ICGN
International Corporate Governance Network
Inspiring good governance & stewardship

European Commission

Directorate-General for Financial Stability, Financial Services and Capital Markets Union

Brussels

4th February 2022

Dear Madame or Sir,

Re: European Commission consultation: Strengthening of The Quality Of Corporate Reporting and Its Enforcement

The International Corporate Governance Network (ICGN) welcomes the European Commission's (EC) Consultation document on the Strengthening of The Quality Of Corporate Reporting and Its Enforcement.

Led by investors responsible for assets under management in excess of US$59 trillion, ICGN is a leading authority on global standards of corporate governance and investor stewardship. Headquartered in London, our membership is based in more than 45 countries and includes companies, advisors, and other stakeholders. ICGN offers an important international investor perspective on corporate governance and investor stewardship to help inform public policy development and the encouragement of good practices by capital market participants. For more information on the ICGN, please visit www.icgn.org.

Quality audit practices and transparent corporate reporting are fundamental to good governance and investor protection, and they represent an ICGN policy priority. Investors have both the need and the legitimate expectations for high quality and reliable corporate reporting and auditing. So, we welcome the EC's initiative to address higher reporting standards across the European Union (EU). We note here as reference our response to the UK Business Energy and Industrial Strategy's (BEIS) 2021 consultation on audit reform in the UK, as similar questions are addressed in both the EC and the BEIS consultation.[1]

We are taking a selective approach to this consultation response, focusing on the questions that have the greatest relevance for global investors and good corporate governance. We have submitted our answers to these questions directly to the EC through its online survey form. This letter serves to put our comments in the public record and in a holistic context. We will attach a copy of this letter to our online electronic submission to the EC.

[1] ICGN Comment Letter to UK Business Energy and Industrial Strategy's (BEIS) consultation on audit reform, 2021: https://www.icgn.org/sites/default/files/14.%20ICGN%20Letter%20BEIS%20audit_0.pdf

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Summary of key points

We believe that the corporate financial reporting in the EU is generally strong in a global context. It is nonetheless healthy for the EC to undertake a review of how corporate reporting can be strengthened.

A few summary considerations reflected in our online summary are as follows:

- **Sustainability reporting**. We observe that the focus of this corporate reporting consultation is on more traditional financial reporting and auditing. However, the topic of 'corporate reporting' is itself broad, and given the EC's great efforts in the area of sustainable finance and sustainability reporting, it is remarkable that this consultation is virtually silent on these issues. If anything, it should be a priority to promote the linkage and integration of financial reporting to sustainability reporting. However, for purposes of this consultation, sustainability reporting, including the recent EU's Corporate Sustainability Reporting Directive (CSRD), appears to reside in a separate silo. This causes us to question whether the scope of this consultation is too narrow.

- **Integrated reporting**. Investors are increasingly looking to integrated reporting to bring together financial and narrative information in a cohesive and coherent way, including the reporting of environmental, social and governance (ESG) data alongside financial reporting. Progress is being made, but there is still a long way to go. More focus could be placed on integrated reporting in particular.[2]

- **ESG data and standards**. Reliable, harmonised, and consistent ESG data is critical for investor to assess relative ESG related risks in companies. This is a growing priority for corporate reporting in general, not just sustainability reporting. Now that there is a movement to global consolidation of ESG reporting standards and frameworks, it is critical that the EU, as a leader in this area, is also promoting ESG reporting standards that align with developing global standards, including independent assurance. Again, these questions are not addressed in the consultation.

- **Climate accounting**. Another key reporting issue is the linkage between sustainability factors and the financial statements themselves. Climate change, in particular, is an area of focus by investors, as many companies begin to manage their businesses toward a net zero model.[3] This can have accounting implications on questions of costs, asset values and contingent liabilities and needs to be part of the mainstream debate on corporate reporting in the EU.

- **Limits of hard law**. Beyond disclosure requirements, we are wary of hard law governance legislation prescribing changes in board responsibilities and director duties. This is particularly the case in the EU given the diversity of governance regimes among the member states. For example, we would not support the idea of targeting individual board members with a different liability from other directors. Collective board responsibility is critical to good governance. Tinkering with changes to this can result in unintended consequences.

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[2] An important development was the announcement in October 2021 by the Value Reporting Foundation on its "Transition to integrated reporting: A guide to getting started | Integrated Reporting." www.integratedreporting.org/news/transition-to-integrated-reporting-a-guide-to-getting-started/
[3] Institutional Investors Group on Climate Change (IIGCC), "Investor Expectations for Paris-aligned Accounts", November 2020: https://www.iigcc.org/download/investor-expectations-for-paris-aligned-accounts/?wpdmdl=4001&masterkey=5fabc4d15595d

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- **Audit quality**. As a tactic to promote audit quality, we encourage introduction and standardisation of audit quality indicators (AQI) across the EU. These can serve as useful hooks promoting engagement between investors and companies.

