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Our ref **MV/288**

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Dear Mr Demarigny

Concept Paper on Equivalence of Certain Third Country GAAP and on Description of Certain Third Countries Mechanisms for Enforcement of Financial Information

We appreciate the opportunity to respond to the invitation to comment on The Committee of European Securities Regulators (CESR) concept paper on *Equivalence of Certain Third Country GAAP and on Description of Certain Third Countries Mechanisms for Enforcement of Financial Information*. Our general comments are immediately below. Responses to the concept paper's specific questions are attached as an Appendix to this letter. This letter expresses the views of KPMG International.

We generally agree with CESR's approach to the assessment of equivalence. However we believe that it is inappropriate for filers to select the appropriate remedy based on individual circumstances. Instead, we believe that CESR should determine the degree of non-equivalence of each GAAP and mandate the appropriate remedy for all users of that GAAP. Further, we consider that CESR should assess what additional guidance and clarification regarding the application of the mandated remedies should be provided to issuers.

Notwithstanding the mandate of the European Commission (EC), we believe that CESR should assess and conclude on the equivalence of IFRS as issued by the IASB to those required by the European Union. It is important that those third country issuers that wish to use full IFRSs are able to do so.



*Concept Paper on Equivalence of Certain Third Country
GAAP and on Description of Certain Third Countries
Mechanisms for Enforcement of Financial Information
22 December 2004*

Please contact Mark Vaessen at +44 (0)20 7694 8089 or David Littleford at +44 (0)20 7694 8083 if you wish to discuss any of the issues raised in this letter.

Yours faithfully

KPMG International

KPMG International

Appendix 1

Responses to invitation to comment questions

A. Objectives of equivalence

Q1: Do you agree with the proposed definition of equivalence and references to investors' needs?

We agree that "equivalence" should not be defined to mean "identical" and agree that equivalence should be assessed in respect of "investors' needs". We support the proposal that a third country GAAP should be considered to be equivalent to accounting standards adopted for use in the EU (EU adopted standards) when the financial statements prepared under third country GAAP enable users to take at least similar decisions in terms of whether to invest or divest, as if they were provided with financial statements prepared on the basis of EU adopted standards. However, we would ask that CESR clarify that "take at least similar decisions" should mean that investors making an investment decision on the basis of a third country GAAP are provided with information that is equally relevant to their needs.

Q2: Do you agree with this approach?

Generally we agree with CESR's proposed approach for assessing equivalence. However, as part of CESR's review of the general principles of the third country GAAP, CESR proposes to consider "evidence that market participants responding to the present consultation will provide to CESR on the reliance placed on third country GAAP financial statements in making investor decisions (compared with decision making based on IFRS financial statements)."

Given the purpose of the assessment, we believe that information received from investors and users of financial statements that are "market participants" will be of greater importance. However, we are unsure how CESR might balance anecdotal evidence received from various market participants who may be biased in respect of a particular third country GAAP on the basis of their familiarity with that GAAP. See also our comments in response to Q5 concerning the assumption of knowledge of investors. Accordingly, we believe that evidence from market participants would be more appropriate if obtained formally through empirical studies rather than the anecdotal evidence that will be received through this consultation process.

Q3: What characteristics should a difference between IAS/IFRS and third countries GAAP have to be perceived as significant for an investor?

We believe that a difference between EU adopted standards and third country GAAP is significant if it could influence the economic decisions reached by users of the financial statements. That is, a difference is significant if the specific difference in GAAP results in the information that is available to investors (see Q5) being so different that it may influence investing/divesting activities.

IAS 1.16 is clear that inappropriate accounting policies are not rectified by the disclosure of the policy used or by explanatory material in the notes. Accordingly, CESR may need to reconsider the approach suggested in paragraph 40 of the concept paper that such disclosure is sufficient to result in equivalence. CESR may conclude that recognition and measurement differences that are “significant” should result in a remedy based on reconciliations rather than disclosure.

Q4: Do you consider other general aspects should be taken into account for the assessment of equivalence?

We have not identified any other aspects at this time.

Q5: Do respondents believe that EU investors can be assumed to have a good knowledge of third country GAAP or that IAS/IFRS should be assumed to be the only benchmark?

