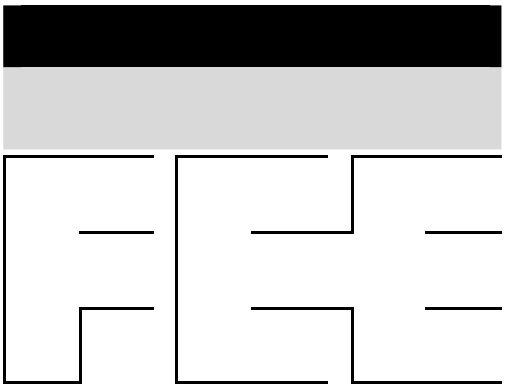

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# DISCUSSION PAPER ON ENFORCEMENT OF IFRS WITHIN EUROPE

**April 2002**

## CONTENTS

# 1. EXECUTIVE SUMMARY

**Key Messages of this Discussion Paper**

- Following the IAS Regulation, a large number of companies, at least all listed companies but also others depending on implementation of the Member States option will use IFRS in 2005. It is therefore crucial that effective enforcement for IFRS is in place at latest by 2005.

- Enforcement should be built on effective national enforcement bodies. All EU Member States should urgently review their arrangements for enforcement. In countries where such an enforcement body for accounting standards does not exist, it is recommended, given the short time scale and limited resources available, to establish an enforcement body based on a review panel model. Such a model should be sufficiently flexible to extend enforcement to all IFRS companies, including public interest companies, banks and insurance undertakings and also other companies which use IFRS in their financial information.

- There is a clear need for a European coordination on enforcement in order to ensure consistency in application decisions within Europe: European Enforcement Coordination (EEC). Action needs to be taken by the EU Commission, CESR and all other relevant parties to establish the EEC.

- Such a European coordination needs to involve all enforcement bodies, whether they follow a securities regulator or review panel model.

- Enforcement should not result in standard setting. Enforcement bodies should be cautious in issuing interpretations and limit themselves to application guidance in individual cases. This guidance would be referred to IASB or to IFRIC as well as to EFRAG. EFRAG should consider whether to provide additional commentary to IASB giving EFRAG's assessment on general applicability and the need for IFRIC interpretations or amendments to IFRS.

- Pre-clearance should be offered only where cost-effective and with the full involvement of the Board of Directors and the auditors of the company concerned. Pre-clearance should be limited to issues where no IFRS or IFRIC interpretations exist.

## *1. Introduction*

The EU Commission's Financial Services Action Plan was adopted in March 2000 and the Lamfalussy Report on the Regulation of European Securities Markets in March 2001. This drive to create an integrated financial services market in the EU is endorsed at the highest level of Governments and by the European Parliament.

One element of the plan is for all listed companies in the EU to prepare consolidated accounts using International Financial Reporting Standards (IFRS) by 2005. Enforcement of IFRS needs therefore at latest to be in place by 2005. In recent years FEE has been at the forefront in supporting the proposed IAS Regulation to require IFRS to be implemented in 2005, and in recommending improvements to IFRS so that they are increasingly suitable for this task. To be ready by 2005 is a large challenge for preparers, auditors, regulators and others.

As the reliability of audited financial statements and other financial information is an important element for confidence in the markets, a proper and rigorous enforcement of IFRS is an integral part of the integrated European Securities Markets initiative. Recent cases of company failures

and fraud have implications for all those concerned with financial reporting. These cases have shown a clear need for a debate about the effectiveness of the national arrangements in Europe for enforcement of high quality financial reporting and whether there is any need to improve these arrangements. While all aspects of the overall enforcement system are important, special attention needs to be paid to one aspect of enforcement, in a somewhat narrower sense, which relates to the institutional oversight mechanism for checking the correct application of IFRS by an enforcement body independent from the reporting enterprise as well as from its auditor and other stakeholders. In the recitals to the IAS Regulation, Member States are required to take appropriate measures to ensure compliance with IFRS.

The purpose of this FEE paper is to serve the public interest by contributing to a full and thorough debate both on the enforcement of high quality financial reporting and on the need for the improvement or establishment of effective institutional oversight systems by Member States. This debate needs to engage Member States, existing enforcement bodies in Europe, and representatives of preparers, users and other market participants, as well as the European Commission, EFRAG and CESR.

## *2. Definition of Enforcement of Accounting Standards used in Financial Reporting*

In this paper FEE uses the following definition of enforcement of accounting standards applied in financial information:

*"Enforcement is a system to whenever possible prevent, and thereafter identify and correct, material errors or omissions in the application of IFRS in financial information and other regulatory statements issued to the public."*

Prevention of material errors or omissions in the application of IFRS in financial information is important. The aim should be to "get things right the first time" and avoid the need for later correction. It should be remembered that aggressive earnings management, misrepresentation and fraud could hamper the proper application of IFRS. On the other hand, errors and omissions are not always unintentional. For these reasons, there is a need for the careful preparation, review and approval of financial information by individuals and bodies within companies whose responsibilities are established under a suitable corporate governance structure. Companies themselves are the first line of defence in all circumstances – not only when information is unaudited.

## *3. The Scope of Enforcement: Financial Information not just financial statements*

The primary objective of an overall enforcement system should be to detect and correct material errors and omissions before they enter the public domain, whenever possible. An overall enforcement system comprises both internal and external processes. Internal processes should involve the application of an effective system of corporate governance, including the operation of internal controls and review by management and directors, whilst external processes involve a variety of organisations, including the external audit and those bodies charged with enforcement by Company Law and securities legislation: "enforcement bodies". This paper concentrates on the role and responsibilities of these enforcement bodies.

Taking into account the minimum scope of the envisaged IAS Regulation the enforcement body to be improved or established should cover at least consolidated annual financial statements of listed companies[1]. However, bearing in mind the importance of other types of documents being prepared under IFRS which provide price-sensitive financial information for the capital market, it is not appropriate to limit the scope of enforcement to consolidated annual financial statements. Similar considerations apply to the financial information of non-listed companies as it is important that IFRS are applied and enforced in a consistent way irrespective of whether IFRS are used by listed or non-listed companies. FEE therefore believes that the enforcement system should extend to all documents that provide price-sensitive financial information using IFRS, and should not be limited to annual financial statements or just to listed companies. However, pending new EU Commission proposals on prospectuses, enforcement in relation to prospectuses is not specifically addressed in this paper.

FEE notes that the wider the scope of enforcement, the greater the resources that are required to make it effective. The scope of enforcement should therefore take into account cost benefit considerations, particularly when and how the initial scope of enforcement should be extended. Therefore, FEE suggests that the scope of the enforcement mechanism should be limited to start with. In a first step enforcement should apply to the application of IFRS in the audited consolidated financial statements of listed companies. Thereafter it should be developed as experience is gained and sufficient personnel and financial resources become available to cover larger numbers of documents and companies. A three-step approach might be:

- consolidated financial statements of listed companies, including other regular and ad-hoc financial reporting information of listed companies as related EU or national requirements are put in place or developed;
- financial reporting information of all public interest companies, in particular those in regulated industries, for which IFRS may be required; and
- financial reporting information of all companies using IFRS, including coverage of non-listed companies.

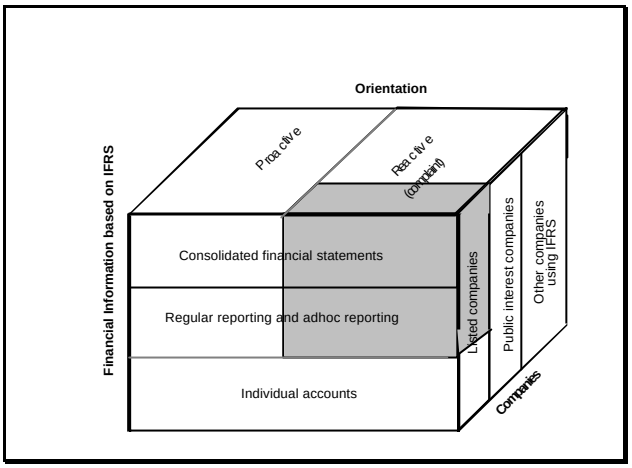
The proposed three-step approach requires that the enforcement mechanism and the way it is organized is sufficiently flexible to broaden its scope over time as necessary to cover all financial information prepared using IFRS. Some Member States may wish to take the first two steps at once in order to cover all large public interest companies.

Irrespective of the type of documents and companies to be subject to enforcement, such enforcement may be organised on a proactive basis or on a reactive basis. Under a proactive approach, the enforcement body reviews at its own initiative, after publication, financial statements of companies (and other public financial information). Under a reactive approach, the enforcement body reviews the financial information of individual companies only in response to specific complaints received from other parties.

The following diagram illustrates the financial information and companies that could be subject to enforcement in a step-by-step approach; and the orientation of such enforcement. The shaded dimensions show a possible first step.

[1] Listed companies are publicly traded companies.

**Diagram 1: Dimensions of Enforcement**[2][3][4]




## *4. A Framework for High Quality Financial Reporting*

In discussing how to improve or establish an effective enforcement mechanism all the major influences which affect the quality of financial reporting should be considered as well as how each element of the overall framework for financial reporting can play its proper role. In order to facilitate high quality financial reporting, FEE believes that there is a need to strengthen corporate governance arrangements so that they are equally effective across Europe in relation to financial information using IFRS. The principal elements of this framework are:

- Preparation by an effective and well resourced internal company accounting function
- Internal audit and informed review by directors, Audit Committees or Supervisory Boards
- Proper approval procedures of financial information by the body responsible within the company
- External audit and external review subject to appropriate quality assurance systems
- Effective enforcement bodies. An expert specialised body charged with delegated enforcement responsibilities over the application of accounting standards in financial information may be an effective arrangement
- Stock Exchanges with supportive listing agreements
- Sponsors, advisers and investment bankers committed to high quality financial reporting particularly in respect of complex transactions
- Investors, analysts, rating agencies and the financial press, all of which should have clear ethical obligations to raise issues of dubious financial reporting

Each of these parties should be subject to enforcement in relation to their responsibilities to support high quality financial reporting. This is enforcement in its broad sense.

[2] It does not address IPOs or transaction related information pending the Commission's revised proposals on prospectuses to which FEE will respond later.

[3] Extension of scope involves further resources.

[4] For the purposes of enforcement, consolidated financial statements can be taken to include financial information in annual reports prepared using IFRS but not non-financial information.

## *5. Features of Effective Enforcement Bodies – Preparing National Enforcement Bodies*

The increased complexity of IFRS when compared to many national accounting standards will require all Member States to review their existing enforcement mechanisms in order to decide whether improvement is needed to ensure proper and rigorous enforcement of IFRS. FEE has identified the following essential features of an effective body, which include:

- ***Support for high quality corporate governance and external audit*** – An effective system of enforcement relies upon all those with influence on financial reporting playing their part. It is important that the enforcement body supports the effective functioning of the roles of management, Directors and the Supervisory Board or the Audit Committee and the external audit. In order to support the audit function, discussion of financial reporting issues between companies and enforcement bodies should take place in the presence of the auditors, and on the basis of a comprehensive written explanation of the issue confirmed by the company's Board.

- ***High quality, expert, globally-consistent decisions on important issues –*** IFRS need to be applied rigorously and consistently to all companies throughout Europe, with due regard for how they are applied elsewhere in the world. Enforcement bodies will need to have the necessary expertise to make high quality enforcement decisions at a time when IFRS expertise is scarce. Enforcement bodies have little time to prepare for IFRS as some companies can use IFRS today and others will do so for 2003 and 2004 if permitted. It will continue to pose an even greater challenge in 2005 and the initial period thereafter. Involvement of a range of experts and practitioners should enhance the respect for the decision taking process and acceptance of the decisions taken, provided that due ethical precautions are put in place to guard against conflicts of interest and preserve independence.

- ***Freedom from bias –*** The enforcement body should make unbiased decisions. However, in FEE's view this would not require each of the individuals working within the enforcement body to be independent from all stakeholders in financial reporting, providing they give an undertaking to behave in good faith and avoid conflicts of interest arising from any individual case.

- ***Transparency and clear procedures –*** transparency of the activities of the enforcement body is of crucial importance for widespread acceptance of its decisions. Enforcement bodies should demonstrate that they follow clear procedures and take enforcement decisions in a competent manner. Each enforcement body in Europe should publish its working procedures in some detail. These procedures should be consistent with a framework of common European best practice principles, which might be established by a European enforcement coordination mechanism (see Section 7) after suitable consultation.

  To ensure transparency of decision taking where financial information has been found by the enforcement body to be defective and is to be corrected, there should be a clear, well-known and public statement that is widely disseminated.

  Enforcement bodies should feed their decisions to IASB or IFRIC. These decisions should also be referred to EFRAG. EFRAG as part of its pro-active role towards IASB should consider to provide a commentary of its assessment of their general applicability and the need for IFRIC interpretations or amendments to IFRS. Enforcement bodies should also provide information to other regulatory or supervisory authorities or private oversight bodies with a view to their imposing sanctions where appropriate.

- ***Confidentiality and speed of action*** – errors and omissions may lead to the creation of a false market in shares or debt instruments. Once an issue has been identified as non-compliance, it is important that it is resolved quickly, so that appropriate information can be shared with market participants as soon as possible. However, this needs to be balanced with appropriate confidentiality. It is equally inappropriate for the price of shares or debt instruments to be depressed by rumour that an accounting issue is under investigation.

  Confidentiality is also an issue in a European enforcement coordination and in cross border enforcement; the ability to share information between enforcement bodies is an important issue but needs to be approached very carefully, with well developed and legally sound procedures. Speed of action also requires the availability of sufficient resources.

- ***Avoidance of making detailed accounting rules*** – it remains vital that accounting standards be based on principles and not detailed rules. Rules could enter the IFRS environment within the text of individual standards or interpretations, or by many different enforcement bodies publishing their own positions on how the various principles should be applied. Enforcement bodies should refer problem interpretation issues to the IASB and IFRIC as well as to EFRAG. EFRAG should consider to provide a commentary on general applicability and the need for IFRIC interpretations or amendments to IFRS. It is not appropriate for an enforcement mechanism to publish that it has "cleared" an accounting treatment or "cleared" a specific set of financial statements containing a specific transaction, as this adds to the base of rules that risk being inappropriately applied elsewhere.

- ***Focusing resources*** – Resources need to be identified to meet the deadline for having proper enforcement systems for IFRS in place by 2005. A risk-based approach should be considered in determining the scope and coverage of reviews to allow for efficient allocation of enforcement resources.

  To prevent waste, procedures should be in place to avoid time consuming and expensive investigation of relatively minor matters of non-compliance and to identify malicious, trivial or ill-informed complaints.

- ***Rectification of defective financial information*** – The proper rectification of defective financial information is a characteristic of good enforcement. The appropriate means of rectification depends on the particular case and could range from restatement of defective financial statements to subsequent disclosures or other forms of publication. Guidance on the appropriate means of rectification needs to be developed, taking into account different national environments. The potential legal implications of requiring restatement of defective financial statements should be fully considered. An enforcement body needs to have the power to start a court case and sufficient financial resources to do so, to defend its decisions and to appeal against adverse court rulings.

- ***Sanctions*** – In order to ensure that enforcement decisions and rectification are implemented, a proper sanctioning system for all responsible parties involved is essential. It is not a necessary feature of an enforcement body that it should itself become involved in imposing sanctions. There are strong arguments for separating the role of enforcing correct application of accounting standards from the additional function of sanctioning. The primary emphasis of an enforcement body should be on correcting inappropriate application of IFRS, so that the integrity of financial information is upheld. While sanctions are an essential feature of effective enforcement, the means by which they are applied can vary. They should not involve an additional system to those already in place through other legal or regulatory arrangements.

Care should be taken that the new enforcement system for Europe should be accompanied by broadly equivalent sanctions in order to provide a level playing field within the EU and to avoid enforcement arbitrage. This is to avoid companies seeking a jurisdiction where the sanctioning is thought to be less strict.

FEE's view is that a review of existing enforcement arrangements should be conducted. It should take as benchmark the features set out above. The results would help to explain to all market participants why new arrangements are necessary and to promote widespread support.

## *6. Enforcement Models at a European Level – the choice of model*

Ideally global standards require global enforcement. The ultimate objective should be to establish one enforcement system that applies to those that use IFRS throughout the world. However, given national differences in corporate governance and legal and economic systems, a single enforcement system, even at a European level, is an unrealistic goal at present, and will be so for a significant future period. Therefore, enforcement of accounting standards should be arranged at the national level following the general EU principle of subsidiarity.

An enforcement body with delegated power can be a securities regulator, such as COB in France or CONSOB in Italy, or a body constituted by stakeholders for the specific purpose (referred to as review panel), such as the UK FRRP.

Taking into account the public interest in financial reporting, it is necessary for there to be an official government body ultimately responsible for the establishment and maintenance of an enforcement body which is able to enforce IFRS in a proper and rigorous way and which could delegate power to the enforcement body. Equally it is clear that there are perhaps compelling advantages in involving a wide range of representation and expertise resulting in broader acceptance and better mutual communication of the parties concerned and coverage of all companies using IFRS.

Taking into account the need to have an effective enforcement mechanism in place at the latest in 2005 action needs to be taken, especially by those countries which do not already have official bodies for enforcement of accounting standards. A review panel model could probably be introduced relatively quickly with sharing of cost and personnel resources. If a review panel model is opted for, a proper relation with the securities regulator needs to be established.

There is no reason why both models could not co-exist in Europe. Indeed it may not be practical to expect to have precisely the same arrangements for enforcement in each country. Thus a mixed model comprising a securities regulator in some countries and a review panel in others, both with delegated powers, would accommodate such necessary variations, while encouraging convergence in practice.

Enforcement decisions on financial information prepared using IFRS need to be co-ordinated in order to create a level playing field across Europe and to ensure consistent decisions. The procedures for co-ordination will need to be carefully developed in detail.

The coordination mechanism should be established as a partnership between the national enforcement bodies, whether they follow a securities regulator or a review panel model, in order to discuss and exchange important enforcement decisions and the reasons for those decisions and to aim at convergence and harmonisation of enforcement decisions. Therefore, the

coordination mechanism should be consulted before a national enforcement body takes a decision or action in an individual case on IFRS which would set a significant precedent of general European significance. The partnership mechanism (European Enforcement Coordination – EEC) will need to:

- be confidential, such that an issue about a specific company does not become public knowledge in advance of a formal ruling;
- respond quickly and work well in practice, so that the process engenders a high level of confidence;
- be treated as if it is binding on enforcement bodies of all EU Member States, so that confidence in the process does not break down; and
- be acknowledged as part of the solution, if and when individual decisions of general significance are made public.

It is a large challenge for preparers, auditors, regulators and others to be ready to implement IFRS by 2005. Given the practical difficulties of establishing or modifying enforcement bodies in at least some countries by 2005, FEE emphasises the significant further challenge of establishing a coordination mechanism across Europe at the same time that IFRS are implemented on a broad scale.

## *7. European and Global Consistency of Application of IFRS*

Consistent application of IFRS is a feature of effective enforcement. It is a major issue for preparers, auditors and those charged with enforcement, bearing in mind:

- the comparatively short time until at least listed companies must apply IFRS in their consolidated financial statements;
- the ambitious programme of IASB to further develop and improve IFRS in the immediate future, so that the standards will themselves be evolving over the period to 2005;
- the special issues that may arise on initial implementation by companies of IFRS and the IASB project on first time application of IFRS;
- the potential for issues of urgent interpretation of IFRS to arise; and
- the practical need for consistency across the Member States (and in future Member States as well) and with due regard for global consistency.

It is necessary to avoid making separate national or European rules. This is despite the fact that urgent issues are likely to arise for decision. To the extent possible, the creation of additional rules and structures during the transitional period should be avoided. There should be reliance instead on the guidance expected from IASB on first time application of IFRS.

The interpretation of IFRS by enforcement bodies gives rise to unavoidable difficult issues. These include:

- the need to avoid inadvertent development of a separate permanent system of case-by-case interpretation in the EU, akin to SEC Staff Accounting Bulletins;
- achieving global consistency;
- consultation with IASB/IFRIC as far as possible;
- ensuring that other enforcement bodies agree on the enforcement decisions taken;
- making other preparers and auditors immediately aware in time to take account of the interpretation;
- the formal status of the views expressed;

- the risk that IASB/IFRIC will on consideration take a different view of the issue in question.

In view of these difficulties, enforcement bodies should be cautious in issuing interpretation in the form of interim application guidance, and limit themselves to application guidance in individual cases.

In order to resolve these difficulties as far as possible, detailed consultation arrangements with IASB and IFRIC are desirable. The IASB and IFRIC should provide a facility for consultation by national enforcement bodies. The enforcement bodies should also feed information about issues commonly arising in any interim application guidance which lead to the conclusion that IFRS need amendment or interpretation. Furthermore this information should be referred to EFRAG in view of EFRAG's proactive role towards setting the agenda from a European perspective for high quality accounting standards. EFRAG should consider to provide additional commentary to IASB of their assessment whether the decision on the application of IFRS taken by the enforcement body should lead to IFRIC interpretations or amendments to IFRS. It would be helpful if communication on such issues was also established on a regular basis with the US SEC and other global securities regulators and other enforcement bodies.

Enforcement bodies should not reduce the existing flexibility contained in IFRS standards but rather request directly or through EFRAG that the IASB should do so when it is thought desirable.

Enforcement bodies will need close links with other parties, in particular:

- with other enforcement bodies within the EU, through both CESR and the wider coordination mechanism described above;
- with enforcement bodies elsewhere, notably the SEC in the US and similar bodies in other global capital markets, with a view to ensuring consistent interpretation in the course of enforcement;
- to IASB, IFRIC and EFRAG;
- to preparers and auditors; and
- to other market participants, in view of these parties roles and influence on financial reporting.

In preparing for 2005, it should also be recalled that many companies may apply IFRS early, possibly from 2003 or 2004 if permitted to do so. FEE calls on all those involved in the process to organise themselves to minimise the risks of first time application through an action plan whereby:

- national standard setters throughout Europe should change their standards, at least for listed companies, to IFRS over the period between now and 2005 as far as possible under the Accounting Directives;
- at least each listed company should establish a specific plan for IFRS conversion and for implementing changes to national GAAP;
- at least each listed company should establish a training plan and implement it for all concerned;
- audit firms should establish and implement a specific training plan for IFRS within their firms.

Some European enforcement bodies offer the facility of pre-clearance whereby companies approach them to give advance clearance on accounting issues. There are some difficulties as well as advantages with pre-clearance and the pre-clearance process has recently been described as "not utopia" by the Chief Accountant of the SEC.

