ecoDa
The European Voice of Directors

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The 7th of February 2022,

Subject: Comment letter to ecoDa's Response to the EC Consultation on Corporate Reporting

Dear Mr Gentner,

The European Confederation of Directors' Associations (ecoDa) which represents the main national institutes of directors in Europe (and more than 55000 individual board members) agrees on the overarching goal of the European Commission to promote reliable corporate reporting through a systemic approach and an analysis of the multiple factors that can influence quality and reliability, keeping costs/benefits in mind and the impact on the competitiveness of companies within the EU. This initiative is ever more important as non-financial information will play a larger role in the future and add another layer of information for which quality and reliability is expected by a larger group of stakeholders.

Our general recommendation concerning European Corporate Governance is principle based. The use of soft law (Comply or Explain) should be the point of origin when considering new EU rules. Due to differences in Corporate Governance systems throughout the EU, there is no one-size-fits-all solution and the principle of subsidiarity should prevail. A fundamental cornerstone is proportionality, and rules and regulations should not put more administrative burdens on companies than is motivated by the size and complexity of the company.

As a general statement, the EU corporate reporting framework has considerably evolved over the last decade with the implementation of DIRECTIVE 2014/56/EU and REGULATION (EU) No 537/2014 (together, the "EU Audit Reform"), and it has taken some time for all Member States to transpose. Also, the cycles implied by the reforms (duration of audits) and for governance (with an average directors' tenure between 3 and 5 years), combined with the urgent situation created by the Covid pandemic over the last 2 years, have created a situation where the EU framework may not have achieved all the desirable results compared to expectations.

Our views are that corporate reporting, governance and audit quality and supervision have all improved overall for the period, albeit in a manner that lacks harmonization and homogeneity.

Far from rejecting the progress made, we consider this is an indication that the framework is developing in the right direction, based on incentives with a due consideration for costs versus benefits. **More regulation is not in general what we recommend. However clarifications, simplification and more uniform rules with less exemptions are required for a more harmonized framework across the EU**, better consistency with the initial objectives, greater homogeneity of application of the rules, as well as more cooperation to promote these objectives at an EU level.

We have included in this letter some developments (which we could not make in the consultation response form due to the low number of characters) to better express some of our views.

In general, we do not support further regulation and more detailed requirements regarding corporate reporting. Our firm belief is that the current audit reform is driving the quality of corporate reporting and the board of directors' and audit committees' quality of oversight in the right direction. Although the effects of the reform are yet to materialize fully, we do recommend the following changes and simplifications:

- Inconsistencies and incoherence should be corrected ;
- Exemptions should be reduced ;
- The principle of collegiality should be emphasized ;
- The audit committee and the board should both be responsible if the quality of the corporate reporting is not acceptable ;
- We do support transparency both of inspection reports, audit quality as well as other information relevant to stakeholders ;
- We strongly advise that joint audit shall not be made mandatory in any Member State;
- The EU framework should be simplified and streamlined.

We have included an executive summary under the form of a table with reference to specific paragraphs where we discuss our views.

We remain at your disposal to develop on certain aspects of this letter or our responses contained in the consultation response form.

Yours faithfully,

Leena Linnainmaa
ecoDa Chair

Anne-Hélène Monsellato
Chair of ecoDa Working Group
on Audit Committees

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The EU corporate governance framework needs more time for a full assessment of its merits before its next major iteration

The corporate governance framework has been slightly less effective than it should have been in part because not all boards have implemented the major new requirements and upgraded their internal organization as they should have.

1. The EU framework has been well thought through with a strong coherence amongst its diverse components. It represents a major change in practice for the work of many audit committees, but for some reasons this has not totally happened to the level of sophistication expected in the work of certain audit committees, for the following reasons:
   - The EU Audit Reform has been transposed in all EU Member States with delays for some countries, and the complexity of the Reform has required some time for appropriation by the various institutes of directors and other stakeholders, as well as to roll out practical training and guides for audit committees. As a consequence, whilst audit committees are mandatory for most PIEs (and should be for all PIEs), there are still differing perceptions as to the extent of involvement of audit committees, in particular regarding the dialogue with auditors (including appointment, non-audit services and fees). Also, not all components of the EU audit Reform are well known to all audit committees (for example regarding the inspection process by audit regulators);
   - It takes time to embark the necessary change management into governance bodies, which do not meet very often during the year, especially during the last two years under the COVID pandemic where audit committees, finance and accounting departments and external auditors have all struggled to maintain "business as usual" and a strong level of quality, despite remote working conditions. Although these factors do not totally explain the lag, these past two years have indisputably caused some delays in the gradual implementation of the EU Audit Reform;
   - In addition to the learning curve necessary to fully reflect the required changes in all dimensions of the work organization of audit committees, in case the competencies of the audit committee members were assessed as not sufficient, upgrades in the composition would usually happen when directors' mandates expire. Considering an average mandate duration between 3 and 5 years in the EU, and the delays in the roll-out mentioned above, not all audit committees have been able to upgrade over the period.
2. Our views are that the EU Audit Reform, as far as audit committees are concerned, has not been fully rolled-out by boards to reach its full potential, and it would probably need another 3-4 years to fully assess the impact.
3. To a certain extent, the same can be said about the implementation of national audit regulators, the effective start of their inspections, and their work methods.
4. Certain improvements can be made to clarify the framework in particular regarding the principle of collegiality and the coherence with other related EU frameworks. Currently, audit committee members could be regarded with a higher responsibility than the rest of the directors because sanctions are related to missions of the audit committee, and because they are tasked with a specific decision (pre-approval of non-audit services). This is regarded as a breach in the collegiality principle, as the audit committee is a committee of the board and should not have an external position distinct from that of the board (either in a one-tier or two-tiers systems).
5. Our rationale is that if an audit committee has failed to carry out its duty, the full board should be considered for sanction as it would be responsible for not having properly monitored how

the audit committee discharged its duty, and (as a root cause) for not appointing competent audit committee members. There should not be a higher responsibility for an audit committee member than for the rest of the board.