We believe that no assumption should be made of the extent of an EU investor’s understanding of third country GAAP. However, we do believe the assessment of equivalence should be based on the assumption that the EU investor is a “reasonable investor with an understanding of the application of EU adopted standards”. Under the IFRS framework, users of financial information are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. Further, as EU adopted standards are to be the basis of EU financial reporting, it is appropriate that it is the benchmark for the comprehensibility of a third country GAAP to EU investors. We acknowledge that the level of understanding of the application of EU adopted standards in the EU is still increasing in the period to transition. However, we consider this to be the appropriate benchmark for the post-2005 period. A “reasonable investor with an understanding of the application of EU adopted standards” should be in a position to read third country GAAP financial statements and note differences between third country GAAP and EU adopted standards.

Q6: Should this issue have an impact on the assessment of equivalence, and if so, how?

The assessment of equivalence should take into consideration the assumption that the EU investor is a “reasonable investor with an understanding of the application of EU adopted standards”. Accordingly, a third country GAAP that is more similar to EU adopted standards (in general principles and with respect to individual standards themselves) should have a higher equivalence assessment.

Q7: Do you think that CESR should distinguish professional and individual investors in assessing equivalence?

Distinguishing between a professional and individual investor assessment would not be appropriate in the assessment of equivalence as both professional and individual investors participate in EU regulated markets. Therefore, we do not think that CESR should distinguish professional and individual investors in assessing equivalence. Consistent with our discussion at

Q5 and Q6 above, we believe CESR should adopt the assumption of a “reasonable investor with an understanding of the application of EU adopted standards”.

B. Review of general principles

Q8: Do you believe that the three elements mentioned above are relevant and sufficient for conducting a review of general principles?

We believe that generally the three elements mentioned in the concept paper are relevant and sufficient for conducting a review of the general principles of third country GAAP. However, we would like to make the following comments about specific paragraphs of the concept paper:

- Paragraph 25 – CESR quotes paragraphs 39 and 40 from the IFRS framework concerning comparability. While the paper notes the importance of comparability (paragraph 5), it does not elaborate on how comparability (or lack thereof) might impact the assessment of equivalence.

We believe that comparability in the assessment of equivalence should mean that a reasonable investor will be able to compare a company’s financial performance, position and cash flows presented on the basis of the third country GAAP to a similar company’s financial performance, position and cash flows prepared based on EU adopted standards.

- Paragraph 26 to 28 – We believe that the assessment of the scope of the compared GAAPs cannot be distinguished from the impact of such requirements (or lack thereof). Accordingly the assessment proposed under these paragraphs should be subsumed into the “Technical Assessment” of the third country GAAP.
- Paragraph 27 - We disagree with the comment “Third country GAAP could appear as not equivalent if they do not cover all topics regulated by IAS/IFRS”. We believe that all “topics” are covered by each GAAP, the difference is the level of specific guidance offered on a given topic by the GAAP. For example, where a specific standard does not exist, the application of a conceptual framework or hierarchy would need to be considered. We believe that where a topic is not covered by a specific standard, if the hierarchy or ultimately the framework of the third country GAAP is sufficiently similar to the IFRS framework, then the recognition, measurement and presentation of that topic in the financial statement may be equivalent to EU adopted standards. For example, unlike EU adopted standards, US GAAP does not contain one single standard which provides generic guidance on accounting for intangibles. Instead, US GAAP includes a number of standards dealing with specific forms of intangibles, including SFAS 141, *Business Combinations*, SFAS 142, *Goodwill and Other Intangible Assets*, EITF 00-20, *Accounting for Costs Incurred to Acquire or Originate Information for Database Content and Other Collections of Information*, SFAS 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, SFAS 50, *Financial Reporting in the Record and Music Industry*,

SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* and SOP 00-2, *Accounting by Producers or Distributors of Films*. However, the accounting principles derived by analogy to these specific standards may be sufficiently similar to the EU adopted standard on intangibles generally.

Q9: Do you have other views on how to take investors' needs into account in a global assessment?

We have no specific comments under this question.

Q10: Do you believe that the review of general principles as described above is appropriate and sufficiently complete?

Refer to our comments in Q8.

Q11: Do you have comments on the articulation between the technical assessment and the review of the general principles, which are both parts of the global assessment?

We believe that the review of the general principles and the technical assessment and can be referred to as a "top-down approach" and "bottom-up approach" respectively.

The review of the general principles is the "top-down approach" as it focuses on objectives and the framework of the third country GAAP, whereas the technical assessment is the "bottom-up approach" which focuses on the application of the standards and identifies specific significant differences.

C. Technical assessment

Q12: Do you agree with the proposed approach for identifying significant differences between third country GAAP and IAS/IFRS?

We agree with CESR's proposed approach for identifying significant differences. We believe that differences which are identified most frequently in practice together with those commonly known to be significant by the financial and audit community in Europe and third countries should be the initial focus of the review.

