Deloitte.

Deloitte Advisory, S.L.
Plaza Pablo Ruiz Picasso, 1
Torre Picasso
28020 Madrid
España

Tel: +34 915 14 50 00
www.deloitte.es

Attn Mr John Berrigan
DG FISMA
European Commission
1049 Brussels

4th February 2022

Dear Mr Berrigan

Deloitte is grateful for the opportunity to respond to the European Commission's ('the Commission') consultation on 'Strengthening of the Quality of Corporate Reporting and its Enforcement'.

On behalf of the Deloitte[1] firms in the European Union (EU) and Deloitte Global, and to supplement our responses to the detailed questions in the consultation, we are highlighting some key messages for your consideration. Our comments are based on evidence that is included in our Call for Evidence submission. In the EU, Deloitte employs over 75,000 people and audits in excess of 1,800 Public Interest Entities (PIEs).

Introduction

We welcome the Commission's approach to review the whole corporate reporting eco-system which seeks to reinforce the three pillars of corporate reporting, namely corporate governance, statutory audit, and supervision (both of auditors and of companies). We support evidence-backed and proportionate changes to EU legislation in all three pillars where the public interest benefits of change are present. The quality of corporate reporting should be the overriding principle. As economies emerge from the pandemic and face macroeconomic and supply chain challenges, the focus should be on proven solutions.

Relevant and reliable corporate reporting, including future sustainability information, plays a key role for capital markets and society. It helps channel finance to strong, sustainable businesses and helps protect investors and other stakeholders against unexpected corporate failures[2]. Consistent corporate reporting in the EU should also act as a lever for the EU's capital markets union, helping encourage cross-border investment in companies. Technology will change how and when companies report, so the corporate reporting landscape will change. Policy makers will need to keep an eye on the future landscape when strengthening today's regime.

Over the past decade, audit has been subject to numerous regulatory and legislative changes, such as mandatory firm tendering and rotation, audit partners signing in their own name, and restrictions on non-audit services, as well as amendments to professional standards. Other changes, such as the introduction of International Standard on Quality Management 1 (ISQM1), are underway. All these changes need time to become established and make an impact. It is important that the other two pillars forming part of this consultation – corporate governance and supervision – also adapt and develop. Investors and other

[1] For more information see Deloitte.

[2] This is highlighted in 'What are the wider supervisory implications of the Wirecard case?' by Langenbucher, Leuz, Krahnen. Pelizzone – for European Parliament (EP) Economic Governance Support Unit, at the request of the EP ECON Committee, November 2020, p.7. One of the suggestions states that 'at a minimum, the law should require that publicly listed firms have an appropriate and effective internal control system. External auditing report of this control system should be considered', p.24.

stakeholders also need to engage even more. It is important that stakeholders engage with company boards to challenge the business model and risk profile as appropriate.

Corporate governance

The primary responsibility for the quality and integrity of corporate reporting rests with the company's management and board. Any new legislation and regulation should clarify companies' responsibilities and accountabilities. We support more transparent, rigorous, and detailed responsibilities for PIEs regarding the reporting of both financial and non-financial information, including future reporting of sustainability information, to help better protect investors and other stakeholders.

We also support EU-wide requirements for management and/or the board to (1) establish effective internal controls based on an established reliable and well understood framework over financial reporting, aligned to the key risks in the entity's business model, including a focus on the risk of fraud and going concern, and (2) publish a statement on their effectiveness. As corporate reporting broadens, there will also be a need for effective internal controls over this broader reporting.

We believe that an effective internal control environment provides multiple benefits and would outweigh any drawbacks, such as a rise in costs for companies. Key benefits would include:

- Improved company operational effectiveness, efficiency, and reliability of information
- Reduced risks of job and investment losses, unexpected corporate failures, material frauds, and material accounting misstatements, leading to greater protection for shareholders and other stakeholders
- Increased reliability and usefulness of corporate reporting, allowing users of the management report and financial statements to differentiate between companies more easily and make judgments that are better informed
- Internal controls providing the basis for the external auditor to deliver high-quality financial audits

We support strong, independent audit committees that collectively have robust experience in accounting, corporate reporting, auditing, and internal controls to oversee management's internal controls over corporate reporting[3].

