NBA ALERT 27

Separation of audit services and other services and mandatory audit firm rotation

in connection with the implementation of the Dutch Audit Profession Act

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(Unofficial translation, in case of differences between the English language and the official Dutch Language the latter is leading)

Nederlandse
Beroepsorganisatie
van Accountants

NBA

NBA Alert 27: Separation of audit services and other services and mandatory audit firm rotation in connection with the implementation of the Dutch Audit Profession Act

Content

1 Introduction

With the adoption of the Dutch Audit Profession Act (*Wet op het accountantsberoep*) the legislator, on December 11, 2012, approved/ratified two amendments that affect the services carried out by audit firms at public interest entities (PIEs). The legislative amendments, which have been incorporated into the Audit Firms Supervision Act (*Wet toezicht accountantsorganisaties, Wta*), aim to increase the independence of auditors of PIEs by prohibiting audit firms from performing services other than audit services and by introducing mandatory audit firm rotation.

In principle, the legislative amendments will not affect the small and medium-sized enterprises (SME) sector, although they might affect the SMEs that are part of a group that includes a PIE.

The formulation of the new legal provisions and the interpretation in the parliamentary debate attributed to it, have raised questions among businesses and audit firms. This Alert aims to provide answers to the most important questions. It is important to the NBA to ensure that the legislative amendments thus adopted should be enacted in a manner that meets expectations of society with regard to the audit profession. Therefore the NBA aims to introduce detailed regulation that might go beyond the literal wording of the law, thus embracing the spirit of the law.

It's crucial to the NBA to generate broad social support for the contents of this NBA Alert. For that reason, in addition to coordinating the contents of this Alert with the audit firms concerned, the NBA has incorporated the comments from the key stakeholders (political groups, businesses and investors). The outlines of this Alert are aligned with the Netherlands Authority for the Financial Markets (AFM).

Since this Alert was compiled in a short period, the NBA cannot provide definitive answers to all questions yet. Particularly, the cross-border effects of the Act require further examination.

The NBA will elaborate further on the new legislative provisions in it's own independence rules, and aims to complete this task in the spring of 2013, as part of a broader project launched to formulate new independence rules. This will also help to provide a definitive interpretation of the effects of the new legislative provisions for the profession.

2 Separation of audit services and other services

2.1 The law and legislative history

The amendment submitted by the member of parliament Plasterk *et al.* (Parliamentary Document 33025, No. 18) concerns the separation of audit services and other services at PIEs and reads as follows:

> *"An audit firm that performs statutory audits at a public interest entity shall not carry out any other services for that entity in addition to the audit services."*

This amendment has been included as Section 24b in the Audit Firms Supervision Act, accompanied by the following explanatory note:

> *"Audit services performed for a public interest entity (PIE) must be separated from other services performed for that entity. This means that an audit firm cannot provide audit services and perform other services for a PIE at the same time. Audit services are understood to include and be limited to statutory audits, audits of the company or consolidated financial statements; audits of interim or annual financial reviews; the certification of statements for supervisory authorities as referred to in the Pensions Act (Section 147(5)) and the Financial Supervision Act (Book 3, Section 72(7)); and the provision of assurance in connection with the Report of the Management Board, the Corporate Governance Report, the Risk Management Report and the Corporate Responsibility Report. With regard to other services for which the engagement was signed prior to the date on which the amendments entered into force and which the audit firm is thus contractually obliged to perform, the legislator has arranged that such existing procedures can be carried out up to two years after the entry into force of the Audit Profession Act."*

During the debate in the Senate of the Dutch Parliament, on November 27, 2012, senator Postema emphasized the importance of ensuring that this separation result in a logical demarcation of audit services. In his opinion the provision of 'assurance' in particular raised questions, as he explained:

> *"My political group advocates a broad interpretation of this so as to ensure that it can also be understood to include the provision of assurance and reporting on the outcome of fact-finding services commissioned by third parties – for example comfort letters – and the provision of assurance and reporting on the outcome of fact-finding services carried out on behalf of the entity's Supervisory Board – for example in the area of internal control, M&A and fraud."*

Postema asked the Minister to acknowledge that he supported such a broad interpretation, to which the Minister responded as follows:

> *"(...) in connection with the Plasterk amendment we may choose to adopt a formulation or interpretation of what is and what is not permitted that fits well into the formal text incorporated into the Act. (...). Such a text might provide that the "assurance" mentioned should be understood to mean audit services aimed to provide assurance concerning the information supplied by the audited client for the benefit of external users of this information and also for the benefit of the Supervisory Board, as referred to in the reports mentioned."*
>
> *"The emphasis, therefore, is very much on the interests of external parties. External parties, by which I mean stakeholders or parties in any other capacity, must be able to rely on the accuracy of the information provided by a company. Protecting this interest is our highest priority, and among these parties we include Supervisory Directors. After all, it goes without saying that Supervisory Directors must be assured that the information on the basis of which they perform their supervisory tasks and assume their responsibilities is reliable."*

Senator Postema then tabled a motion that was passed by the Senate on December, 11 2012 and reads as follows:

> *"The Senate of the Dutch Parliament,*
>
> *having heard the deliberations and observing that the audit services referred to in the notes to the amendment submitted by Plasterk et al. (33025, No. 18) are understood to include the provision of assurance with respect to the Report of the Management Board, the Corporate Governance Report, the Risk Management Report and the Corporate responsibility Report,*
>
> *having regard to the fact that questions may be raised with respect to the interpretation of this text from the note,*
>
> *as regards the legislative history of the bill, determines that the term assurance must be understood to mean 'audit services aimed to provide reliability concerning the information supplied by the audited client for the benefit of external users of this information and also for the benefit of the Supervisory Board, as referred to in the reports mentioned'."*

The Postema motion was passed on December 11.

2.2 How will the separation of audit services and other services affect companies?

According to the NBA's interpretation of the legislative history of Section 24b of the Audit Firms Supervision Act, audit firms, in an engagement for a PIE, are permitted to perform audit and assurance services as well as fact-finding services[1] carried out on behalf of external users of the information and the Supervisory Board[2]. All other types of engagement, including the compilation of financial statements and the provision of advisory services (such as tax advice, management advice and M&A advice) will no longer be permitted. The ethical principle that auditors should not audit their own (advisory) work is put into practice. More specifically, this means that auditors of PIEs are permitted to perform the following audit services on behalf of the public or the Supervisory Board of Directors[3]:

i. the statutory audit of company or consolidated financial statements;
ii. the audit or review of interim and annual financial summaries;
iii. the provision of assurance with respect to other aspects of annual reporting, such as corporate governance, risk management or corporate responsibility;
iv. the provision of assurance and fact-finding services on behalf of reporting to supervisory authorities and the Tax Office;
v. any other statutory task in relation to audit services that is imposed upon the external auditor or audit firm by the law;
vi. the provision of assurance and fact-finding services on behalf of external users (for example in the form of comfort letters);
vii. the provision of assurance and fact-finding services on behalf of the Supervisory Board (for example in the area of internal control, M&A and fraud).

[1] Fact-finding services carried out by auditors are described in Standard 4400 and comprise audit procedures of a predetermined scope in which factual findings are reported without being accompanied by any conclusions.
[2] In the Further Regulations on Audit and Other Standards (NV COS) the Supervisory Board and comparable bodies are defined as "those charged with governance".
[3] This may also be the Audit Committee.

2.3 How does the separation of audit services and other services relate to the engagement standards (Nadere voorschriften controle en overige standaarden - NV COS)?

The NBA has “translated" the above overview of audit services into the NBA’s professional engagement standards as codified in the Nadere voorschriften controle en overige standaarden (NV COS). By doing so the NBA aims to promote a uniform interpretation of the new rules among the audit profession and thereby also promote the quality of professional audit practice.

On the basis of the above mentioned, the NBA observes that the following engagements can be provided in combination with the statutory audit of PIEs:

- Engagements to audit historical financial information (Standards 100-999)
- Engagements to review historical financial information (Standards 2000-2699)
- Assurance engagements other than audits or reviews of historical financial information (Standards 3000-3850)
- Engagements to perform agreed-upon procedures[4] regarding financial information (Standard 4400).

This means that no procedures may be performed any more under Standards 4410[5] and 5500[6] [7], and that “other engagements”, such as the provision of management advice and tax advice, will no longer be possible either under the new legislation[8].

