CFA Institute

Rue du Champ de Mars, 23
1050 Brussels
Belgium

+32 (0) 2207 12 10 tel
info@cfainstitute.org
www.cfainstitute.org

February 18, 2022

Mr. John Berrigan
Director General
Directorate General for Financial Stability, Financial Services and Capital Markets Union
European Commission
Rue de Spa / Spastraat 2
1049 Brussels, Belgium
Brussels, Belgium

Dear Mr. Berrigan:

CFA Institute[1] appreciates the opportunity to comment and provide our perspectives on the European Commission (the "Commission" of the "EC") Consultation Document, *Strengthening Of The Quality Of Corporate Reporting And Its Enforcement* (the "Consultation").

CFA Institute has a long history of promoting fair and transparent global capital markets and advocating for strong investor protections. We are providing comments consistent with our objective of promoting fair and transparent global capital markets and advocating for investor protections. An integral part of our efforts toward meeting those goals is ensuring that corporate financial reporting and disclosures and the related audits provided to investors and other end users are of high quality. Our advocacy position is informed by our global membership who invest both locally and globally.

We have completed and submitted the five-part questionnaire (the "Questionnaire") to the Commission as well as posted a more complete comprehensive response on our website. In this letter, we summarize the qualitative views underlying the numeric responses provided in the Questionnaire. We provide this letter to the European Commission as we believe it is important to present, connect and synthesize our views for the Commission and for other interested stakeholders. We refer to the various parts or questions of the Consultation/Questionnaire as appropriate throughout this letter.

1 With offices in Charlottesville, New York, Washington, DC, Brussels, Hong Kong, Mumbai, Beijing, Shanghai, Abu Dhabi and London, CFA Institute is a global, not-for-profit professional association of more than 181,000 members, as well as 160 member societies around the world. Members include investment analysts, advisers, portfolio managers, and other investment professionals. CFA Institute administers the Chartered Financial Analyst® (CFA®) Program.

CFA Institute

OVERARCHING CONSIDERATIONS

Background and Context for Our Consultation Response

The Wirecard Situation Illustrates the Policy Issues Under Consideration in the Consultation – The implosion of Germany's Wirecard demonstrated that those parties – management, the audit committee and board, auditors, audit regulators and corporate reporting regulators – that investors compensate and rely upon to attend to their capital investments failed them on multiple levels. These parties charged with protecting investors are the "pillars" of high-quality, reliable corporate reporting referred to in the Consultation. In the context of the European Commission's pursuit of the capital markets union, the Wirecard scandal highlights that the integrity and efficiency of the union in facilitating the free flow of capital for investors will likely be judged by the weakest link – especially when such egregious examples of deficiencies in investor protection emerge in the European Union's largest economy. While we agree with the concept and ambition of the capital markets union, the events that led up to the publication of the Consultation – and the effort expended in responding to the Consultation – only highlight the fragmented and challenging nature of connecting the principles within European Commission legislation (regulations/directives) with the actual national jurisdictional rules, implementation, application, and enforcement. Our responses with respect to the Consultation are focused on what is needed throughout the European Union to protect investors and increase transparency and accountability in what we will refer to as the corporate reporting and auditing ecosystem. Our overarching guiding principle is whether and what improvements are necessary to increase transparency and accountability of the pillars that support high-quality and reliable corporate reporting.

Below we highlight anecdotes from the Wirecard situation – as they relate to corporate governance and regulatory supervision, specifically audit supervision – because they so poignantly illustrate the challenges investors face in navigating and connecting the principles within European Commission legislation (regulations/directives) with the actual national jurisdictional rules and the implementation, application, and enforcement of each. They also demonstrate key investor concerns in these areas – that are directly queried in this Consultation – and why investors seek reforms as well as more commonality, and checks and balances, across the European Union. The Consultation seeks our input on the pillars of high-quality, corporate reporting;how the pillars interact with each other; and the relationship between member state and EU level legislation. Wirecard can't help but inform investor views in that regard. As such, we offer these anecdotes in that spirit and as backdrop that informs and contextualizes our investor centric views.

An Investor Perspective on Corporate Governance – Articles such as, *Wirecard is a Scar on Germany's Corporate Landscape: The Scandal Shows Why Shareholders Must Have More Rights*,[2] highlight investor concerns related to the basic tenants of good corporate governance:

> *The Wirecard affair, the latest in a series of corporate scandals in Germany, raises an important question.* ***Why does Germany find it so difficult to protect investors?***
>
> ***Those outside Germany who admire the Rhineland model for its seemingly enlightened form of capitalism ought to examine the Wirecard collapse*** *in detail.* ***From my perspective, the chief problem of German corporate governance is that shareholders lack the power to hold management accountable****.* ***Wirecard shareholders tried to question Markus Braun, the company's chief executive, at annual general meetings. But they did not have a chance to grill him. German law makes it easy for a company's board members to evade awkward questions by talking in platitudes****.*
>
> ***The erosion of shareholders' rights is a scar on Germany's corporate landscape that investor protection groups have complained about for many years.*** *A related problem is that* ***Germany's two-tier system of a management board and a supervisory board does not produce the necessary stringent controls. Wirecard's supervisory board say they did not have a clue about how executives were cooking the books****.*

[2] *Wirecard is a Scar on Germany's Corporate Landscape: The Scandal Shows Why Shareholders Must Have More Rights,* Financial Times; Robert Peres; January 3, 2021. (https://www.ft.com/content/63edde75-642d-40ae-aa25-20e22e01705c)

Documents such as, [*Consequences of Wirecard Scandal: New Requirements for Corporate Governance and Audit of German Listed Companies - Gibson Dunn*], highlight changes being implemented in Germany post Wirecard including:

- Mandatory audit committee comprising at least two financial experts;
- Extended information rights and functions for audit committee members;
- Legal obligation to establish an internal control system and a risk management system; and
- Separate meetings with the auditor without the management board.

However, in making these changes it highlights how nascent and weak corporate governance actually was and remains. The changes made also demonstrate that significant changes are still necessary related to the quality and competence of audit committees; the limited information rights of the audit committee; the lack of management accountability for a quality system of internal control and risk management and the inability auditors have had to speak freely in the protection of the rights of investors.

The Wirecard situation has simply drawn attention to the weak corporate governance in protection of investor interests across the European Union and the fragmented nature of corporate governance requirements as well as their application at the member state level. Making it more complicated is that many rules related to corporate governance over corporate reporting and audit come through audit and corporate reporting regulations/directives rather than being integrated with corporate governance regulations/directives. This creates a complex patchwork of inconsistently applied regulations/directives that makes it challenging for investors to discern the rules that establish their rights – let alone seek to assess the quality of their application, or their enforcement. The fragmented nature of corporate governance regulation impedes investment capital and is, in our view, an impediment to the EU's desired capital markets union.

We believe the consistency of board responsibilities for reporting, the liability of company boards for reporting, the obligation to establish an audit committee, rules on the composition of the audit committee, tasks of the audit committee, and the external position of the audit committee (e.g., in relation to shareholders) must be assessed by the Commission across the various regulations and directives at the EU and member state level, the application of these principles across the member states and the integration and application of member state corporate governance rules. We believe EU level legislation to improve corporate governance and the need for more consistent principles and their application is essential to facilitate the capital markets union and capital investment.