Audit

We welcome developments that improve the quality of audits and corporate reporting, while safeguarding the international competitiveness of EU capital markets. Deloitte is committed to delivering high-quality audit services and serving the public interest.

Recent EU audit developments have contributed to audit quality and the value that audit provides, for example through the auditor's report to the audit committee including key audit matters and through annual dialogue between EU regulators and auditors. However, the lack of consistent rules on audit across the EU (e.g. variations in mandatory firm rotation rules, and how oversight authorities inspect and report on audit firms) reduces effectiveness and increases operational costs for audited entities and auditors. In

[3] Also noted in 'What are the wider supervisory implications of the Wirecard case?' by Langenbucher, Leuz, Krahnen. Pelizzone – for EP Economic Governance Support Unit, at the request of the EP ECON Committee: 'Supervisory boards need access to critical information independent from management. Therefore, the head of the internal control function should report to the supervisory board (as external auditors already do). To strengthen supervisory board oversight of external audits, publicly listed companies should be required to have a dedicated audit committee. The chair of this committee needs to be independent and a financial expert. In addition, the majority of the audit committee members need to be independent', p. 24. Moreover, 'ESMA also supports the EC initiatives to enhance EU requirements in the areas of corporate governance and audit with a particular emphasis on strengthening and clarifying the role of audit committees and their supervision' as outlined in Stephen Maijoor's (ESMA Chair) letter to Commissioner McGuinness dated 26 February 2021.

addition, ensuring that firms are able to attract and retain high quality talent is essential to deliver high quality audits.

Concerns have been raised regarding the high level of concentration in the audit market for the largest companies listed on regulated markets. Large, international listed companies require large, international audit firms with sufficient global coverage as well as the capabilities and expertise to challenge management. The number of audit firms that meet these criteria is likely to be limited[4] although competition between these large firms is fierce[5]. We believe that the primary concern is not the lack of competition but the resilience of the audit market. We acknowledge that there could be an issue if one of the large audit firms were to exit the market. We, therefore, support proven solutions that would increase choice and improve resilience as long as audit quality is safeguarded.

With audit quality as the guiding principle, we support:

1. Greater transparency on the value and quality of audits, such as through the following measures:
    i. auditors to provide more clarity in the audit report on the audit process and judgement used, and work with regulators to ensure greater consistency across the EU[6]
    ii. consistent with ISQM1, articulation of audit quality measures across the EU and in concert with jurisdictions around the world, as well as exploring greater use of Audit Quality Indicators at either the firm or engagement level
    iii. the publication of audit firm inspection results (on a non-identifiable basis with regards to the audited entity and the individual auditor) provided that EU audit regulators adopt a harmonised EU-wide inspection methodology, findings taxonomy and risk approach
2. Clarifications of:
    i. auditors' role and responsibilities regarding the scope of an audit, fraud, and going concern
    ii. company boards/directors' roles and responsibilities
    iii. distinct liability regimes for auditors and directors
3. EU wide harmonisation in relation to[7]:
    i. mandatory firm rotation, without reducing the mandatory rotation period below 10 years (or below 24 years in case of joint audit)
    ii. more consistent, timely, and transparent auditor oversight reporting, including the definition of regulators' findings in terms of both severity and nature

[4] See 'Report on joint audit', Spanish Institute of Auditors (Instituto de contabilidad y auditoria de cuentas – ICAC), 2021, which notes that the weight of the positive and negative impacts of market concentration on audit quality may depend on market segments. Thus, large multinational entities require an audit firm capable of providing them with audits that have the necessary technology and resources that may not be present with auditors that act at a national level carrying out less complex audits and, consequently, need fewer resources; so imposing on these large entities a joint audit regime involving an audit firm that does not have the necessary technology and resources could lead to a decrease in the quality of audit work.

