A Description of the Historical Developments in Standard Setting and Regulations for Auditors and the Audit Firms in an International Perspective

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1. Introduction

The profession of auditor in its current form has its starting point approximately 130 years ago. That being said, ever since people have been administering other people’s assets, there has been a need for supervision of this administration and auditing of the accounts regarding this administration. Only after the industrial revolution, auditor became a separate profession, in some cases as a “spin-off” of another profession. The position of the auditor has always been different in various countries. In some countries, the emphasis lay solely on the audit, whereas in others there were also important supervisory aspects to the function. Regulation has sometimes had the function to support the development of the profession, on other occasions it was rather a reaction to (perceived) abuse concerning financial reporting. During the 1980s, the profession of auditor was one of the first professions to internationalize and later globalize following the business world. Regulations that touch the core of the activities that auditors are concerned with: company law, securities law and the professional audit regulations were and are in general organized on a local and sometimes regional level. This has caused and still causes all kinds of problems in the coordination of the audits in various jurisdictions, the findings of which have often to be communicated to users in other jurisdictions.

Particularly in the last decade, the rules and regulations for the audit profession have exploded. This is for an important part caused by the domination of Anglo-Saxon views on the profession during the last decades. In order to comprehend the current rules and regulations, it is necessary to be aware of the historic developments in the accountancy/audit profession. These will be set out in Section 2. Subsequently as an example of the rather limited regulations until the turn of the century the Dutch audit regulations as prevalent at that time are set out in Section 3. Although the international and in particular European influence is already visible in these rules and regulations, this influence on audit rules and regulations has strongly increased after the turn of the century. That is why in Section 4 the outlines of the international developments in audit rules and regulations will be addressed, before discussing the European regulations that still being debated in Section 5. Finally, again as an example, the current Dutch rules and regulations will be discussed in Section 6, which will be followed in the final Section 7 by some critical observations and closing remarks.

2. Outline of Historical Developments in the Audit Profession

The profession of auditor has developed differently in different countries. In written history, almost every country has examples of supervision on the accounts. In particular, of interest for the accountancy profession is the period in which Western Europe started organizing shipping companies for trading with the West.1 Already in those companies, a division and separation was made between the direct management of the company by the directors and the supply of risk-bearing capital by the main participants. It was, however, the demand for capital during the industrial revolution that prompted the rise of companies that were managed by people who did not necessarily also provide its capital on a much larger scale.

This occurrence of an explicit division between management and the providers of the funds of the company, required accountability of those managing the company: on a large scale, the board of directors. History has taught us that giving account by the board of directors can go wrong, either on purpose or otherwise. This prompts the need for supervision. In all countries, at some stage, the external providers of funds, often the

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shareholders or representatives thereof, are requested to provide this supervision. This is how the predecessor of the current auditor function develops in most countries during the second half of the 19th century. In Scotland, for instance, people providing services around “trusts” (often lawyers) start providing services that nowadays would be qualified as accounting services. These activities resulted in the first specialized accounting firm, which as one of its services provided auditing of the financial reporting of companies for the benefit of the shareholders of these companies – a development, which shortly thereafter also becomes visible in other parts of the UK and in the US.2 In France, it remained customary for a long time to appoint a supervisory director from the ranks of the shareholders (“commissionnaire de surveillance”). In the first half of the 20th century, due to financial scandals it became apparent that it was desirable for such a supervisory board director to have a solid knowledge of accounting. At a certain stage, this knowledge became an official requirement. This officer of the company was called the “commissionnaire aux comptes” (supervisory director of the accounts).3 In Germany, the big industrial companies in general used the company structure of the “Aktiengesellschaft” (AG). Smaller companies used the form of the “Gesellschaft mit beschränkter Haftung” (GmbH). The AG used a two-tier board structure with a management board that is charged with the actual management of the company and a (extensive) supervisory board, which was given the task of supervising the management activities. This supervision explicitly encompassed the supervision of the financial reporting. The supervisory board was assisted by an auditor (“Wirtschaftsprüfer”), who addressed his report to the supervisory board. The developments in Italy were quite similar to those in the aforementioned countries. In Italy, the financial supervision was entrusted to the “Collegio Syndacale”, of which the auditor forms part.4 Also in the Netherlands, the origin of the profession of auditor lies at the heart of many misunderstandings about the concept of “supervision on the financial state of affairs” and the concept of “audit of the financial reporting” is not given more attention, as it seems that this difference lies at the heart of many misunderstandings about the role of auditors which in generally referred to as the expectation gap. From the outset, those leading the auditing profession in the Netherlands have been rather Anglo-Saxon oriented. In the development of the profession in the 20th century, this is clearly visible. It is remarkable that certainly in the early days, and in a number of countries, also until today, the aspect of supervision on the financial course of affairs has a more prominent position than the actual auditing of the financial reporting. It is strange that this division between the concept of “supervision on the financial state of affairs” and the concept of “audit of the financial reporting” is not given more attention, as it seems that this difference lies at the heart of many misunderstandings about the role of auditors which in generally referred to as the expectation gap. In all countries, auditors at some stage tried to get their profession legally recognized and protected.5 For instance in the Netherlands it was given official status in 1962. Before that date, there were various competing professional bodies that all had their own rules. In the years after 1962, two professional bodies remained, both of which had powers under public law. On 1 January 2013, these bodies were unified in one professional body for the accounting profession. Until 2006, the professional bodies were responsible for regulation and oversight of the profession, including disciplinary rules and proceedings. When the law was amended in 2006, the oversight was partly entrusted to the Netherlands Authority for the Financial Markets (Autoriteit Financiële Markten (AFM)), whereas the disciplinary proceedings were entrusted to a special division of the Dutch court system. Auditors – perhaps because of their background in economics – were among the first to delegate tasks to assistants and professionals working under their responsibility. This resulted in a more efficient, quicker and cheaper audit. However, a side effect was that over time, the audit process became standardized, lessening the direct involvement of the auditor. A gearing of one partner on ten to fifteen associates is not unusual. The auditing profession has been influenced by globalization as no other profession. It followed the business world, which very quickly internationalized after World War II. The auditing of annual accounts of multinationals required international cooperation, among other reasons, because of the practice of drawing up consolidated accounts that in some jurisdictions already existed prior to World War II. In particular, auditors from the US, the UK and the Netherlands took the lead in this process of international cooperation. In the 1980s, accountants from different countries started cooperating on a large scale, which in the 1990s lead to accountants operating under a joint name and finally in the beginning of this century in large multinational audit firms. The developments on the capital markets, which markets became even more prominent after the fall of the

