must be expressed more clearly and the communication between the supervisory board and the shareholders about the way in which the assignment to and supervision of the functioning of the external auditor took place must be improved.

The system of supervision is opaque and complex. The relationship between independent supervision and quality control must be adjusted. From now on, supervision of the entire accountancy sector must be exercised de jure and de facto by the AFM. The system of quality control should be central to the supervision.

Technological developments will radically change the accounting profession. The quality of audits can be raised through innovation, for example through the application of new technology. Obstacles to the application of new technology in auditing standards and supervision must be removed and sufficient attention must be paid to this in training.

It is important to implement the measures proposed by the Commission in the short term. This requires a coordinated commitment of different actors. In the short term, a quartermaster should be appointed by the Minister of Finance who will be responsible for the implementation process of the various recommendations and, where necessary, will provide sufficient 'pressure on the boiler'.

This is even more important as the committee is convinced that there is no silver bullet that solves all problems. The various problems are addressed by a combination of measures.

There is nevertheless a risk that, despite significant improvements in the quality of the statutory audit, social dissatisfaction will persist and that, for this reason, new measures will always be taken in the expectation (or hope) that 'the problem' will be solved. This can lead to a downward spiral. The rules multiply and the prestige of the profession devalues, which in turn leads to new problems. The challenge is, on the one hand, to take measures to sustainably improve quality but, on the other hand, to put an end to this downward spiral. It does help if society realizes that incidents will inevitably occur.

The committee makes the following recommendations:

Recommendation 1: In order to make the quality of statutory audits more transparent, uniform Audit Quality Indicators should be established in the short term and assessed by the regulator. These indicators should collectively represent the three levels of quality.

Recommendation 2: Audit firms should report periodically on the quality of the statutory audits carried out based on these indicators. These reports should be compiled in one publicly accessible location to facilitate comparison of audit firms.

Recommendation 3: Science, regulators and the accountancy sector should endeavor to conduct more (scientific) research into the quality of the Dutch accountancy sector, including the factors that explain differences in quality.

Recommendation 4: The Committee recommends that the effective operation of disciplinary law be investigated further.

Recommendation 5: The Committee recommends that statutory audits should pay more attention to aspects of financial fraud and (dis)continuity. When auditing medium-sized and large entities, standard forensic expertise should be present in the audit team at the various stages of the audit process. More attention should also be paid to these subjects in (permanent) education.

Recommendation 6: Regarding non-financial information, the Committee recommends that it should not be fully reserved for auditors and that auditors should be transparent about the degree of assurance that can be derived from an examination of non-financial information.

Recommendation 7: The Committee recommends further investigation into existing alternative structure models such as audit only and joint audit.

Recommendation 8: The Committee recommends an analysis of foreign experience with alternative structure models.

Recommendation 9: The Committee recommends experimenting with an intermediary on a limited scale.

Recommendation 10: The Committee recommends the introduction of a regime inspired by the two-tier board system for PIEs and large non-PIE audit firms. In doing so, the supervisory board should be instructed to pay particular attention to the public duty and responsibility of the audit firm and be given approval rights for important decisions, for example with regard to profit distribution, remuneration policy - in which quality should be central - and investments.

Recommendation 11: The culture change that has been initiated must continue unabated. This requires changes in training for auditors and audit firms, with more attention being paid to soft skills, reflection and intervision, workload, the work-life balance and a culture aimed at

'doing the right thing'. Autonomy and open communication must replace hierarchy and bureaucracy. Professional judgement must be given sufficient room.

Recommendation 12: The Committee recommends that the concept of Organization of Public Interest be better defined based on clear criteria.

Recommendation 13: The Committee recommends investigating to what extent a distinction can be made in legislation and supervision at client level rather than at the level of the audit firm.

Recommendation 14: The Committee recommends that the possibility of extending Article 17(4) of the audit regulation be included in the Wta after all, in line with the deadlines customary in Europe.

Recommendation 15: The Committee recommends the introduction of a power for the Minister of Finance - as an ultimate remedy - to assign an audit firm to an entity subject to audit duty that has failed to contract an audit firm despite reasonable efforts.

Recommendation 16: The Committee recommends that the responsibility of the audited entity for the design and operation of the risk management and control systems be given greater prominence. The way this should be done should be the subject of further investigation.

Recommendation 17: The Committee recommends that the communication between the supervisory board and the shareholders concerning the manner in which the engagement and supervision of the functioning of the external auditor is carried out should be improved. The way in which this is done should be the subject of further investigation.

Recommendation 18: The Committee recommends that the implementation of the supervision should be organized in such a way that it is de jure and de facto exercised by the AFM.

Recommendation 19: The Committee recommends that the implementation of supervision should focus on the assessment of quality control systems, in addition to paying sufficient attention to compliance and the factors that have a material influence on quality, and that the aim should be to promote quality improvement.

Recommendation 20: The Committee recommends that the regulator develops an easily accessible facility where auditors and audit firms can report shortcomings in the performance of audits by other auditors or audit firms.

Recommendation 21: The Committee recommends that obstacles in the application of new technology in auditing standards and supervision be removed and that due attention be paid to this in training.

Recommendation 22: The Committee recommends that a quartermaster be appointed to ensure the energetic implementation of the various recommendations.