[5] See 'EU Statutory Audit Reform Study: Impact on costs, concentration and competition', Marleen Willekens (PI), Simon Dekeyser, Ines Sima - Directorate-General for Internal Policies – provided at the request of the ECON Committee of the EP, April 2019'. One of the conclusions notes that 'both the archival as well as survey evidence is consistent with increased rivalry and market share mobility in the EU audit market in recent years', p. 11.

[6] Also noted by CEAOB in its responses to the 'EC targeted consultation on supervisory convergence and the single rulebook', May 2021 and in particular the response to question 5.6.1

[7] Ibid

iii. the definition of audit and assurance services as well as prohibited services for PIE audited entities, including a clear and uniform list of prohibited services in addition to the general principles of independence [8]

4. Assurance by the auditor on any management/board statement on internal controls over financial reporting. This could be limited in scope to specific PIEs such as PIEs included in EU / Member States' main stock indexes, systemic financial institutions, and other PIEs deemed as higher risk[9].

We do not, however, support suggestions to eliminate or increase liability caps. Given the potential company losses that can arise, especially if a PIE were to collapse, increased or no liability caps can represent a threat to the very existence of an audit firm. Moreover, this could act as a deterrent for firms entering the market for the audit of larger listed companies and can stifle innovation[10].

Similarly, we do not support the mandatory introduction of joint audits. There is no empirical evidence that joint audits improve audit quality[11]. Joint audits increase costs[12] and risks with no clear benefits[13]. A joint audit does not mean four eyes undertaking the audit of a company but rather two sets of eyes looking at different parts of a business. Moreover, the increased use of proprietary audit technology will only increase the challenges of conducting a joint audit, resulting in lesser incentive for innovation. In addition, there is no evidence that joint audit of itself improves choice and nor does it encourage new entrants capable of leading large-listed audits[14]. Companies are already allowed to appoint joint auditors in the EU. However, the Member States' uptake is low, indicating a lack of perceived benefits by companies, those charged with governance and, importantly investors.

[8] 'What are the wider supervisory implications of the Wirecard case? Public Oversight Systems for Statutory Auditors in the EU', García Osma, Gisbert, Navallas – for EP Economic Governance Support Unit, at the request of the EP ECON Committee, November 2020, which also concludes that 'PIE definition should be harmonized', p. 30.

[9] As supported by ESMA in Stephen Maijoor's (ESMA Chair) letter to Commissioner McGuinness dated 26 February 2021: 'ESMA also supports the EC initiatives to enhance EU requirements in the areas of corporate governance and audit with a particular emphasis on … enhancing the assurance on, and disclosure requirements regarding, effectiveness of issuers' internal controls.'

[10] In the 'Report of the independent review into the quality and effectiveness of audit', December 2019, Sir Donald Brydon CBE notes that anxiety around liability has limited the evolution of the audit report p. 100.

[11] In a meta-study considering 20 separate studies carried out between 2007 and 2012 on the joint audit in markets where it has operated, such as France and Denmark, 'Joint Audit: Issues and Challenges for Researchers and Policy Makers', Ratzinger-Sakel et al, 2013, the authors conclude that mandatory joint audit does reduce market concentration, but there is limited evidence for quality improvements and a mixed picture over the impact on cost; and it is also difficult to infer a direct link between perceived trends and joint audit specifically - other factors may be in play - particularly where the joint audit decision is voluntary, p. 194.

[12] The authors of 'Are Joint Audits Associated with Higher Audit Fees?', André, P. et al., 2013, compare audit fees paid during the years 2007-2011 by listed companies in France (where joint audits are mandatory) with those paid by British and Italian companies. They find significantly higher audit fees in France after controlling for well-documented auditor, client, and engagement attributes, which vary across countries. Furthermore, since no statistically significant differences in the magnitude of abnormal accruals is observed, the higher audit fees observed in France do not appear to be associated with higher audit quality, p. 29.

