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Sent to consultaties@nba.nl

Subject: Eumedion response to 'Consultation Practice Note 1137 Corruption, duties of the external auditor'

Reference: B23.17

The Hague, October 2, 2023

Dear Mr. Douma,

Eumedion appreciates the opportunity to comment on the Consultation Practice Note 1137, Corruption, duties of the external auditor ('Draft Practice Note'). Faithful transparency about corruption risks, incidents, anti-corruption policy, and its effectiveness is of great importance to institutional investors.

Corruption is an aggravated form of fraud

Corruption is more than just a crime, it undermines the business and investment climate of countries. It rewards and strengthens those individuals that unlawfully benefit and can even initiate the decline of states, or hinder the path to a healthy society. We are pleased that the Draft Practice Note recognises the negative impact of corruption on society and emphasises that corruption is not only occurring in distant countries but also closer to home.

Companies that knowingly undermine the healthy functioning of society through corruption can expect to lose access to capital from long-term institutional investors, regardless of the extent of the corruption. Additionally, the liability and reputational risks of corruption can be significant; so

significant that they can endanger the continuity of a business. For long-term institutional investors, there is no financial gain from corruption, even if it remains unnoticed. The destructive nature of corruption also negatively impacts many other companies in which institutional investors invest. Eumedion views corruption as an aggravated form of fraud and a destructive form of short-termism by companies that is at odds with sustainable, long-term value creation.

Eumedion therefore advocates a zero-tolerance approach by management and the supervisory board of companies towards corruption, regardless of its amounts, and we emphasize the importance of transparent reporting on this. The primary responsibility for external transparency lies with management. They, in consultation with and under the supervision of the audit committee, contextualise the reporting towards shareholders.

Reporting on corruption by companies is inadequate

However, we have found that when companies provide insights into their corruption risks and anti-corruption policies, these explanations often fall short of investor expectations. There is in particular a lack of clarity about the effectiveness of anti-corruption measures and about (signs of) incidents that have occurred. The external auditor (and the Practice Note of the NBA) has an essential role to play in this.

Numerous improvements in Draft Practice Note

We are pleased that the Draft Practice Note contains many significant enhancements. Corruption is now regarded as a form of fraud, rather than merely an instance of non-compliance with laws and regulations. This makes corruption risks rightly part of the mandatory fraud risk analysis. The Draft Practice Note also explicitly points out the gatekeeper role that external auditors have concerning corruption, including a hyperlink to a relevant disciplinary rulings against auditors.

Further refinements are needed

Eumedion believes that incidents and the actions of the management related to them should be reported diligently in the company's reports, and insight should be provided into the nature and quantity of suspicions and indications of corruption. Such information can be an essential indication that the management is (not) sufficiently alert to ensure that the anti-corruption policy is effective. Where management's reporting in this area falls short, we see a core task for the external auditor to clarify this in the auditor's report.

The Practice Note for the external auditor should not only lead to improvements 'under the hood' in the audit process and the effectiveness of the company's anti-corruption efforts but, in our eyes, is only complete if it will also substantially contribute to enriching investors' insight and justified trust in the reporting on the effectiveness of the anti-corruption policy.

In this context, we would like the Practice Note to be formulated differently in certain respects.

Corruption is qualitatively material

Although the Practice Note touches on the qualitative aspect of corruption, there is in certain cases a one-sided emphasis on the quantitative impact on the current financial statements that are to be audited. For example, in the following passage that deals with the identification of corruption risks, which is often the starting point of the audit:

“The greater the sensitivity of a transaction flow, account balance, or explanation for a material deviation - the more likely the deviation is.”

Furthermore, according to the Draft Practice Note, loss of reputation may only be material if it has consequences for items in the current financial statements:

“If the client does not comply with the law and regulations, for example by participating in corruption, this can result in a material deviation in the financial statements. Due to the threat of fines, damage claims, loss of reputation, and loss of turnover, a provision or adequate explanation may be required in the financial statements (Standard 250.19b).”

The Draft Practice Note does not preclude that the external auditor could continue to use the overall group's materiality threshold, which is too low a hurdle in our view:

“The external auditor must not only approach materiality in terms of figures but also take into account the qualitative aspects of materiality. [...] If the external auditor recognizes corruption risks, the external auditor considers whether a specific materiality level should be used that is lower than the materiality for the financial statements as a whole.”

Corruption is often a hidden cost item; its discovery and possible reclassification should not necessarily lead to a different net result in the past financial year. Some external auditors might conclude that therefore only the plausible prospect of a fine or the loss of an ongoing contract may lead to a material deviation. From an investor's perspective, indications that the anti-corruption policy does not seem to have been effective are material in themselves, and the company, and if not the company, the external auditor should report on this.

The Practice Note could specifically address the situation where the external auditor is the first or the only potentially plausible party to identify the risk or suspicion of corruption. In such a situation, it is not unthinkable that the corruption could continue for a long time if the external auditor would not intervene. The external auditor could conclude that the chance of a material deviation is limited as long as no internal control measures are taken. The Practice Note should ensure that the external auditor prioritises the public interest here. Slide 5 of chapter 4 in the Draft Practice Note seems counterproductive in this regard:

“This especially applies to shortcomings that the management does not address. See also Appendix 2 of Standard 315 on inherent risk factors (the susceptibility of an assertion to a deviation that may be material in itself or in combination with other deviations before considering any related internal control measures).”

The above examples of the quantitative approach in the Draft Practice Note, in our eyes, do not do justice to the significant impact of corruption on both society and the potential future negative

consequences for the company itself. The Practice Note should therefore approach the subject of corruption much more as qualitatively material.

All in all, Eumedion commends the NBA for consulting a Draft Practice Note that contains numerous substantive improvements. We also find the updated format of the Draft Practice Note refreshing; this layout should be considered for future NBA documents as well. We would like to point out that page numbering would be a useful addition.

Of course, we are available to further explain this letter if desired. Our contact person is Martijn Bos (email: martijn.bos@eumedion.nl, tel. 070 2040 304).

Yours sincerely,

Rients Abma

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