6. To this respect, discussions regarding the external position of the audit committee should also take into consideration how these developments could drive additional liability for audit committee members, in a context where the CSRD is likely to add another role for audit committees regarding non-financial information. Non-financial information require broader competences than those of an audit committee, which focuses on process and audit, whereas the overall content of such information is of the remit of the board at large (like for financial information).
7. A board committee is a consultative body and does not bear additional responsibility, and all decisions should remain with the board. Institutes of Directors are recommending to that effect that pre-approval decisions be made by audit committees in a pragmatic approach, and ratified at the next board meeting so that the collegiality principle is respected.

Some provisions lack consistency and coherence

Overall, our views are that some provisions of the EU Audit Reform lack consistency and coherence, are not proving to be effective, or are too broad and would require simplification and streamlining to be more effective and more efficient.

8. These issues are described below:
9. The **organization of the EU corporate reporting framework** is not harmonized across the EU regarding structure and role of the various authorities (national audit regulators, authorities in charge of corporate reporting enforcement, market securities regulators), which creates unnecessary complexity and loopholes, and complexifies the work of the EU bodies in charge of monitoring (ESMA and CEAOB);
10. Some entities can benefit from an **exemption from the requirement for implementing an audit committee**. Also, in certain instances, the full board can constitute the audit committee. As the audit committee is charged with a very specific role, the absence of an audit committee is detrimental to the scope of expertise required within the board to carry out these specific duties, and sessions dedicated to these missions do not happen with the same focus;
11. The **non-audit services provision** is too complex as the scope is different within the EU and it excludes third party countries (for which a mere analysis of safeguarding measures is required). This area of complexity has left open the possibility of prohibited services rendered by the same network as the auditor of the PIE parent company, and the clarity of the objective has been blurred for many audit committees (lack of consistency and coherence);
12. The **70% fee cap** has just recently been in effect, but has already created a lot of debate on how it should be computed. Whilst the initial intent was clear, the wording has created unnecessary complexity and provided for some unintended consequences. The complexity of the computation is created by the unnecessary details regarding legal entities of the audit firm's network, instead of considering the network as a whole. The inconsistency is created by the fact that it can be circumvented depending on how the audit fee billing structure is implemented by the audit firm for a group (billing 100% by the PIE parent company, with reinvoicing internal to the audit firm, or billing by each affiliate to each audit component). The incoherence is created regarding non-audit services expressly required pursuant to other, non-EU, regulations (such as

audits under PCAOB standards, as an illustration), or for which it is standard market expectations that the services are provided by the statutory auditor (such as for comfort letters or interim financial statements limited reviews, as an illustration). These provisions have put some audit committees unknowingly in breach of the requirements, although there was no threat regarding auditors' independence in these instances. It seems that the way it is described has lost the initial objective of the EU Audit Reform, which was to provide an absolute cap for services which would put the independence of the auditors at risk;

13. The **mandatory rotation purpose** was designed to enhance independence by prohibiting too much familiarity. As such, the 24 years period for joint audit is proving too long, especially taking into account the start of the period for mandatory rotation (currently interpreted as being upon qualification as a PIE). For many mid-sized PIEs, the combination of the two could provide for the same firms auditing a company for a period of more than 40 years (lack of consistency and coherence);

14. Besides, the **existence of different mandate duration**s in the EU, which usually are not multiples of the maximum mandate duration of 10 years (before mandatory rotation) is introducing many difficulties in a context with so few actors and rendering the whole process of rotation unnecessarily complex. This results in discouraging rotation based upon the analysis of auditors' performance, which in turn prevents a better match of audit fees with audit effort and complexity in the absence of the benchmark provided by a tender offer;

15. The view on **joint audit** is inconsistent: either it is viewed as demonstrably improving independence, audit quality, and market deconcentration, and rendered mandatory across the EU, or not (and left on a voluntary basis as a safeguarding mechanism in certain very specific situations). There has not been a marked investors' interest (i.e. impression of higher independence and audit quality) in companies under joint audit, and our view is that the efficiency of joint audit is more of a belief than a demonstrated position. Many other criteria with a greater impact over audit quality and independence have changed or could be implemented (e.g. internal control over financial reporting), for which the cost/benefit analysis is much greater. The mandatory requirement by some Member States is proving to be a large burden for companies as it artificially increases market concentration and *de facto* prevents audit committees to more readily consider a rotation;

16. The **additional report to the audit committee** encompasses many topics, however it is short of one of the areas which is of a significant focus of the EU Audit Reform, namely the inspection reports. Currently, the Regulation provides that the inspection report is communicated "upon request" to the audit committee instead of as part of the additional report to the audit committee, which (for countries where they are not publicly released), has had the effect of some audit committees not being made aware of their existence (and in particular when the audit file was not targeted by the inspection). As such, some conversations which should have taken place and put pressure on audit firms, have not;

17. Besides, the absence of a clear requirement regarding **publicity of the inspection report** by national audit regulators has created wide differences and inconsistencies in the EU: these reports are confidential in France (with a confidentiality obligation for audit committees which is the subject of a specific monetary sanction) and publicly released in countries like Sweden (on all three components regarding the assessment of the quality control system, transparency report, and anonymized issuers' findings);

18. The provisions around **transparency reports** have been implemented so that these reports provide qualitative information to stakeholders on the audit firms and audit quality. In many countries, the content of the transparency report is usually mainly narrative regarding major determinants of audit quality, not always harmonized across the audit firm's network, and does not provide all the information that would be useful for audit committees to assess the impact

of measures taken towards audit quality, and for other stakeholders to conduct an assessment of the quality of services offered by the different audit firms;

