

## **The measurement of audit quality in the Netherlands: a practical note**

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### **Abstract**

Several committees, institutions, and practitioners are currently working on defining appropriate, and reliable Audit Quality Indicators (AQIs). This project deliberates on a wide range of audit quality measures applied in international academic auditing research. The project discusses the availability of these measures, their (potential) information value, limitations, and makes practical recommendations for the related data sources. The key findings are presented in Appendix A.

This research project informs audit practitioners who manage and design the quality control (monitoring) systems of audit firms, those involved in preparing the transparency reports, and policymakers and regulators in their considerations of AQI's.

### **The research project in a nutshell**

An understanding of audit quality measures and their data sources is a prerequisite for developing appropriate and reliable Audit Quality Indicators (AQI's). This research project discusses the availability of these measures, their (potential) information value, limitations, and makes practical recommendations for the related data sources (see Bosman 2021). The

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conclusion of this study is that there is room for improvement in the audit quality data sources in the Netherlands.

The five important recommendations from this research are:

1. Public statutory audit register

Stakeholders of the audit profession would benefit from a central public register that is free of charge and includes standardized machine-readable (XBRL) filings. Public registers that have such a structure are available in the UK, Germany, Belgium and for the SEC registrants. There is currently no central database that contains key information on all Dutch statutory audits, such as: the corresponding audit opinions, going concern and restatement information, the responsible audit firms, and partner. A central database would offer transparency over the performance of the auditing profession and its involvement in financial reporting. The existence of such a central register would make it easier for audit clients to select an audit firm and audit partner, based on audit quality metrics and not (only) on the audit fee. Researchers could use such a database to investigate several phenomena and make informed policy recommendations. For example, how do much going concern opinion errors do auditors currently make?

2. Public Auditing and Accounting Enforcement Releases

Auditing and Accounting Enforcement Releases (AAERs) provide for an important source of data on how the regulator interprets and enforces certain accounting and auditing regulations. However, AAERs are not publicly accessible in the Netherlands. Publishing AAERs would make it possible for the auditing profession and its stakeholders to learn from prior mistakes.

3. Public Insolvency register

The insolvency of a medium-sized or large legal entity is a significant societal event. Therefore, the bankruptcy register for insolvent medium size or large entities should preferably not be erased after only six months but should remain assessable for a longer period. This allows the profession and stakeholders to investigate and learn from prior mistakes.

4. Enforcement of financial reporting and disclosure requirements

A serious concern for the transparency of Dutch organizations and the audit profession is the timeliness and completeness of trade register filings. This includes the non- or incomplete filing or of financial statements (Langendijk 2011; Litjens and Suijs 2020; Vergoossen and Meershoek

2018) and board reports (Vergoossen and Van Beest 2019). A regulatory intervention like the German intervention in 2006, where automatic fines for non-filers was introduced, seems justified here.

5. Central monitoring of audit firm internal proprietary audit quality data sources  
 As part of their quality system, audit firms could centrally monitor and follow-up on data on identified internal control deficiencies and audit misstatements. Structural analyses of the differences between the first and final audited version of financial statements, could give stakeholders to the auditing profession some important insights on the (previously invisible) value-added of an audit. In addition, central monitoring by the audit firm of specialist involvement, consultations and client complexity might help to identify engagements that tend to under- or over-utilize specialist or consultation resources and help prevent accidents from happening.

The rationale for each audit quality measure discussed in this research project, including the corresponding limitations and data availability are summarized in Appendix A.

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## Appendix A: discussed Audit Quality topics and measurements, their information value, limitations, and availability in the Netherlands