An Investor Perspective on Regulatory Supervision – The Wirecard failure and scandal have also highlighted weaknesses in German federal financial regulatory supervision at BaFin; the Financial Reporting Enforcement Panel (FREP) charged with investigating violations of accounting requirements; and the German audit regulatory oversight organization APAS Audit Oversight Body. Innumerable press articles[3] highlight the failures of BaFin, FREP and APAS including: an inability to perform their oversight functions

[3] Press articles:

- *Wirecard Inquiry: Germany's Political and Financial Elite Exposed,* Financial Times; Guy Chazan and Olaf Storbeck; April 18, 2021. (https://www.ft.com/content/6e0c6b5f-3461-463d-b49b-f572dbc39c26)
- *Wirecard Collapse Leads to Call for German Parliamentary Inquiry,* Reuters, Andreas Rinke and Neil Jerome Morales; June 29, 2020; (https://www.reuters.com/article/us-wirecard-accounts-idUSKBN2401Y7)
- *German Audit Watchdog Chief Faces Probe Over Wirecard Share Trading,* Financial Times; Olaf Storbeck; December 11, 2020; (https://www.ft.com/content/7c8da57b-aee5-4c62-87c3-5ba0a7ac2a40)
- *Head of German Accounting Watchdog to Step Down in Wake of Wirecard*, Reuters; Hans Seidenstuecker and Tom Sims; February 24, 2021; (https://www.reuters.com/article/us-wirecard-accounts-frep-idUSKBN2AO2LJ)
- *German Watchdog Reports EY to Prosecutors Over Wirecard Audit,* Financial Times; Olaf Storbeck; November 26, 2020; (https://www.ft.com/content/c3b9791a-15b2-4a7c-92da-be4458f528d7)
- *BaFin Boss 'Believed' Wirecard Was Victim Until Near the End,* Financial Times; Olaf Storbeck; January 24, 2021; (https://www.ft.com/content/a021012e-bd2e-44d5-a160-96d997c662f1)
- *All Financial Reporting Enforcement Panel Articles,* Compliance Week; Various (https://www.complianceweek.com/financial-reporting-enforcement-panel/8021.tag

because of conflicts of interest (i.e., including ownership in Wirecard and holding board seats in companies under their supervisory power); a lack of coordination of supervisory efforts; a disbelief that the claims regarding the company were true; unqualified and insufficient staffing at regulators; and knowledge by the audit profession of the inadequacies and ineffectiveness of APAS. These are but a few of the findings. These reports have put financial regulation, corporate oversight, corporate reporting, and audit supervision regulation in the line of sight for investors, in addition to regulators. The reports of [weak supervision at BaFin have led to reforms and more powers for BaFin](). As that publication highlights:

> *Up until now, the Financial Reporting Enforcement Panel (Deutsche Prüfstelle für Rechnungslegung – FREP), an institution organised under private law, was responsible for looking into suspected violations of accounting requirements. BaFin was only called on to examine a company if the latter refused to cooperate with the FREP, disagreed with the results of the examination or if there were considerable doubts about the examination procedure or results of the FREP examination.* ***This two-tier model has proved inefficient. The responsibility for financial reporting enforcement has now been assigned exclusively to BaFin****.*

A recent court ruling, however, only highlights the importance of greater investor rights related to supervision for the protection of investors. A January 19, 2022 article, *Wirecard Investors Case Against German Regulator BaFin Dismissed By Court*,[4] notes the following:

> *The investors accused BaFin of not stopping market manipulation by Wirecard, failing to investigate evidence of illegal conduct by the company and failing to inform the public properly.*
>
> ***The lawsuits were dismissed****, with the court arguing that under German law,* ***BaFin explicitly works for the wider public interest rather than that of individual investors****.*

Dismissal of this case with the view that BaFin works for the wider public interest rather than that of individual investors leaves investors curious as to who protects their interests – the audit committee, the auditor, the corporate reporting regulator, the audit regulator? It seems all failed in the case of Wirecard. For example, the head of Germany's audit regulator APAS admitted to owning Wirecard shares while investigating Wirecard's auditor EY[5]:

> *It was an innocuous question, posed shortly before midnight some nine hours into an exhausting parliamentary hearing into the Wirecard scandal.* ***"Did you ever actually own Wirecard shares?"*** *Cansel Kiziltepe, the Social Democrat MP,* ***asked Ralf Bose, head of Germany's auditor watchdog Apas****.*
>
> *His answer caused a political earthquake and brought an abrupt end to his more than 30-year career.* ***A former partner at KPMG, Bose ran a government agency that is normally protected from public scrutiny by stringent secrecy laws****. But those laws do not apply to the Bundestag's inquiry into Wirecard.* ***Bose disclosed that he had bought and sold Wirecard stock while Apas was investigating Wirecard's auditor EY****. Just hours later the German government started to probe the transactions.* ***And within a matter of weeks Bose had been fired****.*

APAS is referred to as *"a* ***government agency*** *that is* ***normally protected from public scrutiny*** *by* ***stringent secrecy laws.****"* As the audit regulator in the EU's largest economy and a member of the Committee of European Auditing Oversight Bodies (CEAOB), the credibility of APAS, CEAOB, and auditor oversight more broadly within the European Union is in question given the lack of independence, transparency, accountability and effectiveness of these organizations. How auditors are supervised – especially in light of the audit payor model – is an essential part of the strength of the corporate reporting ecosystem. Audit regulators act as an important key backstop to facilitate and assist auditors – who lack independence because of the payor model – in the execution of their duties.

---

4 *Wirecard Investors Case Against German Regulator BaFin Dismissed By Court,* Olaf Storbeck; January 19, 2022; (https://www.ft.com/content/9fab6842-4ee6-4114-a35c-09bf9c62a94a)

5 *German Audit Watchdog Chief Faces Probe Over Wirecard Share Trading,* Financial Times; Olaf Storbeck; December 11, 2020; (https://www.ft.com/content/7c8da57b-aee5-4c62-87c3-5ba0a7ac2a40)

CFA Institute

Investor Perspectives on Corporate Reporting That Inform Our Consultation Response

The following investor perspectives inform our responses to the Consultation/Questionnaire:

1) ***The Elements of High-Quality Corporate Reporting and Audit Are Not Jurisdictionally Specific –*** CFA Institute's efforts related to corporate reporting and audit have been global for many years, because the foundational elements of high-quality corporate reporting and audit are not unique to a particular jurisdiction. What is jurisdictionally specific is the manner in which such elements are incorporated into the legal and regulatory regimes in the respective countries in which investee companies are domiciled and how they are enforced.

   Investors invest globally and investing is a comparative process whereby investors look across jurisdictions for investee companies with a comparative advantage. A high-quality reporting and audit system in a company's jurisdiction of domicile are a consideration in the investment process as they influence and impact the quality of information used for investment decision-making. Without high-quality information the cost of capital must increase to compensate for the additional risk associated with investing in that jurisdiction.

   As the largest global organization of professional investors who have advocated for meaningful audit and corporate reporting reforms globally for over 50 years, we have devoted significant time to our consideration of corporate reporting and auditing globally. As a matter of practice, we address issues in particular jurisdictions – such as the US, the UK and now in the European Union – because reforms in one market can inform and influence other jurisdictions as a result of the fact that corporations in which we invest, and the audit firms who audit them, are increasingly globally interconnected, and because the elements of high-quality corporate reporting and audit are not unique to a particular market.

   In the last two years, CFA Institute has devoted significant time to addressing UK government corporate reporting, governance, and audit reform consultations as a result of high-profile failures in their market. We encourage the European Commission staff to review CFA Institute's consultation responses related to UK audit reform[6] as they address – and are an excellent compendium of – our global investor views on corporate governance related to high-quality corporate reporting, the elements of high-quality audits (including independence, content of audit reports, rules on auditor rotation and non-audit services), auditor and corporate reporting supervision – all elements of this European Commission Consultation. Specifically, we would point you to Appendix A to our Brydon comment letter response as it includes a comprehensive list of our work related to audit specifically, but also the pillars of the corporate reporting ecosystem you reference in this European Commission Consultation.

   References to our UK audit reform consultations included herein, and in the Consultation and Questionnaire, are provided as they reflect our global views that we are sharing with the European Commission to highlight the consistency of our global perspectives not because they are UK specific views.