19. The implementation of **national audit regulators** has been slow in many EU countries, with heterogeneous working practices. Whilst we appreciate the fact that there is a learning curve for newly established regulators (compared to countries where the regulators were organized long ago), their action has been less efficient in a number of areas which could have been effective in helping market deconcentration, such as the review of the tender offer process and a better dialogue with audit committees (as a first step) to make them aware of how tender offers criteria could have a discriminatory impact on auditors selection (disproportion between tender offer requirement and underlying audit complexity);

20. The role of the audit committee has been described in sufficient detail, except with regards to **internal control over financial reporting**, for which the wording is not clear and has led to widely diverging views regarding the extent of involvement of the audit committee and any underlying requirement from management. Some view it as a specification that would *de facto* require an assessment of internal control over financial reporting by management (so that audit committees are able to monitor the effectiveness of such a system), which some others would contradict. In a large part, these conflicting views are driven by the exposure to the US environment and the internal culture that it has created. Internal control over financial reporting, because it is a systematic approach, is widely seen as a major improvement in the quality of the financial reporting, which directly flows into effective improvements in both the quality and the conditions of an audit. By not clarifying the wording and the underlying level of expectation, this provision has not resulted in the drastic changes that had been intended, and has directly resulted in a much-reduced efficiency;

21. A further example of the impact caused by a lack of clarity regarding internal control over financial reporting is that a robust internal control system must encompass a review over the monitoring component. The monitoring component is (usually) composed of both monitoring by management (eg. through an internal audit function) and monitoring by governance bodies (eg. through a high-level assessment of the effectiveness of the audit committee). By not clarifying the wording and the underlying level of expectation, this provision has prevented companies to more readily embark on these changes as well as forming a basis for auditors to request that these components be improved;

22. Also, by requesting that **significant deficiencies in internal control** over financial reporting be reported only in the additional report to the audit committee, the impact of such significant deficiencies has been limited (compared to what it would have been if there was an obligation to publicly disclose the material weaknesses, together with management remediation actions). This has created a difference of treatment for certain PIEs dual-listed in the EU and in the US, for which EU authorities in charge of corporate reporting enforcement usually request that the material weakness disclosed to US investors be also disclosed to the EU investors in their Universal Registration Document, whereas PIEs not listed in the US would not have to disclose such elements;

23. Finally, the regulated markets in the EU do not require the existence of an **internal audit function** (contrary to the New York Stock Exchange, for instance). Although one would assume that, as part of an effective internal control system, all companies (over a certain size) would have implemented an internal audit function or similar mechanism, this is not the case (in great part related to an insufficient understanding and conceptualization of internal control). Absent such a requirement as well as a clear understanding around expectations regarding internal control over financial reporting, audit committees in companies without an internal audit function have a very limited basis to rely on regarding their monitoring of the effectiveness of

internal control over financial reporting. As such, this provision has been rendered much less effective.

Indicators would help stakeholders to better focus on quality improvement initiatives

24. Indicators are useful to orient action towards what matters and set objectives. They measure status against expectations and track progress in a systematic way. They can also be followed over time and help understand whether, and to what extent, effort is spent in the right direction with a measurable impact. They should be developed with a view towards homogeneity across the EU to ensure comparability, consolidation and prioritization of actions.

25. They would also serve as an additional source of information for a range of actors (audit committees, shareholders, rating agencies but also academics) to assess quality and provide an anchor point for meaningful discussions and more targeted questions. This is of particular interest as the **selection process** for audit firms by audit committees, as well as the approval process by shareholders, is to a certain extent based on the **assumed reputation** of a particular brand, as opposed to facts regarding audit quality. Apart from the well-publicized audit failures, and to a lesser extent enforcement actions at EU level (which furthermore lack a consolidated visibility), there is no public systemic information regarding quality upon which audit committees and shareholders can rely to approve or reject a candidate / recommendation, except for (regarding audit committees) the quality of the written and verbal responses during the tender offer process, which can be highly subjective, which a decision in certain cases more responsive to glossy marketing and good media training than to actual, overall, culture of audit quality at an audit firm.

26. We consider it is possible to have indicators for the three areas of corporate reporting, statutory audits and the effectiveness of supervision, beyond those that already exist. Below are some illustrations of our views.

27. **Indicators of the quality of corporate reporting**: authorities in charge of corporate reporting enforcement could provide a rating following their review of corporate reporting in broad categories (Exemplar – Good – Needs improvements – Needs substantial improvements). This would help inform the view under Question 3 of the Consultation, and could also provide information for the audit firm's quality indicators.

28. **Indicators of the quality of statutory audits** should be included in the transparency reports, provided on a 3 to 5 years basis to assess trends. They should include a selection of input measures (e.g. audit hours) and output criteria (e.g. restatements) on an aggregated basis for the audit firm / network (at country level i.e. independent of legal entity, and EU level), and should be developed in coordination with academics so that they can be used in research regarding correlation with audit quality when analyzed in comparison with companies' failures and bankruptcies, audit failures and enforcement actions.

29. These indicators would help put a better perspective on certain audit failures, which may have a disproportionate effect on the reputation of audit firms, but also enable better academic research to understand drivers of audit quality, as well as provide useful information for audit firms governance. As non-financial information is requested from corporate entities, we believe these indicators should be developed to provide a view on the conditions (including culture) for the audit activities, at entity level and audit engagement level (aggregated) and considering public expectations of quality (output such as restatement, ratings by authorities).