The NBA advises auditors who are invited to perform an engagement for a PIE where they also carry out the statutory audit, to answer the following questions before accepting the engagement:

- **Does the engagement comply with the permitted Standards from NV COS?**
- **Is the engagement intended to be carried out on behalf of the public or of the Supervisory Board in order to help it perform its supervisory tasks?**

As a rule, if the answer to either of these two questions is negative, the engagement cannot be accepted.

Other professionals who collaborate with the auditor and come within the scope of the regulations[9] can only perform procedures that are covered by the seven points listed under b above and are consistent with the standards described in NV COS.

2.4 Scope

As appears from paragraph a, the amendment with respect to Section 24(b) of the Audit Firms Supervision Act (separation of audit services and other services) concerns the audit firm, which is formally the legal entity registered with the Authority for the Financial Markets as the holder of the PIE licence. According to the NBA this legal definition is unduly restrictive. Stakeholders in society at large cannot be expected to be aware of the legal difference between the audit firm and the Dutch sections of its network, which tend to operate under the same name. This is why the NBA believes that Section 24(b) of the Audit Firms Supervision Act should cover the network of the audit firm in the Netherlands.

[4] “Agreed-upon procedures” is the term used in NV COS for fact-finding services.
[5] Standard 4410, Engagements to compile financial information
[6] Standard 5500, Transaction-related advisory services
[7] In NV COS the Supervisory Board or comparable bodies are defined as “those charged with governance”.
[8] Needless to add, the “new” prohibition also implies a ban on services already prohibited under existing regulations. This concerns services that result in self-assessment (such as the implementation of financial information systems, valuations, the provision of internal accountancy services or mediation services in the recruitment of senior staff) or in conflicts of interests (such as trading in the shares of an audited company or acting on its behalf).
[9] For information about the scope of the separation of audit services and other services, see the section about Scope.

As regards the *cross-border* effects of the legislation, it is too early to draw any conclusions, for example concerning the question of whether the prohibition laid down in Section 24(b) of the Audit Firms Supervision Act should also cover non-Dutch components of the audit firm's network. This issue requires further research, which the NBA will be conducting in consultation with the AFM and possibly with other parties. One of the focal points selected for this research is the meaning of Article 34 of European Directive 2006/43/EC, which provides that in respect of the statutory audit of consolidated financial statements, Member States may not impose additional requirements on an audit firm established in another EU Member State that performs the statutory audit of a subsidiary company. This also concerns requirements in respect of independence. On the other hand, independence rules in other countries do appear to imply cross-border effects. The AFM has indicated its intention to refrain from enforcement measures in respect of this particular aspect until the research is completed. To all intents and purposes, it could not have been the intention of the legislator to allow non-Dutch entities in the audit firm's network to perform prohibited services in the Netherlands.

The NBA emphasizes that uncertainty regarding this particular aspect of the Act does not detract from the responsibility of Dutch auditors to maintain their independence in light of the services provided by the non-Dutch entities of the audit client. This is prescribed by the current professional rules (the international Standard 600), stating that an auditor who intends to rely on the work of an auditor of another group entity (the "component auditor") will have to determine whether that component auditor is independent.

3 Mandatory audit firm rotation

3.1 The law and legislative history

The amendment submitted by member of parliament Van Vliet (Parliamentary Document 33025, No. 19) concerns mandatory audit firm rotation and reads as follows:

> (Section 23) *"The audit firm shall not perform statutory audits at public interest entities in respect of which they*
>
> *a. ...*
> *b. ...*
> *c. for a period of two years following a period of eight consecutive years in which the audit firm performed the statutory audits, or kept or organised a substantial part of the accounts."*

This amendment, which has been included as Section 23(c) of the Audit Firms Supervision Act, is quite general in its wording. The explanatory note reveals the legislator's intention:

> *"By introducing a supplement to Section 23 with respect to public interest entities (PIEs), this amendment will make it mandatory upon such entities to rotate their auditor every eight years (which means they will have to engage a different audit firm, rather than transfer the audit to a different auditor within the same firm). After those eight years the law provides for a cooling-off period of two years before the same firm can again be engaged for the statutory audit of the financial statements."*

During the debate in the Senate on November 27, 2012, the Minister of Finance explained that he did not intend the amendment to take effect until January 1, 2016 so as to allow for a transition period of three years.

