

## **REFORM! The challenge is out there.**

Speech by Gerben Everts, Board Member Authority for the Financial Markets, conference Foundation for Audit Research (8 June)

Ladies and Gentlemen,

Thank you for your invitation to speak at your international conference today. I do this with great pleasure.

First of all, because I now get a first idea on what the Foundation is able to deliver. And you need to deliver. As audit quality can only improve if all stakeholders work together: the audit profession, the regulator and – key element - academics.

Gatherings like these will assist the audit profession in its important journey to improve audit quality. The license to operate is under pressure, as NBA's Green Papers issues yesterday rightfully addresses. And it is. The challenge is out there.

And anyone who read *NRC Handelsblad* on 29 May this year will know that discussions on issues like audit quality are vital. The headline was: 'Auditors learn too little from their mistakes'.

And this came three years after the first publication of the Dutch report '*In the public interest*'. Many of you in the audience assisted in a variety of roles in the writing and finalisation of this report. In any case, all audit firms and the NBA wholeheartedly supported the analysis and its 53 improvement measures.

The article in the NRC highlights an important issue for the audit sector: more work must be done if we are to create a business environment in which we learn from one another and learn from our mistakes. This is something that continues to undermine audit

quality. So it seems that there is still a long way to go on this important journey. Have we just started? Are we half-way? Are we entering home strait?

And for anyone who was hoping that I would be able to give you a first glimpse in term of an answer, by updating you on the conclusions of the AFM Dashboard and the latest inspection results vis-à-vis the Big-4, I will leave you in suspense for a little longer.

The other reason why I am here is because I remain committed to and passionate about this sector. As some of you may know, I began my career in auditing. As a student, I worked 1 day a week for a small SME audit firm. This is a great way to learn the basics. After I graduated, I joined one of the Big-5 by then.

So you could say that my roots are in auditing. Since, I've constantly been in the driving seat for trying to improve the audit sector in terms of governance, culture, incentives and quality. First, by introducing independent supervision on accounting and auditing in the Netherlands. Later by leading roles in international organisations. Now, 2 decades later, I see to it that the auditors and audit firms comply with the requirements that were introduced as well as many new and strengthened requirements introduced after strong pressure from the AFM – in the Netherlands, but also globally. The strong commitment of the AFM to IFIAR, the international forum of audit regulators, is a case in point.

What makes auditing so interesting, is its constant evolution. It is a dynamic sector. The move from self-regulation to independent oversight – a decade ago – had a great impact.

I would like to take this opportunity to share my views on current developments in the sector. How far is the role of auditors changing? How should auditors respond to this? And what should they expect from us, regulators?

There are many aspects to consider. This is only natural, given the complex world in which we live. I see several developments in the field of finance that will determine the future direction of the audit sector as well:

- First, low interest rates;
- Second, technological developments;
- Third, international developments and regulation (transcending both sectors and borders).

Each of these trends will certainly have an impact:

1. There is not much extra return if you are keeping your money in a savings account these days. People are looking for other ways to get a return on their capital. And institutions as well. They need to show their value for money. Actively managed portfolio's, search for yield and alternative investments are opportunities, but also a risk. As long as everyone is willingly taking those risks, and able to digest losses, I would call this an efficient capital market. However, this is not a guarantee. I will go into this in more detail in a moment.
2. The audit sector is also being affected by developments in areas such as data analytics and big data. I personally think that in a few years, we reach the point that assurance provided by pure data analytics is higher than the assurance provided by the then old-fashioned audit. The question is how to respond to these developments.
3. And finally, we continue to face long-standing challenges in the sector. Structural and cultural. And we are still searching for the optimum response. Unfortunately, the issues that were highlighted in the Dutch *Public Interest* report have yet to be fully addressed.

Let's begin by considering the consequences of the prevailing low interest rates. With low or even negative returns on their savings,

people are looking for other ways of achieving a return on their capital. Investors are searching for opportunities to make their money work harder. Investing in successful companies is one way of achieving this. However, this all depends on trustworthy financial reporting, proper and sound valuation and objective assessments by independent auditors. The role of audit is therefore becoming increasingly important. Now, and more particularly when tapering is entering the scene, interest rates go up and impairments start to hurt companies.

You all know auditors play a key role in protecting consumers and investors. These are your key ultimate clients. What auditors call clients, we as regulators call 'those subject to supervision', not clients. Good auditing is a way for audit firms to contribute to public confidence in listed companies. The challenge is to make a meaningful contribution to that confidence. How can this be done? I can see you thinking... This is the regulator speaking... surely this means that the focus will be on strict legal and regulatory compliance - as reflected in the NBA's green paper.