30. The following are for illustration purposes:

- A selection of results of independent or internal anonymous survey of firm personnel for topics which are relevant to the quality of statutory audits: rate of engagement, (usually based on a combination of questions), specific questions regarding tone at the top, disconnect between management practices and quality expectations, assessment over whether the workload is considered manageable, how work / life balance is assessed (a determining factor for the attractiveness of the sector), etc.;
- Results of internal quality controls (% of partners and senior managers per rating categories, with a separate category for partners and senior managers working on PIE audits), with an indication of how many of the identified deficiencies arise from internal procedures stricter than ISAs;
- Results of inspection by audit regulators (number and severities of deficiencies regarding quality control system, number and severities of deficiencies remediated at the satisfaction of the audit regulator, number of audit files reviewed, number of audit files with deficiencies, etc.);
- Number of restatements and supplemental public disclosures, categorized by source (e.g. inspection by national audit regulators, review by authorities in charge of corporate reporting enforcement, first year audit, reviews under internal quality control systems and processes, other sources);
- % of personnel trained by nature of training (IFRS and like, audit methodology, soft skills useful for audit engagement such as interviewing techniques, etc.);
- Average time spent by senior executives (all partners and senior managers, so including experts and in subsidiaries) on PIEs audits, as a % of total hours on the audited PIEs, on a consolidated basis;
- How much of management pay is based on audit quality objectives (based on total pay) -- the definition of management should be based on role, not legal structure;
- Average number of audit chargeable hours per partner (break-down by range of partners' compensation level);
- Statistics on diversity per gender, for all grades (numbers and average pay).

31. Also, the list of audited PIEs should be provided with an indication of the audit and non-audit fees, versus total fees for the audit firm. As some audit firms have more than one legal entity, this data should also be provided on a consolidated basis (country-based, and EU level).

32. Other indicators should also be provided to the audit committee on a systematic basis to help assess the quality of the audit approach, such as a summary of the audit hours by grade (partners, senior managers, seniors, staff), expertise (audit, IT, tax, etc.), audited entities and major areas where time is spent (distinguishing by KAM; other key audit areas; audit topics such as : understanding and testing of internal control, consolidation, audit of footnotes, review of Universal Registration Document, etc., and administrative matters related to the monitoring of independence, planning the audit approach, coordination with components teams, joint audit cross-reviews, etc.). This summary allows audit committees to understand: 1- extent of involvement of experienced personnel, 2- whether sufficient time is dedicated to the KAM and other (less significant) audit risk areas, 3- whether sufficient additional expertise is brought to the audit, 4- whether sufficient time is devoted to supervision, 5- possible areas of improvement in the process of financial information preparation, etc. This information is on a per audit basis, should be requested by each audit committee and is already included in various guides for audit committee members issued by Institutes of Directors, however it is difficult to obtain from audit firms with reliable and consistent information. Clear expectation guidelines from the CEAOB or ESMA regarding this indicator would help disseminate the practice, **as well as provide support for national audit regulators to review at the time of inspection**.

33. There is active research regarding audit quality indicators, in particular in the US (the PCAOB also published on July 1st, 2015 a Concept Release on Audit Quality Indicators detailing 28 audit

quality indicators), and international cooperation as well as fostering academic involvement would be useful to gain a global overview, especially regarding large networks.

34. **Indicators regarding effectiveness of supervision** should be published by the audit regulator (which is usually the case in their annual reports) and the CEAOB on an EU consolidated basis, and could include (as an illustration):

    - A rating regarding the quality control system, per audit firm (Exemplar – Good – Needs improvements – Needs substantial improvements), and same regarding the quality of the transparency report;
    - Number of audit files reviewed per year, per audit firm (with a split for audit deficiencies leading to restatements, audit deficiencies which required additional documentation in the audit file, etc.), number and in % of total PIEs audited by the firm;
    - An indication of aggregate market cap or revenue covered by the audit files inspected (relative to total market cap).

35. At the EU basis, CEAOB and ESMA, as an illustration:

    - A consolidated view per network and categories of PIEs (by sector and range of revenues), of the information above.

The EU framework would gain considerably from simplification and streamlining

The EU Audit Reform is a complex set of requirements, and some of these requirements would benefit from clarification, simplification and streamlining, so that they achieve better consistency and coherence with the overall objective.

Actions with higher impact and priority

*There is an insufficient focus on **internal control over financial reporting** on the part of both audit committees and external auditors, in particular when a substantive audit approach has been implemented.*

36. Currently, internal control over financial reporting is discussed under EU Regulation 537 / 2014, Article 11 section (j) re. "*report on any significant deficiencies in the audited entity's or, in the case of consolidated financial statements, the parent undertaking's internal financial control system, and/or in the accounting system. For each such significant deficiency, the additional report shall state whether or not the deficiency in question has been resolved by the management*".

    a. First, internal control [over financial reporting] is viewed at the level of the parent company in case of consolidated financial statements, and not at the level of the entire group, including subsidiaries (where a substantial portion of the preparation of the consolidated financial statements usually occurs);

    b. Second, the framework for auditors regarding internal control in the EU primarily refers to ISA 315 – *Identifying and Assessing the Risks of Material Misstatements* and ISA 265 – Com*municating Deficiencies in Internal Control to Those Charged with Governance*. We note that in the revision process of ISA 265 a decision was made to eliminate the concept of material weakness from the definitions. By doing this, the standard has weakened the link with governance. Under AA07 in *Application and other explanatory material* of ISA 265,

"*evidence of management's inability to oversee the preparation of the financial statements*" is noted as an example of indicators of significant deficiencies in internal control, but stopped short of mentioning quality of oversight. On the contrary, under PCAOB standards AS 2201 – *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, indicators of material weaknesses in internal control over financial reporting expressly include "the ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee". **This provision has been a major reason behind many changes in the composition of audit committees when companies elect to go public in the US,** to strengthen the competences of financial experts regarding audit and internal controls over financial reporting;

c. And third, there is no requirement to publicly disclose a material weakness (a significant deficiency with a higher level of severity or more pervasive), although in certain EU countries the authorities in charge of corporate reporting enforcement require that dual-listed national PIEs that have to publicly disclose a material weakness under a foreign framework, such as SOX Section 404, must also disclose a material weakness in their home country.

