

Paradox of Audit Regulation: An Exploration of the Dutch Regulatory Space

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ABSTRACT

This paper explores the development of audit regulation in the Netherlands from 2002 to 2012 after the creation of a regulatory body in 2002. The focus of the study is on the relationship between the Dutch regulatory body and the big four audit firms. This is a qualitative field research which utilized semi-structured interviews and archival data/documents. This study illustrates the presence of a strong arm's length regulation in the Netherlands during the period under investigation. The enforcing actions of the regulatory authority received much criticism and resistance from the auditors especially with respect to the interpretation of rules. The findings of this study provide a counterpoint to the prior research which suggests that the regulatory bodies mostly play a symbolical/rhetorical role. The study points out that the regulation of audit is a complex issue and it is an oversimplification to assume that the arm's length regulation builds trust. It is paradoxical that the regulatory body aims to restore trust by employing strict arm's length regulation but its actions destroy trust (partly due to differences on the interpretation of rules) in auditors because of the media coverage of the violations committed by the auditors.

Keywords: Audit regulation, Self-regulation, Arm's length regulation.

1 INTRODUCTION

The collapse of Enron, WorldCom and other companies destroyed the public confidence in financial reporting and raised questions on how to restore the trust in auditors. An objective judgment of the accountants is of great importance to the proper functioning of capital markets. The capital market would not work properly without sufficient trust in the statements of an accountant. To restore confidence in financial reporting, it is considered necessary that trust in the audit is first restored (Tweede-Kamer, 2004). One solution could be arm's length regulation to protect investors (Scott, 2012). In arm's length regulation, an independent oversight body (other than peer auditors) reviews the work of auditors. Such a regulatory body aims to reign in the auditors.

The pattern of regulation has been changing in the United States (Scott, 2012) from deregulation to regulation in recent years. The introduction of the Sarbanes-Oxley Act (SOX) and creation of the Public Company Accounting Oversight Board (PCAOB) in the United States is an obvious example. The laws and regulations are also evolving all over the world partly in response to accounting scandals. The behavior of the accounting professionals is crucial in this regard. But it is not always possible to fully rely on the professionals nowadays. Sometimes, professionals behave opportunistically and do not always act in the best interest of the investors (Scott, 2012). Therefore new regulatory bodies have been created to monitor the audit profession through an arm's length regulation. Prior to audit scandals and financial crisis, auditors were mostly self-regulated. But public accounting firms are now accountable to regulatory organizations and are no longer understood as a self-regulated professional activity (Malsch and Gendron, 2011). Arm's length regulation aims to restore trust in the audit profession. However, arm's length regulation may not be effective because of prior professional ties between public accounting firms and regulatory bodies (Malsch and Gendron 2011). Further, the new regulatory bodies may not have the expertise to properly regulate audit firms (Anantharaman, 2012).

Although many studies have examined the quality of audits, relatively little attention has been paid to the research into the oversight of auditors and most of the research that has been done on the functioning of the oversight bodies relates to the United States and the impact of SOX (e.g; Sharma and Iselin, 2012, King et al., 2012, Blankley et al., 2012, Deng et al., 2012, Moehrle et al., 2014). The regulatory spaces outside US or North America have been relatively less explored and a research outside the North American context may provide useful insights. Therefore, this paper explores the development of audit regulation in the Netherlands. The development of regulation in the Netherlands would be different from the regulation in the US because the institutional environment is different. For instance, the US is known for their rules-based GAAP but the continental Europe has a more principles-based GAAP. This paper investigates the relationship between the big four audit firms and a regulatory body called the Netherlands Authority for the Financial Markets (Autoriteit Financiële Markten -AFM). AFM monitors compliance with the laws and regulations by all market participants. The aim of AFM is to strengthen the trust of consumers and businesses in the financial markets. Since 2006, with the introduction of the Act on the Supervision of Auditors' Organizations (Wet toezicht op accountantsorganisaties- Wta (Wta, 2006)) and the Decree on the Supervision of Auditors' Organizations (Besluit toezicht accountantsorganisaties-Bta (Bta, 2006)), AFM has been supervising the audit profession. The Wta and Bta were created to restore the trust in the financial market (AFM, 2006). This field research is exploratory in nature that draws upon semi-structured interviews and different documents in order to provide insights on the development of audit regulation from

2002 to 2012. The research question is as follows: *How did the regulation of audit develop in the Netherlands from 2002-2012?*

The analysis suggests that a strong arm's length regulation prevails in the Dutch regulatory space. This is in contrast with Malsch and Gendron (2011) who conclude the presence of an allegiance between accounting firms and regulatory body in Canadian regulatory space. This research also contributes to the theory of regulation which states that trust can be restored with an extra layer of oversight (DeFond, 2010). Our analysis suggests that an extra layer of oversight creates tensions in the relationship. Regulatory body aims to build trust by reporting violations and penalties to public through different media but paradoxically these actions create distrust in auditors. Accounting firms consider the media coverage of specific cases is unhealthy and detrimental to trust in the audit profession because there is disagreement between auditors and AFM on the interpretation of rules. But AFM considers it to be its fiduciary duty to disclose the violations to the public. However, all the field participants agreed that the quality of audit improved with the arrival of external oversight. This is consistent with Lennox and Pitman (2010).

