ACCOUNTANCY EUROPE.

VIEWS

STRONGER INTERNAL CONTROLS TO REDUCE CORPORATE RISKS

AUDIT & ASSURANCE

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HIGHLIGHTS

This publication recommends six actions to improve the corporate reporting ecosystem. All key parties, and their interactions, will need to evolve to more effectively mitigate the risks of corporate fraud and failures.

Robust corporate governance with stronger internal controls could significantly improve the quality of financial reporting. To achieve this, different parties in the ecosystem need to act: EU and national legislators, supervisors, and financial reporting & auditing standard setters.

One of our proposals is a mandatory public statement by companies on the effectiveness of internal controls over financial reporting which will help ensure that management and board are discharging their responsibilities. Having independent assurance by the statutory auditor on these controls would further enhance their reliability.

CONTEXT

Company's management and board are primarily responsible for establishing appropriate internal controls over financial reporting (hereafter: internal controls) and for managing risks such as fraud, going concern and non-compliance with laws and regulations. This responsibility includes preparing and fairly presenting the company's financial information.

Strengthening internal controls in an effective corporate governance framework is the most efficient way to improve the reporting ecosystem and mitigate corporate risks. Therefore, robust corporate governance and public reporting are preconditions to enhance the auditor's role on internal controls.

Corporate fraud and failures can cause serious harm to people, companies and the economy, eroding the public's trust in markets. Accordingly, companies should pay specific attention to fraud and going concern risks when designing and operating internal controls. Our recommendations below are further clarified in our publications on fraud and going concern (February 2021).

OBJECTIVE

This publication aims to address European Commission's (EC) consultation questions on listed companies' risk management systems and internal controls. We have already responded to this consultation to improve the quality of corporate reporting and its enforcement. We support this initiative and believe that all key parties in the financial reporting ecosystem (i.e., companies' boards and management, auditors, legislators, standard setters and regulators) and their interactions need to evolve.

We further specify our views, and propose a way forward, on internal controls. Such controls include policies and practices that help ensure reliable and timely financial reporting in compliance with applicable rules.

The actions we suggest focus on companies that fall within the three categories of public interest entities (PIEs) set at the European Union (EU) level: listed companies, credit institutions and insurance undertakings. For more details on the EU PIE definition and how the Member States have designated PIEs at national level, see the results of our survey from 2019.

ACTIONS TO REDUCE CORPORATE RISKS

EU AND NATIONAL LEGISLATION

Policymakers need to consider limiting the scope of companies affected when introducing any new requirement on corporate governance and reporting. They could focus only on the most important companies within entities designated as PIEs by the EU legislation (i.e., excluding the PIEs designated by the Member States).

Mandate an audit committee

Entities designated as PIEs by the EU legislation should have a separate audit committee with enough members competent in accounting and auditing. In the most important companies, an independent internal audit function and well-established whistleblowing structures should support the audit committee. Legislators should abolish provisions that allow the EU Member States to derogate from such requirements.

Mandate reporting on the internal controls' effectiveness

Effective and adequate internal controls are vital for the quality of financial reporting. Management needs to establish these controls as part of the corporate governance structure, and the board is responsible for approving and overseeing this structure. When designed and implemented properly, these controls enhance the reliability of the financial information that the company reports.

EU-level PIEs should be required to establish a system of internal controls for financial reporting and issue a public statement about its effectiveness. Such a statement would include, for example, details about how the company's risk management programs on fraud and going concern function.

Provided that such a public statement becomes mandatory, statutory auditors could be required to provide assurance on companies' internal controls.

Make early warning mechanisms for auditors effective

According to EU legislation, when auditors suspect irregularities, including fraudulent acts, they should inform the audited company and invite its management to investigate and take appropriate measures. If management does not investigate the matter, the auditor has to notify the authorities responsible for investigating such irregularities. Such 'early warning' is also required for information

likely to jeopardise the continuous functioning of the company. Under specific circumstances, the auditor has to notify the authorities before, or without, informing the company's management.

In many EU countries, it is unclear how, and to which authority, auditors should report for some types of PIEs. In addition, rules around confidentiality in some Member States create practical challenges for such reporting by auditors.

National legislation should specify the competent authority and the related procedures for auditors to issue early warnings. There should be a designated competent authority for all PIEs and clear guidance for auditors on how to comply with their legal obligations.

SUPERVISION AND STANDARDS

Supervisors to help improve and coordinate

The educational and remedial aspect of supervision needs to be enhanced, based on the results of root cause analyses performed by supervisors. Supervisory reviews and reports should always include information on what should have been done differently, i.e., constructive comments to help companies and auditors develop and improve. The coordination and cooperation between different supervisors (on reporting, auditing, securities markets, etc.) should also be improved and better interlinked.

Mandate going concern disclosure by companies even when there is no uncertainty

Financial reporting standards should introduce mandatory disclosure on the bases of management's going concern assumption. This should focus on the critical judgements made during the going concern assessment and should be required even when the company's management does not identify a material uncertainty.

Broaden auditors' area of consideration and communication

To respond to evolving market needs, auditing standards should require auditors to:

- communicate in the auditor´s report why they agreed with management's assessment of going concern and which procedures they performed to agree with this assessment
- report their work on fraud, and present related findings, to boards and audit committees, even when they have not identified any issue to consider as a 'key audit matter', or otherwise impacting their audit opinion

WAY FORWARD

The accountancy profession is open-minded to change and ready to contribute to the EC's efforts to enhance the corporate reporting ecosystem. We concur with its systemic approach, i.e., looking into corporate governance, reporting, auditing and supervision together. Accountancy Europe will provide evidence-based facts and constructive recommendations to further the debate on these pertinent matters.

The overall framework should become more coherent, ensuring that all parties play their role in promoting public trust in the markets, including the reliability of financial reporting.

Robust corporate governance with stronger internal controls could significantly improve the quality of financial reporting. To achieve this, different levels will need to evolve: EU and national legislation, the supervisory framework as well as financial reporting and auditing standards.

A mandatory public statement by companies on the effectiveness of internal controls over financial reporting will help ensure that management and board are discharging their responsibilities. Having independent assurance by the statutory auditor on these controls would further enhance their reliability.

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