

***Memorandum of comment submitted by the Institute of Chartered Accountants
in England and Wales to the Committee of European Securities Regulators
concerning the consultation paper ‘Proposed Statement of Principles of
Enforcement of Accounting Standards in Europe’, published in October 2002***

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INTRODUCTION

1. The Institute of Chartered Accountants in England & Wales welcomes the opportunity to respond to the Committee of European Securities Regulators (CESR) concerning the consultation paper 'Proposed Statement of Principles of Enforcement of Accounting Standards in Europe', published by CESR in October 2002.
2. We have reviewed the consultation paper and set out below a number of comments. We deal first with significant matters before commenting on the specific principles set out in the consultation paper and then on points of detail.

MAJOR POINTS

Support for the Initiative

3. We consider that implementation by 2005 of a common approach to the enforcement of International Financial Reporting Standards (IFRS) is a prerequisite for the successful creation of a single European capital market and for strong investor confidence. We therefore welcome the publication by CESR of the draft framework for enforcement action by European institutional oversight systems. In general we support the proposals, although we have recommended a number of improvements.

Principles

4. We strongly support the adoption of a principles-based approach to enforcement, to be used for developing standards of best practice for securities regulators. An approach based primarily on principles should result in a clearer and more understandable enforcement process. Standards of best practice and other supplementary material should not be so extensive and complex that the principles are obscured.
5. The principles should relate clearly to the fundamental characteristics of an enforcement regime likely to build investor confidence; the Statement of Principles is not the appropriate location for discussion of more practical issues, such as alternative methods of enforcement. CESR may like to consider whether some of the draft 'principles' discuss operational details that might be better excluded from a SOP.

Interpretations

6. Interpretation of IFRS should be the sole responsibility of the International Financial Reporting Interpretations Committee (IFRIC). CESR should work with the International Accounting Standards Board (IASB) to ensure that :

- IFRIC operates effectively and on a timely basis and
- a clear mechanism for the referral of new issues to IFRIC is in place.

This issue is discussed in more detail below under Principle 20.

Different Models

7. We strongly endorse the recognition in Section B, ‘Enforcers’, that Member States should be permitted to adopt different organisational models of enforcement, provided these operate on the basis of common concepts and comparable techniques. In our view, there are no decisive advantages or disadvantages associated with the adoption of a securities regulator model or a review panel model for the enforcement process, although we accept that one national body should have ultimate responsibility for the effectiveness of the enforcement regime.
8. It is important that consistency of IFRS application is not achieved only in relation to entities with regulated securities. We would prefer the remit of national enforcement bodies to include appropriate categories of non-listed entities, including public interest companies, banks and insurance undertakings and other entities which adopt IFRS. This highlights one significant advantage of a review panel model: it is flexible enough to encompass all entities that use IFRS and provides an effective mechanism for co-ordinating the work of different national regulators.

Co-ordination of Enforcement

9. We agree that enforcement in Europe should be built on effective national enforcement bodies, with decisions co-ordinated at European level to ensure that enforcement takes place on a consistent basis in all jurisdictions.
10. We recognise that the current priority is early implementation of effective and co-ordinated enforcement in relation to listed companies. However, the co-ordination mechanism should not be solely a forum of securities regulators, to which other bodies might be invited on an *ad hoc* basis. It would certainly be inappropriate to subject unlisted companies to oversight by securities regulators. The objective should be the creation of a co-ordination mechanism flexible enough to embrace all sectors and entities that use IFRS.

Risk and Enforcement

11. We advocate an element of pro-activity in monitoring, as we believe it has a major impact on the behaviour of companies and auditors. We also strongly support the view expressed in Section E of the SOP, ‘Methods of Enforcement’, that the selection process should always include a risk-based element. However, we consider that discussion of suitable selection methodology in a ‘Statement of Principles’ might be counter-productive. A sophisticated, flexible and confidential

approach to risk assessment and selection is required to address the risk that inappropriate accounting may undermine investor confidence in Europe. Companies and other market participants should be confident that non-compliance is likely to be detected, irrespective of whether *prima facie* a company falls into a high-risk category.

Transparency

12. The SOP should contain an explicit requirement for the enforcement body to publish and follow clear procedures. Adherence to published procedures is an essential requirement of a transparent enforcement regime.

Membership

13. We believe that the SOP should refer to the importance of the membership of enforcement bodies being broadly-based, encompassing all key stakeholder groups. In our view, the inclusive nature of the membership of the UK Financial Reporting Review Panel (FRRP) has been a key factor in its success.

Information Powers

14. Any power to require supplementary information from auditors might, in practice, result in competent authorities seeking access to audit working papers, which in our view would be inappropriate. This matter is discussed in greater detail below under Principle 5.