FEE's view on pre-clearance is that it should be offered only where cost effective and with the full involvement of the Board of Directors and the auditors of the relevant company. Pre-clearance should be limited to issues where IFRS or IFRIC interpretations are not available. Where a pre-clearance mechanism is offered by a national enforcement body, it should publish a detailed set of procedures to be followed which should implement a framework of common European principles which would be established by the European Enforcement Coordination mechanism. Not all enforcement bodies may consider it necessary or even desirable to have a pre-clearance mechanism.

For cross border listings by European companies there should be reliance on the home country enforcement body for correct and consistent application of IFRS in financial information. Further guidelines may be needed where the issuing company is listed only in a host country and not its country of incorporation. A system needs to be developed which avoids regulatory arbitrage and facilitates regulatory cooperation in enforcing accounting standards, both for European companies and for foreign companies listed in Europe. While IOSCO is developing mutual recognition arrangements, interim mechanisms such as memoranda of understanding may be useful.

Unless there is a mutual recognition agreement, a foreign company should be supervised by the country of first listing in Europe. The company should be able to change the country of supervision in Europe with the agreement of both enforcement bodies involved. This issue needs further investigation.

## *8. Interaction between Auditors and Enforcement Bodies*

Auditors in some countries may in some circumstances have to communicate with the enforcement body. The question arises whether enforcement bodies might be able to ask for information from the auditors about their client.

It is clearly the responsibility of directors and management to prepare proper financial statements and other information. They are also responsible for providing directly any more detailed information required by enforcement bodies. In this context it has to be borne in mind that in many countries and circumstances, confidentiality requirements legally preclude auditors from providing third parties (including enforcement bodies) with information about their clients unless the client specifically allows such access.

If the quality of information provided by the company to an enforcement body is of particular significance to them, then it is possible for this to be subjected to a special report on agreed terms by the auditors. This would however generally be a report to the company, copied to the enforcement body within the normal relationship.

The general confidentiality obligations of auditors may be overridden, for example by whistle blowing legislation or under a court order. FEE would not consider whistle blowing as being an issue in relation to enforcement of IFRS because the auditor reports publicly on the application of IFRS. Also in sectors mostly connected with banking, insurance or other financial services, there may be rights and duties of direct communication between supervisory bodies and the auditors of the regulated entities. It would be inappropriate and costly to apply sector-specific rules and regulatory arrangements, indiscriminately to mainstream listed companies and their auditors. Requirements such as those for regulated financial institutions reflect the particular

nature of the activities of banking, insurance or other financial services and their pervasive transactions and relationships throughout the economy.

If, in any circumstances, there are grounds for concern about the quality of an audit there should be a mechanism to make a complaint to the audit regulator, to have that complaint properly investigated and to require appropriate action to be taken from a range of effective sanctions. Taking into account both justice and administrative efficiency, auditors should be subject to only the audit regulator for investigation and discipline and should not be exposed to "double jeopardy" in respect of one matter of complaint.

The need for good audit quality in Europe is fully recognised and supported by FEE. Therefore, FEE commends the work of the EU Committee on Auditing, in which it participates, which is actively working to improve further the quality of statutory audit in Europe.

# 2. INTRODUCTION

## *2.1 Towards the Completion of the Internal Market for Financial Services*

***The Financial Services Action Plan***

In March 2000 at Lisbon, the EU Heads of Government Council in its conclusions set a deadline of 2005 to implement the Commission's Financial Services Action Plan, which is designed to accelerate completion of the internal market for financial services. One element of the plan is for all listed companies to prepare consolidated accounts using IFRS by 2005. Enforcement of IFRS needs therefore to be in place at latest by 2005. To be ready by 2005 for IFRS is in itself a large challenge for preparers, auditors, regulators and others.

***The Lamfalussy Report on the Regulation of European Securities Markets***

The Lamfalussy Report covers the conclusions of a Committee of Wise Men on the Regulation of European Securities Markets. Essentially the report makes proposals to speed up the integration of the European Capital Markets.

The Committee of Wise Men took the view that there are significant gains available from building an integrated financial market in the EU. These include better allocation of capital, greater liquidity, lower cost of capital and better yields for investors. At a macro level, the productivity of capital and labour is expected to be increased, economic growth to be stronger and employment to be increased.

The approach proposed by Lamfalussy was endorsed at the EU Heads of Government Council held at Stockholm in March 2001. This Council also agreed on proposals to create a new streamlined legislative process for EU Securities Market legislation. The idea is that broad principles are established through primary legislation, under the co-decision procedure between the Commission and the Council of Ministers and European Parliament, with the details left to two new specialized committees. These are the European Securities Committee and the European Securities Regulators Committee (CESR). The intention is to increase the speed at which new financial services legislation can be introduced.

The Lamfalussy Report recommended a four level regulatory approach.

- Level 1 deals with the framework EU legislation which will set out general principles and will be adopted by the Council of Ministers and the European Parliament.

- Level 2 deals with the adoption by the Commission of implementation measures assisted by the two newly created committees above, on the basis of powers delegated to the Commission.

- Level 3 will provide means of greater coordination between national regulators of securities markets.

- Level 4 will aim for better enforcement.

On 5 February 2002 the European Parliament adopted, with some additional safeguards, the new structure as envisaged in the Lamfalussy proposals.

The additional proposals are based on the von Wogau Report and are intended to safeguard the European Parliament rights. The main features are:

- in the event of disagreement between the Commission, the Council of Ministers and the Parliament over implementation measures, an informal meeting between representatives of each will attempt to reach a balanced solution;

- agreement that the Parliament will have equal rights to information, on a timely basis, with the Council Committees implementing the new legislative measures required to build the internal market for financial services;

- the Commission has agreed to a delay of three months to allow MEPs time to examine the implementing measures, albeit on the understanding that this period could be reduced for urgent decisions;

- a market participants committee is to be set up under the auspices of the European Securities Regulators Committee;

- the Parliament intends to revise the Commission's delegated powers after a four-year period.

These initiatives constitute a great step forward towards establishing a deep and liquid capital market across Europe.

## *2.2 The Financial Reporting Strategy for Europe – IFRS by 2005*

Over the last few years FEE has been actively involved in the debate on a financial reporting strategy for Europe. The EU Commission has proposed a Regulation on the Application of International Accounting Standards (now IFRS) to introduce a requirement for listed companies to use IFRS from the financial year 2005 onwards for their consolidated accounts. Individual Member States of the EU will have the option of applying IFRS to other companies, including in preparing their individual accounts. In March 2002, the European Parliament has voted and approved the IAS Regulation.

One aspect of the IAS Regulation is that International Financial Reporting Standards must be endorsed for use in the EU and as part of this an endorsement mechanism has been established by the EU Commission.

At the request of the EU Commission, FEE led the creation of EFRAG, the European Financial Reporting Advisory Group in March 2001. EFRAG is the European forum designed to influence the work of the International Accounting Standards Boards (IASB) to set high quality standards that are relevant to the complex business transactions encountered in Europe today and to keep those standards up to date as transactions and the business environment change. EFRAG will provide the technical level of the endorsement mechanism created by the EU Commission.

FEE strongly supports and promotes the use of International Financial Reporting Standards (IFRS) by European companies where they are used to communicate with the capital markets and other interested parties. In recent years FEE has been at the forefront in supporting the Regulation to require IFRS to be implemented in 2005, and in recommending improvements to IFRS so that they are increasingly suitable for this task.

IFRS are themselves undergoing extensive change according to the improvement and convergence programme of the IASB, which is aimed at building a body of accounting standards that constitute the "highest common denominator" of financial reporting.

## *2.3 High Quality Financial Reporting*

Accounting standards and their application need certain essential characteristics if they are to make their full contribution to creating a deep and liquid capital market in Europe. In particular, they need to be highly relevant to the needs of users of financial statements and to be highly reliable such that they instil confidence in investors and analysts who make economic decisions.

There is a need for a reliable system of financial reporting primarily as a high quality instrument to make accounting trustworthy for all companies operating in the European market. FEE acknowledges the complexity of the process and fully supports the idea of a step by step approach, starting with the consolidated financial statements of listed companies, moving to the annual accounts of the listed companies and progressively spreading to all IFRS companies, whereby SMEs should have a much simpler "ad hoc" disclosure standard created for their needs. A reliable system starts with the internal arrangements within companies, including proper corporate governance structures, to prepare reliable financial statements. High quality financial statements should show a true and fair view of a company's performance and position. High quality financial reporting rests on three pillars as stated by Paul Volcker, Chairman of the IASC Trustees:

- Accounting standards setting out with clarity logically consistent and comprehensive "rules of the game" that reasonably reflect underlying economic reality;

- Accounting and auditing practices and policies able to translate those standards into accurate, understandable, and timely reports by individual public companies;

- A legislative and regulatory framework capable of providing and maintaining needed discipline.

Recent cases of company failures and fraud have implications for companies internal arrangements, corporate governance, financial reporting standards, auditing, regulatory arrangements and for other participants in the capital markets such as investment analysts and rating agencies. These recent cases have shown a clear need for a debate about the arrangements in Europe for enforcement of high quality financial reporting. Even a well-established system of standards and enforcement can apparently fail as evidenced by recent US experience.

## *2.4 Enforcement*

Enforcement arrangements covering the financial statements of European companies prepared under IFRS are a key component of the new arrangements to require use of IFRS by 2005. The IAS Regulation expresses in one of the recitals that a proper and rigorous enforcement regime is key to underpinning investors' confidence in financial markets. Member States are required to take appropriate measures to ensure compliance with IFRS. The Commission intends to liaise with Member States, notably through CESR, to develop a common approach to enforcement.

Successful enforcement will address, amongst other matters, the following risks:

- The risk that IFRS are not correctly implemented for the first time;
- The risk that non-compliance with IFRS is not detected or properly sanctioned;
- The risk that enforcement mechanisms in Europe are regarded as insufficient so that the regulators of other capital markets, such as the SEC, continue to apply their own enforcement of IFRS used by European companies which are also listed overseas;
- The risk of inconsistent implementation and enforcement of IFRS across the EU.

Thus European enforcement arrangements need to be effective as a step towards global acceptance of IFRS for listings worldwide. While all aspects of the overall enforcement system are important, special attention needs to be paid to one aspect of enforcement, in a somewhat narrower sense, which relates to the institutional oversight mechanism for checking the correct application of IFRS by an enforcement body independent from the reporting enterprise as well as from its auditor and other stakeholders. The European Commission and CESR are now developing their proposals rapidly in this area, following the Lamfalussy Report.

Like CESR, FEE believes that there needs to be a debate on enforcement involving all stakeholders and key players in financial reporting, since only with the involvement of all stakeholders will the arrangements for European enforcement achieve the necessary credibility with the capital markets and others.

The purpose of this discussion paper is to contribute to a full and thorough debate both on the enforcement of high quality financial reporting and on the need for the improvement or establishment of effective institutional oversight systems by Member States, within FEE and its Member Bodies, and to facilitate similar debate with other stakeholder organisations, both at EU and national level. This debate needs to engage Member States, existing enforcement bodies in Europe, and representatives of preparers, users and other market participants, as well as the European Commission, EFRAG and CESR.

This paper follows a number of previous relevant papers published by FEE. In 1999, FEE published its "Discussion Paper on a Financial Reporting Strategy within Europe" followed by a note for debate entitled "Financial Reporting Strategy – Main Issues at Stake" in 2000. FEE also published a factual study about "Enforcement Mechanisms in Europe" in 2001. This study concluded that there are important differences in the institutional oversight systems in Europe. In relation to enforcement of financial reporting standards, it concluded that for nearly half of the countries surveyed there was at that time no institutional oversight system in place.

The new arrangements for enforcement to be planned and implemented in Europe must be robust in the public interest and credible and should therefore be fully debated with great thoroughness and take into account experience elsewhere.

**Summary of Section 2**

The drive to create an integrated financial market in the EU is endorsed at the highest level of Governments and by the European Parliament.

One element of the plan is for all listed companies in the EU to prepare consolidated accounts using International Financial Reporting Standards by 2005. Enforcement of IFRS needs therefore to be in place at latest by 2005. In recent years FEE has been at the forefront in supporting the Regulation to require IFRS to be implemented in 2005, and in recommending improvements to IFRS so that they are increasingly suitable for this task. To be ready by 2005 is a large challenge for preparers, auditors, regulators and others.

Recent cases of company failures and fraud have implications for all those concerned with financial reporting. These cases have shown a clear need for a debate about the arrangements in Europe for enforcement of high quality financial reporting.

The purpose of this FEE paper is to serve the public interest by contributing to a full and thorough debate on enforcement of high quality financial reporting.

# 3. SCOPE OF THE ACTIVITIES OF AN ENFORCEMENT BODY

## *3.1 Financial Information subject to Enforcement*

The correction of financial information once it is in the public domain represents a failure. It leads to a loss of confidence in management and the process of review by management, the Board of Directors and Supervisory Boards or Audit Committees. In relation to audited information it leads to a loss of confidence in the audit process. The primary objective of an overall enforcement system should be to detect and correct errors and omissions in financial information before they enter the public domain, whenever possible. An overall enforcement system comprises both internal and external processes. Internal processes should involve the application of an effective system of corporate governance, including the operation of internal controls and review by management and directors, whilst external processes involve a variety of organisations, including the external audit and those bodies charged with enforcement by Company Law and securities legislation: "enforcement bodies". This paper concentrates on the role and responsibilities of these enforcement bodies.

The recognition and measurement of a transaction may be first encountered in interim financial information in the year in which it takes place. If applied incorrectly, it may lead to a distortion in the market price of a company's shares. Similarly, in relation to a new company which is seeking a listing, the market first receives a historical financial record in the prospectus, in advance of the subsequent annual financial statements.

This paper focuses on the enforcement of IFRS in financial information. Although the first step is to address the consolidated annual financial statements of listed companies, the discussion on the improvement of enforcement arrangements in Europe should also cover the application of IFRS in other types of financial information, including regular quarterly or interim reporting, ad hoc reporting and financial information prepared using IFRS in the annual report. It should be noted that not all of this information is subject to audit. In a further step, also individual accounts based on IFRS could be covered. This would in particular be relevant for those Member States that will implement the option to extend the use of IFRS to the individual accounts of companies. This paper does not seek to cover the regulation of other information in the published glossy annual report.

Neither does this paper seek to cover the initial listing or offering of securities (admission to the capital markets), since enforcement in relation to prospectuses has different features in relation to exante control, depth of review and scope for restatement.

## *3.2 Companies subject to Enforcement*

In some EU Member States the option in the IAS Regulation to extend the use of IFRS to consolidated financial statements of unlisted companies and to individual financial statements will be implemented.

It is important that for all companies using IFRS, IFRS are applied and enforced in a consistent way. Given the current differences in enforcement mechanisms, corporate governance structures and in interaction between regulators and other interested stakeholders and the need to be ready to implement IFRS by 2005, the initial scope of enforcement as to which companies are covered should be carefully considered.

Enforcement of IFRS could as a first step start with the consolidated annual financial statements of listed companies, since the proposed IAS Regulation applies directly to listed companies and companies with publicly traded debt securities.

The IAS Regulation includes the option for Member States to extend the use of IFRS beyond listed companies. More specifically for unlisted financial institutions and insurance companies, Member States may wish to extend the requirement to apply IAS to facilitate sector-wide comparability and to ensure effective and efficient supervision. FEE considers that as a second step enforcement should be widened to cover all public interest companies, in particular those in regulated industries for which IFRS may be required. More specifically FEE sees merit in applying enforcement arrangements to banks and insurance companies at an early date. Some Member States may wish to combine these two steps into one, given the importance of non-listed public interest companies.

As a third step the scope could be broadened to all companies using IFRS. If a company chooses, or is by law required, to use IFRS, it may be reasonable that the related consequences include applicability of enforcement, depending on the enforcement arrangements established in the Member State. Ultimately all IFRS companies should be enforced in the same way. Therefore, over time and subject to cost benefit considerations, be it in a step-by-step approach or otherwise, the enforcement mechanism should within a reasonable number of years be extended to all companies using IFRS, so that these standards are applied rigorously and consistently to all such companies throughout Europe.

For this reason, the arrangements for enforcement of accounting standards should be designed so as to be capable of covering non-listed[5] companies. In this context, it should be noted that in an enforcement mechanism for listed companies, securities regulators may play an important role. This is not the case for non-listed companies, where the regulators do not have responsibility or authority. There may be a public interest in companies which are unlisted or do not operate in regulated industries. For example, the draft European Commission Recommendation "Statutory Auditors Independence in the EU: A Set of Fundamental Principles" defines public interest entities as:

*"Entities which are of significant public interest because of their business, their size, their number of employees or their corporate status is such that they have a wide range of stakeholders. Examples of such entities might include credit institutions, insurance companies, investment firms, UCITS, pension firms and listed companies."*

The issues of enforcement in relation to companies with cross border listings and foreign companies with EU listings are considered later in this paper (at Section 8.6).

Overall therefore, the scope of the enforcement mechanism could be broadened as experience is gained and sufficient resources become available to cover larger numbers of companies. Since listed companies have a large impact on economic life, the use of IFRS will spread to other companies, even in the absence of specific requirements. Also the enlargement of the EU will increase substantially the number of companies which may or have to use IFRS. The enforcement system to be put in place needs to be sufficiently flexible to be ultimately capable of covering all classes of companies.

[5] Companies without securities that are admitted to trading on a regulated market within the meaning of Article 1.13 of Council Directive 93/22/EEC

## *3.3 Orientation of Enforcement – Proactive or Reactive ?*

Irrespective of the type of documents and companies to be subject to enforcement, such enforcement may be organised on a proactive basis or on a reactive basis. Under a proactive approach, the enforcement body reviews at its own initiative, after publication, financial statements of companies (and other public financial information). Under a reactive approach, the enforcement body reviews the financial information of individual companies only in response to specific complaints received from other parties. This matter is considered in more detail later in this paper (see Section 10.1).

As with the other elements of scope, the extent of selection has serious resource implications. Cost-benefit considerations should therefore be addressed in determining the appropriate scope of enforcement, particularly when assessing whether and how the initial scope of enforcement should be extended.

**Summary of Section 3**

The primary objective of an overall enforcement system should be to detect and correct errors and omissions before they enter the public domain, whenever possible. FEE therefore believes that the enforcement system should extend to all documents that provide price-sensitive financial information using IFRS, and should not be limited to annual financial statements or just to listed companies. However, pending new Commission proposals on prospectuses, enforcement in relation to prospectuses is not specifically addressed in this paper.

FEE suggests that the scope of the enforcement mechanism should be limited to start with. Thereafter, it should be developed as experience is gained and sufficient resources become available to cover larger numbers of companies. A three step approach might be:

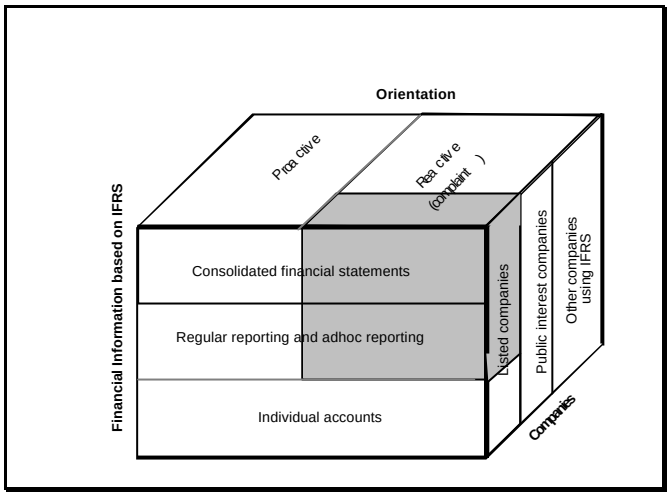
- consolidated financial statements of listed companies, including regular and ad-hoc financial reporting information as related EU or national requirements are put in place or developed;
- financial reporting information of all public interest companies, in particular those in regulated industries, for which IFRS may be required; and
- financial reporting information of all companies using IFRS, including coverage of non-listed companies.

The wider the scope of enforcement, the greater the resources required to make it effective. The scope of enforcement should therefore take into account cost benefit considerations, particularly when assessing whether and how the initial scope of enforcement should be extended.

The diagram on the next page illustrates the financial information and companies which could be subject to enforcement in a step-by-step approach; and the orientation of such enforcement.

The shaded dimensions show a possible first step.

**Diagram 1: Dimensions of Enforcement**[678]




6 It does not address IPOs or transaction related information pending the Commission's revised proposals on prospectuses to which FEE will respond later.

7 Extension of scope involves further resources.

8 For the purposes of enforcement, consolidated financial statements can be taken to include financial information in annual reports prepared using IFRS but not non-financial information.

# 4. A FRAMEWORK FOR HIGH QUALITY FINANCIAL REPORTING

## *4.1 All the Major Influences on Financial Reporting should be Considered*

In discussing how to improve or establish an effective enforcement mechanism all the major influences that affect the quality of financial reporting should be considered as well as how each element of the overall framework for financial reporting can play its proper role.

An overall framework for high quality financial reporting can be developed to illustrate this. The framework is quite neutral as to the legal form of the companies and scope of the financial information that might be the subject of enforcement (e.g. annual financial statements, interim reports, etc.) and the scope of the companies involved (e.g. listed, other public interest, non-listed, etc).

The purpose of the framework is not to be a prescriptive blueprint. It is intended instead to prompt all stakeholders with an interest in high quality financial reporting to identify the elements that are currently present in any particular enforcement system and to consider whether the system could be enhanced by introducing additional elements from the framework. Efficient enforcement should depend on "getting things right in the first place" with mechanisms to enforce changes being mobilised only on an exception basis, when required. The SEC Chief Accountant[9] stated recently:

*"Working together to get it right the first time. Our capital markets are much more efficient if the financial statements you prepare, or audit, reflect appropriate accounting policies and contain appropriate disclosures. Getting it right after a restatement resulting from a staff review or enforcement action by the Commission will still be possible, but it's far less desirable."*

The maximum effort should be concentrated on successful implementation of IFRS in Europe by 2005, in view of the scale of the challenge involved.

The enforcement arrangements for application by companies of IFRS in financial information should not seek to duplicate regulatory or supervisory arrangements in place over other participants. Each participant should have proper industry codes and practices including a clear ethical obligation to raise issues, in the first instance with the company or its Audit Committee or Supervisory Board, and in the second instance, if direct liaison with the company is unsatisfactory, with the enforcement body. Duplication should be avoided where adequate quality control systems and supervision are already in place. Those charged with enforcement should of course have the facility to refer issues of concern to other supervisors and regulators.

