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An effective internal control environment for EU filers: does it lead to greater protection of capital-market stakeholders?

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Background

Recent high profile corporate failures and scandals in Europe have damaged the public's confidence in both the quality of financial information and in the transparent functioning of capital markets. In many cases, these failures have been attributed to inadequacies in the corporate internal control environment.

Existing EU legislation requires an entity whose securities are traded on an EU regulated market to include, in its annual financial reporting, a corporate governance report describing the key aspects of its internal control and risk management systems pertaining to financial reporting. Individual Member States may set more extensive requirements and national legislative frameworks cover a wide range of different approaches. These factors have contributed to an EU debate over the need for a more consistent and stronger approach to legislation governing corporate internal controls in Member States.

In this context, in November 2021 the European Commission (EC) published its Consultation Paper 'Strengthening of the Quality of Corporate Reporting and its Enforcement'. It seeks views on whether and how to strengthen the three pillars of high-quality and reliable corporate reporting: corporate governance, statutory audit, and supervision both of auditors and companies, acknowledging their key importance for healthy financial markets, business investment, and economic growth.

Deloitte views

We believe that high-quality and reliable corporate reporting, including future sustainability information, is of paramount importance for both capital markets and society in Europe. It helps protect stakeholders against unexpected corporate failures, channels finance to strong, sustainable businesses, and encourages cross-border investments. Internal controls that are effectively designed, operated, and maintained, with appropriate oversight, are fundamental to high-quality corporate reporting.

To this end, we welcome the EC's holistic approach, which aims to address possible shortcomings in the corporate reporting ecosystem. We support evidence-backed and proportionate changes to EU legislation in the three pillars (corporate governance, statutory audit, and supervision both of auditors and companies), to help safeguard the long-term sustainability of enterprises and improve the reliability of corporate reporting.

The primary responsibility for the quality and integrity of corporate reporting rests with the company's management and board. Consequently, management should design, implement, and maintain effective internal controls over corporate reporting, as well as assess their effectiveness, under an established, reliable, and well-understood internal control framework aligned to the key risks in the entity's business model, including a focus on the risk of fraud and going concern. In this context, enhanced requirements for management to publicly assess the proper design and the operating effectiveness of the company´s relevant internal procedures and controls are key to greater reliability of financial reporting.

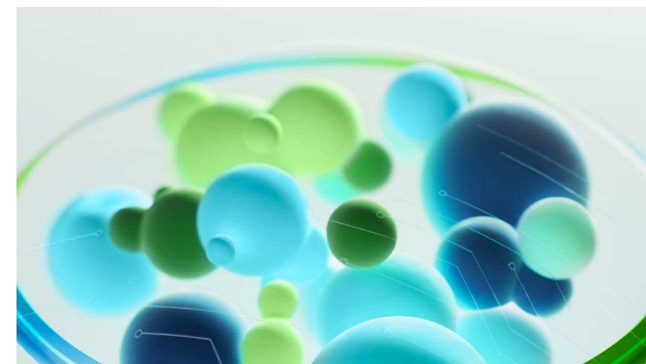
External auditors are responsible for delivering audit services with quality and integrity, in accordance with appropriate standards. Later in this article we refer to research that shows:

- The external auditor's ability to conduct a high-quality financial audit would benefit from an increase in the quality of the internal control environment of the audited company and the effectiveness of the company's corporate governance
- High quality external audits of the system of internal controls pertaining to financial reporting benefit the quality of the overall information in financial statements and increases the entity's focus on their control system.

Therefore, we support EU legislative proposals that: i. require the auditor to audit the design, implementation, and operating effectiveness of relevant internal controls, and; ii. set standards to issue an associated assurance report.

In addition, we believe that any future developments that will further contribute to audit quality and the value that an audit provides, will also increase the attractiveness and credibility of the audit profession, which in turn will help it provide enduring support to capital markets.

Changes to the EU's legislative framework should be scalable and proportionate. We recognize that designing and maintaining effective internal controls can be more challenging for smaller companies, so the legislation could exclude smaller issuers in the initial phase, with the option to change the threshold at a later stage. Smaller listed companies could, of course, elect to report on the effectiveness of internal controls and obtain an auditor's assurance too, on a voluntary basis.



