Our Ref NJJ/AM
Your Ref ESMA

European Securities and Markets Authority

By email

11 October 2013

Dear Sirs

Consultation paper: ESMA Guidelines on enforcement of financial information

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Focus for a common approach

Grant Thornton is a founder member of the Forum of Firms and has long been a supporter of international standards in financial reporting, auditing and ethics. Consistent high quality implementation of those standards benefits from consistent high quality enforcement. We therefore welcome the consultation paper as a step towards an improved enforcement approach across the European Union (EU).

Not all member states have robust enforcement of financial information, so we encourage ESMA to focus attention, at least in the early years of the Guidelines, on the main building blocks for EU enforcement. The key areas for a common proportionate European approach which informs investor confidence in financial reporting are:

- balanced public reporting by the enforcer of its enforcement activity
- appropriately matching enforcement action against the proven breach, and
- financial statement examination procedures.

In our view, a common approach should remain at a relatively high level, to enable innovation in enforcement techniques and encourage sharing of good practice among enforcers. Accordingly, a common approach should describe what an enforcement body should do, but it should stop short of describing how those activities should be conducted. There will be marginal gains to investor confidence once a common approach starts to look at finer details of enforcement.
For example, we support enforcement bodies having a pre-clearance process. It is better to deal with issues before they become public. However, it should be left to individual bodies to decide how that process should be run.

**Focus on investor needs**
The Guidelines should reduce the references to "regulatory arbitrage by issuers". This is because in our view regulatory arbitrage is not a significant problem in practice in the EU at the present time (despite the differences in regulatory regime noted above). This objective also focuses on the issuer rather than the needs of investors. Issuers follow investors in that they issue shares in the jurisdiction where they believe they have the best chance of obtaining and retaining the best share price from that investor community. Issuers may also be inclined to issue shares in a country which is the focus of their operations. Even if regulatory arbitrage did exist within the EU it is immaterial compared to the more common situation where a company has transatlantic operations and/or investors and is considering listing either in North America or the EU. As it stands there is very little scope or incentive for regulatory arbitrage within the EU.

It is incumbent on all EU market participants to make the EU an attractive investment proposition to investors from within and outside the EU. Investor confidence will be sustained when enforcers take appropriate corrective actions, and where warranted when enforcers give due prominence to positive findings. Common proportionate enforcement across the EU will thereby foster pan-EU investment. Therefore the focus of the Guidelines should be on the level of enforcement which is required by investors. A focus on investor needs will guide enforcement activity only insofar as it is needed to bring benefits to investors. In contrast a focus on the issuer omits that control and therefore risks making a pan-EU regime more onerous than others outside the EU including more onerous than the US.

Yours faithfully

April Mackenzie
Global head – governance and public policy
For Grant Thornton International Ltd

T +44 (0)20 7391 9522
E april.mackenzie@gti.gt.com
Appendix – questions and Grant Thornton comment

Q1: Do you think that the proposed guidelines will improve the quality and consistency of financial reporting in Europe?

Grant Thornton comment:

We support all initiatives that will either improve the quality and consistency of financial reporting, or improve investor confidence in financial reporting (provided that the costs do not outweigh the benefits). We believe that enforcers can improve investor confidence by making public statements in context of overall quality. There will always be improvements which can be made, but public statements on improvements should refer to a relative degree of importance so as to maintain overall investor confidence where such confidence is warranted.

While consistent enforcement will benefit issuers and auditors we believe that the biggest benefits will accrue to investor confidence from transparency about what European enforcers are doing and enhanced understanding of the overall quality of financial reporting based on independent enforcement. Investor benefits will be maximised when enforcement is proportionate and public reporting is firm but balanced in telling investors where they have found weakness and where they have found strength.

There is a balance to be struck between tailoring an enforcement approach to the national environment, and common enforcement methodology. National enforcers will need to retain a degree of latitude within the guidelines to direct resources as they see fit. In questions 7 (enforcer appointments), 8 (pre-clearance), 12 (selection criteria), 13 (enforcement priorities), 18 (emerging issues and decisions) we make observations where we believe that the guidelines are unnecessarily detailed and to the potential detriment of national enforcement quality.