COMMENTS ON SPECIFIC DRAFT PRINCIPLES

B. Enforcers

Principle 1

Competent independent administrative authorities set up by member States should have the ultimate responsibility for enforcement of compliance of the financial information provided by the companies identified by Principle 7 with the reporting framework.

Principle 2

Other bodies might carry out enforcement on behalf of the competent administrative authorities, provided that these bodies are supervised by and responsible to the relevant competent administrative authority.

Principle 3

Irrespective of who carries out enforcement any code of conduct or best practice or procedure established by CESR should be complied with.

Principle 4

Competent administrative authorities shall have adequate independence from government, and market participants, possessing the necessary powers and having sufficient resources.

15. We agree that enforcement bodies must have sufficient resources, and would emphasise the importance of access to appropriate IFRS expertise.

Principle 5

The necessary powers – which may be delegated to those acting on behalf of the competent independent administrative authority – should at least include power to monitor financial information, require supplementary information from companies and auditors, and take measures consistent with the purposes of enforcement.

16. Any power to require supplementary information from auditors might, in practice, result in competent authorities seeking access to audit working papers. We consider this to be inappropriate as auditors are responsible solely for their report on the financial statements. Their working papers will be relevant only to supporting the opinion set out in their report and are unlikely to represent a suitable source of information requested at a subsequent date. Directors may, of course, request information from the auditors when providing financial information to the enforcement bodies. It might also be appropriate for enforcers to be empowered to require companies to obtain a special report from their auditors on particular issues.
17. We also consider that any requests for information or reports should be based on reasonable, specific grounds for investigation, which should be disclosed to the company at the outset.
18. Finally, we note that no right of appeal is referred to in Principle 5. We assume that such a right will be included in the separate ‘principles for powers to be attributed to the enforcement’ referred to in Section A of the draft SOP.

Principle 6

The competent administrative authorities should be responsible for:

- *the setting up of an appropriate due process of enforcement consistent with the application of the Principles hereby stated;*
- *the implementation of that due process.*

C. Companies and Documents

Principle 7

The Principles for enforcement here identified should apply to financial information provided by companies:

- a) whose securities are admitted to trading on a regulated market;
- b) that applied for admission to trading of their securities on a regulated market.

Principle 8

*The Principles for enforcement here identified should apply to financial information provided by all harmonized documents, including **annual and interim** financial statements and reports, prepared on individual and consolidated basis as well as prospectuses and equivalent documents.*

- 19. We consider that the enforcement system should extend to all documents, including ‘non-harmonised documents’, in relation to any price-sensitive financial information based on IFRS.
- 20. The SOP should make clear, at least in the explanatory remarks, that not all harmonised documents referred to in Principle 8 are subject to audit. For instance, in some countries interim information is not subject to audit.

D. Definition of Enforcement

Principle 9

The purpose of enforcement of financial information is to protect investors and promote market confidence by contributing to the transparency of financial information relevant to the investors’ decision making process. With regard to financial statements, the above implies that enforcement contributes to a consistent application of the IFRSs in the EU financial regulated markets.

- 21. We question whether it is appropriate to state that the purpose of enforcement in relation to financial information is to ‘protect investors’. In our view, the purpose of an enforcement regime is to enhance confidence in the reliability of reported financial information. This, in turn, will bolster investors’ confidence in financial markets, as anticipated in Recital 16 of the EU Regulation adopted in June 2002.

Principle 10

For the purpose of this SOP enforcement may be defined as:

- *monitoring compliance of the financial information with the applicable reporting framework;*
- *taking appropriate measures in case of infringements discovered in the course of SOP enforcement.*

The reporting framework mainly includes:

- *the International Financial Reporting Standards adopted by the EU;*
- *the disclosure standards required by EU legislation.*

With regard to financial statements, the above implies that enforcement contributes to a consistent application of the IFRSs in the EU financial regulated markets.

22. Principle 10 defines enforcement from the perspective of the regulator. The SOP should acknowledge more clearly that it addresses only one aspect of ‘enforcement’, albeit a key one. The FEE discussion paper on enforcement of IFRS, published in April 2002, examines the various components of an effective system of enforcement.

E. Methods of Enforcement

Principle 11

For financial information other than prospectuses ex-post enforcement is the normal procedure, even if pre-clearance is not precluded.

23. In our view, pre-clearance is not an effective use of resources, and generally is not desirable or necessary. There is a risk that it will encourage the development of European interpretations of IFRS.

Principle 12

For prospectuses ex-ante approval is the normal procedure as specified by the EU directives, which also identify the nature of the approval. Ex-post enforcement of financial information provided by prospectuses is possible as a supplementary measure.