5. Already in 1900 the professional organisations offered the government a draft of a law regarding the legal recognition of the profession (see Frielink 1974).
commercial regimes in the late 1980s, and which markets were largely governed by Anglo-Saxon customs and rules, were an important impetus for internationalization. Against this background, it is only logical that the focal point of this development lays in the end with the firms in the US. It is safe to say that all “Big Four” audit firms are currently de facto dominated by the US. Because these firms wished to offer their services as a “worldwide quality product”, the audit approach of the various countries in which they operated was to be aligned. Understandably, this became in larger part an American audit approach. The internationalization and corresponding increase in size of audit firms also brought a development, which occurred in other professions at a later stage as well. Because of the scale and the importance of the international network, the opinion of the person who rendered the service became subordinated to opinions about the audit approach and interpretation of accounting rules and regulations, which were centrally determined within the audit firm. Also the fact that processes that had to be audited were becoming more and more automated, which required specific knowledge and the fact that the audit was supported by computers, required a certain scale to be able to invest the necessary amounts in hardware, software and know how. In fact, there occurred a paradigm shift – which has been largely ignored – from the personal profession of auditor to the audit firm offering audits. This also prompted awareness of the entrepreneurial aspects of the operations, whereby the commercial interests of the audit firm played a substantial role. Standardization of the production processes and marketing became important elements of management of such firms. In order to keep a balance between the interests of the organization itself and the public interest, strict internal quality procedures were to be introduced that further repressed the influence of the individual professional. Remuneration systems, even those of partners, were structured in a more entrepreneurial fashion and often modelled according to American examples. It cannot be ruled out that these remuneration systems together with an increased entrepreneurial culture may carry certain perverse incentives. From the late sixties onwards against the background of the goal of creating a European internal market, amongst other directives, the company law directives saw the light. From the early days onwards, attention was given to harmonization of the accounting rules and the regulation of the issue and publication of annual accounts and of the audit of these accounts. Also the requirements that an auditor must meet were laid down, more particular in the eight company lay directive. This directive was replaced by the Directive on Statutory Audits of Annual Accounts and Consolidated Accounts in 2006. In the latter directive, more emphasis was put on the position of the organization that actually employed the statutory auditors: the audit firm. The directive contains not only more comprehensive rules regarding access to the profession, professional competence, permanent education and mutual recognition than before, but also contains rules regarding independence and objectivity, use of international accounting standards, the responsibility for the audit of consolidated accounts, quality-assurance systems, effective systems of investigations and penalties to detect, correct and prevent inadequate execution of the statutory audit as well as public oversight. In addition, the directive determines that public-interest entities (PIE) require an audit committee and that the auditor has to draw up a transparency report. Furthermore, in case of a public-interest entity, the key audit partner has to rotate every seven years. All these rules need to be implemented in the laws of the Member States. The Netherlands has for instance, incorporated most of the directive in the Audit Firms Supervision Act (Wet toezicht accountantsorganisaties) and Auditors Disciplinary Law Act (Wet tucht spreuk accountants), in which acts the Dutch government in some cases has felt it necessary to get ahead of the EC directives. Legislative initiatives relating to the accountancy profession have substantially increased over the last decade, not only because of the reasons mentioned above, but also because of some notorious accounting scandals and frauds surrounding the profession, most notably the Enron scandal. In said scandal, the role of the accounting firm Arthur Andersen was one of the key issues, which was regarded of almost similar importance as the fraud committed by the managers. Since this scandal almost all other scandals and crises have had a major negative impact on the audit profession. Even in those cases where the courts have in the end decided that there had not been any false or even incorrect accounting, the picture of an accounting fraud to which the auditors were complicit remains in the public mind as the Ahold case has painfully demonstrated.

Apparently, the accountancy profession is unable to communicate in a satisfactory manner with the users of its services and also seems to serve their needs inadequately. Already in the 1990s accountants discussed amongst themselves the so-called expectation gap. Obviously, accountants at that stage already were aware that their customers draw other conclusions from their activities than the auditors themselves deemed justified on the basis of these activities. However, accountants have neither in the discussion in the 1990s, nor afterwards drawn the obvious conclusion that the users of their services not merely desire a test of the accounts on the basis of the expected quality, but also demand a test that is independent of the parties involved. The question of independence is particularly important in view of the nature of the services provided and the purpose of the statutory audit. It is not to be expected that a firm of auditors will freely and voluntarily offer an opinion that does not correspond with the expectations of management. It is a fundamental requirement that the independence of the auditing firm is given by law. The Directive on Statutory Audits of Annual Accounts and Consolidated Accounts requires that an audit firm shall be independent, with regard to (both past and present) clients and their interests. The aim is to ensure that the critical and objective role of the auditor is not compromised by conflicts of interest or a lack of independence. The Directive introduces a number of measures to ensure independence, including the prohibition of certain services that could impair the auditor’s objectivity, the establishment of a minimum distance between the audit firm and its clients, and the prohibition of direct and indirect financial interests in the client.


8. In the Ahold case the Criminal Division of the Court of Appeal ruled that in view of the circumstances, the consolidation of the 50% – subsidiaries was not a violation of the law.
the basis of drawn up accounting standards and regulations, be it on a global level or otherwise, but in fact desire supervision as it was performed by the supervisory director in charge of supervising the issuing of the annual accounts (balanscommissaris) in the early days of the profession. The reaction in the business community, in any event in the United States, which has a one tier board system, was the introduction of an audit committee, which more or less functions as the aforementioned balanscommissaris and to which the auditor reports. From this perspective, it is not unlikely that in the future the tasks of the audit committee will compete or concur with those of the auditor. In recent years, many legislators tried to make the position of the auditor more independent, e.g., by forbidding certain consultancy services. This resulted in audit firms divesting their consultancy services, which were often focused on IT. Currently other services are criticized (in particular administrative and financial services).

In a two-tier company structure, the task of supervision that company law in such systems vests in the supervisory board or similar corporate body generally entails both the actual supervision of management as well as advising management. In other words, advice is regarded as complementary to or even an element of supervision. A strict prohibition on advice by auditors accordingly seems at odds with the audit task as being a part of the supervisory structure.

3. An Example of the Limited Regulations until the Turn of the Century: The Dutch Audit Regulations before 2000

Until the institutionalization of the audit profession in 1962, the regulations of regarding the profession were limited. The only rules applicable were a code of conduct. When the Act on (Registered) Auditors (Wet op de registeraccountants) was enacted in 1962, the content of this code of conduct was incorporated in a ministerial order.

In 1973, this order was replaced by a regulation of the professional body Nederlands Instituut van Registeraccountants (NIVRA) concerning professional conduct and ethics for auditors (Verordening Gedrags- en Beroepsregels Registeraccountants (GBR)). This regulation has remained in place, save some minor changes, until the introduction of the new Regulation Code of Ethics for Auditors (Verordening Gedrags Code (VGC)) in 2006, which was structured in a totally different way.

Already in the GBR, a distinction was made between rules applying to every auditor and those for statutory auditors. The rules also addressed the issue of auditors acting in partnerships, both amongst themselves, and with other professions. The elaboration of the rules were initially laid down in soft law of the professional organization, for instance opinions of the board of the professional body, research papers and in so-called “audit alerts”. Somewhat more imperative were the guidelines (Handreikingen). In first instance, official regulations of the professional body on technical matters were limited to the fields of permanent education and quality assurance. In 1996 International Standards on Auditing of the International Federation of Accountants (IFAC) were translated into Directives for the Audit (Richtlijnen voor de Accountantscontrole) and published, at first without including them in an official regulation of the professional body as later happened at the time the VGC was adopted. The audit standards were at that time incorporated in an additional Regulation for the Audit and Other Standards (NV COS).

The institutionalization of the profession was effected by the introduction of the Act on Registered Auditors (Wet op de Registeraccountants/Wet betreffende het accountantswezen) in 1962. This act regulated the way in which the professional body (NIVRA) functioned, the disciplinary proceedings and rules, the registration of the auditors and the auditors exam. In 1992 this Act, was amended substantially based on the Eight Company Law Directive. At the time the Audit Firms Supervision Act (Wet toezicht accountantsorganisaties) and Auditors Disciplinary Law Act (Wet tuchtrechtspraak accountants) were enacted, again substantial amendments have been made, in particular with respect to education, the regulative powers of the professional body and disciplinary proceedings and regulations. The manner in which the professional body itself operated, however, remained unaffected. On 1 January 2013, the existing laws on auditors were repealed and replaced by the new Act on the Audit profession (Wet op het accountantswezen).

During the turn of the last century the regulations regarding the audit profession, the auditors and audit firms thus existed of the Act on the (Registered) Auditors (as well as the Act on the Accounting-Consultants) and a regulation of the professional body concerning professional conduct and ethics for auditors (GBR). In addition, there were some regulations by the professional body NIVRA, which did not yet include any provisions regarding the performance of the audit. Some guidelines as to the way in which the audit should be performed were given in the Directives for the Audit (Richtlijnen Accountantscontrole). Regulations thus merely determined the structure of the audit profession and

9. See, e.g., Dutch Civil Code Book 2, Art. 250-2: “The duties of the supervisory board shall be the supervision of the policy of the management and the general course of affairs of the company and the enterprise connected therewith. It shall assist the management with advice. In the performance of their duties the members of the supervisory board shall be guided by the interest of the company and the enterprise connected therewith.”

the general principles of ethical behaviour. They did not yet include any specific detailed provisions regarding the performance of the audit.

