



31 October 2013

Our ref: ICAEW Rep 159/13

Your ref:

Ms Roxanna Damianov
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European Securities and Markets Authority
103 Rue de Grenelle
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Dear Ms Damianov

Consultation Paper *ESMA Guidelines on enforcement of financial information*

ICAEW is pleased to respond to your request for comments on *ESMA Guidelines on enforcement of financial information*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

ESMA GUIDELINES ON ENFORCEMENT OF FINANCIAL INFORMATION

Memorandum of comment submitted in October 2013 by ICAEW, in response to the European Securities and Markets Authority (ESMA) consultation paper on *Guidelines on Enforcement of Financial Information*, published in July 2013.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper *ESMA Guidelines on Enforcement of Financial Information* published by ESMA on 19 July 2013, a copy of which is available from this [link](#). We have taken the opportunity to restate our general views on the role of enforcers.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. ICAEW's Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

MAJOR POINTS

The role of enforcers: some general principles

5. As a starting point, we believe that enforcers around the world need to continue to explore ways of working together more closely, exchanging information and sharing experiences, to ensure an appropriate degree of consistent and coordinated enforcement of financial standards. However, an effective enforcement regime must be based on the operation of effective national enforcement bodies. They understand the specific requirements of the national regulatory framework and as a result are best placed to tailor their enforcement approach accordingly. Therefore whilst guidance designed to promote more consistent enforcement of financial information is welcome, European-level guidelines must pay due regard to the diversity of European markets and enforcement regimes.
6. Effective and proportionate enforcement activity underpins investor confidence in financial reporting by European companies. But enforcers need to be aware that by their actions and style, they may over time encourage the disclosure of immaterial items in financial statements or stifle the exercise of the professional judgement required to apply principles-based accounting standards. Avoiding these unintended outcomes should be a high priority for enforcement regimes.
7. Enforcers should avoid straying into the area of general interpretation of IFRS or the development of authoritative application guidance. Enforcers are important stakeholders in the financial reporting process, and their views should be heard at a European and international level when standards are under development. But enforcers often have a particular focus, not necessarily aligned with the interests of investors. They should have no particular influence over the determination of the detailed requirements of accounting standards for general purpose financial reporting.
8. Finally, we believe that a principal feature of an effective enforcement regime is timeliness. Guidelines on the enforcement of financial information should emphasise the importance of timeliness throughout the enforcement process, during procedures, actions, consultation on

accounting issues and decisions. Otherwise there is a risk of a protracted review process which delays the delivery of transparent financial information to market participants. If enforcement action means that a restatement is required, for example, it should be possible in terms of timing for issuers to implement this in the next set of annual financial statements.

9. We have made reference to these principles when assessing ESMA's draft Guidelines.

RESPONSES TO SPECIFIC QUESTIONS

Question 1

Do you think that the proposed guidelines will improve the quality and consistency of financial reporting in Europe?

10. We agree that the proper and rigorous enforcement of financial information can improve the quality of financial reporting and underpins investor confidence in the European single market. We therefore support efforts to develop high level guidelines to foster more effective enforcement, particularly in countries where enforcement may be less robust.
11. An effective enforcement regime must be based above all on the operation of effective national enforcement bodies. They understand the specific requirements of the national regulatory framework and as a result are best placed to tailor their enforcement approach accordingly. Thus in producing guidelines to promote consistent enforcement of financial information, ESMA must pay due regard to the diversity of European markets and enforcement regimes. A common principles-based approach should be sufficiently flexible for national enforcement bodies to select a suitable approach in keeping with their national regulatory framework. Too much emphasis on conformity could undermine the effectiveness of some national enforcement regimes, impose unnecessary change, discourage innovation or create uncertainty. ESMA should be confident that such unforeseen consequences will be avoided before it finalises the guidelines.
12. Enforcers should avoid straying into the area of general interpretation of IFRS or the development of authoritative application guidance. Enforcers are important stakeholders in the financial reporting process but often have a different focus, not necessarily aligned with the interest of investors. A clear division between the responsibilities of standard setters and enforcers is therefore of high importance. This is recognised in paragraphs 44, 72 and 73 of the draft guidelines; we think that these references should be elevated to the status of a bold-type Guideline.

