

Vulnerabilities in the structure of the audit sector

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The Dutch Authority for the Financial Markets

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As an independent market conduct authority, we contribute to a sustainable financial system and prosperity in the Netherlands.

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1. Introduction

Reliable reporting that includes an independent and objective opinion from the auditor is a crucial precondition for a properly functioning financial system. The statutory audit is the procedure where assurance to the public is provided regarding the reliability of the information provided by companies in their financial reporting, prepared in accordance with generally accepted reporting standards (Knechel 2001). Auditors are independent professionals that provide an expert, objective and independent opinion regarding the reliability of this information. They accordingly primarily serve a broad public function as the trusted representative of the public interest, and they fulfil a bridging function between the providers and the users of information.

The statutory audit is de facto a 'public good' and the public interest of high-quality statutory audits should always be the central priority. Audit firms and auditors must therefore provide adequate counterweight against any incentives to put the interests of the audit client first.¹ In their statutory audit, the auditor has to establish whether the reporting presents a true and fair view of the financial performance and position of the company. This true and fair view is important to the public, because it means that members of the public can make well-founded decisions on the basis of this reporting.

This public service role of the sector has come under pressure, which has led to a loss of trust in the profession. Accounting scandals have come to light in which Dutch audit firms were also involved. To achieve a justified restoration of confidence, the legislature has set high requirements for the audit firms and established the AFM's supervision of audit firms.

The audit firms have taken necessary steps in recent years. The report "In the Public Interest: Measures to improve the quality and independence of audits" from the NBA's Future of the Accountancy Profession working group put forward 53 measures in this respect. These include measures designed to change behaviour and culture, strengthening the governance of audit firms and the remuneration model, as well as improving controlled business operations and quality control and monitoring systems

¹ Reference here to 'auditors' is to *statutory auditors* in a Dutch context: the natural persons working for or affiliated to an audit firm or audit office who are responsible for the performance of statutory audits (Section 1 (1) (f) Wta).

(NBA, 2014). In addition, there have recently been statutory reforms designed to strengthen, among other things, governance at audit firms.

Based on its most recent findings, the AFM concludes that the improvement programme at the PIE audit firms is progressing too slowly and that the quality of the inspected statutory audits at the Big 4 audit firms is not satisfactory. The speed of change does however vary from firm to firm (AFM, 2017).² These findings are compatible with the conclusions of the International Forum of Independent Audit Regulators (IFIAR), which found that internationally, the percentage of audits reviewed with significant findings is unacceptably high (IFIAR, 2018). Following this, the Minister of Finance stated that he shares the conclusion of the AFM that the implementation of changes designed to bring about a change of culture and a permanent improvement in audit quality at audit firms is proceeding too slowly (Ministry of Finance, 2017). The Monitoring Commission Accountancy (MCA) also stated that the increase in quality is taking too long to materialise (MCA, 2016 and 2018). More recent accounting scandals in South Africa and the United Kingdom have put further pressure on the trust in the sector.³

Against this background, the AFM has studied potential causes of poor quality audits incorporated in the structure of the sector or the audit firms on the basis of the economic theory of market failure. Achieving lasting changes in a market that is characterised by market failure is difficult and could put pressure on the effectiveness of supervision. Structure here refers to the market organisation of the sector and the legal, operational and commercial structure of audit firms. If market failure occurs, the operation of the market leads to undesirable outcomes for the prosperity of society as a whole (SER, 2010; Den Hertog, 2010). In the context of the audit sector, this means that if market failure in the sector occurs, the quality of statutory audits can fall below the level that is socially desirable because the statutory auditor and the audit firm have not adequately focused on the public interest.

There are other factors influencing the quality of statutory audits in addition to the structure of the sector, and this means that the analysis in this report is only

² PIE audit firms are audit firms licensed to perform statutory audits of Public Interest Entities (PIEs). PIEs are listed legal entities, banks, insurers and reinsurers. In 2015, the Minister of Finance at the time announced that he was proposing to designate network managers, large pension funds, large scientific policy institutions and most housing associations as PIEs. This regulation is currently under preparation. The PIE audit firms in the Netherlands are the 'Big 4' (Deloitte, EY, KPMG and PwC), and the 'Next 5' (Accon, BDO, BTB, GT and Mazars).

³ The accountancy scandals at Steinhoff and VBS Mutual Bank in South Africa and the United Kingdom (UK) respectively, along with the bankruptcy of Carillion, have led to a political debate on the structure of the sector, and in the UK to a debate on the role of the supervisory authority (see also CMA, 2018).

partial. These factors for example concern behaviour and culture at audit firms, technological developments and the AFM's role as the supervisory authority.

A healthy organisational culture at audit firms will always be a precondition for quality. Structure, behaviour and organisational culture have a complex interaction. Structure influences behaviour and culture, and behaviour and culture in turn influence how structures operate. The relationship between (elements of) culture and the quality of statutory audits is a recurring subject of academic research (Jenkins et al., 2008), on the basis of the expectation that the culture in an organisation will affect the working environment and therefore the quality of the service provided. International standard setters are also increasingly considering the organisational culture in the development of standards for improving quality control at audit firms.

Technological developments can also have an effect on the occurrence of market failure. A more automated audit could remove sources of market failure, for instance by expanding market supply and restricting market power. It is also quite possible that the current governance model at audit firms with partners at the top who direct teams in hierarchical structures could change if data analytics are used more extensively in statutory audits. At the same time, the relationship between technological developments and for instance the revenue model at audit firms is less clear at first sight.

Finally, as a supervisor of audit firms the AFM has a role in the reporting and auditing structure. Supervision is a method of mitigating market failure and the negative effects thereof, and providing objective feedback to the market with respect to quality. The AFM designs its supervisory activities with the aim of encouraging better audit quality. At the same time, there is also the possibility that supervision could provide incentives that negatively affect audit quality, in the sense that the sector could see supervision as an incentive to take a more compliance-driven approach, as a result of which intrinsic motivation ('we want to do this ourselves') is replaced by extrinsic motivation ('the supervisor is making us do this') and within the available capacity there will thus be less room for self-reflection and professional judgement.

Based on its supervisory role, the AFM hopes that this report will make a constructive contribution to the public debate on sustainable and consistent quality of statutory audits. It is too early to conclude that the improvement programme will not have the desired effects, or that improvements in the quality of statutory audits cannot be achieved in the current structure of the audit sector. The

improvement programme already under way has to be given the chance to achieve the desired effect (AFM, 2017; MinFin, 2017). At the same time, the AFM sees the added value of an open discussion of what may be the more structural causes of poor quality statutory audits and exploring potential solutions.

Structure

Section 2 contains a summary and the conclusions of this report. Section 3 identifies potential sources of market failure and looks at whether there are indications that these sources negatively affect the quality of statutory audits. Section 4 considers how the quality of statutory audits could be improved with additional measures within the current structure. Finally, Section 5 explores various alternative structural models for the audit sector and audit firms that would remove sources of market failure.

Research approach

The research question

This report analyses the potential causes of poor quality statutory audits on the basis of the economic theory of market failure. Does market failure in the audit sector occur as a result of vulnerabilities in the structure of the sector or the audit firms, and if so, are there indications that this negatively affects the quality of statutory audits?

Conduct of the research

The research is based on an analysis of the academic literature, in the first place in the field of auditing, and also on academic contributions from the literature on behavioural finance and psychology. Since academic literature by definition follows current developments, we also interviewed more than 30 external experts from the sector, professors and academics working in the field of auditing or associated disciplines, our fellow supervisors in other countries and other stakeholders, including members of the supervisory boards of large Dutch companies and representatives of interest groups for shareholders, among others. These insights are not used to support conclusions, they offer an up-to-date point of view in addition to the academic literature.

Definitions used

There are several definitions of the quality of statutory audits. In this report, the definition of the quality of statutory audits follows that used in previous publications by the AFM. This means at least compliance with rules for professional conduct and practice by the auditor, including the rules on professional competence and the Further Regulations on Auditing and Other Standards (NV COS), in order to obtain sufficient and appropriate audit evidence to substantiate the opinion stated in the auditor's report. If auditors have failed to obtain sufficient and appropriate audit evidence to substantiate their opinion, they have provided false assurance to the users of the financial reporting and the audit opinion. Several measures for audit quality are used in the academic literature, including compliance with audit standards, the quality of the disclosures in the reporting, the amount of discretionary accruals, the number of going-concern opinions issued, the number of material misstatements identified and the extent to which the auditor permits misstatements not to be corrected, or the amount of the audit fee paid.

Focus of the study

The research focuses mainly on the market for statutory audits of PIEs, most of which are performed by the Big 4 audit firms (Deloitte Accountants B.V. (Deloitte), Ernst & Young Accountants LLP (EY), KPMG Accountants N.V. (KPMG) and PricewaterhouseCoopers Accountants N.V. (PwC)). The findings may however also apply to the market for statutory audits of non-PIEs.

2. Summary and conclusions

Conclusion 1: There are indications in the academic literature that the current structure of the auditing sector incorporates several sources of market failure that have or may have a negative effect on the quality of statutory audits.

Vulnerabilities in the structure of the audit sector are analysed on the basis of the economic theory of market failure. Market failure is a situation in which market operation in a sector leads to an outcome that is undesirable from the perspective of prosperity for society as a whole. In the context of the audit sector, this means that if market failure in the sector occurs, the quality of statutory audits may fall below the level that is socially desirable because the statutory auditor and the audit firm have not adequately focused on the public interest.

In the audit sector, potential sources of market failure are found mainly in five major structural features. Market failure can arise due to an imperfect operation of supply and demand in the market for statutory audits, and also due to potentially harmful incentives arising from revenue, partner and business models at audit firms.

Market failure on the demand side of the market for statutory audits arises from information imperfections in combination with high transaction costs or high costs for searching, replicating or verifying information. As a result, users such as shareholders, debt providers, investors, analysts, supervisory boards (SBs) and audit committees (ACs) and society in general are not in a position to properly monitor, evaluate and compare the quality of auditors and therefore are not able to apply discipline in cases where audit quality is not adequate. The academic literature confirms that:

- The monitoring and disciplining of the quality of statutory audits is indeed not a simple matter for users. Statutory audits are therefore a credence good: quality is not or only barely observable, it is not measurable and cannot be compared to the quality of other providers.
- Most users are less equipped or have little inclination to monitor and evaluate the quality of statutory audits on the basis of publicly available information and at an acceptable cost, and thus to discipline the providers.
- There are indications that there may be intentional or unintentional capture of users as a result of financial incentive structures, short-term interests or principal agent

issues, as a result of which these parties do not or do not wish to fully exercise the options they have with respect to disciplining the providers. Generic behavioural finance literature stresses the importance of biases, meaning that users may believe that they are monitoring and disciplining adequately but in fact they are not (unconscious incompetence).

- The SB and the AC are the most appropriate bodies for challenging the statutory auditor and the management, but the degree of their independence and the expertise of their members is not a given. The interviews with experts also revealed concerns regarding independence with respect to the management, the number of years of relevant experience and the expertise of the SB and AC members. Other experts, however, took the view that these aspects were satisfactory, especially at the SBs/ACs of larger listed companies.

Market failure arising from the revenue model may arise because the audit firm is engaged and paid by the audited entity. This creates the risk of inadequate countervailing power and professional scepticism on the part of the auditor, meaning that statutory audits may be of poor quality. The analysis of the literature reveals the following:

- The already created statutory and other safeguards designed to reduce harmful incentives arising from the revenue model may not be sufficiently effective, such as the fact that the SB/AC makes a nomination for appointment of an auditor that is put to the Annual General Meeting for approval. The auditor is still after all paid by the entity they are auditing.
- There are strong indications from empirical and experimental studies that market failure exists and that negative effects on the quality of statutory audits have occurred as a result of the revenue model.
- The dependence created by the revenue model creates biases for the auditors that may involve a conscious or unconscious change of attitude in favour of the audit client.

Market failure arising due to the partner model may occur because audit partners simultaneously have the roles of professional practitioner, owner and entrepreneur. This means that these auditors serve commercial interests as well as the public interest, such as the interests of the client, the interests of the firm and their own personal interests. Due to these multiple roles, an auditor is continuously torn between these various interests, meaning that the public interest may not always take priority

and the quality of the statutory audit may thus be impaired. The analysis of the literature shows:

- There is no consensus between academia as to whether the partner model creates sufficient safeguards for the independence of the auditor and the serving of the public interest in the form of high quality statutory audits. On the other hand, research into alternative ownership structures that do not feature the partner model shows that the independence of the auditor is not in principle impaired in such cases and therefore also that this does not therefore lead to low quality statutory audits.
- One potential risk is that the partner model provides insufficient incentive for long-term investment in quality, but this risk is not undisputed. There is a possibility that an ownership structure other than the partner model, such as a corporate model, could contribute to audit firms making long-term investment in quality improvement.
- Lastly, the partner model features risks within multi-disciplinary business service providers of which audit firms are a part, in the form of inefficient direction and decision-making and an excessive focus on commercial performance (revenue).

The interviews with the experts raised a number of aspects with respect to the partner model that could present obstacles to improved quality, such as the inherent commercial dynamic of the partner model and the limited diversity of the partner group. The fact that the management includes a limited number of external members, the possibly too extensive span of control and the possibly too early age at which partners retire are also causes for concern. Several experts interviewed, however, see that one strong advantage of the partner model is that the partners lead their company collectively on the basis of equality and therefore have an incentive to call each other to account.

Market failure in the business model of audit firms is associated with the independent performance of the statutory audit becoming impaired as a result of (i) the provision of non-audit services (NAS), (ii) the tenure of the audit firm and the audit partner and (iii) affiliation (the degree of association) of the audit firm with the audit client or the supervisor. The academic literature shows that:

- There is no straightforward undisputed academic answer with respect to the provision of NAS, although the balance appears to be tilted towards a threat to independence and a negative effect on the quality of statutory audits (to the

disadvantage of positive knowledge spill-overs in cases where NAS are also provided by the multi-disciplinary service provider of which the audit firm is a part). In particular behavioural finance research into (unconscious) biases in the field of auditing supports the negative effect of NAS and the importance of an independent performance of the statutory audit as a safeguard of quality. Some of the literature concerns the situation in which simultaneous provision of statutory auditing and NAS to the same client was still permitted. But even in cases where a restriction is imposed, incentives that negatively affect the auditor's independence still apply as long as multi-disciplinary service providers continue to offer both statutory audits and advisory services.

- Academic opinion is also divided with respect to both audit firm tenure and auditing partner tenure. There is no compelling evidence for the positive effects of tenure as a result of the accumulation of expertise and knowledge of the audit client, nor for the negative effects of tenure in the form of a threat to independence and lower quality of the statutory audit. The balance in recent studies appears to shift in the direction that longer tenure at the level of the audit firm makes a positive contribution to the quality of statutory audits, but at partner level tenure has a negative effect due to impaired independence.
- The issues associated with independence in relation to affiliations and statutory audit quality are given little attention in the academic literature. Nonetheless, affiliation of the auditor with the audit client can harm independence, as can affiliations between the auditor and the supervisory authority; if not in practice, at any rate in the perception of the users.

The interviews with the experts raised the question of undesirable correlation that can occur between audit services and advisory services, in addition to affiliations.

The current structure in which audit and advice are under one roof could constitute a harmful incentive to optimise usage of the information obtained through the audit practice for one client for advisory services to another client that operates in the same sector.

