ViewPoints
FOR THE AUDIT COMMITTEE LEADERSHIP SUMMIT

Issue 27: 30 July 2014
TAPESTRY NETWORKS, INC · WWW.TAPESTRYNETWORKS.COM · +1 781 290 2270

Mandatory audit firm rotation: the Dutch experience

On 19 June 2014, the European and North American Audit Committee Leadership Networks (EACLN and ACLN, respectively) met with several audit committee members of Dutch companies and several EY partners from the Netherlands to discuss their experiences in complying with the new Dutch law related to auditing, known as the Dutch Audit Profession Act.[1] This *ViewPoints* presents a summary of the key points discussed, along with background information and selected perspectives that members and subject matter experts shared before and after the meeting.[2] For further information on the networks, see "About this document," on page 6. For a full list of participants, see Appendix on page 7.

Executive summary

Participants reviewed the details of the Dutch law on auditing and then discussed their observations regarding its implementation:

- **The new Dutch law and its European context** *(page 2)*

  The Dutch Audit Profession Act imposes an eight-year audit firm rotation period and sharply restricts non-audit services. It applies to public interest entities incorporated in the Netherlands and listed in the European Union. The restrictions on non-audit services took effect on 1 January 2013, and mandatory rotation takes effect 1 January 2016. The Dutch legislation is more restrictive than the recently passed EU legislation, which allows (as an option for member states) longer tenure periods and places fewer restrictions on non-audit services.

- **Tendering and transition under the new law** *(page 3)*

  Participants were skeptical of how effective the Dutch law will be in achieving its goal of better audit quality, and they said the "big bang" imposed by its swift implementation had exacerbated many of the issues associated with mandatory audit firm rotation. Addressing large, complex, global public companies' constrained choices in selecting a new auditor will require a multiyear, multiservice "Big Four strategy" covering not just the audit but other critical services, such as tax. Managing the transition from the incumbent firm to the new firm will require balancing the need to minimize disruptions with the benefits of fresh eyes on the audit. With careful planning, audit chairs noted, implementation of the new requirements can go relatively smoothly and achieve satisfactory results.

- **Impact on the audit profession and market** *(page 5)*

  Participants have seen downward pressure on fees, and they are worried that the need to shift teams frequently from one client to another will create a significant need for resources. Both developments could undermine audit quality. Meanwhile, mid-tier firms have not yet benefited from the wave of tendering in the Dutch market, and they are grappling with the same staffing issues and challenges of developing proposals for multiple bids.

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[1] Three other topics were discussed at the summit. See Audit Committee Leadership Summit, "Enhancing communication among investors, auditors and the audit committee," *ViewPoints*, 30 July 2014, Audit Committee Leadership Summit, "Integrated reporting," *ViewPoints*, 30 July 2014 and Audit Committee Leadership Summit, "Emerging international risks," *ViewPoints*, 30 July 2014.

[2] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

The new Dutch law and its European context

In December 2012, the Netherlands approved the Dutch Audit Profession Act, imposing an eight-year audit firm rotation period and restricting the non-audit services that independent auditors can provide. Both restrictions stem from the stated goal of Dutch policymakers to increase the independence of the external auditor and, consequently, the quality of the audit. Another goal is to increase competition in the audit market by providing more opportunities for mid-tier audit firms.

The restrictions apply to so-called public interest entities (PIEs). Dutch PIEs include companies incorporated in the Netherlands under Dutch law that are listed on a regulated market in the European Union (EU), plus banks, central credit institutions and insurers with registered offices in the Netherlands, and entities falling into certain categories designated by the Ministry of Finance.[3] As the Netherlands Institute of Chartered Accountants (NBA) noted in its alert on the legislation, the new law is not intended to apply to small- and medium-sized enterprises.[4] It also does not apply to Dutch subsidiaries of a foreign PIE, unless the Dutch subsidiary itself qualifies as a Dutch PIE.[5]

Restrictions on non-audit services

The restrictions on non-audit services took effect 1 January 2013, though there is a two-year transition period for preexisting contractual obligations. The NBA's alert explained which services are permitted, including fact-finding services for external users (such as regulators) and the supervisory board,[6] as well as audit and assurance services. According to the NBA, "All other types of engagement, including the compilation of financial statements and the provision of advisory services (such as tax advice, management advice and [merger and acquisition] advice) will no longer be permitted."[7]

Mandatory audit firm rotation

The effective date for mandatory firm rotation in the Netherlands is 1 January 2016. Companies that will have had the same auditor for eight consecutive years on that date will need to change firms before that date.[8] When an audit firm rotates out of an engagement, there is a two-year cooling-off period before that firm can be hired again. However, the mandatory rotation of audit partners, which stands at seven years under the EU's Eighth Directive, still applies.

