



**Proposed Statement of
Principles of Enforcement of
Accounting Standards
in Europe**

Consultation Paper

October 2002



Introduction

This consultative paper contains a Statement of Principles (SOP) covering definition and methods of enforcement of accounting standards in Europe. The SOP will be used for developing standards of best practices of enforcement among CESR members. The paper puts forward the way in which harmonisation of the institutional oversight system may be achieved in Europe. In particular, it provides a definition of enforcement of financial information, selection techniques applicable by enforcers and finally, a description of the responsibilities of the different parties involved. Finally, this consultative SOP does not, in any way, pre-empt the discussions currently taking place on related proposed EU directives.

This SOP has been prepared by CESR's standing committee (CESR-Fin) in the area of financial reporting chaired by Henrik Bjerre-Nielsen, Director General of the Danish Financial Supervisory Authority and more specifically by the Sub-committee on Enforcement (SCE), chaired by Mr Angelo Apponi, Chief Accountant at Commissione Nazionale per le Società e la Borsa (CONSOB).

This SOP should be regarded as part of CESR's contribution to the task of developing and implementing a common approach to enforcement of International Accounting Standards (IAS) in Europe. The harmonisation of enforcement systems is expected to be an effective tool to create an efficient capital market within the Union and should restore and improve investors confidence in capital markets.

In order to give interested parties an opportunity to express their opinions on the SOP, CESR will hold an open hearing on January 7, 2003 at the CESR premises in Paris. Please register your interest in participating by e-mail to the secretariat of CESR at secretariat@europefesco.org.

The deadline for submitting responses to the consultation paper is **15 January 2003**. Responses should be addressed to Mr Fabrice Demarigny, Secretary General, CESR, by email at secretariat@europefesco.org.



A CONTEXT AND SCOPE OF THE SOP

On the 13th of June 2000 the EU Commission issued a Communication to the Council and the European Parliament on the future EU financial reporting strategy. The new approach, which has been implemented by a EU regulation adopted by the EU Council on 6 June 2002, is based on the introduction of the International Financial Reporting Standards (IFRSs) or International Accounting Standards (IASs)¹ in Europe.

Further steps toward harmonization in the EU have also been taken in the field of disclosure, where an amended proposal for a directive on prospectuses is under examination by the EU Council and the European Parliament. A further proposal on transparency issues, including periodic reporting, is forthcoming.

The above mentioned Communication as well as the IAS Regulation and the prospectus proposal imply that an efficient and effective financial information system in a transparent European capital market should be based on the development and the harmonization of:

- clear and enforceable financial reporting standards (i.e. IFRS) and other disclosure requirements (e.g. prospectus and regular reporting requirements) which can be timely and efficiently interpreted;
- transparent corporate governance systems;
- auditing regulation, including technical, ethical and quality control standards, up to develop a first external line of defense against inappropriate application of financial reporting standards;
- independent institutional oversight.

In particular, harmonization of enforcement systems in Europe is seen as an effective tool to create an efficient capital market and an actual level playing field within the Union. It is also expected that harmonisation of enforcement practices throughout Europe will help improve investors' confidence in financial markets and enhance comparability between financial information published by listed companies in Europe.

In particular, the Regulation from its inception calls for CESR to have a role in developing standards for enforcement. Recital n. 16 of the regulation says:

“A proper and rigorous enforcement regime is key to underpinning investors' confidence in financial markets. Member States, by virtue of Article 10 of the Treaty, are required to take appropriate measures to ensure compliance with international accounting standards. The Commission intends to liaise with Member States, notably through the Committee of European Securities Regulators (CESR), to develop a common approach to enforcement.”

To this end CESR set up the CESRfin Sub-Committee on Enforcement (SCE), which agreed upon a work plan whereby standards, guidelines and practices will be considered by the enforcers.

The Work Plan, which was approved by CESR in January 2002, includes the development of principles, guidelines and standards in the areas of:

- definition of enforcement;

¹ IFRSs being the same name of IASs since May 2002.



- selection techniques;
- powers to be attributed to the enforcement;
- cross border listings and offerings.

This document summarizes the general principles on which, in CESR's view, harmonization on the institutional oversight systems in Europe may be achieved.

In particular, a definition of enforcement of financial information, its scope, the selection techniques applicable by the enforcers and the responsibility of the different parties involved are outlined.

However, the group recognises that enforcement of prospectuses should take into consideration the special characteristics and definition of scope which will be defined by the evolving EU legislation.

The SCE is currently working to develop in the short term principles on powers to be attributed to enforcement as well as on the responsibilities in cross border listings and offerings.

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.**
- 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.**
- 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.**

Differences in corporate governance legislations as well as other companies regulations in the European Member States ask for the organization of the institutional oversight at national level according to the different legal environments. However the integration of European security markets requires that the national models operate on the basis of harmonized concepts and comparable techniques.

CESR recognizes that in the EU Member States various organizational models of the enforcement systems are in place, including enforcement conducted by securities regulators, stock exchanges and review panels.