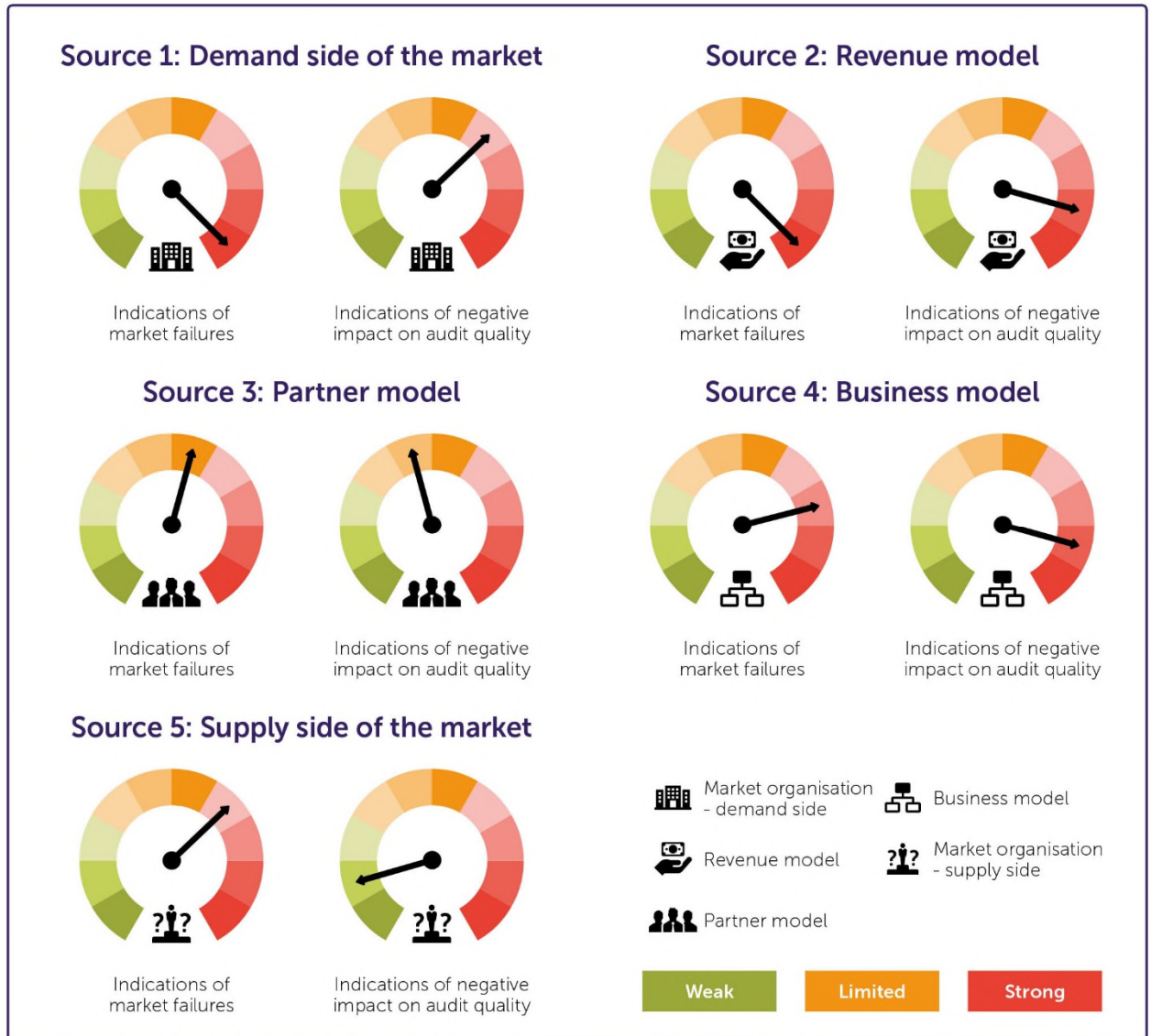
Market failure arising from the presence of market power (supply side) can lead to little or no competition with respect to (among other things) the quality of statutory audits. The academic literature shows:

- Market failure resulting from market power cannot be assumed sector-wide, but there are indications of this at larger companies and at companies operating in segments in which not all PIE audit firms have sufficient expertise. There is also

evidently a 'too few to fail' problem. However, a direct negative relationship with the quality of statutory audits cannot be empirically established.

Figure 1: Indications of market failure and a negative effect on the quality of statutory audits

Source: AFM -qualitative conclusion based on the academic literature











Generally, there are indications for the five sources reviewed that the sources lead to market failure in the audit sector and that these may contribute to a greater or lesser extent to the deficient quality of statutory audits. The robustness of these indications, however, varies for each source reviewed. The indications regarding market failure are especially robust for the demand side of the market, the revenue models and business models of the audit firms and to a lesser extent for the partner model and the supply side of the market. The indications for the negative impact of market failure on the quality of statutory audits apply mainly to the revenue and business model, and to a lesser extent to the demand


side of the market and the partner model. A negative impact on quality cannot be established for the market as a whole for the supply side of the market (figure 1).


Conclusion 2: There are possible ways to address market failure in the current structure of the sector. Quality-improving measures lessen the negative effect of market failure, but the sources of market failure continue to exist.


Reforms have been implemented in recent years to increase the quality of statutory audits and improve the independence of audit firms. As an extension to these reforms already in place, quality-improving measures within the current structure can be identified that relate to encouraging stakeholders to fulfil their responsibility to ensure high quality. This concerns both the audit firm or the auditor, as well as the audited entity and its SB/AC, the shareholder and the supervisor (figure 2).


Figure 2: Measures to improve quality within the current structure
 Source: AFM

Measure	For which sources of market failures are the negative effects reduced?
1. Strengthening governance at audited companies	 Revenue model  Demand side
2. Improving quality of financial reporting by audited companies	 Demand side
3. Encouraging auditors to focus on quality	 Partner model
4. Policy of management of PIE audit firms in service of quality	 Partner model
5. Strengthening quality safeguards at audit firms	 Business model  Partnermodel
6. Expansion of enforcement policy	 Demand side

 Demand side

 Revenue model

 Partnermodel


















 Business model


These measures do not remove the underlying sources of market failure, but they (further) limit the negative effect of market failure. These measures, however, would entail very little risk of new market failure, as they could mainly be introduced at national level and they would be an extension of previously introduced reforms.


Conclusion 3: Sources of potential market failure can be removed by the introduction of alternative structure models. This would however require significant intervention in the market for statutory audits or in the structure of audit firms. Further study is therefore needed.


This report analyses 10 alternative models that could remove the sources of market failure. Alternative structure models would change the structure of the market for statutory audits or the structure of the audit firms. This may possibly bring the quality of statutory audits permanently and consistently to a higher level (figure 3).


Figure 3: Alternative models are designed to remove the sources of market failure
Source: AFM


Model	Which sources of market failures would be removed?	
1. Audit only	 Business model	
2. Intermediary	 Revenue model	 Demand side
3. The Government Auditor	 Supply side	 Business model
4. Financial Statement Insurance	 Revenue model	
5. Abolition of statutory audit requirement	 Demand side	 Supply side
6. The user decides	 Revenue model	 Demand side
7. Audit Quality Indicators	 Demand side	 Supply side
8. Joint Audits	 Demand side	 Supply side
9. Limit Big 4 market share	 Supply side	 Business model
10. Corporate model	 Partner model	

 Demand side

 Revenue model

 Partner model

 Business model

 Supply side

These ten alternative models would generally require significant changes to the market for statutory audits or the structure of audit firms. It cannot be said with certainty for any of the models that they will lead to high and permanently assured quality of statutory audits, also because they could introduce risks of new market failure or government failure. Further study is therefore needed. Most of the 10 models studied would probably require changes to international legislation and regulation and would therefore only be feasible if they could be implemented at international level.

3. Potential sources of market failure in the audit sector

3.1 Introduction

Market failure is a situation in which market operation in a sector leads to an outcome that is undesirable from the perspective of prosperity for society as a whole (SER, 2010; Den Hertog, 2010). For the audit sector, the consequence of any market failure in the sector is that the quality of statutory audits will not be up to a standard that is socially desirable and therefore the auditor and the audit firm do not adequately focus on the public interest. Government intervention in the form of financial instruments (such as taxes or grants), regulation (price, quality, remuneration rules) or public provision can in theory increase prosperity (Llewellyn, 2006, among others). Economic theory explains market failure from various perspectives (figure 3.1).

Figure 3.1: Economic theory explains market failure from various perspectives

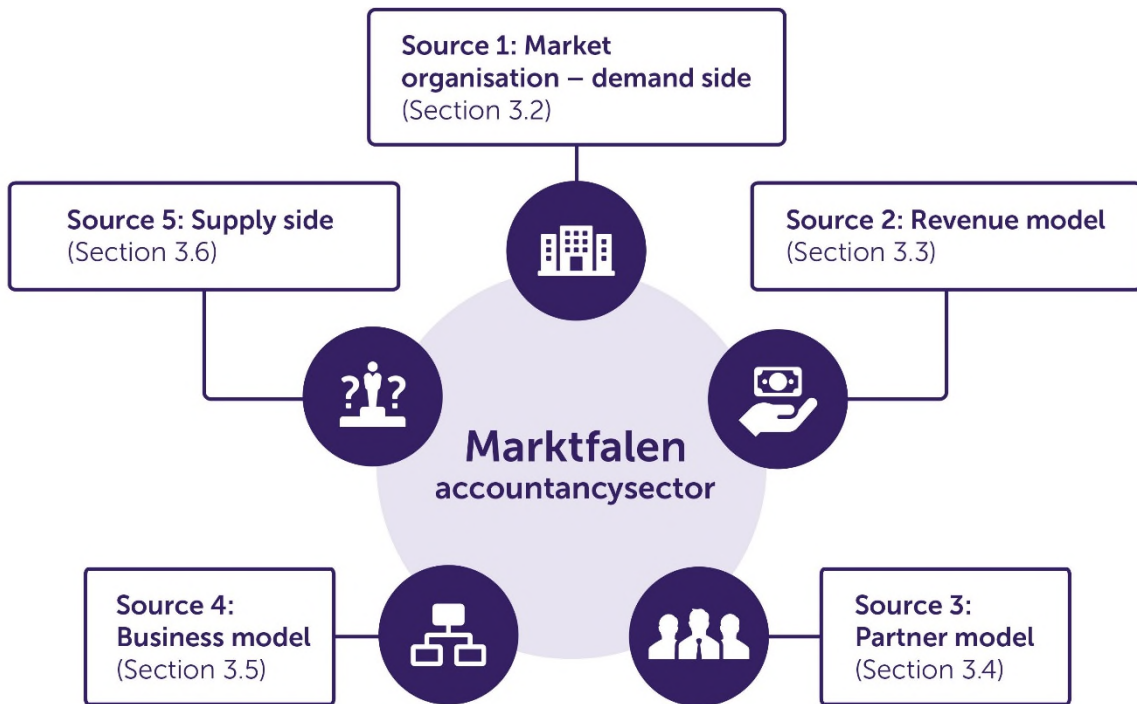
Source: AFM

<i>Economic theory and sources of market failures</i>	<i>Description</i>
1. Information imperfections	Information asymmetry: a market party has more information than other stakeholders. Information gap: all stakeholders lack information because this is not available, observable or measurable.
2. Contract theory and ownership rights	Absence or incompleteness of establishment of rights and obligations between economic agents, leading to legal uncertainty.
3. Market power	A company or group of companies can, as a result of market organisation (monopoly or oligopoly) behave independently with respect to other companies (for example, regarding price-setting).
4. Externalities	Negative (or positive) consequences of production or consumption without the originator making (or receiving) a payment; not reflected in the market price and not influencing an individual behaving rationally in an economic sense.
5. Public goods	Non-excludable and non-rivalrous consumption.
6. Irrationality and biases	Non-rational behaviour by people or markets.
7. Transaction costs	Ex-ante costs (costs of information and searching) and ex-post costs (monitoring and compliance costs, replication costs, competence requirements) hinder monitoring and disciplining of providers of products and services.
8. Principal agent theory, common agency	The relationship between the principal (the client) and the agent (the contractor) creates a conflict of interest and moral risks, partly due to information imperfections and (high) transaction costs.
9. Corporate finance	Limited disciplining of management/shareholders by creditors.

Five potential sources of market failure can be found in the structure of the audit sector (figure 3.2). Market failure can arise due to an imperfect operation of supply and demand in the market for statutory audits, and may also be caused by potentially harmful incentives arising from revenue, partner and business models at audit firms.

These structural features do not necessarily (to the same extent) have to lead to harmful incentives and a socially undesirable outcome in the form of inadequate quality of statutory audits. The inadequate quality of statutory audits may also not be traceable to one or more structural features, but this could exist as a result of the interplay between sector and behavioural characteristics.

Figure 3.2: Five structural features that are potential sources of market failure
Source: AFM



The remainder of this section analyses these five structural features as the major potential sources of market failure in the audit sector on the basis of a study of the **academic literature**. The main question is whether there are indications that (i) market failure occurs, and if so, (ii) to what extent market failure contributes or leads to the inadequate quality of statutory audits? Each paragraph includes more anecdotal indications of the extent to which these sources of market failure take hold based on our interviews with external experts.

3.2 Market organisation - demand side of the market

3.2.1 Description of market failure

Market failure on the demand side of the market arises from information imperfections. Information imperfections apply if a market party has exclusive information or needs distinguishing competences for the collection, monitoring and

interpretation of data and can benefit from this due to the lack of knowledge or competence of other parties (De Haan et al., 2012; Llewellyn, 2006, among others). Examples are information asymmetry (a market party possesses more information than other stakeholders), either within a principal-agent situation (the agent has an incentive to withhold information for their principal) or not, and information gaps (all other parties lack the desired information, for example because it is not ex-ante available). Interestingly enough, some of the literature suggests that in the market for statutory audits, knowledge and experience asymmetry between the management of the audited company and the auditor has at least as important a role in market failure as information asymmetry between the auditor or the management and the other stakeholders, such as shareholders and debt providers (Gendron and Spira, 2009).

Market failure in the demand side of the market for statutory audits results if users are unwilling or unable to monitor and discipline providers and the quality of the statutory audits they provide. The statutory audit thus involves information asymmetries, high transaction and research costs associated with data collection and high costs for the replication and verification of information, as well as requiring a high level of competence for monitoring and evaluation. This makes it difficult, if not impossible, for users to monitor the quality of statutory audits and discipline the providers. It is also difficult for all stakeholders in the market to clearly evaluate the quality of a statutory audit because this is not or not easily observable (due to the credence good nature of statutory audits). On the other hand, there may be (unconscious) capture of certain stakeholders due to harmful incentives, as a result of which the potential for disciplining is not fully used.⁴ These may include financial incentives and short-term interests of management and members of the SB/AC within their principal-agent relationship with shareholders, the (possibly) short-term interests of the shareholders themselves, as well as shared interests of the management and creditors and providers of corporate finance.

3.2.2 Analysis based on academic literature

Monitoring and disciplining by stakeholders is not a simple exercise in practice because the demand side of the market for statutory audits is fragmented. For instance, internal stakeholders can be identified, including the management board (MB), the SB and the AC and the employees, as well as external stakeholders such as

⁴ A situation of a captured agency applies if the agency is influenced, for example by lobby organisations or other interest groups so that it ultimately serves the interests of these groups instead of the public interest or the primary interest associated with its role.

shareholders, debt providers, creditors including banks, suppliers and trading partners, asset managers, investment analysts, consumers and society as a whole.

Most external stakeholders are thus ill-equipped or have little inclination to monitor and evaluate the quality of statutory audits, let alone discipline the providers. The central question is whether external stakeholders are able (on the basis of public information and at acceptable cost) to assess whether an auditor has made the right decisions during a statutory audit and delivered adequate audit quality. The psychology and behavioural finance literature moreover stresses the importance of biases, whereby stakeholders may believe that they are monitoring and disciplining adequately but in practice are not (unconscious incompetence; for a general overview of the biases at work in people's financial behaviour, see among others Kahneman, 2011; Moore et al., 2006 and 2010). Then again, some stakeholders may have their own divergent (short-term) interests, such as shareholders or bank financiers, so there is little incentive to assess quality if this does not serve their interests.

Debt providers and creditors are an exception, as according to corporate finance theory they have an incentive to monitor management and shareholders so that they do not take on too much risk when making investments. Shareholders and management may display excessive risk seeking behaviour, for instance if the business is doing badly, or to maximise profits (gambling for resurrection). They are in a position to appropriate the returns from high-risk projects, while any losses or bankruptcy resulting from high-risk investment can be largely shifted to bond holders and other debt providers (risk-shifting; Jensen and Meckling, 1976). Bond holders will try to restrict opportunistic behaviour on the part of management and shareholders through explicit supplementary debt contracts (covenants, Smith et al., 1979), shortening debt maturities (Myers, 1977), demanding a higher rate of interest (Bergman and Callen, 1991), but also through closer and more frequent monitoring and reporting (Jensen and Meckling, 1976) or requiring more conservative reporting (Ahmed et al., 2002), either through the auditor or otherwise. On the other hand, there is empirical evidence that a higher frequency and (assumed) higher quality of statutory audit tends to reduce the costs of debt for audited companies (Sengupta, 1998; Francis et al., 2005). There are also indications that the quality of reporting affects decisions by audited companies to opt for private or public debt finance, with companies of low quality choosing bank finance (Bharath et al., 2008). This could be an indication of (a perception of) less intensive monitoring and disciplining by banks than that exercised by shareholders or bond holders.

Of the internal stakeholders, the AC or the SB is the most suitable organ for challenging the auditor (and the management), but the academic literature with respect to their functioning is divided. From the principal-agent approach, monitoring and disciplining of statutory audits can be effectively conducted by an independent SB or an AC reporting to the SB of the audited company. The AC thus provides a counterweight against biases and a potentially divergent self-interest of the management and the auditor and protects the interests of the shareholders, investors and other users of statutory audits. There is evidence in the literature that there is an association between an independent and expert AC and high quality statutory audits (Bédard and Gendron, 2010).⁵ There are also indications that AC members have become more knowledgeable and independent since the introduction of SOX (see for instance Hoitash and Hoitash, 2008). Finally, there is empirical (if somewhat dated) evidence from a survey of 114 PIE audit firms that ACs consisting fully of independent members and with at least one member that has an accountancy background achieve a high quality of the internal audit function (Raghunandan et al., 2001), benefit the quality of reporting (Seetharaman et al., 2014; DeFond and Zhang, 2014) and reduce the possibility of fraud by the management (Ege, 2015). On the other hand, both the AC and the auditor are paid by and therefore to some degree dependent on the management for matters such as salaries, references, etc. (Ronen, 2006). There is moreover evidence that in the US, despite the more independent role for ACs that became mandatory with the introduction of the Sarbanes Oxley Act (SOX), the MBs of large audited companies using the Big 4 audit firms retain a significant influence over the selection and appointment of the statutory auditor; a higher quality of the AC, expressed in years of experience of the AC members in auditing, did not mitigate this (Dhaliwal et al., 2015; Lin et al., 2006).

3.2.3 Anecdotal indications

A number of experts stated that the professional expertise, quality and independence of the SB/AC is in their view adequate, especially at the larger listed companies. In its selection of the auditor for these companies, the AC independently considers criteria such as the quality of the auditor and the extent to which the auditor forms an independent opinion, as well as the composition of the team that will carry out the statutory audit.