Technical insights

An optimal EU's legislative and regulatory framework comprises the following components:

Internal Controls Framework	A suitable Internal Controls Framework would be: – Reliable and well-established for the proper design, implementation, operation, and maintenance of internal control over financial reporting – Applicable to listed companies though scalable and proportionate to the entity's reporting risks that may be influenced by the dimensions of the issuer – Suitable and well-recognized, i.e., established by experts using due process, including the broad distribution of the framework for public comments. One of the most frequently used is the framework established by: i. the US Committee of Sponsoring Organizations of the Treadway Commission (COSO) and, ii. the UK Financial Reporting Council's 'Internal Control: Guidance for Directors on the Combined Code'.
Management's Assessment of Internal Controls over Financial Reporting	An enhanced regulatory framework should require the management report to include management´s assessment of the proper design and the operating effectiveness of the relevant internal procedures and control structure over financial reporting, including the internal controls designed and conducted to assess and mitigate fraud and going concern risks. Such a framework should: – State management's responsibility for establishing and maintaining adequate internal controls and procedures for financial reporting – Describe the framework used for the assessment – Assess that internal controls over financial reporting are properly designed and have operated effectively (including disclosure of any deficiencies in such internal controls that comes to its attention) – State that appropriate actions are taken to correct identified deficiencies, and estimate timeline for remediation – [if legislation also provides for auditor's assurance on internal controls] State that the independent auditor has attested to, and reported on, management's evaluation of the company's internal controls over financial reporting. Management should ideally be requested to assess the company´s internal controls as of the financial statements' period-end date, as this approach represents a fair balance regarding the level of confidence offered to the stakeholders and the incremental costs over the implementation and maintenance of the internal control system. Also, this approach would provide management with the ability to remediate deficiencies identified during the year, with no impact on the disclosures included in the financial reporting. Management should also be required to disclose any material changes to the internal control structure that occurred during the interim periods in any mandatory interim financial reporting. Ideally, the assessment should be signed by both: (i) the company´s principal executive officers, and (ii) the principal financial officers or persons performing similar functions.

External auditor's assurance	Deloitte supports legislation for external auditors to:
	– Plan and conduct audit procedures on the proper design, implementation, and operating effectiveness of relevant internal controls designed and conducted by management to assess and mitigate financial reporting risks; including those related to fraud and going concern.
	– Issue an assurance report
	  ▪ separate from the auditor's report on financial statements to attest to the effectiveness of the company's internal controls
	  ▪ setting out identified deficiencies (or a combination thereof) in the internal controls such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented or detected on a timely basis
	  ▪ disclosing any material error in financial reporting identified by the auditor, or prior year restatement, that – based on the auditor's judgment – were caused by or remained undetected due to deficiencies in internal controls.

The current European debate

The chart below gives an overview on some of the European jurisdictions presenting more advanced legislative and regulatory frameworks applicable to internal control over financial reporting for listed entities.

Current EU landscape: Limited regulatory provisions within the current EU legislation with respect to the establishment of effective shared rules on internal controls exist. The European Commission issued its Consultation Paper "Strengthening of the quality of corporate reporting and its enforcement" in November 2021, seeking views on whether and how to strengthen the three pillars of corporate reporting: corporate governance, audit, and supervision (of both reporting entities and auditors).

France: The Financial Security Act of 2003 extended the scope of the Chairman's report on internal control and risk management procedures implemented by companies making public offerings, to include details about procedures relating to financial reporting for the parent company financial statements and, where appropriate, the consolidated financial statements.

Spain: CNMV (Spanish securities markets regulator) - Circulars require listed companies to provide annual information related to risk management and internal control systems in connection with the financial reporting process, including: i. entity control environment; ii. risk assessment of financial information; iii. control activities; iv. information and communication; v. monitoring of the operation of the system; vi. other relevant information; vii. external auditor´s report (if any); and viii. a response to Good Governance Recommendations (i.e., required disclosure over the degree of compliance with the "good governance recommendations" provided by the CNMV). Companies may also request the external auditors to perform "agreed upon procedures", and issue a report thereof, on the above information they stated. In this case, auditors would typically confirm that they read the information prepared by management, they questioned management on that information and that no exceptions were identified