[6] CFA Institute has responded to the UK Government's efforts regarding improving the audit regulator (Kingman Review), competition in the audit market (CMA Review) and audit quality (Brydon Review) in 2018 and 2019 as well as the 2021 UK Government's Department of Business, Energy & Industrial Strategy (BEIS) overarching consultation (BEIS Overall Consultation), *Restoring Trust in Audit and Corporate Governance: Consultation on the Government's Proposals*. In 2019, CFA Institute provided comprehensive responses to *Sir Donald Brydon's Independent Review of the Quality and Effectiveness of Audit* and the *Competition and Market Authority (CMA)'s Statutory Audit Services Market Study*) proposals. Jointly with the Council of Institutional Investors (CII), we also provided in 2019 our views to BEIS on the importance of internal controls over financial reporting. In 2021, we provided a response to the BEIS Overall Consultation.

2) ***Transparency & Accountability: In the Europe Union's Largest Economy, the Wirecard Affair Exposed the Weakness in the First Principles of High-Quality and Reliable Corporate Reporting*** – Investors rely on and compensate all of those who are charged with looking after their capital investments. This includes management, the audit committee and board, auditors and in some jurisdictions – through government assessments on public companies – even audit regulators (e.g., US PCAOB). That said, investors get very limited communication from such parties. Only recently have extended audit reports provided more information to investors. Audit firm transparency reports are limited in usefulness to investors and, as such, are generally not used. There is also very little, if any, useful communication from audit committees to investors in many jurisdictions. Audit regulators provide far too little information (i.e., investors perceive this to be the case in the US where there is far more information than in the EU). As a result, improvements needed in the pillars of high-quality corporate reporting are related to the first principles of the responsibilities of those charged with protecting investor interests – those being transparency and accountability.

3) ***Audit (Corporate Governance & Supervision) is a Credence Good:***
Purchasers (Investors) Lack Transparency in Evaluating the Quality of the Good,
Greater Transparency is Essential to Improving Corporate Reporting and Audit
We would note that audits are a credence good[7] whereby the quality of the audit is difficult for the purchaser – the investor – to assess even after purchase. For that reason, we believe greater transparency from those hired (e.g., management, the audit committee, auditors, audit regulators and corporate reporting regulators) to protect the interests of investors is essential. We would also make two related observations: 1) The other pillars of high-quality corporate reporting – including elements of corporate governance and regulatory oversight of corporate reporting and audit supervision – also lack the transparency that allows investors to judge the quality of the work of these agents, who are charged with protecting investors, perform on their behalf, and 2) The European Parliament and Commission – like investors – suffers from a corporate reporting and audit ecosystem that lacks transparency. Without greater transparency in all the pillars, the European Parliament and Commission cannot make improvements in legislation (regulation/directives) to protect the interests of investors and other stakeholders.

4) ***The Audit Payor Model Reduces Skepticism & Independence: Requires Strength in Other Pillars*** – We would also note that a fundamental behavioural issue with the quality of corporate reporting stems from the audit payor model wherein the auditor perceives they are paid, for audit and non-audit services, by the management of the company being audited – what they refer to as their "client". The auditor is thus leveraged to the satisfaction of management, rather than to the satisfaction of investors – who are paying the auditor, the actual client. This makes the auditor incentivized to maintain a non-confrontational relationship with their perceived client. This naturally leads to decreased skepticism. This is why regulation to strengthen the transparency and accountability of the other pillars – corporate governance (**Part II** of the Consultation) and audit supervision (**Part III** of the Consultation) are particularly important.

As investors consider the elements of high-quality and reliable corporate reporting they are guided, irrespective of jurisdiction, by the aforementioned principles of independence, professional skepticism, transparency, accountability and appropriate checks and balances between those hired (e.g., management, the audit committee, auditors, audit regulators and corporate reporting regulators) to protect their interests.

[7] Colleen Honigsberg, Phd, Professor of Accounting at Stanford Law School rightly highlighted this point at a September 9, 2021 meeting of the SEC Investor Advisory Committee. It is a sentiment we expressed in our letter to the UK Government during its recent audit reform efforts.

CFA Institute

A SUMMARY OF OUR VIEWS & RECOMMENDATIONS

Our Current Assessment of the Pillars of High-Quality, Reliable Corporate Reporting

Part I of the Consultation focuses on the pillars of high-quality, reliable corporate reporting. Our current assessment of the pillars and how they need to work together is summarized below. Our prioritized recommendations are included in the next section. These comments relate to **Questions #2** and **2.1** of the Consultation.

Wirecard Demonstrated All Pillars, Not Just Audit, Failed to Protect Investors – We generally find much of the focus and public narrative on corporate scandals, reporting problems and failures gets assigned to auditors. The Wirecard scandal demonstrated that the issues with high-quality and reliable corporate reporting did not simply rest at the feet of the auditors. This time failures occurred across the entire reporting ecosystem (i.e., pillars) – management, corporate governance, financial reporting regulators, audit regulators and financial supervisory regulators, as well as the auditors' execution of the audit. Wirecard illustrated all such pillars were not effectively working in the European Union's largest economy. Accordingly, this Consultation rightly focuses on all the elements of corporate reporting and audit quality.

EU Legislation Has Heavily Focused on the Auditors Over the Other Pillars – Much of the EU legislation in the post financial crisis era focused on new audit legislation, without a change in the auditor payor model, the biggest conflict of interest. Rotating auditors, reducing non-audit services, and assessing the competitiveness of the audit market, are not measures that will address this fundamental conflict of interest, however. The desire of the auditor to please management will always reduce auditor skepticism and the quality of audits. As such, if the payor model is meant to stay in place, then there needs to be stronger accountability by management; stronger and more transparent audit committees; the existence of competent and effective audit regulators and a corporate reporting regulator with stronger powers. All of these are needed as a backstop to the auditor to enable them to offset the payor model.

Management Accountability is Foundational – EU level legislation to date appears relatively more focused on holding auditors accountable rather than management – those who are principally charged with ownership of effective internal controls over financial reporting. Management, in particular, does not appear to have sufficient accountability for the internal controls over financial reporting. Without that being remedied, the corporate reporting and audit ecosystem will never sufficiently improve. Management accountability for controls over financial reporting is not simply a pillar, but the foundation of high-quality and reliable corporate reporting. We believe the Consultation rightly contextualizes the need for reform in the various pillars, but we believe greater and more specific emphasis on the accountability of management – not simply corporate governance broadly – needs to be emphasized.

Strength in Other Pillars: Essential to Improving Quality and Reliability of Corporate Reporting – Auditors cannot improve a company's broken reporting system, they can only report on it, and advocate for its improvement. The intractable conflict of interest created by the payor model prevents this from effectively occurring, however. Without a corporate reporting/audit ecosystem with pillars of equal or greater strength, auditors are pushing a boulder uphill alone. EU legislators through their audit regulations/directives are simply pushing on the end of a string and additional EU legislation (regulation/directives) on auditors will have no further meaningful effect.

The Other Pillars Are Not Sufficiently Strong to Support the Audit Pillar – Without transparency, accountability, and effectiveness of all the other pillars to support the auditor, they cannot hold management accountable for high-quality and reliable corporate reporting. That said, as we undertook completion of the Consultation we heard the pillars in greatest need of reform – in addition to strengthening management accountability – related to: 1) broadly improving corporate governance because of the fragmented corporate governance requirements at the EU member state level, and 2) the need to improve statutory audit oversight because of similar member state fragmentation. There is also realization that the quality of staff, lack of resources, lack of transparency and independence at the member state level were not seen as unique to Germany. Our comments in **Part II** and **Part IV** of the Consultation provide more detail.

***Our Responses to Question #2* –** In responding to **Question #2**, we found all the pillars relevant to high-quality and reliable corporate reporting and that EU intervention was justified in each case. Our responses as they related to effectiveness, efficiency and coherence in **Question #2** were much lower for corporate governance and audit supervision as reflected in the immediately preceding comments. Our ratings on the dimensions of effectiveness, efficiency and coherence were much higher for supervision of corporate reporting (i.e., see comments in **Part V** of the Consultation) and the audit ecosystem (i.e., see comments in **Part III** of the Consultation**)**. This is driven by the fact that the EU and EC have taken stronger legislative and regulatory actions at the EU level in these areas in the last decade. Our overall ratings of the ecosystem have been lowered because of our views on corporate governance and supervision of statutory audit as we describe in **Parts II** and **Part IV** of the Consultation, respectively. See also comments in **Appendix B** related to the "efficiency via further simplification" and "coherence in existing provisions" parts of **Question #2**.