While we agree with the proposed approach to identifying significant differences between EU adopted standards and third country GAAP, we are concerned that differences will only become apparent over time, notably when EU adopted standards are applied for the first time. This may need to be considered in devising any "Early Warning Mechanism" (see Q19).

Q13: Do you see other specific elements to be considered for defining what the significant differences are?

No. However, we have a specific comment with respect to paragraphs 38, 39 and 40:

- Paragraph 38 – We accept that the assumption “that each and every third country issuer makes use of the most demanding set of third country accounting standards applicable to any listed company when it claims to obtain the benefits of the equivalence” is appropriate to the assessment of equivalence. However, we consider that it should be a requirement for equivalence that the most demanding set of accounting standards is actually used by a company that applies an equivalent GAAP.
- Paragraph 39 and 40 – We believe that information that is required by mandatory regulation which is not part of third country GAAP should be considered in the assessment of equivalence only if such information is required to be included in the financial statements (for example as an appendix) when the third country GAAP financial statements are used in satisfying an EU requirement for equivalent financial statements on a regulated market.

One additional issue that requires consideration is whether the additional information has been subject to the same level of review or audit as the third country GAAP financial statements themselves. We would expect that in at least some cases, it will not have been subject to an audit opinion. We discuss this further under Q15.

D. Consequences of non-equivalence

Q14: Do you agree that there may be three potential outcomes from the assessment process, as described above?

We believe there are two potential outcomes:

- i) Equivalence for which no remedies are required. In this case the third country GAAP financial statements are filed as is;
- ii) Non-equivalence. In this case remedies (or results) range from additional disclosures to a requirement to submit full financial statements based on EU adopted standards (i.e., full restatement).

We believe that upon completion of the assessment of equivalence of Canadian, Japanese and US GAAP, CESR should declare whether each of Canadian, Japanese and US GAAP is equivalent or not equivalent. For those third country GAAPs determined to be non-equivalent, CESR should, based on the results of its assessment of equivalence, determine which remedy is appropriate. That remedy would then be applied by all issuers using that GAAP. We discuss this further under Q16, Q17 and Q18.

Q15: Do you agree that the auditor's opinion should cover the original third country GAAP financial statements and the additional remedies? Which level of comfort should be provided for the additional remedies (equal to full audit)?

If CESR requires the remedies to be included in the financial statements filed by third country GAAP filers as additional notes to the financial statements then, assuming that the audit of those financial statements is conducted in accordance with International Standards on Auditing, the assurance provided by auditors will be equivalent to that for the other notes to the financial statements (see IAPS 1014 *Reporting by Auditors on Compliance with Financial Reporting Standards*). We believe that this is an appropriate approach.

We note that the separate disclosure and filing of remedies outside of financial statements may be less helpful to investors. In addition, the separation of these disclosures from the financial statement makes the provision of readily understandable reports by the auditors that cover those remedies more difficult. Therefore, we propose that CESR require any remedies to be integral to the financial statements and that the audit opinion cover the entire document. This approach is consistent with the recently revised ISA 700, *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*, which states that the auditor's opinion covers supplementary information, for example, the auditor's opinion covers notes or supplementary schedules that are cross referenced from the financial statements.

Q16: Do you believe these three different kinds of remedies are appropriate or whether one or more of them would be enough in all circumstances?

In instances of non-equivalence, we agree with CESR that three different kinds of remedies described as "additional disclosures", "statements of reconciliations" and "supplementary statements" are appropriate.

Clearly, if the third country GAAP is considered equivalent then no remedy is required and the third country GAAP financial statements will be filed as is.

However, if a third country GAAP is considered non-equivalent, then we believe that CESR should make an assessment of the extent to which the third country GAAP is not equivalent and determine the appropriate remedy (from one of the three remedies above) for all filers using that particular third country GAAP. We do not believe that it is appropriate for filers to assess this individually. That remedy would then be applied by all issuers using that GAAP. We note that the extent of additional disclosures and the items identified in any reconciliation will differ depending upon the individual circumstances of the issuer and also upon the accounting policy choices it is able to make.

Q17: Are the three remedies sufficiently clear? If not, please provide us with specific alternatives?

We believe that further clarification of the remedies is required. Provided that CESR mandates the required remedy, we consider that the provision of such guidance should be practicable and we expand on the appropriate areas below.

However, if CESR proceeds with its proposal to permit issuers to select their own remedy then substantial additional guidance will be necessary (see below). We are not convinced that such guidance could be possible in a manner that results in sufficient consistency in the application of the remedies.