Netherlands: The Netherlands Corporate Governance Code - applicable to Dutch issuers, based on the "*comply or explain*" principle -contains provisions aimed at defining responsibilities for long-term value creation, risk control, effective management and supervision, and the relationship with stakeholders, including the management board responsibility to monitor and review all material controls (financial, operational and compliance). The Dutch government and the Dutch audit sector commissioned reviews into the "future of audit" in 2018-2020 including corporate governance. Findings include that:

- there is added value in a so-called 'in-control' statement by the board, to be assured by the auditor
- there seems to be no doubt in the public debate about the responsibility of management board for internal (financial) control and reporting. The fact that this responsibility can also be made explicit is also not widely challenged
- there is sufficient reason (though further research is required) for the Netherlands to set stricter standards requiring management board to declare and substantiate that the company's internal risk management and control systems have functioned properly, and auditors to assure such a statement.

- Regulatory framework requires no assessment of the ICS effectiveness
- Regulatory framework requires management's assessment on ICS effectiveness
- Regulators framework requires management to disclose the internal controls review process
- Non-responding countries
- Countries outside the survey's scope

Greece: The 2020 Hellenic Capital Markets Commission ''HCMC'' resolution no. 1/891 (in reference to Greek Law 4706/2020 governing *Societes Anonymes*) requires the introduction of a periodic (every three years) ''evaluation'' of the system of internal controls of the entities under the HCMC jurisdiction. The evaluation is to be carried out according to 'best international practices', including ISAs, the International Professional Practice Framework of the Institute of Internal Auditors, and the Internal Control Intergraded Framework of the COSO Committee. The 'evaluators' should submit their report reflecting their conclusion and summarizing findings and results depending on the relevant reference framework-standards they used regarding the adequacy and effectiveness of the system of internal controls. The report must include their evaluations of risk and the resulting ramifications of such risk, as well as the entity's management responsiveness to the reported findings and their remedial actions. and the timeframe of their completion.

Germany: The German Act to Strengthen Financial Market Integrity (FISG) of 2021 introduced relevant changes to legislation over corporate governance and internal controls; among others:

- The supervisory board of German stock companies that are of public interest shall be strengthened in its powers and required to establish an audit committee
- Listed companies have to establish and maintain effectively operating risk management and internal control
- The Stock corporation act ('AktG') requires:
- Listed companies to have an early risk warning system
- Auditors to verify the effectiveness of the early risk warning system

There is no requirement for management to disclose an assessment of internal control, neither is there an auditor's duty to attest on ICS effectiveness. However, to facilitate a voluntary assessment of internal control by an independent auditor, as a basis for the supervisory board's supervision, German auditing standard IDW AuS 982 was issued in 2017.

Italy: Law no. 262/05 ('Savings protection law') requires management (both the officer delegated by the Board and the manager responsible for the preparation of the accounting documents) to provide written assessment on the adequacy of the entity's procedures and internal controls for the preparation of financial information issued to the market. There is no requirement though for an external auditor's assurance on the internal control system.

Also, Decree no. 231/2001 encourages companies to systems adopt broader corporate governance structures and risk prevention (defined as "organizational model") to prevent executives from committing crimes. Though broadly adopted, its application is voluntary.

The UK: Current regulations regarding internal controls reporting in the UK come under the 2018 UK Corporate Governance Code issued by the Financial Reporting Council (the Code), which applies to Premium listed entities.

The Code requires the Board to explain the process for their review of the effectiveness of the risk management and internal control systems, rather than comment on the outcome of the review.

On 18 March 2021, BEIS issued its white paper setting out the UK Government's proposals to respond to over 150 recommendations arising from the independent reviews commissioned to Sir John Kingman (2018) and Sir Donald Brydon (2019). With regard to exploring options for attestation on internal controls, the paper sets out a tentative preferred option which:

- would require Company directors to carry out a review of the effectiveness of their company's internal controls each year and make a statement as to whether they consider them to have operated effectively. The statement should disclose the benchmark system used and explain how the directors have assured themselves that it is appropriate to make the statement
- would leave the decision on whether the statement should be assured by an external auditor to the directors, audit committee, and shareholders.