## *4.2 The Principal Elements of the Framework*

***Preparation of financial information by an Effective and Well Resourced Internal Company Accounting Function***

An effective system commences with each internal company accounting function, which should have systems and adequate resources to check the:

[9] Robert K. Herdman, Chief Accountant SEC "Advancing Investors' Interests" speech 6 December 2001

- internal controls;
- reliability of the data capture for each transaction;
- selection and application of appropriate policies recognition and measurement of balances; and
- completeness of the resulting disclosure of transactions, balances, risks and uncertainties.

***Internal Audit and Informed Review by Directors, Audit Committees and Supervisory Boards***

Such a system also includes an extensive program of internal audit and an internal system of regular and detailed review of financial information by an Audit Committee or a Supervisory Board and by the Board of Directors for each company. Audit Committees or Supervisory Boards and Boards of Directors need to make themselves adequately informed and resourced about IFRS. Directors may not themselves be experts in accounting, but their companies should at least have a senior member of management with a delegated responsibility for monitoring developments in IFRS and raising issues with the Board. In describing the systemic problems which have been exposed in the United States, the Chairman of the SEC said recently[10] that they include:

*"audit committees that often do not understand the accounting principles employed by management, or the consequences of using different principles or different assumptions."*

The above corporate governance processes result in a necessary system of internal checks that cover all transactions, balances and disclosures that are reported in management accounts, interim financial information, annual financial statements, financial information in listing particulars and similar documents.

***Proper Approval Procedures of Financial Information by the body responsible within the company***

There is a growing consensus that Audit Committees or Supervisory Boards are a key element of corporate governance best practice, because of the role which they can play in helping to ensure high quality financial reporting and effective internal control. It is less evident, however, that there is full, widespread and consistent agreement on what their roles and responsibilities should be, or on which practices are most effective. National requirements diverge across Europe and the world, especially between one-tier and two-tier systems, and different business and governance cultures have varying impacts on their effectiveness.

The Board of Directors is responsible in law for preparing the accounts in accordance with GAAP, in this case IFRS. After formal approval and adoption of the accounts by the organ of the company that is legally competent to do so, the individual accounts of the legal entity are a legal document that creates legal relationships. Annual accounts which are defective can lead to civil court action as well as criminal court action. This emphasises the importance of the care which the organ of the company responsible for the approval of the financial statements should take to ensure, as the first line of defence of high quality financial reporting, that:

- the internal company accounting function is effective and properly resourced
- internal audit is applied to a high standard
- as directors, they are adequately informed and resourced about IFRS
- their review of financial information is thorough and is based on good corporate governance practices, such as use of Audit Committees or Supervisory Boards.

[10] Chairman Harvey L. Pitt: Remarks at the 29th Annual Securities Regulation Institute, 23 January 2002

It is noted that in the United States there are new Government initiatives to consider the reform of corporate disclosure and governance and specifically whether new obligations should be imposed on corporate officers and directors. In the United Kingdom, new government and parliamentary initiatives will address corporate governance and the role of non-executive directors, as well as external audit arrangements. In Germany, recently a corporate governance codex has been published which introduces the requirement of the Supervisory Board to approve not only individual but also consolidated financial statements. Furthermore, the codex recommends to establish an Audit Committee providing input to the Supervisory Board in relation to the examination and approval of (individual and consolidated) financial statements. Also the European Commission has undertaken a study of corporate governance practices in Europe, which may result in further proposals in due course.

FEE believes that there is a need to strengthen internal corporate governance arrangements so that they are equally effective across Europe in relation to financial information using IFRS. These should be codified in a new initiative as part of implementing the Financial Services Action Plan.

***External Audit and External Review subject to Appropriate Quality Control Systems***

Another key element of the system is that of the external audit of annual financial statements and external review of other financial information which is presented to the public. The audit subjects information to independent and objective scrutiny, thereby increasing the reliability of financial information. An audit of financial statements involves checks, on a test basis, of individual transactions and balances using a risk-based approach. It also involves a detailed consideration of accounting policies and presentation of overall financial statements comparing the results with experience gained of the application of the standards to identical or similar transactions. Trustworthy and effective audits, accompanied by appropriate quality controls systems, are essential to the efficient allocation of resources in a capital market environment, where investors and other stakeholders are dependent on reliable information. The EU Commission has issued a Recommendation on the Minimum Requirements for Quality Assurance for the Statutory Audit of Financial Statements in the EU.

However, if financial statements depart from accounting standards, it is the duty of the auditors to draw attention to the departures in reporting to the stakeholders. It should be recalled that the auditors have no legal power to enforce correction of errors and misstatements or to issue sanctions, although they will qualify their report for the departure from accounting standards.

Auditing standards increasingly emphasise the role of auditors in communicating on the quality of results in proposed financial statements to those charged with governance. This helps to promote high quality reporting.

***Effective Enforcement Bodies***

Another essential element of the framework for high quality financial reporting is the institutional oversight system for checking the correct application of IFRS by an enforcement body being independent from the reporting enterprise as well as from its auditor and other stakeholders. Enforcement bodies are a necessary part of any financial reporting framework in that they investigate, as a minimum, complaints about non-compliance when they are received. They often have the delegated power to force changes to the financial statements where errors or omissions have escaped the internal company and external audit processes and have at least the power to start a court case. Enforcement bodies can also refer issues to other regulators or supervisors for example in relation to the activities of market participants and auditors.

Enforcement may be undertaken directly by securities regulators or by bodies constituted by stakeholders for that specific purpose (referred to as review panels). However, it needs to be recognised that if enforcement is undertaken solely and directly by securities regulators, they may not be competent to act in relation to unlisted entities whose financial reporting is of public interest, that other regulators may have a role to play and that special arrangements may then be needed for unlisted companies, both those of public interest and others using IFRS. Also, other stakeholders can make major contributions in providing oversight over, and demonstrating commitment to, high quality financial reporting. Therefore, an expert specialist body charged with delegated enforcement responsibilities over the application of accounting standards in financial information established by a private sector initiative with involvement of all stakeholders such as the UK Financial Reporting Review Panel (see description in Appendix 4) may be an effective arrangement.

***Stock Exchanges with Supportive Listing Agreements***

Stock Exchanges can use listing agreements with companies to reinforce standards of transparency and corporate governance which foster high quality financial reporting.

Stock Exchanges are now generally regulated commercial entities subject to independent supervision. Several Stock Exchanges have announced plans to alter their ownership structures and to develop as commercial enterprises. There is a risk that conflicts of interest may arise between commercial interests and the regulatory responsibilities of exchanges.

***Sponsors, advisers and investment bankers with a formal commitment to high quality financial reporting***

Sponsors, advisers and investment bankers, who understand the financial reporting consequences of complex transactions, play a crucial role in the structuring of complex transactions that pose some of the greatest challenges in the application of accounting standards. Their understanding of the accounting treatment of such transactions is often central to the resolution of difficult financial reporting challenges and subsequent issues of enforcement. They should be formally committed to high quality financial reporting in respect of complex transactions, perhaps as part of the terms on which they are licensed and regulated and have an obligation to cooperate with Audit Committees (Supervisory Boards) and external auditors.

***Investors, Analysts, Rating Agencies and the Financial Press, each of which should have clear ethical obligations to raise issues of dubious financial reporting***

Investors, sell and buy-side analysts, rating agencies and the financial press have a public interest role to play in promoting high quality financial reporting in the public interest. They should have proper industry codes and practices including a clear ethical obligation to raise issues identified in a way that leads to their correction.

## *4.3 The Framework – Enforcement in a Broad Sense*

This framework explains the major influences and market participants affecting the quality of financial reporting. Each of these should be subject to appropriate enforcement in relation to their responsibilities to support high quality financial reporting. This is enforcement in its broad sense.

The next section of the paper addresses the definition of enforcement in the special sense of enforcing proper application of accounting standards used in financial information.

**Summary of Section 4**

- All the major influences which affect the quality of financial reporting should be considered and how each element can play its proper role

- An overall framework for financial reporting can be developed to illustrate this. The principal elements of the framework are:

  - preparation by an effective and well resourced internal company accounting function;
  - internal audit and informed review by directors, Audit Committees or Supervisory Boards;
  - proper approval of financial information by the body responsible within the company;
  - external audit and external review subject to appropriate quality assurance systems;
  - effective enforcement bodies. An expert specialised body charged with delegated enforcement responsibilities over the application of accounting standards in financial information may be an effective arrangement;
  - Stock Exchanges with supportive listing agreements;
  - sponsors, advisers and investment bankers with formal commitments to high quality financial reporting particularly in respect of complex transaction;
  - investors, analysts, rating agencies and the financial press, each of which should have clear ethical obligations to raise issues of dubious financial reporting.

- Each of these parties should be subject to enforcement in relation to their responsibilities to support high quality financial reporting. This is enforcement in its broad sense.

- FEE believes that there is a need to strengthen corporate governance arrangements so that they are equally effective across Europe in relation to financial information using IFRS.

# 5. DEFINITION OF ENFORCEMENT OF ACCOUNTING STANDARDS USED IN FINANCIAL INFORMATION

## *5.1 Enforcement as part of EU Financial Reporting Strategy*

In the Frequently Asked Questions published by the Commission together with a proposal for a Regulation on the application of international accounting standards in February 2001, the question on how enforcement of IFRS (then IAS) can be improved is raised:

> *"An **equivalent level of enforcement is necessary** to bring about an **efficient capital market** Companies which apply IAS do not always fully comply with the standards. This needs to be corrected. First of all, common guidance is needed about the way in which the standards are to be applied. This is first of all the task of the Standards Interpretation Committee, which develops interpretation guidelines for the proper implementation of IAS. If need be, these guidelines could be supplemented at the EU level by the endorsement mechanism.*
>
> *Secondly, the financial statements must be **properly audited**. The audit profession is on the front line in this respect, as auditors are required to certify that the financial statements have been properly prepared. In order to ensure an equivalent high quality level of audit throughout the EU, the Commission has published a Communication in 1998 setting out the priorities for action in this area. Last year, the Commission issued a Recommendation on Audit Quality Assurance (see IP/00/1327). Further work is under way within the EU Committee on Auditing on subjects such as auditing standards, the audit report and independence.*
>
> *Thirdly, **external supervision** is necessary in order to protect investors. Securities supervisors have a critical role in ensuring that listed companies comply with financial reporting requirements. The Commission looks to European securities markets supervisors through FESCO (the Forum of European Securities Commissions)[11] to develop and implement a common approach to enforcement. It is FESCO's intention to set up a permanent sub-committee that will work on enforcement issues, notably **enforceability of accounting standards**."*

The IAS Regulation expresses in one of the recitals that a proper and rigorous enforcement regime is key to underpinning investors' confidence in financial markets. Member States are required to take appropriate measures to ensure compliance with IFRS. The Commission intends to liaise with Member States, notably through CESR to develop a common approach to enforcement.

## *5.2 Some Previous Discussion of What is Meant by Enforcement*

In the FEE 2001 study on enforcement mechanisms in Europe, enforcement is defined in a broad sense as all procedures in a country in order to assure the proper application of accounting principles and standards. Efficient enforcement should be made up of due process and economic efficiency, the essential performance measure being to deter harmful violations.

FEE, as well as the previous IASC Board in its legacy statement of December 2000, identified as a key feature of effective enforcement the ability to require the restatement of financial statements that do not comply with applicable accounting standards.

[11] CESR (The Committee of European Securities Regulators) has taken over all undertakings, standards, commitments and work agreed within FESCO from mid 2001 onwards.

CESR[12] defines[13] enforcement as the combination of supervision and sanctioning in cases of non-compliance with the rules. CESR distinguishes several participants in the regulatory framework for financial information. It indicates that "the competent authorities may build their work on the activities of statutory auditors, their professional bodies and the regulated markets – however this requires that these parties not only are financially liable for their actions but also are subject to adequate supervision from competent authorities". The purpose of enforcement according to CESR in its 2001 response to the EU's new accounting strategy is to ensure that IFRS will be properly enforced throughout the EU. The enforcement will contribute to comparable financial statements for listed companies and a level playing field in Europe in order to prevent regulatory arbitrage.

### *5.3 Prevention – Careful Preparation, Review and Approval of Financial Information – The First Line of Defence*

As explained in the previous section of this paper, in considering the definition of enforcement, there should be emphasis on the internal company arrangements for high quality financial reporting as the first line of defence. It should be remembered that aggressive earnings management, misrepresentation and fraud could hamper the proper application of IFRS. On the other hand errors and omissions are not always unintentional. Attention should be given to the careful preparation, review and approval by companies of financial information which they will issue. This internal company process should be carried out within a suitable corporate governance structure. Such information, for example quarterly reports, may not be subject to audit or review by auditors. Prevention of material errors or omissions in the application of IFRS in financial information is important. The aim should be to "get things right the first time" and avoid the need for later correction.

### *5.4 Criteria for Assessing the Effectiveness of Enforcement Systems*

Enforcement systems for financial reporting are designed both to prevent and to detect and correct material errors and omissions in the application of financial reporting standards.

Effective enforcement systems therefore should have certain features, which are discussed more fully in Section 6 of this paper. Such systems should:

- support responsible behaviour by all market participants who can influence financial reporting, as well as high quality corporate governance and external audit, so as to prevent material errors and omissions;

- issue decisions which consistently and expertly apply international financial reporting standards, in order to correct errors and omissions;

- command general acceptance through being perceived to be free from bias, operating transparent and clear procedures, acting confidentially and quickly, dealing only with material matters, avoiding detailed rule-making and striking a balance between costs and benefits;

[12] CESR (The Committee of European Securities Regulators) has taken over all undertakings, standards, commitments and work agreed within FESCO from mid 2001 onwards.
[13] FESCO's response to the EU's new accounting strategy, 28 February 2001.

- have the power to force rectification of financial statements and other financial information; and

- be able to refer parties responsible for errors and omissions to appropriate disciplinary or other authorities for sanctioning or impose such sanctions directly.

These five items above can be considered to constitute criteria for assessing the effectiveness of enforcement systems.

## *5.5 FEE's Definition of Enforcement*

In this Discussion Paper, the following definition of enforcement is used:

*"Enforcement is a system to whenever possible prevent, and thereafter identify and correct, material errors or omissions in the application of IFRS in financial information and other regulatory statements issued to the public."*

This paper concentrates on the role and responsibilities of enforcement bodies rather than on the overall enforcement system as described in Section 4.

**Summary of Section 5**

Effective enforcement of accounting standards is part of the EU financial reporting strategy to use IFRS.

The previous IASC Board, FEE and CESR have recognised the importance of enforcement and considered how it might be described.

Prevention of material errors or omissions in the application of IFRS in financial information is important. The aim should be to "get things right the first time" and avoid the need for later correction. It should be remembered that aggressive earnings management, misrepresentation and fraud could hamper the proper application of IFRS. On the other hand, errors and omissions are not always unintentional. For these reasons, there is need for a careful preparation, review and approval of financial information by individuals and bodies within companies whose responsibilities are established under a suitable corporate governance structure companies themselves are the first line of defence in all circumstances – not only when information is unaudited.

There are certain criteria for assessing the effectiveness of enforcement systems.

In this paper FEE uses the following definition of enforcement of accounting standards applied in financial information:

*"Enforcement is a system to whenever possible prevent, and thereafter identify and correct, material errors or omissions in the application of IFRS in financial information and other regulatory statements issued to the public."*

# 6. FEATURES OF EFFECTIVE ENFORCEMENT SYSTEMS

## *6.1 Preparing Enforcement Systems*

All European Member States should be required to implement an effective system of enforcement of accounting standards. FEE conducted a detailed review of existing institutional oversight systems to enforce accounting standards throughout Europe during 2001. The study "Enforcement Mechanisms in Europe" identified that there was a wide variation in the nature and scope of existing systems, which may result in a wide variation in their effectiveness. Only a few European countries have an enforcement body checking the correct application of IFRS in annual financial statements. In most countries which have an institutional oversight system the enforcement body is only responsible for enforcement in relation to other documents than financial statements (e.g. prospectus) or is only prepared to undertake reviews limited to formal checks whether the documents to be published are complete.

The increased complexity of IFRS when compared to many national accounting standards will require all Member States to review their existing enforcement mechanisms in order to decide whether improvement is needed to ensure proper and rigorous enforcement of IFRS. Some non-listed companies will wish to adopt IFRS to give them added credibility with lenders and providers of private equity capital. Banks and insurance companies will probably need to apply IFRS, including non-listed banks and insurance companies. Other non-listed companies will wish to adopt IFRS as part of their preparation for a listing to establish a reliable track record, or for other reasons. It is important that the application of IFRS to these companies should be consistent with those which are listed.

The following characteristics of enforcement need to be addressed in the discussion of how to improve the enforcement of accounting standards:

1. Support for high quality corporate governance and external audit

2. Quality of decision taking
   - Consistent application and interpretation of accounting standards
   - Competence and expertise

3. Generally accepted enforcement process:
   - Freedom from bias
   - Transparent and clear procedures
   - Confidentiality and speed of action
   - Avoid making detailed accounting rules
   - Focusing of resources
   - Rectification of defective financial information
   - Corrective actions and sanctions.

In addition, the financing of the enforcement arrangements needs to be considered but is not discussed further in this paper at this stage of the debate.

## *6.2 Support of High Quality Corporate Governance and External Audit*

As already explained in Section 4 of this paper, enforcement cannot be addressed without consideration of proper corporate governance structures and other influences on financial reporting. Each of the parties involved needs to assume responsibility to make its contribution

strong and of high quality, in particular in relation to the enforcement of IFRS aiming at high quality financial reporting. It is the responsibility of the management of the company to develop proper procedures to ensure that financial statements are in compliance with an agreed set of GAAP, in this case IFRS. Furthermore, the body responsible for examination and approval of the financial statements within the company has to fulfil its tasks in a responsible manner (see also Section 4).

As explained in Section 4, FEE believes that there is a need to strengthen corporate governance arrangements so that they are equally effective across Europe in relation to financial information prepared using IFRS. It would be helpful if an internationally agreed minimum framework for corporate governance disclosure regimes were to be adopted. The management, Directors and Supervisory Board or Audit Committee, be obliged to disclose how they discharge their responsibilities (as described in Section 4 and Appendix 1).

These responsibilities are also recognised by the US SEC which recently issued a Report of Investigation and Statement[14], setting out a framework for evaluating a company's cooperation with the SEC in determining whether and how to charge violations of the federal securities laws:

- *"Self-policing prior to the discovery of the misconduct, including establishing effective compliance procedures and an appropriate tone at the top;*

- *Self-reporting of misconduct when it is discovered, including conducting a thorough review of the nature, extent, origins and consequences of the misconduct, and promptly, completely, and effectively disclosing the misconduct to the public, to regulators, and to self-regulators;*

- *Remediation, including dismissing or appropriately disciplining wrongdoers, modifying and improving internal controls and procedures to prevent recurrence of the misconduct, and appropriately compensating those adversely affected; and*

- *Cooperation with law enforcement authorities, including providing the Commission staff with all information relevant to the underlying violations and the company's remedial efforts."*

According to the Communication from the European Commission "EU Financial Reporting Strategy: The Way Forward" of June 2000 "the statutory audit function, which ensures a proper application of accounting standards, will need to be carried out to uniformly high levels across the EU. This requires giving urgent attention to the establishment of benchmarks for auditing, the development of professional ethics standards and the implementation of effective quality assurance systems for the statutory audit function." The accountancy profession is prepared to fulfil its part, as evidenced by the strong input of FEE in the Committee on Auditing and its support for the Recommendation on Quality Assurance Requirements for Statutory Audit.

Both corporate governance and external audit form essential pillars of high quality financial reporting. Any enforcement system should therefore support both high-quality corporate governance and high-quality external audit and contribute to it. In this context, the issue of confidentiality needs to be borne in mind. Auditors have, on a confidential basis, access to the whole of the company and are involved in an exchange of confidential information with the company. The accompanying bond of trust between the company and the auditor is crucial for the quality of the audit and therefore needs to be respected in the enforcement process (for more

[14] Press release 23 October 2001 (2001-117)

detail see Section 9). In order to support the audit function, discussion of financial reporting issues between companies and enforcement bodies should take place in the presence of auditors, and on the basis of a comprehensive written explanation of the issue confirmed by the company's Board.

## *6.3 Quality of Decision Taking*

***Consistent application and interpretation of accounting standards***

There is a need for IFRS to be applied rigorously and consistently to all companies throughout Europe, with due regard for how they are applied elsewhere in the world. IFRS will be applied across most countries in Europe. Consistency of application is crucial. Consistency with global standards raises questions on interpretation at national or European level of IFRS. Because of its complexity the issue of consistent application and interpretation of IFRS is discussed in detail in Section 8.

***Competence and Expertise***

To focus on quality, enforcement bodies will need access to those with significant experience of applying and interpreting IFRS on a daily basis. This will be a particular problem in 2005, and the initial period thereafter, when such experience will be scarce. Indeed, this may be an even more difficult issue in the near future as many companies will probably wish to use IFRS for 2003 and 2004 if permitted to do so.

As the quality of decisions will improve if based on expertise, the enforcement body should have the necessary competence and expertise. This could be achieved by involving experts and practitioners in the enforcement decisions. Senior independent practitioners, with direct experience of contemporary issues and practice, are already involved in the review process at the French COB (see Appendix 2).

Involvement of other participants as well as regulators would widen the range of experience and should result in better decisions. Enforcement bodies could obtain expertise from the private sector (through recruitment, secondments or otherwise). Sufficient resources – funding and staff – should be available in order to attract the necessary competence and expertise. Involvement of a range of experts and practitioners from different groups of stakeholders should enhance the respect for the decision taking process and acceptance of the decisions taken, provided that due ethical precautions are put in place to guard against conflicts of interest and preserve independence.

## *6.4 Generally Accepted Enforcement Process*

In order to be well understood and generally acceptable to all stakeholders, the following characteristics should be met: freedom from bias, transparent and clear procedures, confidentiality and speed of action, avoidance of making detailed accounting rules, focusing resources, rectification of defective financial information and sanctions.

***Freedom from bias***

The enforcement body should make unbiased decisions. Confidence in a system arises where the relevant parties believe that they will be treated fairly and on the basis of a level playing

field with their peers. However, in FEE's view this would not require each of the individuals working within the enforcement body to be independent from all stakeholders in financial reporting, including Stock Exchanges, investors, analysts, investment banks, companies and the accountancy profession. Individual members of the enforcement body can come from interested parties (stakeholders) provided that none of the stakeholders dominates in the decisions taken and individual members are free of conflicts of interest in respect of individual cases. The decision process needs to be fair and its outcome respected. Individual members should give an undertaking to behave at all times in good faith and to withdraw from consideration of any individual case in which they might have a conflict of interest.