Following from our comments in Q16, when CESR has made the assessment of the extent to which a third country GAAP is not equivalent it should mandate the required remedy for all filers of that GAAP. Specifically when CESR mandates that the non-equivalence of a third country GAAP can be rectified by additional disclosures, we believe that CESR should provide more detailed guidance i.e. CESR should develop a list of the specific additional disclosures that filers should provide in their financial statements in order to satisfy the particular remedy. In the case of a requirement to provide a reconciliation, we consider that CESR should consider what guidance will be necessary in order to ensure that there is sufficient consistency between issuers in their preparation and presentation. Similarly, in the case of supplementary financial statements, it will be necessary for CESR to specify the form and content of such statements and provide guidance on their preparation.

If CESR proceeds with allowing filers to select the remedy and requiring the remedies to be endorsed by the auditor, then we consider that the remedies and their application are not sufficiently clear. Specifically, we believe further guidance will need to be provided by CESR as to circumstances under which a statement of reconciliation or supplementary statements are appropriate. In particular:

- CESR has indicated that, when there are differences of measurement or recognition which do not affect many lines in the income or balance sheet, CESR believes that a sufficient remedy might be to require reconciliation from the local GAAP to equivalent EU adopted standards requirements. We believe that under this remedy, CESR will be required to provide specific guidance as to what may constitute “differences of measurement or recognition which do not affect many lines in the income statement or balance sheet”.
- Also, CESR has indicated that, where differences in measurement or recognition are complicated or numerous, CESR believes that reconciliations would be too complicated for users to understand the full implications and that in such circumstances, it would be appropriate to provide supplementary statements. As with the reconciliation remedy, we believe that CESR will be required to provide specific guidance as to what may constitute “differences in measurement or recognition are so complicated or numerous”.

- CESR should provide guidance or a framework for the auditor to assess the appropriateness of the remedy selected by the filer. However, we note there is no international auditing or reporting standard that addresses an auditors' "endorsing" of a remedy as proposed by CESR in paragraph 63 of the concept paper, therefore we do not believe it to be a practicable requirement.

Q18: Do you agree with this approach?

No, we do not believe that remedies should be selected by the issuer and endorsed by their auditors. We are not convinced that differences in the specific impact on a particular issuer warrants any remedy specific to that individual issuer. We believe this will lead only to preparer and investor confusion and a lack of comparability. Each issuer applying a particular GAAP should be subject to the same remedy.

Instead, we believe that CESR based on their assessment of whether Canadian, Japanese and US GAAP is equivalent or not equivalent should decide what the appropriate remedy is and for each GAAP identified as non-equivalent.

While we support the inclusion of the required disclosures, reconciliations etc in audited financial statements and therefore their inclusion within the scope of any audit report, we consider that it is inappropriate for the remedy to have previously been "endorsed" by the auditors".

E. Early warning mechanisms

Q19: Do you agree with this approach?

We agree that some early warning mechanism is required. However we do not agree with CESR's recommendation that an early warning mechanism should take the form of a mandate to a special body set up specifically to monitor this. We believe that once an assessment of equivalence is made, the modifications to EU adopted standards or to third country GAAP that could result in a third country GAAP moving closer to (or achieving) equivalence will be monitored (and in fact lobbied for) by the third country GAAP constituents (filers and standard setters). Therefore the move from non-equivalence to equivalence does not need to be actively monitored by CESR.

Alternatively, modifications to EU adopted standards or to third country GAAP could result in a third country GAAP becoming less equivalent.

There is a risk that as EU adopted standards lead and other GAAPs follow there will be periods where the degree of equivalence lessens. From a practical perspective, we doubt that it would be desirable for third country GAAPs to swing from equivalence to non-equivalence and back on a

regular basis. Accordingly, a decision to reclassify a GAAP as non-equivalent is unlikely to be taken without serious consideration and then only on the basis of significant and potentially prolonged differences between EU adopted standards and the third country GAAP. We believe that there will be sufficient information generally available in respect of the small number of third country GAAP under consideration for equivalence that a sub-committee of an existing body could be given the task of monitoring this.

Balancing stability of remedy and the potential benefits of various convergence initiatives, we believe that CESR should formally update their assessment of equivalence on a periodic basis, for example once every 2 years.

F. Description of enforcement mechanisms in Canada, Japan and US

CESR has not specifically asked questions regarding the principles and procedures that they will follow in order to provide a description to the EC of the enforcement mechanisms in Canada, Japan and the US. We consider that the questionnaire envisaged in paragraph 83 of the concept paper should be the primary source of information on third country enforcement mechanisms.