[13] 'Effects of and experiences with joint audit', E. Dijkgraaf, J. Hoogstins, E. Maasland, Erasmus Competition & Regulation institute, October 2021, commissioned by the Netherlands Ministry of Finance, concludes that the joint audit model does not appear to result in an improvement of audit quality; national and international regulators do not appear to be convinced of the benefits of the joint audit model; stakeholders do not have a strong desire to adopt the model; and the joint audit model may have a price-increasing effect, p. 27 - 31.

[14] In 'Are two eyes more costly than one? Large-sample evidence on joint versus single audits in the EU', Paul A. Griffin, David H. Lont, Stephani A. Mason & Carol Pomare, 2020', the authors find that joint audits are more expensive than those firms with only one auditor. In addition, with regards to market concentration, in France, except for Mazars, no other auditor from outside the largest four networks has been able to gain a significant market share. Mid-tier firms BDO's and Grant Thornton's market share is less than 2% in all markets examined, including France, p. 18.

Supervision

Audit supervision

We support the following measures aimed at strengthening the effectiveness and efficiency of audit supervision:

- Increased powers for the EU audit oversight body and an enhanced role for colleges of auditor oversight bodies
- Consistent methodologies and processes for inspections, findings and reporting across the EU, in order to leverage the impact of inspection and allow economies of scale[15]
- Consistent, timely, and transparent auditor oversight body reporting on audit quality, giving a clear picture of the quality of the firm's overall system of quality management, and reflecting any remedial action by the auditor
- Auditor oversight body communication with/oversight of audit committee
- Need for clear separation of powers in every EU Member State between different roles: setting audit standards, inspections, investigations, and sanctions

Supervision of corporate reporting

We support:

- Clear communication channels between corporate reporting supervisors and auditor oversight bodies at Member State level and between ESMA and the Committee of European Audit Oversight Bodies (CEAOB), as well as cross border cooperation with other regulators to ensure alignment of policies and regulations[16]
- Corporate reporting supervisors communicating with audit committees in addition to management, including making them aware of any corporate enforcement actions
- Regular constructive dialogue between regulators and both companies and auditors
- Enhancement of the consistency of enforcement actions across the EU
- Exploring the merits of proportionate supervision of corporates with greater emphasis on their risks and performance, limited to PIEs considered to be high risk or with a high societal impact

[15] 'What are the wider supervisory implications of the Wirecard case? Public Oversight Systems for Statutory Auditors in the EU', García Osma, Gisbert, Navallas – EP Economic Governance Support Unit, provided at the request of the EP ECON Committee, November 2020, concludes that 'POBSAs must report on reviews and inspections. These reports should be comparable and publicly available. We recommend the Irish IAASA (2020) Guide to reports on quality assurance, that describes the quality assurance review process and explains the content of the reports on each quality assurance review', p. 30. Also, 'a standardized rating could be implemented to grade auditor quality control systems and files reviewed/inspected', p. 30. Moreover, such proposals are also outlined in the letter from Stephen Maijoor's (ESMA Chair) letter to Commissioner McGuinness dated 26 February 2021 as outlined under the fourth proposal for 'Strengthening of harmonised supervision of information across the EU'.

[16] Ibid ('What are the wider supervisory implications of the Wirecard case? Public Oversight Systems for Statutory Auditors in the EU') suggests 'coordination between the oversight of auditors and of financial reporting is fundamental', p. 30.

Closing comment

Deloitte is committed to play its role in delivering sustainable change that embraces audit quality, improves choice in the market, restores trust, and works in the public interest.

We welcome the opportunity to discuss these matters further with you, if it would be helpful.

Yours sincerely,

Pablo Zalba
Managing Director EU Policy Center
Partner Deloitte Spain

Jean-Marc Mickeler
Global Audit & Assurance
Business Leader

David Barnes

David Barnes
Global Regulatory & Public Policy
Leader