4. Developments in International Audit Regulations

As set out above the internationalization/globalization of the economy and the corresponding increased importance of international capital markets have been important drivers of the developments in the audit profession. The worldwide significance of the financial markets in the United States and United Kingdom, placed auditors in those countries at the forefront of international developments in audit firms as well as in the regulatory bodies. Against that background, it is important to be aware of the different contexts of various jurisdictions.

The United States have a common law system, in which the focus lies on case law rather than comprehensive codes. In very general terms and very summarily stated emphasis is on legal certainty rather than an equitable outcome which is (amongst other things) obtained by drawing up extensive agreements; in that context grammatical interpretation is the prime method of interpretation. Also in this context, in order to acquire more certainty with respect to one’s actions beforehand it is not unusual that a group of people having a shared interest regarding a certain topic (e.g., businesses or professions) that are confronted with the need for regulation draw up rules and regulations within their own community (self-regulation). Accountants have done this with respect to financial reporting issues as well as with respect to issues regarding audit and other services. The profession has formed commissions that have come up with in general rather detailed rules that are constantly supplemented by issues that the profession sees itself confronted with in every day practice. When serious issues occurred that had a broader public interest, they were often dealt with by the legislator, which in such cases often reacted with laws specifically addressing the relevant issue. A good example is the Sarbanes-Oxley Act, which was a direct result of the Enron scandal. The method of enacting rules and regulations in the common law tradition differs from that in the continental European tradition (Civil Law). It could be argued that the form of the laws in an Anglo-Saxon context mirrors judgements drawn up by judges. The motivation, explanation and instruction are all part of the same document; and sometimes no clear distinction is made between the three. With respect to accountancy, one should furthermore be aware that, in particular in the US, important parts of the relevant rules and regulations are addressed to listed companies and their auditors as part of (federal) security laws. Company law is drawn up on a state-by-state basis and plays a far less important role.

In Continental Europe, on the other hand the tradition is that of civil law. In general terms and very summarily stated the law is laid down in (all encompassing) codes, which (theoretically) implies that every citizen can know the law; the judge applies the relevant rules and regulations from the relevant code to the situation presented to him; the orientation is on justice/reasonable outcome in the case at hand rather than legal certainty; the wording of the law exists in briefly formulated instructions; the explanation of the actual rules, as well as the debate on that explanation and the information exchanged in this process, is incorporated in the parliamentary documents and plays as such a supporting role in interpretation issues; there are several methods of interpretation. In Europe the regulation concerning financial reporting and auditing of accounts is often drawn up by governmental bodies, which give rules on broad lines in which general principles are specified to some extent, but not on a very detailed level. An interesting exception on the civil law tradition in the Netherlands is the private elaboration of the reporting rules from the Dutch Civil Code by the Dutch Counsel on Annual Reporting (Raad voor de Jaarverslaggeving) in its directives (Richtlijnen voor de Jaarverslaggeving). Here a more Anglo-Saxon approach (i.e., private regulation by communities that have an interest in the matter) was chosen in addition to the continental approach. In the European context the harmonization of the reporting rules as well as audit rules and rules regarding oversight were in first instance harmonized via company law, using the European Company Law Directives as an instrument. It was only after the swift extension of the capital markets in the 1990s that a European harmonization of security law became an issue, e.g., via the Transparency Directive. Also in this respect, the European context differs from the Anglo-Saxon context.

Given the importance of the financial markets in the US and the UK and also in view of the fact that the organizations within these countries were taking most initiatives in the field of accountancy and were structuring the audit services on offer, it is only logical that the audit services became largely Anglo-Saxon in form. In general, the auditors themselves rather than the legislator initially took to drawing up regulations. After initially formulating a number of standards on specific topics, the approach became that a conceptual framework was set up and subsequently instructions were developed that aimed to answer as many questions as possible that came up in the accounting and auditing practice. One of the particular aspects of this approach is that it focuses on threats of the fundamental principles and the safeguards that are to compensate these threats. This approach has resulted in bodies of rules on how to carry out audits and of reporting rules that often encompass

many hundreds if not thousands of pages.14 The forms in which these rules are formulated are clearly Anglo-Saxon in nature. The principles and its explanation are explicitly put together, whereby in the process attempts have been made to accentuate the difference by printing the principles in bold and its explanation in normal font. Because the European legal systems often are open systems, in the sense that many rules are directory rather than mandatory in nature, rules from other jurisdictions can in general be quite easily imported in this system. The following example may demonstrate this. If in the Netherlands, which has such open system, for example, an auditor accepts the engagement as referred to in Article 2:393 of the Dutch Civil Code to audit the accounts, Book 7, Section 7 of the Dutch Civil Code, called “Assignment” applies to this engagement and arranges for the gaps, i.e., defines the relation between parties regarding the issues that parties have not explicitly made arrangements for. As a result, if there is agreement on the price of the service, the rest of the arrangements follows in principle from said part of the Dutch Civil Code. In the US, however, it is necessary to define and lay down the content and scope of the engagement with every new assignment. The American audit practice has accordingly developed the custom to draw up an engagement letter for every new assignment. The advantage of this approach is that every detail of the agreement between the party giving the assignment and the auditor is made explicit and laid down. Within the American profession, this practice has become a standard. In the international context the American auditors instructed their European (and other) colleagues to do the same presumably in order to create certainty as to the agreement made and/or in order not to have to study the various local laws. The continental European legislation does not preclude this practice, as long as the content of the engagement letter does not conflict with rules of a mandatory nature. In the standards of the IFAC this practice of the engagement letter was made the standard, later on these IFAC standards were included in the Dutch auditors’ Code of Ethics – thus introducing as it were a specification of Dutch directory law. Another example of the above phenomenon is the letter of representation (LOR). Until the Sarbanes Oxley Act, apparently it was not customary for the management board of a US company to sign the consolidated balance sheet. The Sarbanes Oxley Act introduced the obligation for both the Chief Executive Officer and the Chief Financial Officer to sign these accounts. Against the background that these officers do, or in any event did, not sign these accounts it is not illogical that the auditor explicitly requested that the management board members represent the completeness of the information provided to the auditors as well as that they have disclosed all relevant facts to the auditor. It was this practice that evolved into the LOR. In most European jurisdictions, however, management board members have to sign the accounts, thus in any event implicitly stating their agreement with the accounts and representing that the accounts include all relevant information. A separate declaration of the management board is thus, strictly speaking, not required. Nevertheless, the Anglo-Saxon auditors again instructed their European colleague to also demand a LOR from management of the company. Among other things because a LOR always confirms the completeness of the disclosed information, auditors felt that more comfort was acquired by having a LOR in their files and took on this Anglo-Saxon custom.

An important part, due to the strong international focus of the audit profession, international technical collaboration was organized at an early stage. The most important organization that resulted from this collaboration is the IFAC, which was founded in 1977 in Munich on the 11th World Convention of Accountants. IFAC was founded with the aim to strengthen the accountancy profession by:

• developing high-quality international standards in auditing and assurance, public sector accounting, ethics, and education for professional accountants and supporting their adoption and use;
• facilitating collaboration and cooperation among its member bodies;
• collaborating and cooperating with other international organizations; and
• serving as the international spokesperson for the accountancy profession.

Initially the organization existed of 63 founding members from 63 countries. Today the organization exists of 173 members from 129 countries. The IFAC took among other things, the initiative to set up an International Accounting Standards Committee (IASC), the predecessor of the standard setter in the field of financial reporting the International Accounting Standards Board (IASB). The IFAC operated by means of relatively independent committees that have in the meantime been transformed into independently operating boards. Some of the boards that are important for the regulations for accountants are:

• International Ethics Standards Board for Accountants (IESBA) (previously Ethics Committee);
• International Auditing and Assurance Standards Board (IAASB) (previously International Auditing Practices Committee).