The rest of the paper is organized as follows. The next section briefly reviews the literature on the regulation of audit profession. Then research context and methodology is discussed. After that field analysis is given. Finally the last section outlines conclusions, limitations and suggestions for future research.

2. LITERATURE REVIEW/ THEORY

There are two types of regulation in the literature: arm's length regulation and self-regulation. Self-regulation used to be very important in auditing profession. In such a regulation it is considered important that professionals have a critical view of their work and the work of their peers. Arm's length regulation is often described as two groups who behave independently and have no relationship to each other. This is to ensure that both parties remain objective in their judgment towards each other. The accounting profession regulates itself to some extent but it is also subject to extensive government regulation (Knechel et al., 2007). Spira and Page (2003) state that the success of the self-regulation model is that it serves the interests of the agents of the state, the groups being regulated and the institutional representatives of those groups. The incentive for regulation is frequently some kind of scandal or cause which produces public pressure for some mechanism to prevent future occurrences (Watts and Zimmerman, 1986). Most of the parties would previously favor self-regulation solution. For instance, Hilary and Lennox (2005) find that peer reviews are good as they provide credible information about quality differences between audit firms and they state that audit firms gained clients after receiving

clean opinions from their reviewers and lost clients after receiving modified or adverse opinions. This suggests that peer reviews (self regulation) are effective.

Accounting firms would like to avoid state regulation, which is seen as inflexible and difficult to influence. However, many authors criticize self-regulation for their lack of credibility. For instance, it has been recognized that peer reviews are not perfect and self-regulation may also be ineffective if professionals act in the best interest of their constituents rather than in the best interest of the public (Hilary and Lennox, 2005). It has been pointed out that it is possible that PCAOB inspectors would uncover more problems than peer reviewers would find (Hilary and Lennox, 2005). Similarly, Anantharaman (2012) recognizes an important flaw in the use of peer reviews. She finds that firms choosing their own reviewers are likely to be connected through prior relationships and they tend to receive peer review opinions more favorable than in PCAOB reports. This suggests that some firms may have obtained friendly reviews from their peers. Therefore, the peer review program has endured criticism for affording audit firms the discretion to select their own reviewers (Lennox and Pittman, 2010). This creates suspicion that they strategically influence the reporting outcomes. As a result independent regulator is considered necessary to reduce the 'gaming' of the peer review system. Further, the self-regulated peer reviews are criticized for their reluctance to impose punitive sanctions on low-quality audit firms (Lennox and Pittman, 2010). In contrast to the peer reviews, the PCAOB prevents such 'gaming' behavior since audit firms cannot influence the selection of their inspectors and the inspectors do not have current ties to audit firms and the PCAOB is an independently funded organization. The crisis faced by the audit profession led to the implementation of the Sarbanes- Oxley Act (SOX) in the United States in 2002. These regulatory changes came about because of the perceived inability of auditors to address fundamental concerns about conflicts of interest in the work they were performing for their clients (Gunz and Jennings, 2011). The collapse of huge companies resulted in the public perception that auditors either missed significant points in their control activities or they were just blinded by their close connections with their clients. Therefore, the profession could not be self-regulated alone and regulatory reforms were unavoidable. The system of self-governance was effective for over a century, but did not prove effective for the audit profession when it entered a new era of price competition and expansion of services (Gunz and Jennings, 2011). It has been suggested that the current 'we will self-regulate as needed' is not adequate anymore.

However, arm's length regulation has its own problems. For instance, it is recognized that external regulators may be ineffective if they are captured by the constituents being regulated (Hilary and Lennox, 2005). Regulatory bodies, auditors and auditees may provide an (symbolic) appearance of high level assurance necessary to legitimate regulatory programs (Power, 2005). These actors might be

interdependent and no one would break the circle. The issuing of audit reports may become subject to organizational and regulatory politics. Some argue that the PCAOB was created by the government to show that something was being done after the collapse of Enron (Anantharaman, 2012). Furthermore it is often argued that PCAOB inspectors do not have the in-depth expertise as compared to the partners and managers currently practicing at an accounting firm. Peer reviewers might be less objective and sometimes even behave friendly. However, they do bring superior knowledge to the process through greater familiarity with local clients and practices (Anantharaman, 2012). The PCAOB prevents opportunism since audit firms cannot influence the selection of their inspectors, and inspectors do not have ties to the audit firms. But PCAOB have less technical expertise to properly regulate audit firms. DeFond (2010) recognizes that in the choice for regulation, an important trade-off between expertise and independence needs to be made between the two types of regulation. Sikka (2009) points out that more and more auditing standards and regulatory bodies would not help to reinvigorate auditing. But society, government, business, and the profession all wish to avoid future massive auditing failures and a wide variety of rules govern the public accountant nowadays. The degree of self- or government regulation varies from country to country. What they all have in common is that they aim to protect the integrity of the profession and the trust of society in auditors (Knechel et al., 2007).