37. There is no uniform understanding in the EU regarding what is meant in the EU Directive 2014 / 56, regarding the role of the audit committee, by "*monitor the **effectiveness** of the undertaking's **internal quality control and risk management systems** and, where applicable, its internal audit, regarding the financial reporting of the audited entity, without breaching its independence*" (Article 6 (c)). Whilst in companies dual-listed in Europe and in the US, the effectiveness of "internal quality control and risk management systems" is generally construed as similar to a SOX Section 404 (a) type of situation (which requires an assessment by management of internal control over financial reporting using a reputable framework of internal control), this requirement can be interpreted in a different manner in another company without this background, i.e. in a manner which will not require a systematic mapping of internal control over financial reporting (let alone testing), including regarding control environment and risk assessment. In many countries over the world, the interpretation of what is a robust system of internal control has been clarified, and our views are that, for still too many companies in the EU, a corresponding evolution has not yet taken place even though the second mission of the audit committee should have resulted in actions taken at the company level. It is time for a stronger incentive.

38. **We strongly suggest that as a first step, the wording be clarified in the Directive to clearly discuss "internal control over financial reporting", as well as a shared interpretation regarding what that monitoring should entail (i.e. a requirement for management to assess such internal control), which could be done through publications by the CEAOB and/or national audit regulators.**

39. This clarification (wording and intent) should have, in itself, a wide impact on how internal control is implemented / formalized in EU companies compared to current situation, and a systematic documentation and testing of internal control over financial reporting would have a far greater impact on audit quality than other measures such as joint audit. We would recommend starting with this first step before considering a possible second step in the future (assessment by the external auditors), after an assessment of the impact of the clarification.

40. Some members of the ecoDa working group also believe that the practice of disclosing material weaknesses, which is required by market regulators for certain PIES also listed in the US when the situation arises, should be expanded to non-PIE companies over a certain size and clarified in the ISAs as well as in the EU framework.

Joint audit** has been very much in debate however we believe that there has not been a robust assessment of its merits and that it should on a **voluntary basis in all Member States

41. Joint audit was implemented in France in 1966, with the objective to bring better independence to auditors (at a time when auditors in France were mostly individuals), enhance audit quality (at a time when auditing standards were much less developed, audit firms less developed / staffed and quality control systems absent), and provide for a market for the national statutory auditors facing competition from US new entrants. Our views are that the maturity of the audit profession (auditing standards, independence rules, quality control requirements) and the conditions created by the EU Audit Reform have rendered joint audit obsolete with respect to the three objectives of audit quality, independence and deconcentration, as further explained below. Our assessment is that there are better ways of reaching the objectives than those which are usually put forward to support a joint audit requirement, and in particular we strongly believe that it is counterproductive regarding market concentration. As joint audit generally implies an extra administrative cost of coordination, usually perceived as being between 15 to 25% of the total audit budget, ***our views is that it should not be mandatory in any Member State, and that it should be left to the board / audit committee to decide on the opportunity to appoint joint auditors, or to the audit firms to respond to request for proposal with a joint audit response, depending on the circumstances, or to the national audit regulator to decide should the specific circumstances of a particular company would warrant it**.*

42. Joint audit is generally favored for bringing a **second view** on the accounting of complex transactions. This view, which was acceptable when the concepts around internal control over financial reporting were not fully developed, is now outdated. In an environment with strong internal control over financial reporting, the company must support its accounting position with robust position papers. When the capacity of the accounting and finance departments to develop such positions papers for highly complex transactions is not sufficient, an accounting firm (the "Consultant") with the appropriate set of competencies is usually hired (otherwise, it could result in a material weakness). As the position memo is reviewed by the external auditor, the reputation and capacity of the Consultant is assessed and factored into the assessment of internal control, providing a strong incentive for the Consultant to provide an unbiased position, likely to withstand scrutiny from the external auditor. For dual-listed companies with a SOX Section 404 requirement in France (a country with a joint audit situation), it comes down to having three audit firms looking at the same position paper (the Consultant, and the two audit firms), plus the accounting and finance department, and the audit committee. Joint audit is currently favored to the detriment of a better way which is the implementation of robust internal control over financial reporting.

43. Another supporting view of joint audit is that, beyond the second set of auditors' eyes on complex accounting treatment, the **cross-review** will enable a second set of eyes for the full audit. This view does not resist inquiries in the cross-review process, which usually happen at the start of the audit engagement (discussions on materiality and audit approach), and at the very end of the audit engagement (and sometimes, a few days before the issuance of the joint audit opinion). The principles of cross-reviews are based on an auditing standard in France (NEP 100) which has not followed a due process, is vague and imprecise, and has not been updated to reflect the current approach in situations that require the auditor to take responsibility for the work of others (concepts which can be found under US auditing standards, such as the "reperformance" concept). Audit areas are shared between the joint audit firms, and cross-reviews are often not assigned with the level of experienced personnel that it would require (in particular considering the approval bias) and are sometimes left to taking copies of the work papers without appropriate challenge/scrutiny. Although some progress has been made over the years by audit firms, we believe the way it works in practice is not transparent and does not

ensure a better audit quality, considering the extra cost and additional complexity regarding the rotation of auditors.