The IESBA/IFAC has formulated a Code of Ethics to which the members of the IFAC are bound. The code and its scope are described as follows:

The IESBA develops and issues in the public-interest high-quality ethical standards and other pronouncements for professional accountants for use around the world. The IESBA Code of Ethics for Professional Accountants applies to all professional accountants, whether in public practice, in business, education, or

14. For instance see International Reporting Standards (IFRS) reporting rules with guidance as issued by the International Accounting Standard Committee, which cover more than 2,000 pages and International Standards on Auditing issued by International Federation of Accountants/International Auditing and Assurance Standards Board (IFAC/IAAS), which cover over 1,500 pages.
the public sector. The IESBA Code serves as the foundation for codes of ethics developed and enforced by members of the IFAC. No member body of IFAC or firm issuing reports in accordance with International Auditing and Assurance Standards is allowed to apply less stringent standards than those stated in the IESBA Code.

Also the IAASB has developed standards, the so-called International Standards on Auditing (ISA’s). The way in which these rules are subsequently incorporated in the legal systems of the states in which members of IFAC are active differs and sometimes poses interesting legal questions. In the Netherlands, for instance, the professional body of auditors (at that time the NIVRA), has taken the standpoint that their organization as member of IFAC was on the basis of their membership-agreement obliged to impose the standards on their members. This raises the question, which has never been answered, whether a body under public law is entitled to enter into agreements with other (foreign) organizations, regarding the authority to issue regulations that is given to her by the government.

The activities of the IFAC have in the last decennium, for an important part, been dominated by criticism on the audit profession caused by the accounting scandals. These scandals related predominantly to listed companies, which occurred for an important part in the Anglo-Saxon sphere of influence. The reaction has also been Anglo-Saxon: drawing up of more (detailed) regulations and the extension of supervision on compliance with these rules.

In reaction to the accounting scandals, the professional associations of auditors in various countries started strengthening the internal oversight of the audit firms, among other things by drawing up new rules that aimed to secure quality within the audit firms and by supervising compliance with these rules. Nevertheless, governments in many countries felt a need to place the oversight of the profession with institutions outside the profession, in most cases government agents. In the US, a “non-profit company”, the Public Company Accounting Oversight Board (PCAOB) was introduced when the Sarbanes Oxley Act was passed in 2002. The PCAOB’s task is to oversee the audit of listed companies in order to safeguard the interests of the investors and the public in general in the preparation of fair, independent and informative audit reports. The members of the PCAOB are appointed by the SEC. the PCAOB registers the audit firms that are allowed to audit public companies and is authorized to give standards and to take enforcement measures. Non-US audit firms that furnish, prepare or play a substantial role in preparing an audit report for any issuer also are subject to PCAOB rules. Also in the UK, a separate oversight body was created. In 2004, the Professional Oversight Board for Accountancy (POBA) was formed to resort under the Financial Reporting Council (the organization entrusted with oversight of the financial reporting of listed companies). The POBA was in turn equipped with the Audit Inspection Unit (AIU), in order to allow it to perform effective oversight. In 2006 because of legislation based on European regulations (see below), the oversight got a statutory basis and the board’s name was changes into “Professional Oversight Board” (POB).

Similar developments are visible in other countries, in important part due to the fact that European regulations so require. Reports of het different oversight bodies indicate that, in particular, those bodies from countries with an Anglo-Saxon orientation (including the Netherlands) have relatively frequent contact amongst each other and tend to coordinate their approach to some extent. To what extent differences in legislation and legal culture are taken into account, is not yet clear due to the fact that the oversight is relatively new and the reporting of the oversight bodies is very limited and not very detailed. Accordingly, the approach seems rather Anglo-Saxon, which implies that certain methods of supervision are chosen on the pragmatic merits rather than on principal legal ones. As a result of this apparent pragmatism for instance the legal principle that the setting/issuing of rules, the supervision on compliance and the authority to penalize non-compliance should not be vested in one and the same agency, seems not always given due consideration.

5. Developments in European Regulations of the Last Decade

The accounting scandals have also resulted in a call for stricter rules on auditing of annual accounts on a European level, resulting in the development and enactment of a number of new EC directives in a relatively short period. These rules have been drawn up with hardly any preceding studies into the causes of these scandals and, in important part, merely following the American example. They were enacted around 2006.

When in 2008 the credit crisis presented itself, politicians reacted with yet stricter requirements for the supervision of listed companies in general and financial institutions in particular. In that context, the auditors were again made a subject of the legislation process as audit forms an important part of the supervision of listed companies. European Commissioner Barnier has in 2011, after publishing a Green Paper on the subject matter in 2010, presented a draft directive concerning the audit of financial reporting of listed companies, which is currently being discussed with the Member States and the European Parliament. This draft directive includes very far-reaching provisions, which seem rather based on the opinion of the larger public with respect to the audit profession than on scientific study.
The manner in which accounting and audit regulations developed on European level is not very transparent. In addition to the representatives of the Member States and the committees of the European Parliament, a great number of public interest and other groups are actively influencing the legislation process. An important player is without doubt, the Fédération des Experts-comptables Européens (FEE), which represents the joint European audit profession and tries to add to the quality of the regulations from a technical perspective. There are, however, also many other groups trying to influence the legislative process, of which the technical expertise and/or the interests represented are less clear.

Another important player is the European Group of Auditors’ Oversight Bodies (EGAOB). This group was created on the basis of a decision of the European Commission of 14 December 2005 to promote the cooperation between the oversight bodies and to advise the Commission on oversight. From the publicly available information, it is unclear which people are representing the oversight bodies as well as how these people determine their position on relevant issues. If one reviews the publicly available minutes of the meetings, it is evident that the group does not limit itself to questions relating to the oversight as such, but that they also deal with and decide upon issues concerning substantive accounting and audit matters, whereas it is explicitly provided that the representatives in the group may not be accountants/auditors. It is therefore not clear what the legitimacy of the decisions of this group is from a technical or democratic perspective or what influence they have on the Commission. It is clear that the oversight perspective may offer valuable input for legislation. However, the lack of transparency and unclear legitimacy of the modus operandi of the group is incomprehensible.

Around the turn of the century, the European regulations with respect to the audit were provided for in the Eight Company Law Directive. In a Green Paper of the Commission of 1996 (“The role, the position and the autonomy of public-interest entities, business relationships, employment with the audit firm, family and other personal relationships with the audit client, non-audit services for the audit client, the type and basis of and accountability for fees, litigation between audit client and the auditor/ audit firm and the involvement of the same senior personnel on the same account for a long period of time”)[18] the issue of the independency of auditors was addressed. Further to the communication of the Commission of 1998[19] “The Statutory Audit in the European Union: The Way Forward” the EU Committee on auditing was created, that regarded the problem of the independency of external auditors as one of its top priorities. Finally, the communication of the Commission underlines how important the Commission regards that all audit activities in the European Union are performed to the same high standard and that a joint approach of professional ethics would be followed.

It should be noted that the regulations concerning the requirements for auditors were addressed to natural rather than legal persons, although the Eight Company Law Directive does allow for firms of auditors provided they are under majority control of auditors. If one reviews the rules and regulations regarding the audit that have been brought about on a European level since the turn of the century, one detects the following line.