Question 2

Do you have any comments on the potential costs to the financial reporting community of any aspects of these proposals?

13. We have no comments at this stage.

Question 3

Do you agree that a common European approach to the enforcement of financial information is required in order to avoid regulatory arbitrage by issuers? In this context, regulatory arbitrage refers to the position where an issuer's choice of the market on which to list its securities may be influenced by different approaches to enforcement being applied in different European jurisdictions.

14. We are not aware of any evidence to support the view that regulatory arbitrage is, or is likely to be, a widespread issue in the European single market. In our opinion, the decision by a company to relocate to another jurisdiction within the EU single market is more likely to reflect other factors, such as the pool and quality of investors.

15. We believe that further evidence should be gathered by ESMA, or published if it is already available, to demonstrate the extent to which regulatory arbitrage occurs in practice in the European single market. The question infers that companies may choose markets where enforcement is more lax; in our experience, however, a strong but proportionate enforcement regime is attractive to companies as it enhances their reputation and brand. As explained above, guidelines on the enforcement of financial information should clearly demonstrate how they will help enforcement bodies achieve a proper and rigorous enforcement regime within their own jurisdictions, and should be no more extensive than is strictly necessary. It is also important that they do not constrain or force unnecessary change on models of enforcement within the EU that already meet that standard and are widely acclaimed as successful.

Question 4

Do you agree with the objective, definition and scope of enforcement set out in paragraphs 11 to 21 of the proposed guidelines?

16. We agree that the objective of the proposed guidelines should be to ensure that the enforcement of financial information contributes to more consistent application of the relevant reporting frameworks and to the transparency of financial information relevant to investors' and other users' decision making processes. However, ESMA should recognise at the same time the importance of professional judgement in IFRS financial reporting; the focus on consistency should not stifle the exercise of the professional judgement that underpins the application of principles-based accounting standards. It should also not stifle innovation, particularly as annual reports are frequently criticised for length and complexity and, in the UK at least, companies are being encouraged to find better ways to communicate through restructuring the information in their financial statements, while still complying with the relevant standards.
17. We agree that the enforcement of financial information should be defined as examining the compliance of financial information with the relevant reporting framework, taking appropriate measures where infringements are discovered during the enforcement process and taking other measures relevant for the purpose of enforcement.
18. We support the scope of the proposed guidelines, which would apply to financial information in harmonised documents provided by issuers whose securities are admitted to trading, and by issuers who have applied for admission to a regulated market.

Question 5

Do you agree that issuers from third countries using an equivalent GAAP to IFRS should be subject to an equivalent enforcement and coordination system? Do you agree with the measures proposed to make this enforcement more efficient?

19. We agree that issuers from third countries using an equivalent GAAP to IFRS should be subject to an equivalent enforcement and coordination system, and are content with the measures proposed to make this enforcement more efficient.

Question 6

Do you agree that enforcers should have the powers listed in paragraph 30 of the proposed guidelines? Are there additional powers which you believe that enforcers should have?

20. We note that Article 24(4a) of the Transparency Directive states that 'each competent authority shall have all the powers necessary for the performance of its functions. It shall at least be empowered to require auditors, issuers, holders of shares or other financial instruments, or person or entities referred to in Articles 10 or 13, and the persons that control them or are controlled by them, to provide information and documents.' The powers listed in the proposed guidelines broadly reflect the relevant sections of the Transparency Directive.
21. However, we believe that further consideration should be given to the draft guidelines on the application of these powers by enforcers. The auditor has an important role in the drive

towards consistent application of relevant financial reporting standards, and it may well be appropriate for an auditor to be involved in the enforcement process. But we consider that direct contact between the enforcer and the auditor of an issuer over financial information prepared by the issuer is generally inappropriate. It is for management to provide the additional explanations and information required by the enforcer. It may be appropriate for ESMA to consider clarifying the guidance in this area by outlining the situations in which it considers direct contact between the enforcer and auditor to be appropriate.