However, Sinclair (1997), states that much of the debate has been characterized by a choice between two mutually exclusive policy options: 'strict' command and control on one hand (arm's length regulation), and 'pure' self-regulation on the other. On the one hand regulators are more objective than self-regulators but have less industry expertise. On the other hand, self-regulators have more expertise than regulators but they are less objective. However, the transition between the regimes may be more nuanced than a pure trade-off of expertise or independence (Anantharaman, 2012). Both approaches to regulation have different strengths and weaknesses which might support claims that a combination of both approaches may work. Sinclair (1997) suggests that a combination of the both would provide an ideal regulatory outcome. Short and Toffel (2010) provide a more cooperative approach between regulators and industry. This means that novel government programs may encourage firms to monitor their own regulatory compliance and report their own violations with the regulators. Regulatory agencies may embrace programs that see firms as active participants in their own governance. These new cooperative arrangements could enjoy wide support. However, most of the research on regulation pertains to US and it is relatively less explored in other contexts/countries. Therefore, this research would shed light on the development of regulation in the Netherlands.

3 RESEARCH CONTEXT AND METHODOLOGY

3.1 Research context

3.1.1 Regulation in the Netherlands

Stable and orderly financial markets are important to the Dutch economy. Individual financial institutions and the financial system as a whole are therefore supervised by the government (government.nl: accessed 23-03-2012). The government supervision is exercised by two organizations on the behalf of the Minister of Finance who has the final responsibility for the financial system within the Netherlands: the Dutch Central Bank (De Nederlandse Bank- DNB), and the Authority of Financial Markets (AFM). These organizations are created to ensure that consumers and businesses enjoy the greatest possible protection when they entrust their money to financial institutions (government.nl: accessed 23-03-2012). Under the Directive of the European Parliament and the Council on statutory audits, European countries are obliged to have a system of independent public supervision of auditors' organizations (public accounting firms) (Tweede Kamer, 2004). AFM has been responsible for supervising the audit profession in the Netherlands since 2006.

3.1.2 The creation of the AFM

The AFM is the successor to the (Stichting Toezicht Effectenverkeer –STE) Securities Board of the Netherlands which would supervise all participants in the securities trade. The STE was in charge of monitoring the stock exchanges from 1992 to 2002. In 2002 the name changed from STE to AFM –Authority for the Financial Markets. A new organic structure was necessary due to the change of the governance structure. Therefore the transformation process also led to the change of name. It was decided to create a new functional model of supervision whereby a distinction is made between prudential and conduct supervision. In the new structure, the prudential supervision is the responsibility of DNB, and AFM is responsible for the conduct supervision. It transformed STE from a securities regulator to a conduct supervisor. The STE was, for that reason, renamed the Netherlands Authority for the Financial Markets on 1st March 2002 (annual report AFM, 2002). As the STE/AFM state “the change of name is a logical consequence of the expansion of our area of operations beyond the securities markets”. The Authority has supervised the business conduct of the entire Dutch financial industry: savings, investments, insurance and lending since 1st March 2002 (Annual report AFM 2001).

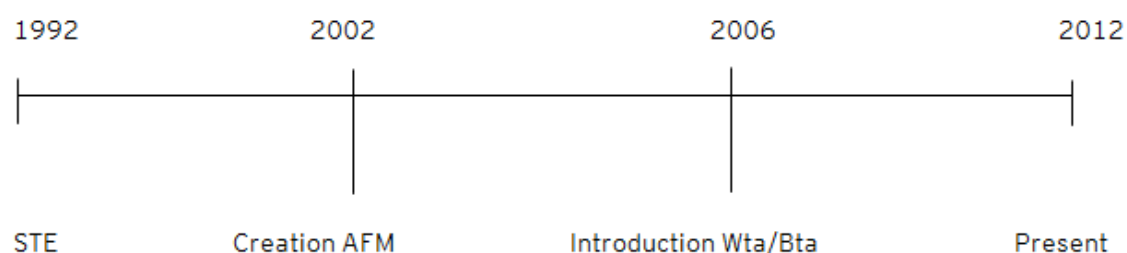
3.1.3 Tasks of the AFM

AFM's mission is to strengthen consumers' and businesses' confidence in the financial markets, both nationally and internationally. It monitors compliance with the laws and regulations by all market participants and also advises the Ministry of Finance on new legislation on the supervision of the conduct of the financial markets (annual report AFM 2002). AFM is an autonomous authority that has the power to

supervise the conduct of the financial markets. AFM is responsible for the fulfillment of its supervisory function. After the arrival of the Act on the Supervision of Auditors' Organizations (Wet toezicht op accountantsorganisaties-Wta) and the Decree on the Supervision of Auditors' Organisations (Besluit toezicht accountantsorganisaties-Bta), in 2006, AFM was assigned to monitor the audit profession. These laws were created to restore the trust in the financial market. The Wta includes independent public oversight on auditors who perform statutory audits. With the introduction of the Wta and Bta, auditors' organization (public accounting firms) may only carry out statutory audits if it has a license to do so (AFM annual report 2006). The Wta assigns the AFM the tasks of granting and withdrawing of licenses to audit firms. AFM also supervises compliance with the licensing requirements by the firms. They can penalize the accounting firms for breaches of Wta (AFM Annual report 2006).