***Transparent and clear procedures***

Transparency of the activities of the enforcement body is of crucial importance for widespread acceptance of its decisions by the different parties involved, as the enforcement body can by transparency demonstrate that it follows clear procedures and takes its enforcement decisions in a competent manner. Taking into account different national environments, the procedures do not need to be identical for each enforcement body, but convergence should take place over time by cooperation and experience.

Given the aims of transparency and consistency, there is a good case for each enforcement body in Europe to publish its working procedures in some detail. An example is the UK Financial Reporting Review Panel's "Operating Procedures", attached at Appendix 5. It follows that each body's procedures should be consistent with a framework of common European best practice principles. As there will inevitably be some modifications required for each national enforcement body, for example due to the requirements of national law, it would be helpful if each body's procedures gave a brief explanation of any significant necessary departures from the common European framework of best practice principles, which might be established by a European enforcement coordination mechanism (see Section 7).

Part of the procedures should be to feed in decisions to the IASB or to IFRIC and to recognise the authority of endorsed IASB interpretations and standards, since an enforcement decision should not create new "GAAP". Furthermore these decisions should be referred to EFRAG. EFRAG should consider whether to provide a commentary on these decisions for general applicability and the need for IFRIC interpretations or amendments to IFRS.

For reasons of transparency, at the end of each investigation, where the financial information is found by the enforcement body to be defective and is to be corrected, there should be a clear and well-known public statement that is widely disseminated. Furthermore, the enforcement body should issue an annual report which gives an overview of its enforcement activities (e.g. the number of complaints, different kinds of actions taken by the enforcement body and financial reporting issues considered by the enforcement body).

***Confidentiality and speed of action***

In the beginning, any investigation needs to be confidential in order to avoid an immediate impact on the share price and misuse of the system by competitors or others. A trustworthy process is needed to guarantee confidentiality and to establish a proper dialogue with the company concerned. If the complaint proves to be unfounded, the company may be entitled to expect an enforcement body to keep its affairs confidential. During the process the company involved may need to react and to break the confidentiality in a formal way, for instance if it is of the opinion that the issue is of sufficient public interest to require a public debate. It should also be observed, under certain enforcement systems, that it is not unusual for complainants to notify the press that a complaint has been filed. The conclusions and decision of the

enforcement body are usually published as specific or general cases and fed into the standard setting process.

However, it can be questioned if decisions should be published when the information is not yet in the public domain. On the other hand, if the information is not published, this may be unfair to other companies in similar situations. A level playing field needs to be found in the communication of decisions, with due respect for confidentiality.

Confidentiality is also an issue in a European enforcement coordination and in cross-border enforcement: the ability to share information between enforcement bodies is an important issue but needs to be approached very carefully, with well developed and legally sound procedures.

A pure court based system of enforcement would slow down the speed of action, as actions by court can be long lasting (see Appendix 1). The enforcement system needs to be cost effective and concern contemporary standards. Timely action is needed so that in case of abuse, it does not persist. Errors and omissions in financial information may lead to the creation of a false market in shares or debt instruments. Once a financial reporting issue has been identified as constituting non-compliance, it is important that it should be resolved quickly, so that appropriate information can be shared with market participants as soon as possible. Reasonable speed nevertheless needs to allow for a proper due process. Reasonable speed would usually require decisions before the next financial reports (interim reports, financial statements, etc.) are published. Speed of action also requires the availability of sufficient resources.

It is evident that any necessary European or international consultation will have implications on the speed at which enquiries may be finalised.

***Avoidance of making detailed accounting rules***

It remains vital that accounting standards be based on principles and not overly detailed rules. Such rules could enter the IFRS environment within the text of individual standards or interpretations, or by many different enforcement bodies publishing their own positions on how the various principles and accounting standards should be applied. Enforcement bodies should refer problem interpretation issues to the IASB or IFRIC. Furthermore these issues should be referred to EFRAG. EFRAG as part of its pro-active role towards IASB, should consider whether to provide additional commentary to IASB giving EFRAG's assessment whether the decision on the application of IFRS taken by the enforcement body should lead to IFRIC interpretations or changes to IFRS. It is not appropriate for an enforcement mechanism to publish a statement that it has "cleared" particular accounting treatment or "cleared" a specific set of financial statements containing a specific transaction, as this adds to the base of rules that risk being inappropriately applied elsewhere (for more detail see Section 8).

***Focusing resources***

Resources need to be identified to meet the deadline for having proper enforcement systems for IFRS in place by 2005. There are costs and benefits inherent to each system of enforcement and a proper balance needs to be found. To design systems of no failure and 100% coverage would be very costly and may indeed be impossible. A risk-based approach should therefore be considered in determining the scope and coverage of reviews to allow the efficient and appropriate allocation of (personnel and financial) enforcement resources.

In addition, an effective enforcement process should have procedures in place to avoid time-consuming and expensive investigations into relatively minor matters of non-compliance. A step-by-step approach to enforcement could also help in focusing resources (see Section 3).

An enforcement body should also have a mechanism for identifying malicious, trivial or ill-informed complaints.

***Rectification of defective financial information***

The proper rectification of defective financial information is also a characteristic of good enforcement. The appropriate means of rectification depends on the particular case and could range from restatement of defective financial statements to subsequent disclosures or other forms of publication. Guidance on the appropriate means of rectification needs to be developed taking into account different national environments. For example, the company law of some countries prohibits restatement of approved financial statements. An enforcement body needs to have the power to start a court case if it has no direct power to force changes to the financial information.

When a correction relates to the individual accounts, an additional problem may appear if the profit is changed, since this profit may have been used for dividend determination. This is why decisions of the enforcement body need to be supported by suitable legal authority. The individual financial statements have both a legal function (capital maintenance, distribution and taxation purposes) and an information function, whereas the consolidated accounts usually have only an information function.

It is also possible to go to court for a final legal judgement on an issue considered by the enforcement body, with the risk that the court might interpret the accounting standards differently. This risk is inherent in any type of enforcement system. This reinforces the need for decisions of the enforcement body need to be widely respected and accepted. An enforcement body also needs to have sufficient financial resources in order to be able to go to court to defend its decisions, or to appeal against adverse court rulings.

***Sanctions***

Enforcement decisions and rectifications need to be implemented. This requires a proper sanctioning system for all responsible parties involved. While the enforcement mechanism should be an advocate for investors, the actions of all responsible parties involved in financial reporting should be eligible for review. There should be an incentive for each party involved to get the financial information right, including systems of discipline and sanctions. In this respect a level playing field needs to be created within Europe.

When an enforcement decision is taken and made public, adequate supervision and discipline is needed of the parties involved. Given the need for timely decisions, a distinction needs to be retained between investigation into the alleged defective financial information – which focuses on any necessary correction of the accounting matter at issue – and the conduct of those responsible for the information and for whom separate legal representation may be required. Each of the parties responsible should be subject to consideration of their actions and in serious cases amenable to court action.

It should be emphasised that it is not a necessary feature of an enforcement body that it should itself become involved in imposing sanctions. Indeed there are strong arguments for separating the role of enforcing correct application of accounting standards from the additional function of sanctioning. The primary emphasis should be on correcting inappropriate application of IFRS, so that the integrity of financial information is upheld. While sanctions are an essential feature of effective enforcement, the means by which they are applied can vary. Instead of imposing sanctions itself the enforcement body should provide information to other existing regulatory or

supervisory authorities, including any relevant private oversight bodies responsible for those concerned, such as directors and auditors. For effectiveness reasons an additional system to those systems of discipline and sanctions already in place through other regulatory arrangements should not be introduced.

Sanctions on the company and those concerned with financial reporting can have various forms, including public criticism ("naming and shaming"), fines, suspension of listing and combinations of these sanctions. A large diversity in the use of sanctions may create incentives for enforcement arbitrage, because some companies may seek a jurisdiction where the sanctioning is thought to be less strict compared to other jurisdictions. This would undermine therefore the benefits of the creation of a single market. Therefore, broadly equivalent sanctions needs to be established in order to avoid distortion of the single market and to provide a level playing field within the EU. These sanctions should be provided for at national level.

## *6.5 FEE's View*

FEE's view is that a review of existing enforcement arrangements should be conducted. It should take as benchmark the features set out above. The results would help to explain to all market participants why new arrangements are necessary and to promote widespread support.

**Summary of Section 6**

- **Member States should review their existing enforcement bodies by reference to certain essential features.**

  The increased complexity of IFRS when compared to many national accounting standards will require all Member States to review their existing enforcement mechanisms. FEE has identified the following essential features of an effective body, which include:

- ***Support for high quality corporate governance and external audit*** – An effective system of enforcement relies upon all those with influence on financial reporting playing their part. It is important that the enforcement body supports the effective functioning of the roles of management, Directors and the Supervisory Board or the Audit Committee and the external audit. In order to support the audit function, discussion of financial reporting issues between companies and enforcement bodies should take place in the presence of the auditors, and on the basis of a comprehensive written explanation of the issue confirmed by the company's Board.

- ***High quality, expert, globally-consistent decisions on important issues*** – IFRS need to be applied rigorously and consistently to all companies throughout Europe, with due regard for how they are applied elsewhere in the world. Enforcement bodies will need to have the necessary expertise to make high quality enforcement decisions at a time when IFRS expertise is scarce. Enforcement bodies have little time to prepare for IFRS as some companies can use IFRS today and others will do so for 2003 and 2004 if permitted. It will continue to pose an even greater challenge in 2005 and the initial period thereafter. Involvement of a range of experts and practitioners should enhance the respect for the decision taking process and acceptance of the decisions taken, provided that due ethical precautions are put in place to guard against conflicts of interest and preserve independence.

- ***Freedom from bias*** – The enforcement body should make unbiased decisions. However, in FEE's view this would not require each of the individuals working within the enforcement

body to be independent from all stakeholders in financial reporting, providing they give an undertaking to behave in good faith and avoid conflicts of interest arising from any individual case.

- ***Transparency and clear procedures*** – transparency of the activities of the enforcement body is of crucial importance for widespread acceptance of its decisions. Enforcement bodies should demonstrate that they follow clear procedures and take enforcement decisions in a competent manner. Each enforcement body in Europe should publish its working procedures in some detail. These procedures should be consistent with a framework of common European best practice principles, which might be established by a European enforcement coordination mechanism after suitable consultation.

  To ensure transparency of decision taking where financial information has been found by the enforcement body to be defective and is to be corrected, there should be a clear, well-known and public statement that is widely disseminated.

  Enforcement bodies should feed their decisions to IASB or IFRIC. These decisions should also be referred to EFRAG. EFRAG as part of its pro-active role towards IASB should consider to provide a commentary of its assessment of their general applicability and the need for IFRIC interpretations or amendments to IFRS. Enforcement bodies should also provide information to other regulatory or supervisory authorities or private oversight bodies with a view to their imposing sanctions where appropriate.

- ***Confidentiality and speed of action*** – errors and omissions may lead to the creation of a false market in shares or debt instruments. Once an issue has been identified as non-compliance, it is important that it is resolved quickly, so that appropriate information can be shared with market participants as soon as possible. However, this needs to be balanced with appropriate confidentiality. It is equally inappropriate for the price of shares or debt instruments to be depressed by rumour that an accounting issue is under investigation.

  Confidentiality is also an issue in a European enforcement coordination and in cross border enforcement; the ability to share information between enforcement bodies is an important issue but needs to be approached very carefully, with well developed and legally sound procedures. Speed of action also requires the availability of sufficient resources.

- ***Avoidance of making detailed accounting rules*** – it remains vital that accounting standards be based on principles and not detailed rules. Rules could enter the IFRS environment within the text of individual standards or interpretations, or by many different enforcement bodies publishing their own positions on how the various principles should be applied. Enforcement bodies should refer problem interpretation issues to the IASB or IFRIC as well as to EFRAG. EFRAG should consider to provide a commentary on general applicability and the need for IFRIC interpretations or amendments to IFRS. It is not appropriate for an enforcement mechanism to publish that it has "cleared" an accounting treatment or "cleared" a specific set of financial statements containing a specific transaction, as this adds to the base of rules that risk being inappropriately applied elsewhere.

- ***Focusing resources*** – Resources need to be identified to meet the deadline for having proper enforcement systems for IFRS in place by 2005. A risk-based approach should be considered in determining the scope and coverage of reviews to allow for efficient allocation of enforcement resources.

  To prevent waste, procedures should be in place to avoid time consuming and expensive

investigation of relatively minor matters of non-compliance and to identify malicious, trivial or ill-informed complaints.

- ***Rectification of defective financial information*** – The proper rectification of defective financial information is a characteristic of good enforcement. The appropriate means of rectification depends on the particular case and could range from restatement of defective financial statements to subsequent disclosures or other forms of publication. Guidance on the appropriate means of rectification needs to be developed, taking into account different national environments. The potential legal implications of requiring restatement of defective financial statements should be fully considered. An enforcement body needs to have the power to start a court case and sufficient financial resources to do so, to defend its decisions and to appeal against adverse court rulings.

- ***Sanctions*** – In order to ensure that enforcement decisions and rectification are implemented, a proper sanctioning system for all responsible parties involved is essential. It is not a necessary feature of an enforcement body that it should itself become involved in imposing sanctions. There are strong arguments for separating the role of enforcing correct application of accounting standards from the additional function of sanctioning. The primary emphasis of an enforcement body should be on correcting inappropriate application of IFRS, so that the integrity of financial information is upheld. While sanctions are an essential feature of effective enforcement, the means by which they are applied can vary. They should not involve an additional system to those already in place through other legal or regulatory arrangements.

  Care should be taken that the new enforcement system for Europe should be accompanied by broadly equivalent sanctions in order to provide a level playing field within the EU and to avoid enforcement arbitrage. This is to avoid companies seeking a jurisdiction where the sanctioning is thought to be less strict.

- FEE's view is that a review of existing enforcement arrangements should be conducted. It should take as benchmark the features set out above. The results would help to explain to all market participants why new arrangements are necessary and to promote widespread support.

# 7. ENFORCEMENT MODELS AT A EUROPEAN LEVEL: THE CHOICE OF MODEL

## *7.1 National or European Level ?*

Ideally global standards require global enforcement. The ultimate objective should be to establish an enforcement system that applies to those that use IFRS throughout the world. However, effective enforcement would need ultimate access to a court of law which would have jurisdiction worldwide or throughout Europe. A single enforcement system, even at a European level, is an unrealistic goal at present, and will be so for a significant future period. Therefore, at present enforcement needs to be maintained at the national level given the differences in corporate governance, legal and economic background. The same view was held by the old IASC Board in its legacy statement:

*"Initiatives on enforcement must be primarily matters for national regulators. Evident difficulties exist in forming a global regulatory body directly, at least at the present stage of international developments, but the Board hopes that the national regulators will be able to set up a mechanism, including exchange of information that will limit the possibility that inconsistent enforcement decisions may be made in different jurisdictions. This may turn out to be one of the most important building blocks for the provision of good services to the global capital markets."*

Therefore the idea of a "European SEC" which has sometimes been referred to is at present not a viable alternative. A European SEC would not only need a Treaty but also would require a far higher degree of harmonised securities legislation than is currently available or even foreseeable in the EU. In addition, although progress has been made in a number of areas, corporate governance systems and the legal and economic environment are still very different amongst the Member States. For similar reasons, a single European Financial Reporting Review Panel is not considered immediately feasible.

Instead of introducing a single European enforcement body, the priority – as stated in the Lamfalussy report – should be the establishment of common rules and practices, not the establishment of an additional centralised European body, aiming at a level playing field in Europe with consistency of outcomes despite the differences in enforcement systems. This however requires the existence of effective and efficient enforcement bodies at national level. As the FEE 2001 study on enforcement mechanisms in Europe has shown, the institutional oversight systems for enforcement of accounting standards differ widely around Europe. In some countries such an enforcement body does not yet exist at all.

The present conclusion therefore is clearly that enforcement of accounting standards should be at national level. This is consistent with the general EU principle of subsidiarity.

## *7.2 Enforcement Bodies with Delegated Power: Securities Regulator or Review Panel ?*

An enforcement body with delegated powers can be a securities regulator, such as COB in France or CONSOB in Italy, or a body constituted by stakeholders for the specific purpose (referred to as review panel), such as the UK FRRP. A brief description of each of those enforcement bodies, in relation to their role in enforcement of accounting standards, is given in Appendices 2, 3 and 4.

Taking into account the public interest in financial reporting, enforcement of accounting standards could not, however, be solely in the domain of a private organisation. Also cross-boarder enforcement may require official legal power. Rectification and changes in legal relationships (which are constituted by the approval or adoption of financial statements) require an official legal power, either directly applied by a government body or delegated to a review panel. For these reasons, in case of introducing a privately organised enforcement body it is necessary that an official governmental body exists which guarantees the establishment and maintenance of an institution which is able to enforce IFRS in a proper and rigorous way and which could delegate power to the enforcement body.

### *7.2.1 Why a Securities Regulator ?*

Reasons to prefer an official government body (securities regulator) which will be responsible for enforcement might include:

- intuitive guarantee of the public interest;
- authority to take legal or administrative action on particular enforcement issues;
- facilitation of cross border cooperation;
- clear official government sole responsibility for successful enforcement;
- the model exists in some countries and is planned in at least one country.

### *7.2.2 Why a Review Panel ?*

Reasons why it might be considered desirable, at least in some countries, to use a body constituted by stakeholders for the specific purpose with delegated powers might include:

- a wider range of representation and expertise and, in consequence, broader acceptance and better mutual communication of the parties concerned;
- better use of scarce regulatory expertise through delegation, without loss of authority;
- greater flexibility to appoint to membership experts from other EU countries to improve coordination, whereas this might be more difficult in the case of a purely governmental body;
- concentration of enforcement expertise in respect of all types of companies (including those regulated by various different government bodies such as unlisted banks and insurance companies);
- coverage not only of listed companies, but also of other public interest companies and non-listed companies using IFRS; its scope is flexible;
- the model exists or is planned in some countries;

- speed and cost – it could probably be established relatively quickly with sharing of cost if desired; taking into account the need for having an effective enforcement mechanism in place at latest in 2005 this is of importance especially for those countries which do not have an enforcement body already in place.

It is proposed to introduce a review panel model in Ireland, following a process of consultation and debate. In various countries, including Germany, Norway and Sweden, there are advanced discussions amongst stakeholders to introduce a review panel as private sector initiatives (most likely with delegated powers). For example, in Germany a Governmental Panel under the leadership of Theodor Baums which had been set up by the German Chancellor to develop proposals how to improve German Corporate Governance (so-called Baums-Kommission) recommends providing for an enforcement body supported and organised by the private sector, following the example of the UK FRRP.

In practice, this approach would mean that a governmental body would delegate to a privately organised institution the task of enforcing IFRS. Such delegation might extend to:

- selecting financial statements for screening;
- undertaking the review of financial statements;
- agreeing restatements or other actions with the companies concerned, in accordance with agreed procedures;
- referring cases requiring legal or cross border action, or cases of public concern, to court or to the government body for direct action where necessary;
- enforcement of IFRS for non-listed companies.

In order to meet the features of enforcement (Section 6), FEE considers that it is advisable that all stakeholders should be involved in the enforcement process. In this context, f a review panel model is opted for, a proper relation with the securities regulator needs to be established. This could well be organised by an enforcement body involving all stakeholders to which power would be delegated by government, i.e. a review panel.

## *7.3 A Mixed Model*

From the above discussion it is clear that it is necessary for there to be an official government body ultimately concerned with enforcement issues in each country. Equally it is clear that there are perhaps compelling advantages, to arranging for enforcement of accounting standards in financial information using IFRS to be carried out by a body constituted by stakeholders for a specific purpose, i.e. a review panel model, at least for those countries which do not already have enforcement bodies enforcing accounting standards in place.

There is no reason why both models could not co-exist in Europe. Indeed it may not be practical to expect to have precisely the same arrangements for enforcement in each country. Thus a mixed model comprising a securities regulator in some countries and a review panel in others, both with delegated powers, would accommodate such necessary variations, while encouraging convergence in practice. It should be avoided that companies select to be incorporated in a certain country because of the lighter enforcement regime in place for accounting standards (regulatory arbitrage).

In saying this, FEE readily acknowledges that European countries where an effective enforcement body for accounting standards already exists might not be in favour of establishing a separate specialised body (review panel). In these countries, it may not be considered efficient to organise a review panel in addition to a public body. On the other hand if, as part of a mixed model, such a review panel model is found to be reasonably successful for enforcement in respect of listed companies in some countries, then its use could even be considered in other countries already having a securities regulator enforcing accounting standards for listed companies, for the purpose of enforcement in relation to non-listed companies.

## *7.4 Co-ordination of the Mixed Model: European Enforcement Coordination (EEC)*

The conclusion at Section 7.1 that enforcement of accounting standards should be at national level raises the issue of co-ordination. Enforcement decisions on financial statements and other financial information prepared using IFRS need to be coordinated quite independently from the particular structure of the national enforcement bodies, in order to create a level playing field across Europe and to ensure consistent decisions. It is essential to avoid a conflict of decisions between enforcement bodies in different countries.

CESR already provides for coordination of European securities regulators. Not all CESR's members have the power or are involved in effective enforcement of accounting standards. CESR's membership does not cover review panels such as the FRRP in the UK. CESR has already created CESRPOL, being a pan-European regulatory framework to provide the broadest possible mutual assistance between the competent authorities of Member States of the EEA so as to enhance market surveillance and effective enforcement against financial abuse. CESR has also created a permanent Committee on Financial Reporting (CESRfin) with two permanent subcommittees in the area of endorsement and enforcement. The enforcement subcommittee[15] *"should be a forum where the CESR members could exchange views and experiences on methods for supervising the companies issuing listed securities. This subcommittee should also be instrumental in establishing standards of best practices or a peer review. One of the subcommittee's tasks would be to give recommendations on how to converge supervisory practices, including sanctions. Another task for the committee and its subcommittee is to help produce implementation guidance that facilitates common application of IAS in the CESR member countries".*

In a mixed model, co-ordination arrangements would need to extend beyond CESR, in a way which appropriately includes the review panels with delegated powers. In order to make such a system work and to achieve transparency, the enforcement bodies should be empowered to enter into an appropriate exchange of information with their counterparts elsewhere. This needs to be carefully balanced with suitable arrangements for maintaining confidentiality.

Thus a mechanism should be organised where decisions and the reasons for decisions of the national enforcement bodies are discussed and exchanged in order to aim at a convergence and harmonisation of decisions. This may be particularly relevant when a company is listed in more than one country: enforcement bodies of all the countries involved may need to be part of the decision making process.