Overall – In sum, our view is that the pillars must work together to create an environment that works for investors and other stakeholders. The ecosystem must have transparency and accountability at each pillar to work effectively. When one pillar fails the system fails.

Pillars in Most Immediate Need of Reform: Address Weaknesses in Corporate Governance (Including Management Accountability) and Audit Regulatory Supervision

Part I of the Consultation focuses on the pillars of high-quality, reliable corporate reporting. Our current assessment of the pillars and how they need to work together is summarized above. Our recommendations are included below and relate to **Questions #5, 5.1** and **5.3** of the Consultation.

As we note above, we believe there are improvements needed in each of the pillars and the improvements certainly need to be done in a coordinated manner. As we note above, we believe the greatest improvements are needed in the corporate governance pillar and in supervision of audit. (i.e., **Question #5**). As it relates to at what level action is needed (i.e., **Question #5.2**), we believe that auditors should take action to improve their work, but as we note above, without action by management, audit supervisors and individual member states there will be no overall improvement by auditors because of the inherent conflicts of interest. That said, we don't believe – without action at the EU level – there will be improvement by management, audit supervisors or the member states in their responsibilities. They need to be compelled to act. Our responses to the questions in **Parts II-V** of the Consultation provide more specifics (See also **Appendix A**) to the improvements needed, but our most significant improvements – in order of priority – needed are as follows:

1) ***Implement Management Certifications, Supported by Audits, of Internal Controls Over Financial Reporting*** – As we note in **Part II** of the Consultation, we have found that the implementation of management certifications supported by auditor attestations on internal controls over financial reporting (ICFR) have had significant impacts on the behaviour and accountability of management in the execution of their responsibilities and their allocation of resources to financial reporting. As a result, such measures have enhanced the quality of corporate reporting. We believe this is a necessary improvement that the EU should implement. Investors are willing to pay the cost of such certifications and attestations. We explain there that the cost/benefit analysis on ICFR certifications and attestations include the direct cost of performing the work without recognizing the benefit of improved financial reporting and the lower cost of capital to investors. We draw special attention to **Appendix B** where we discuss the appropriate – investor focused – cost-benefit analysis that needs to be deployed in assessing the implementation of ICFR certifications and attestations.

2) ***Create European Union Audit Regulator* –** As we note in **Part IV** of the Consultation, we believe a detailed, independent review and inspection of EU member state audit regulators and the CEAOB to determine how they should be improved is necessary. In our view this review would be about how, not if, to create a stronger pan-European Union audit regulator. In our view, it is essential that the cost of national vs. a European Union-wide audit regulator be assessed such that sufficient resources are deployed – and economies of scaled gained – by such an EU wide model. Such regulator would have oversight of audit standard setting and endorsement, inspections, and enforcement actions. We would envisage an organization like ESMA, but with the greater powers we highlight are needed at ESMA in **Part V** of the Consultation. Relative to the Public Company Accounting Oversight Board in the US, and the planned improvements in the Financial Reporting Council – becoming the Audit, Reporting, and Governance Authority (ARGA) – in the UK, the European Union appears to be a laggard in audit supervision with very limited oversight of auditors and with limited transparency.

3) ***Strengthen Regulatory Oversight of Audit Committees to Improve Functioning*** – As we describe in **Part II** of the Consultation, we believe that there remain improvements necessary in the functioning of audit committees and their oversight by regulators.

4) ***Establish Engagement Level Audit Quality Indicators*** – As we note in **Part III** of the Consultation, we believe the most important improvement related to audit – in addition to ICFR attestation – is to develop audit quality indicators (AQIs). While audit firm level information, quality standards and transparency reports are important, they are not sufficient. Engagement level audit quality indicators provide management, the audit committee, the audit regulator, and the consumer (investor) with metrics to communicate and measure progress. Measuring audit quality is about providing more information to investors – and the agents engaged to protect their interests – to move audits out of the realm of a credence good.

5) ***Strengthen the Responsibilities and Powers of ESMA* –** As we note in **Part V** of the Consultation, ESMA's formation has been highly effective at bringing an EU-wide perspective and vantage point to the quality of corporate reporting. A similar EU-wide vantage point is missing as it relates to audit supervision as noted above. That said, ESMA lacks the access, strength of supervision and enforcement powers that are necessary to really effectuate the enforcement necessary to improve corporate reporting. The situation with Germany's Financial Reporting Enforcement Panel (FREP) in the wake of the Wirecard scandal highlights the lack of ability of ESMA to bring change on an ex-ante basis – when it is most needed. The published news accounts suggest it was well known that FREP lacked the resources and capabilities to execute its necessary duties. Even on an ex-post basis ESMA, when asked by the Commission to look at the Wirecard issue, can only observe and comment on changes needed but cannot bring them to bear. In that regard, we believe improvements to strengthen ESMA are necessary. Supervision by its nature is an ex-post activity, and it is an important backstop, but much of supervision's efficacy depends on public displays of enforcement to function as an effective ex-ante deterrent. That is why we believe changes are necessary at the ESMA level to provide greater supervisory and enforcement powers to ESMA. We also believe it is essential that the cost of national vs. a European Union-wide corporate reporting regulator be assessed – and an assessment be made of whether ESMA is sufficiently funded such that sufficient resources are deployed, and economies of scaled gained, through ESMA.

   We would also note that we believe the establishment of the ESEF and the ESAP has the potential to significantly increase the ability of EU level oversight of corporate reporting and auditing. As users of tagged data tools, the ability to search across all public companies – in the US, for example using CalcBench – there are immeasurable benefits to having the data tagged and collected in a single source across the European Union. This type of EU-wide effort enhances the concept of the capital markets union.

For more detail on the recommendations above and a summary of the responses to other questions, see **Appendix A**.

****

Thank you for your consideration of our views and perspectives. We would welcome the opportunity to meet with you to provide more detail on our letter. If you have any questions or seek further elaboration of our views, please contact Sandra J. Peters at sandra.peters@cfainstitute.org.

Sincerely,

/s/ Sandra J. Peters

Sandra J. Peters, CPA, CFA
Senior Head, Global Financial Reporting Policy Advocacy
CFA Institute

CC:
- Josina Kamerling, Head, EMEA Policy Outreach, CFA Institute
- Alexandra Jour-Schroeder, Deputy Director General, Directorate General for Financial Stability, Financial Services and Capital Markets Union, European Commission
- Ugo Bassi, Director, Financial Markets Directorate, European Commission
- Sven Gentner, Head of Corporate Reporting, Audit and Credit Rating Agencies Unit, European Commission

APPENDIX A

KEY CONSIDERATION BY CONSULTATION/QUESTIONNAIRE SECTION

Part I – The EU Framework for High-Quality and Reliable Corporate Reporting

Part I of the Consultation focuses on the pillars of high-quality and reliable corporate reporting individually and collectively. The section, A Summary of Our Views & Recommendations, in the body of the letter comprise our views on **Part I** of the Consultation.

Part II – Corporate Governance

The section, *Background and Context for Our Consultation Response: An Investor Perspective on Corporate Governance,* in the body of this letter provides an important backdrop to our views on corporate governance as articulated in **Part II** of the Consultation. As we note there, the Wirecard situation has drawn attention to the weak corporate governance in protection of investor interests. There is a complex patchwork of inconsistently applied regulations/directives that make it challenging for investors to discern the rules that establish their rights – let alone seek to assess the quality of their application, or their enforcement. We believe EU level legislation to improve corporate governance and the inconsistent application is essential to facilitate the capital markets union and capital investment.