For the execution of their supervision task, the AFM could make use of an existing professional accounting organization. The Netherlands institute of Chartered Accountants (Nederlandse Beroepsorganisatie van Accountants – NBA), is the professional accounting organization in the Netherlands. This is an association of the Netherlands Institute of Registered Accountants (Koninklijk Nederlands Instituut van Registeraccountants-NIVRA), and the Netherlands Organization of Accounting Consultants (Nederlandse Orde van Accountants-Administratieconsulenten-NOvAA). NIVRA and NOvAA are professional organizations for the entire accounting profession. These organizations therefore also focus on non-statutory audits (nba.nl). Before the law on audit supervision was in effect, the NIVRA was responsible for overseeing the audit profession. However since the introduction of the law, AFM no longer makes use of the 'testers/inspectors' of the NIVRA (NRC, 2007). However the Dutch House of representatives initially wanted the AFM to work together with the professional organization because of extended scope of work and increase in administrative costs and AFM relied on NIVRA for the execution of their supervision tasks partly in beginning. But in 2007 the cooperation with the NIVRA ended because AFM decided on assessing the offices at its own. Figure 1 below shows a timeline with the most important development in regulation the last decade.

Figure 1: Timeline: Development of Regulation in the Netherlands



3.2 Research approach and data collection

A qualitative field research approach was used because qualitative data are a source of well-grounded, rich descriptions and explanations of processes occurring in local contexts (Miles and Huberman, 1994). The nature of the research question required a close engagement with the field participants rather than an objective and distanced capture. Qualitative research can give compelling descriptions of the qualitative human world and can provide us with well-founded knowledge about the reality (Kvale and Brinkmann, 2009). Such a research can provide a deeper understanding of social phenomena than that would be obtained from quantitative data (Silverman, 2005). This research uses multiple sources of evidence (Yin, 2003) in the form of documents and interviews.

The use of documents provides data that can easily be reviewed repeatedly and data has a broad coverage which means information from a long time span can be retrieved (Yin, 2003). Historical data in the form of documents was collected from 2002 till 2012 (See Appendix A for details). One of the important sources for documents was the annual reports of both the Big Four companies and the AFM (AFM, 2006, AFM, 2007, AFM, 2011). Especially the annual reports for the years 2006-2007 were of important because of the implementation of the Wta. In these reports, both auditors and regulator gave their reactions on the development of audit regulation. The annual reports were also easily accessible. Besides, annual reports the intranet of one of the big four audit firms was used because one of the researchers of this paper was working there. The name of the audit firm is kept confidential. With the use of the intranet, access was possible to 'News Portal' where important news were published regarding the change in legislation. Internal publications about how to cope with the changing legislation were also available there. Further, the minutes of meetings, presentations, and press releases were also accessed. The reaction of the management of the audit firms regarding the change in regulation was reflected in several documents. Historical documents from 2002 to 2012 were found in the database. News articles, press releases and publications were also investigated. Most of the articles were collected from renowned national accounting magazine and newspapers including: AccountancyNieuws, Maandblad Accountancy en Bedrijfseconomie (MAB), Nrc.next, Volkskrant and the Financieel Dagblad. Furthermore governmental documents about the implementation of the new regulation of the Wta and Bta were studied. From the enormous amount of available documents, the number of documents was reduced to twenty documents. The selection of the documents was based on the year of publication, reliability of source, and contents of the documents. The documents needed to have a direct linkage to the development of audit regulation.

In total 7 semi-structured interviews were conducted. The participants were asked about their experiences and expectations related to the regulation of audit. The thoughts of the participants were central in this research (Boyce and Neale, 2006). Three interviewees were from one of the big four audit firms, three were from AFM, and one from NBA. Participants at the audit firm had over ten years' experience in their profession. Participants from AFM and NBA had over five years' experience with AFM. All the auditors were registered accountants (chartered accountants) and all were actively involved in the compliance laws and regulations. From the NBA, a member from the regulation department was interviewed. The participants were selected based on their experience in audit profession and regulation (both in national and international). Two of the three auditors, were both active in the national and international practice and therefore experienced in both the Dutch regulation and the US-based SOX regulation. Table 1 describes different participants from the three organizations: Audit firm, AFM, and NBA. The participants are identified as "A" for Auditor, the "R" for regulator, and the "I" for Institute. The interviews were conducted in May 2012 in Dutch language because the mother tongue of the participants was Dutch and they were comfortable with answering questions in Dutch. The interviews had duration of approximately 45-60 minutes.