[15] FESCO's response to the EU's new accounting strategy, 28 February 2001

It will be difficult to determine whether or not decisions are consistent unless there is some uniformity of reporting by national regulatory bodies at the end of their "successful" investigations. This would need to embrace both the amount of details provided in the findings about the facts and particular considerations of a case (which may carry additional confidentiality considerations) and the extent to which the basis for conclusion is explained.

The coordination mechanism should be established as a partnership between the national enforcement bodies, whether they follow a securities regulator or a review panel model. The coordination mechanism should be consulted before a national enforcement body takes an enforcement decision or action in an individual case on IFRS which would set a significant precedent of general European significance. The procedures for such consultation will need to be carefully developed in detail.

In particular, the partnership mechanism (European Enforcement Coordination – EEC) for coordination will need to:

- be confidential, such that an issue about a specific company does not become public knowledge in advance of a formal ruling;
- respond quickly and work well in practice, so that the process engenders a high level of confidence;
- be treated as if it is binding on enforcement bodies of all EU Member States, so that confidence in the process does not break down; and
- be acknowledged as part of the solution, if and when individual decisions of general significance are made public.

Given the practical difficulties of establishing or modifying enforcement bodies at national level in at least some countries by 2005, FEE emphasises the significant further challenge of establishing a co-ordination mechanism across Europe at the same time that IFRS are implemented on a broad scale.

## *7.5 European Enforcement Coordination – The Way Forward*

In the near future, such a mixed model in form of a partnership: European Enforcement Coordination appears to FEE to be the way forward, since coordination needs to be in place by 2005. The existing institutional arrangements in each country should be used as far as possible and effective. This would allow comparison of experience and for convergence, where appropriate, to evolve. For an enforcement mechanism to be sustainable, it needs to be acceptable to all stakeholders. This could be achieved by combining existing and working enforcement systems for financial statements with new initiatives in the form of review panels with delegated powers.

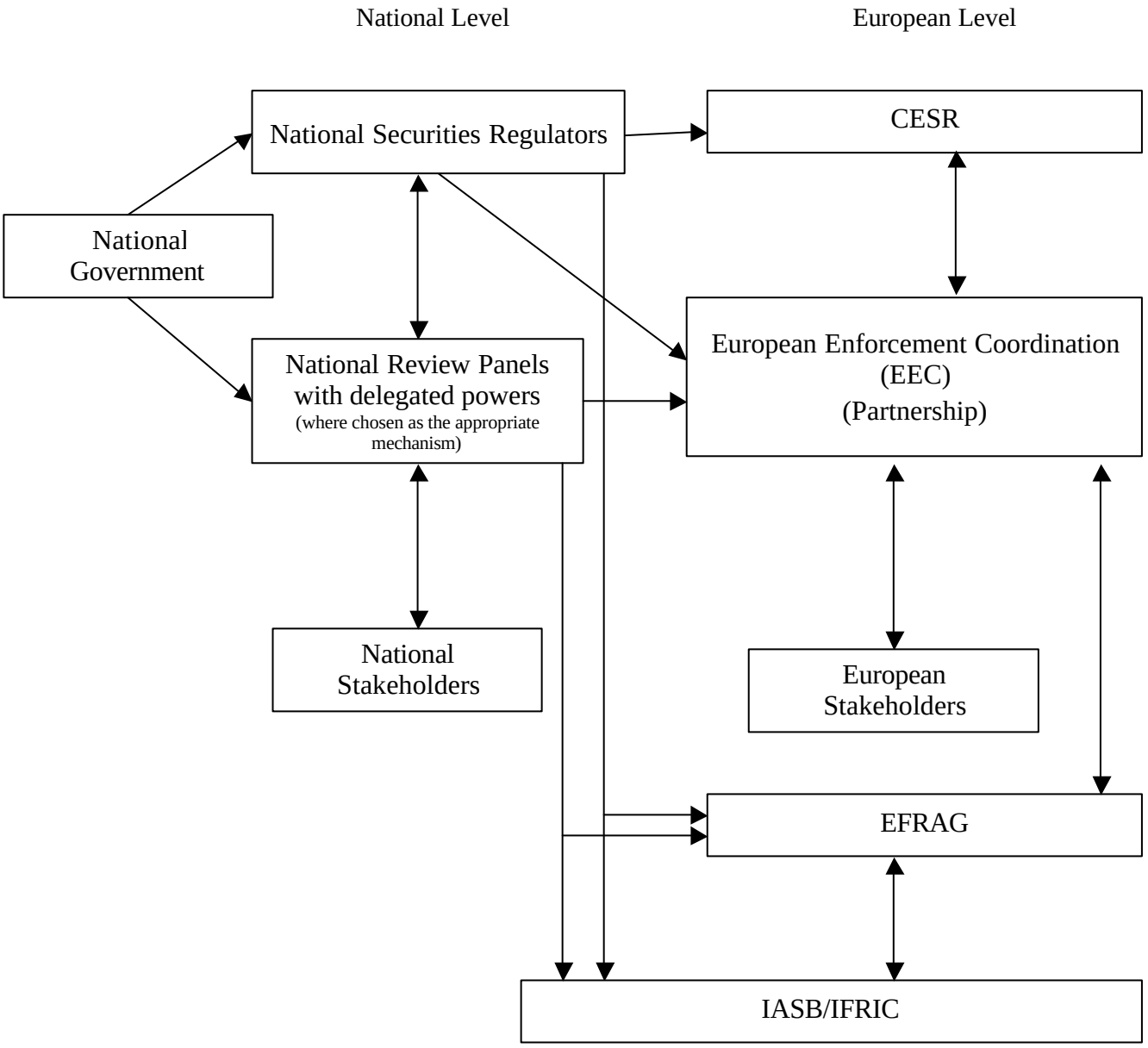
With the introduction of national arrangements for enforcement and the related coordination, the administrative and legal sanctions at national level will be in place and a major step towards consistent enforcement will have been taken. A review panel model can probably be quickly established and attract the support of all stakeholders involved. Therefore, in countries at present lacking a system for enforcement of accounting standards, such an initiative, involving all relevant stakeholders and with delegated authority, would seem to be the best guarantee to have systems in place in time when companies in Europe will be obliged to use IFRS financial statements on a large scale in 2005.

The European Enforcement Coordination would be able to meet the necessary features of enforcement described in this paper at Section 6. These features could be both applied to the coordination itself as well as to the individual national mechanisms. Such a structure would also fit well with the framework outlined in Section 4.

Further thought needs to be given to the operating procedures of the European Enforcement Coordination (EEC). This would include such issues as confidentiality of information and decision taking procedures (see also features as described in Section 6) and also whether the EEC should be a virtual or physical body with related resources issues.

The figure below illustrates a possible method of co-ordination of the national and European levels under a mixed model of enforcement.

**Diagram 2: Co-ordination of the Mixed Model – European Enforcement Coordination**



**Summary of Section 7**

- For the present practical reasons, enforcement of accounting standards should be arranged at the national level, rather than at the European or global level. This is also consistent with the general EU principle of subsidiarity.

- There are certain reasons to prefer a securities regulator, to carry out the task of enforcement.

- There are also reasons to prefer a review panel with delegated powers, which could be privately organised with the support of government regulators.

- It is necessary for there to be an official government body ultimately concerned with enforcement issues in each country. Equally it is clear that there are advantages, perhaps compelling advantages, to arranging for enforcement of accounting standards in financial information using IFRS to be carried out by a review panel with delegated powers, at least for those countries which do not already have other enforcement bodies already in place enforcing accounting standards.

- There is no reason why both models could not co-exist in Europe. Indeed it may not be practical to expect to have precisely the same arrangements for enforcement in each country. Thus a mixed model would accommodate such necessary variations, while encouraging convergence in practice.

- Enforcement decisions on financial information prepared using IFRS need to be co-ordinated in order to create a level playing field across Europe and to ensure consistent decisions. The procedures for co-ordination will need to be carefully developed in detail.

- The coordination mechanism should be established as a partnership between the national enforcement bodies, whether they follow a securities regulator or a review panel model. The partnership mechanism (European Enforcement Coordination (EEC)) will need to:

  - be confidential, such that an issue about a specific company does not become public knowledge in advance of a formal ruling;
  - respond quickly and work well in practice, so that the process engenders a high level of confidence;
  - be treated as if it is binding on enforcement bodies of all EU Member States, so that confidence in the process does not break down; and
  - be acknowledged as part of the solution, if and when individual decisions of general significance are made public.

- Given the practical difficulties of establishing or modifying enforcement bodies in at least some countries by 2005, FEE emphasises the significant further challenge of establishing a coordination mechanism across Europe at the same time that IFRS are implemented on a broad scale.

# 8. EUROPEAN AND GLOBAL CONSISTENCY OF APPLICATION OF IFRS

## *8.1 Consistent Application of IFRS is a Major Issue*

Consistent application of IFRS is a feature of effective enforcement. It is a major issue for preparers, auditors and those charged with enforcement, bearing in mind:

- the comparatively short time (2005) until at least listed companies must apply IFRS in the EU in their consolidated financial statements;
- the ambitious programme of IASB to further develop and improve IFRS in the immediate future, so that the standards will themselves be evolving over the period to 2005;
- the special issues that may arise on initial implementation by companies of IFRS and the IASB project on first time application of IFRS;
- the potential for issues of urgent interpretation of IFRS to arise; and
- the practical need for consistency across the Member States (and in future Member States as well) and with due regard for global consistency.

## *8.2 The Background to Interpretation and Implementation Issues*

Confidence in the enforcement system will arise from widely respected decisions reached on important issues, whilst it would be undermined by decisions on points of secondary importance in respect of immaterial items. It is important that all those involved in the process believe that the system will identify and address material deficiencies and not be distracted with points of excessive detail.

Confidence in IFRS financial information produced by companies in Europe and in enforcement of IFRS will also be undermined if there were to develop regional or national interpretations of IFRS. Further, confidence in the enforcement system in a particular country to protect the interests of its investors and analysts will be undermined if enforcement decisions on IFRS are inconsistent with the application of those standards elsewhere in Europe, or in the world. Enforcement bodies in Europe, in the US and others worldwide must find ways together to minimise these risks. However, interpretations should in principle be determined at worldwide level; regional and national standards and interpretations should be avoided. In principle, only IFRIC should give interpretations of IFRS.

Consistent and robust decision-making should not result in standard setting. The experience of enforcement bodies provides a key input to the process of continuous improvement of standards. Investigation of a particular company case may lead an enforcement body to the conclusion that IFRS standards need amendment, addition or interpretation. Enforcement bodies should refer such matters directly to the IASB or to IFRIC, and not create a new rule of their own for national application resulting from application in a particular case. Furthermore these issues should be referred to EFRAG. EFRAG as part of its pro-active role towards IASB should consider whether to provide additional commentary to IASB giving EFRAG's assessment whether the decision on the application of IFRS taken by the enforcement body should lead to IFRIC interpretations or changes to IFRS. IFRS are principle based and will require the special efforts of all parties involved in first time application. All efforts need to be concentrated on achieving a proper transition to IFRS. To the extent possible, the creation of additional rules

and structures during the transitional period should be avoided, relying instead on the guidance expected from IASB on first time application of IFRS.

IASB and IFRIC have no responsibility for enforcement, but need a proper and rigorous enforcement to enhance the credibility of their standards. Therefore, they should be prepared to support the national enforcement bodies and should respond when assistance is specifically requested by an enforcement body. IASB and IFRIC should consider the possibility of a direct consultation facility ("help line") in order to respond promptly to major questions on a selective basis. It should however be realised that there are resource implications involved.

CESR states in its 2001 response to the EU's accounting strategy that another task for the Committee on Financial Reporting (CESRfin) and its subcommittees (on endorsement and on enforcement) is to help produce implementation guidance that facilitates common application of IFRS in the CESR member countries. Also in paragraph 31 of the June 2000 Commission Communication on the "EU Financial Reporting Strategy: The Way Forward", the issue of specific implementation guidance is raised. It was also considered in the final joint proposals on EFRAG "Expert Level of the Endorsement Mechanism - the Establishment of the "European Financial Reporting Advisory Group" (EFRAG)", dated 31 March 2001. In the latter the position is taken that, to the extent possible, separate European guidance should be avoided:

"*para 20:* *It is important that endorsed IAS are properly implemented. In a number of countries there is not much technical expertise with IAS. Although implementation guidance – where not provided at IASB level – may need to be provided at national level, a forum is needed at European level to discuss and coordinate implementation issues to avoid different interpretations within and between countries. EFRAG could facilitate such a discussion and coordination and it could act as a channel to bring the issues to the SIC and IASB. Implementation guidance should be defined in a narrow sense and be clearly distinguished from interpretations. It is however recognised that specific national issues remain which are unique for one country and need to be addressed at the national level. A regular contact needs to be established with the SIC/IASB. So far in many countries, IAS are only applied through national standards as part of a certain jurisdiction and not directly. Direct application needs a form of coordination at a European level.*

*para 21:* *EFRAG should communicate issues for interpretation and suggested solutions to the SIC for new and existing IAS. EFRAG should not issue interpretations itself. EFRAG should discuss implementation problems and where necessary – in absence of IASB implementation guidance and after consultation with the IASB – coordinate at European level, resulting in coordinated national guidance. EFRAG could be involved in any IASB debate on implementation guidance and interpretation since this still needs to be solved at IASB level."*

The US SEC does, and CESR anticipates needing to, give interpretations/application guidance both on pre-clearance in advance of publication of financial information and on subsequent review of already published financial information. This is further discussed below.

## *8.3 Interpretation and Implementation Issues – The Way Forward*

***Avoid making separate European rules***

It is difficult to make a distinction between implementation issues and interpretations. It is of importance to involve all players in the financial reporting field, to share responsibilities and to bring the issues to the IFRIC and IASB where appropriate together with an assessment by EFRAG on general applicability and the need for IFRIC interpretations or amendments to IFRS. In this way, the risk can be avoided that different sets of common interpretations might circulate within Europe, including those from enforcement bodies, auditors and preparers themselves. It can however be questioned if separate general European application guidance is needed. EFRAG could draft proposals for IFRIC based on European experience but there should be no separate European rules. In this respect, it is helpful to note that IFRIC has a wider competence than SIC and also has the tasks of an urgent issues task force.

***Urgent decisions do arise***

It is understood that in the enforcement process, urgent and real time decisions will be needed that cannot wait for an interpretation by the IASB/IFRIC or that there are country specific or company specific cases of application. An example in this respect is an IPO: somebody needs to take a decision within a limited number of days. It would be helpful if for such decisions how to apply IFRS in a special case under discussion different terms than "interpretations" are used perhaps.

***The difficulties of interpretation of IFRS by enforcement bodies***

Where an individual enforcement body expresses a view on a particular issue of interpretation of IFRS of general significance in a specific case, and which will have value as a precedent, very difficult issues arise such as:

- the need to avoid inadvertent development of a separate permanent system of case-by-case interpretation in the EU, akin to SEC Staff Accounting Bulletins;
- achieving global consistency;
- consultation with IASB/IFRIC as far as possible;
- ensuring that other enforcement bodies agree on the enforcement decision taken ;
- making all other preparers and auditors immediately made aware in time to take account of it;
- the formal status of the view expressed;
- the risk that IASB/IFRIC will on consideration will take a differing view on the issue in question.

In view of these difficulties, enforcement bodies should be cautious in issuing interpretation in the form of interim application guidance and limit themselves to application guidance in individual cases.

***Enforcing existing standards and consultation arrangements with the IASB, IFRIC, EFRAG, the SEC and other enforcement bodies***

The task of an enforcement body is to enforce existing standards. Enforcement bodies have to respect IFRIC decisions, as being the authoritative interpretations. Enforcement bodies should avoid rule making separately from IASB/IFRIC.

Enforcement bodies have a duty to discuss among themselves how to interpret certain matters and to feed this into IASB/IFRIC in order to reduce the risk of inconsistent guidance. This is an important task of the coordination mechanism described in Section 7. If a company appears to transgress a standard, the enforcement bodies should, in case of doubt, feed back this information to IASB/IFRIC and EFRAG for future cases. The IASB and IFRIC should therefore provide a facility for such consultation.

Enforcement bodies need to feed in information about issues commonly arising and any interim guidance given to IASB/IFRIC. This information should also be given to EFRAG in view of its proactive role of influencing the work of the IASB to set high quality standards that are relevant to the complex business transactions encountered in Europe and to keep those standards up to date as transactions and the business environment in Europe changes. In addition EFRAG, as being an expert body, should consider whether to provide additional commentary to IASB giving EFRAG's assessment whether the decision on the application of IFRS taken by the enforcement body should lead to IFRIC interpretations or changes to IFRS. Specific communication of this sort of information is highly desirable, even if the enforcement bodies have published a series of decisions or interim guidance themselves. It would be helpful if communication on such issues was also established on a regular basis with the US SEC and other securities regulators and enforcement bodies outside Europe. This would help in a practical way to contribute to global consistency and sharing of information about topical issues. This would be in the interests of preparers, users, auditors and enforcement authorities as well as the standard setters. It would therefore be helpful for the enforcement bodies in Europe to agree with IASB/IFRIC and EFRAG, as well as other parties such as SEC, on the mechanisms to achieve such communication and exchange of information. In this way, the enforcement bodies in Europe will maximise their potential for improving the quality of financial reporting generally, through an informative and constructive dialogue with IASB/IFRIC, EFRAG and such bodies as the SEC.

Another reason for the enforcement bodies to have close links with IASB and IFRIC is to ensure that there is no misunderstanding about interpretation issues, for example due to translation into languages other than English of IASB materials and also in order to refer to them for guidance. Similarly, close links with EFRAG will ensure both that topical European issues requiring improvement of standards or additional interpretations are fed back to IASB and IFRIC and also that practical European experience is taken into account in the endorsement process.

***The status of enforcement decisions***

Enforcement decisions may form interim guidance, pending an authoritative interpretation of IFRIC on the same matter. Where no relevant IFRS or IFRIC interpretation or regulatory guidance exists on the issue, companies should not be required to restate previously approved financial information when the guidance or interpretation did not exist at the time of approval and the accounting treatment applied could reasonably be regarded as acceptable. Companies may therefore need to rely on interim guidance at a particular point in time.

Where interim guidance is given in the form of an enforcement decision, it is important that all other preparers and auditors are immediately made aware of it in time to take account of it promptly. This should be done in a manner which preserves confidentiality, contains sufficient detail to avoid its inappropriate application in different circumstances and which makes clear that the guidance is of an interim nature pending action by IASB or IFRIC.

***The standard setters subsequent interpretation may differ from interim guidance***

Another reason for caution on the part of enforcement bodies in issuing interim guidance is that the matter will in due course come under review by IASB or IFRIC. It is possible that IASB or IFRIC, after wider debate of the issue on a global basis in accordance with their due process, may issue a standard or interpretation that comes to a different conclusion from interim guidance provided by a national enforcement body.

As noted above, it should be clear that companies should not be asked to restate accounts or other financial information in these circumstances, provided the accounting treatment they applied at the time could reasonably be regarded as acceptable.

Overall, this point emphasises the need for consistency in interpretation of IFRS in the course of enforcement decisions.

***Enforcement bodies should not reduce the existing flexibility contained in IFRS***

Enforcement bodies should not reduce the existing flexibility contained in standards (for instance by deciding to close options). If companies in Europe are not allowed to use certain treatments, they are at a competitive disadvantage compared to other companies in the world. Moreover the wider goal of mutual recognition should be taken into account: why have a restricted choice of IFRS treatments in Europe and subsequently accept the full choice of treatments within IFRS that may be used by companies that come to Europe to raise capital?. Under a principles approach, a certain flexibility and judgement will always exist and is desirable. European companies would also be at a disadvantage if the enforcement body of one country were to enforce a stricter set of rules than the enforcement body of another country. This would undermine the principle of global standards and global interpretations. Companies should be able to use the full flexibility provided by IFRS. It is the task of the IASB to reduce any flexibility, as is at present the case in the IASB improvements project. Enforcement bodies could ask the IASB for more restrictive standards when they see deficiencies in them, but should not be involved in standard setting themselves. The role of enforcing accounting standards is to enforce those standards that exist.

***Court interpretations of accounting standards***

Another issue to note is the risk of inconsistency of interpretation of accounting standards arising from appeal to a national court. This could result in a variety of opinions in Europe in respect of the same accounting standard. There needs to be an appeal possibility for enforcement decisions. Further consideration needs to be given to the legal possibilities for such an appeal.

***Enforcement bodies will need close links with other parties***

From the above discussion, it is clear that those charged in Europe with enforcement of accounting standards will need close links to:

- other enforcement bodies within the EU, both through CESR and the wider co-ordination mechanism described at Section 7 if a mixed model of enforcement is adopted;

- enforcement bodies elsewhere, notably the SEC in the US and similar bodies in other global capital markets with a view to ensuring consistent interpretation in the course of enforcement;

- to IASB, IFRIC and EFRAG;
- to preparers and auditors; and
- to other market participants as described in Section 4 of this paper, in view of these parties roles and influence on financial reporting.

## *8.4 Preparing for IFRS 2005*

In order to achieve high quality financial reporting, it is very important that the transition to IFRS by 2005 goes smoothly. Enforcement bodies should to the extent possible avoid additional changes in structure and guidance at the same time.

It should also be recalled that many companies may apply IFRS early, possibly from 2003 or 2004 if permitted to do so.

Experience shows that the first time application of a new standard carries greater risks of non-compliance when compared with the application in subsequent periods. This is illustrated by the work of the UK FRRP where there is a higher number of rulings following the introduction of new standards. The challenge of making the change to IFRS is much greater than merely changing a few national standards and the consequent risk of errors and omissions is the first few years of implementation of IFRS is much higher.

FEE calls on all those involved in the process to organise themselves to minimise these risks. In particular, FEE proposes an action plan to reduce these risks through the following measures:

- national standard setters throughout Europe should change their standards, at least for listed companies, to IFRS over the period between now and 2005 as far as possible under the Accounting Directives;
- at least each listed company should establish a specific plan for IFRS conversion and for implementing changes to national GAAP;
- at least each listed company should establish a training plan and implement it for all management and Directors (including the Supervisory Board or Audit Committee); it should cover the essentials of the differences arising from introduction of IFRS and the more complex IFRS areas and issues;
- audit firms should establish and implement a specific training plan for IFRS covering all partners and staff involved in the audit of EU companies which will implement IFRS in their firms.