We are supportive of all the actions included in **Question #9** regarding improving the quality and reliability of reporting of listed companies as follows:

a) ***Strengthening the responsibilities of the board*** for incorrect reporting;
b) Requiring ***proper expertise of specific board members*** related to corporate reporting;
c) Increasing responsibilities for specific board members (e.g., CEO and CFO) and their liability for corporate reporting;
d) ***Giving company boards an explicit responsibility to establish effective risk management and internal control systems*** related to corporate reporting, fraud and going concern;
e) Requiring ***more transparency of company boards about the effectiveness of the companies' risk management***;
f) ***Removing exemptions in EU legislation for establishing an audit committee***;
g) ***Increase tasks of audit committee***;
h) ***Strengthen*** the ***external position of the audit committee***;
i) Setting up specific ***whistle blowing procedures***;
j) ***Require auditors*** to provide ***assurance on the systems of internal control related to fraud and going concern***; and
k) ***Strengthen the role of shareholders on corporate reporting***;

These items correlate with the deficiencies observed by investors, and they are basic elements of good corporate governance. Fragmented EU and member state corporate governance requirements and their application deters investor protection, capital investment and ultimately the capital markets union. We believe each are basic tenants of good corporate governance observed in other developed markets/jurisdictions and the cost/benefit (efficiency/effectiveness) have been demonstrated. We believe all are important to implement.

That said we have two specific points to add to the items listed above and articulated in the body of the letter, but more fully described below:

1) ***Implement Management Certifications, Supported by Audits of Internal Controls Over Financial Reporting*** – We note that Items (c) and (j) relate, respectively, to increasing responsibilities of specific board members such as the CEO and CFO and requiring auditors to provide assurance on the systems of internal control related to fraud and going concern (i.e., internal controls over financial reporting more broadly are not mentioned). While these are directed at increasing accountability on

management, they fall short of articulating the requirement for management certification of internal controls over financial reporting. We believe implementing a requirement that management certify the effectiveness of ICFRs is essential to improving corporate reporting in the EU. Only management has the level of detailed knowledge and day-to-day ability to impact the quality of corporate reporting as it happens. Audit committees are not involved in the day-to-day operations of the business and have limited access to the detailed books and records. Auditors, though, they may have greater access can only report on findings – in a system that disincentivizes this – to audit committees who have limited powers in various EU jurisdictions. In our view, existing EU legislation places more responsibility/regulation on auditors than management for ensuring the integrity of corporate reporting. This is akin to pushing on the end of a string. Auditors can't fix a broken internal control structure and poor corporate reporting – only management can. We believe it is essential that management is held to account for the systems of internal control over financial reporting and that such certifications are only effective if auditors are then required to attest to the effectiveness of those internal controls. One without the other is not effective.

As we noted in our 2019 letter to the UK Government's Department of Business, Energy & Industrial Strategy (BEIS) – where we note our global views – on this same topic:

> *Internal Control Certification – Both CFA Institute and the Council of Institutional Investors have long been supportive of the attestation over internal controls as required by Section 404 of SOX (SOX 404). In particular, we have found the certification of internal controls by management (SOX Section 404(a)) – along with the attestation of disclosure controls and procedures required by SOX Section 302 –* ***have been an effective behavioural change for management. These laws, which clearly place accountability (and legal liability) for internal controls over accounting and financial reporting with the principal officers of the company, have had the effect of increasing the resources necessary to enhance financial reporting. These certifications have had the effect of making upper management accountable for providing resources and attention to these important elements of financial management****. We believe similar requirements should be implemented in the UK and, depending upon the respective laws, being attested to by management, directors or both as appropriate to UK law.*
>
> *Internal Control Audits* ***– We are also supportive of the audit of internal controls as we believe it provides a higher degree of assurance and accountability by the auditor and ensures management takes their certification responsibilities seriously. In complex businesses, testing of – and confidence in – internal controls is an essential element of the audit****. As such, reporting on the auditors internal control work is something investors have found useful, and that assurance is an important driver of confidence in the integrity of financial statements and in the fairness of our capital markets.*

In our 2021 response to the BEIS consultation, *Restoring Trust in Audit and Corporate Governance: Consultation on the Government's Proposals* we reiterated this point. Whether in the US, the UK or the European Union these certifications and attestations are an essential element (first principle) of high-quality corporate reporting. We reiterate the point made above, that while much focus on the quality of audits and corporate reporting falls to the auditors when high-profile failures occur, the principal responsibility falls with management. We have found in the US that the implementation of management certifications and auditor attestations on internal controls over financial reporting have had significant impacts on the behaviour and accountability of management in the execution of their responsibilities and their allocation of resources to financial reporting. Auditors cannot fix poor internal controls and poor culture. They can simply report them, but without strong audit committees and a strong regulator – and with the existing audit payor model that disincentivizes such behaviour – this will not occur.

Investors are willing to pay the cost of such attestations and internal controls. While management/preparers complain about the cost of ICFR certifications and audit attestations, investors ultimately pay the cost of such certifications and attestations, and they are willing to bear the cost. We would refer you to the discussion of "efficiency" in **Appendix B**.

Preparers generally tally the direct time or money they employ in applying the ICFR requirements – without the experience to balance this with effectiveness investors see in such measures and without recognizing that those who ultimately bear the cost (i.e., investors) are willing to pay for such regulations. Further, management – and regulators – don't understand and don't tally the cost of not providing the necessary information or assurance to investors. Specifically, they don't tally the equity risk premium and increased cost of capital applied by investors when deploying capital in company's and in jurisdictions where lower quality reporting exists.

ICFR certifications and attestations are a prime example of where European companies have decreased comparative attractiveness in capital flows to jurisdictions such as the US and will experience a higher cost of capital to European companies because of a high risk of poor internal controls.

2) ***Implement Improved Regulatory Oversight of Audit Committees*** **–** Given the needed improvement in audit committees in the EU as noted in our response to **Questions #7.1** and **Question #9** of the Consultation, we believe transparency, accountability and effectiveness could be improved by implementing better regulatory oversight of audit committees. The 2020 EC Report on Audit Market Monitoring notes the following:

> ***The available data does not allow for an overall assessment of ACs' performance, given the differing approaches to AC monitoring across Member States and the fact that most information is based on ACs' self-assessment****. However, NCAs have made progress in gathering information and establishing a relationship with ACs.*

We suggest this be studied and considered as part of the establishment of a stronger audit regulator as noted in our response to **Part IV** of the Consultation.

In our 2019 response to the UK *Competition and Market Authority (CMA)'s Statutory Audit Services Market Study* proposal we made a similar request noting the specific items in the excerpt below. We would note that the 2021 UK Government's Department of Business, Energy & Industrial Strategy (BEIS) overarching consultation (BEIS Overall Consultation), *Restoring Trust in Audit and Corporate Governance: Consultation on the Government's Proposals* includes a requirement that the newly formed Audit, Reporting and Governance Authority study how this can be implemented. Our 2019 recommendation – reflecting our global views – included the following:

> *Function & Qualifications of Audit Committees– The audit committee's primary function and purpose is to provide oversight of the financial reporting process, system of internal controls and compliance with laws and regulations. Their independent oversight of the audit is key to ensuring that the audit is of high quality. Representing investors in the selection and appointment of the auditors in an independently minded way is essential for audit quality – as is effective oversight of the execution, and price, of the audit. To this end,* ***it is important that the audit committee be comprised of members who, among other skills, possess current and deep experience conducting audits as well as in the greatest risk areas associated with the audit. We believe audit committee chairs must have more recent and direct experience executing audits as well as having the requisite industry and risk management expertise****.*
>
> *Audit Fees – We worry when audit committee members laud their ability to reduce audit fees as if to engender themselves to management or flex their muscle on auditors who seek to retain their "clients". Investors – those who pay the bill – are less price sensitive to audit fees than one might expect.* ***While the cost of an audit is important, pressuring auditors to reduce fees to the point where they are not allowed to make reasonable profits on the audit alone is not a model investors support, as it reduces audit quality. Auditors should be in position to make a reasonable profit in the provision of such services****. Audits should not be loss leaders for the Big 4 as audit partners need to be seen as executing a valuable service to the firm. Partners should not be more highly valued for winning "clients" than performing quality audits.*
>
> *We believe that competition is fierce among the Big Four within the confines of tendering rules and mandatory rotation in certain jurisdictions. That said,* ***our view is that competition is largely based on audit fees (price) and delivery of services – not necessarily on audit quality****.* ***Currently, it is difficult for investors to challenge the audit committees or auditors who are meant to serve their interests as audit fees are very hard to compare across companies. They are generally large lump sums with very high-level qualitative explanations****. This fee reporting, and the tendering process create perverse incentives where the Big 4 underbid large clients to gain the work knowing that there are high switching costs and that without mandatory rotation they have the hope of raising fees and creating a lengthy annuity for the audit firm. They also seek to gain clients for name recognition, marketing, and market sector expertise, and, as we said above, because sales rather than line partners are more highly rewarded for winning clients – even at bad prices.* ***We believe greater reporting on the audit fees including the hours and fees – associated with significant audit areas or risk areas – would provide greater information content to all market participants and provide them with greater ability to judge the fairness of fees for the company relative to the disclosures in the auditor report and relative to peers****.*

__Investors need greater reporting on audit hours, staff mix of hours, and rate per hour to be able to be well informed participants in the marketplace__. Adding additional challenger firms has the potential to increase competition on price – without transparency to the buyer. __It is not in the best interest of investors to increase competition for the audit without simultaneously providing better communication from the audit committee on a variety of issues including fees to allow the market to work more efficiently.__

<u>Regulatory Oversight</u> – __We don't believe the audit committee should be replaced by a regulator as we believe an important function of audit committee members is integrating their understanding of the totality of the board's oversight responsibilities, and understanding of the business, into an analysis and reporting of financial results. That said, we are generally supportive of increased regulatory scrutiny of audit committees__. What is not clear from the CMA's Audit Market Study is who will act __as the regulator with these oversight responsibilities and whether it would be the same regulator that oversees the auditor. We think it would be most effective if they were the same regulator__.

We note that __the audit committee oversight remedy in the Audit Market Study focused on the oversight of the selection of the auditor__. While we agree this is an important element of the role audit committees play__, the oversight should include several other activities important to ensuring audit quality__ including:

1) *Reviewing the __selection and qualification of the audit committee members and the audit committee chair__;*
2) *The __process the audit committee follows in supervising the auditor's execution of the audit__;*
3) *The __time spent by the audit committe__e in __overseeing the execution of the audit__;*
4) *The __audit committee's engagement on critical audit matters__ including communication with and by the auditor;*
5) *__The audit committee's communication to investors__ regarding how it carries out its responsibilities with investors;*
6) *__Review of the audit fee__ including, hours, staff mix, rates, hours spent in risk areas and audit firm profitability.*

While these are __not meant to be an exhaustive list__ of the areas of oversight, we see __this suggested remedy as having the greatest potential to improve audit quality__. __A regulator that oversees the execution of these responsibilities – as well as performing audit inspections – and balances the incentives of audit committee members and auditors would be helpful in improving audit quality__.

Part III – Statutory Audit

Overarching Considerations Related to Statutory Audit – As background to our responses to the questions in **Part III** of the Consultation, please see the section *Overarching Considerations: Investor Perspectives That Inform Our Consultation Response* in the body of the letter.

As we note in our response to **Question #10**, and in the aforementioned section of the body of the letter, while there is focus on independence, performance of non-audit services, and mandatory rotation, the auditor payor model without a strong ecosystem including corporate governance and statutory audit oversight will never balance out the lack of skepticism and conflict of interest established by the auditor believing company management is their "client." We also note that while there is always room for improvement in audit reports, it and these other areas of focus (i.e., non-audit services, and mandatory rotation) are not the most urgent elements in need of consideration in the European corporate reporting and audit ecosystem. We support improving the other pillars including requiring management certifications and auditor attestations of internal controls over financial reporting, greater transparency of fees as described in **Part II** above and the establishment of audit quality indicators as described below

Establish Engagement Level Audit Quality Indicators – We believe there needs to be implementation of engagement level audit quality indicators to enhance transparency around the quality of the audit at the engagement level. There is a perception – almost mystique – that audit quality is an elusive, unmeasurable quality. We disagree. There are many products (i.e., products that are much more vital to our lives (e.g., vaccines)) where measures of quality are routinely defined, measured, monitored, tested – and adjusted over time – at the specific product level. Audit is no different. While firm level information, quality standards and transparency reports are important, they are not sufficient – many investors believe they serve as marketing materials rather than useful instruments for evaluating audit effectiveness. Engagement level audit quality indicators provide management, the audit committee, the audit regulator, and the consumer (investor) with metrics to communicate and measure progress.

Measuring audit quality is about providing more information to investors – and the agents engaged to protect their interests – to move audits out of the realm of a credence good. What gets measured gets monitored. Standard-setting delays in developing audit quality indicators is, in the view of some, an indicator of their potential to be highly effective.

Without the transparency that can be achieved through audit quality indicators there cannot be trust and without trust there cannot be confidence by investors in the audit profession. As investors, we respect and want to work with the audit profession, for we are their genuine client, not the audit committee or management. We have a mutual interest in seeing the audit profession succeed. We do not believe the audit profession should be judged by their worst moments, as reported in the press upon high-profile audit failures. We believe that auditors should be judged by the good work undertaken each day by members of the audit profession, and we believe that greater transparency about their functions will increase the visibility of their good works. We also believe that auditors should be paid fairly for their work. For that reason, we believe audit quality indicators would facilitate recognition of the good work of auditors.

***Competition & Audit Quality* –** The lack of transparency from auditors limits the ability of investors to say that audit contributes as much as possible to the quality and reliability of corporate reporting, the ability to assess their satisfaction with the role of auditors, and the reliability of their work in a manner that inspires trust in capital markets.

Competition vs. Quality – Our response to the *UK Competition and Market Authority (CMA)'s Statutory Audit Services Market Study* highlights our global views on audit market competition and our view that increased choice and competition without an ability to judge audit quality will not address the real issue of audit quality. Refer to the excerpt from that response below:

> ***Audit Concentration & Competition*** *– The current degree of concentration among the Big Four – and the market resilience – has existed for nearly twenty years. Accordingly, this concern is not new or unique to the UK. If another failure on the scale of Arthur Andersen were to occur, such a change would be disruptive to publicly listed companies, investors and firm employees as well as many other stakeholders. However, enhancing the competitiveness of the challenger firms through the aforementioned remedies doesn't seem like a viable plan for addressing the resilience of the market as many publicly listed companies wouldn't switch to a challenger firm for the reasons already articulated.*

We go on to say:

> *As we describe above, Remedy #2 (Mandatory Joint Audit), #2A (Market Share Cap), #3 (Additional Measure to Reduce Barriers to Challenger Firms)* ***seem to focus on increasing the number of market participants by increasing the involvement in the audit market of challenger firms, but they don't seem to address the primary issue for investors, that of audit quality****. We are especially concerned by creation of mandatory joint audits where auditors may be incentivized to compete on engendering themselves to management and audit committees rather than focusing on audit quality. How a market share cap would work in a dynamic market is also challenging to envision.* ***Broadly, we don't see that joint audits, market caps or other measures to enhance competition of challenger firms is the solution to improving the audit market because we believe we need a market where buyers are more well informed not simply where there are more sellers.***

Joint Audits Reduce Quality – As the above excerpt highlights, we do not support joint audits. More specifically we noted in that same consultation:

> ***Joint Audit – We very strongly oppose the notion of the joint audit. In our view, joint audits reduce accountability to investors****.* ***When everyone is responsible, no one is responsible. Joint audits increase audit quality risk****. Such audits require careful coordination, cooperation, division of responsibility and accountability between two firms, which has the potential to increase audit risk and decrease quality. While less averse to a shared audit, we aren't convinced either remedy improves audit quality. The ten-page discussion in the Audit Market Study includes a discussion of the liability framework and how challenger firms would benefit. However, it falls short, in our view, in precisely articulating how this remedy will improve audit quality for the benefit of investors.* ***We see this remedy as having the potential to increase fees without improving, and possibly decreasing, audit quality****.*

We do not believe that increasing audit competition or the number of auditors – without any way to judge audit quality – is the way to improve audit quality. It simply creates more competition in providing a credence good. A market does not improve when there is a lack of transparency between market participants.