⁵ Bédard and Gendron conclude therefore that "... the existence of audit committees [in itself] is a necessary but not a sufficient condition for enhancing financial reporting quality."

Other stakeholders raised a concern with respect to independence towards the management of the audit client, the number of relevant years of experience and the expertise of the AC members. In certain cases the MB exercised significant influence over the selection and appointment of the statutory auditor. These signals could point to an obstacle to improving the quality of statutory audits. Another concern voiced was that it could not be ruled out in some cases that an unqualified audit opinion may be a higher priority for the management and the AC in question than a high quality statutory audit, for example if the audited company was experiencing difficulties like facing continuity problems. This could be another reason for the AC (whether due to management pressure or not) not using the possibilities for disciplining the auditor to the fullest extent.

3.3 Revenue model

3.3.1 Description of market failure

In essence, the revenue model means that the audit firm is appointed and paid by the audited company, while the customer is the public as a whole. This could mean that in case of a profit-oriented business culture at the audit firm, the financial interest of the audit engagements could be greater than the importance of the quality of its statutory audits. The public interest would therefore no longer have central priority, There is accordingly a risk that the auditor could find themselves in situations in which they (either intentionally or not) offer insufficient countervailing power and take a less sceptical approach in order to protect the relationship with the audit client. This could negatively affect the quality of the statutory audit.

3.3.2 Analysis based on academic literature

Appropriate safeguards have been created in recent years in order to mitigate the risks arising from the revenue model (NBA, 2017). One of these safeguards is that the SB and the AC reporting to it makes a nomination for the appointment of an audit firm that is subsequently put to the AGM for approval.⁶ This de facto introduces a separation between the audited company and the organ that appoints the auditor and to which the auditor reports. This potentially contributes to the independence of the auditor and increases shareholder engagement. Academic research also shows that the stronger

⁶ For PIEs, the SB – on the advice of the AC - presents its nomination for the appointment of the auditor to the AGM and oversees the performance of the auditor (in accordance with the Dutch Corporate Governance Code). The AC/SB must put forward at least two options for the audit engagement to the AGM, with a substantiated preference for one of these options (EV 537/2014).

the corporate governance at an audited company, the higher the quality of the statutory audit will be (Asare et al., 2018).

These safeguards will however only be effective in practice if the SB/AC has sufficient specialist financial knowledge of the company's business and actually carries out its role independently and effectively. As stated above, the literature is divided on this point. Although there is evidence of independent ACs with sufficient knowledge and expertise (among others Hoitash and Hoitash, 2008; Bédard and Gendron, 2010; Raghundandan et al., 2001), there are also indications suggesting (i) that the management of audited companies influences the appointment of the auditor (and the termination of the engagement) and (ii) that the AC is not sufficiently independent in these cases (Hurley et al., 2018; Dhaliwal et al., 2015; Fiolleau et al., 2013; Almer et al., 2014; AFM, 2015).⁷ Secondly, the disciplining role of the AGM is limited, since in practice only one of the nominations for an auditor put forwards by the SB can be approved.⁸ And of course, none of this changes the fact that the audit firm is paid by the audited company.

Although some of the academic literature deals with the risks associated with the revenue model only in relatively superficial terms (among others Choi et al., 2010; Ronen, 2010; McCoy, 2003), there have also been a number of empirical and experimental studies producing indications that the revenue model has a negative influence on the quality of statutory audits. A first indication comes from a study of the period 2007-2010 of approximately 8,000 audited Belgian companies (Dekeyser et al., 2014). This study shows that the quality of statutory audits is lower at audit firms where the compensation for the auditor is linked to the fees received from the audit client for the audit. Based on these findings, the authors conclude that this type of remuneration structure brings with it a higher possibility that auditors empathise with their audit clients too much in order to protect the client relationship and the future revenue stream.⁹ A second indication comes from a recent empirical study of 850

⁷ Although interviewees indicated to the AFM that one member of the AC or the SB would generally take the lead in the selection committee for the appointment of a new audit firm, a number of supervisory directors stated that the CFO also has a pivotal role here in practice. "It would thus seem to be the case that in practice the influence of the company, and in particular the influence of the CFO, on the selection process regularly goes further than simply organising the selection process. This is contrary to the increasingly common perception that the audited entity should not appoint its own auditor" (AFM, 'Exploring the critical reporting and auditing capabilities of audit committees', 2015).

⁸ In theory, the AGM can reject the SB's preferred candidate in favour of the other nominated audit firm or even put forward its own candidate.

⁹ The study does not show any clear connection between the amount of goodwill brought in by a partner and the quality of statutory audits, while the hypothesis of the authors was that there would be a positive connection here. After all, the risks for the partner of potential legal proceedings against them due to a deficient audit increase in proportion to the financial interest the partner has in the audit firm.

audits in the Netherlands during the period 2005-2015 (Asare et al., 2018), which makes a connection between the economic importance of the audit client for the audit firm and the quality of the statutory audit. The empirical results of this study show that auditors are less inclined to follow up on material misstatements in the reporting of the audited company as the economic importance of the company to the auditor (and therefore the economic incentives) increases. This applies for instance if the company pays exceptionally high fees for the statutory audit. In other words, fees that are higher than would normally be expected on the basis of the scale and complexity of the audit. This study also shows that the risk of no follow-up by auditors on misstatements in the reporting is lower if the company has an independent SB/AC. This is in line with the previously identified importance of strong corporate governance at the audited company for the quality of statutory audits. A third indication comes from another study of approximately 400 Belgian audited companies that went bankrupt in the period 1992-1996, which shows that in 67% of cases the auditors had made no mention of continuity issues at the company in the year preceding the bankruptcy (Vanstraelen, 2002). This turned out to be significantly higher than for a control group because the auditors that made no mention had lost audit clients in the preceding period and therefore had a greater interest in retaining audit clients and the audit fee for these auditors was higher. Another empirical study shows that there is a negative connection between statutory audit quality and the economic importance of the audit client in terms of audit fees, since as a result of this auditors are more inclined to follow the wishes of the audit client (Choi et al., 2010).

If the economic link between auditors and their audit clients is removed, experimental studies show that the quality of statutory audits will significantly increase. The results of an experiment in which the auditors were not appointed by the management of the company but through a system of random allocation by an independent third party are notable in this respect (Hurley et al., 2018). In this experiment the auditor was as it were nudged, since they had to fulfil an explicit responsibility to the shareholders of the audit client. Taking the inherent limitations of an experimental set-up into account, this significantly increased the quality of the statutory audit. The study concluded that for the quality of statutory audits to improve, it was important to no longer give the company or its management a role in the appointment of the auditor, but to give this role more explicitly to the shareholders, for example.

Experiences in other sectors where similar market failure plays a role due to the revenue model underline the negative relationship between the revenue model and the quality of the service. One salient example is the market for credit rating agencies (CRAs). The revenue model is a source of market failure in this market that is similar to those occurring in the audit sector. After all, a CRA is paid by the party that issues the financial instruments for which a credit rating is requested (the 'issuer pays model'), while the user of the rating is actually the investor, or the wider public. This results in a conflict of interest. Experiences gained in the financial crisis of 2007 and a significant number of empirical studies over this period show that as a result of this revenue model, the CRAs have in the past and on a wide scale issued ratings that were inaccurate and not objective and as a result were too high (Bahena, 2010; European Commission, 2015 and 2016; Bolton et al., 2011; Griffin and Tang, 2011; Jiang et al., 2011; Strobl and Xia, 2011; Bhattacharya et al., 2018).¹⁰

In addition to the empirical and experimental literature, there is also a school of thought in the academic literature that looks at potential market failure in the audit sector – in particular from the perspective of the revenue model – on the basis of the principal-agent theory and 'auditor capture' (among others Ronen, 2006 and 2010; Causholli and Knechel, 2012). There is a principal-agent relationship in the audit sector between the auditor (the agent) who performs the audit and issues the auditor's report and the external stakeholders in the audit (the principals), such as shareholders. Ideally, the auditor should be the agent of these external stakeholders. In practice, however, the possibility that as a result of the revenue model the auditor sees their role mainly as that of an agent of the management of the audited company cannot be ruled out. A study by the competition authority in the UK is illustrative in this respect (UK Competition Commission, 2013). This study reveals that the independence and 'professional scepticism' of auditors is pressured because partly due to intense competition in the market the auditors experience economic incentives to serve the interests of the audited company, even if these interests do not correspond to the interests of the shareholders of the company in question.

These principal-agent problems from the revenue model are exacerbated by a number of organisational features of audit firms. An empirical study of 112 Dutch

¹⁰ The CRA market features other forms of market failure that are generally similar to those seen in the audit sector and which potentially have a negative effect on rating quality. For instance, the transparency of ratings is limited and therefore there are limited external incentives for monitoring and disciplining from the demand side of the market (the users of the ratings). There is also little competition or operation of market forces in a market that is dominated worldwide by three large parties (Fitch, Moody's and S&P).

audited companies shows that (i) a strong profit orientation from the auditor and therefore to their own remuneration, (ii) an economic dependence on a limited number of audit clients and (iii) a strong identification with the audit client, especially in the context of the principal-agent problem results in low statutory audit quality (Pruijssers et al., 2013). According to the authors, the results are in this sense a clear indication that the gradual shift of audit firms from 'public-spirited' to more 'commercial' organisations with a client-oriented revenue model has been to the detriment of the interests of other important stakeholders, such as shareholders. The academic literature cited on this point suggests that the principal-agent problem in the revenue model can only be solved if the incentive structure is radically changed. Audit firms would then receive a financial reward for an excellent quality statutory audit provided by the shareholders of a company and not by the existing management.

Another school of thought in the academic literature explains the occurrence of market failure as unconscious behaviour by auditors to place the interests of the audit clients above the public interest. This psychological and behavioural literature suggests that the greater the incentives for professional audit firms to display behaviour that is not in the public interest, the greater the deviation from what are defined as professional standards of conduct can be expected to be. It is difficult in practice for individuals in these organisations to objectively acknowledge such incentives and the unconscious behaviour that they engender, let alone to provide a degree of countervailing power. Auditors in the audit sector do acknowledge that the revenue model and the resultant conflict of interest can influence behaviour, but they do not recognise this influence in their own behaviour or the behaviour of the audit firm for which they work; this is known as the 'inaccuracy of self-perception' (Bazerman et al., 2002 and 2006; Moore et al., 2006 and 2010).

There are thus many kinds of unconscious self-serving biases that play a role in the human mind that influence behaviour.¹¹ In the context of the audit sector, according to this literature it is feasible that auditors are for instance exposed to a selective perception bias, where they only observe data and information that serve the interests of their audit client.

A number of studies have conducted experiments to determine the extent to which such biases occur. These experiments show that the evaluations of auditors are

¹¹There have been studies of the issue of biases and the psychological and other behaviour of economic actors in many sectors, including supervision. See among others DNB, 2015; AFM, 2016.

indeed frequently biased in favour of the audit client and above all that the closeness of the relationship between auditors and their audit clients has a significant negative effect on the quality of statutory audits (Bazerman et al., 2006; Moore et al., 2010). They also conclude that these biases are not easy to correct, because the auditors are not fully aware of them. Against this, there are studies focusing on how these biases can be reduced (King, 2002). There are indications that auditors could be able to resist these biases because they are part of a group (such as a partnership), and thus feel social pressure to conform to the standards of the group (such as an independent attitude towards the audited company).

Lastly, reputational and claims risk should in principle have a significant disciplining function for auditors to deliver high quality statutory audits and thereby reduce the risks inherent in the revenue model. Indeed, reputational damage as a result of incidents relating to deficient quality can lead to loss of the audit client relationship and to claims and financial losses. On the one hand, there is literature that supports this (Skinner and Srinivasan, 2012; Gao et al., 2011; Lin and Tepalagul, 2014). On the other, the results are not unequivocal (DeFond and Zhang, 2014), or there are doubts regarding the disciplining effect of claims and reputational risk (Ronen, 2010; Bazerman et al., 2006). The reason for these doubts lies in the fact that reputational and claims risk manifests only in the longer term and with an uncertain probability of occurrence, while the possibility of building a profitable client relationship lies in the short term and has a certain probability of occurrence. There are also indications that reputational risk may well apply to audit firms in general, but to a lesser extent to auditors who have individual client relationships and experience different incentives (Ronen, 2010).

3.3.3 Anecdotal indications

A number of experts noted that in comparison to the US, for example, the number of claims and disciplinary cases brought against auditors in the Netherlands due to statutory audits of insufficient quality is relatively limited. A factor here is that the burden of proof is complicated, since it is very difficult to demonstrate deficient quality in a statutory audit without access to information from the audit file. This does not change the fact that claims could be brought against audit firms in cases of severe financial loss, for instance due to sizeable effects on share prices or the bankruptcy of

the audited business, in the Netherlands as well.¹² In addition, it was stated that the reputational effect was inherently restricted by the limited competition in the Dutch audit sector (see also section 3.6). Large listed companies were not able to change their auditor readily, due to the limited number of parties that can perform their statutory audits. Lastly, some of the interviewees stated that it was not necessarily the case that the quality of statutory audits would increase if the revenue model were changed, also because the effect of alternative revenue models was difficult to assess on any empirical basis since there was no experience of such alternatives to go on.

3.4 Partner model

3.4.1 Description of market failure

Market failure arising due to the partner model may occur because auditors who are also partners (audit partners) simultaneously have the roles of professional practitioner, owner and business operator. This means that these auditors serve commercial interests as well as the public interest, such as the interests of the client, the interests of the firm and their own personal interests. Audit partners are continuously torn between the various roles and interests they have, meaning that the public interest may not always take central priority and the quality of the statutory audit may thus be under pressure.

A potential consequence of this is that audit partners united in a partnership (partner group) may not have sufficient financial interest in, and therefore insufficient incentive, to invest in quality at the audit firm.¹³ Such investment will take a long time to be repaid, and the return is by no means certain in advance. In other words, it takes a relatively long time before investment in matters such as quality control and compliance systems, innovation and training in ethics, business conduct and professional behaviour will result in higher earnings. The propensity to make such investments on the basis of the principle of an economic return may thus be lower than desirable from the point of view of the public interest. This effect possibly intensifies as the partners approach retirement, since they will not see a return at all.

¹² In 2018, the Dutch Investors' Association (the VEB) held Deloitte Accountants BV and Deloitte & Touche South Africa liable for the loss suffered by Steinhoff shareholders as a result of irregularities in Steinhoff's reporting, which were provided with an unqualified auditor's opinion by Deloitte. Another example concerns PwC, which reached an arrangement with the receivers of the bankrupt energy company Econcern at the end of 2015, as a result of a ruling by the disciplinary court that the audit opinion had been issued without sufficient depth and with insufficient professional scepticism.

¹³ A partnership is a long-term relationship between multiple parties in which these parties share both the costs and the benefits of the general cooperation.

3.4.2 Analysis based on academic literature

One point of debate is whether the partner model creates sufficient safeguards for the independence of the auditor and high quality statutory audits. Opinions on this point in the literature vary. On the one hand, an audit partner may not have sufficient incentive to place the interests of parties such as the shareholders or other external stakeholders above the interests of the client (Pickering, 2012). On the other, the partner model may constitute a quality safeguard for stakeholders due to the ownership role of the partners and the long-term continuity of the organisation (Levin et al., 2002; Levin et al., 2004). By law, the majority of the control at audit firms must be in the hands of qualified auditors, so that sufficient knowledge and attention to audits is assured and quality is thus encouraged.¹⁴ Lastly, a benefit of the partner model is that it leads to a more effective use of human capital at audit firms. The partner model has correspondences with a master-apprentice structure, in which novice auditors gain experience and develop under the wings of a partner (NBA, 2017).

Research into alternative ownership structures, in which the partner model is abandoned and audit firms are owned for instance by external investors, shows that the independence of auditors will not in principle be impaired and therefore will not lead to lower statutory audit quality (Oxera, 2007). One important argument in favour of this is that the commercial incentives for external investors (and the management that represents these investors) would possibly be the same as those for the audit partner. After all, a statutory audit of inadequate quality is also a risk for an external shareholder in an audit firm, if for instance this leads to the loss of an audit client relationship or claims for damages and therefore to a decline in value of the share in the audit firm. It is also not immediately clear why positive effects on the quality of statutory audits as a result of the partner model, such as the master-apprentice structure, could not also apply in other ownership structures.¹⁵

Another point of discussion is the potential risk mentioned that the partner model does not provide adequate incentive for long-term investment in quality. Although the literature on this topic is limited, there are indications that the partner model at audit firms indeed creates inherent limitations with respect to long-term investment in

¹⁴ In the Netherlands, this is enshrined in the Audit Firms Supervision Act (Wta).

¹⁵ The absence of external owners in the audit sector would actually seem to be mainly due to the current statutory requirements with respect to control (Von Nordenflycht, 2008). Experiences in other sectors (the legal profession, investment banking, advertising, management consulting) show that when these kinds of statutory restrictions are removed, the partner model in these sectors is frequently changed to an investor ownership model, for example in cases where there is a need for capital investment for expansion.

the development of quality (Oxera, 2007). One important argument in favour of this is that partners are expected to require a high return on their investment, since their share in the investment is not tradable and the proceeds thereof will take a relatively long time to materialise. There is also the point that in the current partner model, external investors will demand a premium because they will have limited influence due to the requirement that the majority of the management has to consist of qualified auditors. It cannot therefore be ruled out that an ownership structure other than the partner model, such as a corporate model, could contribute to audit firms making long-term investment in quality improvement.