Table 1: Interviews (A= Auditor, R=Regulator, I= Institute)

#	Participant Code	Organization	Position	Description	Duration (minutes)
1	A1	Audit Firm	Partner	He has been working in the audit firm for 10 years and working in the audit profession for 16 years.	49
2	A2	Audit Firm	Senior manager compliance Office	He has been working in the audit firm for the last 13 years.	62
3	A3	Audit Firm	Senior manager	He has been working in the audit firm for 5 years and has been in the audit profession for 17 years.	56
4	R1	AFM	Member management group	He has been working at AFM for the last 4 years.	63
5	R2	AFM	Staff regulation financial reporting department	He has been working at AFM for the last 8 years. Before joining AFM, he was a manager at Ernst & Young	40
6	R3	AFM	Staff regulation accounting organizations	He has been working at AFM for the last 6 years.	55
7	I1	NBA	Head Professional Practice	He has been working at NBA for the last 5 years.	65

The audit firms under consideration were only the Big Four accounting firms in the Netherlands because it was expected that they would have the supervision focus of AFM. The Big Four offices have a combined market share of approximately 80 percent of total sales for statutory audits in the Netherlands (AFM annual report 2010).

4- FIELD STUDY ANALYSIS AND DISCUSSION

The analysis and discussion of the field study is organized around three broad themes which are strict versus symbolic arm's length regulation, interpretation of rules/violations and relationship between arm's length regulation and trust in the capital market.

4.1 Strict versus symbolic arm's length regulation:

The study of documents revealed that the background of the most of the members of the board of AFM was not accounting. Only one out of five managers had a background in accounting (Annual report AFM 2011). This is in contrast to the study of Malsch & Gendron (2011) in which members of the regulatory body were from the accounting profession. This gives AFM more independence as they have no prior ties with the audit profession. This means AFM is at an arm's length from the audit profession. The following discussion strengthens the view of the existence of arm's length regulation. The analysis of both the documents and interviews showed that AFM was executing the supervisory tasks with a coercive power. For instance, documents of AFM show: penalties on audit firms, procedures to improve reliability, and the increased rules and regulations for accountants. The member of AFM emphasized their role to ensure compliance with Wta as follows:

"There is one thing you'll have to understand: we do not tolerate. If we observe a violation of the law, it may not take long before that conflict is eliminated. We are inexorable." (AFM 2005).

Both auditors and the NBA also experience the same form of strict execution of oversight by the AFM as follows:

"My view on the relation between AFM and auditors is a very formal relationship whereby the AFM exerts coercive power to oversee compliance with the rules." (A2)

AFM is very clear in their position regarding compliance with the law and they exercise coercive power on auditors. One way of showing their power is to impose penalties or taking legal measures against auditors. The execution of the coercive oversight by the AFM, especially the publication of penalties contributes to its strict image. The annual reports of AFM explain this. In December 2009 AFM presented a report on the investigation of audits for financial firms and they concluded that the auditors lacked an objective professional attitude. This harsh criticism was repeated in the annual report of 2010 which was noted by the media. For example the excerpt regarding overall findings on the audit quality in the report of 2010 goes like this:

“The findings of the AFM show that too many external auditors on some parts do not, or not sufficiently, comply with standards that are applicable in performing audits. The AFM found relevant shortcomings in 29 out of 46 audits that they examined as part of the regular studies on the quality of the audit.”

With the publication of the report of AFM on the audit quality of Big4 firms in 2010, the attention of the media was enormous. A few headlines from different newspapers from the week of the publication of the report are as follows:

“AFM expresses strong criticism on auditor: the quality of the work of auditors would be below standards”(Trouw, 2010)

“The quality of accountants who audit construction and real estate companies, structurally fail” (Fiancieele Dagblad, 2010)

“Accountants are inaccurate in the audit” (Nrc Handelsblad, 2010)

“AFM: Big audit firms fail” (NOS, 2010)

“The credibility of the accounting profession is at stake” (De Volkskrant, 2010)

“Lack of professional skepticism by auditors.” (Rtl Z, 2010)

These are just a few examples of the reaction of the media on the report of AFM. It shows that AFM has a huge impact on society. In 2012, accountants were again in the news in an unpleasant way: For instance different cases such as KPMG and Vestia (a client), KPMG and Weyl (a client), Ernst & Young and DSB (a client) and Deloitte with their CEO (Mr. Piet Hein Meeter) who was accused of violating the independency rules. Accountants were doing badly in the media. Regarding the Vestia case, some professors believed that the involved auditor (KPMG) was losing their bond with society by withdrawing their unqualified opinion retroactive. They accused auditors for only starting with a thorough investigation after press releases. Following is a paragraph from a magazine:

“The auditor plays an important role in society. Because of these practices, the discipline loses its credibility and its relationship with society, the latter must be confident that accountants actually do research: in search of something we do not know.” (Accountant, 2012)

Auditors say that AFM should play a role in restoring the image of auditors instead of destroying it. For example an auditor and an NBA member have similar views on the role of AFM as follows:

“Because of the negative publicity, society thinks that auditors are doing a shitty job. But in fact we are doing a better job now; we improved the quality of the audits” (A2)

“I am looking for a clear image. The AFM does a lot of good work, and the AFM needs to be there, but please more nuances. Good to say: they made a mistake, but

they did a good job. Be clear and give firm specific report which says what went wrong but also what went good, that is important.” (I1)

Roderick Munsters (a renowned businessman-Chairman of Eumedion) suggested that AFM should also publish good things about the audit firms as follows:

“The AFM should reward good behavior by highlighting things it is happy about. This can be expressed for example in its annual report, in an interview or during a lecture.” (Annual report AFM 2006).