Other Elements of Audit Quality – As it relates to specific elements of improving audit quality highlighted in **Question #14** of the Consultation, we note that:

a. *Fraud* – Until there is a definition of fraud that is consistent between the audit profession and the general public, improvements will be challenging.
b. *Information Value of Audit Reports* – The transparency and information value of audit reports can be improved in many respects, but this would require a separate consultation.
c. *Internal Firm Governance* – Improving internal firm governance needs to come through engagement level audit quality indicators such that existing transparency reports are not marketing materials, but useful decision-making communications.
d. *Joint Audits* –We are very strongly opposed to joint audits and see them as a race to the bottom on audit quality.
e. *Mandatory Audit Rotation* – We have not supported mandatory audit rotation, but have supported disclosure of audit tenure and routine audit tendering when investors perceive the tenure is excessive.
f. *Non-Audit Services* – We support prohibition in the providing of certain non-audit services to audit clients. There appears to be some simplification worth considering, though some investors view that all non-audit services should be banned. Some investors believe that reporting on sustainability information should be considered a prohibited non-audit service. We are not convinced of this argument and believe further study on the nature of the disclosures being assured, their connection to the financial statements, and their linkage to internal controls should be explored further before a determination is made on that point.
g. *Liability Caps* – We believe that all caps on legal liability should be removed.
h. *Limit Member State Options* – Optionality always reduces comparability and quality in corporate reporting and audit. As such, we do not support optionality at the member state level. Optionality also reduces effective enforcement. Tenants of high-quality reporting are not optional.
i. *Passporting* – We need more information on what this would look like and the legal challenges to be able to comment most effectively.

Part IV – Supervision of PIE Statutory Auditors and Audit Firms

An Investor Perspective on Supervision of Statutory Auditors – As background to our responses to the questions in **Part IV** of the Consultation, please see the section *Background and Context to Our Consultation Response: An Investor Perspective on Regulatory Supervision* in the body of this letter. There we highlight how the audit regulator in the EU's largest economy – German audit regulatory oversight organization APAS Audit Oversight Body and a member of the Committee of European Auditing Oversight Bodies (CEAOB) – along with other German regulators failed investors and diminished the credibility of APAS, CEAOB and auditor oversight more broadly within Europe given the lack of independence, transparency, accountability and effectiveness of these organizations. How auditors are supervised – especially in light of the audit payor model – is an essential part of the strength of the audit ecosystem. Audit regulators act as an important key backstop to facilitate and assist auditors in the execution of their duties.

Recommend Creation of EU Level Statutory Audit Supervisor

Through numerous discussions with investors and others – including auditors – in the EU, we hear that supervision in other EU member states is equally poor and the CEAOB is an ineffective affiliation. We hear that staffing as such audit supervisors is insufficient, of low quality, and ineffective. We have repeatedly heard the audit supervisory organizations – including their inspection findings – lack transparency. The CEAOB, as evidenced by its website, also lacks transparency. As such, we believe a detailed, independent review and inspection of EU member state audit regulators and the CEAOB to determine how they should be improved is necessary. In our view this review would be about how, not if, to create a stronger pan-European audit regulator. It is essential that the cost of national vs. a European-wide audit regulator be assessed such that sufficient resources are deployed – and economies of scaled gained – by such an EU wide model. Such regulator would have oversight of audit standard setting and endorsement, inspections and enforcement actions. We would envisage and organization similar to ESMA, but with the greater powers we highlight are needed at ESMA in **Part V** of the Consultation.

Europe's Supervision of Statutory Auditors Lags Other Developed Market

By way of background, CFA Institute similarly advocated, subsequent to high-profile corporate failures such as Enron, for the formation of the Public Company Accounting Oversight Board (PCAOB) and other audit reforms that were enacted by the Sarbanes-Oxley Act of 2002 (SOX Act) – including audit standard setting, auditor inspection and enforcement. CFA Institute has been an active participant in the PCAOB standard setting and audit oversight process over the last 20 years. While not perfect, we see clear evidence that the PCAOB has improved audit quality through more vigorous inspections, but also – and maybe more importantly – by providing auditors with a backstop to pressure company management and audit committees to provide the evidence necessary to support the audit opinion. This has created important behavioural change to the audit – where an auditor payor model inhibits auditors' ability to challenge management on accounting and internal control issues and seek the audit evidence necessary to support accounting and reporting conclusions.

We have also been active in the debate on audit reform in the UK for the reasons noted in the body of this letter (i.e., that they represent our global views in various jurisdictions) And while we did not respond, because of timing, to the initial Kingman Review – which reviewed the strength and quality of the audit regulator – our response to the 2021 UK Government's Department of Business, Energy & Industrial Strategy (BEIS) overarching consultation (BEIS Overall Consultation), *Restoring Trust in Audit and Corporate Governance: Consultation on the Government's Proposals* highlights that the most significant outcome of the UK Government's audit reform efforts appears to be a stronger audit regulator, the Audit, Reporting and Governance Authority. Below is an excerpt from our comment letter to this effect:

> *Stepping away from the details of the Consultation, **it would appear the UK Government's most significant audit reform is to replace the FRC with the new Audit Reporting and Governance Authority (ARGA)** – as we address in the following paragraph. While certainly **stronger enforcement by a regulator can be an effective deterrent, such enforcement must be swift, strong, visible, and frequent**. Further, **a reputation of strong enforcement must be established by the new ARGA and the UK Government for investors to see evidence of credible deterrence**.*

By contrast to the US and UK, the European Union is a laggard in audit supervisory reform with essentially no EU level oversight and powers – and with a regulator in the largest economy in the European Union with demonstrably weak supervision and conflicts of interest.

Again, our recommendation is that the European Commission undertake a review of member state audit regulators and the CEAOB – similar to the UK Kingman Review – and that such review include making recommendations for improving the supervision of audit and establishing a pan-European audit regulator. Overall, we believe something more akin to ESMA – but with stronger, enforcement powers on an ex-ante and ex-post basis – is needed related to audit supervision.

Additional Areas of Improvement – We believe all the items articulated in **Question #17** of the Consultation would be both highly effective and efficient at improving statutory audit supervision as we note below:

a. *Independent & Appropriate Resources* – Numerous media reports identify the lack of independence, quality, and number of audit supervisory resources as a significant contributor to the lack of quality audit supervision. Consolidation of efforts could increase quality, resources, and efforts.
b. *Transparency of Supervisors* – The lack of transparency of the member state audit supervisors is a problem observed by auditors, investors and the media. This is also evidenced at CEAOB by simple review of their website. Transparency is one of the first principles of audit quality. Without it the quality of the credence good will never be assessable.
c. *Consistency of Cross Border Supervision* – We believe a pan-European audit supervisor would be best placed to ensure consistency of cross-border supervision.
d. *Ensure Supervision of Audit Committees* – As we note in **Part II** of the Consultation, we support enhanced regulatory oversight/supervision of audit committees.
e. *Harmonize & Strengthen Investigation & Sanctioning of Audit Supervisors* – We support pan-European level legislation to ensure convergence of statutory audit supervision. We believe a pan-European organization is the most effective mechanism to support strength and harmonization.

f. *European Level Instruments to Ensure Convergence of Statutory Audit Supervision* – We support a European level legislation (regulation) to ensure convergence of statutory audit supervision.
g. *Grant a European Body Right to Register & Supervise Statutory Auditors and Audit Firms* – As in other jurisdictions we would support such an initiative.