24. If a prospectus is already subject to ex-ante approval, it is unclear why ex-post enforcement would be required as a supplementary measure.

Principle 13

Enforcement of all financial information is normally based on selection of companies and documents to be examined.

The preferred models for selecting financial information for enforcement purposes are the mixed models whereby a risk based approach is combined with a rotation and/or a sampling approach.

However, a pure risk based approach may be an acceptable selection method. A pure rotation approach as well as a pure reactive approach is not acceptable.

25. We advocate an element of pro-activity in monitoring, as we believe it has a major impact on the behaviour of companies and auditors. We also strongly support the statement that the selection process should always include a risk-based element. However, as discussed above, we consider the discussion of suitable selection methodology in a SOP to be unhelpful. A sophisticated and flexible approach to risk assessment and selection is required to address the risk that inappropriate accounting may undermine investor confidence in Europe.

26. It should be clear in the SOP that enforcement bodies should always respond to complaints, provided they are not clearly vexatious or frivolous, regardless of the underlying enforcement model.

Principle 14

In order to allow enforcers to adopt gradually the selection methods provided for by Principle 13, a mixed selection technique based on a combination of a random selection and rotation is considered a workable transitional step. However, such a methodology should be designed to give an adequate level of detection risk.

Principle 15

Methods of enforcement on selected information cover a wide spectrum of possible checking procedures, ranging from pure formal checks to in-depth substantive-in-nature checking. The level of risk should normally determine the intensity of the review to be performed by the enforcers. The type of document to be examined and the level of information available on the issuer is also to be taken into consideration.

F. Actions

Principle 16

Where a material misstatement in the financial information is detected enforcers should take appropriate actions to achieve an appropriate disclosure and where relevant, correction of misstatement (in line with the requirements of the reporting framework). Non-material departures from the reporting framework may not necessarily trigger public correction even though they normally deserve an action as well. Misstatements are material if they are able to affect investors' decision and may have a negative impact on market confidence.

27. In our view, the draft SOP does not deal adequately with the important issue of public correction. Where financial information is found by the enforcement body to be defective and in need of rectification, a clear and widely disseminated public statement should be issued to ensure that the decision-taking process is transparent. This should be made clear in the SOP.
28. It is unclear why action should normally be required in relation to non-material departures.

Principle 17

Actions taken by the enforcers should be distinguished from sanctions imposed by the national legislation because:

- *actions are measures generally aimed at improving market confidence and integrity;*
 - *sanctions are mainly aimed at punishing the infringer.*
29. Companies should be motivated to comply fully with the spirit of IFRS by the credibility and rigour of the enforcement regime, rather than the frequent application or potential severity of sanctions. The role of enforcing correct application of accounting standards, including rectification where necessary, is best kept separate from the function of determining and imposing sanctions.

Principle 18

Actions should be effective, timely enacted and proportional to the impact of the detected infringement.

30. We note that Principle 18 does not deal with any right of appeal against the enforcer. A clear appeals process should be established, as discussed above in relation to Principle 5.

Principle 19

A consistent policy of actions should be developed, whereby similar actions are adopted where similar infringements are detected.

G. Co-ordination in Enforcement

Principle 20

In order to promote harmonization of enforcement practices and to ensure a consistent approach of the enforcers to the application of the IFRSs, coordination on ex-ante and ex-post decisions taken by the authorities and /or delegated entities will take place.

Material controversial accounting issues will be conveyed to the bodies responsible for standard setting or interpretation.

No general application guidance on IFRSs will be issued by the enforcers.

31. We agree that enforcers should not issue general application guidance on IFRS and should limit themselves to application guidance in individual cases. Enforcement should not result in standard setting. There is a danger that the application of a new set of accounting standards, based primarily on principles, might result in the creation by European enforcers of a body of accounting interpretations comparable to that built up by the U.S. Securities and Exchange Commission (SEC).
32. We consider that interpretation of IFRS should be the sole responsibility of the IFRIC and is best achieved through the amendment of standards, avoiding the development of a complex and diverse body of accounting literature. CESR should work with the IASB to ensure that:

- IFRIC operates effectively and on a timely basis ;and
- a clear and well understood mechanism for the referral of new issues to IFRIC is in place.

I. Reporting

Principle 21

Enforcers should periodically report to the public on their activities providing at least information on the enforcement policies adopted and decisions taken in individual cases including accounting matters.

33. We agree on the assumption that decisions taken in individual cases will be made public only where public action is taken.

OTHER POINTS

34. Principle 16: an 's' should be added to 'decision'.
35. Section 'I. Reporting' should be section 'H'.

January 2003