### Section of the

Paper / Measure	Rationale / Information-value	Limitations	Availability in the Netherlands
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3.1) Restatements	If audited financial statements need to be restated, this is a relatively hard indication of a lack of audit quality of the restated audit.	Extreme relatively seldom occurring events.	Most misstatements are corrected in the next year's financial statements, with a correction of the comparable figures and a corresponding disclosure. A researcher needs to go through several PDFs of financial statements an organization to be able to identify such misstatements. The restatements in accordance with Art 2:362 sub 6 BW are very rare and are hard to identify in the KVK. Several PIE audit firms report on this topic in their transparency report. For equity listed PIEs available from January 2018 onward in Audit Analytics Europe.
3.2) Lawsuits against or convictions of the responsible audit partner	A professional disciplinary conviction of an auditor is an indication that he/she has not delivered audit quality by complying with the regulations.	Depends on the size and risk of the audit (firm/partner) portfolio, which is not directly observable. Furthermore, these are relatively extreme events. It is very hard for outsiders to link the convictions to the audits they relate to, due to the anonymization of information.	The names and sentences of convicted auditors are available in the NBA register for a period of 10 years after court proceedings. This register is hard to access and has no download option.
3.3) Accounting and Auditing Enforcement Releases (AAERs)	If the regulator issues a regulatory action against an audited company and/or its auditor, this is a sign of a lack of audit quality.	Relatively seldom and extreme event in the Netherlands. Most of the interactions between the financial market regulator and the audited organization from the comment letters process is unobservable.	Only the restatements resulting from this process are publicly observable ("Aanbevelingsbericht"). Where these are relatively rare, and the last instance was in 2014 (as of November 2020).
3.4) Going Concern Opinions (GCOs) and type II error rates	When an organization files for bankruptcy and an auditor did not issue a GCO, this is a sign of a lack of audit quality.	Relatively seldom and extreme events. The information the auditor had at the time of the issuance of a GCO might not indicate any bankruptcy risk for the next 12 months. In addition, a too conservative stance on GCOs (type I errors) might cause the CGO to lose its informational value for stakeholders.	Available in the PDFs of filed financial statements. There is no central database with the Dutch audit opinions. Furthermore, the Dutch bankruptcy register is erased six months after court proceedings. For equity listed PIE's this information is included in Audit Analytics Europe from 2010 onwards.
3.5) Inspection Outcomes	The outcomes of audit file inspections of internal and external inspectors provide a direct feedback on audit (file) quality. If work is not documented in the audit file it is not considered to be done (properly).	The sampling of audit files subject to inspection is seldomly pure random (mainly risk-based) and therefore subject to selection bias. Furthermore, the inspection outcome usually only tells something about the quality of the audit file and not the entire audit process.	Disclosed for audit firms with a PIE license in their transparency report. Individual audit file inspection outcomes or the audit partners they relate to are not disclosed. Where the AFM now can inform the auditee of adverse audit file inspection outcomes.
3.6.a) Earnings Response Coefficient (ERC)	When investors respond to audited financial statements intensely, this is an indication of the level of confidence they have in the audit.	Relatively noisy measure that is only available for equity listed entities (limited population). Furthermore, it is hard to disentangle which part is due to the auditor and which part is due to the company / credible management.	Is available, but the metric only applies to listed companies, which is a relatively small sample in the Netherlands.
3.6.b) Stakeholder feedback / ratings	When stakeholders value the audit, this is an indication of audit quality. Furthermore, service quality is also a factor in the auditing landscape.	Important to understand the sampling and survey techniques applied. There is a potential risk of only surveying friendly clients or stakeholders (sampling bias) and receiving socially desirable answers.	Not always structurally collected by audit firms after each audit. Collecting is hard and subject to several GDPR concerns and complexities.
3.7) Values, Ethics and Attitudes	Provide information about what is considered acceptable behavior in the audit firm, how the firm is perceived to deal with important issues and how the error and learning climate is.	General risks of survey research such as providing socially desirable answers and dependency on self-reporting.	Highlights are disclosed in the transparency reports of PIE audit firms. The surveys and survey techniques differ between audit firms.

4) Financial reporting quality	The financial statements are the object of the audit. Therefore, variation in financial reporting quality gives an indication about the quality of the audit.	Relatively noisy (imprecise) measures, there is not always academic consensus over how to measure them, are susceptible to measurement error, potentially sensitive for design choices and possibly subject to selection biases. Furthermore, it is hard to attribute the quality of the financial statements to the auditor or other factors.	Proxies include small earnings (surprises), earnings discontinuities, (discretionary) accruals (the level of earnings management) and disclosure quality proxies. These can all be collected in the Netherlands. Practical concerns exist relating to the enforcement of / compliance with filing requirements for private companies and the role of auditors therein.
<b>Topic / Measure</b>	<b>Rationale / Information-value</b>	<b>Limitations</b>	<b>Availability in the Netherlands</b>
5.1) Client Acceptance and Risk Assessment	When an auditor does not accept or dismisses high-risk clients, this is considered a sign of conservatism which is usually interpreted as a sign of audit quality.	There is a risk that the biggest audit firms only accept easy to manage and well behaving clients and so pass the problem on to smaller audit firms. The non-acceptance of audit clients can only be observed if they fail to find any auditor. The non-continuance of an audit engagement can be observed but is hard to disentangle whether this is due to the client, the auditor or some (independence) regulation.	Information on an audit firm level disclosed in the transparency reports of PIE audit firms. Overarching database with all Dutch statutory audits is not available.
5.2) Internal Control Deficiencies	If an auditor identifies internal control deficiencies and has recommendations to improve the companies' internal control system, this is interpreted as an indication of audit quality.	Not all audits rely on the internal controls of a company and the internal controls are not the audit object of the auditor. There is anecdotal evidence that auditors are using internal controls less and less to obtain their audit evidence. Furthermore, the base rate of internal control deficiencies varies from organization to organization and cannot be observed, where auditors are more inclined to rely, evaluate and report over internal controls for relatively better organized organizations.	Available in the audit files, management letters and auditor reports to the clients' oversight body. But not publicly observable as it is confidential information.
5.3) Audit Effort	When the audit firm exercises a high level of effort by experienced professionals, this is considered an important input factor for delivering audit quality.	High effort might also be a sign of inefficiency.	Information on an audit firm level disclosed in the transparency reports of PIE audit firms and on an individual level disclosed to the auditees in the (non-publicly observable) auditors report.
5.4) Specialists Involved and Consultations	When an auditor engages specialists and consults technical issues, this is considered an important input factor for delivering audit quality.	A high number of consultations might also be an indication of an auditor that is not willing to take ownership of important decisions in the audit.	Information disclosed on the audit firm level in the transparency reports of PIE audit firms. Not publicly observable on an individual engagement level.
5.5) Identified Audit Misstatements	If an auditor finds more important misstatements, this is considered an important output factor of audit quality. The correction of material misstatements in the financial reporting process is an important, perhaps the most important, added value of the audit.	There is seldomly a clear first and documented version of the financial statements prepared by the client. Therefore, this measure might be incomplete. Furthermore, not all auditors comply with the internal regulations to document all misstatements in a certain field in the documentation system and include an attachment to the LoR with the uncorrected misstatements. Finally, the base rate of misstatements in the first version of financial statements is unobservable and varies between organizations and years. It is unobservable how many material misstatements the auditor did not find, other than subsequent restatements.	Documented in the audit files and as an appendix to the Letter of Representation (LoR) signed by the client. Not disclosed in the transparency reports or elsewhere.