22. Paragraph 33 of the proposed guidelines states that enforcers, in performing their function 'should have the right to require necessary information irrespective of whether a suspicion exists or not in relation to the issuer's financial information accuracy'. We are unclear why an enforcer should be entitled to require information from issuers and their auditors in the absence of any suspicion in relation to the accuracy of financial information, which could lead to unnecessary intervention where there is no basis for regulatory concern. This would grant significant powers of enquiry to the enforcer. We suggest that at the very least a justification should be required for any request for information by an enforcer and that appropriate parameters for such requests are included in the guidelines.

Question 7

Do you agree that enforcers should have adequate independence from each of government, issuers, auditors, other market participants and regulated markets? Are the safeguards discussed in paragraphs 38 to 41 of the proposed guidelines sufficient to ensure that independence? Should other safeguards be included in the guidelines? Do you agree that market operators should not be delegated enforcement responsibilities

23. We agree that an enforcer must be adequately independent from government, issuers, auditors, market participants and regulated markets. However, it is not clear how ESMA intends to monitor this requirement or how it would seek to identify enforcers which are not adequately independent. It might be beneficial to clarify this aspect of the guidelines.

Question 8

Are you in favour of enforcers offering pre-clearance? Do you have any comments on the way the pre-clearance process is described and the pre-conditions set in paragraph 42 to 45 are described?

24. In our opinion, pre-clearance is not the most effective use of resources, and generally is not desirable or necessary. However, we are aware that enforcers in some EU jurisdictions have well-developed pre-clearance systems and in these circumstances it is possible for an enforcer to obtain an enforcement decision before financial information is published. For this reason we agree that the guidelines should cover pre-clearance decisions to assist those national enforcement bodies that oversee such a system.
25. We note that in cases where pre-clearance is used, the draft guidelines require that the issuer has 'finalised' its position on the accounting treatment concerned. The explanatory notes then go on to state that the issuer and its auditor should have 'determined' the accounting treatment to be applied based on specific facts and circumstances. The rationale for this is that an ex-ante decision by an enforcer should be based on the same level of information as an ex-post decision and that it should not be treated as a general interpretation on IFRS.
26. While we accept that it is necessary to establish a formal process when obtaining a pre-clearance decision, the term 'determined' needs to be clarified in the explanatory note. This term could be interpreted to mean 'finalised', particularly when that is the term used in the bold text for draft Guideline 5. This appears to be contrary to the purpose of obtaining a pre-clearance decision ie, if the enforcer's decision is not in accordance with the issuer and its auditor but has no impact on the accounting treatment. One option might be to amend this term to be 'determined their tentative views based on the specific facts and circumstances'.

Question 9

Do you agree that in order to ensure investor protection, the measures included as part of a prospectus approval should be supplemented by additional measures of ex-ante enforcement in relation to financial information? If yes, could you please specify the exact nature of ex-ante enforcement that you would expect from enforcers?

27. We are not convinced that enforcement of financial information is a common factor for regulatory arbitrage by issuers within the EU Single Market (see our comments in paragraph 15 above) and we support maintaining the current approach of ex-ante approval, including the possibility of ex-post enforcement of financial information provided by prospectuses as a supplementary measure.
28. The prospectus approval process takes into account risks related to an issuer and matters around the issue of securities, for example in relation to the working capital statement. There is a limited timeline for prospectus approval, which allows for obvious inconsistencies to be picked up by the competent authority and corrected prior to prospectus approval. Additional enforcement measures would have a time and cost impact for issuers and additional scope implications for the competent authorities, in particular where the competent authority is comprised of more than one regulatory body.