In November 2000, the Commission issued a recommendation[20] concerning the need for quality assurance for the statutory audit. The commissions recommend that the Member States bring all statutory auditors under one form of oversight, be it external oversight or oversight by peers. In the notification, there is already more emphasis on the position of the audit firm. The audit firm’s quality control systems are an important point of attention. Also an important division is made between quality assurance for auditors that audit PIE and other auditors. It is also, so far we can see, the first time the notion of a public-interest entity is used in this context. As PIE quality listed companies, credit institutions, insurance companies, investment firms, undertakings for collective investments in transferable securities (UCITS) and pension funds. The quality control for these PIE’s has to be more frequent and more thorough than for other audits. In addition, the file of the auditor has to be accessible for the authority entrusted with external oversight. At that time, there is not yet a clear definition of this authority, but it is mentioned that a majority of the members of the overview board of the quality-assurance system should be non-practitioners. Furthermore, the Commission recommends a systematic link between negative outcomes of quality reviews and initiating sanctions under the disciplinary system, including the possibility of removal of the statutory auditor from the audit register.

In May 2002, the Commission issued a recommendation regarding statutory auditors’ independence.[21] The recommendation is divided in a Section A with basic principles and essential quality-assurance measures, and a Section B concerning specific circumstances. The latter encompasses rules or rather principles concerning financial interests, business relationships, employment with the audit client, managerial and supervisory roles in audit clients, establishing employment with the audit firm, family and other personal relationships with the audit client, non-audit services for the audit client, the type and basis of and accountability for fees, litigation between audit client and the auditor/ audit firm and the involvement of the same senior personnel on the same account for a long period of time. The Commission recommends incorporating these principles and measures in the legislation for auditors on member state level. The recommendation includes an annex with guidance to the recommendation and various examples.

It is noteworthy that in Paragraph 1.1 of Section A of the recommendation it is mentioned that objectivity and professional integrity are the overriding principles and that these principles must be demonstrated by acting, and being seen to act, independently, while at the same

time concluding in Paragraph 1.2 that “Objectivity (as a state of mind) cannot be subjected to external verification, and integrity cannot be evaluated in advance.” These two statements seem at odds with each other as the one implies that objectivity can be demonstrated by deeds, whereas the other seems to imply it is predominantly a state of mind, which is not verifiable. Whatever the case may be, the recommendation subsequently defines certain aspects concerning independency, whereby the hierarchy that may exist within audit firms is addressed as one of the issues that has an impact on the independency for the first time. Paragraph 3 of the recommendation defines persons that can influence the audit and reads: “all persons, who form part of the Chain of Command […] for the Statutory Audit within the Audit Firm […] or within a Network […] of which the firm is a member”. This is to be understood against the following background. Originally, the cooperation between accountants was organized in partnerships between professionals that stood in a more or less equal relation to each other and sometimes shared personnel. The Anglo-Saxon influence that also prompted a more entrepreneurial approach to the profession, also brought a larger inequality between partners within European firms. Also the different legal forms that were used for operating audit firms added to this inequality. In fact it is in this paragraph of the recommendation that the paradigm shift from individual professional to entrepreneurial performance of the statutory audit that has been mentioned above, is made explicit for the first time in (European) regulations. Finally, it is worth mentioning that with respect to certain measures a division is made between PIE and other audit clients. The Member States were free in the manner in which they wished to implement the recommendations. Most countries have incorporated these issues in the professional/ethical rules for the auditors and, in as far as possible, in the various corporate governance codes that were created over the last decade in various countries. In 2006, partly as a reaction to aforementioned accounting scandals, the Council Directive on the statutory audits of annual accountants and consolidated accounts, generally abbreviated to the “Audit Directive”22 was adopted. In this directive, previous recommendations of the Commission have been incorporated. The directive has substantial influence on the legislation in the Member States regarding activities of auditors and the harmonization thereof. In view of the importance of the directive, the topics of the directive are briefly discussed below:

- Definitions: the statutory audit is referred to as “audit”. Specific attention is given to the audit firm, the audit organization of a third country, the group auditor and the network of which the auditor is part of. This ties in with the current entrepreneurial and internationally oriented way in which the profession is being exercised. The audit firm may have every legal form and can be given the assignment of the statutory audit of the annual accounts. As a statutory auditor must sign the final audit opinion, the directive includes specific provisions with respect to the external responsibilities of the statutory auditor on the one hand and the managers within the audit firm on the other. However, the directive is silent on the internal relations and responsibilities. The directive apparently assumes that the statutory auditor is able to arrange his internal position in such a way that he can carry his own responsibility. Some scepticism as to the correctness of this assumption may be justified in view of the entrepreneurial environment in which auditors operate. Furthermore, the “competent authority” is introduced, which may be one or more authorities or bodies designated by law that are in charge of the regulation and/or oversight of statutory auditors and audit firms or of specific aspects thereof. In the section covering public oversight (below), the division of tasks between different authorities will be addressed. Under definitions, also the public-interest entity is defined.23

- Approval, continuing education and mutual recognition: statutory auditors and audit firms have to obtain approval. Each Member State is to designate competent authorities responsible for approving statutory auditors and audit firms. Such competent authorities may be professional organizations, provided they are subject to a system of public oversight (see below). Auditors are to meet certain requirements regarding theoretical knowledge and practical training. For audit firms an important requirement is that the majority of the voting rights in such entity are to be held by auditors and that the statutory audit activities have to be performed by auditors that have been approved by a member state. The majority of the members of the administrative or management body of the entity must be approved audit firms or auditors. The relevant article of the directive adds after the word “majority” the elucidation “up to a maximum of 75%”. It is unclear to us what the council and parliament have meant here. This seems to imply that at least 25% of the members must be non-auditors. This assumption, however, is merely based on the wording of the provision and is not clarified in the preamble nor is it clear why such should be the case. The directive further indicates quite specifically what theoretical knowledge is required for an auditor. An examination of professional competence must be

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23. “Public-interest entities” means entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of point 14 of Art. 4(1) of Directive 2004/39/EC, credit institutions as defined in point 1 of Art. 1 of Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions (16) and insurance undertakings within the meaning of Art. 2(1) of Directive 91/674/EEC. Member States may also designate other entities as public-interest entities, for instance entities that are of significant public relevance because of the nature of their business, their size or the number of their employees.
passed, which is of university final or equivalent level. However, it is unclear what is meant with university final level. Where the content of theoretical knowledge is concerned, quite some emphasis is placed on knowledge of various fields of law. From a continental European perspective, this is understandable because the audit profession has a tradition with a strong legal component. In countries that are more focused on an Anglo-Saxon approach, including the Netherlands, this is less evident, and one can question whether the level of legal knowledge that the professional education offers meets the requirements of the directive.

