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**Research Report**

## Commentary on ESMA Guidelines on enforcement of financial information

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Hans-Joachim Böcking, Marius Gros and Daniel Worret

# Commentary on ESMA Guidelines on enforcement of financial information

Policy Letter No. 15

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## Consultation Paper: ESMA Guidelines on enforcement of financial information

To whom it may concern,

we are writing to comment on the Consultation Paper “ESMA Guidelines on enforcement of financial information”. We appreciate the opportunity to comment and support the efforts to improve enforcement and financial reporting quality within the European Single Market. Hereinafter please find our responses to the 20 questions of the Consultation Paper.

### **Question (1): Do you think that the proposed guidelines will improve the quality and consistency of financial reporting in Europe?**

Latest accounting research suggests that there is an impact of enforcement on accounting quality. Thus, we believe common standards on enforcement within the European Single Market could have a positive impact on the quality of financial information published by issuers, although the competition of enforcement systems could also be of positive influence. However, it remains unclear how the quality of financial reporting or enforcement can be measured reliably. Moreover, it has not been researched yet, which particular enforcement system applied within the Member States is superior in promoting accounting quality.

To get a better understanding of which particular enforcement mechanisms are of positive influence on the quality of financial information, we suggest an analysis of the strengths and weaknesses of the different enforcement systems applied within the Member States. In our view, this analysis is necessary in order to examine which enforcement design should be aimed to achieve as a result of the European harmonization process. Therefore, we

suggest that future regulation should be also based on the evidence gained by additional research on the various influences of enforcement mechanisms.

Finally, the suggested measures to increase financial reporting quality should not be discussed separately from the proposed reform of the EU audit market. High quality audits are expected to increase the reliability and accuracy of financial information and therefore should also decrease the need for additional enforcement actions.

**Question (2): Do you have any comments on the potential costs to the financial reporting community of any aspects of these proposals?**

To our knowledge, there are no studies examining the costs and benefits of the particular enforcement mechanisms. In our view, ESMA should be in the position to accumulate data on the European enforcers' (financial) resources. Therefore, we suggest ESMA to prepare a study on the costs of enforcement on its own or in cooperation with researchers.

**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.**

First of all, there is no empirical evidence for regulatory arbitrage regarding the enforcement of financial information. Thus, we encourage EMSA to gain evidence on this hypothesis. Also, we refer to our answer to question (1), where we pointed out that there is no unambiguous evidence on the impact of enforcement mechanisms on financial reporting quality and more research has to be conducted on this topic.

In addition, there are no studies showing that the listing choice of issuers depends on the enforcement design at the designated listing place. It has not been researched whether a high level of enforcement leads to an increasing attractiveness of the capital market because of lower risk premiums or whether a low level of enforcement quality is preferred by issuers to avoid additional regulation.

**Question (4): Do you agree with the objective, definition and scope of enforcement set out in paragraphs 11 to 21 of the proposed guidelines?**

In general, we agree to the suggested objective, definition and scope of the proposed guidelines. We also refer to our answer to question (17).

**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?**

First of all, we encourage ESMA to clarify whether the competent authority is the enforcer of the resident state or the listing state.

We agree that issuers from third countries using an equivalent GAAP to IFRS should be subject to an equivalent enforcement and coordination system. We do not agree to all proposed measures intended to increase the efficiency of the enforcement process. We do not support the delegation of enforcement activities to third parties, because some of the enforcement actions listed in paragraph 54 may not be applicable in third countries due to national restrictions. However, we are in favour of enforcement actions including the consideration of third parties, for example by obtaining expert opinions.

**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?**

In our opinion, it should be clarified that market participants should be informed about misstatements in an appropriate and timely manner. Moreover, it should be clarified that enforcers can cooperate and communicate with national law enforcement agencies and audit oversight boards like it is stated in § 342b (8) of the German Commercial Code.

**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?**

We agree that enforcers should have adequate independence from each of government, issuers, auditors, other market participants and regulated markets. To avoid biased decisions in the enforcement process, in our opinion, cooling of periods and full-time employments at the European enforcers are an appropriate measure to assure high levels of independence.

**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?**

First of all, we agree that pre-clearance has to be organized in a formal process. However, the last sentence of paragraph 45 can mislead into an informal procedure. At least some minimum requirements for pre-clearance should be outlined within the ESMA guidelines.

**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?**

In our opinion, additional ex-ante enforcement of financial information in prospectuses is not necessary since in almost all cases the published information is derived from financial statements that have already been audited. Moreover, in practice the design of prospectuses is commonly supported or reviewed by audit firms, which also should

increase the reliance of the published data. However, we are in favour of ex-post enforcement actions on a random basis.

**Question (10): Do you agree that a risk-based approach for selection should not be used as the only approach?**

Yes.

**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?**

Yes.

**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)?**

Yes. However, ESMA should take into consideration that a maximum period should not lead to a setting in which the issuer can anticipate the execution of (future) enforcement actions.

**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?**

The common enforcement priorities have to be taken into account while determining the (risk-based) selection of issuers.

**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?**

Especially in a two-tier-board-system, the supervisory board or the audit committee is responsible for auditing and approval of financial information. Therefore, enforcers should also communicate with the chairman or financial expert of these institutions.

**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?**

Yes. In general, we support the assessment of materiality according to the relevant applicable accounting standards. However, ESMA should take into consideration that the resulting materiality threshold can differ between enforcers and auditors.

**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?**

Enforcers should only require restatements (paragraph 57a) in accordance with the applicable accounting standard, for example IAS 8. ESMA should be aware of the fact that national company law may regulate restatements to a certain extent. As an alternative to the proposed mechanism in paragraph 57, ESMA might consider a “corrective note only approach”, as already implemented in the German enforcement system. However, the decision on this topic should be also dependent on research results concerning the influence of different enforcement systems on accounting quality as described in our answer to question (1).

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

We agree with ESMA that accounting standards should only be developed by standard setters. We also agree that the development of “EU IFRS” should be avoided. The publication of emerging issues and enforcement decisions bears the risk of contributing to case-based “EU IFRS”. The interpretation of accounting standards is not up to enforcement institutions, as this may compromise the segregation of powers. However, an internal use of a database may be beneficial to ensure a consistent enforcement within the European Single Market.

**Question (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 most important factor for increasing the level of harmonization is to make sure all national enforcers have sufficient human and financial resources. The manpower should be professionally skilled and experienced as described in paragraph 35 of the discussion paper. The “comply or explain”-approach as intended by ESMA may also contribute to an increased harmonization, while still leaving the opportunity to allow for national characteristics.

**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?**

The harmonization of enforcement requires also harmonized reporting by national enforcers. The reports should at least include some minimum content, such as the number of reviews, the quantity of misstatements, and enforcement priorities adopted. The presentation of enforcement activities should also include at least a separation of misstatements concerning recognition and measurement on the one hand and disclosure on the other hand.

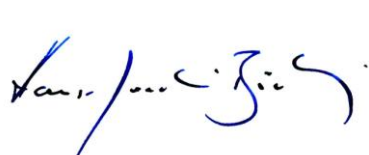
**Question (20): What are your views about making public on an anonymous basis enforcement actions taken against issuers?**

We refer to our answer to question (17).

If you would like to have any further explanation or clarification of our responses, please do not hesitate to contact us.

Yours sincerely,

Frankfurt/Main, October 11<sup>th</sup> 2013



(Prof. Dr. Hans-Joachim Böcking)



(Dr. Marius Gros)



(Daniel Worret)