Question 10

Do you agree that a risk-based approach to selection should not be used as the only approach as this could mean that the accounts of some issuers would potentially never be selected for review?

29. We agree that the selection model for enforcement should be based on a mixed model whereby a risk-based approach is combined with a sampling and/or a rotational approach. A purely risk-based approach to selection would likely result in some issuers never being subject to enforcement. Equally, a purely random or rotational approach may result in high risk issuers not being selected on a timely basis.
30. Paragraph 50 of the draft guidelines states that a possible trigger for selection by an enforcer would be an indication from the auditor of misstatements whether in reports or otherwise. However, we are not clear how an auditor would indicate misstatements other than in their report. It may be appropriate to clarify this point to avoid confusion.

Question 11

Do you agree that the risk-based approach should take into account both the risk of an individual misstatement and the impact of the misstatement on financial markets as a whole?

31. We agree that the risk-based approach should take into account both the risk of an individual misstatement and the impact of the misstatement on financial markets as a whole or on particular sectors.

Question 12

Do you think that a maximum period should be set over which all issuers should have been subject to at least one full review (or to be used to determine the number of companies to be selected in sampling)?

32. We agree that a maximum period should be set – at national level – over which issuers should be subject to at least one full review. We note that the proposed guidelines do not currently include any reference to the need for a maximum period or any guidance on how this may be determined within different jurisdictions. It may be necessary to provide some brief commentary on this issue.

Question 13

What are your views with respect to the best way to take into account the common enforcement priorities established by European enforcers as part of the enforcement process?

33. We understand that ‘common enforcement priorities’ relate to common accounting matters for enforcement identified by EU enforcers. The selection of priorities would be coordinated by ESMA and communicated to market participants in advance of the reporting period. Enforcers would then include these matters in their enforcement programme as areas for review and would report back to EECS with their findings and actions taken.
34. We agree that common enforcement priorities should be communicated by ESMA to enforcers for consideration during their reviews. But enforcement priorities will vary across different sectors and national economies; enforcers should always report back to ESMA, but should be free to adopt different enforcement priorities according to local circumstances. To give just one example, in some countries it is reasonably common for companies to have defined benefit pension schemes, information about which can often be material to a company's financial statements. Regulators in those countries may wish to focus therefore on defined benefit accounting issues. In other countries such pension schemes are rare or non-existent and a focus on the accounting for them would be pointless.

Question 14

Do you agree that the examination procedures listed in paragraph 54 of the proposed guidelines are appropriate for an enforcer to consider using? Are there other procedures which you believe should be included in the list?

35. We note that the examination procedures referred to in the draft guidelines as available in the enforcement of financial information include:
- Scrutinising the annual and interim (consolidated) financial reports, including any financial report published subsequently
 - Asking questions to the issuer, usually in writing, in order to better understand: the significant risky areas of the issuer, the significant accounting issues which arose in the year under review, how the issuer treated the significant accounting issues, and how the issuer's chosen accounting treatment complies with the relevant reporting framework
 - Posing questions to or having meetings with the auditors of the issuer to discuss complex issues or issues of interest, depending on the needs of the examination process
 - Identifying accounting issues inherent in the issuer's industry, available, for example, from the EECS database
 - Engaging external experts, where considered necessary, to assist in providing industry or other specialist knowledge
 - Exchanging information concerning the issuer with other departments within the enforcer, for example, where the issues may concern market abuse, takeovers or major voting rights
 - Engaging in on-site inspections.

The draft guidelines also indicate that the following procedures could be relevant as part of the examination process:

- Reviewing other relevant financial information made by the issuer
- Reviewing recent press articles and accounting commentaries concerning the issuer and its industry
- Comparing the issuer's financial reports to those of its competitors
- Comparing key financial relationships and trends within the issuer's financial reports, both in the year under review and for prior periods.

