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Commissie Toekomst Accountancysector
Via Internet Submission

Dear Members of the Commissie Toekomst Accountancysector:

Introduction

I am a Canadian and United States chartered accountant, born in El Salvador, who transferred to The Netherlands in 2001 with PwC. I was a partner with PwC Netherlands until 2008 and subsequently founded an international crisis consultancy business with former FBI Director and U.S. federal judge, Louis J. Freeh. In 2007, I completed a PhD at the Vrije Universiteit and the title of my thesis was *Principles, Processes and Practices of Fraud Prevention*. In 2018, I published a follow-up book titled *Broken Business: Seven Steps to Reform Good Companies Gone Bad* that addresses lessons learned from my career helping global organizations confront some of the largest accounting fraud, corruption, and money laundering cases on record. In 2003, I was called upon to support the investigation and remediation work following the accounting fraud at Royal Ahold. Since then, I have assisted large global organizations based in Germany, Switzerland, Sweden, and Canada address corruption, fraud, and money laundering challenges under the purview of U.S. prosecutors. As CEO of Ortus Strategies, a corporate crisis consultancy, I serve as an independent expert and strategic advisor to boards and management at a number of organizations.

I am currently a guest faculty member at the Vrije Universiteit and I also serve 210,000 accountants as CPA Canada's representative to the Canadian government's Advisory Committee on Money Laundering and Terrorist Financing ("ACMLTF"). I am writing this letter in a private capacity as a concerned professional accountant, with a vested interest in ensuring that the accounting profession remains strong and delivers on its mandate to protect public trust.

Where we are today

My belief is that the accounting profession and the auditing market in The Netherlands are facing their worst crisis in a generation. There is a widespread perception that weak audits have contributed to business failures and that auditors are not serving the public interest. In particular, the Big 4 firms are accused of putting their self-interest ahead of the public interest. And, following the financial crisis of 2008 and the ensuing scandals in The Netherlands, there is public outrage and intense media scrutiny on the accountancy sector. Never before have auditors been so famous for all the wrong reasons.

I have observed that many of those who have publicly criticized auditors and the Big 4 firms have little real experience from the inside of major cases of fraud, corruption and corporate misconduct, and have adopted populist positions that are not soundly based in research about the global nature of business and capital markets. We must resist following such myopic and uninformed views. The failure rates in auditing are extremely low in comparison to the number of audit opinions issued every day. That is not to say that processes within audit firms could not be improved, as identified from AFM reviews. But true audit failures – those where audit opinions missed material frauds and such failures led to business collapses – are exceptionally rare. Simply put, material accounting frauds are rare events and this has not changed in the last decade.

The increased focus of the AFM, NBA and the Dutch government has brought about major changes in the culture of audit firms in The Netherlands. The question for today is whether we have done enough, need to do more, or to allow time to assess whether the changes that are being implemented deliver on higher-quality processes that support better audit opinions. Unfortunately, regardless of the answer we bring forward on the structure of the audit market, the limitations of financial reporting will inevitably remain and therefore the probability of future business failures occurring may not necessarily change by altering the audit market. Specifically, accounting is reliant on the historical cost convention and mark-to-market adjustments, based on rules set internationally. Additionally, the "expectation" gap for auditors to be guardians against fraud will largely remain. When management and third-party collusion is involved, fraud, corruption, and money laundering will remain increasingly difficult to detect for an organization's internal controls and the best auditors.

The generational challenge today

Canada, where I began my career as an accountant, enjoys one of the healthiest accounting professions in the world. It has adapted to changes from stakeholders and regulators, while keeping the spirit of the profession and its Code of Ethics front and centre. However, the accounting profession in Canada – like The Netherlands – is facing a complex, once-in-a-generation challenge: (1) how can the profession and the global order of parties that oversee and participate in the capital markets address the threat posed by corporate crime and players that benefit from facilitating dirty money or win from dirty business practices; (2) how can improvements and reforms be introduced without destroying a country's competitive advantage and attractiveness to foreign investment, which creates jobs; and (3) what checks and balances can be effected to ensure fair play, increase accountability, build trust in business, and prevent undue gains.

Scandals, crises and failures in business typically stem from lapses in judgment by business leaders. Greed has been often cited as a key issue affecting auditors. Indeed, the entire nature of capital markets is driven by money and the pursuit of profit, creating a ripe environment for a culture of greed that can overshadow trust and integrity principles. In my experience and research, organizations most vulnerable to corporate misconduct are notable for their environments characterized by extreme pressure to meet targets, there is undue risk taking, and a toxic culture where fear and silence reigns. Greed, cheating, and related challenges extend beyond accounting and auditing.