- **Solvency/Resilience statement.** A report on company solvency can be a useful indicator of company resilience, particularly in difficult periods such as the 2020 covid-linked challenges to the economy. This has proven to be useful in the UK.

- **Capital Allocation**. This is a critical dimension of corporate governance and is not addressed in this document. Capital allocation is where corporate finance meets corporate governance. The board should disclose a clear policy on the company's approach to capital allocation as a foundation for long-term value creation. The policy should clarify how a sustainable balance of capital allocation is achieved among different and potential trade-offs between company, shareholder, creditor and stakeholder interests, while maintaining a sufficient level of capitalisation and liquidity to cushion against foreseeable risks.

- **Joint audits**. Joint audit requirements are problematic, and we do not encourage this practice.

- **Audit firm rotation.** This should be a good opportunity to standardise audit firm rotation periods across the EU.

- **Shareholder engagement**. As an overarching comment, we would like to emphasise the constructive role that investors play as the most fundamental users of corporate reporting. Investors' dialogue with companies can play an important role in promoting greater corporate transparency and providing market-based scrutiny over audit committees.

In the Appendix below we present our answers to the specific consultation questions that we submitted through the EC's online survey.

In conclusion, ICGN appreciates the opportunity to provide comment on this important consultation and we hope you find our feedback helpful in your deliberations. Should you wish to discuss our comments further please contact me or George Dallas, ICGN's Policy Director: george.dallas@icgn.org.

Yours faithfully,

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Appendix: Responses to Consultation Questions

Below are our selective responses to the consultation questions that were submitted online to the EC.

For the consultation questions presented in this Appendix, we limit our answers to questions of most direct relevance to investors and where we are in a position to provide meaningful 1-5 rankings on specific questions. We appreciate the EC's desire to convert the consultation responses into data sets for statistical analysis, but we found many of these questions too broad for us to provide a meaningful numeric ranking.

Part I - The EU framework for high quality and reliable corporate reporting

Question 2.1

Please describe the main issues that you see, if any, in the four areas mentioned in the table above. Where possible, please provide concrete examples and evidence supporting your assessment.

You may want to consider the following aspects:

- Have any factors reduced the effectiveness / rendered the relevant EU framework less effective than anticipated? Which rules have proven less effective than anticipated?
- Is there room to improve efficiency via further simplification?
- Are existing provisions coherent with each other?

Where is sustainability reporting mentioned here? How does this link to the CRSD? These may be the most gaping holes.

Question 3.1

Please provide concrete examples and evidence supporting your assessment in question 3 and explain the consequences that the quality and reliability of corporate reporting or lack thereof has on you.

Companies listed in the EU understand the assignment given and fulfil the requirements. The issue is whether the requirements are adequate to provide investors with the information they need. Given technological advances, companies are able to provide more useful information and disclosure, but the rules do not require them to do so.

Question 4

There are no generally accepted standards or indicators to measure the quality of corporate reporting and of statutory audit, nor the effectiveness of supervision. In light of this, what are your views on the following questions on a scale of 1 (strongly disagree) to 5 (strongly agree)?

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Questions	Scale
Would it be useful to have specific indicators to measure the quality of corporate reporting, of statutory audits and the effectiveness of supervision?	5
Is it possible to have clear and reliable indicators to measure the quality of corporate reporting, of statutory audit and the effectiveness of supervision?	4
Should the European Commission develop indicators on the quality of corporate reporting, of statutory audits and the effectiveness of supervision?	2

Question 4.1
Please provide any further explanation supporting your views, and, where relevant, please suggest possible indicators of the quality and reliability of corporate reporting, statutory audit and supervision, where possible with concrete examples.

We support the development of a consistent set of audit quality indicators (AQIs) across the EU. Experience in the UK shows that AQIs, while not perfect or infallible tools, can nonetheless communicate important information to investors about audit quality that can provide a focus or 'hook' for engagements between investors, company executives and boards relating to audit matters. The EC could certainly encourage the development of a consistent set of AQI standards across the EU, however such an initiative should be informed by a clear understanding of investor needs and expectations relating to audit. Moreover, given the increasingly international holdings of institutional investors, we believe that any such effort in the EU should seek to be compatible with other AQIs as they emerge globally.

Question 5

In your view, should the Commission take action in the areas of the

- Corporate governance pillar
- Statutory audit pillar
- Supervision of PIE auditors and audit firms
- Supervision of corporate reporting

to increase the quality and reliability of reporting by listed companies?