36. We have already noted our concerns about direct contact between enforcers and an issuer's auditor. We also have reservations over the reference to on-site inspections. It is not clear to us why an on-site inspection by an enforcer might be required as long as issuers are obliged to respond to all reasonable information requests. At the very least, appropriate parameters would need to be established in order to justify the need for such a procedure.
37. We believe that a principal feature of effective enforcement regime is timeliness. Guidelines on the enforcement of financial information should emphasise the importance of timeliness throughout the enforcement process, during procedures, actions, consultation on accounting issues and decisions. Otherwise there is a risk of a protracted review process which delays the delivery of transparent financial information to market participants. We therefore encourage greater reference to the importance of timeliness within the proposed guidelines. If enforcement action means that a restatement is required, for example, it should be possible in terms of timing for issuers to implement this in the next set of annual financial statements.

Question 15

Do you agree that, in determining materiality for enforcement purposes, materiality should be assessed according to the relevant reporting framework, e.g. IFRS?

38. We agree that materiality used for enforcement purposes should be assessed in the same way as that used for reporting purposes under the relevant framework.

Question 16

What are your comments regarding enforcement actions as presented in paragraphs 57 to 67 of the proposed guidelines? Do you agree with the criteria proposed?

39. We note that draft Guideline 9 states that when a material misstatement is detected, the enforcer should in a timely manner take one of the following actions:
- require a restatement;
 - require a corrective note; or
 - require correction in future financial statements with adjustments of comparatives, where relevant.

The draft guideline also states that where an immaterial departure is left intentionally uncorrected by an issuer to achieve a particular presentation of an entity's financial position, financial performance or cash flows, the enforcer should require its correction. It adds that where an immaterial departure from the reporting framework is detected but there is a significant risk that it might become material in the future, the enforcer should inform the issuer about the departure and where appropriate, based on the nature of the item, require a change in the accounting treatment in future financial statements without adjustment of comparatives.

40. We broadly agree with the actions set out in the draft guidelines. However, we believe that greater emphasis should be placed on the importance of enforcers taking action in a timely manner. In addition, they are unduly prescriptive in places. We also do not agree that immaterial departures left intentionally uncorrected should require correction. A departure from the relevant financial reporting framework which has been appropriately classified as immaterial should not require correction by enforcers. Indeed, enforcers should seek to minimise the number of restatements required; recourse to restatement should be a last resort for enforcers. Any other approach will tend over time to undermine investor confidence in the financial reporting framework and in the enforcement process.

Question 17

Do you have any comments on the specific criteria for the submission of decisions or emerging issues to the EECS database?

41. We agree that in the circumstances outlined in paragraph 74, discussion of emerging issues in EECS is desirable before decisions are made by the relevant national enforcer. But it should be acknowledged in the guidelines that the final decision is the sole responsibility of the national enforcer and that, in some circumstances, the need for timeliness may preclude ex-ante discussion in EECS.
42. We welcome explanatory notes 72 and 73 of draft Guideline 12, which clarify that the issuance of accounting standards and interpretation of their application is reserved to standard setters. As noted above, enforcers should not issue general application guidance on IFRS and should limit themselves to application guidance in individual cases, avoiding contributing to the development of a complex and diverse body of accounting literature.

Question 18

What are in your opinion appropriate activities that would help to achieve a high level of harmonisation of the enforcement in Europe?

43. We have no further comments at this stage.

Question 19

Do you have any comments on the transparency, timing and frequency of the reporting done by the enforcers with respect to enforcement actions taken against issuers?

44. We reiterate in this context our concerns about the risks of enforcers straying inadvertently through their reports into the areas of general interpretation of standards or application guidance.

Question 20

What are your views about making public on an anonymous basis enforcement actions taken against issuers?

45. We have no further comments at this stage.

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