In my book, *Broken Business*, I document what my research and experience has taught me about the nature of misconduct, how to fix it, and how to prevent it from occurring in the first place. I believe that this book lays out important foundational principles that can help frame the

Commission's work and provide insight into addressing the generational challenges ahead of us. The Netherlands has an opportunity to lead the world but it cannot do so alone. I would strongly advise that any major changes envisioned to the auditing profession be done through Brussels (as a European project). This would help preserve a level regulatory playing field and avoid placing the Netherlands at a competitive disadvantage compared to our European peers. More coordination on issues of audit firm rotation between The Netherlands and Brussels could have avoided undue burdens on business that we have experienced in the past few years.

Framing the Work Ahead: Discussion and Commentary

Although questions remain about how to best implement reforms, it is clear that there are valid trust and credibility issues affecting the accounting profession that need to be studied and addressed. There is legitimate public anger and frustration from corporate failures. It is correct to demand that executives involved in misconduct (or being willfully blind to it) are held personally accountable and face prosecution. The same should apply to those that facilitate misconduct as intermediaries or gatekeepers.

Business and auditing failures have contributed to the erosion of trust and it is incumbent on all of us to restore trust in both business and its gatekeepers. The profession can and should take further steps to improve audit quality and continue investing in its quality management systems, technology, quality-focused culture, and interaction with stakeholders to reduce the gap in performance versus expectations.

To find effective solutions, it is important to apply a more holistic approach and analyze concerns, issues and solutions in the context of the entire business and reporting ecosystem. Such an analysis is not meant to detract from the responsibilities of auditors themselves but rather inform about the context and variables that influence audit quality.

A Holistic Approach to Improving the Business and Reporting Ecosystem

The auditing profession has rightfully faced criticism from regulators, politicians, and other stakeholders including the public. Since the AFM's first report in 2010 about the results from audit file inspections – and especially since its second report covering the Big Four in 2014 – it has become clear to the audit profession that discipline in delivering ISA-compliant audits needs to improve. Accordingly, numerous measures have been taken aimed at improving audit quality and independence, such as the introduction of supervisory boards at the audit firms, mandatory firm rotation, prohibition of providing non-audit services at Public Interest Entities, stronger roles for audit committees in relation to the appointment of the auditor, and quality-driven promotion and remuneration schemes. Given that these measures were implemented relatively recently, the effects of these measures cannot be measured reliably yet.

The Commissie Toekomst Accountancysector has now been tasked with examining potential additional changes to be made to the audit profession to further enhance audit quality. I agree that this it is relevant and important to continuously consider how further improvements can be realized. However, the current approach that places most of the focus exclusively on the auditor (rather than on the wider business and reporting ecosystem) is too narrow in scope and insufficiently holistic to be meaningful and deliver on public expectations. In my view, the current ecosystem has weaknesses that go beyond the role of the auditor, which should be addressed using a comprehensive approach.

Additionally, certain measures that have been suggested could put the Netherlands at a disadvantage internationally and even *degrade* the quality of audits rather than improving them. In particular, "live experimentation" with the fundaments of the design of the Dutch audit profession that functions in a global business context is risky, especially when it concerns changes which academic research has already indicated have a low probability of a positive outcome. If major changes are envisioned, then The Netherlands should win over our European Union partners in Brussels to ensure that changes are widely adopted and don't put us at a competitive disadvantage. It is important that measures taken do not negatively influence:

- The attractiveness of the profession for talent with the required skills to perform high quality audits.
- The attractiveness of the (entire) audit market for firms to operate in.
- Good co-operation between Dutch audit firms and the large international accountancy networks and relevant specialists.
- Incentives to meet stakeholders needs, innovate, work efficiently and within time constraints that are expected by the market (i.e. the users that need timely information).
- Flexibility to allow new models to develop if the market (stakeholders) would demand this.

Rather than focusing on the audit profession alone, an analysis that would yield real improvements in transparency and reliability should focus on the *entire system* for doing business and the checks and balances therein. I therefore propose – and would be pleased to support – a strategic re-think of roles and responsibilities throughout the current business and reporting ecosystem system to address its weaknesses and enhance public trust.

The Wider Business and Reporting Ecosystem

If we look at the business and reporting ecosystem in the Netherlands, numerous different parties play critical roles, including:

1. Policymakers that make laws and regulations;

2. Individuals within organizations engaged in business and reporting;

3. Executives charged with managing organizations;

4. Supervisory Board members charged with oversight responsibilities;

5. Auditors that validate (parts of) the information provided to stakeholders;

6. Creditors and investors that provide capital and have certain decision-making powers;

7. Intermediaries that facilitate transactions (lawyers, accountants, notaries, bankers, analysts);

8. Regulators that oversee businesses and markets;
9. Prosecutors that pursue crimes and seek to hold perpetrators accountable; and
10. Judges that weigh evidence and apply the law in assessing the actions of individuals and organizations.

If any of the parties in the business and reporting ecosystem fails to adequately fulfill its role, this is likely to affect the ecosystem as a whole and the effectiveness of the other parties within it. This certainly does include auditors and it is important that the profession continues to work on improving quality and reducing the risk of failure. This is not only in the interest of stakeholders, but also in the interest of the audit firms themselves given the significant financial and reputational damage that a firm suffers in case of failure.

