Dear Sirs

ESMA Consultation Paper, Guidelines on enforcement of financial information

On behalf of KPMG International we welcome the opportunity to comment on the Consultation Paper. We have consulted with, and this letter represents the views of, the KPMG network. We set out our general views below. Our responses to the specific questions raised in the paper are attached.

Generally we are supportive of a common European approach to the enforcement of financial information and believe this is important to create a common European understanding of IFRS. Such an approach will be particularly helpful in setting benchmarks for countries still setting up their enforcement of financial information. However, it must be recognised that harmonising the approach of enforcers across the EU will need continuing efforts, given that the various national enforcers operate in different jurisdictions, with different legal frameworks.

As well as sanctions and enforcement mechanisms, we consider that greater emphasis should be placed in these guidelines on the need for ESMA and other regulators to work with standard setters, preparers/issuers and the audit profession. We believe this will help in creating a consistent application of IFRS, a common European understanding of IFRS and agreement on the treatment of emerging issues.

We agree that enforcers of financial information need effective powers. However, we do not agree that the enforcer should perform on-site inspections of issuers as this would involve re-performing the work of the auditor – which is already subject to inspection by the appropriate audit regulator. In addition, the primary review object of the enforcers of financial information is the financial statements of the issuer and therefore the required information and documentation should come from the issuer and not from their auditors. Audit regulators already have access to the audit files as they perform their audit inspections of firms and individual audit engagements; we consider that enforcers should focus their investigations on
obtaining from issuers information about specific concerns about the issuer’s financial reporting for which they have definite evidence.

The Consultation Paper refers to regulatory arbitrage on a number of occasions and that this can be avoided by a common European approach. We are not aware of studies or other evidence that regulatory arbitrage between different jurisdictions in Europe regarding the enforcement of financial information is a significant cause for concern. There are a number of reasons why issuers choose to list in a particular jurisdiction, such as the depth and liquidity of the market or the tax or corporate governance regimes, but in our experience the regulator’s approach to enforcement of financial reporting is not one of them. Any claim that regulatory arbitrage is a real issue should be supported by independent research and the results published to inform the debate.

Finally, it is not clear to us what the consequences for national enforcers will be of not adhering to these guidelines, or how ESMA will report in a transparent manner on such non-adherence and on actions taken.

Yours faithfully

KPMG IFRG Limited

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Response to specific questions

Objective, concept and scope of enforcement

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

We support the objective of the guidelines of raising the quality and consistency of enforcement across all member states.

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

No comment.

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.

As discussed in our general comments, we are not aware of any studies or other evidence that show that regulatory arbitrage between different jurisdictions in Europe regarding the enforcement of financial information is a significant cause for concern.

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

We agree that paragraphs 11 to 21 of the proposed guidelines set out some aspects of enforcement, but greater emphasis should be placed on ensuring the quality and consistency of financial reporting in the first place. We suggest that the activities set out in paragraph 7 of the draft guidelines should be included in the objective, definition and scope of enforcement.

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?

We agree that effective enforcement should be applied to all issuers and that the proposed measures will help the competent authorities achieve a consistent level of enforcement across member states. We suggest that, where there is some debate as to which national enforcer’s jurisdiction an issuer comes under, there should be a mechanism to ensure that an enforcer is appointed so that an issuer is always answerable to one EU enforcer.

We believe that coordination between enforcers is always important, both with respect to IFRS and equivalent third country GAAP. We therefore encourage European enforcers to coordinate
also with their counterparts in third countries before reaching any conclusion. In addition, it
would also be important to agree on reciprocity from the third country enforcer with respect to
European issuers in that jurisdiction.

European enforcers

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?

We agree that enforcers should have most of the powers in paragraph 30. However, as the
primary review object of the enforcers of financial information is the issuer’s financial
statements, we consider that the relevant information and documentation should come from the
issuer and not from their auditors – who are subject to rigorous monitoring by independent
external supervisory bodies. In some countries there may be difficulties in auditors providing
such information because of client confidentiality requirements.

We also believe that enforcers should not carry out on-site inspections of issuers as this will
duplicate the work already performed by the auditors. Rather, they should ask issuers for
information to address the enforcer’s concerns. These should be specific to the issuer’s financial
information and should be based on proper evidence, not just general suspicions. This is also
important to control costs and to work efficiently.

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?

We agree that enforcers should be independent of the types of entity mentioned above, although
we acknowledge that the relationship with government is different from that with the other
bodies mentioned in paragraphs 38 to 40. There are a number of Ethics Codes dealing with
independence which enforcers could use as a basis for their own codes.

Enforcement activities

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
paragraphs 42 to 45 of the proposed guidelines?

Pre-clearance is established practice in a number of Member States and we therefore recognise
that the guidelines do not wish to prohibit it. However, there is a risk that pre-clearance will
preclude an appropriate discussion by all parties involved in preparing and auditing the issuer’s
financial statements (management, audit committee and auditor) and may undermine the
responsibility of issuers and auditors to apply their own professional judgment. On the other hand, in jurisdictions that use pre-clearance, the mechanism is recognised as useful, at the initiative of the issuer and the auditor, under the conditions described in paragraph 44. On balance therefore, while we do not favour systematic pre-clearance of issuers’ annual reports and accounts, we recognise that it can be useful in special circumstances to clear up specific accounting issues.

If pre-clearance is offered, we strongly agree with ESMA that it should be a pre-requisite that the issuer and its auditor should have determined the accounting treatment to be applied before seeking pre-clearance.