- Yes, there is a need to improve some or all of the areas listed above
- Yes, there is a need to improve some or all of the areas listed above as well as other areas
- No, but there is a need to improve other areas than those listed above
- No, there is no need to take further action in any area

If you think there is a need to improve other areas than those listed above, please indicate which areas you have in mind:

As noted above, a missing element to this consultation is the need to integrate sustainability reporting and develop integrated reports that combine financial results with a narrative on non-financial (including ESG) data.

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Question 5.2

If you responded that you think that there is a need to improve the quality of corporate governance, audit, audit supervision and/or supervision of corporate reporting, at what level should action be taken, rating the relevance of each level on a scale of 1 (strongly disagree) to 5 (strongly agree)?

Companies themselves should take action to improve their reporting	5
Auditors themselves should take action to improve audits	5
Audit supervisors themselves should take action to improve their functioning	4
Individual Member States should take action if the situation in their market requires this	4
The EU should take action	4
Several of the above should take action	4

Question 5.3

Please provide any further explanation supporting your views expressed in question 5.2:

The list of options presented above is silent on the role of investors and investor engagement. In many situations, investors are better situated that regulators or external supervisors to influence high quality corporate reporting and auditing.

Question 6

To what extent is there a need to modify the EU framework on corporate reporting to support the following objectives (on a scale of 1 (not at all necessary) to 5 (highly necessary)?

I. The green transition	5
II. The digital transition	4
III. Facilitating doing business by SMEs	4
IV. Reducing burdens and/or simplify	5
V. Better Corporate Social responsibility, including tax transparency and fair taxation	5

Question 6.1
Please provide, if needed, any further explanation supporting your views expressed in question 6:

Reporting on the green transition, in particular, is likely to have relevance for the Corporate Reporting Sustainability Directive that is under review. It will be key for the EU to work with other standard setters and jurisdictions to align standards globally.

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Part II - Corporate governance

Question 7.1

Please describe the main issues you see, if any, as regards corporate governance (*role boards, audit committee role, shareholders, and other stakeholders*) and, where possible, please provide concrete examples and evidence supporting your assessment.

You may consider the following aspects:

- Are there factors that have reduced the effectiveness / rendered the relevant EU framework less effective than anticipated? Which rules have proven less effective than anticipated?
- Is there room to improve efficiency via further simplification?
- Are existing provisions coherent with each other?

a) We would encourage a requirement for the Board to publish a statement of company purpose in addition to its standard financial and sustainability reporting.
b) Any increasing director liability should be undertaken with great caution so as not to discourage capable, diverse and qualified candidates from joining boards.
c) It is not only good to require the existence of an audit committee, but it is also a fundamental aspect of good corporate governance. At the executive level, PIEs over a minimal size threshold should establish an internal audit function to liaise, as required, with the board audit committee.
d) ICGN Global Governance Principles call for full independence of audit committee members. At a minimum, audit committees should be majority independent.
e) A statement of internal controls, as in the US Sarbanes Oxley Act, has the potential to exert positive discipline, as long as it is not heavy handed.
f) Shareholder dialogue with audit committee chairs and members warrants greater emphasis, consistent with investor stewardship obligations.

Question 9

How effective and efficient would the following actions be in increasing the quality and reliability of reporting by listed companies, on a scale of 1 (Not effective/efficient) to 5 (Very effective/efficient)?

Question 9.1

Have you identified other actions that would effectively and efficiently increase the quality and reliability of reporting by listed companies?

X Yes
☐ No

Question 9.1.1

If you have replied ‘yes’ to question 9.1 please explain which action(s) you have in mind.

ICGN’s Global Governance Principles call for a report on a company’s solvency or resilience, and we believe this concept has relevance for EU companies. The board should confirm in the annual report that

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it has carried out a robust assessment of the company's financial position and identify any material risks, including to its solvency, liquidity and short-term continuity that would threaten its continued viability. The board should state whether the company will be able to meet its liabilities as they fall due and continue in operation for the foreseeable future, explaining any supporting assumptions and risks or uncertainties relevant to that and how they are being managed. Disclosure on such risks should include a description of:

a) risk in the context of the company's strategy;

b) risk to returns expected by shareholders with a focus on key consequences;

c) risk oversight approach and processes;

d) how lessons learnt have been applied to improve future outcomes; and

e) the principal risks to the company's business model and the achievement of its strategic objectives, including risks that could threaten its viability.

Particularly given the risks to many companies as they transition to net zero strategies, reporting of this nature can provide both a sense of short term and long-term resilience.

Question 9.2

Please provide any details to support your views. Any evidence, including on expected benefits and costs of such action is welcome.