In this context, the relevance of taking a stronger and more consistent European approach to governing corporate internal controls, is also supported by recent academic studies. Among others, it is worth citing:

- The 2021 study 'Introducing an internal control statement' conducted by the Leiden University - following a recommendation by the Dutch Ministerial Committee - on the future of the accountancy sector. The research focuses - inter alia - on how to encourage the responsibility of audited entities for the design and operation of the governance, risk management, and control processes in the context of annual reporting and auditing. To this end, key proposed interventions are:

  i. Introduction of a legal requirement for a Risk Management statement. The board should explain whether and to what extent the entity has effective and adequate risk management and control systems for operational, compliance, and reporting risks. This declaration may be issued: a) as a specific part of, or as an annex to, the management report; or b) by electronic means by which the declaration is directly and permanently accessible.

  ii. Development of a framework of standards by a commission representing relevant stakeholders.

  iii. Auditors may issue an assessment statement on the Risk Management statement, and a framework of standards should also be developed for this. By prescribing such a statement, the quality of the internal risk management and control systems would improve and therefore the quality of the audit increase.

- The 2020 study 'Internal Control Quality and Audit Quality' conducted by academics at the Ludwig Maximilian University of Munich and the University of Amsterdam providing an overview on the association between effective internal controls (IC) and audit quality (and fees), and on the relevance of IC weaknesses in this space. The study suggests that:

  i. The quality of the IC system is an important input for auditors when assessing audit risk and planning audit effort, as high quality IC allow the auditor to rely on the results of IC procedures and to allocate audit effort on more urgent matters.

  ii. IC weaknesses, and their remediation, affects audit fees over time, i.e., audit fees premium paid in the presence of control deficiencies can remain even after the deficiency has been removed.

  iii. Despite auditors being generally able to reduce the risk of future misstatements upon detecting weaknesses in IC, some evidence suggests that weak IC still have a negative effect on audit quality.

The study concludes that literature on the consequences of weak IC for the audit shows that auditors are unable to fully prevent the negative results of IC material weaknesses (ICMW), i.e., while auditors adjust their effort, and have a positive impact on reporting quality when an ICMW is detected, the likelihood of financial misstatements remains significantly higher.

Why is SOX a relevant story?

The US Sarbanes-Oxley Act of 2002 (“SOX”) is a good example of a mechanism that features prominent and continued focus on internal controls after initial listings of public companies and illustrates how all participants of the corporate reporting ecosystem are linked and held responsible. SOX is focused on corporate and auditing accountability, responsibility, and transparency, and includes a strong emphasis on effective internal controls. SOX also provides protection for employees of publicly traded companies who provide evidence of fraud and prohibits companies from retaliating against employees who lawfully participate in an investigation or who file, or participate in, proceedings relating to fraud against shareholders. SOX has proven to be effective in improving the quality and integrity of financial reporting.

A strong internal controls regime:

- Reduces the frequency of restatements of financial information, improving financial reporting quality and reliability – The Center for Audit Quality (CAQ) notes a “decline in the frequency and severity of restatements [2003-2012]... in part [attributable] to improvements in internal control over financial reporting (ICFR) due to SOX Section 404 - ICFR assessment and reporting requirements”. Later studies show the number of total restatements was 484 in 2019, a steady decrease from over 800 in 2011, which highlights the continued impact of the regime. Also, a 2017 survey of CFOs conducted by the CAQ showed that 79% of CFOs felt that the overall quality of information in audited financial statements has improved since the enactment of SOX.
- Increases investor confidence in the capital markets – In the years following the introduction of SOX, the CAQ notes that 79% of investors expressed confidence in US capital markets, and 81% have confidence in investing in US public companies. An SEC study noted in 2009 that respondents recognized no effect of Section 404 compliance on: the company’s ability to raise capital, investor confidence in the company’s financial reports, the company’s overall firm value, and the liquidity of the company’s common stock. A Financial Executives Research Foundation (FERF) study found that 83% of large company CFOs agreed that SOX had increased investor confidence, with 33% agreeing that it had reduced fraud.
- Enhances fraud prevention and detection – Prevention and detection of fraud has proven to be a valuable cornerstone of the SOX regime. Studies have shown that in 2003 5% of the identified restatements involved fraud. By 2012 it was 1%. While this cannot necessarily be attributed only to the introduction of SOX, it is to be reasonably assumed that SOX has played a key role.