However, additional quality investments on the side of the auditors are unlikely to be as effective as they could be if the other parties in the ecosystem do not work to examine and improve their own contributions to the integrity of the system. A few examples of other areas in the ecosystem that should, in my view, be integrated within an assessment of how the effectiveness of the audit can be enhanced are discussed in the remainder of this section.

Better laws and regulations

There is considerable room for improvements in the laws and regulations governing financial reporting and auditing. For example, currently, there is only a legal requirement for verification of *financial* statements by the auditor. The auditor's responsibility in relation to other (i.e., non-financial) information is limited to knowledge obtained during the audit of financial statements, and there is no specific mandated legal framework (or responsibility) to address non-compliance with laws and regulations (e.g., corruption, money laundering). In short, the auditor's responsibility is limited to fraud and non-compliance affecting the financial statements (i.e. financial statements fraud). However, it is clear from the public debate that many stakeholders expect a broader role for the auditor. This means there is currently a significant gap between the statutory requirements imposed on auditors and the expectations of a public that expects greater assurance regarding an organization's overall level of compliance and transparency. Managers at organizations need to likewise extend and improve internal financial and compliance controls. This creates a situation that the audit profession cannot resolve on its own, and which will require a strong commitment from legislative and regulatory bodies to properly address.

There are also legal requirements for audits when many parties – including managers themselves – consider them unnecessary or a burden of business. Audit requirements should be set by market participants and clear, strong internal controls should be expected from those subject to audit. Weak internal controls can be easily used to disguise corrupt or inappropriate transactions and facilitate management circumvention of established policies.

Balanced supervision of all actors aimed at reaching a shared objective of effective capital markets

A strong and capable regulator that oversees various actors in the ecosystem in a balanced way further enhances public trust in the system. Currently, some important stakeholders, including various groups of companies and audit committees, are not subject to such supervision. Furthermore, the regulator appears to have been much more focused on its supervision of the audit profession than its supervision of companies and the quality of their financial reporting and related controls. In my view, this creates an imbalance in the system. A review of the audit profession would therefore in my view also require a re-assessment of the scope and priorities of supervision by the regulator.

More active participation of stakeholders in the governance of companies

A similar observation applies to specific stakeholders of companies, such as shareholders and lenders, who are in the position to obtain information from companies and assurance on such information (e.g., via the shareholders meeting or bank covenants). A strong reporting ecosystem requires stakeholders that actively participate in governance and hold companies accountable when they not live up to expectations. However, in practice, many stakeholders operate at a distance and do not demand high-quality reporting at the companies that they are invested in. Instead, stakeholders often try to use the auditor to achieve what they should achieve directly with the company via the mandate that they have in the company's governance system or the contracts that they have with the company.

Establishing stronger audit committees that are held accountable for the quality and robustness of internal controls, the engagement of the auditor, the scope of the audit, and setting the preconditions for an effective audit could have a positive effect on audit quality and trust. Research in the United States environment has for example shown that the improvements in governance and audit committee requirements resulting from the Sarbanes-Oxley legislation had a significant positive impact on audit quality. Sarbanes-Oxley was a major step towards enhancing the requirements for other actors in the ecosystem (i.e., management and audit committees) and has had a positive impact on the audit and the ecosystem as a whole.These changes followed over 15 years ago from the Enron and related fraud-failures. US-listed companies today are not suffering from broad-based financial reporting fraud concerns and trust in the audit profession has developed positively.

Stronger control structures in organizations

Inspection outcomes and root cause analyses indicate that auditors struggle in situations where companies lack adequate control structures. It appears that in such cases the auditor (unintentionally) may allow the company's own deficiencies to affect the quality of the audit, for example by taking on activities that the company should do itself or by allowing time pressure to arise as a result of inadequate or untimely delivery of information from the side of the auditee. Although a lack of quality at the auditee should not be an excuse for the auditor to deliver a non-compliant audit, the quality of the audit (and the reporting ecosystem as a whole) would likely benefit from considering mandating stronger control structures at companies and responsibilities for the quality of such internal controls by those charged with governance.

In The Netherlands, expectations for such control structures in ensuring high quality financial reporting are largely implicit, especially outside the domain of Public Interest Entities. To improve the reporting ecosystem, I believe it is important that requirements for audited organizations be made more robust and explicit. This view is also supported by research into the effects of the Sarbanes-Oxley internal control requirements that were introduced in the United States.

I would strongly advise the Commission to study the effectiveness of having those charged with governance (including CEOs and CFOs) periodically certify that they have personally reviewed financial statements and assessed the adequacy of compliance and financial controls. Such certifications should be backed by significant consequences for misrepresentation or failures to exercise due care.

Conclusion

Thank you for the opportunity to contribute to your deliberations towards a future with better checks and balances and a more robust and healthy accounting profession. I would be happy to respond to any questions at your convenience.

Sincerely,

Dr. José R. Hernandez, CA, CPA