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?**

Although enforcers normally pre-approve prospectuses, this focuses more on compliance with the requirements of the Prospectus Directive than on the compliance of the accounting information with the relevant reporting framework. It is not clear what exactly enforcers do to arrive at their decision specifically in relation to the historical financial reporting information included in a prospectus and it would be helpful if more information were made public about this pre-approval process. However, we are not convinced that a full review of all the information is required to ensure investor protection. If enforcers decide to supplement their current procedures with additional measures, we observe that this will require the enforcer to increase their in-house expertise in financial reporting and may mean that the pre-approval process will take longer.

10. **Do you agree that a risk-based approach for selection methods should not be used as the only approach?**

We agree that the approach should primarily be risk based. However, this should not be the only criterion – enforcers need to cover a selection of financial information across all market sectors.

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?**

We consider that the main criterion should be the impact of the misstatement on financial markets as a whole, although the risk of an individual misstatement should also be considered. The focus should be on minimising the risk of a serious market disruption.
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)?

We do not think it necessary for a maximum period to be set over which all issuers should be subject to at least one full review. In any case there will be inconsistencies in coverage achieved between enforcers in different jurisdictions, for example because of differences in the enforcer’s capacity and the size of the market.

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?

Common enforcement priorities will be enforced locally by national enforcers in conjunction with local priorities. As such, national enforcers need to be informed of European priorities to include with their own priorities. Establishing European and local priorities will need cooperation between preparers, users and auditors.

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?

We mainly agree with the procedures, except as set out in our comments on Question 6 in relation to obtaining information from issuers’ auditors and on-site inspections of issuers.

We consider that there is a place for partial reviews where the enforcer wishes to focus on one or more particular issues but over a wide range of issuers.

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

Agreed. We welcome the fact that the IASB is working on a revision of IAS 1 to supplement existing guidance on materiality.

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?

We understand that enforcers should have sanctions available – but would stress that, if things get to this stage and a material misstatement is detected in financial information, it is a sign that the process has failed. The enforcer should put efforts into ensuring the quality and consistency of financial reporting, as discussed in our general comments above, and should see having to use the actions in paragraphs 57 to 67 as a last resort.

The enforcer should be required to consider the costs and benefits of the action(s) it proposes and should not insist on actions where the costs are disproportionate.
Paragraphs 57 to 67 do not provide a comprehensive set of criteria. Instead, it should be made clear that they set out some factors for the enforcer to consider when deciding what actions to take. Account also needs to be taken of legal differences in different jurisdictions – for example, in certain countries enforcers do not have the right to request restatements. Paragraph 57 seems to suggest that these three actions are the only actions a regulator can take and we believe that there may be circumstance where other measures would be appropriate.

We also have some concerns about so called “immaterial departures” in paragraph 58. Even though such a misstatement might be quantitatively immaterial, because of its effect on the financial statements we would not consider it should be counted as immaterial. We would therefore suggest that paragraph 58 should be rephrased as:

Materiality in the context of misstatements in financial statements is a function not only of the size but also of the nature, including the effect, of the misstatement. Therefore, where a departure is left intentionally uncorrected by an issuer to achieve a particular presentation of an entity’s financial position, financial performance or cash flows, it cannot be counted as immaterial and the enforcer should require its correction.

This is explained in more detail for example in International Standard on Auditing 450 Evaluation of misstatements identified during the audit, paragraphs 11 and A15-A16, also in chapter 3 paragraph QC11 of the IASB’s uncompleted Conceptual Framework.

**European supervisory convergence**

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

We agree that the criteria in paragraph 78 are useful guide in determining when a permanent record of a decision on an accounting matter may be required. It is important that decisions should be reached after discussion with preparers and auditors as well as other enforcers.

However, we are concerned that there is a lack of clarity as to the role of the EECS database. In particular, paragraph 77 seems to imply a high degree of authority for decisions recorded in the database. We consider that this paragraph should be brought more into line with paragraphs 72 and 73, which make it clear that material controversial accounting issues should be referred to be decided upon by the relevant standard setting and interpretation bodies. We suggest this should be clarified by explaining in or around paragraph 77 that decisions are recorded in the database as an aid to enforcers on the application of standards in specific jurisdictions. In this respect we welcome the cooperation between ESMA and the IASB and the IFRIC Interpretation Committee, as well as the recent Memorandum of Understanding between IASB and IOSCO at the international level.
18. What are in your opinion appropriate activities that would help to achieve a high level of harmonisation of the enforcement in Europe?

In our view, the priority for enforcers should be a high standard of financial reporting by issuers in Europe. We consider this is best achieved by focussing on engaging with standard setters, preparers and auditors to ensure that standards are appropriate and that consensus is arrived at in addressing significant emerging issues so that financial reporting is not misleading and does not lead to ex-post corrective measures that markets find disruptive.

Enforcers need to be up to date with developments in financial reporting so that decisions are taken in line with best current practice, irrespective of previous decisions by enforcers.

It is also important that enforcers should not be seen to be going beyond IFRS – for example, seeking to impose a single solution where IFRS allow flexibility.

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?

We only comment on reporting by ESMA – EECS, not on how decisions are published by different enforcers in the different jurisdictions.

We have no observations on the frequency of the reporting by ESMA. However, we consider that the published decisions could be more informative if they included discussion of all factors of relevance in arriving at the decision. At present most of them are discussed in a generic way and seem to lead straightforwardly to the decision taken by the enforcer. However, we recognise that this may conflict with the requirement that decisions should be anonymised.

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

We believe that in most cases public reporting should be done on an anonymous basis.