EU legislation and the current Dutch law

The EU legislation adopted on 14 April 2014 entered into force in June 2014, and member states will have two years to transpose it into their national law. The legislation is generally directed at audits of PIEs, for the most part the same kind of companies to which the Dutch legislation applies. It also restricts certain non-audit services and caps the fees for permitted non-audit services at 70% of the audit fees, but whereas the Dutch law specifies what services are permitted, essentially prohibiting all non-audit services, the EU

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[3] Ernst & Young, *New Legislation Covering "Organisaties van Openbaar Belang" (OOB)* (London: Ernst & Young Global Limited, 2013), page 4.

[4] Netherlands Institute of Chartered Accountants, *NBA Alert 27: Separation of Audit Services and Other Services and Mandatory Audit Firm Rotation* (Amsterdam: Netherlands Institute of Chartered Accountants, 2012), page 11.

[5] Ibid., page 12.

[6] In certain countries, such as the Netherlands and Germany, public companies have a dual board system with a management board and a supervisory (or mostly non-executive) board.

[7] Netherlands Institute of Chartered Accountants, *NBA Alert 27: Separation of Audit Services and Other Services and Mandatory Audit Firm Rotation,* page 5.

[8] Ernst & Young, *New Legislation Covering "Organisaties van Openbaar Belang" (OOB),* page 7.

legislation specifies what is not permitted, allowing more scope for some non-audit services. Member states can allow certain tax and valuation services, subject to certain conditions, though they can also prohibit additional services.[9]

Another difference from the Dutch legislation is that the EU legislation allows an initial 10-year engagement to be extended by 10 years when an audit tender has taken place or 14 years when there is a joint audit, so the effective rotation period may be longer.[10] At the same time, the initial tenure period and the ability to extend that period are member state options, so member states could adopt a tenure period shorter than 10 years and may or may not provide extensions. It is unclear how long the maximum tenure will be in different countries. In fact, it is possible that there will be a patchwork of different requirements across the EU.

In the Netherlands, the shorter eight-year mandatory firm rotation period will remain in effect for now, though Dutch officials have signaled they may align their regulation with the EU's 10-year period. Italy's nine-year rotation period and France's joint auditor legislation are also expected to remain in effect.

Tendering and transition experiences under the new law

While the effective date for mandatory rotation in the Netherlands is still 18 months away, the new law is already having a substantial impact on the Dutch market. Audit chairs and auditors who participated in the meeting believe that the new law is misguided and poorly timed. In particular, the rapid implementation period for the new requirements is proving to be a challenge. One participant remarked, *"A key failure in the Dutch system is the big bang. The politicians said, 'You have three years.' But that's not how it works."* An audit committee member added, *"We should go back to the minister of finance and ask, 'Could we not get a one-year extension?'"*

Participants in the Amsterdam meeting discussed their views of the tendering process and the transition from an incumbent firm to a new firm. Their comments echoed some of the points made in a previous network discussion of retender and rotation in Italy, where rotation has been mandatory since 1974.[11] However, the fact that the requirements in the Netherlands have only recently been imposed – and are being implemented so rapidly – has introduced additional considerations for companies and audit firms.

The tendering experience

Reflecting on their experiences so far with tendering and bidding for audits under the new law, the participants made several points:

- **Large, global companies need a multiyear plan for audit.** As expected, the number of choices a large, global public company has in practice may be limited, given that there are typically only three Big Four audit firms (since the incumbent is excluded) that can be considered, and some of them may be providing critical services in important areas such as tax, where companies may be reluctant to switch to another provider. In a given country, each audit firm may also have a limited number of partners with specific technical or sector experience. The audit firms themselves are sometimes declining to bid for an audit, citing their preference for providing non-audit services or bidding for another audit.