44. Third, views have been expressed in favor of joint audit in the sense that it would reinforce the independence and position of the auditors in front of the company and its CEO / CFO. The role of the auditor is to issue an audit report, but the auditor can also, if the situation calls for it, issue a qualified report or decline to issue an audit report (as was made obvious in France in 2021, for example, in two widely publicized instances). This view also arises from an outdated view of the signatory partner as the "person in charge". With the reinforcement of the quality control systems within audit firms, the signatory partner is no longer sole in charge and must be backed up by the full power of the technical department of the audit firm, as well as by a strong incentive to protect the audit firm's reputation (beyond the fact that an audit partner of a PIE now rarely signs under his/her own responsibility). Also, independence standards have been considerably reinforced. This view stems from a double misconception and is not consistent with the EU framework and maturity of the audit market and regulation : of the auditor's role and capacity (a professional who is hired for his/her capacity to make independent judgments in complex situations), and of the role of the audit committee under the EU Audit Reform (under which the primary relationship has been repositioned between the external auditor and the audit committee, as opposed to between the CFO and the external auditor).

45. Finally, joint audit, which has been in existence in France for many years, never succeeded in bringing a second-tier audit firm on par with the Big 4s in terms of size and number of audit mandates. The reasons for this should be carefully analyzed, however joint audit does not seem to be the best way to develop other large actors. Experience from audit committees in France is that in a situation with a Big 4 and a second-tier firm, the second-tier firm usually takes the back seat (and key audit areas are rarely rotated). The only situation where rotation of key audit areas happens, and there is a fair balance in the relationship, is when the joint audit is between two Big 4 firms. We believe that not only other options should be explored for the deconcentration of the audit sector (such as large new entrants, transitioning from the audit of non-financial information to the audit of financial information, for example), but also the fact that **having a second-tier firm as the sole auditor of a mid-size company will be the best way to put them in capacity of developing the skills, competencies and systems, and expand to take on a larger role** (re. BDO being appointed as auditor of SAP). The current focus on audit fees should also better position these second-tier actors to benefit from their engagement as sole auditor and to be able to invest in their systems and processes.

46. Joint audit should be viewed (by audit committees, auditors and regulators) as a safeguarding mechanism, commensurate to the size and complexity of the PIE, as well as the relative impact on the auditor operations and independence, and the implementation of a joint audit should stem from a case-by-case analysis rather than a mandatory requirement.

47. We believe this requirement will have many benefits: redirect administrative hours to direct audit work for all PIEs, provide a sufficient basis of companies for second-tier audit firms to fully develop on their own (without taking a back seat), and decrease the pressure on rotation created by a mandatory rotation in a situation of too few audit firms. **Taken together with the clarified requirement of an assessment of internal control over financial reporting by management, it will be a better use of company funds and of auditors' resources.**

48. Joint audit in France also had an indirect consequence of freezing the market (i.e. making audit committees willing to extend the current audit mandate as long as possible), independent of audit quality (but with a reputable signature), as it is much more difficult to operate a rotation with such a limited number of actors, taking into account the need for consulting services (which at the same time, are also needed by audit firms to shield them from the potential impact of

losing a large audit fee). Our proposal would free a large number of PIEs from these considerations, providing for a better dynamic regarding both deconcentration and audit quality.

*The publicity of the **inspection report** has been interpreted differently in certain countries.*

49. We have identified a best practice where in certain countries (e.g. Sweden, Ireland, UK) inspection reports are made public per audit firm, which include the assessment of the transparency report, the review of the effectiveness of the quality control system, and an anonymized description of audit deficiencies regarding inspected issuers (much like in the US regarding PCAOB inspection reports which are published on the PCAOB website). On the contrary, in certain other countries (e.g. France), a specific obligation for audit committees has been created to maintain confidentiality around inspection results (and the audit firm's network fees, re. L823-21).
50. Also, the EU framework base requirement is to provide the inspection report upon request from the audit committee. As a consequence, in countries that do not require public release, many audit committees have failed to require the inspection report as they were told by their auditors that the audit file related to the company had not been reviewed during the inspection. Audit firms do not spontaneously communicate on the assessment of the transparency report and review of the effectiveness of the quality control system, which are systematically reviewed during inspections, independent of whether the audit file is reviewed. As such, the questioning by audit committees regarding remediation of quality control system deficiencies has been less effective, as individual audit files are not reviewed very often.
51. Furthermore, the specific confidentiality obligation should be removed as it goes against the explicit purpose of the Audit Reform, which is to improve audit quality and auditors' independence. Deficiencies arising from an audit regulator's inspection for a specific audit firm should be made available to the public, so that it can be used by all stakeholders in their monitoring of the overall performance of audit firms and networks, as well as by audit committees in the appointment process.

*The **transparency report** by audit firms does not currently receive much publicity, and should be an important document for audit committees to be used in the process of selection of an auditor.*

52. Currently, the transparency report is mainly a narrative document which describes the audit firm's internal processes. Our views are that the transparency report should include facts beyond the narrative description, such as a summary of the inspection findings (on the three pillars of quality control, assessment of the transparency report and inspection of selected audit files), over five years to measure improvement over time, with a follow up of actions undertaken following the results of inspections. This section should cover all inspection results (i.e. inspection by the national audit regulator as well as by other foreign audit regulators such as the PCAOB).
53. Also, large networks usually conduct annual internal employees' surveys, however the results of these surveys are not rendered public (although they usually communicate largely on them when they are in the top 5 of best employers). Some of the information in these surveys are of interest to audit regulators and audit committees, in particular when they relate to how quality is perceived internally, tone at the top, disconnect between tone at the top regarding audit quality and actions, and engagement. This information should be disclosed to a certain extent in the transparency report.