Investors need confidence that given a similar set of circumstances enforcers in one country will arrive at the same conclusion as another. The key areas for a common proportionate European approach which informs investor confidence in financial reporting are:

- public reporting by the enforcer of its enforcement activity
- matching enforcement action with seriousness of corrections, and
- examination procedures.

Q2: Do you have any comments on the potential costs to the financial reporting community of any aspects of these proposals?

Grant Thornton comment:

We do not have Euro cost estimates. We observe that any cost-benefit analysis must take account of the benefits to investors, who are the primary audience for financial reporting and financial reporting enforcement.

Q3: 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.
Grant Thornton comment:

We agree that a common European approach to investor protection is required, and a critical element of investor protection is the proportionate enforcement of financial information. ESMA appears to be concerned that issuers will gravitate towards jurisdictions which are perceived to have a relaxed approach to enforcement, and that this could harm investors. In our experience, from the perspective of the issuer, the risk of regulatory arbitrage is low because the jurisdiction decision is primarily influenced by where the issuer will achieve the best share price and liquidity. The emphasis or focus on eliminating regulatory arbitrage is at best a distraction, but could raise the cost of equity if it results in inappropriate guidelines or regulation. The best share price will generally be achieved in a jurisdiction which is supported by investors, and they will invest where there is a proportionate approach to investor protection.

A common European approach to some degree will be desirable, but as described in our answer to question 1 a common European approach in every detail puts enforcement quality at risk where that does not address risks arising at national level.

Q4: Do you agree with the objective, definition and scope of enforcement set out in paragraphs 11 to 21 of the proposed guidelines?

Grant Thornton comment:

The art of appropriate regulation is to balance cost with benefits. Too much regulation and the cost of equity will be raised by compliance costs which outweigh the protection benefits; too little regulation and the cost of equity will be raised by an excessive compensating risk factor. The risk factor applied by investors investing cross borders (and to companies of operating cross borders) will be minimised where jurisdictions implement appropriate common standards and those standards are subject to a proportionate common approach to enforcement.

The objective should clarify that enforcement targets financial information which is primarily relevant to shareholders.

We are concerned that describing an objective of enforcement as aiming to eliminate regulatory arbitrage (by targeting the issuer decision) will ignore the needs of shareholders and the impact of the enforcement regime on their cost of equity. Impact on cost of equity would guide policy makers to a proportionate and appropriate enforcement regime. This concern is apparent in the section on concept of enforcement which describes an absolute approach to correct financial information, as opposed to materially correct information.

On the scope of enforcement, only IFRS decisions need to be shared – national GAAP decisions will not have application elsewhere. We support the statement in paragraph 19 that the guidelines should apply only to regulated markets.

We note the objective in paragraph 11 of the draft guidelines refers to consistent application. Consistent application is a desirable attribute or objective but the role of consistency in a principle-based financial reporting framework is also a complex and multi-faceted issue. We believe that promoting compliance with the financial reporting framework should be the primary objective. Consistent application is a secondary objective that should be pursued to
the extent that it does not conflict with the principle-based nature of IFRSs and the need for reasonable professional judgement.

Q5: 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?

Grant Thornton comment:

Yes, and yes.

Q6: 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?

Grant Thornton comment:

We support the powers described in paragraphs 30a-30c. We have concerns about paragraph 30d which says "[enforcers shall have] the power to ensure that investors are informed of material infringements discovered and provided with timely corrected information", and paragraph 34 which refers to informing markets of "material infringements" and providing "corrected information".