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[9] EY, *European Union Audit Legislation,* Point of View (London: Ernst & Young Global Limited, April 2014), page 3.
[10] Ibid., page 2.
[11] European Audit Committee Leadership Network, *Audit Firm Retendering and Rotation,* ViewPoints (Waltham, MA: Tapestry Networks, 2014).

However, participants noted that companies can address the challenge of constrained choices through careful planning, with audit committees focusing on the long term and considering the company's overall needs, including the sectoral expertise needed. An audit chair explained, *"You need to sort out the services that are conflicted, and you need to plan what you need. You need to plan the process early. The decision making on where we want advisory activities to land is the most interesting."* Over the long term, audit firms, too, can respond to the need for specific expertise by drawing on skills across their organizations and encouraging more mobility of staff.

- **The need for audit committee support is increasing.** While the Dutch law (and the EU law) restricts the decision making of audit committees on rotation and non-audit services, observers note that the increased frequency and challenge of tendering creates additional work for audit committees. Furthermore, the law has altered the balance of power between executive management and the audit committee: whereas in the past, the executive committee would ask for audit committee input and then make a decision, the roles are now reversed, with the audit committee making the final decision.
- **Tendering has brought some benefits.** Despite the challenges and the additional burdens, several audit chairs reported that their overall experience with tendering was good. In a pre-meeting conversation, an audit chair noted that recent tendering experiences had brought *"pleasant surprises,"* including valuable internal discussions on how to streamline and restructure the financial reporting process and innovations in audit offered by tendering audit firms that approach the audit with a *"fresh pair of eyes."* At the meeting, participants mentioned questions for bidding firms that have proven valuable, such as what the bidding firm's perspective is on the audit profession and its evolution, and how the firm has resolved difficult client disputes in the past. Participants noted that it should be possible to complete the tendering process in four months.
- **Sharing previous audit opinions has pros and cons.** Some companies ask bidding firms for their views on previous audit opinions. An audit chair said, *"We do it on important accounting judgments. I find it valuable to understand how bidding firms think about those issues. I want to understand that before I hire you."* However, some participants noted that regulators might be concerned about this practice: *"A regulator would take issue if it goes too far. They don't want a commitment to continuity."*

Managing the transition

With a large number of transitions between incumbent audit firms and newly selected firms now under way or coming up soon, participants touched on the challenges of achieving a smooth and effective transition. In many cases, these challenges stem from the need to protect the main rationale behind rotation – a fresh pair of eyes on a company's audit – while avoiding excessive disruptions and other costs. Audit chairs discussed some of these challenges in their session on rotation in Italy, highlighting the importance of cooperation between the incoming and outgoing firms and support from both management and the audit committee.[12] In Amsterdam, participants touched on some approaches they are seeing in the Dutch market:

- **The company plans the transition well in advance.** Transition planning can begin as early as the tendering process. An audit chair said that asking for audit firms' views of previous audit opinions was less about picking a firm with compatible views and more about understanding how the eventual transition would work: *"We actually chose the auditor that was the most critical. You just want to know*

[12] Ibid.

the issues in advance." Audit committees and executives also need to establish a climate of reasonable behavior early in the process – the incoming firm should not have an *"incentive to exaggerate"* in order to prove that it is taking a fresh approach.

- **The new firm shadows the incumbent firm.** Audit chairs have noted that, under a mandatory rotation regime, the incoming firm and the outgoing firm have an incentive to cooperate in order to make the transition go smoothly. Several participants mentioned that having the new firm shadow the incumbent firm as it completes its last audit is a useful technique for helping the new firm learn about the company and its accounts. Other participants were less enthusiastic. One audit chair remarked, *"There is a need for a fresh view, so I'm not sure about shadowing."* Regarding the cost, a participant recalled only one case in which the client paid for the shadowing, but noted that even if the incoming firm covers the cost, the economics work out favorably over the eight years in which that firm will have the business.