Well, let me be clear. Compliance with the law and regulations is the *sine qua non*. After all, this is the public interest that we are talking about. Strict compliance and enforcement are therefore absolutely justified.

However, in my view, rigorous oversight of legal and regulatory compliance does not mean that we cannot cast our net wider in our quest for meaningful quality in auditing. As AFM we do far more. We see to it that the audit profession is serving the public interest. Hence our public call for own initiatives by the sector which led to the Public Interest report. Hence our call for regulatory initiatives to strengthen the governance, structure and culture within the profession. Hence our active engagement with audit standard setting governance reforms.

I know that the audience sometimes believes we as regulator focus on ever more box-ticking. But this is a clear misperception. What we really want to bring about is a different approach. What I would really like to see is the work of auditors going beyond simply performing checks.

Those of you that read our inspection reports know that. Minor weaknesses are not even reflected upon. The findings we have are all material and significant. Focusing on professional scepticism which is not applied, essential basic methodologies not complied with and ineffective audits on valuations.

However, it is always a nice and easy soundbite: the regulator showing its teeth vis-à-vis formalities. I can assure you, this does not reflect reality. In fact, the audit firms and the AFM are fully aligned that inconsistent audit quality needs to be tackled and this journey goes far further than a pure compliance exercise. So I would like to provide my support to the Green Paper's focus on this wider notion of audit quality.

This means, first of all, providing even better insight into business operations. Looking at matters of continuity and integrated reporting – to name just two examples. But most importantly, the transition must be made towards a systems-oriented approach that is based on data analytics. Then, the basics need to be top-notch.

Measuring quality is difficult due to a variety of characteristics. We have learned an important lessons over the last decades. Self-regulation too often led to the search for the lowest common denominator in terms of audit quality, high materiality thresholds and ever lower dedication in terms of time and effort by audits partners. An ever increasing span of control which did not serve the markets well.

Therefore, the introduction of external public oversight was needed. The AFM's of this world are the only ones that can effectively verify audit quality. Clients cannot do this. Nor investors and consumers. And part of the reform package is that we would like the audit firms to re-establish audit quality controls within the firms. Such that you are not informed by us on lack of audit quality, but that the firms themselves inform us about that. Of course, by then the firms will have started the mitigating actions already. This is what serves the markets.

This is the more needed as data is playing an ever increasing role in the sector. This means that your work is becoming less visible for the wider society. While society has an ever higher interest in assurance services. It is therefore key that the audit profession has established a mandate from society for making the switch to a systems-oriented approach. You need to act now, to be granted the license to operate in this New World.

And to pre-empt a question that is bound to come up later... This wider remit must go hand in hand with the independence of the auditor. Broader, higher-quality audit may well lead to closer relationships with clients. Nothing wrong with building closer partnerships, just as long as there is a clear separation between auditing and advice.

The key will be to ensure connected partnerships without losing autonomy. That is also crucial for us in our work as regulators. We put a lot of effort in our connection with stakeholders in a range of areas. We believe this is vital for good oversight of the sector. These days, in a rapidly changing economy, we cannot afford to retreat into our offices on the Vijzelgracht. So we connect, but without losing our professional autonomy. So my appeal to the sector is to follow our example.

This brings me to my second point.

A broader notion of audit quality will also involve making optimal use of technological developments. Technological developments such as machine learning, algorithms and big data are having an impact on the work of auditors. In technological terms, the sector has the capacity to process the data. I have no doubt about that. But that is not the issue. So what is the issue?

- Machine learning and algorithms are starting to become part of our work, even though audit firms may not consider these developments as given. The auditors of the future – or perhaps even of today – will need to understand these technologies. They will need to know how algorithms are designed. And how they relate to existing laws and regulations.
- And even more, auditors are using big data when they carry out their audit work. There is nothing wrong with that. But the crucial calls will always need to be made by a human brain. Data alone tells you very little. It is the way that the data is analysed that adds value. This means that auditors must be able to provide excellent data analytics. And currently, that is by no means a guarantee. An auditor needs to further develop these skills.
- But because not all auditors currently have them, data experts are hired to carry out the analyses required. These experts, in turn, lack the skills and knowledge that auditors have. With all the consequences.
- The supervisor also has work to do in this area. At the moment, the supervision of data analysis requires additional workarounds. Like I said earlier: personally I think that in a few years we reach the point that assurance provided by data analytics is higher than the assurance provided by the then old-fashioned audit. Are the international audit standards able to

adhere to this disruption? More generally, I think it is worth taking a good look at whether all these workarounds are really necessary. That could be done at the national level, by the regulator, but I am, in fact, a strong supporter of international cooperation in this area. IFIAR provides an excellent forum in which to discuss this issue. After that, the Monitoring Group, which I Chair, is standing ready to take further action and will consult on necessary reforms in the audit standard setting governance next month.