> *"I shall explain how I arrived at those three years. The European proposal on audit firm rotation mentions a term of four years from the moment the decision takes effect. The Lower House passed the amendment early this year, at the beginning of 2012. If we add four years, the date is January 1, 2016. I believe that is a reasonable transition period."*

That date, January 1, 2016, was confirmed in a letter of December 7, 2012 sent by the Minister of Finance at the request of the Senate. In that letter he also explained how he intends to test the amendment against European legislation.

> *"During the debate with your House I expressed my intention to ensure that the mandatory audit firm rotation regulations take effect on January 1, 2016. I also noted that I intended to send your House a letter six months in advance, reporting on the state of affairs in Brussels and the progress made in the Netherlands in preparation for January 1, 2016. It goes without saying that we will have to amend the current legislative text if – and only if – it gives rise to a conflict between Dutch and European regulations."*

Having taken cognisance of this letter, the Senate passed Section 23(c) of the Audit Firms Supervision Act on December, 11 2012.

3.2 When will mandatory audit firm rotation come into effect?

The NBA infers from legislative history that the audit firm rotation rules will apply to financial years ending on or after January 1, 2016. This implies that the incumbent auditor should be able to complete the audits for financial years beginning on or prior to December 31, 2015, even if this means that some procedures will have to be finalized after that.
This is how the three-year period (the 2013, 2014 and 2015 financial years) mentioned by the Minister in his explanation to the Senate is put into practice.

Postponement of the effective date is intended to allow audit firms and companies to arrange a phased introduction of the audit firm rotation system. The NBA, the AFM and other interested parties have pointed out that a "big bang" implementation will cause problems for the business community and the accountancy sector. The NBA therefore calls upon audit firms to do whatever it takes to facilitate a phased introduction. For that reason, the NBA advises audit firms to prepare for the new legislation in close consultation with their PIE audit clients. The NBA also recommends involving the shareholders, in their role as the formal clients of the auditor. Auditors, companies and investors alike will have to invest in efforts to provide all the parties involved in the rotation with the requisite knowledge. This will make it possible to enhance both the quality and the effectiveness of the auditor appointment process.

3.3 Scope

Under Section 23(c) of the Audit Firms Supervision Act, mandatory audit firm rotation only applies to audit firms of PIEs and does not apply to the audit firms of any group components. This is in line with the proposals issued by the European Commission, which likewise limits mandatory rotation to the PIE and the audit firm.

At the same time the professional rules require that auditors (of PIEs) form their own professional judgment, where applicable[10], of the material aspects of the group financial statements. In many cases this means that the auditor or the network for which he works will only accept a new engagement if it relates to a significant part of the audit of the group components.
The responsibility of the group auditor arises from the requirements of Standard 600, paragraph 12, which reads as follows:

> *"In applying ISA 220, the group engagement partner shall determine whether sufficient appropriate audit evidence can reasonably be expected to be obtained in relation to the consolidation process and the financial information of the components on which to base the group audit opinion. For this purpose, the group engagement team shall obtain an understanding of the group, its components and their environments that is sufficient to identify components that are likely to be significant components. Where component auditors will perform work on the financial information of such components, the group engagement partner shall evaluate whether the group engagement team will be able to be involved in the work of those component auditors to the extent necessary to obtain sufficient appropriate audit evidence."*

[10] Not all PIEs are required to prepare group financial statements.

4 Final remarks

The debate frequently revolved around the question of how this legislation relates to the proposed adjustment to the independence requirements in Europe following European Commissioner Barnier's proposals. In this context it has also been observed that Dutch rules on the separation of audit services and other services or audit firm rotation may still have to be adapted in response to developments in Europe.

The Minister has indicated that he regarded the period until 2016 as a transition period that would allow the profession and PIEs time to prepare for the mandatory audit firm rotation. As long as the legislator is not expected to amend this part of the Audit Firms Supervision Act to diverging European legislation (as laid down in a EU Directive or Regulation), it must be assumed that the mandatory audit firm rotation rules will come into effect in their current wording on January 1, 2016.

The newly introduced statutory rules on audit firm rotation and the separation of audit services and other services are more stringent than the Further Regulations on Independence (NVO) currently applicable in the Netherlands. It goes without saying that the law takes precedence over these regulations, which means that the NVO audit firm rotation requirements will no longer apply with respect to audit services for Dutch PIEs. The other NVO requirements however will continue to apply.