We agree that regulators should have the power to enforce correction, but care is needed to differentiate between those errors which are so significant that they should be corrected when they are discovered, and those errors which may be corrected at the next scheduled announcement by the issuer. A goal of enforcement should be to sustain investor confidence where warranted, therefore reporting by the enforcer of restatements should be placed in context, and aiming to improve financial reporting over time. A system which requires continual updates of historical information draws investor attention away from new announcements and risks giving investors the unwarranted impression that financial reporting is not of the requisite quality. Some restatements are processed in the natural course of financial reporting, such as revisiting prior valuations at subsequent period ends, stock obsolescence and contingent liabilities.

Q7: 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?

Grant Thornton comment:

Yes, we agree that enforcers should have adequate independence from the stakeholders listed.

We support the safeguards on paragraphs 38-41, other than to observe that paragraph 40 could usefully expand on the meaning of "[undue influence] by members of the political system". For example, it would be appropriate for the government to request the enforcer to investigate an issue in the public interest, but it would be inappropriate for the government to influence how that investigation was carried out or the decisions taken.

We support a "code of ethics" for individuals involved in the enforcement process, and in addition we would support a code for appointments to the decision making body (board) of
the enforcer including nominations, appointment process, and board composition. However, this is an area where absolute conformity across Europe is not necessary, not least because the pool of potential enforcers will vary in depth and breadth between countries.

We agree that operators of markets should not be delegated enforcement responsibilities, other than to observe that consistent with the scope of enforcement described in paragraph 19 this should be applied only to operators of regulated markets.

Q8: 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?

Grant Thornton comment:

We support proposals which improve the quality of financial information before that information is made public. We believe that ex ante mechanisms in relation to periodic financial statements have some advantages and also some potential drawbacks. For example, pre-clearance mechanisms may alter the governance relationship between company management and the auditor and discourage the exercise of legitimate professional judgement. On balance, however, we are in favour of enforcers being able to offer pre-clearance. We make the following suggestions for a process of pre-clearance:

- should be part of a formal process
- a requirement for pre-clearance should not be imposed on enforcers because that will not be appropriate for all enforcers in all jurisdictions - pre-clearance should not substantially delay the announcement process, and not all enforcers will be resourced to offer pre-clearance on a timely basis
- the risk of abuse of the pre-clearance system by preparers should be mitigated if the enforcer is empowered to refuse to give pre-clearance where it believes the issue is addressed by the financial reporting framework
- to preserve transparency the pre-clearance decision should be made public once the company has published its financial information
- the risk of inconsistent pre-clearance decisions from different enforcers should be mitigated by a rapid consultation mechanism, although in recognition that enforcement remains a national responsibility the result of that consultation should be non-binding on the enforcer.

We note that the variety of practices and attitudes towards pre-clearance among national EU enforcement bodies is a significant area of difference in enforcement regimes. Such differences might continue for historical and practical reasons for the time being, but we support continuing efforts to agree on best practices and promote harmonisation over time.

Q9: 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?

Grant Thornton comment:

It is preferable to identify corporate reporting issues before the financial information is published. Accordingly we support ex-ante reviews of financial information, providing those reviews do not unreasonably delay publication of the prospectus. We believe that financial
reporting enforcement bodies should be able to strike the appropriate balance between protecting investors and timely publication.

Those reviews should be based on the information presented by the company from the perspective of an informed but not expert user.

To preserve national consistency of financial information enforcement, reviews of prospectuses (ex-ante reviews and ex-post reviews) should be conducted by the same body that conducts reviews of historical financial statements. This should also contribute to regulatory efficiency. We make this point because in some countries, ex-ante reviews of prospectuses are conducted by different regulatory bodies to ex-post reviews of historical financial information. In such countries we recommend that the relevant bodies come to a working arrangement, which is formalised in a memorandum of understanding.

We believe that ex-post enforcement of prospectuses is appropriate if at the time of ex-ante approval the approver did not have sight of material elements of the prospectus, or if the published prospectus was significantly different to the version which was submitted by the applicant for ex-ante approval.

**Q10: 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?**

**Grant Thornton comment:**

Yes. We support an approach that is primarily a mixture of risk-based and random selection. Selection of financial information on a rotation basis is appropriate if the issuer has not previously been selected on a risk-based or random basis.