We see on a global basis that more and more publicly traded companies are operating at a loss. Many of these companies have large market capitalizations, but the operations of the company may be in question. Having the requirement will focus management more on solvency issues, and if a company is reaching insolvency or failing, it should provide such information to its shareholders.

Part III – Statutory audit

Question 12

On a scale of 1 (strongly disagree) to 5 (strongly agree), please share to which extent you agree to the following statements.

Question	Scale
I. Statutory audits contribute as much as is possible to the quality and reliability of corporate reporting by PIEs	3
II. I am satisfied with the role of the statutory auditors / audit firms of PIEs	3
III. The work of auditors is reliable so I trust their assessment and reports and their work inspires trust in capital markets	?

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IV. There is not enough choice for public interest entities in finding an audit firm at appropriate costs	4
V. Joint audits contribute to the quality of audit	2

Question 12.1

If you want to add any comments, and/or mention specific issues you see you can insert them here. Where possible, please provide concrete examples and evidence supporting your assessment:

Question III is confusing as written. It links two possibly different clauses and is likely to lead responders to misinterpretation. For example, the work of the auditors may generally be reliable, but this does not necessarily inspire trust in the capital market.

Question V. We discourage joint audits on the basis that the theory of their benefits can be easily offset by lack of coordination between joint auditing bodies.

Question 14

How effective and efficient would the following actions be in increasing the quality of statutory audits of PIEs? On a scale of 1 (not effective/efficient) to 5 (very effective/efficient)?

Areas	I. Effectiveness	II. Efficiency in terms of cost / benefits of action
a) Ask auditors to disclose how they have assured the directors' statement on material fraud, and what steps they have taken to assess the effectiveness of the relevant internal controls and to detect any fraud	5	5
b) Strengthen the informational value of audit reports	5	5
c) Improve the internal governance of audit firms	5	5
d) Incentivise or mandate the performance of joint audits for PIEs, including to enhance competition on the PIE audit market	2	2
e) Further harmonise the rules on mandatory rotation	4	4
f) Limit the scope for statutory auditors and audit firms to provide non-audit services	3	3
g) Increase or eliminate caps on auditor liability, at least for cases of gross negligence of statutory auditors	3	3
h) Limit the number of Member State options in the EU Audit framework to ensure consistency across the EU and to incentivise cross-border statutory audits	4	4

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i) The creation of a passporting system for PIE auditors and audit firms, allowing auditors to provide their services across the Union based on their approval in a Member State	2	2

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Part IV – Supervision of PIE statutory auditors and audit firms

Question 17

How effective and efficient would the following actions be to increase the quality and effectiveness of supervision of PIE statutory auditors and audit firms? On a scale of 1 (not effective/effective) to 5 (very effective/efficient)?

Areas	I. Effectiveness	II. Efficiency in terms of cost / benefits of action
a) Ensure better the independence and appropriate resources of supervisors of auditors and audit firms	5	4
b) Increase the transparency of audit supervisors	3	3
c) Increase the consistency of supervision of cross-border networks of audit firms	4	4
d) Ensure supervision of audit committees		
e) Harmonise and strengthen the investigation and sanctioning powers of audit supervisors	4	4
f) Ensure that at European level there are legal instruments available that ensure supervisory convergence as regards statutory audit of PIEs	3	3
g) Grant a European body the task to register and supervise PIE statutory auditors and audit firms	3	3

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Part V – Supervision and enforcement of corporate reporting

Question 19

How effective and efficient would the following actions be in increasing the quality and reliability of reporting by listed companies on a scale of 1 (not effective/efficient) to 5 (very effective/efficient)?

Areas	I. Effectiveness	II. Efficiency in terms of cost / benefits of action
a) Clarify the role and responsibilities of the national authorities charged with the enforcement of corporate reporting and entities to whom the supervision of corporate reporting is delegated/designated, and improve their cooperation	5	5
b) Improve the system for the exchange of information between authorities and entities involved in the supervision of corporate reporting, and other relevant national authorities	4	4
c) Strengthen the rules ensuring the independence of national authorities or entities involved in the supervision of corporate reporting	4	3
d) Increase the resources of national authorities or entities involved in the supervision of corporate reporting	5	4
e) Increase the powers for national competent authorities to enforce corporate reporting, such as forensic, powers to obtain any necessary information from banks, tax or any other authorities in the country, powers to request information and corrective actions, etc.	3	3
f) Improve cooperation and coordination between national authorities of different Member States	4	4
g) Increase transparency on the conduct and results of enforcement activities by national authorities	5	5
h) Strengthen the role of ESMA on the enforcement of corporate reporting	3	3

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