Accounting enforcement activity in Europe

Michael Kavanagh summarises the key points in ESMA's recently published report on the regulatory activities of the EU's accounting enforcement agencies.

The European Securities and Markets Authority (ESMA) recently published its 2017 annual report on the enforcement and regulatory activities of accounting enforcement agencies within the EU. It was another busy year in the ever-changing world of financial reporting and the ESMA's report touches on many key regulatory issues. There is a lot of information packed into the 30-plus pages, which deals with a range of items including:

- An overview of the activities of EU accounting enforcement agencies and the accounting enforcement regime across Europe;
- A summary of the results of EU enforcers' examinations of the financial information provided by listed entities in 2017;
- An assessment of compliance with ESMA's 2016 common enforcement priorities;
- The priorities for ESMA in 2018;
- An outline of some of the areas discussed at the European enforcers coordination sessions;
- A summary of the results of ESMA's peer review of the effectiveness of accounting enforcement agencies in certain jurisdictions; and
- ESMA's contribution to various international initiatives in the area of financial reporting.

While this short article cannot cover all aspects of the ESMA report, what follows is a summary of some of the aspects of particular relevance to an Irish audience.

Quantitative data on accounting enforcement activities in the EU and Ireland

Europe: European enforcers examined the interim and/or annual financial statements of 1,141 publicly listed entities, representing an average examination rate of 19% of all IFRS issuers with securities listed on regulated markets. These examinations resulted in actions being taken against 328 issuers in order to address material departures from IFRS. This represents an increase of 6% when compared to 2016. The main deficiencies identified are illustrated in Table 1.

As can be seen, the main deficiencies were identified in the areas of financial statements presentation, impairment of non-financial assets and accounting for financial instruments. These three areas represent more than 40% of all the issues covered by enforcement actions taken by European enforcers in 2017. It is remarkable that this was also the case in 2016 and 2015, and there is little change in these particular percentages in the past three years.

Ireland: the above statistics include those of the Irish accounting enforcement agency, the Irish Auditing and Accounting Supervisory Authority (IAASA). IAASA published a snapshot of its accounting enforcement activities during 2017 in January of this year. During 2017, IAASA examined 34 financial statements. However, this included 17 follow-up examinations, which would not normally be included in the 1,141 ESMA examination statistic quoted above. Corrective actions were taken against 13 of the issuers examined. While the snapshot doesn't outline the areas where actions were taken (this will be outlined in IAASA's annual report), it does outline the main areas raised with Irish issuers. The top three in this regard were issues relating to fair value accounting (IFRS 13), financial statements presentation (IAS 1), and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* with emphasis on the implementation of the new IFRS standards.

Common enforcement priorities

ESMA believes that an important step in fostering supervisory convergence in Europe is establishing common enforcement priorities for financial reporting and communicating them to stakeholders in advance of the finalisation of annual financial statements. The ESMA report revisits the 2016 priorities and analyses the findings by European agencies in relation to 204 issuers, which led to 76 enforcement actions being taken against 56 issuers. The ESMA report also gives further background to the 2017 enforcement priorities, which encompass:

- Disclosures related to the expected impact of the new standards (IFRS 9 and IFRS 15);
- IFRS 3 *Business Combinations*; and
- Specific issues relating to IAS 7 *Statement of Cash Flows*.

Table 1: Areas addressed by enforcement actions taken in 2017

Financial statements presentation	18%
Accounting of financial instruments	13%
Impairment of non-financial assets	11%
Fair value measurement	6%
Cash flow statements	5%
Income taxes	5%
Operating segments	5%
Revenue	3%
Share-based payments, employee benefits	3%
Business combinations	3%
Other	28%

> Effective financial reporting depends on appropriate and consistent enforcement of high-quality standards. In this regard, ESMA plays a vital role in facilitating the coordination and consistency of financial reporting enforcement across Europe.

Presentation of financial information

One aspect of financial reporting that gets much focus in the report is the area of the presentation of financial performance, which was a 2016 common enforcement priority. Indeed, it takes up five pages (15%) of the report and is also an area that IAASA has focused on in the past. As well as outlining enforcement actions taken in 2017, the report provides the results from a sample of 170 issuers.

Amongst the issues dealt with is the use of additional line items in the primary financial statements (income statement, balance sheet etc.) The financial reporting standard governing this area (IAS 1 *Presentation of Financial Statements*) sets out the overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. It is not prescriptive in nature, and practice has developed whereby a variety of primary statement presentations prevail. For example, the use of non-IFRS terms such as "operating profit" and "exceptional items" in the income statement appears to be particularly prevalent among UK and Irish entities, with the latter in particular being unique to these islands. However, from my experience, entities in jurisdictions such as France, Belgium and Denmark do use variations of these in some instances – for example, by highlighting non-recurring or "special" items. There was some concern expressed locally when the report stated that "it is not acceptable to label subtotals or line items as 'exceptional' (IAS 1, Paragraph 87)". However, this was in error as Paragraph 87 of the Standard deals with "extraordinary" items, which is a completely different concept from a financial reporting concept. I have also confirmed with ESMA that this is indeed the case.

Peer review of the effectiveness of accounting enforcement agencies in certain jurisdictions

In an effort to increase regulatory convergence in Europe, ESMA issued *Guidelines on Enforcement*, which every EU national authority is expected to adhere to. ESMA is playing an increasing role in directing the type of work national authorities conduct in the accounting enforcement space. In 2017, for example, ESMA conducted – and made public – the results of a peer review, which focused on national authorities' adherence to selected guidelines. The peer review provided an assessment of the effectiveness and degree of convergence in the enforcement of the provisions under review as well as an assessment of the application of law and supervisory practices, and the extent to which the practices in existence achieve the objectives of the guidelines. The peer review was carried out on the basis of a questionnaire to all EU accounting enforcement agencies and on-site visits to seven jurisdictions (Germany, Italy, Malta, Norway, Portugal, Romania and the United Kingdom). The report identified areas where improvements were required and makes for interesting reading. This is the start of an ongoing process, so it is only a matter of time before ESMA reviewers land in Ireland to conduct an on-site visit to IAASA.

Conclusion

Financial reporting plays an essential role in securing and maintaining investors' confidence in financial markets. Effective financial reporting depends on appropriate and consistent enforcement of high-quality standards. In this regard, ESMA plays a vital role in facilitating the coordination and consistency of financial reporting enforcement practices across Europe.

The ESMA report can be downloaded at www.esma.europa.eu.

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