Impact on the audit profession and market

Participants in the Amsterdam discussion speculated on the impact of the new Dutch law on the audit profession and market, including fees, professional recruiting, firm concentration and ultimately, audit quality. Though they noted that it is still too early to be sure of the impact, several points emerged:

- **Fee pressures must not undermine quality.** One of the key issues for all stakeholders, including audit regulators, is how the Dutch law will affect audit quality. Participants noted that the ultimate impact may not be clear until a few years after the first audits under the new regime have taken place. However, they are seeing downward pressure on fees, including unrealistically low bids in some cases, which will mean that audit committees will have to be vigilant in defending quality. Audit firms in turn may have to improve their assessments of the risks and difficulties of a prospective audit engagement in order to avoid underpricing it.
- **Market pressure will create a significant need for resources.** The frequent need to redeploy staff to new accounts will require flexibility and additional resources, which could represent another threat to quality. At the same time, recruiting young people into the profession could become more difficult if the turmoil in the profession makes it less attractive. A participant spoke of the human element in imposing rotation after *"someone has worked very hard to land a client."*
- **Mid-tier audit firms have not yet received a boost.** If an objective of the new law was to increase competition from non-Big Four firms, it has not yet succeeded in that respect, according to participants in the meeting as well as other observers of the Dutch market.[13] The law is not yet reducing the concentration in the market, a result also observed in Italy.[14] Mid-tier firms may be facing the same staffing issues affecting larger firms, and they are also grappling with the challenges of developing many proposals within a short time. Indeed, the environment has been a strain for even the biggest firms, as an auditor noted when reflecting on the lessons for the rest of Europe: *"There's a level of fatigue in the profession. A lot of emotional energy is burned on these proposals. There's a limited capacity [on the part] of all firms. 2016 has been really tough to manage. You need to avoid having everything happen at the same time."*

[13] Vincent Huck, "Audit Musical Chairs in the Netherlands," 3 June 2014.
[14] European Audit Committee Leadership Network, *Audit Firm Retendering and Rotation,* page 10.

Conclusion

Reflecting on the impact of the new Dutch audit law and its lessons for the rest of Europe, participants in the Amsterdam meeting expressed doubts that the law will achieve its objectives, and they criticized in particular its rapid implementation. Nevertheless, many large companies are responding successfully to its challenges by carefully planning their procurement of services from audit firms, and some are reaping benefits from the tendering process that they did not expect. One audit chair noted, *"All three bidding firms sharpened their pencils – it was a good experience, and we were satisfied with the results."* Companies are also exploring ways to ease the transition from one firm to another and to balance the need to minimize disruptions against the benefits of bringing a fresh perspective to the audit. In the face of pressure on fees and staffing constraints, an overarching imperative for both the audit profession and audit committees is to ensure audit quality remains high.

About this document

The European Audit Committee Leadership Network (EACLN) and Audit Committee Leadership Network (ACLN) are groups of audit committee chairs drawn from leading European and North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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EYG no. AU2615

Appendix: Participants

Members participating in the session on Dutch audit reform sit on the boards of 25 large-, mid- and small-capitalization public companies:

- Dr Byron Grote, Audit Committee Chair, Unilever
- Ms Michele Hooper, Audit Committee Chair, PPG Industries
- Mr Lou Hughes, Audit Committee Chair, ABB
- Ms Marie Knowles, Audit Committee Chair, McKesson
- Dr Maurizio Lauri, Audit Committee Chair, Unicredit
- Mr Chuck Noski, Audit Committee Chair, Microsoft
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi
- Ms Guylaine Saucier, Audit Committee Chair, AREVA
- Mr Tom Schoewe, Audit Committee Chair, General Motors
- Ms Martine Verluyten, Audit Committee Chair, STMicroelectronics and Thomas Cook

Dutch experts on audit who participated in the session on the Dutch case study included:

- Mr Giljam Aarnink, Chairman, Assurance, EY Netherlands
- Mr Auke de Bos, Partner, Professional Practice Group, EY Netherlands
- Ms Carin Gorter, Audit Committee Member, ING
- Mr Jeroen Kremers, Audit Committee Chair, Nederlandse Spoorwegen
- Ms Thessa Menssen, Audit Committee Chair, PostNL
- Mr Marcel van Loo, Country Managing Partner, EY Netherlands

Additional EY participants included:

- Mr Frank Mahoney, Americas Vice Chair of Assurance Services
- Mr Christian Mouillon, Global Risk Managing Partner
- Mr Mark Otty, Area Managing Partner, EMEIA