The appendix contains answers to a number of frequently asked questions.

A NBA Alert is published in response to a new development.

NBA Alerts can be issued in advance of new regulation or a practice note from the NBA .

NBA - Alerts expire after one year, unless the duration is specifically extended.

5 Appendix to the NBA Alert 27 Frequently asked questions

Q1: Why did politicians take the initiative to segregate audit services and other procedures and to introduce mandatory audit firm rotation in connection with PIEs?

Various stakeholders in social and economic life are of the opinion that auditors and audit firms are not yet sufficiently independent. By introducing these measures, the authorities aim to provide better assurance as regards the independence of auditors and thus to enhance the quality of the statutory audits performed.

Q2: To which parties do the separation of audit services and other services and mandatory audit firm rotation apply?

The proposals are expressly aimed at PIEs and are emphatically not intended to apply to SMEs. The proposals may however have consequences for SMEs that are part of a group that includes a PIE. Also see Q6.

Q3: How does the NBA support auditors in implementing the separation of audit services and other services and audit firm rotation?

First of all, the NBA has issued an NBA Alert which explains the new legislation based on the law and its legislative history and shows auditors how to implement the legal provisions in practice.

In addition, the NBA provides answers to frequently asked questions from auditors and other stakeholders. The answers are incorporated into the appendix to the Alert and published on the NBA website.

Q4: What is a PIE?

The term PIE (public interest entity) is defined as follows in Section 1(1)(l) of the Audit Firms Supervision Act:

- public interest entity:
  - 1°. a legal entity with registered offices in the Netherlands and incorporated in accordance with Dutch law, the shares of which have been admitted to trading in a regulated market as referred to in Book 1, Section 1 of the Financial Supervision Act;
  - 2°. a bank with registered offices in the Netherlands as referred to in Book 1, Section 1 of the Financial Supervision Act that has been granted a licence pursuant to that Act;
  - 3°. a central credit institution with registered offices in the Netherlands as referred to in Book 1, Section 1 of the Financial Supervision Act that has been granted a licence pursuant to that Act;
  - 4°. a life insurer or non-life insurer with registered offices in the Netherlands as referred to in Book 1, Section 1 of the Financial Supervision Act that has been granted a licence pursuant to that Act;
  - 5°. an enterprise, institution or public body that falls under one of the categories designated in accordance with Section 2.

Section 2 of the Audit Firms Supervision Act makes it possible for the legislator to expand the class of PIEs.

Q5: Can international networks impose different rules?

It goes without saying that an international network may impose different rules. That does not alter the fact, however, that Dutch audit firms carrying out the statutory audit at a PIE will be subject to Dutch law.

Q6: How will the prohibition on services other than audit services affect related third parties of PIEs?

The Act does not mention entities other than the PIE itself. Nevertheless, the NBA is of the opinion that the prohibition should also cover a PIE's related third parties in the Netherlands. Please refer to the Alert for information about any consequences outside the Netherlands. According to the Alert, further research is required before a definitive position can be taken.

Q7: How will the prohibition affect a Dutch PIE that is part of a group which, outside the Netherlands and under foreign law, qualifies as a PIE[11] itself?

Please refer to the Alert for information about any consequences outside the Netherlands. According to the Alert, further research is required before a definitive position can be taken.

Q8: Does the prohibition also apply to Dutch entities (non-PIEs) that are group companies of a foreign PIE[12]?

No, such entities are governed by the local rules of the foreign PIE[13], unless the group company qualifies as a PIE in the Netherlands. In that case the Dutch rules do apply, of course.

Q9: To which procedures does the two-year transition period apply?

The two-year transition period covers all services that are currently permitted but which are prohibited under the new regulations, provided that the service engagement concerned was signed before January 1, 2013. Those services must be completed by December 31, 2014 at the latest. The engagement will have to be sufficiently specific and legally valid.

Q10: When will mandatory audit firm rotation be implemented?

The debate in the Senate has shown that the Minister intends to implement Section 23(c) of the Audit Firms Supervision Act as of January 1, 2016. Based on legislative history, the NBA assumes that an audit firm will not be permitted to perform a statutory audit at a PIE for a financial year that ends on or after January 1, 2016 if that firm has already performed the statutory audits of that same PIE for eight or more years.