In addition, the partner model is frequently evaluated in the literature in the context of the development of the role of partners at service providers, of which the Big 4 audit firms form a part. It is acknowledged that the partner model in itself can be an effectively operating model, but with significant challenges that have to be addressed (Empson, 2007; Empson and Greenwood, 2003; De Vries and Herrijgers, 2018). The partner model has limitations in large and complex organisations, for instance with respect to direction and decision-making and access to external capital. Also, young auditors increasingly are less attracted to a career aimed at becoming a partner in today's world that places more importance on a balance between work and free time, with an increasing tendency to focus more on the outside world.

Finally, several authors mention the risks of the partner model for the culture at audit firms. A study of the working attitude of auditors working at the Big 4 audit firms in the UK and Canada distinguished between a technical-professional logic and a technical-commercial logic in their working attitude (Spence and Carter, 2014). While all auditors are considered to have extensive professional expertise with respect to correct compliance with legislation and regulation, the emphasis in a technical-professional attitude is on giving central priority to the public interest. On the contrary, with a technical-commercial attitude there is more emphasis on serving the interests of the audit client and generating revenue. Although both attitudes of course exist, this study revealed that the technical-commercial attitude had the upper hand among auditors at the organisations reviewed. One important reason for this is that people with this attitude are more likely to be promoted to partner status. The study concludes that this culture, in which employees with a commercial attitude to their work strive to progress to become partners, is contrary to the 'accounting profession's public interest mandate'. A development related to this is the fact that the remuneration of audit partners seems increasingly to be based on individual performance. While there are

also advantages to this (for instance of the possibility of more effective management based on quality), this development can also contribute to an excessive focus on commercial performance and less on professional expertise and competences (Coram and Robinson, 2017; Knechel et al., 2013), certainly if the commercial attitude to work prevails at the audit firm in question.

3.4.3 Anecdotal indications

A number of experts state that one potential powerful advantage of the partner model is that the partners lead their firm on the basis of equality and therefore have an incentive to call each other to account with respect to behaviour or deficient quality of statutory audits. Other interviewees had comments to make in this respect. It is questionable whether partners do actually call each other to account with respect to behaviour, or whether they are sufficiently self-critical with respect to their own work. Some interviewees also said that an incentive for partners to call each other to account (also individually) is lacking at international level. In situations where unacceptable behaviour or deficient quality of statutory audits lead to litigation, claims and fines, the financial liability of the partnership is limited by means of legal compartmentalisation. Accordingly, the partners at a Dutch audit firm for example have no incentive to call partners of their US counterpart to account with respect to deficient quality of a statutory audit, or vice versa.¹⁶

Another point mentioned was whether the commercial dynamic of the partner model and the limited diversity within the group of partners over time form an obstacle to the structural embedding of social developments and the public interest at audit firms. This concern is strengthened by the fact that the management of the audit firms consists mainly of partners and only to a limited extent of external parties. There is thus less of an outward-looking view at these firms.

Several experts also stated that the audit partners at a Big 4 audit firm have a large span of control. Some people thought this was too great, for instance in comparison

¹⁶ Deloitte is internationally structured as a UK private company limited by guarantee (LBG). Deloitte Nederland is a Dutch member firm of the Deloitte network within this LBG. Members do not share in the risk-bearing capital at network level; they act as guarantors and have little or no shared liability with other member firms in the network. PwC also has an international network consisting of individual member firms that are members of PricewaterhouseCoopers International Limited (PwCIL), an LBG established in the United Kingdom. There is therefore no international partnership or reciprocal liability between member firms (i.e. all services are provided for the account and responsibility of the individual member firms). KPMG has a similar organisation, in which the individual members (member firms) are affiliated to the Swiss cooperative KPMG International, a legal entity incorporated under Swiss law. Finally, Ernst & Young Accountants LLP, which operates in the Netherlands, is organised as a UK Limited Liability Partnership (LLP) and is a member firm part of Ernst & Young Global Limited LBG.

to other professional groups such as lawyers, and that this could potentially impair the quality of statutory audits. A large span of control also makes it difficult for an audit partner to direct the members of the audit team to prioritise quality in their work and to be closely involved in the performance of the statutory audit.

A final aspect mentioned was that the normal practice at the Big 4 audit firms, whereby partners retire at 55 to 60 years of age, could lead to harmful incentives regarding the quality of statutory audits. This relatively early retirement age could increase the commercial pressure on these audit partners. Relatively early retirement may also be harmful because experience is lost that is crucial for statutory audit quality. This is not helpful for the necessary focus on quality, long-term behaviour and taking account of the public interest. On the other hand, it was acknowledged that the inflow of new partners could contribute to a change dynamic and boost renewal.

3.5 Business model

3.5.1 Description of market failure

Market failure in the business model of the audit firms is associated with impairment of the independent performance of statutory audits. The independent performance of the statutory audit is an essential precondition for public confidence. There are potentially three threats to the independent performance of statutory audits in the business model used by the PIE audit firms (Beattie and Fearnley, 2002):

- a. Provision of non-audit services (NAS) by the multi-disciplinary service provider of which the audit firm is a part;
- b. The tenure of the audit firms and the auditor; and
- c. Affiliation of the audit client with the audit firm.

3.5.2 Analysis based on academic literature

Provision of NAS by a multi-disciplinary service provider of which the audit firm is a part can put the independence and objectivity of the auditor at issue. NAS include corporate finance activities, tax advice, administrative services and valuation services (figure 3.3). These services are not usually provided by the audit practice, but by other service lines at the multi-disciplinary services provider, for example by the advisory branch. For some years in the Netherlands, there has been a mandatory separation between audit services and non-audit services: briefly, a multi-disciplinary service provider may not provide other services to PIEs if it also performs a statutory audit

engagement. The aim here is to reduce the mixing of auditing and advice and the related independence issues.¹⁷

Figure 3.3: NAS are extensive in nature (partly based on Beattie et al., 2002)

Source: AFM

<i>Service</i>	<i>Description</i>
Administrative services	Preparing projections, budgets and liquidity calculations (incl. guidance and advice), support for annual reporting and selection of accounting policies (IFRS, NL GAAP, US GAAP); guidance and/or support for the financial administration of the audit client, salary administration; design of a financial information system (incl. advice), implementation of a financial information system (incl. advice), evaluation of a financial information system.
Services relating to valuation	Valuations of specific assets or liabilities, valuations of an entire organisation, support in the valuation of shares.
Services relating to internal controls	Design of the administrative organisation and system of internal controls, design of the planning-control cycle, design of internal control procedures, assessment or evaluation of the system of internal controls;
Legal services	Acting in a dispute (including a case involving dismissal or an employment dispute), acting in tax proceedings, drafting and evaluating contracts, minutes and agreements, advice on company law (incorporation, liquidation, issuance, mergers, etc.), employment law or tenancy law, advice in the field of intellectual property.
Corporate finance services	Advice and guidance on mergers and acquisitions, business succession and transfer, due diligence investigations, transaction finance and business finance, development and determination of strategy, business planning & coaching, corporate recovery - restructuring and reorganisation, investment decisions, balance sheet optimisation.
Tax services	Advice on tax returns, pensions and retirement provisions, gift and inheritance tax, financial and estate planning, international tax, tax and other optimisation for international structures, transfer pricing, mergers and acquisitions, dividend distribution, employee benefits, cash repatriation.
Other services	Advice with respect to corporate governance, forensic investigation, litigation support, Corporate Social Responsibility reporting, risk management, compliance, IT audit & advice, provision of training and courses.

As multi-disciplinary service providers, NAS accounts for around 60% of the Big 4's revenue, with around 40% of total revenue coming from audit and assurance engagements (table 3.1).

¹⁷ The provision of other services to non-PIEs is also not permitted. This is not a general prohibition, as it is permitted to put measures in place to mitigate any risk that independence will be impaired.

Table 3.1: Proportion of revenue per service line¹⁸

Source: Deloitte, EY, KPMG¹⁹ and PwC; consolidated financial statements, 2016-2017

2016-2017	Revenue from Audit/ Assurance as % of total revenue	Revenue from Audit/ Assurance	Revenue from Advisory/ Consulting	Revenue from Tax	Other	Total revenue
Deloitte	27%	224	339	191	61	815
EY	45%	334	164	218	31	746
KPMG	54%	247	203	0 ¹⁹	11	461
PwC	39%	300	204	264	0	768
Total	40%	1105	910	673	103	2790

There are two contradictory hypotheses in the literature with respect to the auditor's independence in case of provision of NAS: the 'economies of scope' hypothesis and the 'independences' hypothesis. The *economies of scope* hypothesis states that positive knowledge spill-overs from NAS can enhance the quality of the statutory audit. The independences hypothesis on the other hand states that by providing both audit services and NAS, the auditor's independence and objectivity in the performance of the statutory audit are impaired, so that quality suffers.

Both hypotheses have their supporters in the literature, and both camps offer apparently contradictory evidence in practice, mainly due to the use of different definitions of quality and different measures. On the one hand, some studies find a clear negative connection between the quality of a statutory audit and the provision of NAS to the same client. Quality here is measured by the price of the statutory audit: the possibility of being able to provide NAS leads to price pressure on and therefore potential lesser quality of the audit (Simunic, 1984; Simon, 1985; Palmrose, 1986). There is also fairly robust evidence that the likelihood that an unqualified audit opinion will be issued increases if the audit firm provides more NAS to the same client (Lim and Tan, 2008) and that the likelihood of material misstatements also increases (Zhang et al., 2007). A recent empirical study provides evidence that auditors are more inclined to ignore material misstatements by the audit client in cases where NAS are also provided (Asare et al., 2018). On the other hand, there are some studies that cast doubt on this

¹⁸ The classification of services into service lines is not the same at each audit firm. The audit practice is part of the service lines known as Audit or Assurance.

¹⁹ The Tax practice of KPMG in the Netherlands is carried out by Meijburg&co and these data are not recognised in the relevant consolidated financial statements of KPMG.

(Abdel-Khalik, 1990; Whisenant et al., 2003) or which find no significant evidence that providing NAS makes it more likely that the auditor will issue an audit opinion that is favourable for the audit client (DeFond et al., 2002; Geiger and Rama, 2003). The literature that estimates quality by discretionary accruals²⁰ also shows a mixed picture. Some studies find evidence that more NAS leads to lower quality reporting, characterised by higher accruals (Srinidhi and Gul, 2007; Frankel et al., 2002). Other studies find no significant connection (Ashbaugh et al., 2003; Mitra, 2007).²¹

An important negative driver for quality lies in the remuneration system for auditors, that is significantly related to generating revenue and contributing to the result. The potential for generating future revenue from audit clients from the advisory branch can undermine the auditor's independence (Blay and Geiger, 2013). There is robust evidence for low quality of statutory audits at clients that (i) are undergoing rapid business expansion, meaning that the ex ante chance of winning future advisory engagements is greater and (ii) take additional advisory services from the audit firm in the year after the audit engagement (Causholli et al., 2014). Interestingly enough, this evidence is found only for the years 2000 and 2001 (before statutory limitations on the simultaneous provision of audit and non-audit services to the same client were imposed in many jurisdictions) and not for the years 2006 and 2007 (after the introduction of statutory limitations). The conclusion also therefore implies that the negative effects of providing audit and advice services have been reduced since the introduction of statutory limitations (Van Brenk, 2018).

The literature is divided regarding knowledge spill-overs between NAS and audit services. A number of older studies find no evidence for this (Simunic, 1984; Beck et al., 1988). Others put forward evidence to support the assertion. There is some weak evidence that the simultaneous provision of NAS and audit services increases the effectiveness of the audit, measured by the number of errors identified by the auditor in or the adjustments made to the reporting (Joe and Vandervelde, 2007). In addition, another study finds no significant evidence that the provision of NAS leads to a low quality statutory audit, measured by the number of corrections to the reporting (Kinney, et al., 2004), in contradiction to another study that did find significant evidence of this

²⁰ Accruals are defined as income and expense that make the difference between the profit of a company and its cash flow. Examples of accruals are payments into provisions, write-downs and income from sales for which the finance has not been completed. Discretionary accruals are accruals that are not due to business operation, but are influenced by managers.

²¹ There are a number of studies that find evidence that businesses that have the audit firm provide both audit and advisory services make higher profits, but this is not related to the quality of the audit (see for instance Ciconte et al., 2015). This literature is accordingly left out of consideration.

(Ferguson, et al., 2010). Also if quality is measured by the degree of conservatism in the reporting, no evidence is found that more NAS income leads to a less conservative auditor's report (Ruddock, et al., 2006). Another study presents the hypothesis that the likelihood of being able to sell NAS to an audit client will make an audit firm more inclined to accept an audit client. However, no evidence was found to support this (Asare et al., 2005). Lastly, another study finds no evidence for a negative connection between the provision of NAS and the quality of statutory audits for large companies, but it did find such evidence in the case of SMEs (Bell et al., 2015).

There is also no definitive answer as to which hypothesis dominates on empirical grounds. The underlying reason for this lies in the use of various definitions of the term 'quality of statutory audits'. As stated above, the quality of a statutory audit is difficult or impossible to observe, as a result of which academic research applies a range of different standards to measure 'quality' on the basis of publicly available data.²²

There is ample and robust evidence that users have the *perception* that the auditor's financial dependence on their audit clients leads to low quality statutory audits and reporting as a consequence of the simultaneous provision of NAS. (See Kinney et al., 2004; Lavin, 1977; Shockley, 1981; Lowe and Pany, 1995; Lowe et al., 1999; Swanger and Chewing, 2001; Frankel et al., 2002; Krishnan et al., 2005; Francis, 2004; Francis and Ke, 2006). Research based on earnings response coefficients also finds strong evidence that users, including investors, assume there will be a deterioration of the quality of statutory audits if the auditor earns a larger part of their income from the provision of NAS, either to the same client or not (among others, Lisic et al., 2018; Khurana and Raman, 2006).

The strongest argument for the importance of an independent performance of a statutory audit as the only safeguard of quality may be based on behavioural finance (or 'behavioural auditing') theory and research into human biases, especially unconscious biases. The measures implemented by supervisors and legislators have thus in no way removed the dependencies between the audit firm and the audit client (Bazerman et al., 2006). More fundamentally, the behavioural auditing literature states that even if auditors as a profession are convinced that they are sufficiently independent with respect to the audit client, the existing combination of the

²² Some studies state that it is impossible to establish the independence of the auditor in practice, but research findings with respect to the perception of independence (independence in appearance) are robust: auditors have to avoid the *appearance* of dependence (Habib et al., 2012).

revenue model, the business model, the partner model and the degree of competition will lead to biases among auditors of which they are not aware (Bazerman et al., 2001; Chugh et al., 2005; Moore et al., 2006).²³ Purely for the American market, the response has been to emphasise the importance of the overall balance of incentives for auditors to determine whether they are biased or not. Reputational damage and fear of legal consequences in the form of high penalties and/or imprisonment are important counter-incentives in the US system (Nelson, 2006). There is little competition in the PIE segment in the Dutch market, and also limited enforcement in the form of high penalties or market sanctions such as high claims or rulings.

Some of the above literature relates to the situation in which simultaneous provision of statutory audit and NAS to the same client is permitted, but also in situations in which there are limitations, negative incentives with respect to the auditor's independence remain so long as the same multi-disciplinary service provider provides both statutory audits and advisory services (Meckfessel and Sellers, 2017). There are several factors involved here. Firstly, the more commercial culture of the advisory practice is not a good fit with the public interest of statutory audits (Dirsmith et al., 2015; Malsch and Gendron, 2013; Wyatt, 2004; Zeff, 2003; Greenwood and Empson, 2003). The combination of advisory and audit services in a single multi-disciplinary service provider creates friction between an advisory culture that is focused more on commercial interests and an audit culture that should be focused on the public interest and the long term (Gendron and Spira, 2010; Huddart, 2013; Malsch and Gendron, 2013; Meckfessel and Sellers, 2017; Wyatt, 2004; Zeff, 2003). Secondly, the attention of the management and the accent of investment in quality could shift from the audit to the advice practice, if the latter contributes more to growth and profitability. In addition, the MCA notes that sharing profit by means of an internal formula becomes more difficult if one part of the organisation is focused on and designed for growth and generating revenue, while the other part is focused on investing the quality of statutory audits (MCA, 2016). Thirdly, the partners in the audit practice could have an incentive to make a career in the advice practice over time, given the more favourable commercial prospects for growth and the limited risks of liability in this field. If this leads to a focus on the importance of good relationships with

²³ Bazerman says that the pro status-quo literature has a three-stage plan against change: (1) "[to] rely on public acceptance of the status quo", (2) "to obfuscate the evidence [that accountants are biased]" and (3) "to call for the need for careful, precise cost-benefit analyses and further research" (Bazerman et al., (2001).

audit clients rather than giving central priority to the public interest, this could have a detrimental effect on the quality of statutory audits.

Audit firm tenure and partner tenure can lead to capture and a less independent attitude by the auditor Supervisors and legislators are generally concerned that independence will be negatively affected and that the quality of statutory audits will be poor as a result of lengthy tenures. Generally, they see mandatory rotation as an instrument to increase independence and professional scepticism on the part of the auditors (European Commission, 2010; among others, Jackson et al., 2008).