54. Finally, some audit quality indicators should also be disclosed, such as the result of the internal audit quality inspection (e.g. how many files inspected, ratings by partners and senior managers, over five years). We have included illustrations of these in the section above **Indicators would help stakeholders to better focus on quality improvement initiatives**).

55. This information would help audit committees but also other stakeholders to more fully assess the efforts undertaken by audit firms regarding audit quality, ask meaningful questions during the appointment process, develop the recommendation to the board during the selection process, and when reviewing performance assessment.

Simplifications with a large impact

56. **All exemptions for the implementation of an audit committee should be removed**. The establishment of an audit committee mechanically requires additional sessions of work primarily dedicated to corporate reporting and relationship with the external auditors, not replicated in the board agendas, whereas the board agenda is mostly driven by strategy and the monitoring of operations. In the absence of an audit committee, the time dedicated by the board to the process and audit of corporate reporting is rarely sufficient, less effective, and the quality of dialogue with the auditors suffers as a consequence.

57. **Options for Member States**, which have resulted from the lengthy and sometimes controversial development process of the regulation, should be reduced. In particular, the different options for Member States regarding prohibited services (and derogation thereof under Article 5.3) should be removed, so that the framework of possible non-audit services is the same across the EU, without any difference based on the legal entity that provides these services and the localization of the component. For example, any affiliate of the external auditor in a specific country should not be able to provide or bill services which would be authorized by option in its home country but prohibited in the home country of the parent PIE. The primary objective of the EU Audit Reform is to enhance the quality of corporate reporting and auditing by reinforcing the independence of audit firms and ensuring that the external auditor is firmly focused on the quality of the audit. This provision has created conflicts of interests and unnecessary discussions with the external auditors, and the safeguarding measures are highly subjective and difficult to assess and follow-up in practice.

58. The regulation regarding the provision of non-audit services should be made **extra-territorial**, without consideration for the localization of the legal entity. Currently, affiliates to the external auditors of subsidiaries in third party countries can provide non-audit services which would be prohibited for the external auditor in the home country of its parent PIE. This creates unnecessary complexity in view of the underlying objective (independence and focus of the external auditor on the audit) and has provided a window of opportunity for lengthy and unnecessary discussions regarding what was possible (or not) in terms of non-audit services.

59. The **computation of the 70% cap** is highly complex and can be easily circumvented by way of how the audit is invoiced and billed (whether all affiliates bill the EIP parent company's legal entity of the external auditor, which in turns bill the EIP, or whether each affiliate bills the subsidiary in its home country). The way the regulation is currently written provides for loopholes and does not equate the primary intention. The basic principle should be construed as such: non-audit services for the whole network, worldwide, should not exceed 70% of the audit services.

60. Also, **non-audit services which are expressly required** pursuant to EU regulations are excluded from the 70% cap computation, but non-audit services expressly required pursuant to other, non-EU, regulations, or for which it is standard market expectations that the services are provided by the statutory auditor, should also be excluded. For example, audit services required

under PCAOB standards for companies listed in the US, or in a non-EU stock exchange, or services incurred in connection with an initial public offering, comfort letters, attestations, review of interim financial statements, etc. In certain situations, these services may well exceed the level of statutory audit fees (requiring the approval by the national audit regulator), and the 70% cap adds unnecessary complexity in a context where independence is clearly not at risk. Therefore, we suggest that assurance and audit related services exemplified here should be excluded from calculation of non-audit services.

61. Some members of the ecoDa working group support the view that based on such principles, if non-audit services which are expressly required pursuant to EU and non-EU regulation are excluded from the computation as well as a careful selection of certain other non-audit services with a clear rationale, the 70% cap seems very high and might need revision to clearly focus the external auditor on audit services. Some academic research, in particular in the US, seems to indicate a correlation between a low ratio and audit quality (See in particular Measuring Audit Quality [1], by Shivaram Rajgopal, Suraj Srinivasan and Xin Zheng, and Do practitioner assessments agree with academic proxies for audit quality? Evidence from PCAOB and internal inspections [2], by Daniel Aobdia,). As a general comment, a systematic review (meta-analysis) of this specific topic in the academic literature should be done in this area.

62. The EU Directive and EU Regulation have stopped short of requiring an **internal audit function** for companies over a certain size (which is already compulsory for financial institutions and in certain Member States for other companies). Experience shows that the existence of an internal audit function in a company fosters discussions on internal control, generally using a reputable framework (and thus encompassing risk management). Although the internal audit function is generally part of the monitoring component of internal control frameworks, we believe that for the avoidance of doubt, internal audit function should be rendered mandatory for companies over a certain size.

63. A **duration of mandate of 10 years** seems appropriate to balance out a lack of independence (too much familiarity created by a long-term relationship) and the learning curve required for the audit of large and complex companies. However, the start of the period should be reviewed so that the years before the entity qualifies as a PIE are taken into account in the 10 years. Currently, the start date for the rotation period under the regulation is the opening of the fiscal year when the entity first qualifies as a PIE. Which means that for certain companies listed in a non-regulated market for a number of years, and then transferring to a regulated market at some later stage, the number of years with the same auditor can well exceed 10 years (or 24 years in case of joint audit situation). Also, the duration of minimum and maximum mandate should be homogenized across the EU, with the maximum duration being a multiple of the minimum duration, to facilitate rotation as well as the conditions for a good audit.

64. Regarding the auditors' **appointment process**, we strongly suggest that conditions for the resignation of auditors of subsidiaries should be simplified to allow for the resignation of all the affiliates of the audit firm's network in case the PIE's parent company audit firm is not renewed (along the recommendation that minimum audit mandates and maximum duration be homogenized across the EU).