A fourth method should also be utilised, which is to conduct a review of a specific area of reporting, for example retirement benefits, across a broad range of issuers. The specific area could be selected based on common findings on full reviews, new reporting areas such as revised rules for reporting on financial instruments, or anticipated areas where reporting is perceived to be at risk such as acquired intangibles in a period of economic growth.

Different economies will have strong representation from different industry sectors. National enforcers may wish to take a different selection approach to different sectors.

**Q11: 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?**

**Grant Thornton comment:**

Yes.

Paragraph 49 describes characteristics which should be taken into consideration when determining the probability of infringements, specifically "...the level of experience of the issuers' auditor with the relevant financial reporting framework...". Experience of the auditor is a contributory factor to the quality of a company's financial reporting. However, EU market participants are not always well informed on this matter and some mistakenly equate size to quality when some recent high profile cases of low quality reporting have involved large companies and the largest audit firms. Auditor oversight in some countries is still
reaching maturity and oversight reporting is not always transparent or balanced. We therefore urge caution in assessing the experience of audit firms, and where the enforcer is in doubt ask the audit firm to explain their IFRS credentials.

Q12: 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)?

Grant Thornton comment:

Yes, but the maximum period should be set at national not European level, because that period will be driven by a combination of available resources, how many issuers are covered by risk-based reviews, and assessment by the enforcer of the wider risks to reporting quality in the national environment.

Q13: 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?

Grant Thornton comment:

It is useful for enforcers in one jurisdiction to know the priorities of enforcers in other jurisdictions. We support discussions but not requirements for common priorities across the European Union, because enforcement priorities will vary across sectors and national economies. Enforcement priorities in a growing economy will likely be different to priorities in a struggling economy. Different economies will have different representation among industry sectors, and as noted in our answer to question 10 enforcers may wish to take a different selection approach for different sectors.

Q14: 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?

Grant Thornton comment:

Examination procedures should be one of the priority areas for a common European approach. This section of the guidelines would benefit from a degree of structure to reflect the step by step nature of a review of financial statements, including:

• discussions between the enforcer and if necessary the auditor before reaching a final conclusion on whether further investigation is needed (initial consideration)
• in reaching a final conclusion on whether a correction is needed (formal enquiry); and
• in reaching a conclusion on corrective action (see comments on questions 15 and 16)

Initial consideration: When an issuer’s financial statements have been selected for review a desktop review will be conducted by the enforcer. If, as a result of this review there is, or may be, a question whether the financial statements comply with the relevant requirements, then the enforcer should contact the issuer setting out the relevant issues and requesting further information. If there is no such question then the enforcer will carry out no further procedures. When the enforcer does make contact the issuer should be encouraged to consult their auditors and involve their audit committee. It may be that possible breaches or areas for improvement can be rectified without the need for further review or action.
Reviews of financial information should be desk-top reviews of the published document (or draft document if review is for pre-approval of a prospectus). On-site inspections are therefore not required. Discussions with the issuer and if necessary the auditor should be based on findings of the desktop review. Therefore Guideline paragraphs 54b, 54c, and 54g should be removed.

**Opening a formal enquiry:** Where the enforcer concludes that after initial enquiry there may be a case to answer as to whether the financial statements are defective in material respect and revision may be necessary then the enforcer should open a formal enquiry. If the enforcer is satisfied that no remedial action is required, or that no remedial action beyond that proposed by the issuer is required, then the enquiry should be closed. The enforcer should consider a press notice where the directors agree to take remedial action. If no press notice is issued then the fact that an enquiry was made should remain confidential.

The enforcer should aim to reach agreement with the issuer by persuasion. However if agreement cannot be reached but the enforcer concludes that the matter represents a breach of the relevant requirements then the enforcer may after due consideration have to utilise its powers to require the issuer to prepare revised financial statements.