Approximately 45% of jurisdictions in developed economies apply mandatory firm rotation; 59% apply mandatory auditor rotation. These findings are actually somewhat dated (Ewelt-Knauer et al., 2013). In the Netherlands, PIEs currently must change their statutory auditor every 5 years and their audit firm every 10 years.²⁴

In the literature on capture of the auditor as a result of audit firm tenure and partner tenure, the ‘independences’ hypothesis conflicts with the ‘expertise’ hypothesis. The ‘independences’ hypothesis states that the longer the relationship between the audit firm and the audited company, the closer the two parties become and the more likely it becomes that the auditor’s judgement will favour the company management. This increases the chance that the quality of the statutory audit will decline (among others Anson 2003; Clapman, 2003; Imhoff, 2003). In cases where rotation is not mandatory, the audit firm may have an incentive to provide the initial audit engagement at less than cost with the aim of making profits later on during a lengthy tenure period as a result of economies of learning and scaling down the commitment to (and the quality of) the audit after each ‘successful’ auditor’s report (Gold et al, 2012).²⁵ The ‘expertise’ hypothesis, however, states the opposite: that the longer the relationship between the audit firm or the audit partner and the audit client has lasted, the better understanding the auditor has of the business model and the company. And therefore, the more likely it will be that the quality of the statutory audit will increase (Johnson et al., 2002).

The literature on tenure and mandatory rotation does not provide convincing empirical evidence for either of the two hypotheses, although the balance would seem to favour the expertise hypothesis at audit firm level and the independences

²⁴ The Dutch regulation applies to *statutory* auditors. In many cases this concerns an equity partner, in some cases it concerns a salary partner, director, or senior manager authorised to sign.

²⁵ Gold et al. (2012) explicitly confirm the attention to familiarity bias as a result of lengthy tenure: “The accountant anticipates current results [of the audited company] given the knowledge of prior results instead of objective evaluation of audit evidence for material misstatements”.

hypothesis at auditor level. An illustration is provided by a study that finds evidence that longer audit firm tenure neither increases nor decreases the probability of a favourable going-concern audit opinion for audited companies that later go bankrupt (Knechel and Vanstraelen, 2007).²⁶ Specifically with respect to audit firm tenure, there is no clear evidence that mandatory firm rotation increases the quality of statutory audits, due to the variety of definitions and measures used (DeFond and Zhang, 2014). There is thus some evidence that the quality of statutory audits declines with mandatory rotation (Geiger and Raghunandan, 2002), especially as the rotation date approaches (Cameran et al, 2016)²⁷; no significant evidence is found for this in case of longer audit firm tenure (Carcello and Nagy, 2004). Other studies find either no evidence that quality declines with longer tenures (among others Myers et al., 2003), or some evidence that quality increases in case of longer tenures (Gul et al., 2007; Chen et al., 2010), or that this is the perception among investors (Ghosh and Moon, 2005). Regarding partner tenure, there is literature that asserts that partner tenure increases the efficiency of the audit due to learning economies, although no explicit relationship with statutory audit quality is suggested (Carey and Simnett, 2006; Jenkins and Velury (2008). Against this, there is evidence that particularly partner tenure (of the engagement partner) increases self-identification with the audit client and can lead to capture, but not (or to a lesser extent) the tenure of the audit firm or its review partner (Lin and Tepalagul, 2014; Bamber and Lyer, 2007; Dopuch et al., 2001; Gates et al., 2007; Kaplan and Mauldin, 2008; Gold et al., 2012). These results are in line with the findings of the behavioural auditing literature on biases.²⁸ More theoretical academic research relating to changes of partner and the quality of statutory audits shows a mixed and inconclusive picture and does not present any unequivocal evidence in favour of either of the two hypotheses (Lin and Tepalagul, 2014, Carey and Simnett, 2006; Chen et al., 2010; Chi et al., 2009; Seng and Kee, 2016).²⁹ The empirical results are also varied with respect to the perception by the users that independence declines

²⁶ As a result of mandatory rotation, competition is limited for PIEs that prefer to use one of the Big 4 audit firms due to their size or degree of worldwide organisation. When changing there is a choice of three audit firms, of which one or two may be ineligible due to the provision of non-audit services.

²⁷ Reputational damage or the threat of this applies regardless of whether rotation is mandatory or voluntary, but this is not considered further in this study.

²⁸ Interestingly enough, more recent psychological research into biases suggests that declining auditor independence due to conscious or unconscious identification with the client can develop so quickly that reducing tenure periods may not be sufficient (Bauer, 2015).

²⁹ Seng and Kee (2016) conclude on the basis of a study of the literature that "...there is general support, but no consensus partly due to diverse audit quality measurement, that mandatory firm rotation does not increase audit quality. Audit partner rotation produces mixed results from archival studies although experimental study tends to support the independence hypothesis."

as a result of lengthy tenure, chiefly due to use of different measures for quality in relation to independence and firm and partner rotation.

Affiliation of the auditor to the audit client may impair independence A situation of affiliation applies if the auditor (1) sees an audit client as a potential future employer, (2) works too much for or too closely with the management of the audit client in the relationship instead of the shareholders and other stakeholders, or (3) works with former colleagues employed at the audit client when performing the audit, for example in the client's internal audit department or senior management. Research shows that employment affiliation (the auditor enters employment at a former audit client; around 75% of the cases reviewed) and *alma mater* affiliation (the audit client engages the former employer (an audit firm) of a director for statutory audit services; around 25% of the cases reviewed) are the most common examples. In both these cases, statutory auditors are more inclined to issue a 'clean' going-concern audit opinion (Lennox, 2005; Iyer et al., 1997).

These forms of affiliation may lead to a decline in objectivity and the quality of the statutory audit, if not in practice at least in perception (Lin and Tepalagul, 2014).

Accordingly, a much quoted but older study concludes that the hiring of auditors by audit clients was not unusual and that after entering employment at an audit client the former auditor was less critical with respect to any decline in independence than the users of auditor's reports (Imhoff, 1978).³⁰ Other somewhat dated publications also show that users of reporting associate the existence of affiliations between audit firm and audit client with a lower quality statutory audit because independence has been impaired (Firth, 1997; Koh and Mahathevan, 1993; Parlin and Bartlett, 1994; Kaplan and Whitecotton, 2001). While there is some evidence that companies at which former audit partners are employed report higher extraordinary accruals than companies that do not employ former audit partners (Menon and Williams, 2004), there are several studies that find no significant result in this respect (Geiger et al., 2005; Geiger et al., 2008). Lastly, a publication states that companies are more inclined to engage an audit firm for statutory audit services at which the current directors have been previously employed, unless there is an explicitly independent AC (Lennox and Park, 2007). Independent ACs clearly see affiliation as a threat to the independence of the auditor and may thus be an effective means of avoiding affiliation.

³⁰ The users of auditor's reports took the view that independence was negatively affected in case of a period of six months between the auditor leaving an audit firm and entering employment in the internal audit department of an audit client.

The literature devotes relatively little attention to the issues around affiliation, independence and the quality of the statutory audit. Certainly in comparison with other threats to the independence of the auditor, such as the provision of NAS and limited firm and partner rotation, research into affiliations between auditor and audit client receives so little attention that some parties even take this as evidence that affiliation occurs less frequently in practice than one would expect on the basis of a theoretically cogent argument (Francis, 2004).

3.5.3 Anecdotal indications

In the interviews conducted in the context of this research, there were several references to the undesirable interrelationships that can occur between audit services and other services. One concern here is that the current structure in which audit and advice are under one roof could constitute a harmful incentive to optimise usage of the information obtained through the audit practice on one client for advisory services to another client that operates in the same sector. Insights relating to business strategy obtained in a statutory audit for a particular client can be of value to the audit firm and thus form an incentive to benefit from this through other services for that client's direct or indirect competitors. This places high demands with respect to internal safeguards, such as Chinese walls at multi-disciplinary service providers such as the Big 4 audit firms and therefore compliance with ethical standards. Some experts however stated that the potential negative influence of providing advisory services on the quality of statutory audits is not adequately supported by academic research. Others stated that this also applied to evidence for the existence of knowledge spill-overs between NAS and audit services.

The interviews with experts also referred to affiliations between audit firms and the supervisor. It was noted that the responsible directors at supervisory authorities had sometimes been previously employed as partners at a Big 4 audit firm. At lower organisational levels as well, there would appear to be a practice whereby auditors from the sector, either approaching the end of their careers or not, have been employed at the supervisory authority. This 'adhesion' is indeed to some extent inevitable and even to a certain extent desirable, in view of the knowledge and experience needed by the supervisor.³¹

³¹ Statutory provisions regarding the independence of officers at the supervisory authority, involving a quality evaluation and a cooling-off period, have been in force since 2017.

3.6 Market organisation - supply side of the market

3.6.1 Description of market failure

The presence of market power in the market for statutory audits can lead to little or no competition with respect to (among other things) the quality of statutory audits. This may mean that the level of quality could be lower than the level that is desirable from the public perspective. Market failure in the form of market power can be closely related to other forms of market failure, specifically the existence of information asymmetry between the auditor (and the audited company) and the user of the auditor's report, as well as between the auditor and the audited company itself.

A limited number of providers of audit services can also lead to a 'too few to fail' problem and also moral hazard; an audit firm that expects to be 'saved' experiences incentives to take undesirable risks. This expectation may increase if the public interest in the continuity of an individual audit firm is considered to be too great to accept that an audit firm would leave the market. This interest may be a reflection of short-term considerations (PIEs without an auditor, lack of publication of reporting) or long-term considerations (effect on the market organisation and competitive relationships). The expectation of rational government intervention may then incite audit firms to take socially undesirable risks, such as inadequate investment in the quality of statutory audits, since negative outcomes will be borne by the government. In other words, there is a moral hazard problem.

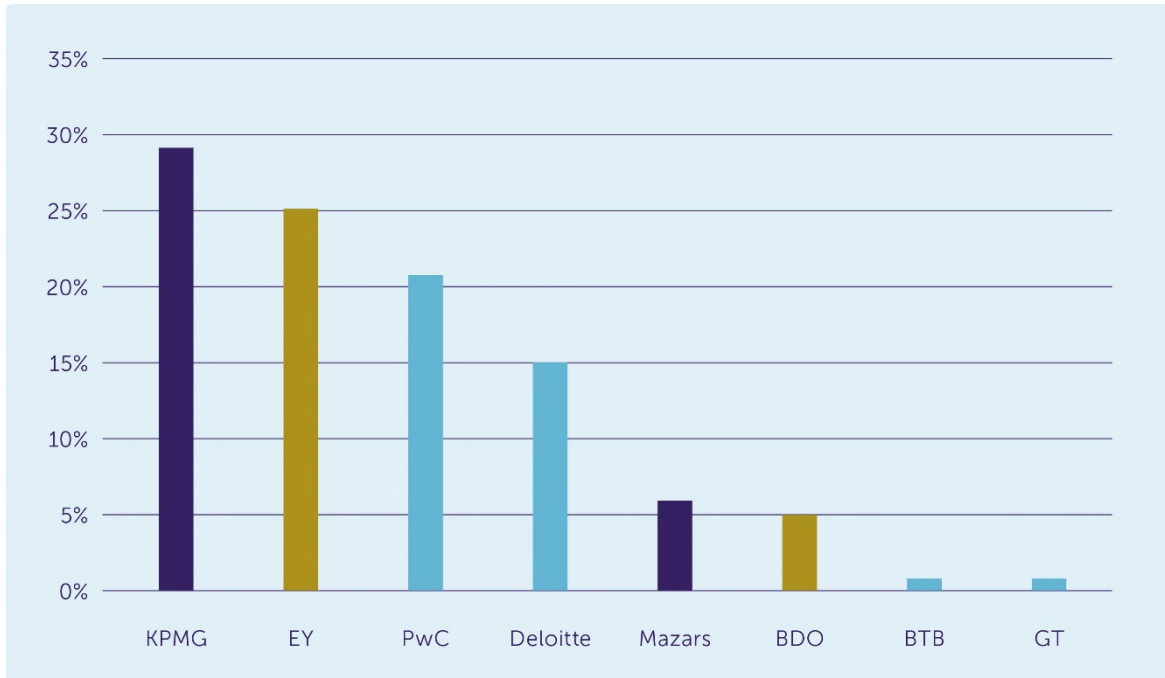
3.6.2 Analysis based on academic literature

In economic theory, the presence of a degree of market power and the degree of competition in a market is usually analysed on the basis of the 'structure – behaviour – results' model. Since behaviour is frequently difficult to observe, observations focus mainly on the market organisation (degree of concentration, access barriers, switching costs) and market results (price, quality, profit margin, etc.) (among others Chu et al., 2017).

The Big 4 audit firms dominate the market for statutory audits of PIEs. Calculation of a Herfindahl-Hirschman Index (HHI) on the basis of the market shares of PIE audit firms gives a score of 2113, which indicates a concentrated market and the presence of market power (figure 3.4).³²

Figure 3.4: Market shares in statutory audits PIE segment (% of PIE audits)

Source: AFM, 2016



The literature does not present any clear evidence that higher concentration in the audit sector necessarily leads to less price or other competition (Pearson and Trompeter, 1994; Bandyopadhyay and Kao (2004); Feldman (2006). There is however evidence that the audit sector becomes less competitive in areas of higher industry specialisation and to the extent that the leading audit firm has a higher market share compared to the share of the number two firm in the market (Numan and Willekens, 2012). Competition in the audit sector particularly takes place at local level, and is associated to certain company characteristics (among others Chu et al., 2017). This means that companies in regulated sectors such as banks, insurers or municipalities often have a limited choice with respect to providers of statutory audits.

There is the question of to what extent audit clients actually change their auditor, on the basis of either a quality difference or other factors such as price. It has been established in the UK market that there are very few changes of auditor other than due

³² The Herfindahl-Hirschman index is the sum of the squares of all individual market shares. Values above 2000 are an indication of a concentrated market and the presence of market power.

to statutory requirements in this regard. This is mainly due to high transaction costs (Hackenbrach and Hogan, 2002; Boone et al., 2008, DoT Advisory Committee on the auditing profession, 2008). There has been more audit firm rotation in the Netherlands in recent years as a result of the statutory requirement to rotate the audit firm.

Other structural factors also limit the degree of competition. Firstly, a statutory audit by definition is not subject to any threat of substitution from the market. An audit is a statutory requirement, therefore obtaining another form of assurance regarding the reporting would only be a realistic alternative if changes were made to legislation and regulation. There are also substantial access barriers, especially in the PIE segment. These include access to capital, liability risk and the importance attached by companies to a certain reputation of the audit firm.

The link between market power and the quality of statutory audits is not easy to establish; the picture in the literature is mixed, and market power is difficult to isolate as an explanatory factor. The intuitive idea that a certain degree of market power means that audit firms experience less incentive from the market to produce high quality audits is obvious. But there are other hypotheses. A degree of market power as a result of high access barriers can contribute to the creation of client-related 'quasi-rents' (DeAngelo, 1981). If an auditor has many audit clients with these quasi-rents, the incentive may be greater to avoid statutory audit quality issues or the perception thereof so as not to lose these quasi-rents. In practice, however, it is difficult to isolate the degree of market power as the explanatory factor for a high or low quality of statutory audits. There is evidence that audit firms that possibly have a greater degree of market power such as the Big 4 audit firms generally can offer a higher quality of statutory audits. At the same time, this quality difference disappears if adjustment is made for audit-client-specific characteristics and the fact that the Big 4 audit firms generally have larger audit clients (Lawrence et al. 2011).

A study of the presence and effects of moral hazard as a result of a too few to fail situation begins with the question of to what extent the market expects the government to intervene if a big audit firm is on the verge of collapse. Research shows that in the US market for statutory audits there are clear reasons for the government to intervene if a Big 4 audit firm looks like it will leave the market. An exit would involve an immediate decline in the consumer surplus (an economic term that defines the collective benefit for the demand side of the market of the transactions entered into in a market) of between USD 1.4 and 1.8 billion (Gerakos and Syverson, 2013). This study has also identified clear indications in practice that concerns

surrounding further market concentration have led to the US government behaving differently with respect to a large audit firm than could have been expected on the basis of previous experience. Other reasons for government intervention include competition issues and the prevention of panic among investors (Cunningham, 2006).

The market organisation and concentration in the Dutch audit sector is generally comparable with the situation in other countries. Data from the European Commission (EC 2017) show that a high concentration of the supply of PIE audits is a common phenomenon internationally. There could therefore be expectations in the Netherlands as well that the government would consider protecting a large audit firm from collapse – for instance by actively supporting the audit firm or deciding *not* to impose potentially fatal enforcement (such as the withdrawal of a licence) if there was good reason for this. The extent to which this potential expectation actually influences audit firms to indulge in risky behaviour is difficult to establish. Firstly, such behaviour can manifest in many ways, including not enough urgency with respect to quality improvement or commercial behaviour that is too aggressive. Secondly, this can only be established in relation to audit firms that do not experience these incentives. Audit firms that do not experience these incentives also vary in many other aspects, meaning that the effect of moral hazard on behaviour is difficult to isolate.