Other simplifications and comments

65. Two provisions of the regulation are made "**upon request**" of the audit committee or the external auditor (discussion of the additional report to the audit committee, and communication

[1] https://www.hbs.edu/faculty/Pages/item.aspx?num=58064
[2] https://www.sciencedirect.com/science/article/abs/pii/S016541011830106X

of the inspection report). We believe that a careful review should be made of the provisions "upon request". As they relate to the discussion of key matters in the additional report to the audit committee and communication of inspection reports, these discussions and communication should happen on a systematic basis so that it fosters a better engagement from both audit committees and external auditors in all PIEs. The EU should draw from the experience of national audit regulators as part of their inspections to decide whether such improvement should be made.

66. Under Regulation 537 / 2014, articles 7 on irregularities and 12.1 regarding reporting to supervisors of PIEs regarding material breaches and threats, provides for certain reporting made by auditors directly to authorities, including as part of the audit of closely related entities. There is nothing in the Regulation that would preclude the governance bodies from being informed of such reporting, and the rules should be clear as to whether the board and the audit committee could or should be informed (possibly, with a specific confidentiality requirement with respect to management).

67. The current duration of **24 years under a joint audit** situation is too long, as it brings too much familiarity between the audit firms and the PIE teams. Currently, there is a tendency to rotate the auditors with a period of overlapping. This will prevent the main advantage of having a new auditor stepping in, namely a set of fresh eyes without anchoring on previous positions taken. Academic studies (and in particular studies which were used to strengthen the auditing standards on fraud in the US, which were later used as a basis for the development of ISA 240), all pointed to the change of auditor as one of the key factors in identifying fraud. We consider that the overlap will prevent a valuable occasion to have the company undergo a deep review of its accounting principles upon appointment of a new auditor. Some observers mentioned that it is difficult to make a complete change of auditors for large groups. We consider that this position does not withstand scrutiny, as these changes must be carefully anticipated in any manner, and as they happen frequently in other countries without a joint audit requirement.

Should external board assessment be rendered mandatory – or not?

68. As a consequence of the slow roll-out by countries and the pandemic, not all boards have duly considered the requirements regarding the audit committees, in particular the requirement regarding the composition of the audit committee, which is key for a well performing audit committee.

69. To ensure a quicker and effective roll-out, some members of the ecoDa working group were in favor of a **mandatory external (independent) assessment** of the board and its committees to be made by an independent consultant (not related to the external auditor and appointed by the board), once every 3 years, as part of the on-going board improvement process. The results for the independent assessment would not be made public, however companies should report on this assessment in their governance report (together with the name of the independent consultant), with the major areas for improvement and broad outline of their action plans.

70. These members pointed to the need for external challenge to the board, in a constructive and iterative manner, and the fact that independent board assessment is currently a best practice in many governance guides that would merit a larger implementation, to better respond to investors' and other stakeholders' request regarding the quality and performance of boards' and committees' inner workings.

71. A mandatory board assessment by an independent (reputable) consultant would provide for an independent review of board composition with a particular focus on the qualification of the "financial expert" in the audit committee (as well as overall competence of the audit committee regarding internal control and audit). The same goes for permanent education and training (including certification), which is a recommendation in soft law but is rarely applied / checked in practice.

72. A mandatory board assessment would also include a deeper review into how independence of the board members (including members of the audit committee) is assessed. We have noted that for many EU companies listed in the US, wide-reaching questionnaires for board members are implemented to review and assess independence, business and financial relationships (including with auditors) and conflicts of interest; a thorough process which is usually lacking in many EU PIEs.

73. Such a requirement would also help disseminate information regarding proper governance, as well as develop more rigorous standards for board evaluation.

74. The requirement could be for all PIEs or for larger PIEs (a first step which we believe might trigger a best practice incentive and replication by medium-sized PIEs). If restricted to larger PIEs, the description by other PIEs of how the board and committees' assessment was conducted, and related action plans, should be made mandatory and improved in the governance statements.

75. This measure would provide more objectivity regarding board assessment compared to a purely internal process, will allow for better benchmarking, and will remediate the current lag in applying fully the requirements of the EU framework, which we consider effective and efficient, **when implemented**. This provision could either be part of the EU framework for corporate governance, or as part of the EU stock markets listing requirements.

76. **The views against a mandatory board assessment** are that the benefits of this extra requirement approach are not proven compared to costs and that the "comply or explain" requirement in the governance statement is sufficient (although it would merit better application and less boilerplate developments). There is a risk of adding a requirement that would end up as a tick-the-box exercise instead of relevant information to stakeholders and improved performance.

77. A lot of board of directors do already annually assess their performance in order to improve their work, and best practice is already well established to facilitate this process by external consultants on a regular basis (eg. every 2nd year). Already in the ecoDa / IFC *Guide to Corporate Governance in the EU* issued in 2015, a Heidrick & Struggles survey carried out in 2014 found that 70 percent of European listed companies undergo a performance evaluation every year, 8 percent undergo one once every two years, 6 percent undergo one once every three years or less often, and 16 percent never undertake one. The same survey revealed that 21 percent of European listed companies use external consultants/facilitators every year, 10 percent use them once every two years, 36 percent use them once every three years or less often, and 33 percent never use one. The survey also found that 78 percent of directors of European listed companies thought a formal board evaluation was important.

78. In countries where this is relevant, best practice is that findings are shared with the election committee in order to assess and recruit the optimal competence to the Board, given the strategic challenges the company is facing. Thus, a mandatory assessment would not add sufficient value as it would be additional to existing assessments (in countries where they are already required) and might even reduce boards' focus on improvement of performance.

79. As a final comment, we note that two other mechanisms have produced good results in the effective review (and upgrading) of audit committee composition and expertise: 1- assessment of internal control over financial reporting (e.g. when a company prepares for an IPO in the US

under which it would be subject to Sarbanes-Oxley section 404), as well as 2- the law on gender quotas in France.

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