- Furthermore, we as AFM are sandboxing and have an innovation room and will invite the audit profession to benefit from this. Your foundation should do this as well.

I have already talked about my wish to see a widening of the notion of auditing quality in the field. So I have one very important aspect left to address.

My third and final point. Looking to the future is excellent. But the sector still has much work to do if it is to restore public confidence in the work of auditors. As I mentioned, it seems that we still have some way to go. We will soon be publishing our findings regarding the AFM Dashboard and latest inspection results of the Big-4. These will include a report on the extent to which changes and improvement measures have actually been implemented and safeguarded. In other words, have your intentions on paper become a reality?

The earlier AFM Dashboard 2015 showed us that, on paper at least, the sector has been working on the proposed improvement measures. Audit firms auditing public interest entities are working hard to bring about a fundamental shift in conduct, culture and governance, in order to improve quality controls and internal oversight. These are vital requirements if audit firms are to raise their



game in terms of statutory audits and ensure that their work safeguards the public interest.

But despite all these efforts, the Monitoring Committee for Accountancy stated last year that a lot more work is needed. In fact, the MCA remains unconvinced that the proposed measures will prove sufficient when it comes to eliminating the structural causes of problems in the auditing sector. Their conclusion: more must be done in order to restore trust and ensure that the public interest is upheld as effectively as possible.

I tend to endorse this view. Progress – on strengthening quality controls, beefing up internal oversight and achieving a cultural shift – has been slow. And there are some real opportunities for success.

- Consider the way in which audit firms are currently structured. This acts as a brake on the quality improvements that need to be made. Working in teams with juniors, seniors and partners may sound attractive and efficient, but there is a risk too. Juniors have insufficient experience and their judgement has not yet matured. Partners, who often run several teams, tend to rely too much on their own judgment and past experience. This routine means that important issues can be overlooked. And finally, the real working bees, the seniors. This is the group that spends the least time discussing matters with other people. Possibly because too many other demands are being made. A change in culture is needed. Stronger teams, more capacity, more dialogue.
- The same governance relationships, in combination with efficiency pressures, result in a climate where learning from one another's mistakes is not obvious. But this is precisely what is needed in order to improve quality. It is essential to take the time to discuss an audit after it has been completed,

for instance. What went well and where is more attention required?

The current funding structure also means that the public interest is not always a priority. There is still tension between maximizing profits and maintaining the highest possible auditing standards.

Of course, firms need to be run profitably, but the current earnings model should not be an excuse for failing to invest time and money in making improvements in the sector. Or for compromising on the standard of auditing. Can you really be independent when you are paid directly by the company whose accounts you are checking? Does this not increase the risk that any mistakes identified will be swept under the carpet for the sake of maintaining good relations?

I am not saying that existing business models should be turned upside-down from one day to the next. But we do need to look actively for alternatives. The challenge to deliver is enormous. And if the audit sector fails to deliver, alternatives need to be explored. The supervisor will certainly be focusing closely on the question of earnings models. But at the same time, it would be preferable for the sector itself to take a critical look at its own business model, put forward suggestions for improvements, test them diligently and then implement them. And always keep the public interest in mind. It is today that we made these changes, not tomorrow.

Ladies and Gentlemen,

At the beginning of my presentation, I referred to my own passion for this sector. You might wonder, then, why I am no longer active as a professional auditor.

I would like to answer that question. Because it is very relevant to what I have been talking about. I left the auditing profession out of sheer frustration and indignation.

There was no oversight of the sector, the quality of statutory audits was challenged, and the public interest was not being safeguarded. Many accounting and audit scandals sprouted from that era.

In every position I have held since 1999, the same passion for the field has led me to try to bring about improvements. Just as you are doing right now.

So,

Let's cooperate, Let's connect and Let's work on our shared goal

Improving the governance, structure and culture within the audit sector. Improving audit quality.

The Dutch Authority for the Financial Markets is not a prosecution office focusing solely on fines for non-compliance. We are erected 11 years ago in order to enhance audit quality. Since then, a lot has changed. In terms of intrinsic motivation to reform within the sector. In terms of a very challenging roadmap the sector has committed itself to. In terms of the necessary regulatory improvements.

We now have done the ground work, the digging and laid the foundations. It is now up to the sector to convince the audience they can deliver on their promise. And it up to this Foundation to assist the audit profession in this important journey. Not by the strength of perception, but the strength of academic proof.

I think – I know - we do have a shared goal.

Thank you for your attention. Happy to answer any questions you might have.