However, the AFM has obligations regarding their supervision in the Wta. Based on this law, the AFM has the power to penalize an audit firm when they breach Wta. AFM accused Ernst & Young in a trial for not adequately carrying out its work as an external auditor. The lawsuit was discussed in public. AFM rejected the request from Ernst & Young to handle the case behind closed doors. A spokesperson of the audit firm motivated the request for treatment of the complaint behind closed doors as follows:

“We believe that our audit was carried out well. We want the court to carefully come to a conclusion without the auditor already being convicted in the media.” (Ernst & Young, 2011)

Similarly, KPMG asked for a treatment behind closed doors in the case of the Philips Pension Fund. Their request was also rejected. According to a spokesperson of KPMG the reputation damage that an audit firm suffered though the publication of a penalty cannot be reversed when a penalty of AFM proves to be unjustified. AFM, however, thought it was good that penalties were made public. They see it as their responsibility to warn the public.

“It is important that society can rely on the judgment of the auditors. It is our task to inform society when things are going wrong.” (AFM)

It is clear from the above that the AFM does not refrain from incorporating information which criticizes audit firms in their annual reports. From this strict oversight, one can conclude that the AFM's role is not just symbolic but it seriously executes its tasks as a regulator. Therefore it can be concluded that an arm's length regulation is present in the Netherlands.

4.2 Issues of interpretation of rules and cooperation:

The findings illustrate that auditors have a feeling of discomfort with AFM. According to the auditors, their negative coverage in the media and publications of the AFM do not fairly represent their performance. They say that they achieved major

improvements in the quality systems of audits during the last decade. Despite these improvements audit firms appear more negatively in the news. The auditors feel that they cannot put their grievances on the table. They feel that they are not heard. Auditors describe this in the interviews:

“They impose and listen to counterargument, which they have to because of the adversarial principle, so they do that. However if you look at how they respond to the counterarguments, this is not flexible at all.”

So according to the auditors and NBA, the AFM does not really cooperate with auditors. They manage to prevent grievances from ever being discussed as they do not listen to auditors. This uncovers that AFM is exercising power over auditors that restricts the power of auditors. AFM receives more and more criticism from auditors and NBA because of the way it is performing its functions. Auditors desire more flexibility on the side of AFM. Chairman of the Confederation of the Netherlands Industry and Employers agrees on this point:

“We would like AFM to show flexibility. This will contribute to an enterprise climate and AFM should first try to resolve the matter together– rather than like a policeman – pointing the finger and immediately going to court in the event of disputes” (AFM annual report 2006).

This also became apparent during the interviews with the auditors and the NBA. They all call for more flexibility and are not happy with the movement towards the more rules based system because Netherlands is more principled based country in terms of financial reporting. An auditor says:

“AFM is very strict in applying the rules, and not flexible. I do not mean that the AFM should deviate from the rules, but I do mean that AFM should not further convert to legal context. The education program to become an auditor is very long and intensive. The auditor is a professional whose activities cannot be captured in rules, it is subject to interpretation.”

One audit firm sees it as a big problem that there is still a discussion with the AFM on the interpretation of rules and standards for audits. This is an important matter to improve according to the auditors. According to that firm, AFM calls it mistakes, whereas auditors postulate that they acted correctly. For instance there is a difference in the interpretation whether an auditor can rely on the work of another auditor. Even professors don't seem to agree on this topic according to an interview with two professors in *Het Financieele Dagblad* (a magazine) (2012). The NBA and auditors respond to a penalty in the interviews as follows:

“In the case where an audit firm was penalized, there were a few points where the penalties could be imposed without a doubt, and a few points on which you could discuss about the interpretation of the rules.”

AFM also imposed a penalty on Deloitte for not following the applicable rules of the profession. Deloitte announces that they disagree with the AFM on some points on the way rules were interpreted.

“Deloitte is considering raising objections against the penalty decision of AFM to thereby contribute to gaining clarity about the limits and interpretation of applicable regulations and the scope of the assessment framework. Deloitte believes that the society as well as the accounting firms and regulator would benefit from this (Accountancynews, 2012)”.

Netherlands has more principle based orientation towards financial reporting (Van Beest, 2011) which means that there is a higher degree of judgment and interpretation. This logic goes against the logic of reasoning of a regulatory body that originally emerged in a rules based environment which is US. AFM also recognizes the importance of open norms, as you need to quickly adapt to the changing environment. However they responded that open norms are not sufficient anymore. Open norms are subject to interpretations, not fully describing how to fill the standards with rules and regulations. The board member of the AFM has the following take on this:

“You can hardly maintain based on open standards, the trick is to make the open standards concrete with guidance without completely closing the standards. You need space to be able to deviate with a sufficient motivation.”