- Registration: the statutory auditors and audit firms are to be entered in a (electronic) public register that is kept by a competent authority. This register is not the register of all those persons that have successfully completed their education and practical training, kept by a professional organization, but a register of those authorized to perform statutory audits.
- Professional ethics, independence, objectivity, confidentiality and professional secrecy: in this paragraph, the principles of the previous recommendation are incorporated. Furthermore, the directive determines explicitly that the auditor is to document threats to the basic ethical principles as well as the safeguards that have been taken to mitigate these threats. The Commission is given authority to adopt further implementing measures. Although it is understandable that there is a desire to be able to test compliance with aforementioned basic principles, there is a clear threat here of red tape. Furthermore, this section of the directive determines that the Member States are to ensure that neither owners/shareholders nor administrative, management or supervisory bodies can intervene in the execution of a statutory audit in a way which jeopardizes the independence and objectivity of the statutory auditor who carries out the statutory audit on behalf of the audit firm. How this should be arranged is not clarified. The internal hierarchy and other relations are not given any substantial attention in the directive. On the one hand the directive gives the administrative, management and supervisory bodies the responsibility for the quality-assurance systems and the right attitude within the audit firm and indicates that the reputation of the audit firm is related to its statutory audits, whereas on the other hand they are not allowed to monitor the execution of such audits too closely. In reality, managers of audit firms are not only held responsible for the quality of the operations but also for the operational results of their firm and will take that responsibility into account in controlling the audit operations. Furthermore, audit firms in practice also formulate their firm’s joint standpoint as to the interpretation of certain audit and accounting regulations, which limits the room for individual judgement for the individual statutory auditor. Finally, it would be naïve to assume that management would not have indirect manners of influence at its disposal that are much more powerful than those whereby the audits are influenced directly. They can, for instance, take away or withhold (prestigious) accounts from partners that are lower in the hierarchy, assign less desired tasks to them, provide them with perks, or influence their income or circumstances in which they work in a negative way. Some clarification on how to achieve this objective would therefore be desirable.
- Auditing standards and audit reporting: the Commission is given the authority to decide to adopt international audit standards for (binding) application, whereby the Member States are given some room for deviation. ISA and IAASB (IFAC) (see above) are, for instance, regarded as such international audit standards. In addition, the directive determines that the group auditor is fully responsible for the audit report in relation with the consolidated accounts.
- Quality assurance: the directive determines that all statutory auditors and audit firms have to be subject to a system of quality assurance, which, inter alia, shall be organized in such a manner that it is independent of the reviewed statutory auditors and audit firms and subject to public oversight.
- System of investigations and penalties: this part of the directive announces, among other things, that before 1 January 2007 the Commission shall present a report on the impact of the current national liability rules for the carrying out of statutory audits on European capital markets and on the insurance conditions for statutory auditors and audit firms, including an objective analysis of the limitations of financial liability. After a public consultation that showed that a problematic situation exists as the systems of liability differ widely as well as the opinions regarding the desirability of certain liability limitations, the European Commission has made a recommendation to the Member States concerning limitation of the liability of the statutory auditor and audit firms. In many countries this recommendation has not been given any follow-up.
- Public oversight and regulatory arrangements: the directive prescribes among other things that every Member State shall organize an effective system of public oversight for statutory auditors and audit firms, to which all statutory auditors and audit firms shall be subject. Non-practitioners who are knowledgeable in the areas relevant to statutory audit shall govern the system of public oversight. The system of public oversight shall have the ultimate responsibility for the oversight of the approval and registration of statutory auditors and audit firms, the adoption of standards on professional ethics, internal quality control of audit firms and auditing, continuing education, quality assurance and investigative and disciplinary systems. A form in which such public oversight system can be organized is government approval of regulations of the professional body on the above-mentioned topics. Because substantial differences could and did exist as a result of the principles of external quality assurance for public-interest compa-
cies as laid down in the directive, the Commission made a recommendation regarding external quality assurance.24

- Appointment and dismissal: the directive determines that the statutory auditor or audit firm is to be appointed by the general meeting of shareholders of the audited entity. This provision implies that a choice can be made between appointment of a natural person or legal entity. Member States may allow alternative systems or modalities for the appointment of the statutory auditor or audit firm, provided that those systems or modalities are designed to ensure the independence of the statutory auditor or audit firm from the executive members of the administrative body or from the managerial body of the audited entity. Auditors or audit firms can only be dismissed on the basis of proper grounds and the authority or authorities responsible for public oversight are to be informed of such dismissal or of the resignation of the statutory auditor or audit firm.

- Special provisions for the statutory audits of PIE: for the public-interest companies a number of additional provisions are incorporated in the directive such as the obligation to have an audit committee in order to safeguard the communication between the audited entity and the auditor. The directive contains specific provisions further detailing this relationship. Furthermore the directive determines that the key audit partner(s) responsible for carrying out a statutory audit rotate(s) from the audit engagement within a maximum period of seven years from the date of appointment and is/are allowed to participate in the audit of the audited entity again only after a period of at least two years. This provision does not imply that another statutory auditor of the same audit firm may not succeed such key audit partner.

- International aspects: this chapter of the directive arranges the approval of auditors from third-countries. The Commission has by decisions in 2010 and 201125 recognized the authorities of a number of third-countries as authority that authorities can cooperate with on the basis of the adequacy of their external quality-assurance system and public oversight.

Notwithstanding this extensive operation to create (detailed) regulations regarding the statutory audit of the annual accounts of companies, the credit crisis of 2008 prompted politicians to draw up even stricter requirements for the audit profession. The European Commissioner Barnier published a Green Paper in 2010,26 after which a consultation was held. On the basis of the Green Paper and the outcome of the consultation a proposal for a new Directive27 and a new Regulation28 have been created and are currently being discussed. The reactions to the proposal for the Directive are diverse.

The most important point on which the proposal for the Directive intervenes in legislation developed prior to 2011 is that the provisions regarding the statutory audit of the annual accounts of PIE are transferred from the Directive to the Regulation. The concept of the public-interest entity is extended to payment institutions, electronic money institutions, investment firms as defined in Directive 2004/39/EC, alternative investment funds, undertakings for collective investment in transferable securities and central security depositories and central counterparties. In addition, the proposed Directive determines that voluntary audits are to be performed on the same basis as statutory audits, while at the same time determining that the size of the undertaking may affect the audit approach. This is of importance as the European Commission considers abolishing the mandatory audit for certain small undertakings. Another change is that the proposed directive no longer stipulates that a majority of the capital or the voting rights in an audit firm is held by statutory auditors or audit firms, although the requirement of the majority of the board existing of licensed audit practitioners remains. Also the possibilities of cross-border services are extended. Finally, the possibility of public oversight is further defined in such a way that the competent authority responsible for public oversight is given more powers and fewer topics are delegated to the professional bodies.

A particular important issue in the proposal for the Regulation that is to arrange the statutory audit of PIE’s is the fact that the requirements to ensure the independence of the statutory auditor and audit firm are much stricter compared with the rules that were already included in the 2006 Directive. The proposed Regulation stipulates that former auditors, key audit partners or their employees are not allowed to take up a key management position in the audited entity, to become a member of the audit committee of the audited entity, to become a non-executive member of the administrative body or to join the supervisory body of the audited entity within two years after the termination of the audit engagement.

In addition, the fees for the provision of related financial audit services to the audited entity should be limited to 10% of the audit fees paid by that entity. Where the total fees, audit and related financial audit services, received by an auditor from a PIE reach a significant

percentage of his/her/its total annual fees, appropriate safeguards should be applied. The statutory auditor, audit firm or member of the audit firm’s network will be prevented from providing certain non-audit services, which are fundamentally incompatible with the independent public-interest function of audit to their audit-entities. For certain other non-audit services, the audit committee or the competent authority will be empowered to assess whether or not they may be provided to the audited entity.

The Commission is empowered to adapt lists of authorized services and of prohibited services. The proposal for the Regulation mentions the following services as prohibited services: expert services unrelated to the audit, tax consultancy, general management and other advisory services; bookkeeping and preparing accounting records and financial statements; designing and implementing internal control or risk management procedures related to the preparation and/or control of financing information included in the financial statements and advice on risk; valuation services, providing fairness opinions or contribution-in-kind reports; actuarial and legal services, including the resolution of litigation; designing and implementing financial information technology systems for PIE as referred to in Article 2(13)(b) to (j) of Directive 2006/43/EC; participating in the audit client’s internal audit and the provision of services related to the internal audit function; broker or dealer, investment adviser, or investment banking services. We note that there is a remarkable difference between the Dutch version of the proposal for the Directive and the English (and German) version. The former includes under point (viii) in addition to the broker, dealer, investment adviser and investment banking services also the service existing in acting for the audit client in legal disputes. This service is not included in, e.g., the English or German version.

In addition to these services that are forbidden because they are qualified as entailing a conflict of interest in all cases, the proposal for the Regulation also indicates services which 

may entail a conflict of interest: human resources services, including recruiting senior management; providing comfort letters for investors in the context of the issuance of an undertaking’s securities; designing and implementing financial information technology systems for PIE as referred to in Article 2(13)(a) of Directive 2006/43/EC; due diligence services to the vendor or the buy side on potential mergers and acquisitions and providing assurance on the audited entity to other parties at a financial or corporate transaction. The statutory auditor or the audit firm may only provide such services, subject to prior approval by the competent authority or the audit committee.