## *8.5 Ex-ante and Pre-clearance Mechanisms of Enforcement Bodies*

***Prevention of errors and omissions in financial information***

As previously stated, the enforcement model in this Discussion Paper seeks to ensure that errors and omissions are identified and corrected prior to their release in the public domain, since it is the responsibility of directors of companies, with the involvement of Audit Committees and

Supervisory Boards, to prepare adequate financial information, which may also be audited. In this context several issues need to be discussed:

***Ex-ante mechanisms of enforcement bodies***

Ex-ante mechanisms review or approve financial information before it is in the public domain, as opposed to ex-post mechanisms whereby financial information is reviewed or approved after it is published, when all the relevant information and circumstances are available. Enforcement bodies may also review certain financial information such as a track record in a document supporting an initial public offering or purchase or sale transaction. Thus ex-ante approval is at present used for the primary market (i.e. first listings) but not generally for other types of information, since it would require too substantial resources or is not feasible within a certain timeframe: financial markets would receive the financial information at a much later date than is desirable. Also for annual shelf registration of prospectuses ex-ante control would not seem to be possible. Under an exante mechanism, the perception is that the published information is correct. There would be no form of appeal against the decision of the enforcement body. It is not possible to come back to a decision taken since all interested parties were involved in the decision.

***Pre-clearance mechanisms of enforcement bodies***

A special form of an exante mechanism is pre-clearance, whereby companies approach enforcement bodies to give pre-clearance on accounting issues. Some European enforcement bodies offer the facility of pre-clearance. The SEC has recently encouraged pre-clearance in respect of difficult financial reporting issues.

Under pre-clearance, novel and unusual accounting questions not directly dealt with in IFRS or IFRIC interpretations can be discussed confidentially with the enforcement body so that the proposed treatment is given official consideration in advance. Pre-clearance may also be a demonstration by preparers of care in dealing with difficult issues and help to avoid subsequent criticism. However, despite such benefits, it is a mechanism with certain inevitable potential difficulties, both for preparers of financial information and auditors and for enforcement bodies themselves. It is therefore necessary to use such a mechanism selectively and subject to certain minimum conditions being fulfilled.

***Some difficulties with pre-clearance***

Pre-clearance brings significant regulatory costs for the company and the market in general. To offer or require such a facility, enforcement bodies will need a much more significant level of resources to be able to meet with companies, their directors and auditors as and when demanded by the companies concerned.

Pre-clearance brings some further significant disadvantages. By their nature the decisions are often reached during the development of a particular transaction, when the facts may not yet be certain: this can lead to a lengthy and time-consuming period of interaction as the transaction develops further. The enforcement body is at the potentially serious disadvantage of not in practice being certain that it has been provided with all material facts and of the context of the financial statements and circumstances of the company overall.

Discussing and debating an issue in this depth may lead an enforcement body to informal rule making and a consequent lack of transparency for others in the market. In doing so it could confer a competitive advantage to one company, for example one bidding for another. If more than one party is seeking a determination, then an enforcement body may find itself having to

manage the risk of creating market distortions in the price of shares of one or other of the parties.

A further potential difficulty with pre-clearance is the possibility of the IASB or IFRIC subsequently coming to a different conclusion on later consideration of the issue. This aspect has already been discussed in this paper at Section 8.3.

Furthermore, as not to undermine the audit function, discussion in relation to financial reporting issues between companies and enforcement bodies should take place only in the presence of the auditors and on the basis of a written explanation of:

- the business purpose of the transaction giving rise to the financial reporting issue;
- the accounting alternatives considered by the company;
- the reasons for the company's proposed accounting treatment;
- confirmation that the company's Supervisory Board or Audit Committee have confirmed the proposed treatment;
- the views of the company's auditors.

***"The pre-clearance process is not Utopia"***

This headline was used in a recent speech by Robert K Herdman, Chief Accountant of the SEC[16]. He pointed out both the advantages of pre-clearance, which the SEC encourages, and its drawbacks.

Interestingly, he said:

*"We understand that GAAP is subject to interpretation and that legitimate differences of opinion can exist. We will not insist on our personal preferences provided investors are adequately protected by your approach and it has a legitimate basis under GAAP".*

It is also worth noting that the SEC has formal procedures in place for dealing with pre-clearance consultations. These are reproduced in Appendix 6.

***FEE's view on pre-clearance***

FEE believes that pre-clearance should be offered only where cost effective. Pre-clearance should be limited to issues where IFRS or IFRIC interpretations are not available and should require full involvement of the Board of Directors and the auditors of the company concerned.

Where a pre-clearance mechanism is offered by an enforcement body, it should publish a detailed set of procedures to be followed. These procedures should implement a framework of common European principles, which could be established within the proposed coordination-mechanism. Within this framework of principles the enforcement body should have the option not to reply to certain trivial or uninformed questions and should operate with full transparency. However, taking into consideration manpower and financial resources not all national enforcement bodies may consider it necessary or even desirable to have pre-clearance mechanisms. Over time, resources and experience with and without pre-clearance will allow convergence of practice in this respect. In any event, preparers and users always have to assume their proper responsibilities for financial information. Pre-clearance may risk passing on inappropriate and detailed responsibilities to the enforcement bodies.

[16] Speech by Robert K. Herdman "Advancing Investors Interests" at AICPA 29th National Conference on Current SEC Developments, 6 December 2001

## *8.6 Cross Border Listings/Foreign Companies Listings*

European companies with cross border listings and foreign companies with listings in Europe raise additional issues of consistent enforcement of accounting standards.

From the FEE 2001 Study on Enforcement Mechanisms in Europe, it appears that where foreign companies are listed on the national Stock Exchange, with two exceptions, reliance is placed on the institutional oversight body of the foreign company in its home country and no additional reviews are carried out. The home country supervision is relied on.

In several studies and publications, it is argued that there is no alternative to reliance on home country supervision for the time being, including for enforcement of accounting standards. As already explained in this paper, it is impractical to create a European supervisor to undertake operational supervision. The functioning of the home country principle should be further streamlined and remaining host country restrictions eliminated over time within Europe.

In its 2001 response to the EU's new accounting strategy, CESR discusses the idea of a European Passport for issuers (prospectuses): once the prospectus has been approved by the home country authority the issuer may make an offer or list its securities in the other EEA countries simply by notifying its intention to the competent authorities of the countries where it is making the offer. It is now proposed to turn this into a requirement in the proposed Prospectuses Directive. However, this proposal received some strong opposition, in particular for securities for which no, or no developed, market exists in the home country, so that the "home supervisor" lacks substantial relevant experience. CESR sees a need to extend the principle of home country supervision to the recurrent information requirements concerning financial statements. An issuing company may be listed only in a host country and not its country of incorporation. Further discussion is needed and guidelines may need to be issued, to determine which country is responsible in these circumstances for supervising which listed companies. The broad concept of a single passport for recognised stock markets is widely supported.

A system needs to be developed which avoids regulatory arbitrage and facilitates regulatory cooperation in enforcing accounting standards, both for European companies and for foreign companies listed in Europe. It should be recognised that IOSCO is working on global and mutual recognition of rules so that ultimately the home or host country principle should eventually make no difference. In the meantime, memoranda of understanding between securities regulators may provide a useful mechanism.

The issue of supervision is in particular relevant when a foreign company has several listings in Europe. Should it be the country of first listing in Europe that is responsible, or the countries where the largest number of shares are listed (which may be difficult to determine given features such as virtual trade and nominee accounts)? What if a company delists? FEE suggests that for the present, unless there is a mutual recognition agreement, a foreign company should be supervised by the country of first listing in Europe. The company should be able to change the country of supervision in Europe with the agreement of both enforcement bodies involved. This issue needs further investigation and debate.

**Summary of Section 8**

- Consistent application of IFRS is a feature of effective enforcement. It is a major issue for preparers, auditors and those charged with enforcement, bearing in mind:
  - the comparatively short time until at least listed companies must apply IFRS in their consolidated financial statements;
  - the ambitious programme of IASB to further develop and improve IFRS in the immediate future, so that the standards will themselves be evolving over the period to 2005;
  - the special issues that may arise on initial implementation by companies of IFRS and the IASB project on first time application of IFRS;
  - the potential for issues of urgent interpretation of IFRS to arise; and
  - the practical need for consistency across the Member States (and in future Member States as well) and with due regard for global consistency.

- In achieving consistency of application of IFRS, enforcement bodies, preparers and auditors will encounter issues of interpretation and implementation. FEE proposes below some features of the way forward.

- It is necessary to avoid making separate European rules. This is despite the fact that urgent issues are likely to arise for decision. To the extent possible, the creation of additional rules and structures during the transitional period should be avoided. There should be reliance instead on the guidance expected from IASB on first time application of IFRS.

- The interpretation of IFRS by enforcement bodies gives rise to unavoidable difficult issues. These include:
  - the need to avoid inadvertent development of a separate permanent system of case-by-case interpretation in the EU, akin to SEC Staff Accounting Bulletin;
  - achieving consistency;
  - consultation with IASB/IFRIC as far as possible;
  - ensuring that other enforcement bodies agree on the enforcement decisions taken;
  - making other preparers and auditors immediately aware in time to take account of the interpretation;
  - the formal status of the views expressed;
  - the risk that IASB/IFRIC will on consideration take a different view of the issue in question.

- In view of these difficulties enforcement bodies should therefore be cautious in issuing interpretation in the form of interim application guidance

- In order to resolve these difficulties as far as possible, detailed consultation arrangements with IASB and IFRIC are desirable. The IASB and IFRIC should provide a facility for consultation by national enforcement bodies. The enforcement bodies should also feed information about issues commonly arising in any interim application guidance which lead to the conclusion that IFRS need amendment or interpretation. Furthermore this information should be referred to EFRAG in view of EFRAG's proactive role towards setting the agenda from a European perspective for high quality accounting standards. EFRAG should consider to provide additional commentary to IASB of their assessment whether the decision on the application of IFRS taken by the enforcement body should lead to IFRIC interpretations or amendments to IFRS. It would be helpful if communication on such issues was also established on a regular basis with the US SEC and other global securities regulators and other enforcement bodies.

- Enforcement bodies should not reduce the existing flexibility contained in IFRS standards but rather request directly or through EFRAG that the IASB should do so when it is thought desirable.

- Enforcement bodies will need close links with other parties, in particular:
  - with other enforcement bodies within the EU both through CESR and the wider coordination mechanism described at Section 7 if a mixed model of enforcement is adopted;
  - the enforcement bodies elsewhere, notably the SEC in the US and similar bodies in other global capital markets with a view to ensuring consistent interpretation in the course of enforcement;
  - to IASB, IFRIC and EFRAG;
  - to preparers and auditors; and
  - to other market participants as described in Section 4 of this paper in view of these parties roles and influence on financial reporting.

- In preparing for 2005, it should also be recalled that many companies may wish apply IFRS early, possibly from 2003 or 2004 if permitted to do so. FEE calls on all those involved in the process to organise themselves to minimise the risks of first time application through an action plan whereby:
  - national standard setters throughout Europe should change their standards, at least for listed companies, to IFRS over the period between now and 2005 as far as possible under the Accounting Directives;
  - at least each listed company should establish a specific plan for IFRS conversion and for implementing changes to national GAAP;
  - at least each listed company should establish a training plan and implement it for all concerned;
  - audit firms should establish and implement a specific training plan for IFRS.

- Some European enforcement bodies offer the facility of pre-clearance whereby companies approach them to give advance clearance on accounting issues. There are some difficulties as well as advantages with pre-clearance and the pre-clearance process has been described as "not utopia" by the Chief Accountant of the SEC.

- FEE's view on pre-clearance is that it should be offered only where cost effective and with the full involvement of the Board of Directors and the auditors of the company concerned.

- Where a pre-clearance mechanism is offered by an enforcement body, it should publish a detailed set of procedures to be followed which should implement a framework of common European principles, which could be established by a European Enforcement Coordination mechanism.

- Pre-clearance should be limited to issues where IFRS or IFRIC interpretations are not available.

- In a mixed European model not all enforcement bodies may consider it necessary or even desirable to have pre-clearance mechanisms.

- For cross border listings by European companies there should be reliance on the home country enforcement body for correct application of IFRS in financial information. Further guidelines may be needed where the issuing company is listed only in a host country and not its country of incorporation.

- A system needs to be developed that avoids regulatory arbitrage and facilitates regulatory cooperation in enforcing accounting standards, both for European companies and for foreign companies listed in Europe. While IOSCO is developing mutual recognition arrangements,

interim mechanisms such as memoranda of understanding may be useful.

- Unless there is a mutual recognition agreement, a foreign company should be supervised by the country of first listing in Europe. The company should be able to change the country of supervision in Europe with the agreement of both enforcement bodies involved. This issue needs further investigation.

## 9. INTERACTION BETWEEN AUDITORS AND ENFORCEMENT BODIES

Auditors in some countries may in some circumstances have to communicate to the enforcement body. The question arises whether enforcement bodies might be able to ask for information from the auditors about their client. In the case of a qualified auditor's report, the enforcement body should consider the financial statements involved and take appropriate action.

It is the responsibility of directors and management of the company to prepare proper financial statements and other information. In cases where enforcement bodies need access to more detailed information to examine whether the required rules have been applied, they need first hand original information that can be provided only by the company itself, and not by the auditor. The audit working papers are by their nature summaries and are in general prepared solely to record the audit work done and to support the auditor's conclusions. They are not prepared for the purpose of collecting information to be passed on to other parties and are therefore not appropriate to be relied on for all regulatory purposes. In many countries and circumstances, confidentiality requirements legally preclude auditors from providing third parties with information about their clients unless the client specifically allows such access. Audit working papers normally remain the property of the auditor. The contractual relationship is generally between the auditor and the company and there is no special obligation to an enforcement body beyond a general duty arising from an audit report. Within that relationship there will be a number of ways in which communications between enforcement bodies, companies and their auditors will be helpful - for example notifying the outcomes of regulatory actions or, where appropriate, the pre-clearance of certain accounting treatments before publishing the financial statements.

If the quality of other information (beyond the contents of audited financial statements) provided by the company to an enforcement body is of particular significance to them, then it is possible for this to be subjected to a special report on agreed terms by the auditors. This would however generally be a report to the company, copied to the enforcement body within the normal relationship.

There are certain circumstances where the confidentiality requirements may be overridden, for example by whistle blowing legislation or under a court order. FEE would not consider whistle blowing as being an issue in relation to enforcement of IFRS because the auditor reports publicly on the application of IFRS. Also in sectors mostly connected with banking, insurance or other financial services, there may be rights and duties of direct communication between supervisory bodies and the auditors of the regulated entities. These sector-specific rules reflect the particular nature of the activities of banking, insurance or other financial services and their pervasive transactions and relationships throughout the economy. A greater degree of supervision in these cases is justified by the special need to protect the counter-parties of banks and other regulated financial institutions throughout the economy, in view of the potentially widespread and serious impact on creditors and other customers of such institutions which would arise from their failure or insolvency. The special regulatory arrangements for financial institutions are not aimed at protection of their equity shareholders. It would be inappropriate and costly therefore to apply these special sector-specific rules indiscriminately to mainstream listed companies and their auditors.

If, in any circumstances, there are grounds for concern about the quality of an audit there should be a mechanism for someone (including the enforcement body for example) to make a complaint to the audit regulator (whether this is a public entity or the auditor's professional body), to have that complaint properly investigated and to require appropriate action to be taken from a range of effective sanctions. Considerations both of justice and of administrative

efficiency, suggest that auditors should be subject to only one regulator for investigation and discipline and should not be exposed to "double jeopardy" in respect of one matter of complaint.

Europe has made considerable progress in this respect with the establishment of the EU Committee on Auditing, bringing together the auditors' supervisors and regulators and the accountancy profession, with the aim of improving further the quality of statutory audit in Europe. FEE is a member of and contributes to the EU Committee on Auditing. A Commission Recommendation "Quality Assurance for the Statutory Audit in the EU: Minimum Requirements" has already been published and a recommendation on independence is forthcoming. Europe should gain experience with its new systems before further steps are considered.

The need for good audit quality in Europe is fully recognised and supported by FEE.

**Summary of Section 9**

- It is the responsibility of directors and management to prepare proper financial statements and other information.
- They are also responsible for providing directly any more detailed information required by enforcement bodies.
- If required, auditors could prepare a special report on agreed terms on such additional information for the company with a copy to be given to the enforcement body.
- The general confidentiality obligations of auditors may be overridden, for example by whistle blowing legislation or under a court order. It would be inappropriate and costly to apply sector-specific rules, such as those for regulated financial institutions, indiscriminately to mainstream listed companies and their auditors.
- Complaints about audit quality should be dealt with by the audit regulator.
- FEE commends the work of the EU Committee on Auditing, in which it participates, which is actively working to improve further the quality of statutory audit in Europe.

# 10. TECHNICAL ASPECTS OF ENFORCEMENT

## *10.1 Orientation of Enforcement – Proactive or Reactive*

As mentioned at Section 3.3, irrespective of the type of documents and companies to be subject to enforcement, such enforcement after publication may be organised on a proactive basis or on a reactive basis. The maximum scope is to review annually all companies financial statements (and other public financial information) falling within the scope of the enforcement body at its own initiative. The minimum scope is to review the financial information of individual companies only in response to specific complaints received from other parties. The extent of selection has serious resource implications.

Financial statements or other financial information with a qualified audit report should under all scopes be subject to review.

The scope could also be gradually increased starting from a reactive complaint basis only. In a second step companies from the first tier of the capital market could be proactively reviewed on a systematic sample basis, with the scope of coverage widening as resources and experience allow and cost benefit analysis justifies.

## *10.2 Systematic Review or Test Basis (selection)*

It could be envisaged to have first a "high level initial screening" to identify companies which should be subject to a more detailed proactive review.

From the FEE study on Enforcement Mechanisms, it appears that a few countries carry out a proactive systematic review of financial information of all listed companies. In most countries having an enforcement body, financial information is proactively reviewed on a test basis or only on a reactive complaint basis. CESR states in its 2001 response to the EU's new accounting strategy that for reasons of efficiency, supervision must be based on selection. The intensity of supervision of each company should be related to the competent administrative authorities' assessment of the significance of the company to the public and the risk of non-compliance with financial information requirements and their potential consequences.

Different methods of selection for proactive review could be considered:

- a rotational cycle
- random methods of selection
- primarily risk-based selection method.

A rotational cycle may be too predictable. Enforcement bodies and auditors have much experience of risk-based approaches to focusing regulatory and audit effort (with assessment of the type of business, the extent of corporate restructuring or acquisition activity, the previous experience of the quality of financial reporting and whether the audit report was qualified, as criteria for example).

In FEE's view, examination of financial information should not only take place on a reactive complaint basis, but should also include a proactive review on a test basis of all financial information using a risk based approach for selection of those to be examined. A step-by-step approach could be envisaged to move from a reactive complaint basis to a sample proactive

review of all financial information falling within the scope of the enforcement body, applying a differentiation in markets and in depth of the review.

As with the other elements of scope, the extent of selection has serious resource implications. Cost-benefit considerations should therefore be addressed in determining the appropriate scope of enforcement, particularly when assessing whether and how the initial scope of enforcement should be extended.

### *10.3 Nature of Review of Financial Information*

The broad choice as to the nature of the review of financial statements (on a complaint basis or otherwise) is either to:

- focus on disclosure primarily. This would involve the reviewer reading the financial statements or other financial information in order to identify any apparent inadequacies in the application of financial reporting standards (broadly the UK FRRP approach);

- focus on both disclosure and measurement. Effectively this involves going further and conducting a positive vetting of the financial statements or other financial information, including testing (or challenging) areas of potential difficulty, higher risk, or involving the exercise of significant judgement (this is along the lines of US SEC approach).

The nature of the review could vary according to the type of company.

**Summary of Section 10**

- FEE suggests that the scope of review could be gradually increased, starting from a reactive complaint basis only. In a second step companies from the first tier of the capital market could be proactively reviewed on a systematic sample basis, with the scope of coverage widening as resources and experience allow and cost benefit analysis justifies.

- FEE believes that enforcement bodies should use a risk-based approach to determine the scope and coverage of proactive reviews, in addition to responding to public criticism or a specific complaint. This should result in an efficient and appropriate allocation of regulatory resources. The scope of additional reviews should depend upon such factors as historical experience of errors and omissions, and the level of confidence that investors and analysts report when reviewing financial information produced by a particular company or industry, and at least cover qualified or adverse audit reports. A step-by-step approach, making a differentiation in markets and depth of review, could be envisaged.

- FEE would propose not to limit the review of financial information prior to disclosure only.

# APPENDIX 1

## SUMMARY AND EXTRACTS OF FEE STUDY "ENFORCEMENT MECHANISMS IN EUROPE"

***Levels of Enforcement***

In 1999, FEE published its Discussion Paper on a Financial Reporting Strategy within Europe, followed by a note for debate Financial Reporting Strategy – Main Issues at stake in 2000 and the factual study about Enforcement Mechanisms in Europe in 2001. In the latter study enforcement is distinguished at six levels:

- Self-enforcement: preparation of financial statements
- Statutory audit of financial statements
- Approval of financial statements
- Institutional oversight system
- Court: sanctions/complaints
- Public and Press reactions.

The first step in enforcing the proper application of accounting principles is the **self-enforcement** on the preparation of financial statements. The responsibility for that rests with the management of the company. Companies should have an appropriate corporate governance structure in place, that safeguards the proper application and implementation of accounting standards resulting in high quality financial statements. It is the clear responsibility of the management of the company that the financial statements are prepared in accordance with an agreed set of GAAP.

The **statutory audit** is an important element of the financial reporting structure because it subjects information in the financial statements to independent and objective scrutiny, increasing the reliability of these financial statements. Trustworthy and effective audits accompanied by appropriate quality control systems within the accountancy profession are essential to the efficient allocation of resources in a capital market environment, where investors are dependent on reliable information. It is the duty of the auditors in the first instance to draw attention to departures from standards in reporting to the shareholders and for regulators or other enforcement agencies and capital and financial markets then take appropriate action against those companies that abuse compliance with the agreed accounting standards. In practice, especially listed companies would be unlikely to file financial statements containing a qualified audit report because of the negative reaction of the capital market and therefore would take into account the auditor's reservations in preparing the financial statements. The auditor, however, has no legal power to enforce correction of errors and misstatements or to issue sanctions.

**Approval** of financial statements as part of the enforcement process exists in all Member States although the form and consequences of the approval may differ from country to country. In most countries, the shareholders meeting usually has the ultimate responsibility to approve the financial statements. In others, e.g. in UK und Ireland, this responsibility is assumed by the board of directors. In continental countries having a two-tier corporate governance structure it is usually the task of the "second tier", the Supervisory Board, to approve the accounts. In some of these countries, the Supervisory Board is allowed to amend or can require management to change the financial statements. Furthermore, in some countries like Austria and Germany, the Supervisory Board also has an examination function which is broader than the task of the

statutory auditor in that the Supervisory Board has not only – based on the statutory auditor's long-form-report – to ensure the compliance of the financial statements and the annual report with national or other relevant GAAP but also to assess whether the accounting policies selected are adequate, rather than only to assess whether the accounting policies selected are appropriately and adequately applied.