Part V – Supervision and Enforcement of Corporate Reporting

Perspectives on Corporate Reporting Supervision – Strength in corporate reporting processes and controls at the company level as we describe in **Part II** of the Consultation and at the supervisory level are particularly important given the principles-based nature of IFRS. As a former member of the IFRS Interpretations Committee – given the limited detail, access, and powers ESMA has – I directly, as an investor and user of financial statements, observed that ESMA brought some excellent issues associated with inconsistencies in the application of IFRS to the IFRS Interpretations Committee (IFRS IC). Like investors, ESMA – at times – was the only one at the table who had an external perspective on the usefulness of financial statements across the European Union and what the end product of IFRS was actually bringing to users of financial statements and corporate reports. The IFRS IC did not, unfortunately, always address these issues.

We believe the establishment of the ESEF and the ESAP has the potential to significantly increase the ability of EU level oversight of corporate reporting and auditing. As users of tagged data tools and the ability to search across all public companies – in the US, for example using CalcBench – there are immeasurable benefits to having the data tagged and collected in a single source across the European Union. This type of EU-wide effort enhances the concept of the capital markets union. You will note that CFA Institute recently commented to the IASB about their proposed changes to disclosure principles that we believe will deter comparability and usefulness of ESEF and the ESAP.

ESMA's formation has been very effective at bringing an EU-wide perspective and vantage point to the quality of corporate reporting. A similar EU-wide vantage point is missing as it relates to audit supervision as noted in our response to **Part IV** of the Consultation. That said, ESMA lacks the access, strength of supervision and enforcement powers that are necessary to really effectuate the enforcement necessary to improve corporate reporting. The situation with Germany's Financial Reporting Enforcement Panel (FREP) in the wake of the Wirecard scandal highlights the lack of ability of ESMA to bring change on an ex-ante basis – when it is most needed. The published news accounts suggest it was well known that FREP lacked the resources and capabilities to execute its necessary duties. Even on an ex-post basis ESMA, when asked by the Commission to look at the Wirecard issue, can only observe and comment on changes needed but cannot bring them to bear. In that regard, we believe improvements to strengthen ESMA are necessary. Supervision by its nature is an ex-post activity, and it is an important backstop, but much of supervision's efficacy depends on public displays of enforcement to act as an effective ex-ante deterrent. That is why we believe changes are necessary at the ESMA level to provide greater supervisory and enforcement powers to ESMA.

Suggested Improvements in Supervision: Mostly National, Not Our Preferred Approach – We believe all the Items (A) to (H) articulated in **Question #19** to the Consultation, and listed below, would be important in improving the quality and the reliability of corporate reporting.

a. Clarify Roles and Responsibilities of National Authorities
b. Improve System of Exchange of Information
c. Strengthen Rules on Independence of National Authorities
d. Increase Resources of National Authorities
e. Increase Powers of National Authorities
f. Increase Cooperation Between National Authorities
g. Increase Transparency on Conduct and Enforcement Activities by National Authorities
h. Strengthen the Role of ESMA on Corporate Reporting

That said, while we believe Items (A) to (G) listed above can have impact, they will result in a fragmented approach as they are focused on national authorities rather than an EU-wide approach that is cohesive and consistent. We would need to be convinced, given Wirecard, how more power at the member state level with national authorities is the best approach. As we highlight above, we believe an EU-wide level approach that strengthens ESMA is a better approach to ensuring there is a coordinated, well-resourced, consistent, more transparent, independent approach to corporate reporting supervision. We believe strengthening the powers of ESMA (Item H) on the enforcement of corporate reporting would be the most effective and have powerful ripple effects back to national authorities. It also provides a stronger balance of power and independence to the national authorities by providing accountability outside of their respective jurisdiction. This is also our preferred approach because we believe it will provide investors with the confidence to compare companies across the European Union, reduce the cost of capital and facilitate the capital markets union.

We also believe it is essential that the cost of national vs. a European Union wide corporate reporting regulator be assessed – and an assessment be made of whether ESMA is sufficiently funded – such that sufficient resources are deployed – and economies of scaled gained through ESMA.

APPENDIX B

CONSULTATION RESPONSE CONSIDERATIONS

Questions 2, **7**, **9**, **10**, **14**, **15**, **17** and **19** of the Consultation all address the efficiency and cohesiveness of the regulations underlying the questions to which they relate. We would make the following overarching observations:

1) ***Effectiveness and Efficiency*** – We would observe that:
   a) Many stakeholders (e.g., management and auditors) have limited experience to comment on the effectiveness of a particular rule as they do not bring to the Questionnaire the perspective of those for whom the rule, or corporate reporting, was created – investors.
   b) Those same respondents have very strong views regarding efficiency – which they generally define at the direct time or money they employ in applying the requirements – without the experience to balance that perspective with effectiveness or an understanding that investors – those who ultimately bear the cost of application – are willing to pay for such regulations.
   c) They – and regulators – don't always understand and don't tally the cost of not providing the necessary information or assurance to investors. Specifically, they don't tally the equity risk premium and increased cost of capital applied by investors when deploying capital in company's and in jurisdictions where lower quality reporting exists.

   An example of how this effectiveness vs. efficiency equation is not appropriately balanced is in the requirement for management certification, and auditor attestation, of ICFR. In the UK and the European Union there is no such requirement with many (i.e., management and regulators at their behest) abstractly (i.e., without study of the cost) tallying the cost of ICFR and saying it cannot be worth it. What this analysis fails to recognize is that:
   a) such an approach (i.e., failure to do ICFR) increases the cost of capital for companies in these jurisdictions relative to, for example, the US;
   b) investors – not management or the company – bear such cost; and
   c) investors are willing to pay for such work as their effectiveness vs. efficiency analysis also includes the cost at which capital will need to be deployed.

   Our responses incorporate a definition of efficiency that considers both the cost of applying the regulation and the cost of capital. We have sought greater transparency on costs, such as audit fees, such that as investors we can best balance the cost of compliance with the cost of capital.

   We highlight this issue as we believe throughout the Questionnaire, there is an asymmetry in this analysis – and that the number of respondents in a particular category may skew the weighting of the results.

b) ***Coherence*** – As with efficiency, the notion of coherence is not only a numerical query response on certain questions (e.g., **Questions 2**, **7**, **10** and **15**) it is also included in the open-ended (e.g., **Questions 2.1**, **7.1**, **11** and **15.1**) qualitive commentary section. We note that the term coherence is not defined in the consultation. This term could be defined as coherence of the EU level legislation (regulations/directives) with each other in a particular pillar or across pillars; coherence regarding integration of the EU level directives in the respective jurisdictions; or coherence in their application in the respective jurisdictions. As such, more specificity on the definition of coherence would be useful.

   Further, we believe it is necessary for the European Commission as it pursues further work on harmonizing legislation across the EU – and in making queries in consultations such as these – to provide a matrix that shows the key elements of the legislation they are referring to and the differences in their application by jurisdiction. Specifically, as it relates to this Consultation, we believe that there needs to be a specific articulation of the elements of the pillars of corporate governance, statutory audit,

audit supervision and corporate reporting supervision that are seen as most important to the corporate reporting and audit quality ecosystem such that stakeholders have a complete cross pillar view of the regulatory landscape and the application in EU jurisdictions. This insight is necessary not only for stakeholders but also for regulators and legislators as they make decisions to ensure the key elements of corporate reporting and audit quality and their application are fully understood by lawmakers.

c) ***Investor Respondents*** – We would also highlight that weighting the numeric responses – without consideration of the limited number of investors responding to the Questionnaire has the effect of skewing the results toward those with the greatest number of respondents, which will always deter the results away from investors/users – those for whom the regulations are meant to serve.