3.6.3 Anecdotal indications

The interviews with experts raised the point that the audit firms are not always prepared to make an offer for the statutory audit if they already have a profitable advisory relationship. This is the result of the prohibition of the simultaneous provision of audit services and other services. In situations where this applies, the market supply contracts and there is less competition. The interviews also revealed that stakeholders experience a negative effect from the mandatory rotation of the auditor on the competitive relationships in the market, as supply is reduced when an audit firm is no longer permitted to tender for an engagement due to the mandatory rotation.

High costs of quotation are an additional barrier to effective competition. Although exact figures on the quotation costs of the audit firms are not available (or what drives these costs), there are anecdotal indications that this can form an obstacle to a competitive market.

4. Quality improving measures in the current structure

4.1 Introduction

Reforms have been implemented in recent years to increase the quality of statutory audits and improve the independence of audit firms. The introduction of the Audit Firms Supervision Act (*Wet toezicht accountantsorganisaties*, or Wta) in 2006 initiated a system of independent public supervision. The legislation has been reformed on several occasions since that time, also as a result of European regulation. The NBA also initiated improvement measures in 2014. The statutory reforms have recently come into effect (figure 4.1).

Figure 4.1: General features of the reforms effected









Source: AFM


Reform	Year of introduction	Objective	Principal measures
The Audit Firms Supervision Act (Wta)	2006	Justified restoration of confidence in auditors and auditor's reports	<ul style="list-style-type: none"> • Introduction of licensing system • Ongoing provisions for audit firms • Introduction of independent public supervision
Amendment of the Wta for implementation of Directive 2006/43/EG	2008	Transparent and efficient market for audit services in order to realise an efficiently operating capital market in the EU	<ul style="list-style-type: none"> • Increased cooperation between supervisors in the EU and with non-EU countries • Mandatory appointment of an audit committee for PIEs
Announcement of refinement of the Wta <i>(*measures not effected due to EU Audit Reform)</i>	2012*	Increase independence of audit firms in audits of PIEs	<ul style="list-style-type: none"> • Mandatory separation of audit services and other services at PIEs • Mandatory audit firm rotation for statutory audits of PIEs
NBA improvement measures: "In the Public Interest"	2014	Improve quality and independence of audits	<ul style="list-style-type: none"> • Appointment of an SB • Management that is primarily concerned with the management of the audit firm • Quality-based remuneration and a claw-back scheme • A leverage model that safeguards quality (remuneration and revenue model) • Introduction of a professional oath
"EU Audit Reform": implementation of Directive 2014/56/EU and EU Regulation 537/2014	2016/2017	Increase in confidence among investors that financial reporting is reliable by improving the quality of statutory audits, and increased competition within the EU	<ul style="list-style-type: none"> • Limitations on concurrent provision of audit and advisory services for PIEs (NL: separation) • Mandatory audit firm rotation for statutory audits of PIEs • Increased role for audit committees of PIEs in the selection and appointment of an auditor • Mutual recognition of auditors and audit firms permitted in other EU/EEA Member States
Audit Firms Additional Measures Act <i>(Wet aanvullende maatregelen accountantsorganisaties)</i>	2018	Strengthening governance of audit firms, powers of the AFM, and improving the quality of statutory audits	<ul style="list-style-type: none"> • Establishment, and definition of tasks and powers of SBs at PIE audit firms • Suitability test for managing and supervisory directors at PIE audit firms • Obligations for audit firms to remediate in case of deficiencies in audits • Sharing of supervisory findings on statutory audits with audit committees of PIEs


In the extension of the already effected reforms, additional measures to achieve high statutory audit quality can be considered. These measures are designed to reduce the negative effects, but they will not remove the underlying causes of market failure. They concern the further engagement of stakeholders in the current reporting and auditing structure to fulfil their responsibility to bring quality to a high level. This concerns not only the audit firm or the auditor, but also the audited company and its SB/AC, the shareholders, debt providers and creditors, as well as the AFM in its supervisory role (figure 4.2). This non-exhaustive list of measures requires further analysis and further discussion with stakeholders to review the extent to which and the manner in which these measures or variants thereof could contribute to sustainably and consistently high quality statutory audits.


Figure 4.2: Measures to improve quality within the current structure


Source: AFM

Measure	For which sources of market failures are the negative effects reduced?	Paragraph
1. Strengthening governance at audited companies	 Revenue model  Demand side	4.2
2. Improving quality of reporting by audited companies	 Demand side	4.3
3. Encouraging auditors to focus on quality	 Partner model	4.4
4. Policy of management of PIE audit firms in service of quality	 Partner model	4.5
5. Strengthening quality safeguards at audit firms	 Business model  Partner model	4.6
6. Expansion of enforcement policy	 Demand side	4.7

 Demand side

 Revenue model

 Partner model

 Business model

4.2 Strengthening governance at audited companies

A critical and independent fulfilment of responsibilities by the SB and the AC is an important precondition for improving the quality of corporate reporting and therefore for the quality of the independently performed statutory audit. The SB fulfils a crucial role in the system of checks and balances between stakeholders, the management and the auditor. The SB can thus play an important disciplining role in reducing potentially harmful incentives arising from the revenue model of audit firms, by strengthening the disciplinary effect on the quality of statutory audits.

The role of the AC has been strengthened in recent years due to changes in European and Dutch legislation and regulation. Among other things, the changes

entail an explicit role for the AC in the selection and nomination of the auditor. After the introduction of the Audit Firms (Additional Measures) Act (*Wet aanvullende maatregelen accountantsorganisaties*) on 1 July 2018, the audit firm must share the principal findings and conclusions of the assessment of the AFM with respect to a reviewed PIE audit with the SB/AC of the audit client in question. The AFM is also now charged with monitoring the performance of ACs.³³ These changes will need time to take effect. Equally clearly, this requires that the changes are implemented effectively at all PIEs - not only listed companies.

Nonetheless, as shown in section 3, the literature is divided on the question of whether the SB and the AC operate with sufficient independence. It cannot be ruled out that in practice the influence of the company, and in particular of the CFO, on the process of selection of the auditor goes further than simply organising and advising on the selection process. There is room for improvement in the selection process regarding the degree of transparency and reporting on the actions of the AC to the shareholders.

Box 4.1: UK legislation and regulation strengthens the role of ACs

In the UK, an AC must explicitly ensure that the interests of shareholders are protected with respect to the company's financial reporting. In a company's annual report, the AC must report on:

- The procedure the AC has followed with respect to the nomination of a new auditor. Although not explicitly stated in the FRC guidance, this would ideally include disclosure of the selection process, the assessment criteria, the fee and the number of hours and the scope of the statutory audit.
- How the AC assessed the effectiveness and quality of the statutory audit. In this respect, the AC for example should express an opinion on how the auditor has arrived at key judgements, the state of internal quality controls at the audit firm, etc.
- The key issues in the financial reporting that were discussed by the AC and how these had been addressed.
- With respect to the taking of non-audit services from the audit firm (if applicable): what the AC's policy is in this respect, how the independence of the auditor is ensured, the fees for the statutory audit compared to the fees for non-audit services and an explanation by the AC for each non-audit

³³ However, this does not mean that ACs are subject to supervision by the AFM.

service of why it was in the company's interest to take the service in question from the audit firm (if this is permitted).

Another requirement in the FRC guidance to ACs is that if the statutory audit of the financial reporting of the company in question is evaluated by the FRC as part of its Audit Quality Review, the AC must discuss the findings with the auditor. The AC must then assess whether these findings are of material significance. If this is the case, the AC must publish the findings, together with the corrective measures to be taken by the AC and the auditor in this respect.

It would therefore seem to be desirable to study whether and if so how the roles of the SB and the AC could be further strengthened. The experiences in the UK – where the obligations for ACs are established in the UK Corporate Governance Code and in guidance from the Financial Reporting Council (the FRC, the UK supervisor of audit firms) – can serve as inspiration here.³⁴ ACs operating under legislation and regulation in the UK have greater responsibilities than in the Netherlands, especially with respect to transparency and accountability to shareholders (box 4.1). Shareholders as a result have more options for fulfilling their disciplining and monitoring role with respect to the company and the auditor, which could contribute to the quality of the reporting and of the statutory audit. The extent to which it would be desirable to implement these measures in the Netherlands could be investigated. For example, it could be determined that the SB/AC will explain its proposed appointment of an auditor to the AGM with information for instance on the number of audit firms that have been asked to quote, the agreed scope of the audit engagement, the fee and the auditor's CV. This would enable the AGM to ask questions on these points. The company's AC could be obliged to prepare a report for the AGM and put this report to the AGM for an advisory vote. This would enable the AGM to give a clear signal regarding the execution of the AC, its evaluation of the quality of the statutory audit, the way in which the company is addressing the key issues identified in the statutory audit and the treatment of the key findings in the auditor's report.

4.3 Improving the quality of reporting of audited companies

High-quality reporting by companies is a precondition for auditors to be able to perform a high-quality statutory audit. Measures that could further improve the quality of reporting could be considered.

³⁴ FRC, *UK Corporate Governance Code* (July 2018); FRC, *Guidance on Audit Committees* (April 2016).

One potential measure is to make it mandatory for the SB of a company to explicitly state each year that its internal control with respect to reporting risks is reliable. For companies listed in the US, in addition to the SOX 404 declaration of the management, the auditor also has to declare that they agree with this declaration by the management.³⁵ The principle here is that the declaration forces the company to be transparent regarding the quality of its internal controls with respect to reporting risks and therefore provide insight into the risks arising from this. Companies thus have an incentive to have adequate internal controls in place, thus reducing the likelihood of errors in the reporting and therefore also the likelihood of bankruptcies. A similar system of a management declaration has already been introduced in the corporate governance code in the Netherlands. There is however no obligation for the auditor to declare explicitly that they agree with the declaration of the management. The current regulations moreover do not include any specific sanctions for the company, the management and the auditor if the requirements are not met. One could consider bringing the Dutch regulations more in line with regulation in the US. By extension, more explicit requirements for company internal controls could also be considered, as well as transparency in this regard. Better internal control will generally reduce the likelihood of errors and could also contribute to the company being better informed with respect to risks and potential problems. This would limit both the initial likelihood of errors occurring and the likelihood of errors slipping through (due to pressure on the auditor or an inadequate audit) and would improve the quality of the information being provided to investors.

One variant is that the management and the SB devote explicit attention in the reporting to the key issues identified in the audit. The SB of a company could state in its report how it has addressed the key audit matters mentioned in the auditor's report. In addition, as mentioned above, one could also consider having the SB/AC devote attention in its report to the key audit matters raised in the auditor's report.

Another possibility would be to have the management report explicitly on the measures it has taken to prevent and detect errors and fraud. The auditor could

³⁵ SOX article 404 sets rules for matters including the internal controls and the financial reporting. The management is obliged to make an explicit statement each year regarding the reliability of the internal control measures in effect at the company. The CEO and the CF(R)O must issue a declaration that the internal control measures are effective and the auditor must add an explicit statement to their auditor's report to the effect that they agree with the declarations of the CF(R)O and the CEO. The SOX regulation includes strict enforcement measures for both the company management and the auditor.

then be obliged to carry out specific procedures on that report as part of their statutory audit and the auditor's report.

Changes to the liability model for the management and/or SBs could also be considered. Currently, it is up to a third party to demonstrate causality between losses suffered and actions or omissions of the management if this party wishes to hold the management or the SB liable. One possibility would be to give the court the room to apply alternative causality (reversal of the burden of proof) if it has convincing indications that the management or the SB has not conducted itself appropriately or has acted culpably.

4.4 Encouraging auditors to focus on quality

A number of potential changes that affect the auditor's focus on quality could also be considered without fundamental changes to the current partner model at audit firms. The underlying purpose of such measures would be to introduce additional incentives that will encourage the auditor to exhibit behaviour focused more on the long term and improving quality.

Potential reforms could lead to certain limits being set for the commercial incentives at audit firms and could have an impact at auditor level. There could for instance be further changes to the remuneration policy designed to encourage quality. One possible measure in this context could be to set a cap on the revenue-related remuneration of the auditors. Beyond this point, pay would depend on quality criteria.

Another reform could be changing the common practice that audit partners retire at 55 to 60 years of age. This could be done in various ways: raising this minimum retirement age to 65 years or to the retirement age of the employees at the audit firm, or to the age of entitlement to state retirement pension (AOW) or the retirement age of comparable professions such as judges (70 years). The idea here is that the investment horizon would increase to some extent, the commercial pressure on partners would be reduced, there would be more room for the public interest and therefore more long-term behaviour, such as investment in quality, would be encouraged. The desirability of this change would have to be considered against the desirability of the inflow of new partners to reinforce the change dynamic and impulses for renewal.

Lastly, the auditor's report could have to be signed by both the auditor and the person carrying out the engagement quality control review (the EQCR). It is a

statutory requirement that an engagement quality control review (EQCR) is performed, at least for PIE audits, prior to issuance of the auditor's report. This four-eyes principle could be extended further with the aim of improving the quality of statutory audits by having the reviewer conducting the EQCR sign the auditor's report. The EQCR is an important element in an audit firm's quality control system. Signature of the auditor's report by both the auditor and the EQC reviewer would provide transparency to the users of the auditor's report. This will introduce a positive incentive for the EQCR carried out on behalf of the audit firm.

4.5 Policy of management of PIE audit firms in service of quality

Most management boards of PIE audit firms consist mainly of partners for whom there are potentially few incentives to pursue a policy focused on the long term.

For instance, this applies to long-term investment with the aim of increasing the quality of statutory audits.

One possible consideration would be to make it mandatory for management boards to have more external members. Directors of audit firms need to possess qualities such as independence, integrity, management skills and an understanding of the public interest in addition to the necessary level of professional competence. The introduction of suitability requirements on 1 July 2018 for directors and supervisory directors will make a further contribution and is expected to have a positive effect on quality. It could be investigated whether the mandatory inclusion of additional external members on the boards of audit firms could contribute further to this. For example, in the UK the management boards of audit firms must have at least three independent and non-executive directors whose primary duty is - based on protecting the public interest - to safeguard the quality of statutory audits (FRC Audit Firm Governance Code, 2016). The underlying idea is that the influence of third parties who are not co-owners of the audit firm will potentially lead to policy and behaviour that is more quality-oriented. Moreover, a board that is more separate from the 'executive' auditors could exercise stronger management.

4.6 Strengthening quality safeguards at audit firms

In addition to the already implemented reforms in the NBA's 'Audit Change Agenda', further progress could be made with respect to business operation and the quality control and monitoring system at audit firms. This could for example concern the institution or expansion of support staff with the aim of keeping the audit

firm in control of its business operation from the perspective of quality. This could also contribute to further professionalisation of the management and the internal supervision. By extension, one could also consider setting more far-reaching quality requirements for the transparency reporting of PIE audit firms. If these reports are made more uniform and for instance included comparable Audit Quality Indicators (AQIs: see below), this would make it easier for ACs and other users to gain an impression of the quality of the audit firms.

4.7 Expansion of enforcement policy

Consideration could be given to whether the AFM's enforcement policy with respect to audit firms needs to be expanded. The underlying aim could be on introducing more balance in the supervision of (i) statutory audit quality, (ii) internal quality safeguards and (iii) behaviour and culture and the associated enforcement measures.

The role of the AFM would thus include enforcement of desirable behaviour as well as encouragement of change. Behavioural and cultural changes involve a lengthy process in which a balance has to be found between rewarding 'pro-culture actors' and 'early adopters' and punishing 'anti-culture actors' and laggards.

As a result of the court ruling at the end of 2017, the AFM may possibly no longer be able to call audit firms to account with respect to a failure to fulfil their duty of care based solely on serious deficiencies in the quality of statutory audits.³⁶ The central issue in the case was whether a violation of the duty of care could be established at organisation level if the investigation by the AFM revealed serious shortcomings in multiple statutory audits. The duty of care is aimed at the audit firms. The duty of care means that the management of an audit firm must ensure that its internal quality safeguards operate in such a way that all the auditors affiliated to it and the auditors it employs meet the relevant applicable legislation and regulation.

Although in its supervision the AFM will continue to focus primarily on the audit firms, it would be worthwhile investigating whether both the audit firm and the auditor can be held responsible for serious deficiencies in the quality of a statutory audit. Currently, the only course open to the AFM for calling statutory auditors to account for serious deficiencies in a statutory audit is through disciplinary law. This

³⁶ Ruling of the District Court of Rotterdam of 20-12-2017. <https://www.afm.nl/nl-nl/nieuws/2017/dec/uitspraak-ey-pwc-zorgplicht>

takes no account of the responsibility of the audit firm and individual auditors for the quality of statutory audits under the Wta.

The complementary nature of the enforcement regime in the US and the UK, with enforcement at both organisation and auditor level, could serve as an example for expanding the enforcement policy of the AFM. Both the PCAOB and the FRC can take direct enforcement action against individual auditors. It is also notable that enforcement sanctions, at both audit firm and individual auditor level, are frequently higher in both these countries than under Dutch (disciplinary) law. From June 2018, the FRC can impose fines of GBP 10 million or more on audit firms for statutory audits with serious deficiencies and exclude auditors from the profession for at least 10 years (Box 4.2). The PCAOB also applies the possibility, in its opinion successfully, of excluding auditors from exercising their profession for several years if serious deficiencies are found.