The **institutional oversight system** is based on the layers of self-enforcement (and corporate governance) and the statutory audit of financial statements. The institutional oversight system for the enforcement of accounting standards in consolidated accounts of listed companies differs from country to country and does not exist in all countries.

Most of the European countries have an institutional oversight system for listed companies. However, in some countries the institutional oversight system is only responsible for enforcement in relation to other documents than financial statements (e.g. prospectus, preliminary results, interim financial statements) or is only prepared to undertake reviews limited to formal checks.

Different types of institutional oversight systems for listed companies can be distinguished as per the beginning of 2001(see Table 1):

- ***Stock Exchange***

  In Sweden, Norway and Switzerland, Stock Exchanges have the responsibility for enforcing financial reporting requirements. In other countries where the Stock Exchange has a regulatory role, often this is limited to prospectuses and interim financial statements of listed companies or the Stock Exchange's reviews are limited to formal checks only. There is a tendency to take the enforcement task away from the Stock Exchange and bring it into an independent oversight mechanism: the Stock Exchange regulator or otherwise.

- ***Stock Exchange regulator***

  In other countries, namely Belgium, France, Italy, Portugal and Spain an independent regulator/supervisor exercises control over the Stock Exchange(s) and enforces the financial reporting standards for all types of reporting, including the annual financial statements for listed companies. In some countries, a development is taking place to combine the various regulators (financial institutions, insurance undertakings and Stock Exchanges) into one regulator. The Paris, Amsterdam and Brussels Stock Exchanges have merged (Euronext). It is not known yet what impact this will have on the regulatory side. The regulators are organised at European level in FESCO, the Forum of European Securities Commissions.

- ***Review panel***

  In the UK, a privately organised review panel – Financial Reporting Review Panel – functions on a reactive basis by investigating complaints that are brought to its attention. If the complaint is valid, the review panel can seek corrective action, which would include presenting the case to the Court. The strength of this mechanism lays also in the public "naming and shaming" by means of press communication. A detailed description of the UK review panel is included in the Appendix.

- ***Governmental department***

  In some cases, there is a companies department within the government that has the task of enforcing financial reporting standards for the annual financial statements of all companies (often not only listed companies, but also unlisted companies). This is in particular the case for regulated industries, such as financial institutions and insurance undertakings. In Denmark, UK (DTI) and the Czech Republic (listed companies only) there is a governmental department that enforces the accounting standards by reviews in substance.

**Table 1: Summary information on institutional oversight mechanisms concerning consolidated accounts of listed companies**

| Institutional oversight mechanism for financial statements | | | | No institutional oversight system[17] |
|---|---|---|---|---|
| Stock Exchange | Stock Exchange Regulator | Review Panel | Other Government | |
| Sweden<br>Norway<br>Switzerland | Belgium<br>France<br>Italy<br>Portugal<br>Spain | UK (FRRP)[18] | Denmark[19]<br>UK (DTI)[20]<br>Czech Republic[21] | Austria<br>Finland<br>Germany<br>Ireland[22]<br>Luxembourg<br>Netherlands[23]<br>Hungary<br>Slovenia |

Countries may have more than one of the four systems described above for the enforcement of financial reporting standards. As an alternative to, or in addition to, the institutional oversight system, all countries have sanctions/complaints systems whereby the respective responsibilities and rights of the company, its management, its shareholders, auditors and other stakeholders are detailed in law.

Austria, Finland, Germany, Ireland, Luxembourg, Netherlands, Hungary and Slovenia have no specific institutional enforcement oversight system to enforce financial reporting standards for financial statements by reviews going beyond formal checks.

A **system of sanctions** (through civil or criminal procedures) exists in all European countries, sometimes in connection with the institutional oversight system or as part of it, as well as the possibility to go with complaints about the financial statements ultimately to Court. In many countries there is detailed legislation for legal reaction by creditors and other third parties in

[17] In those countries the existing institutional oversight systems is only responsible for enforcement in relation to other documents than annual financial statements (e.g. prospectus, preliminary results, interim financial statements) or is only prepared to undertake reviews limited to formal checks.

[18] Large and listed companies

[19] In Denmark, the financial statements of financial institutions and insurance undertakings are reviewed by a special governmental agency: The Financial Supervisory Authority. For other companies, the financial statements are reviewed by the Danish Companies and Commerce Agency on a test/sample basis.

[20] Small and medium sized companies primarily

[21] Securities Committee

[22] The Irish Auditing and Accounting Supervisory Authority (IAASA) is to be established.

[23] In the Netherlands, there is a special Court system, see for further details the appendix on the Netherlands.

case the financial statements are incorrect or not in compliance with the law, including a system of punishments, penalties and enforcement fines by the court. However, in going to the Courts to obtain revision of (alleged) erroneous financial statements, it should be noted that the cumulative effect of:

(i) the financial costs incurred by such action;
(ii) the uncertainty as to whether such action would be successful and, if successful, whether costs can be recovered;
(iii) (presumably) the need to prove economic damage incurred as a consequence of errors in the financial statements; and
(iv) the length of the process involved

is such that in some countries, complainants would rarely consider this a viable option.

Also the risk of **public and press reactions** should not be underestimated and exists in all countries. Naming and shaming may form an effective part of the enforcement mechanism, especially for listed companies. Pressure exercised by public and press reactions can have an influence on the accounting decisions of companies. Companies are aware of pressure exercised by public and press reactions and will avoid their name or reputation being damaged. Therefore the role of public and press can have a positive impact on the proper application of accounting standards.

***Conclusions***

The 2001 FEE study concludes that:

> *"The main differences relate to the institutional oversight systems in Europe. Regulators of security markets have a significant role to play to ensure that listed companies comply with financial reporting requirements so setting and maintaining a high standard to which other companies can be "encouraged" to aspire. FESCO[24] covers most of the regulator based oversight systems but does not encompass the other institutional oversight systems. In some countries such as in Ireland and Spain, developments are taking place towards a regulator-based system.*
>
> *However, also private oversight systems like the FRRP (Financial Reporting Review Panel) can contribute to enforcement in an effective way and, therefore, institutional oversight systems do not necessarily have to be governmental bodies or "regulators.*
>
> *The study focuses on the enforcement of financial reporting standards for the financial statements and on enforcement reviews being substantive in nature and not limited to formal checks. Therefore, it had to conclude that for nearly half of the countries surveyed, there is no institutional oversight system in place. In some of these countries, there is a discussion whether there is a need to establish an institutional oversight system. For example, in Germany, there are proposals to establish a private oversight system like the FRRP.*

[24] FESCO now turned into CESR; CESR has taken over all FESCO activities.

*With the proposed Regulation on the application of international accounting standards and the final Lamfalussy report, changes in the capital market regimes and in enforcement may be expected over the coming years, in particular as far as the institutional oversight systems are concerned. Audit of financial statements will continue to play a major role in enforcement but will in more and more countries be accompanied by an institutional oversight system, be it private or public".*

# APPENDIX 2

## DESCRIPTION OF FRENCH COB

The COB was created by primary legislation (executive order of 28 September 1967). It is an « autorité administrative indépendante », i.e. : A public regulatory agency whose mission is to ensure the protection of investors, and that an adequate information is given to investors.

The Commission is made up of a Chairman and nine members.

**Regulations**

The COB is entitled to issue regulation dealing with the operation of the markets under its supervision such as:

- public offerings;
- securities placed by public offering, portfolios of securities (credit institutions, investment firms asset management companies or UCITS management companies, unit trusts and mutual funds, whether French or foreign).

**The COB is empowered to adopt guidelines and recommendations**

It can impose administrative sanctions concerning practices contrary to its regulations.

**The COB authorizes**

Any person, whether French or foreign, carrying out a public offering is obliged to draw up a "prospectus" for the purpose of informing investors. This prospectus must receive the COB visa.

**The operations concerned are:**

- issues of equity securities or straight-debt securities by companies listed on a regulated market;
- admission to trading on a regulated market of equity securities or straight-debt securities (official listing, Second Marché, Nouveau Marché);
- takeover bids, public exchange offers or public offerings;
- public offerings of equity securities or straight-debt securities;
- issues of shares in real-estate investment companies and securitised loan funds;
- subscriptions to securities savings schemes;
- proposals for investment in other asset under management (in which case the COB issues a registration number, not a visa).

**The prospectus must contain:**

- essential information on the company, its activities, financial statements, senior executives and future prospects.

The COB can accompany its visa by a warning which appears on the first page of the prospectus.

The warning is not designed to qualify the operation or the position of the company concerned, but simply to call the attention of subscribers:

- to certain essential factual elements.

**The monitoring of information by the COB can take other forms:**

The COB supervises the information disclosed prior to those financial operations not subject to a COB visa such as merger or acquisition of asset, implementation of a share-price guarantee procedure, or a compulsory buy-out offer.

In order to monitor the true position of a company, COB uses audited accounts.

A recently issued regulation dealing with shelf registration documents provides that some annual filings will be reviewed after their issuance. In such situation and in case of omission or material misstatement, the COB will inform the issuer who will be required to revise or restate the initially provided information.

**Supervision**

The supervision carried out by the COB is designed to detect all those practices and conduct likely to be harmful to the security of the investor and in particular to investigate:

- Stock Exchange violations: insider dealings (making use of insider information) or illicit disclosure of insider information, manipulation of share prices or dissemination of false or misleading information.

**The COB supervises the information given to the markets.**

**The COB supervises the markets.**

The aim is to detect those movements on the market:

- which may appear abnormal when compared with the customary behaviour of a given security or with that of the market overall on a given day;
- which may be the sign of a practice contrary to the proper operation of the market or of a possible Stock Exchange violation.

The COB can conduct investigations and decide on the action to be taken in the matter.

Following an investigation, the COB can:

- impose a sanction;
- refer the case to the disciplinary or judicial authorities for purposes of prosecution;
- address its observations to the persons concerned;
- close the case.

**Sanctions regime**

The COB can:

- issue injunctions;
- pronounce administrative sanctions;
- pronounce disciplinary sanctions;
- refer certain cases to the judicial or disciplinary authorities.

**Disciplinary Sanctions**

When a supplier of investment services who has received approval to carry out asset management company fails to meet his professional obligations, the COB can, after having heard the person involved, pronounce sanctions ranging from a reprimand to a ban on carrying out all or part of the services provided.

It can additionally pronounce pecuniary sanctions amounting to as much as 5 million French Francs, or up to ten times the amount of any profits realised.

**The COB can refer a case to:**

- the Conseil des marchés financiers when it becomes aware of irregularities committed, depending on the instance, by a stock market or futures market professional;
- the Commission bancaire for facts coming within its field of competence;
- the UCITS disciplinary board when it involves infringements of laws and regulations applicable to UCITS;
- the chambers of discipline of the profession when the latter observes breaches of auditors' professional standards.

**Relationship with CNCC**

- The Compagnie Nationale des Commissaires aux Comptes (CNCC)

  The COB is able to verify the sincerity of companies' financial statements by means of the work carried out by auditors. Therefore, the COB is entitled by legislation to have access to the working documents of the auditors. It is therefore very important that the COB be able to have confidence in the due care exercised by the auditors. Consequently, it has concluded an agreement with the CNCC under which the CNCC monitors the auditors' work in order to make sure that the standards used meet those in force at the international level, and then the CNCC forwards its conclusions to the COB. The COB can itself, when necessary, examine an auditor's work and, where appropriate, refer the matter to the auditors' "chambres de discipline".

# APPENDIX 3

## DESCRIPTION OF ITALIAN CONSOB

## THE ITALIAN COMPANIES AND STOCK EXCHANGE COMMISSION

### THE CONSOB

The Consob was created by act n.216 of 7 June 1974. It is a public authority responsible for regulating the Italian securities market. Its functions were modified and extended by act n. 281 of 4 June 1985 and, particularly, by Legislative Decree 58 of 24 February 1998.
The Commission is made up of a Chairman and five members.

### THE ACTIVITIES

The mission of the CONSOB is the protection of the investing public.

In this connection, the CONSOB is the competent authority for ensuring:

- transparency and correct behaviour by securities market participants;
- disclosure of complete and accurate information to the investing public by listed companies;
- accuracy of the facts represented in the prospectuses related to offerings of transferable securities to the investing public;
- compliance with regulations by auditors entered in the Special Register

### THE REGULATORY POWERS

The Consob, issues a regulation on:

a) financial intermediaries, as investment firms, mutual funds or SICAV;
b) solicitation of public savings by public offerings

In relation to the first point the Consob establishes:

1) the procedures, including internal control mechanisms, involved in providing financial services and keeping records of orders and transactions;

2) the conduct to be observed in dealings with investors, taking into account the need to minimize the risk of conflicts of interest and ensure that asset management on a client-by-client basis is performed in a manner consistent with the specific needs of individual investors and that asset management on a collective basis is performed in conformity with the collective investment undertaking's investment objectives;

3) the information requirements relative to the provision of services; the flows of information between the various sectors of the company, taking into account the need to avoid

interference between the performance of asset management on a client-by-client basis and the other services governed by this part.

In relation to the second point Consob issues a regulation that establishes in particular:

1) the content of the notice to be sent to Consob, before the public offer, and of the prospectus with the information, that is necessary for investors to make an informed assessment of the issuer's assets and liabilities, profits and losses, financial position and prospects and of the financial products and related rights, and the procedures for publishing the prospectus and updating it where necessary;

2) the procedures to be observed before the publication of the prospectus for disseminating new information, carrying out market research and surveying intentions to buy or subscribe;

3) the procedures for making public offerings, *inter alia* with a view to ensuring the equal treatment of the persons solicited.

**THE SUPERVISORY POWERS**

The Consob may take the following actions with respect to authorized persons to intermediate in financial market:

a. convene the directors, members of the board of auditors and managers;
b. order the convening of the governing bodies and set the agenda for the meeting;
c. proceed directly to convene the governing bodies where the competent bodies have not complied with an order issued under subparagraph b).

For the purposes of monitoring the accuracy of information provided to the public by the listed issuers, besides, Consob, on a general basis or otherwise, may:

a) require listed issuers, the persons that control them and companies controlled by them to provide information and documents, establishing the related procedures;

b) gather information from directors, auditors, auditing firms and managers of companies and of persons referred to in subparagraph a);

c) carry out inspections at the offices of persons referred to in subparagraph a).

**THE POWERS OF INTERDICTION**

The Consob may:

a) suspend the public offering as a precautionary measure for a maximum of ninety days in the event of a well-founded suspicion of violation of the related regulations or declare it to be null;

b) prohibit the public offering in the event of an ascertained violation of the rules referred to in subparagraph a).

## THE POWER OF ADMINISTRATIVE SANCTIONS

When the Consob verifies infringements of its regulations, it can pronounce a pecuniary sanction. The sanction shall be dependent on the gravity of the infringements committed and in proportion to the advantages or profits thus derived.

## CONSOB AND AUDITING FIRMS

The Consob keeps a special register of auditing firms authorized to perform the activities of audit in Italy.

The Consob accepts auditing firms in the special register after verifying that they satisfy the requirements referred to in Article 6(1) of Legislative Decree 88 of 27 January 1992 and the requirement of technical adequacy.

The Consob supervises the activity of the auditing firms, entered in the special register to verify their independence and technical adequacy.

In performing its supervision, Consob may:

a) require auditing firms to communicate data, information, records and documents periodically or otherwise, specifying the manner and time limits;

b) carry out inspections and obtain information and clarification from partners, directors, members of the board of auditors and general managers of auditing firms;

c) recommend principles and methods to be adopted for auditing activity, after consulting the *Consiglio nazionale dei dottori commercialisti* and the *Consiglio nazionale dei ragionieri*.

Auditing firms entered in the special register inform Consob within thirty days of the replacement of directors, partners who represent the firm in auditing or general managers, and of transfers of capital parts and shares.

Where Consob finds serious irregularities in the performance of auditing activity with reference to one or more engagements, it may:

a) order the auditing firm not to employ, for a period of not more than two years, the person responsible for the audit in which the irregularities were found;

b) prohibit the firm from accepting new auditing engagements for a period not longer than one year.

Consob may delete the firm from the register where:

a) the irregularities are particularly serious;

b) the requirements for entry the special register are no longer satisfied and the firm does not satisfy them within a time limit, of not more than six months, established by Consob;

c) for an uninterrupted period of five years it has not carried out auditing engagements communicated to Consob.

## INFORMATION TO BE DISCLOSED TO CONSOB

### Periodic Information

Issuers of shares have to send to the Consob just after the approval of the annual accounts:

a) the documents provided for in Article 2435 of the Civil Code (a complete annual financial statement with notes);

b) the consolidated accounts, if any;

c) the reports containing the opinion rendered by the independent auditors.

Issuers of shares have to send to the Consob, within four months of the end of the first six months of the financial year, their half-yearly report, with any observations of the board of auditors and, if prepared, the report containing the opinion rendered by the independent auditors.

Issuers of shares, within forty-five days of the end of each quarter of the financial year, have to send to the Consob a quarterly report prepared by the directors.

### Information on Corporate Actions

Issuers of shares, in the event of a merger or a division, have to send to the Consob:

a) the directors' report at least thirty days before that set for the shareholders' meeting convened to approve the merger or division or, if earlier, no later than the day on which the decision is taken to convene the shareholders' meeting;

b) the additional documentation referred to in Articles 2501-sexies, points 1) and 3), 2504-octies and 2504-novies of the Civil Code at least thirty days before that set for the shareholders' meeting;

c) the minutes of the shareholders' meeting and the resolutions passed within thirty days of the day on which the resolution was voted;

d) a copy of the merger or division document with an indication of the date of its entry.

In the event of significant acquisitions or disposals, identified on the basis of general criteria laid down in advance by Consob, or at the latter's request, and in relation to the characteristics of the operation, issuers of shares have to send to the Consob an information document within fifteen days of the conclusion of the operation.

Issuers of shares that have convened a shareholders' meeting to approve the purchase or sale of own shares have to send to the Consob:

a) the directors' report, at least eight days before the shareholders' meeting convened to approve measures pursuant to Article 2446 of the Civil Code;

b) the minutes of the shareholders' meeting within thirty days thereof.

## CONSOB FUNDING

Since 1995 Consob has been funded partly through a specific allocation from the central government budget and partly through fees collected directly from markets and market participants for the activities it carries out.

By 31 July of each year Consob informs the Minister of the Treasury of its funding needs and forecast revenues for the following year. On the basis of this information the Minister of the Treasury sets the annual budget allocation.

Consob fixes the types and amounts of fees in resolutions rendered effective by a decree signed by the Prime Minister after checking their legitimacy and consulting the Minister of the Treasury.

## RELATIONSHIP WITH CNDC AND CNR

At the moment Consob have no relationship formally recognized with Consiglio Nazionale dei Dottori Commercialisti and Consiglio Nazionale dei Ragionieri. However, there is a stable collaboration between Consob and the Italian accounting profession especially as far as accounting standards and corporate governance issues, with specific reference to the Collegio sindacale conduct in listed companies.

At the moment the Italian Standard setting Body is represented by the Commission jointly established by Consigli Nazionali dei Dottori Commercialisti e dei Ragionieri (Cndc&r). Consob often refers to documents enacted by Cndc&r and Deliberation 1079/82 states that «the set of accounting standards enacted by Consiglio Nazionale dei Dottori Commercialisti relating to commercial and industrial enterprises has to be considered the benchmark for listed companies and audit companies respectively for financial statements preparation and auditing». This position has never been deleted and confirmed other times especially whereas specific accounting standards are referred as integration of Consob provisions.

## CONSOB'S REGULATIONS

Consob Regulation 11522 of 1 July 1998 - implementing the provisions on intermediaries of Legislative Decree 58 of 24 February 1998

Consob Regulation 11768 of 23 December 1998 - implementing the provisions on markets of Legislative Decree 58 of 24 February 1998

Consob Regulation 11971 of 14 May 1999 - implementing the provisions on issuers of Legislative Decree 58 of 24 February 1998

## CONSOB'S COMMUNICATIONS

The Consob publishes in April of each year, the Report describes the Commission's activity and the changes in the legal framework in the previous year and examines developments in the current year. It also contains the Chairman's speech on the occasion of the annual meeting with the financial community.

## APPENDIX 4

## DESCRIPTION OF UK FRRP

The Financial Reporting Review Panel Limited (FRRP) is constituted as a company limited by guarantee and is formally a subsidiary of the FRC, which acts as its sole director. The company contains a Review Panel, which is autonomous in carrying out its functions; it needs neither outside approval for its actions nor approval from the company's director.

The role of the Review Panel is to examine departures from the accounting requirements of the Companies Act 1985, including applicable accounting standards, and if necessary to seek an order from the court to remedy them. Within this framework a main focus is material departures from accounting standards where such a departure results in the accounts in question not giving a true and fair view as required by the Act. Its authority stems from the Companies (Defective Accounts) (Authorised Person) Order 1991—SI 1991/13—made by the Secretary of State for Trade and Industry which, from 1 February 1991, authorised the Panel for the purposes of section 245B of the Companies Act 1985. A parallel Order - Statutory Rules of Northern Ireland 1991 No269 - was made on 24 June 1991 in respect of the Companies (Northern Ireland) Order 1986. This current version of the procedures is in substitution of the September 1993 version and applies to all Panel enquiries that start after 11 July 2000. By agreement with the Department of Trade and Industry the normal ambit of the Panel is public and large private companies, the Department dealing with all other cases. The Review Panel will examine departures from the accounting provisions of the Companies Act 1985 whether or not they also involve departures from accounting standards. DTI remains responsible for all complaints relating to the directors' report and summary financial statements. The companies within the Panel's ambit are thus

- public limited companies (PLCs) (except PLCs that are subsidiaries in a small or medium-sized group)
- companies within a group headed by a PLC
- any company not qualifying as small or medium-sized as defined by section 247 of the Companies Act 1985
- any company within a group that does not qualify as small or medium-sized as defined by section 249 of the Act.

For these categories the Panel is concerned with accounts for financial years beginning on or after 23 December 1989.

As part of the financing arrangements for the new bodies the Panel has available to it a legal costs fund of £2 million maintained on a rolling basis to cover the cost of litigation.

A chief concern of the Panel is with an examination of material departures from accounting standards with a view to considering whether the accounts in question nevertheless meet the statutory requirement to give a true and fair view. While such a departure does not necessarily mean that a company's accounts fail the true and fair test it will raise that question; and the Companies Act 1985 requires large companies to disclose in their accounts any such departures together with the reasons for them, thus enabling them to be readily identified and considered.