Furthermore, the appointment of the auditor is to be effected on recommendation of the audit committee, whereby the requirements set for the audit committee are tightened. The appointment of a statutory auditor and the audit firm is for a period of a minimum of two and a maximum of five years, which may be repeated once. After such period, another audit firm is to be appointed and the audit firm having been engaged the previous years is not to be engaged again for a period of four years.

The larger part of the reactions to the proposals of the Commission have been negative, a recurring element of criticism being that a scientific underpinning of the proposed measures is lacking. Existing scientific studies seem to imply the opposite, for example with respect to the forced change of audit firm. Studies show that particularly in case of changes the chance that audit failures remain undiscovered is substantial.

6. The Recent Changes in Dutch Legislation: An Example

European regulations, but also the consequences that local politicians attach to the role of the auditor in the recent crises, have a major impact on the legislation regarding the audit profession. The Dutch example demonstrates that the developments on a European level and local level sometimes conflict, which can lead to unexpected consequences. Below we will give an outline of the recent changes of Dutch legislation regarding the audit profession.

As mentioned above, as elsewhere in Europe, until the turn of the century there were no major developments in the Netherlands. In the 1990s, there was the recurring discussion about the “expectation gap”. Furthermore, the internationalization/globalization lead to a rather rash introduction in the Netherlands of the “Code of Ethics” and international control standards as issued by various IFAC bodies. Although these developments signified a first movement from the focus on the individual professional to the organization in which he performs his activities, standard setting remained focused on the individual professional and stayed the prerogative of the profession.

As a result of the public outrage regarding the reporting frauds around the turn of the century, politicians also in view of the spirit of that time, felt the urge to get involved in regulations concerning the audit profession; there was a desire, partly inspired by the American and European discussion, for public oversight on audit firms and on individual auditors involved in statutory audits. On 1 October 2006, the Netherlands enacted legislation that went ahead of Council Directive 2006/43. This implied that no major changes in the law were required in 2008, when the directive became effective. In line with this discussion, it was also decided to place the disciplinary proceedings for the audit profession outside the profession as well.

30. Explanatory memorandum, p. 3 to the proposal for the Audit Firm Supervision Act (29 658).
In 2006, the Audit Firms (Supervision) Act (Wet toezicht accountantsorganisaties (Wta)) was introduced. Pursuant to that act audit firms performing statutory audits, are placed under supervision of the Dutch Financial Markets Authority (Autoriteit Financiële Markt (AFM)) for such audits. First of all the definition of audit firm used in the Act is of interest: an audit firm is “an organization or institution that performs statutory audits on a commercial basis, or an organization in which such firms are cooperating”. Noteworthy is the fact that the act explicitly refers to the commercial character of the activities. This shift, however, is not given any consideration in the parliamentary discussion.

The legal entity that the act is addressed to is the audit firm as well as the external auditor performing statutory audits. According to the parliamentary documentation, also an auditor practicing on his own can be an audit firm. In the above, it has been argued that there seems to be a paradigm shift from the individual professional to the firm. In the Netherlands, this is underpinned by the fact that in the licensing system the Dutch Financial Market Authority can issue a license only to an audit firm. The audit firm in turn informs the Dutch Financial Market Authority who its external auditors are, i.e., those auditors that may carry responsibility for a statutory audit. The names of these auditors are to be included in a separate register of the Dutch Financial Market Authority.

The act (nor any other regulation) determines who is authorized to propose someone as external auditor. Most likely this is determined by the internal hierarchy/power structure within the audit firms. In addition to requirements set for the audit firm and its officers, the Audit Firm (Supervision) Act also prescribes certain requirements that the individual external auditor must meet.

At odds with the shift from individual auditor to audit firm, is the requirement in the Audit Firm (Supervision) Act that in addition to stating the name of the audit firm, the audit opinion is to be signed by the audit partner involved himself or herself (i.e., with his personal name). In the Netherlands, some audit firms, following their Anglo-Saxon counterparts, have in the past introduced the practice of (merely) stating the audit firms name and also signing with the audit firms name rather than a personal signature. The parliamentary documentation does not give a reason for the aforementioned requirement, which does not fit well with the overall new approach and is also contrary to practice within some of the big firms.

In addition to some (procedural) provisions that grant authority to the AFM to issue licences, to supervise the profession and to enforce compliance, the act also includes (substantive) provisions concerning the audit firm and the individual external auditor. Among other things the act contains provisions regarding the reliability and expertise of the management board/administrative body of the audit firm, the quality assurance by the audit firm, safeguards for independence, including a ban on statutory audits in case accounts were kept or the financial reporting was drawn up by audit firm. In addition, the act determines that the external auditor has to comply with requirements regarding expertise, independence, objectivity and integrity as set by governmental decree. In the governmental Audit firm (Supervision) Decree (Besluit Toezicht Accountantsorganisaties/ Bta) some of these requirements are specified. The decree, e.g., includes requirements regarding the client administration, the content of the audit files, acceptance and continuation of the engagement, the performance of the audit and compliance with the system of quality assurance. Furthermore, the act determines that external auditors are subject to the disciplinary proceedings of the Audit Division (Accountantskamer) of the district court Overijssel (formerly district court Zwolle).

Noteworthy is furthermore that the act obliges the auditor to inform the judicial authorities of a reasonable suspicion of a material fraud, save for certain exemptions that are included in a governmental decree. The decree defines a material fraud as an intentional action or omission, whereby deception is used to obtain unlawful advantage and whereby the nature or extent is such that decisions that are taken in social and economic life on the basis of the financial reporting of the audit client could be influenced by the (wilful) deception. The exemptions are that no notification has to be made in case the audit client directly upon discovery initiates an investigation and timely takes adequate measures to undo/avoid the fraud. Some argue that the legislator has thus in fact created (on the basis of merely a decree) the possibility to use the auditor as an unsalaried investigation officer for the judicial authorities. In view of the discussions in the past surrounding the duty to notify frauds and the discussions in other professions regarding the same topic, it is strange that there has not been any principle discussion on the merits of this obligation. This is even more puzzling as fraud as defined in this context coincides with the criminal offence of balance sheet fraud (balansfraude) and sometimes also forgery, which gives rise to the question how the combination of this notification obligation and the legal requirement of a statutory audit is to be understood in relation to the nemo tenetur principle and the case-law of the European Court of Human Rights on this topic.

With respect to the PIE’s the Audit Firm (Supervision) Act includes some additional requirements. The act, e.g., determines that an external auditor may be responsible for a statutory audit of a PIE for a maximum of seven years. After such time period, he may not perform any statutory audits for the PIE concerned for at least two years. Also with respect to the independency additional requirements are introduced, e.g., the requirement that the auditor may not be involved in the drawing up of the annual accounts in the two years preceding 2006.
the statutory audit. As far as the quality assurance is concerned, the Audit Firm (Supervision) Decree determines, in addition to detailed provisions regarding the subject of the quality assurance, that also a quality inspection especially on the execution of the audit engagement is to be performed and that the audit firm has to make sure that the audit report of the external auditor is not released before the quality inspection has been completed. Also this provision demonstrates that the primary focus is on the audit firm rather than on the individual auditor.

In 2008, the Act on the disciplinary proceedings for auditors (Wet tuchtrechtspraak accountants (Wtra)) was introduced. Until that moment, the disciplinary proceedings and regulations were entrusted to the professional bodies, which had already merged their disciplinary committees in the past. The committees, which resided in Amsterdam and The Hague were composed of two auditors and one member of the judiciary. Appeal of the disciplinary committees could be filed with the Trade and Industry Appeals Tribunal (College van Beroep voor het bedrijfsleven (CBB)) that consist solely of lawyers. The Dutch government was of the opinion that recovery of trust in the audit profession was served when the disciplinary committee would be placed outside the profession and would be composed of a majority of members of the judiciary rather than auditors. To that end the Audit Division (Accountantskamer) of the District Court Overijssel was installed, which was composed of five members of which three were part of the judiciary and two were auditors, although the president, who is a judge, can determine that the court in view of the nature of the case at hand is composed of only three members (two judges and one auditor) or even that he sits alone. Also the decisions of the Audit Division can be appealed before the Trade and Industry Appeals Tribunal.