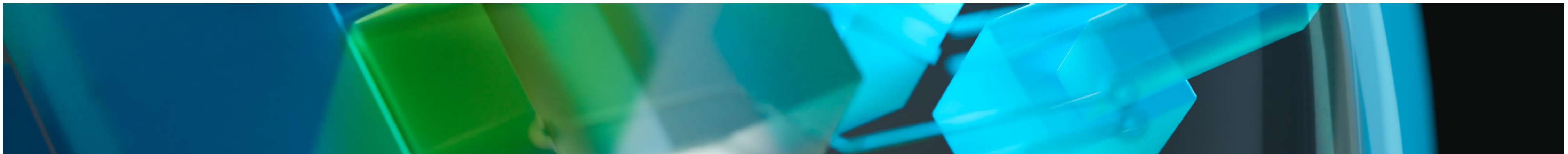
Also, a 2017 Prof Harris et. al. paper argues that the discovery of malfeasance and misstatements using stronger internal controls led to providing public transparency through restatements of financial information and that certain aspects of SOX have been effective in helping companies to detect fraud more easily and corporations have added internal controls and provided restatements of financial statements to demonstrate their commitment to compliance. Consistently, a 2014 University of Rochester study, investigating whether SOX helped combating fraud, found that internal control provisions of SOX reduced of 100 basis points the probability of fraud and increased investor protection.

- Provides also for an external auditor’s assurance on ICFR – Because of concerns about the cost of an ICFR audit, certain smaller and newly listed companies were exempted from the requirement under SOX 404(b) for an external audit of ICFR (although management must still assess and report on the effectiveness of the company’s ICFR). A 2009 Audit Analytics’ study found that companies that disclosed that their ICFR was effective, but did not have an audit of ICFR, had a 46% higher restatement rate than companies that disclosed that ICFR was effective and that did have an audit of ICFR.

In 2013 the US Government Accountability Office (GAO) found that 80% of all companies viewed audits of ICFR as beneficial to the quality of the company’s controls. This is consistent with an American Accounting Association study published in 2017 which concluded that an audit of ICFR provides “an early warning system” for company fraud. Also, a 2014 US academics study (Universities of Kentucky and Louisiana Tech) of the seven-year period from 2007-2013 found that companies subject to ICFR audits experienced higher valuation premiums and credit ratings, and thus overall lower costs of debt. Regarding improvements over time, a 2017 Audit Analytics’ research found that in 2004 (the first year of implementation) almost 16% of companies that had to comply with SOX 404(b) disclosed ineffective ICFR. This was down to just over 5% by 2015.

The GAO also mandated a study to examine the impact of an ICFR audit exemption on the quality of the financial statements which highlighted that: a) companies exempted from the requirement had more financial restatements than non-exempted; b) the majority of these restatements produced a negative effect on the companies’ financial statements; c) compliance with the auditor’s attestation requirement has a positive impact on investors’ confidence in the quality of financial reports; and d) with reference to costs associated with compliance, although they can be significant, especially for smaller companies, these costs have declined for companies of all sizes since 2004. Also, a 2021 Harvard University paper observes that, over time, the legitimacy of the initial criticisms of the act (suggesting that compliance would place severe financial burdens on many smaller companies and it would depress the IPO market) faded or failed to materialize. This is consistent with a 2014 Prof Coates paper which describes significant developments in how the Act was implemented over time and observes that, while the direct costs of the Act were substantial (particularly on smaller companies), costs have fallen over time and in response to changes in its implementation.

- Improves audit quality – A 2019 ‘The Accounting Review’ research article found that audit practice-offices with a large base of SOX 404(b) clients are more likely to identify and report material weaknesses (MWs) in a timely manner (i.e., before resulting restatements come to light) and to detect MW-related misstatements in a timely manner (i.e., before the misstatements become restatements).



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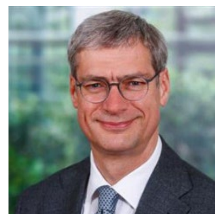

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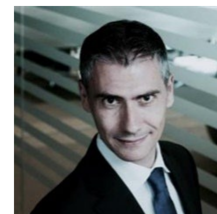

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