Harmonization requires at least consistency of the scope and reliability of those enforcement systems, as well as the identification of the characteristics that the enforcers should have in order to promote market confidence and the powers to be attributed to them.

To this end, in its response to the EU Commission New Accounting Strategy, published in 2001, the Forum of European Securities Commissions (FESCO) expressed the view that in order to boost market confidence, enforcement of financial information should be overseen by an independent administrative authority.

In this context, independence implies that the authorities should not be unduly influenced by the issuers, their auditors, intermediaries, the government or other stakeholders.

The above requirement is satisfied also where an SRO (Self Regulating Organizations) is involved in the enforcement procedure, provided that a competent administrative authority should monitor that the enforcement mechanism follows all the principles hereby stated.



The completeness, accuracy and truthfulness of the financial information is under the responsibility of the companies' relevant bodies (mainly the board of directors). Where applicable, auditors are required to act as a first external line of defence against misstatements by expressing their opinion on the financial information based on their audit.

Enforcers should monitor this financial information with the aim of ensuring actions where infringements are detected.

Due to the intrinsic limitation of any external monitoring, enforcement will not provide a zero failure assurance.

Where applicable, the selection techniques described below imply that defective information may be out of the sample. Therefore, the enforcer may not have the chance to examine it.

In addition, there is no assurance that the enforcers will detect each and any misstatement affecting the documents that they examine. Fraud for example is organized to overcome controls. Most of the errors connected to fraud may only be discovered if extraordinary controls are put in place.

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.*

CESR encourages to consider the principles hereby provided as a best practice benchmark for companies and documents other than those identified under principles 7 and 8 (even if some adaptations may be needed).

For the purpose of this SOP a document providing financial information is harmonized if EU legislation requires its publication and provides guidance on its format and/or content. The special characteristics of enforcement of prospectuses are considered by principle 12 below.

Non-harmonized documents include reports such as press releases and mergers' reports with pro-forma figures.

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.

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.*

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.

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.

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.

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.

The above principles regarding the methods of enforcement do not preclude the development of specific principles or measures for the implementation of the forthcoming Market Abuse Directive, notably regarding misleading information.

The document suggests the application of selection techniques as the basis for harmonization of the enforcement systems in Europe, taking cost and benefit balances into consideration. The appropriateness of applying a selection method, however, depends on several circumstances, including the characteristics of the market and other legal constraints. For that reason, some authorities may consider a systematic review more appropriate.

The selection of items to be considered in the enforcement process and intensity of the review on selected information is determined by several factors identified under principles from 11 to 14. For instance, among these factors the result of enforcement of some documents published by an issuer (e.g. its consolidated accounts) may have an impact in estimating the risk associated with other financial information provided by the same company (e.g. its individual accounts).

Selection of items to be checked is also based on the objective of the enforcement, the quality of information available to the enforcer and the time constraint for the enforcement procedure.

With regard to the intensity of the review a cost and benefit balance requires that an in-depth checking procedure should be justified by indication of possible misstatements in the selected document. Factors like the availability of information, indication by the auditors and clear inconsistencies of the enforced document are normally considered.

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.

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.*

Principle 18 Actions should be effective, timely enacted and proportional to the impact of the detected infringement.

Principle 19 A consistent policy of actions should be developed, whereby similar actions are adopted where similar infringements are detected

A range of possible actions are available to enforcers (e.g. request for reconciliations or a corrective note, restatements, delisting). Several factors should be carefully considered in the selection of the



appropriate action. These include the type of document affected by the misstatement, the timing of the detection and the frequency of the misstatement.

Although actions are decided at national level, the creation of a single EU securities market requires coordination and convergence of the enforcers' policies.

G COORDINATION 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.

Monitoring financial information entails that reporting policies applied by the issuers are compared with the reporting framework in order to take decision on their acceptability.

Decisions of national enforcers reflect the judgement of the enforcer on the compliance of the financial information with the reporting framework. Exchange of information among enforcers prior to the decision are taken is limited by technical feasibility time and confidentiality constraints.

Similar constraints apply where the enforcers are required by the issuers or their auditors to express opinions before the financial information is published (so called “pre-clearances”).

However, harmonization of the enforcement practices and approaches of the enforcers to the IFRSs, aimed at creating a single EU securities market, requires coordination on ex-ante and ex-post decisions taken by the authorities and/or delegated entities.

Consistent with recital 16 of the EU regulation on IFRSs, CESR will promote coordination in enforcement approaches.

In particular, according to its mandate, the CESRfin's Sub-Committee on Enforcement is the forum where regulators compare their experiences in the field of enforcement on a regular basis with the aim of convergence.

The development of legislation or memoranda of understandings will be explored in order to foster exchange of information with non-CESR members.

Issuing general interpretations of the existing standards is part of the standard setting process conducted by the relevant bodies, such as IFRIC. Enforcers may contribute to this process by providing their experience to the interpretation debate. However, harmonization requires that they should not attempt to create a parallel body of interpretations.



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.

The proposed publication of individual cases is to contribute to the convergence of enforcement – not interpretation of IFRS's.

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