[11] This type of entity is often referred to as a foreign public interest entity (PIE). This concerns entities that qualify as a PIE not in accordance with Dutch law but in accordance with the laws of a different state.
[12] Ditto.
[13] Ditto.

Q11: What is meant by statutory audit?

A statutory audit is the audit of the financial statements of a company or institution in the public interest that is mandatory under or pursuant to the statutory provisions referred to in the appendix to the Audit Firms Supervision Act.

Q12: The mandatory audit office rotation rules will not come into effect until 2016. Is there anything I should do now?

During the debate in the Senate it became clear that the Minister and both Houses of Parliament intend to implement the regulations with effect from January 1, 2016. The Minister also indicated that he considered the period until 2016 to be a transitional period that would allow the profession and PIEs time to prepare for the new requirements.

Unless and until it appears that the Audit Firms Supervision Act requires adjustment to reflect diverging European legislation (as laid down in a EU Directive or Regulation), it must be assumed that the mandatory audit firm rotation rules will come into effect in their current wording on January 1, 2016.

For that reason the NBA advises audit firms to prepare for the new legislation, in close consultation with their PIE audit clients.

Q13: How long will the cooling-off period be?

The cooling-off period with respect to the performance of a statutory audit at a PIE by an audit firm which has already performed the statutory audits of that PIE for eight consecutive years (Section 23(c) of the Audit Firms Supervision Act) applies during a period of two years. Note that while the Act uses the term “years”, it must be assumed that it is referring to “financial years”.

Q14: Will audit firm rotation also be mandatory if the audit firm has performed statutory audits for eight years at an entity that obtained PIE status less than eight years ago?

Yes, mandatory audit firm rotation applies even then. Section 23(c) of the Audit Firms Supervision Act provides as follows:

“... performed statutory audits or kept a substantial portion of the financial records for a period of eight consecutive years.”

Section 23(c) does not require that the audited organisation actually qualified as a PIE in each of those eight years.

Q15: The consequence of the eight-year period is that clients will have to deal with at least two external auditors in those eight years. Is that correct?

Yes, based on current regulations this is indeed correct. The external auditor will have to rotate after seven years, and the audit firm after eight years.

The mandatory rotation of the external auditor arises from European law. Article 42(2) of Directive 2006/43/EC reads as follows:

“Member States shall ensure that the key audit partner(s) responsible for carrying out a statutory audit rotate(s) from the audit engagement within a maximum period of seven years

from the date of appointment and is/are allowed to participate in the audit of the audited entity again after a period of at least two years."

In the Netherlands, Article 42(2) of this Directive has been incorporated into Section 24 of the Audit Firms Supervision Act.

Of course an audit firm may also rotate after seven years, and external auditors may also rotate after a shorter period of time.

Q16: Will other services performed (non-audit services) affect the scope for accepting a statutory audit engagement?

Other than the prohibition on statutory audits if the auditor has kept a substantial portion of the financial records as referred to in Section 23(c), the Audit Firms Supervision Act does not contain any new prohibitions concerning the performance of other procedures prior to a period in which the statutory audit is performed. This means that the existing regulations under Section 23(a) will remain effective.

As regards the keeping of a substantial portion of the financial records, the cooling-off period arising from Section 23(a) will not commence for as long as such procedures continue to be performed.

Q17: Will it make any difference who commissions an assurance engagement?

No, that will not make any difference. The Management Board of a company can commission the engagement. As indicated in the NBA's plan of action, the institute recommends that the Supervisory Board should act as the client, but Book 2 of the Dutch Civil Code does not at present prevent the Management Board from doing so. The NBA calls upon the Management Boards of companies to comply with the advice in its plan of action or at least to coordinate this issue with the Supervisory Board.

Needless to add, there must be a real need for the audit services on the part of the external user or the Supervisory Board, from its supervisory perspective. The auditor should ascertain that this is indeed the case.

Q18: Which other services may be provided by other entities within a network?

The legislative history of Section 24(b) of the Audit Firms Supervision Act does not address this issue. This is understandable, given that the scope of this section does not extend beyond audit firms. According to the NBA, other entities of the Dutch network are only permitted to provide services covered by the definition of audit services that appears from the law and legislative history.