Chairman of the Confederation of the Netherlands Industry and Employers points out some developments in the society which has embraced enormous rules:

“The aim should be a Dutch climate which involves strict and clear supervision by the AFM, but which also leaves room for the enterprise across the table to respond to requests from the supervisory authority. In recent decades, the Netherlands has developed in many areas into a society where nearly everything is checked. In this context, the legislator has a preference – inappropriately, in our view – for ex-ante checks, therefore in advance, on the basis of a licensing system. In the Netherlands, we have over a thousand licensing systems with millions of licenses! This situation is very bad for entrepreneurship.” (Annual report AFM 2006)

As a regulator AFM takes its task seriously and is monitoring compliance with the law very strictly. They do not see the need of flexibility:

“It is good that all parties are aware of the standards that are there and to show that the standards are working. It is a good development that auditors are subject to independent regulation nowadays, although it hurts the accountants.”(AFM)

4.3 Arm’s length regulation and trust in the capital market:

An important contradictory discourse is related to the subject of trust. AFM and auditors both have very different views on trust building in the market. Without sufficient trust in the statements of an accountant, the capital market faces problem and the mission of the AFM is to restore trust in the financial market. According to AFM director it is all about restoring trust because people lost faith in the work of auditors due to worldwide audit scandals (AccountancyNieuws). In the report of overall findings on the audit quality of the AFM (2010), it states what leads to restoration of trust:

“The AFM promotes fair and efficient functioning of capital markets, on which investors can trust. The AFM maintains rules for auditors who check the annual reports. The market must be confident that the auditor has audited the financial statement sufficiently. To restore trust in the market, it is our task to inform investors about the functioning of auditors; this will contribute to the trust in the financial market.”

AFM believes that trust is created by informing the public about incidents. Trust in the financial market can only be restored when investors are informed about the functioning of the auditors. On contrary, auditors and NBA think trust cannot be restored by bringing auditors negatively in the media. According to them, trust is not created by executing formal oversight with the imposition of penalties and measures rather this creates distrust. According to auditors and NBA representative people do not believe in the opinion of auditors anymore when they read negatives in the news. According to a member of the NBA and an auditor:

“The task of the regulator is to restore trust in the capital markets. But can you restore trust when you create anxiety in the audit profession?” (I1)

“If the role is to restore trust in the financial markets, this is not the image you get when you read the newspapers.” (A)

In contrast, the AFM states that auditors are responsible for the negative publicity as their work lacked quality. AFM:

“It is partly due to the accountants themselves that this is questioned nowadays. It is up to the accountants themselves, what their position in society will be in the future. The process they are going through at the moment, will determine how society will look at the role of the auditors. The ideal situation will be that auditors will end up a

pedestal, deservedly on a pedestal. If that does not happen, the conception of the auditor will become more an opinion next to the opinions of many others.”

However, the coercive oversight by the AFM together with the pressure to perform well did increase the willingness to change and improved quality among audit firms. The audit firms recognize that independent oversight works and that it contributes to quality improvement.

“The supervisory climate in the Netherlands puts pressure, which coincides well with our own ambitions in the area of risk management. It fits well in restoring the image of the audit profession that will benefit from good legislation and good implementation.” (Ernst & Young Annual Report 2006-2007).

“Our people understand why we emphasized on maintaining the regulations. Also they accept that it is an integral part of the profession. The organization has improved from these developments. Quality goes beyond compliance and the fulfillment of formal requirements only. Therefore we have started a quality program. Quality must be proven in the perception of the customer” (Deloitte annual report 2006-2007).

AFM releases statements concerning investigations on audits performed by the Big4 audit firms. Audit firms respond to their investigation very seriously by implementing a plan to repair the weaknesses. They communicate the weaknesses pointed out by the AFM. It seems independent public oversight helps the audit quality.

To summarize, since the introduction of auditor oversight in 2006, arm's length regulation expanded rapidly. The Dutch regulatory space is now mainly characterized by an arm's length regulation. AFM executes power by imposing penalties. Auditors would like to see more flexibility from AFM and more positive news, to restore trust in the media. Although auditors have some contradictory discourses especially about trust and problems with the regulator, they do recognize the importance of external oversight.

5. CONCLUSIONS

Regulation increased as the result of many audit scandals. Subsequently, new independent regulatory bodies were created to oversee the audit profession. In the Netherlands the auditors became subject to external oversight in 2006. This study shows that arm's length regulation has been dominant in the Netherlands in contrast to Malsch & Gendron (2011) who found an allegiance between audit firms and the regulatory body in Canada. This might have to do with the background of the members of the regulatory bodies. In Canada the members of the regulatory body had prior professional ties with the accounting firms but in this case most of the

members of the regulatory body did not have accounting background and prior connections with accounting/auditing firms.