**Q15: Do you agree that, in determining materiality for enforcement purposes, materiality should be assessed according to the relevant reporting framework, e.g. IFRS?**

**Grant Thornton comment:**

We agree that when reviewing financial statements an error should be assessed for "materiality" by reference to the relevant reporting framework. However, "material" and "immaterial" are not referenced in paragraphs 57-59 in this manner. For example, paragraph 59 states: "Where an immaterial error 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 for its correction". An error cannot be immaterial and require correction. An error that achieves a particular presentation is unlikely to be immaterial.

"Materiality" in the context of financial reporting can be either quantitative (by reference to the financial statements as a whole, or an individual balance) or qualitative (for example the sufficiency of narrative explanation). Therefore a material error (or omission) might be a material omission of information. Either way, materiality is often a matter of judgment and therefore there is no single right answer as to what constitutes a material misstatement, which in turn means that the Enforcement Actions described in the guidelines will need to allow enforcers flexibility when discussing with issuers and concluding on what if any corrective action is required.

There should be a distinction between material in the context of financial statements, and significance from the investors' perspective. The form of corrective action will depend on the circumstances of the case and cannot be assessed by reference to materiality of the error alone. The following among other factors will need to be considered:

- nature and effect of the defect in financial reporting by the issuer
- the need to protect users of the issuers' accounts
- the risk that a false market is operating in the issuer's shares by reference to defective financial information, and
- timing of the entity's reporting cycle
The default corrective action should be restatement with the agreement of the issuer in the issuer's next scheduled published financial report, unless there is reason not to do so.

Q16: 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?

Grant Thornton comment:

Enforcement actions is one of the priority areas for a common European approach. See comments on question 15.

The guidelines should include a provision that if an investigation into an issuer's financial report has been announced but the investigation concludes no action is required then the enforcer should announce to the market that the investigation is closed and no action is required.

If the enforcer issues a press notice where possible it should be issued at the same time as the issuer effects the corrective action. The issuer should be invited to comment on the draft press notice, which should summarise the issues in question, reasoning of the enforcer, and the corrective action taken by the issuer.

Q17: Do you have any comments on the specific criteria for the submission of decisions or emerging issues to the EECS database?

Grant Thornton comment:

Paragraph 74 states: "Enforcement decisions taken on the basis of an emerging issue should take into account the outcome of the discussion in EECS". It would be helpful to clarify that notwithstanding the outcome of the discussion in EECS, the final decision on a particular issue remains that of the national enforcer. Common decisions when faced with a common set of circumstances will be enabled by the EECS discussions, but the EECS outcome should not be binding on national enforcers. An issue should be elevated to EECS discussion at the request of an enforcer, but the enforcer should not be compelled to do so.

Q18: What are in your opinion appropriate activities that would help to achieve a high level of harmonisation of the enforcement in Europe?

Grant Thornton comment:

Increasing the level of harmonisation is an incremental process. The approach described in paragraphs 68 – 82 of the draft guidelines should in our view result in progressive improvements. That said, from time to time more urgent issues of high significance to EU markets can arise. Recent examples include certain aspects of accounting for sovereign debt, and the basis of determination of the discount rate for defined benefit post-employment plans. We encourage ESMA to consider whether additional protocols or procedures should be put in place to enable timely co-ordination in these situations.

Q19: 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?
Grant Thornton comment:

Reporting should be public, annual, and include common accounting matters towards the end of the calendar year so as to inform reporting for subsequent December year ends.

Q20: What are your views about making public on an anonymous basis enforcement actions taken against issuers?

Grant Thornton comment:

We support publication of individual decisions on an anonymous basis, because there should be transparency about the activities of enforcers and the decisions they are taking. This will inform investors, issuers and auditors but will also enable public debate about trends in reporting and enable debate about the quality of financial reporting in the EU based on transparency of enforcement activity.

We note that the publication of selected decisions from the EECS database also has an educational benefit. To maximise this benefit it is important that the extracts are clear and include sufficient details of the relevant underlying facts and circumstances. The objective should be to enable interested parties to evaluate how and why the decision was reached so that key messages can be applied in making accounting judgements in similar situations.