The aforementioned Accountancy Profession Act (Wet op het accountantsberoep) of 2012 was as such not an act with far-reaching consequences. It provided for the merger of the two professional bodies existing at the time (the NIVRA and the NOVAA) into the new professional body the NBA (Netherlands Professional Organization of Auditors) and updated the legislation that had undergone many changes due to, among other regulations, the Council Directive 2006/43. It also contained provisions acknowledging the existence of various types of auditors such as public auditors, internal auditors, government auditors and auditors in business (the residual group of auditors still being active). The public auditors can be subdivided into those who perform statutory audits and those who do not. The auditors performing statutory audits (the external auditors) can again be divided in those serving PIE’s and those who do not. All these groups must be given due consideration within the professional organization. The act includes provisions that serve that end. In addition, the rules regarding the authority to issue regulations and the oversight of the government on that power are clarified in the act. Finally, the act includes provisions regarding the committee that is to set exit qualifications for auditor, which committee has the authority to determine which minimum standards the education of an auditor should meet in the Netherlands.

However, during the parliamentary debate preceding the enactment of the Accountancy Profession Act certain amendments were proposed by members of the Dutch parliament that went (way) ahead of the discussion on the European level regarding the initiative of European Commissioner Barnier and are therefore worth a brief mention in this article. These amendments that have been adopted and included in the act seem to interfere with the level playing field that the European regulations generally aim for and place the Dutch (branches of international) audit firms at a disadvantage and in some cases even threatens their leading roles.

One of the amendments concerns the Chinese Walls, which were introduced as a result of the discussions concerning the enactment of the Audit Firm (Supervision) Act and that should exist within the Dutch Financial Markets Authority (AFM) between the unit entrusted with supervision of the financial reporting of listed companies on the basis of the Financial Reporting (Supervision) Act (Wet toezicht financiële verslaggeving (Wtfv)) on the one hand and the unit tasked with the oversight of the audit firms on the basis of the Audit Firm (Supervision) Act on (Wet toezicht accountantsorganisaties (Wia)) on the other. As a result of this amendment these Chinese Walls no longer exist. Although there was heavy opposition from the audit and legal profession against disappearance of these walls as they implied that supervision of the audit profession could be used to obtain information on listed companies that the Dutch Financial Markets Authority should strictly speaking not be privy to, the Dutch Financial Markets Authority found an audience with politicians with its claim that these Chinese Walls were in fact hindering there supervisory activities. From an operational and practical perspective this claim is understandable, but the fact that this amendment is made and accepted without having the nemo tenetur principle even being touched upon in the parliamentary discussion raises serious doubt on whether those in favour of this amendment are sufficiently aware of the constitutional issues regarding government supervision and enforcement that are at stake.

A second amendment concerns the rotation of the auditor in case of a PIE. Where the proposal for the Directive provides for a rotation of the responsible individual auditor every seven years, this amendment – which has been adopted and incorporated in the act – introduces a rotation of the audit firm every eight years. Apart from

34. Art. 198 Audit Firm (Supervision) Decree.
35. Art. 21 Audit Firm (Supervision) Decree.
36. In the Financial Reporting (Supervision) Act the Dutch Markets Authority was instructed to use for the supervision public available sources. Further information should be gathered by questioning the reporting entity.
the fact that this is a much stricter regime than the already heavily criticized rotation system as proposed by Barnier, there is no evidence that this rotation will have a positive effect on audits. It is not unthinkable that rather the opposite may be the case: enormous costs are involved in the tender proceedings and the change of auditor has a huge practical and operational impact, whereby failure to discover material failures may well increase, if for nothing else for the fact that a new auditor will have to acquaint himself with the organization from scratch alone.

A third amendment concerns the ban for statutory auditors to perform other services for audit clients that are PIE’s.37 The amendment proposed an absolute ban on any kind of other services. As a result of the adoption of this amendment, the provisions in the Dutch act are now also on this topic (much) stricter than the corresponding provisions in the proposal for the Directive that is still the subject of discussion.

7. Some Critical Observations with Respect to the Developments Set Out Above

The above shows that where the auditor was in the past involved in the oversight of financial administration, e.g., as balanscommissaris or commissaire aux comptes, he has allowed regulators to reduce him to someone merely tasked with audit or verification of the annual accounts. Sometimes advise was provided on the basis of the audit, but in many cases by others than the auditor within the audit firm as such advice increasingly required specialized knowledge. Surprisingly, in the discussion about the expectation gap, this issue is hardly ever touched upon. However, if one reads press publications the expectation with investors, representatives of investors and the public in general seems to be that auditors not merely investigate whether the accounting and reporting rules are complied with, but also notify facts or circumstances that may lead to financial risks.

That there is a need for this oversight is demonstrated by the fact that the concept of the audit committee that was developed in the context of US corporate law, was so successful internationally. In fact this audit committee that generally includes a number of non-executive directors, the auditor and the Chief Financial Officer is the “balanscommissaris” or “commissaire aux comptes”, mentioned in the beginning of this article in an institutionalized form. It is curious, though, that this model of the audit committee was also introduced in countries that had a two-tier system, as in those countries there was already a corporate body entrusted with the specific task of oversight: the supervisory board. In those countries, strengthening the financial oversight could simply have been accomplished by adding the auditor as member of the supervisory board.

Another observation worth making at the end of this article is that in particular with small and medium sized companies, the auditor is often the only third person that looks over the shoulder of the entrepreneur and thus operates as a kind of “balanscommissaris” or “commissaire aux comptes” for the entrepreneur and third parties. His value for such small and medium sized companies therefore lays less in the performance of the (statutory) audit than in his or her supervisory and advisory activities. This is a fact that is neither on the European nor on the local level getting sufficient attention.

It is unrealistic to assume that the entrepreneurial approach of the audit profession could be reversed, if necessary or desirable at all. This being the case, however, it is curious that in view of the developments set out in the above, the paradigm shift, the shift in focus from the individual auditor to the audit firm has been given so little explicit attention. It is true that in the meantime regulations for audit firms have been drawn up in addition to those already existing for individual auditors, but in these regulations the important aspect of the way in which internal relations should be organized remains unclear, whereas it is on this level where important preconditions for the performance of an independent and objective audit of the required quality are to be set.

The (overload) of new regulations that auditors and audit firms have been confronted with in the last decade is partly the result of incidents caused by the profession itself, partly the result of the (inadequate) reaction of politicians in their wish to safeguard the public interest against the backdrop of the increasing entrepreneurial spirit that has occurred with the globalization of the audit market. We are of the opinion, however, that more legislation, more regulation and more rules will not solve the (perceived) problems, but rather increase a “thick the box” culture.

We think that more effective results can be reached if the audit profession and the legal profession jointly discuss the structure of corporate governance of companies and the role of auditors, audit committees, supervisory boards and other entities involved with the company in a more comprehensive way. The incidents and crises of the last decade justify a profound analysis in an international context of these structures and of the role of the auditor and its firm in this structure, whereby the differences in legal systems and legal cultures should be part of the search for causes and remedies. Such overall approach on an international level, which will also require extensive comparative study, will add valuable insights that may in the end help to restore trust in auditors and financial statements much better than adding ever more rules and regulations.

The fact that it recently became evident from the discussions within the European Council that Member States differ widely on some of the main subjects elaborated above, such as rotation of audit firms, the list of incompatible activities and the organisation of the over-

37. Art. 8b of the Accountancy Profession Act.
sight on the professions, also underlines the need for a much more profound and comprehensive analysis of the (historical) causes of the different approaches to the profession and to the rules and regulations surrounding auditors in the different jurisdictions.\(^{38}\)

**Bibliography**


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\(^{38}\) See press release on Meeting of Competitiveness Council of the European Union 29 May 2013.