AFM looks after the compliance with laws. Whenever audit firms do not comply with the rules AFM takes measures in the form of imposing penalties, going to court, or giving public warnings. Therefore the legitimacy of accounting firms is questioned in the press and in the eyes of the public. AFM mainly publishes negatives about the work of the auditors. According to the auditors and NBA, the AFM does not really cooperate with auditors. This means that the auditors feel discomfort with the process of regulation. Auditors require more flexibility from AFM. Netherlands is primarily a principle based system where interpretation and professional judgments carry weight. The study suggests that auditors find it difficult to reconcile with rules-based logic of the regulatory authority. Although auditors prefer more room for professional judgment and interpretation of rules, they acknowledge that a regulatory body is good for the audit profession.

Trust is an important discourse on which AFM and auditors do not agree. The objective of the creation of external oversight on auditors is to restore trust in auditors. AFM believes that trust is created by informing the public about incidents where rules are violated. However, the auditors believe trust cannot be restored by portraying a (negative) image of the auditors, especially with respect to interpretation of rules. These are contradictory discourses. These discourses influences the way in which people think and behave. In this sense, a strong arm's length regulation does not contribute to the creation of trust for the audit profession/ firms. The argument that external oversight leads to trust building (e.g; DeFond 2010; Gunz and Jennings, 2011) is an oversimplification because audit regulation is much complex phenomenon and requires further unpacking.

The number of the interviews and documents was limited in this the study because only one of the big four audit firms was interviewed and only Big4 firms were considered in the analysis. It is suggested that future studies with more that data and inclusion of more audit firms may contribute to our further understanding of the regulation. Future research may also be conducted to follow up on the developments in the audit regulation in the Netherlands. Further, it might be interesting for future research to expand the scope of the research in other regulatory contexts.

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Appendix A: Documents collected and analyzed

#	Year	Source	Name	Description
1	2001-2012	Annual report STE/AFM	Jaarverslag AFM jaar 2001 tm 2012	Annual reports of the STE and AFM from the years 2001 until 2012
2	2004	AFM	Definitief advies inzake de Toezichtstrategie Accountants organisaties door de AFM	Report on the strategy of the execution of the Wta law. What are the tasks of the AFM, how should they regulate.
3	2004	Volkscrant	Accountants onder toezicht AFM	Plans to implement external oversight for accountants by the government
4	2005	AFM Published in MAB	Extern onafhankelijk toezicht op de kwaliteit van de accountantscontrole	The way in which external regulation can contribute to the quality of the statutory audits and to restore the public trust.
5	2005-2012	EY, Deloitte, PwC, KPMG	Jaarverslag Big 4 kantoren Nederland 2006-2007	Annual reports of the Big 4 audit firm in the Netherlands with their reaction on the implementation of the Wta/Bta.
6	2008	NBA	Praktijkhandreiking 1103: Accountantsverklaring bij een jaarrekening; praktische aanwijzingen	Practical guideline for auditors for conducting the audit.
7	2009	AFM	Accountants onder toezicht van AFM	The changes for accountants after the implementation of the law regarding audit regulation: Wta, in 2005.
8	2009	NIVRA	Zicht op toezicht: nieuwe (toezicht)wetgeving voor accountants in de financiële sector	The influence of the changing regulation on the work of the accountants.
9	2009	Jaarboek Compliance	Handhaving door de AFM: de toezichthouder op bezoek	The execution of oversight by the AFM. The responsibilities of the AFM
10	2009	AFM Published in Accountancy Nieuws	Interview met Janine van Diggelen en Steven Maijoor, AFM. De slag doorlopend	An interview with two members of AFM who are responsible for regulation on auditors. The interview is a

			toezicht; kwaliteit blijvend op1	review on the current situation as a reaction on the interview from 2004.
11	2010	AccountancyAge	FSA audit report: Regulator seeks power to disqualify audit firms	The execution of supervision by the regulator of the UK
12	2010	EY	Inform, vaktechnisch bulletin	Internal publication with interviews from AFM and EY staff on the quality of the audit and point for improvement.
13	2010	Accountancynieuws	AFM herhaalt kritiek op accountants	The AFM repeats critics on auditors in their annual report.
14	2010	EY	AFM Public reporting	A presentation of EY on the public reporting of the AFM on the auditors
15	2010	AFM	Rapport algemene bevindingen kwaliteit accountantscontrole en kwaliteitsbewaking	Report on the execution of oversight by the AFM, with the finding from AFM on the compliance with the laws.
16	2011	AFM	Prikkels voor kwaliteit accountantscontrole: een verkenning	A report by the AFM on the result of their extensive quality research among audit firms.
17	2011	EY	Ernst & Young reageert op tuchtzaak AFM inzake DSB	The reaction from the audit firm on the critics by AFM regarding the DSB case.
18	2011	Binnenhof TV	Ronald Plasterk wil veranderingen accountantsregels	Interview with Ronald Plasterk following the meeting with the AFM about the quality of the audits in the Netherlands.
19	2012	AFM	Open samenwerking tussen toezichthouders is in ieders belang	Interview with director of AFM and head oversight financial reporting
20	2012	Deloitte Published in Accountancynieuws	Deloitte overweegt om in bezwaar te gaan tegen AFM-boete	A reaction from Deloitte on the penalty imposed by the AFM.