Box 4.2: The UK's FRC tightens its enforcement policy on the advice of the Clarke Committee

The enforcement measures at the disposal of the FRC apply to both audit firms and individual auditors. In increasing order of severity, the FRC can impose a number of measures with respect to individuals:

- Warning;
- Stern warning;
- Instruction;
- Temporary prohibition of exercise of profession of auditor;
- Fine (on penalty of exclusion from profession of auditor);
- Repayment of fees received to the audit client;
- Exclusion from the profession of auditor.

Following the recommendations in the report of an independent committee chaired by Sir Christopher Clarke (October 2017), the FRC will prohibit individual auditors that have acted objectionably from exercising their profession for at least 10 years. With effect from June 2018, the FRC can impose fines of GBP 10 million or more on Big 4 audit firms that have performed their audits of listed companies inadequately. The FRC will also follow the recommendation of making more frequent use of non-financial penalties.³⁷

³⁷ See [frc.org.uk/news/november-2017/independent-review-of-financial-reporting-council](https://www.frc.org.uk/news/november-2017/independent-review-of-financial-reporting-council)

The enforcement policy of the PCAOB indicates that a combination of enforcement at audit firm level and at auditor level could be more effective for improving the quality of statutory audits than enforcement at audit firm level alone. After publication of a disciplinary measure at organisation level, the audit firms punished by the PCAOB saw a reduction in the number of their audit clients, but the quality of the remaining statutory audits did not improve. Furthermore, there was no improvement in the quality of the audits at audit clients who had parted company with their existing audit firm and moved to a different audit firm (Beck et al., 2018).

5. Exploring alternative structural models

5.1 Introduction

This section presents an exploration of alternative structural models. The aim is to give an impression of the extent to which changes in the market for statutory audits or to the structure of audit firms could remove the sources of market failure identified in section 2 in order to ensure consistent good quality of statutory audits. Here the AFM hopes to contribute in a substantiated way to an open debate on what may be the more structural causes of poor statutory audit quality and explore potential ways in which these causes could be removed.


















These alternative models are not new. A long list is mainly derived from publications from the audit sector (NBA, 2017; MCA, 2016 and 2018), the studies in the academic literature cited in section 3, the interviews with external experts and ongoing discussions in the public domain with respect to the quality of statutory audits, as well as initiatives or green-field reflections in national and international forums (such as IFIAR). A selection based on causality and potential (will the source of market failure be removed and is it likely that the alternative model will positively affect the quality of statutory audits) has led to a short list of 10 alternative models (figure 5.1). A description is presented of how each of these models would operate, and a list of each model's advantages and disadvantages. A far-reaching version of each model is presented first, followed by consideration of more moderate variants.






Many of these alternative models could bring about major changes to the status quo. This, and the fact that in both the Netherlands and other countries little or no experience of these alternatives has been gained, implies that these models require further analysis. It thus cannot be stated in advance for any model that it would certainly lead to an improvement in the quality of statutory audits. This is partly because it is not clear in advance whether and to what extent an alternative model would lead to new market failure in practice (for instance, in the form of harmful incentives) or could lead to government failure. On the other hand, this means that none of these models can be dismissed out of hand.

Among the 10 models, no explicit distinction is made between models that would require international implementation and models that could be implemented nationally. International implementation could be required if the model would entail changes to international legislation and regulation, national implementation would not

be effective given, for instance, the international networks within which the Big 4 audit firms operate and/or if national implementation would lead to an unfair playing field, given for instance an international shareholder base for audited companies.

Figure 5.1: Alternative models are designed to remove the sources of market failure
Source: AFM

Model	Which sources of market failures would be removed?	Paragraph
1. Audit only	 Business model	5.2
2. Intermediary	 Revenue model  Demand side	5.3
3. The Government Auditor	 Supply side  Business model	5.4
4. Financial Statement Insurance	 Revenue model	5.5
5. Abolition of statutory audits	 Demand side  Supply side	5.6
6. The user decides	 Revenue model  Demand side	5.7
7. Audit Quality Indicators	 Demand side  Supply side	5.8
8. Joint Audits	 Demand side  Supply side	5.9
9. Limit Big 4 market share	 Supply side  Business model	5.10
10. Corporate model	 Partner model	5.11

 Demand side  Revenue model  Partner model  Business model  Supply side

5.2 Audit only

In the audit only model, the audit practice would be separated from the other divisions of the multi-disciplinary service provider.³⁸ The audit firm would thus no longer be associated with organisational elements that provide services other than audit services and would operate fully independently, in legal, financial and operational terms. This would result in a pure audit firm that focuses on the provision of statutory audits.

The audit only model has a number of potential benefits. Firstly, separation of the audit practice of a service provider would bring an end to potential issues of independence related to the current mixing of audit services and other services,

³⁸ For instance, on 16 March 2018 Stephen Haddrill, chair of the FRC, the UK supervisor of audit firms, called for an effort to increase competition in the audit sector and improve the quality of statutory audits of PIEs and to remove the conflict of interests between the auditing and the advisory branches of audit firms: [ft.com/content/f0589e4e-2a9c-11e8-9b4b-bc4b9f08f381](https://www.frc.org.uk/~/media/f0589e4e-2a9c-11e8-9b4b-bc4b9f08f381). The South African supervisor (IRBA) also recently made a proposal for strict separation of the audit practice from the advisory practice at audit and consultancy organisations in that country.

including advisory services from the same service provider.³⁹ Due to the nature of its work, the advisory service primarily considers the interests of the client and operates in a more profit-oriented business culture that is however not appropriate for the audit practice, which should be more focused on the public interest.

Secondly, separation could increase the focus on the quality of statutory audits.

The risk that the attention of the management and the emphasis on investment in quality in organisations in their current form will (consciously or otherwise) shift from the statutory audit to the advisory practice, for instance if the latter contributes more to growth and profitability, will be effectively mitigated. Separation would also remove the potential incentive for partners in the audit branch to make a career in the advisory branch due to expectations of greater commercial growth potential and lower liability risk. The risks for the quality of statutory audits arising from an excessive focus on the importance of good client relationships (whether conscious or unconscious) and retention of audit clients would be reduced.

A disadvantage of audit only is that there will no longer be direct access by the audit practice to specialist knowledge that is available at the other divisions of the multi-disciplinary service provider. The statutory auditing of PIEs with varied business processes requires specialist knowledge in fields such as IT, cyber security, fraud and property valuation. This need could be met in an audit only model by hiring specialist knowledge in (or possibly by building up a certain degree of in-house knowledge within the separated audit practice). Further quantitative insight is needed into the internal calculation systems used by multi-disciplinary service providers in order to make a comparison between the current practice and a situation in which the separated audit practice would have to hire this knowledge. The costs and the contribution to the result of specialist knowledge originating from the advisory practices of these service providers would thus become transparent and measurable.

Another disadvantage of audit only is the possible reduction in the value and efficiency of international networks. The large Dutch audit firms are part of global multi-disciplinary service providers that combine audit and advisory services in a single organisation. Among other things, this offers potential scale benefits with respect to knowledge gathering and quality monitoring. It would thus be difficult to separate the statutory audit services at a Dutch audit firm without losing large internationally-

³⁹ Since 2013, an audit firm in the Netherlands may no longer offer advisory services to PIEs if it also provides audit services, but this leaves the conflicts of independence as a result of the provision of both audit and advisory services by the same service provider largely in place.

operating listed and unlisted companies as audit clients. This suggests that audit only could only be implemented at international level. On the other hand, it appears to be difficult to quantify the added value and efficiency of a proprietary international network, or the importance of this for the quality of statutory audits. It could very well be that using local audit firms could be an alternative for global reach, if this is needed for the retention or acquisition of international audit clients. The crucial point is that the quality of these local entities must be at an equivalent (or higher) level as the quality of the current international network for adequate comfort and assurance to be provided to the users of the auditor's report.

Intermediate variant 1: A more moderate variant would be to make audit apply only to similar companies within PIE segments. If statutory audits are performed for a particular type of PIE (such as a bank), then the audit firm in question would not be permitted to provide advisory services to any other similar PIE (another bank) or competitor PIEs. Although this would leave the source of market failure to some extent intact, the undesirable possibility of intermingling of auditing and advice as a source of harmful incentives would be considerably limited.

Intermediate variant 2: The contribution of NAS to revenue and profit at audit firms would be capped.

Intermediate variant 3: Another variant is for the partners in the audit practice to always have a majority of votes under the articles of association at the shareholders' meeting for the whole organisation.

5.3 Intermediary

In this model, an intermediary acting as an independent organisation would determine the auditor to be engaged for the statutory audit and the fee due for this. The audited company would no longer have the right to select its auditor and negotiate with respect to the fee. This would remove the economic relationship between the audited company and the auditor and thus also the current revenue model. This intermediary would also oversee the performance of the audit. The model would require changes to national and European legislation, which states that the auditor must be appointed by the AGM/SB/management of the company (in that order).

Various parties could in principle fulfil the intermediary role, including a Non-Departmental Public Body (NPDB) to be incorporated, a trading platform or a

(sector-specific) supervisor. If a trading platform or a supervisor were to be authorised to act as an intermediary, this organisation would appoint and pay the auditor. The audit fee would then be spread across the population of companies to be audited or the audit users.⁴⁰ During the engagement, the auditor would report to the platform or appointed supervisor, also with respect to the quality of the statutory audit.

A potential advantage of this model is that the audit firm would be more independent with respect to the audited company, since the company management would no longer be responsible for appointment and payment. A further advantage is that the intermediary would have an incentive to give central priority to the public interest. Like investors and the wider public, a trading platform has an interest in high-quality reporting and no excessive price volatility, and in good-quality statutory audits. In addition, the mandate of supervisors or a separate government body would have a natural inclination to serve the public interest. As a result of their role, industry-specific supervisors would have an interest in seeing high quality statutory audits in their sectors. These supervisors would also have a good understanding of the developments in their sectors, meaning that extra attention to quality requirements relevant to the sector in question could be realised.

One potential disadvantage is that if a statutory audit is still not of adequate quality, the intermediary will also be held liable. The benefits that might offset this, for instance for a trading platform, are not clear, and it is also not necessarily the case that an intermediary would want to take on this role.

Conflicts of interest could also limit the effectiveness of the intermediary with respect to improving the quality of statutory audits. The possible role of a trading platform would also be influenced by the interest in attracting new listed companies and not losing listed companies it has already acquired. There would also be little incentive for an intermediary to control costs or operate efficiently.

Lastly, an intermediary would have to have adequate knowledge, expertise and instruments in order to select, monitor and discipline audit firms if the quality of statutory audits is not satisfactory. This would require the establishment of a

⁴⁰ In the case of a trading platform, the audit costs could be spread across the issuing institutions, for instance through higher listing costs; an alternative would be for these costs to be spread across the investor community through transaction fees, so that the costs would be paid by the users of the statutory audit. If a supervisory authority is authorised, this body would collect a contribution from each individual company subject to supervision whose reporting is audited by an auditor. This contribution would be paid into a collective fund out of which the auditor would be paid. The auditor could also be selected by the intermediary, with 100% of the costs being borne by the company without spreading the cost over other parties.

managerial position. If this is lacking, the question would arise of whether the model would provide sufficient incentive for improving the quality of statutory audits. These disadvantages could be limited to some extent if a newly incorporated NPDB were appointed as the intermediary, with a clear mandate and adequate capacity.

5.4 The Government Auditor

In the Government Auditor model, an independent public provider of statutory audits would be introduced that would explicitly perform this duty in the public interest. This provider would be made legally responsible for the statutory audits of all PIEs. The Government Auditor would be an independent organisation (possibly an NPDB), with management appointed by the Ministry of Finance. The audits would be performed by auditors in employment, with specialist knowledge either held in-house or hired in. The Government Auditor is a not for profit organisation.

The Government Auditor would be funded by the market through a statutory levy. This statutory levy could take various forms. A first possibility would be a direct fee paid by the audited company on the basis of the actual work performed by the Government Auditor for the audited company. A second option would be a regular levy of audited companies based on a formula that takes account of the scale and complexity of the audit.

An advantage of this model is that the Government Auditor would be primarily focused on reducing harmful incentives as a result of the revenue model.

Commercial interests would be eliminated and the harmful incentives arising from the revenue model and the client relationship would be removed. This would increase the objectivity and independence of the auditor and emphasise the auditor's public role. The costs and benefits of an investment in the quality of statutory audits for the public would be explicitly included in investment decisions.

In addition, the Government Auditor would perform its duty on the basis of giving central priority to the public interest. Market failure from the supply side as a result of the current oligopolistic structure in combination with commercial incentives would be eliminated with the introduction of the Government Auditor. As the statutory performer of PIE audits, the Government Auditor would not have the objective of making a profit.

A Government Auditor could also mean lower audit fees. Both the elimination of the profit objective and potentially greater competition in the market for hiring of specialist

knowledge could reduce the costs of audits. Greater transparency on the cost structure of audit firms is needed in order to make a proper estimate of this.

On the other hand, the Government Auditor would remove the operation of market forces and would introduce the possibility of government failure. Incentives to improve quality and reduce costs arising from market operation and competitive pressure could be removed. Government failure could include 'overproduction' of audits (more audit procedures than are desirable or necessary from a public interest point of view) and possibly political influence with respect to individual statutory audits.

Funding the Government Auditor with a levy system entails limitations regarding room for investment. A fixed levy system would provide limited flexibility with respect to (large-scale) investment in quality, if developments in public expectations, the form or nature of the data to be audited or technological developments make such investment necessary.

The Government Auditor would depend on the work of other auditors when performing a statutory audit for an internationally-operating company. This would require proper agreements on issues such as allocation of roles, financial remuneration and the audit system to be used.

Lastly, the introduction of a Government Auditor would require changes to European law. If the Government Auditor were to be granted a monopoly on the performance of statutory audits, the possibility for market parties to provide audit services to PIEs on the basis of a licence would lapse. This contravenes legislation, including European directives.

Intermediate variant 1: Instead of giving a Government Auditor a monopoly of all PIE statutory audits, this could apply only to segments in which there is a substantial public interest, such as banks, pension funds, municipalities and housing associations.

Intermediate variant 2: The Government Auditor could be introduced as a market participant and would compete with other market parties in the market (on a not-for-profit basis). An advantage of this variant is that positive competitive incentives would continue to exist and this model would be easier to implement. One complex issue would be the creation of a level playing field between a private and a public provider.

5.5 Financial Statement Insurance

In the Financial Statement Insurance (FSI) model, insurers would be positioned as an intermediary between the client and the auditor. The model would thus break the principal-agent relationship between the audited company and the auditor and therefore the current revenue model.

A first step in the FSI model would be an offer of insurance by an insurer. A company would approach a number of insurers for quotations for an insurance for its capital providers against losses as a result of potentially deficient statutory audits. An insurer would then engage an external party that would evaluate matters including the company's internal control environment. This external party could be the auditor who performs the audit. On this basis, the insurer would determine the maximum amount to be covered and the associated premium. This premium would consist of the insurance premium and the costs of the statutory audit.

The company would decide whether to take out the insurance or not. If the insurance is concluded, the company would be compelled to publish the amount covered and the premium. If the insurance is not concluded, the company would fall back on the existing regime where it appoints and pays the auditor.

The next step would be that the insurer appoints the auditor and pays for the performance of the audit. The insurer appoints the auditor and the auditor gives account to the insurer. The company could indicate a preference for an audit firm from a list of audit firms approved by the insurer. The insurer would pay the audit firm out of the premium it receives from the company.

The final step in this model is the possible payment under the insurance. The insurance is only valid if the audit firm issues an unqualified audit opinion on the reporting on year (t) in year (t+1). In case of losses as a result of deficiencies in the statutory audit, a company's capital providers could submit a claim to the insurer. If necessary, an independent arbitration committee could rule on the allocation of the claim.

International harmonisation would appear to be needed for implementation of an FSI model for the Big 4 audit firms. The model would require changes to European legislation, which states that the auditor must be appointed by the AGM of the legal entity. The insurer would additionally have to provide cover for globally-operating Dutch audited companies with an international shareholder base. This means that an

investor located in the UK would be insured for instance for a deficient audit for his investment in Philips, but not for his investment in Tesco. This does not help to create a level playing field for investors. There is also the question of whether Dutch insurers would be willing and able to insure this risk. It could be that audited companies would resort to a European or global insurer or reinsurer.

An important advantage of the FSI model is that it reduces market failure arising from harmful incentives and conflicts of interest arising from the revenue model.

Since the insurer would appoint and pay the audit firm rather than the audited company, the auditor could take a more independent stance with respect to the audit client. This could contribute to the quality of the statutory audit.

In addition, the monitoring and disciplining of the auditor would be strengthened, which could also contribute to the quality of statutory audits.

The principle here is that the insurers will have similar interests as the company's shareholders, debt providers and creditors. All these parties benefit from the highest possible quality of statutory audits: insurers do not want to face claims due to deficiencies in reporting and the auditing thereof, just as loan providers and creditors do not want to bear the losses arising from this. Both have the same aim of high quality statutory audits. To achieve this, the assumption in the FSI model is that insurers would exert maximum pressure on the auditor to perform a high quality statutory audit. The auditors could for instance lose audit clients in case of a deficient quality statutory audit for a client, if this prompts the insurer to decide not to allocate new audit clients to the auditor in question.

Finally, audited companies will have an incentive to improve their reporting, which could contribute to the quality of the statutory audit.