The Panel does not scrutinise on a routine basis all company accounts falling within its ambit. Instead it acts on matters drawn to its attention, either directly or indirectly.

In considering an individual case the Panel normally operates by means of a group of five or more members drawn from the overall Panel membership constituted to deal with it. That group is responsible for carrying out the functions of the Panel for that case; there is no collective involvement by the other Panel members. To secure a consistent approach, all Groups are normally chaired by the Panel chairman.

Groups normally aim to discharge their tasks by seeking voluntary agreement with the directors of a company on any necessary revisions to the accounts in question. (The Companies Act 1985 makes possible the voluntary revision of accounts as well as their revision by court order) The Panel can ask directors to explain apparent departures from the accounting requirements. If the Panel is not satisfied by the directors' explanations it aims to persuade them to adopt a more appropriate accounting treatment. The directors may then voluntarily withdraw their accounts and replace them with revised accounts that correct the matters in error. Depending on the circumstances, the Panel may accept another form of remedial action-for example, correction of the comparative figures in the next set of annual financial statements. But if that approach fails and the Panel believes that revisions to the accounts are necessary it will seek a declaration from the court that the annual accounts of the company concerned do not comply with the requirements of the Companies Act 1985, and for an order requiring the directors of the company to prepare revised accounts. If the court grants such an order it may also require the directors to meet the costs of the proceedings and of revising the accounts. The Panel has £2 million available to it to fund any legal proceedings. To date, all cases examined by the FRRP have been resolved without involving adjudication by the courts.

Where accounts are revised at the instance of the Panel, either voluntarily or by order of the court, but the company's auditor had not qualified his audit report on the defective accounts the Panel will draw this fact to the attention of the auditor's professional body.

Appointments to the Panel are made by an Appointments Committee which comprises the FRC chairman and deputy chairmen together with three members of the Council. There is no upper limit to the Panel's membership. The present chairman of the Panel practised until recently at the commercial bar, specialising in company law including accounting matters, and the deputy chairman was formerly chairman of PricewaterhouseCoopers.

The Panel's formal procedures for receiving and investigating complaints about the annual accounts of companies are considered satisfactory by the Secretary of State. They are currently being reviewed to see if they are best suited to meet the needs and objectives of the Panel, consistent with the demands of natural justice and also to see if there is scope for simplifying them and making them easier to follow for those who may be the subject of an enquiry. Any proposed changes to the formal procedures would need the approval of the Department of Trade and Industry.

The Panel does not make general statements or offer advice on the application of accounting standards or the accounting requirements of the Companies Act 1985.

# APPENDIX 5

## UK FINANCIAL REPORTING REVIEW PANEL

## OPERATING PROCEDURES

1. The Financial Reporting Review Panel ('the Panel') is authorised by the Secretary of State for Trade and Industry[25] to apply to the Court under section 245B of the Companies Act 1985 ('the Act') for a declaration that the annual accounts of a company[26] do not comply with the requirements of that Act and for an order requiring the directors to prepare revised accounts.

***The Remit of the Panel***

2. The Panel's authority under the Act is limited to enquiring into the statutory annual accounts of companies. It does not have the scope to open an enquiry in respect of other documents that may be published with the annual accounts, for example, the directors' report. Directors' reports and Summary Financial Statements remain the responsibility of the Department of Trade and Industry (DTI). In some circumstances, the Panel may enquire into a matter referred to in, for example, the Chairman's statement or Operating and Financial Review, where there is an indication that the statutory accounts may not comply with the Companies Act 1985.

3. The Panel's remit does not extend to opening an enquiry in respect of interim reports or preliminary announcements.

***The Scope of the Panel's authority***

4. Legally, the Panel's authority extends to the statutory accounts of all companies which prepare annual accounts under the Act. However, by agreement with the DTI, the Panel deals normally only with the accounts of public and large private companies. This means that the following come within the Panel's scope:

   - public limited companies (except subsidiaries in a small or medium-sized group which are PLCs);
   - companies within a group headed by a PLC;
   - any private company not qualifying as small or medium sized;[27]
   - any private company within a group which does not qualify as a small or medium-sized group.[28]

25 The Companies (Defective Accounts)(Authorised Person) Order 1991 No 13.

26 References to a 'company' should be read as references to the directors of that company where the context requires it.

27 As defined by section 247 of the Act.

28 As defined by section 249 of the Act.

***Measure of compliance***

5. The Panel is authorised to examine apparent departures from the accounting requirements of the Act, including applicable accounting standards.

***Confidentiality***

6. There is no specific statutory requirement for the Panel to keep its enquiries confidential. It is however sensitive of the need for confidentiality if it is to elicit full responses from, and co-operation with, companies whose accounts are under enquiry. In its internal handling of an enquiry, the Panel uses a code name throughout until the publication of any press notice.

7. Panel members, other than the Chairman and Deputy Chairman, become aware of enquiries only when they are asked to join a Group or otherwise advise on an individual case.

8. The Panel normally keeps all matters referred to it confidential unless and until there is a public announcement. It may, however, refer a matter to another regulator where there is prima facie evidence of something relevant to the scope of that regulator. The Panel normally informs the company of its intention to do so.

Conflicts of interest

9. No member is appointed to a Group or is otherwise asked to advise where a conflict of interest may arise. Members are asked to consider their position on each occasion they are invited to join a Group or otherwise advise on a case. A company under enquiry is also given the opportunity of raising any perceived conflict of interest amongst the members selected to consider its case.

**DETAILED APPROACH**

10. The origin of an enquiry may be a complaint (such as from a regulator, individual or corporate entity) or by the Panel of its own volition following public comment (such as press commentary) or otherwise.

11. When a matter comes to the attention of the Panel, the Secretariat:

    - acknowledges receipt if referred by a private complainant; and

    - informs the Chairman and Deputy Chairman of the case and the matter drawn to the Panel's attention.

12. The Chairman and Deputy Chairman consider, with assistance from the Secretariat, whether there is a prima facie case for the Panel to pursue. They look initially at the matter(s) drawn to its attention but may consider enquiring into other issues.

13. The Secretariat provides a preliminary analysis of each matter brought to the Panel's attention. This analysis looks, initially, at the matters to which the Panel's attention has been drawn. It may also comment on other matters where there appears, prima facie, to be a matter of non-compliance with the requirements of the Act. The analysis includes a recommendation as to a course of action.

14. Depending on the nature of the case, the Chairman and Deputy Chairman may consult with one or two other Panel members or may form a Group to consider the matter. On occasion, they may ask a member of the FRC staff (in confidence) to review a particular accounting issue. More rarely, they may also seek an initial opinion from lawyers or accountants outside the Panel.

The complainant

15. Where the Chairman and Deputy Chairman agree that there is no matter in respect of which an enquiry should be opened, any complainant is informed of that fact. Where the Panel intends pursuing the enquiry, any complainant is informed that they will be advised of the outcome of the case once the Panel has concluded its enquiry.

Request for information

16. Where the Chairman and Deputy Chairman agree that additional information is required to decide whether an enquiry should be opened, the Secretariat may write to the Chairman of the company asking for such information. This does not apply where there is a prima facie case of a breach of an accounting requirement into which the Panel would inevitably want to enquire.

17. A letter from the Secretariat asking for information does not constitute an enquiry by the Panel and does not restrain the Panel from later opening such an enquiry, nor enquiring into matters other than those raised by the Secretariat. The letter does however enclose a note of the Panel's procedures and current membership and invites the company to speak to the Panel Secretariat if it has any questions in connection with the function or powers of the Panel or any other aspect of its conduct or role.

18. The additional information provided by the company is analysed by the Secretariat and then put to the Chairman, Deputy Chairman and those others with whom the Chairman chooses to consult. The analysis includes a recommendation as to whether the Panel should open an enquiry in respect of the matter.

Panel enquiry

19. Where, as a result of any of the steps taken above, the decision is taken by the Chairman of the Panel to open an enquiry, the Chairman or Deputy Chairman writes to the Chairman of the company concerned. This first letter refers to the authority of the Panel, identifies the relevant accounts and indicates the respects in which there is, or may be, a question of whether the accounts comply with the requirements of the Act, including applicable accounting standards. The letter does not indicate to the company how the matter came to its attention. The letter invites the directors to comment on the matters raised. The letter normally asks for a reply within a month and earlier, if practicable.

20. The letter encloses a note of the Panel's procedures and current membership and invites the company to speak to the Panel Secretariat if it has any questions in connection with the function or powers of the Panel or any other aspect of its conduct or role.

21. Depending upon the nature of the issue and relevant timing considerations, the letter may indicate a suitable date for a meeting with the Panel.

22. The Panel may, in the course of its enquiries, extend or vary the ambit of its enquiries. If it decides to extend the nature of its enquiries by raising a new issue it informs the company as soon possible after the decision and requests its comments on that matter.

**The company response**

23. The Secretariat analyses the company response and provides further advice to the Chairman, Deputy Chairman or Group, as appropriate. When considering that advice, the Chairman and Deputy Chairman may also consult with Panel members involved in any preliminary review of the case where a Group has yet to be established.

24. The Panel may be satisfied by the company response that there was no breach of the legislation or that the breach is such that remedial action is not warranted. Alternatively, if the directors acknowledge that the accounts were defective, the Panel turns its attention immediately towards considering an appropriate form of remedial action.

25. If the Panel is not initially satisfied by the company response, the Panel may arrange for a first meeting with the company, if one has not already been agreed. The rationale for the meeting, its purpose and any further information required either in advance of, or at the meeting, is sent to the company in writing. If subsequent review or discussion among the Panel and its advisors persuades the Panel to accept the company's explanation, the meeting is cancelled. Alternatively, the enquiry is conducted through further correspondence and meetings as appropriate.

26. Depending on the nature of the enquiry, and when invited by the company, the correspondence may be directly with those with responsibility for the preparation of the accounts, such as the Finance Director.

Groups

27. At any stage during an enquiry the Chairman may appoint a Group to consider the matter(s) at issue. No case can move towards a court hearing without the involvement of a Group. Groups consist of five or more Panel members and usually include the Chairman and Deputy Chairman. Where the Chairman is unable to chair a particular Group the Deputy Chairman will normally do so. Normally, every Group includes a lawyer. The company is advised when a Group is formed for the purpose of progressing the enquiry and is told of its constituent members. If additional members are appointed to a Group during the course of an enquiry, the company is informed. If the company perceives a potential conflict it is asked to raise the issue as soon as practicable.

28. The Group may, where appropriate, consult with other members of the Panel or seek independent advice.

29. The quorum for a meeting of the Group is at least half of its members. Decisions by the Group, which may include whether to initiate or continue a case or to apply to the Court, require a two-thirds majority comprising at least four members.

**Meetings**

30. A number of meetings may be held with the company during an enquiry. The Panel identifies the purpose of each meeting, notifies the company of any specific points it wishes to cover and informs the company of those Panel members attending. Where practicable, it also indicates possible next steps, for which the company may want to prepare.

31. The meeting may be held for any one, or more, of the following reasons:

- hear further explanation of the matter(s) at issue;
- discuss the appropriateness of the accounting treatment;
- discuss the Panel's concerns;
- explain the Panel's preliminary view;
- explain the Panel's requirement to effect remedial action; or
- hear further explanation prior to issuing a letter of warning (paragraph 41).

32. Panel representation and attendance by the Secretariat depends on the circumstances and the purpose for which a meeting is being held. Normally, Panel representation comprises all members of the Group. When Panel members are not present, they receive a copy of the note of the meeting.

33. The company representation is decided by the directors. The Panel normally encourages the company to ensure that its auditors attend. It is for companies to decide whether other advisers should also be present. This may depend upon the purpose of the meeting and the stage of the enquiry.

34. After each meeting with the Panel the Secretariat prepares a note of the discussions and sends a copy to the company. This confirms the matters discussed and next steps agreed. The company is invited to comment on the substance of the note.

Technical meetings

35. At any stage during an enquiry, the Panel may invite the company to a technical meeting which may be attended by one or more Panel members and the Panel Secretariat. Technical meetings provide an opportunity for a smaller working Group to progress a case and can take many forms. The company is informed of the particular purpose of a technical meeting and of those attending for the Panel. A note of the meeting is prepared by the Panel Secretariat and sent to the company for agreement.

Power to require sight of documents and other evidential material

36. The Panel does not have a statutory power to require a company to produce documents or other evidential material. However, in the course of its enquiries and in advance of any consideration by the court, the Panel is likely to ask for sight of company documents that may shed light on the appropriateness of an accounting treatment. If the Panel considers that a reasonable request for such information is denied by the company, it may draw an adverse conclusion.

**Third parties**

37. In rare circumstances, and subject to considerations of confidentiality, the Panel may seek and receive representations from third parties where it appears that they may have useful and relevant information to contribute to the Panel's enquiry. Similarly, it may seek further information from the complainant if it believes the complainant may have material pertinent to the case that needs to be taken into account.

**Voluntary revision**

38. Where the Panel and the company agree that accounts are to be rectified by way of revision, the directors decide whether this should be effected through a full revision of the accounts or by way of supplementary note. The Panel monitors the company's revision of the defective accounts. If the company fails to carry out the revision in the manner agreed as acceptable to the Panel, it is open to the Panel to re-start the enquiry.

**Other means of rectification**

39. In some cases, the Panel is able to accept alternative corrective action by the directors – for example, a corrective statement published by the company either separately or, if the timing is conducive, in the next interim report, together with a corrective statement in the following annual accounts and adjustment of the relevant comparative figures. What form of corrective action is acceptable to the Panel depends on the circumstances of each individual case. The following, among other factors, will be taken into account:

    - nature and effect of the defect;
    - the need to protect users of accounts;
    - the need to correct/prevent a false market operating; and
    - timing of the company's reporting cycle.

*Application to Court*

40. Where the directors decline to adopt voluntary rectification of the matter at issue and the Panel, having heard the company's explanation, concludes that the matter represents a breach of accounting requirements such that the Panel intends to pursue, the directors are informed accordingly. The Chairman, or his representative, explains in writing that the Panel is minded to make an application to the Court under section 245B(1)(b) of the Act and invites the company to a meeting if it so wishes. This provides the directors with an opportunity to persuade the Panel that the accounts either do comply with the Act or alternatively, to propose corrective action for the Panel to consider.

41. The Panel considers any response to the letter and/or any further submissions made through correspondence or at a meeting. If the Panel is not satisfied by the response, the Chairman may write a final letter to the Chairman of the board of directors. This letter:

    - sets out the grounds on which the Panel believes the accounts are in breach of the Act, including applicable accounting standards

    - indicates that it is the Panel's intention to apply to the Court at any time after 14 days from the date of the letter.

42. The Panel considers any response to this final letter. If the Panel is not satisfied by the response, or no response is received, the Panel can resolve to make an application to the Court.

43. The application to the Court is made in the name of The Financial Reporting Review Panel through Solicitors and Counsel instructed on its behalf.

44. On application to Court the Secretariat informs the Registrar of Companies in accordance with section 245B(2) of the Act and at the same time, makes a public announcement.

Press notices

45. The Panel makes an announcement at the conclusion of an enquiry where, as a result, the directors have agreed that the accounts in question were defective and require corrective action. The company is invited to comment on the Panel's draft press notice.

46. The press notice summarises the accounting or legal issue(s) in question, presents, as far as possible, the Panel's reasoning and its approach to the particular reporting issue, and outlines the remedial action agreed.

47. The Panel does not usually make an announcement at the conclusion of an enquiry when the accounts in question are not found to be defective. If the company makes an announcement however, the Panel may consider releasing its own announcement.

48. As noted in paragraph 44, the Panel also makes an announcement on application to Court and at the end of any subsequent proceeding.

**Other Publicity**

49. Panel meetings are held in private. All communication between the Panel and the company is kept confidential to Group members and, where appropriate, the Panel's advisers.

50. The Panel neither confirms nor denies that it is enquiring, or has ever enquired into, a particular company. It only confirms whether or not a particular company has been the subject of a Panel press notice. The Panel does not provide additional information on a case beyond that which is included in the press notice.

**The complainant**

51. Where a press notice is issued in respect of a complaint drawn to the Panel's attention by a private complainant, the complainant is sent a copy of the press notice.

52. Where the Panel is satisfied in respect of a matter drawn to its attention by a private complainant, the complainant is informed of the outcome of the enquiry and provided with such information as is consistent with the need for confidentiality. The Panel does not enter into further correspondence on the matter.

Advice

53. The Panel does not operate a system of advance clearance and is unable to give advice to a company or its auditors as to whether, in its opinion, a particular accounting treatment would or would not meet the requirements of the Act.

The professional position of auditors and directors

54. To assist those responsible for the regulation of auditors the Panel draws the attention of professional bodies to its press notices. The Panel may provide copy correspondence, notes of meetings and other background information to such bodies as it considers appropriate.

Panel documentation

55. Papers relating to each Panel enquiry are filed under their codename and in secure cabinets in the offices of the Secretariat. No person is authorised to open or refer to the papers with the exception of the Panel Chairman, Deputy Chairman and Secretariat. Care is taken to ensure that Panel papers may not be seen by other persons within the general office area.

56. A master file is retained of all papers relating to each case.

# APPENDIX 6

## GUIDANCE FOR CONSULTING WITH THE OFFICE OF THE CHIEF ACCOUNTANT OF THE UNITED STATES SEC

**Preface**

The SEC staff has long encouraged companies and their auditors to consult with the Office of the Chief Accountant (OCA) on accounting, financial reporting, and auditing questions, especially those involving unusual, complex, or innovative transactions for which no clear authoritative guidance exists. Additionally, in Financial Reporting Release No. 60, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies* (December 12, 2001), the Commission encourages public companies to employ an accounting and disclosure regimen that provides that if companies, management, audit committees or auditors are uncertain about the application of specific GAAP principles related to "critical accounting policies," they should consult with the Commission's accounting staff.

The Commission encourages all those whose responsibility it is to report fairly and accurately on a company's financial condition and results to seek out the staff's assistance. This document provides guidance as to the recommended form and content of correspondence when consulting the Commission's accounting staff in OCA.

Because such matters often involve complex fact patterns, companies should provide a written submission outlining the factual details, accounting considerations, financial statement impact, as well as the disclosures expected to accompany the accounting. Correspondence of this nature is commonly referred to as a "pre-filing" or "pre-clearance" submission.

Questions concerning the age, form, and content of financial statements, required to be included in a filing, should be sent directly to the Chief Accountant of the Division of Corporation Finance, the Division of Investment Management or the Division of Market Regulation, as appropriate.

**Form of Correspondence**

Companies may send pre-filing submissions via mail, electronic mail or fax. Companies are reminded, however, that electronic mail is not confidential, and others may intercept and read the electronic mail. We recommend that companies call OCA and advise us that a pre-filing submission has or will be sent. Companies may contact OCA at (202) 942-4400.

In order to facilitate timely receipt and attention to all correspondence, letters should be addressed to:

Mr. Robert K. Herdman
Chief Accountant
Office of the Chief Accountant
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1103
Fax Number (202) 942-9656
E-mail: OCA@sec.gov

A copy of each submission and the accompanying materials should also be provided to:

Mr. Craig Olinger
Deputy Chief Accountant
Division of Corporation Finance
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0410
Fax number: (202) 942-9582

The submission should include the name and telephone number for a contact person with the company. Also, include the names of the local audit partner and other technical resources consulted, such as national office personnel. Additional contact persons may also be provided such as representatives of the company's legal counsel.

**Content of Correspondence**

Based on our experience, OCA is best positioned to quickly address a company's questions when the following information is provided:

- Overview of the nature of the company's business, together with condensed financial information including assets, stockholders' equity, revenues, gross margin, pretax income, and other relevant measures.
- Timing considerations such as pending filing deadlines or registration efforts.
- Detailed information regarding the specific facts and circumstances giving rise to the accounting, financial reporting or auditing question.
- Specific accounting, financial reporting, or auditing question raised.
- The conclusions reached and the basis for such conclusions.
- Outline of the possible alternative answers considered and rejected.
- Analysis of the current and future financial statement impact of the alternatives considered.
- What you specifically intend to disclose about the proposed accounting, and where it will be disclosed.
- The audit committee's views on the proposed accounting treatment.
- Whether the company or its auditors are aware of any prior SEC staff position related to the issue.
- The conclusion of the company's auditor and whether the submission and the proposed accounting have been discussed with the auditor's national office or other technical resource, and if so, when this discussion occurred.
- A description of any current or previous discussions or correspondence with the Division of Enforcement, Division of Corporation Finance, or other Divisions or Offices regarding the issue(s) in the submission.

Companies should include copies of relevant documents that may assist the staff in reaching a conclusion. Such documents might include: organizational charts, contracts or legal documents, relevant press releases, board of directors' minutes or presentations.

**Oral and No-Name Inquiries**

The staff accepts informal, oral inquiries from companies with participation of the auditor's national office or other technical resource. Generally, these inquiries will involve broader, emerging issues that are not company specific. The staff believes the pre-clearance process is best accomplished through written submissions on a named basis because of concerns that a clear understanding of the facts may not be accomplished solely through oral communications. Additionally, because no-name inquiries are not fact specific, responses to no-name or informal telephone inquiries are not binding and cannot be relied upon by the company as formal positions of the staff.

Written submissions on a named basis take priority over no-name inquiries. Submissions will be assigned to the appropriate SEC staff as received and are generally prioritised based on date received.

**Meeting with OCA**

The staff encourages meetings with companies, members of the public accounting profession, industry representatives, regulators, and others. Often, coordinating the calendars of the meeting participants can be difficult. Therefore, we recommend that there be sufficient advance notice for a requested meeting to ensure that all appropriate company representatives and SEC staff are able to attend. In addition, a written submission generally should be provided at least five business days in advance of a meeting to allow a reasonable time for reviewing the issues.

**Concluding Correspondence**

For a company's records, upon the resolution of an issue, a company may prepare and send to the staff a letter describing the company's understanding of the staff's position. In those instances, a draft of the letter should be sent for staff comment. The final letter may be incorporated into the Commission's files to document the position taken by the staff with respect to the specific company matter.

**Other Matters**

Filings made with an issue pending should indicate within the transmittal memo the nature and status of the issue. Filings made shortly after the resolution of an issue, cleared on a pre-filing basis, should indicate within the transmittal memo the nature of the issue and the response provided by the staff.

This document, Guidance for Consulting with the Office of the Chief Accountant, addresses the routine processing of accounting matters in the Office of the Chief Accountant, and does not provide any individual registrant or person any rights or privileges and places no obligation on the SEC or its staff in connection with any matter before the SEC or its staff.