Audited companies that have not concluded insurance, or that are able to conclude only an insurance with limited cover and high premiums, would be signalling to the market that their reporting is of lesser quality (premiums and cover would be published). And vice versa. This would create a flight to quality in reporting, which could contribute to higher quality statutory audits.

At the same time, commercial incentives for insurers could negate the importance of quality.

Insurers are commercial businesses with the aim of maximising profits. They will estimate the risk that a deficient statutory audit would lead to losses for capital providers that are directly attributable to that audit and therefore lead to payment of a claim by the insurer to the capital providers. In view of the additional difficulty of

demonstrating a causal (or legal) relationship between the quality of statutory audits and losses, which in principle mitigates the risk of a successful claim, it cannot be ruled out that the insurers would estimate this risk as relatively low. This would reduce the incentive for the insurer to focus on the quality of the audits.

Another limitation of this model is that given the oligopolistic structure of the audit sector, there are limited options available to the insurers for replacing auditors who in their opinion deliver audits of inadequate quality. This could limit the incentive to discipline the auditors. There is also the question of whether audited companies would be prepared to pay an insurance premium if they are convinced that their reporting is of high quality. A related potential disadvantage is that the FSI model could lead to less information value in the reporting, since insurers could prefer rule-based reporting as far as possible in order to reduce their risk of being held liable for deficient reporting.

5.6 Abolition of statutory audits

Abolishing the statutory audit would eliminate the legal obligation to have an audit performed. This model could be introduced in various variations. A first – and most far-reaching – variant would be that with the lapsing of the legal obligation, the statutory provisions regarding how an audit has to be performed would also lapse. A second variation would be that the statutory audit obligation lapses, but not the provisions in cases where an audit is performed voluntarily.

Abolition of the statutory audit would require a change to European law. The legal obligation for medium-sized and large companies, banks and insurers to have their financial statements audited stems from European directives. This group makes up around 95% of all the statutory audits in the Netherlands. In practice, the introduction of this model would require a change to European law.

Abolition of the statutory audit introduces the threat of substitution and can thus encourage competition. The existence of the statutory obligation to perform an audit means that there is a guaranteed demand for audits. If this guaranteed demand is no longer there, companies could be incentivised to have an audit performed by the wishes of their stakeholders. This would also mean that auditors could be incentivised to distinguish themselves on the basis of quality (among other things). This requires that quality would have to be adequately visible and the stakeholders with an interest in high quality audits would have to fulfil their role with respect to monitoring and disciplining.

Abolition of the statutory audit would encourage innovation. The statutory prescribed method of providing assurance means that both the audited company and the providers of this assurance could experience less of an incentive to innovate with respect to the methodology used to provide assurance with respect to reporting. After abolition, it could very well be that other forms of assurance would emerge, provided by other types of providers such as Bigtech companies, and on the basis of public data sources and big data techniques.

Against these benefits, there is the risk that abolition of the statutory audit could weaken the position of the auditor. If a statutory audit is no longer mandatory, it could be easier for an audited company to decide to part company with a 'strict' auditor, either temporarily or permanently. This could further undermine the independence of the auditor and therefore the quality of the audit.

Moreover, not every company would be sufficiently incentivised to have a voluntary audit performed for their stakeholders. The obligation to have a statutory audit performed is a reflection of the public interest of an audit. Without the statutory obligation, there could be situations in which an audit would be desirable from a public point of view, but there is not enough pressure from the stakeholders in a company to actually have an audit performed. In addition, there could be an adverse selection problem, where parties that have not prepared their reporting properly could withdraw from an audit. If this happens, the model would not have the desired effect.

***Intermediate variant:** There are several possible variations in the scope of the abolition. It could for example be decided to abolish the audit obligation only for specific segments (for instance, non-PIE audit clients). In addition, the lower threshold for when an audit obligation applies could be raised (since the 2015 financial year, an audit obligation applies for companies with net revenue of EUR 12 million or more, total assets of EUR 6 million or more and 50 FTE employees or more).*

5.7 The user decides

In the current sector structure, the SB and the AC reporting to it makes a nomination for the appointment of an audit firm that is subsequently put to the AGM for approval. As explained in section 3, the literature presents a varied picture with respect to the independence of the SB/AC towards the management in the selection of the audit firm, as a result of which the potentially harmful incentives due to the revenue model may not be adequately mitigated.

The essential feature of the alternative model is that the users of the statutory audit should make the decision with respect to the auditor. The selection of an audit firm is actively determined by parties including the shareholders, debt providers and creditors of the company. Specifically with respect to the shareholders, the AGM's right of rejection with respect to the selection of the auditor could be supplemented with a formal and explicit right of submission, so that candidate audit firms could be nominated for the performance of the statutory audit by the AGM (above a certain cumulative voting rights threshold). The audit client pays the auditor and the auditor submits more detailed reporting to both the SB/AC and the AGM, so that the possibility for monitoring and disciplining by these parties is increased. Consideration could also be given to giving debt providers and creditors a role in this process.⁴¹

With this model, market failure due to the revenue model as a result of a conflict of interest between management and the auditor would be to some extent removed. This would benefit the independence of the auditor, because it can increase the incentive for the auditor to work in the interests of the end users rather than the interests of the existing management. At the same time, the management will retain an influence over the statutory audit through the direct contacts that are necessary for the audit. On the other hand, the auditor will still have some degree of incentive not to give central priority to the public interest. And indeed the public interest does not necessarily fully coincide with the interests of shareholders, debt providers and creditors.

One objection to this model is that debt providers and creditors could in practice opt for a delegation to the AC and could show little involvement in the selection of an auditor. There are few indications that they have called management to account due to dissatisfaction with a statutory audit in practice. In relation to this point, there are a number of practical implementation problems with this model: how would various user groups associate, who would make the actual selection, etc.

5.8 Audit Quality Indicators (AQIs)

There is no clear definition in the current market for statutory audits of what exactly is meant by the quality of statutory audits, nor is there any definition of what constitutes good or inadequate quality. The credence nature of statutory audits means that the required quality of statutory audits is measured on the basis of various

⁴¹ Based on corporate finance theory, debt providers and creditors have a strong incentive for monitoring the management (and shareholders).

indicators worldwide, by both the users of auditor's reports and the audit firms, and the supervisors and other stakeholders, including the academic community.

Audit Quality Indicators (AQIs) are indicators that help to break through the credence nature of statutory audits by explicitly defining quality. In other words, these indicators enable users to better assess the quality of statutory audits. A set of AQIs that audit firms would be obliged to publish would address the current lack of possibilities for ACs to measure the quality of a statutory audit and to make comparisons between audit firms when selecting an auditor. AQIs would encourage a debate on a clear definition of statutory audit quality and the measures for quantifying this. Information originating from AQIs must be comparable and possible to interpret in the right context and uniformly.

There are a limited number of international initiatives for identifying AQIs, and cohesiveness and coordination is lacking. Opinions differ regarding the nature of AQIs (are they quantitative, qualitative or both), the standards (rule based or principle based), applicability (global or local) and the degree of transparency (private application or public reporting).⁴² Provisional suggestions are therefore very diverse and also vary in number: from 28 broad AQIs that cover the entire audit process to less than 10 focusing on specific elements.⁴³ The most broadly endorsed AQIs at the moment are the number of hours of training of each auditor, the use of internal engagement quality reviews and the number of employees per audit partner (FEE, 2016). Although the development of (predictive and other) AQIs is still in its infancy, the potential for improving the quality of statutory audits cannot be ignored.

AQIs have a number of potential benefits. Firstly, AQIs promote competition on quality between audit firms in the performance of statutory audits (instead of competition on price). A second benefit is that AQIs can break through the credence nature of statutory audits. This will put the users of auditors' reports in a better position to measure the quality of these reports and to make comparisons between audit firms. A third benefit is that AQIs will increase transparency with respect to statutory audits

⁴² The European Federation of European Accountants (FEA) has been monitoring the development of AQIs by a limited group of organisations around the world since 2016, including supervisors and regulators [the Canadian Public Accountability Board (CPAB), the US Public Company Accounting Oversight Board (PCAOB), the Swiss Federal Audit Oversight Authority (FAOA), the UK Financial Reporting Council (FRC) and the Accounting and Corporate Regulatory Authority (ACRA) of Singapore] and several sector associations [the US Center for Audit Quality (CAQ), the Chartered Accountants Australia and New Zealand (CAANZ) and the Netherlands Institute of Chartered Accountants (NBA); FEA (2016, 2017)].

⁴³ The International Auditing and Assurance Standards Board (IAASB) published a Framework for Audit Quality in 2014 which included (i) hard input indicators (knowledge, experience, training, number of hours) and soft input indicators (values, ethics, behaviour and culture), as well as (ii) process indicators (the audit process, internal quality monitoring) and (iii) output indicators (reporting, accountability information).

and the quality thereof. AQIs broaden the information base for selection and assessment of audit firms by ACs, other users of auditor's reports and supervisors and regulators. Lastly, AQIs enable audit firms to commit demonstrably and transparently to the quality of statutory audits. This applies to both external reporting and internal settlement and remuneration.

At the same time, AQIs also entail potential disadvantages. Global agreement would appear to be needed for the identification of AQIs, their nature, standardisation, applicability and degree of transparency in view of the international nature of the Big 4 audit firms. AQIs provide a mainly extrinsic motivation for auditors, but not necessarily an intrinsic motivation.

5.9 Joint audits

In a joint audit model, two auditors from two audit firms sign the auditor's report.

The principle here is twofold. Firstly, the two audit firms and auditors keep each other sharp (the 'four-eyes' principle), which can increase the quality of the statutory audit. Secondly, joint audits can give smaller audit firms an opportunity to gain experience of statutory audits of PIEs and thus reduce the oligopoly of the Big 4 audit firms.

In the 1980s, France introduced a joint audit model for the statutory audits of companies with consolidated reporting. This model was enshrined in law, so that today France is the only country anywhere in the world that required two different audit firms for the statutory auditing of the reporting of listed companies.

Until 2006, most joint audits in France were performed by a combination of a Big 4 audit firm and a smaller audit firm. Around 90% of the revenue (and the profit) found its way to the Big 4 audit firm. There was no question of an equal division of responsibilities. In 2006, French law set a 60%-40% division of responsibilities in order to achieve a more equal division and improve the quality of statutory audits.⁴⁴

Deviations from the division of responsibilities are only permitted under a comply or 'explain' policy rule. The auditor's report is signed by both auditors; any differences in conclusions are transparently reported and notified to the company, and form a standard part of the reporting by the company's AC. If the two auditors reach the same conclusion, they are both liable for errors under French law.

⁴⁴ France has around 284 audit firms that participate in joint audits. The listed companies in the CAQ40 are all audited by the Big 5 (the Big 4 audit firms plus Mazars, which is relatively large in France); more than 70% of the approximately 250 French midcap companies are audited by the Big 5 (around 90% of audit revenue).

The French supervisor sees the four-eyes principle and the review of the statutory audit by another audit firm as a big advantage and safeguard for the quality of statutory audits. The relatively low number of financial scandals in France as a result of serious deficiencies in statutory audits can be seen as an indication of the benefits of the joint audit model. This cross-review in the French practice takes place only at the end of the audit. Cross-reviews by the other firm involved do not take place in the interim or during the performance of the audit. The pressure to meet deadlines, however, increases particularly at the end of the process and there is limited opportunity for adjustment, meaning that the review may not currently be that effective. Another benefit could be that the joint audit model would offer smaller audit firms the opportunity to gain experience of auditing larger listed companies and other PIEs.

The joint audit model however makes the statutory audit more complicated due to the coordination required and harmonisation between the two audit firms and requires greater project management skills. This is shown by the 10%-15% higher cost involved compared to an audit by a single audit firm.⁴⁵ There is moreover no hierarchical relationship between the two audit firms and therefore no single point of responsibility for project management, including monitoring of the planning. In case of a combination of a Big 4 audit firm and a smaller audit firm, this would appear to resolve itself naturally, but if two Big 4 audit firms are appointed there may be rivalry, so that cooperation and harmonisation may be less than desirable.

Intermediate variant 1: In a more moderate variant, the joint audit model could be applied only to listed, multi-national PIEs rather than the entire PIE population.

Intermediate variant 2: Consideration could be given to formulating the joint audit model more as a peer review, in which an independent audit firm that has not been involved in the statutory audit first carries out an overall peer review of the audit before the auditor in question signs off.

⁴⁵ Statement by the French supervisor H3C.

5.10 Limit the market share of the Big 4 audit firms

In the Dutch audit market, one could consider limiting the market share of the Big 4 audit firms.⁴⁶ This could take various forms, for example as a maximum percentage of the total number of PIE audits, as is under consideration in the UK.⁴⁷ The Big 4 audit firms currently account for around 90% of the approximately 1,100 PIE audits. Limiting the number of PIE audits performed by the Big 4 audit firms would in the first instance benefit the Next 5 audit firms, and at a later stage, new PIE audit firms as well. This could benefit competition on quality and reduce the potential too few to fail risk, since concentration in the market would be reduced.⁴⁸

One potential disadvantage of this model is that the effect of boosting competition may be limited due to the brake on revenue growth. Audit firms that already have a market share at the level of the cap could not grow their revenue and margin on the basis of quality differentiation. In addition, it is questionable whether the Next 5 (and any new) audit firms have sufficient expertise and capacity to close the gap that the Big 4 would leave due to the introduction of this model.

A further disadvantage is that in the event of a limit on market share for audits, the existing PIE audit firms could purge their audit client portfolio of the riskiest audit clients, the audit clients that pay the worst or the most difficult audit clients. These could then turn to audit firms that possibly would deliver lower quality due to lack of expertise, knowledge of the audit client or lack of capacity.

Intermediate variant: Consideration could be given to easing tender requirements and reducing the associated costs so that the costs of quotation would not be an obstacle for audit firms. This would create a level playing field.

⁴⁶ An example of limiting market share can be found in US legislation in 1994 that capped the share in the market for domestic deposits for US banks at 10%, partly to limit market power and also to prevent the too big to fail problem. This cap was also applied in case of mergers and acquisitions. Another example (and another variant) of limiting market share is the current Policy Regulation on capping the ratio of deposits and loans pursuant to the Financial Supervision Act (*Beleidsregel maximering ratio deposito's and uitzettingen Wft*), which sets an upper limit on the extent to which banks with a Dutch banking licence under the protection of the Dutch deposit guarantee scheme can act as a conduit for deposits raised in the Netherlands and then placed in much riskier markets outside the Member States (a ratio cap: domestic deposits/loans in other countries).

⁴⁷ See the article fd.nl/ondernemen/1263608/britse-accountants-willen-zelf-dominantie-big-four-aanpakken.

⁴⁸ In the Netherlands, the Next 5 audit firms are: Accon avm controlepraktijk B.V. BDO Audit & Assurance B.V. Baker Tilly Berk N.V. Grant Thornton Accountants and Adviseurs B.V. Mazars Paardekooper Hoffman Accountants N.V. (Mazars).

5.11 Corporate model

In the corporate model, the ownership of audit firms would be held by external capital providers. The management of the audit firms would consist of representatives of these external financiers. Partners would no longer have control over the policy of the audit firm. They would become de facto employees and would no longer be self-employed, even if the audit firms could work with a variable remuneration structure. The current partner model would thus lapse. One alternative form provides for a market listing and share issuance by the audit firm. Another alternative would be that the audit firm is funded by private capital providers, for instance a private equity firm. Of course, the audit firm could also raise loan capital to fund itself. In principle, this model would not require any change to international legislation and regulation. One condition would be that qualified auditors hold a majority of the voting rights, which is in line with existing legislation.

A corporate governance structure could reduce the inherent limitations on long-term investment in quality arising from the partner model. In the current partner model, the partners can be expected to demand a high return on their investment. External investors would possibly require an additional return on top of this under this model. One factor for the existing partners is that the time taken for an investment in quality to repay itself may be longer than their own investment horizon, certainly if they are due to retire in the near future. Replacing the partner model with a corporate model could reduce these limitations. A second potential benefit would be increased management decisiveness as a result of the introduction of an independent board that explicitly represents the external shareholders and is separate from the 'executive' auditors. This could make it easier for top-down changes or investments in innovation and quality to be effected. A third potential benefit is that the corporate model contributes to greater disciplining by external stakeholders (the capital providers). The capital providers would indeed have an explicit role as shareholders of audit firms. In addition, this could provide an impulse for more competition in the sector, since the corporate model would give smaller audit firms better access to the capital markets for investment in expansion.

A risk for this model is that the short-term commercial interests of external capital providers could possibly have a negative effect on the independence of the auditor and therefore the quality of statutory audits. There is good reason for the current legislation to determine that the majority of control of audit firms has to be

held by auditors, so that they can give central priority to the public interest. On the other hand, the commercial and other incentives for external investors will possibly be the same as for the individual partners. After all, a statutory audit of inadequate quality is also a risk for an external investor in an audit firm, if for instance this leads to the loss of a client relationship and therefore a decline in value of the share in the audit firm. This raises the question of whether the introduction of external financiers and greater financial strength would actually lead to more investment in quality. It takes a long time for such investments to repay themselves, and the return is difficult to establish. This could also form a limitation for external shareholders, given their inherent commercial incentives (maximising dividend).

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The Dutch Authority for the Financial Markets

T +31(0)20 797 2000 | F +31(0)20 797 3800

PO Box 11723 | 1001 GS Amsterdam

www.afm.nl

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