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Our ref MV/288

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Dear Mr Demarigny

Draft Technical Advice on Equivalence of Certain Third Country GAAP and on Description of Certain Third Countries' Mechanisms for Enforcement of Financial Information

We are writing in response to the invitation to comment on the Committee of European Securities Regulators (CESR) draft technical advice on *Equivalence of Certain Third Country GAAP and on Description of Certain Third Countries Mechanisms for Enforcement of Financial Information* ("the consultation paper"). This letter expresses views on behalf of the KPMG international network of member firms.

We have significant technical, practical and independence concerns regarding the recommendations in the consultation paper. CESR's proposals, if adopted in the form proposed, are not a workable basis for implementing CESR's conclusion that a full reconciliation to EU adopted standards is not required in the case of the Canadian, Japanese or U.S. GAAP. We believe that these concerns can be resolved by CESR and we have set out recommendations for alternative approaches or further consideration as appropriate. A summary of our significant concerns and recommendations are set out below and we illustrate some of our significant concerns in an Appendix 1 to this letter.

We are concerned that a comment period of one month was insufficient for a consultation paper with such wide-ranging implications for the preparation and audit of financial statements, not only in Europe but also in the United States (US), Japan and Canada. Our strong sense is that very few capital market participants are aware of this consultation, especially those outside the EU, including preparers and auditors that will be impacted by any final requirement.

We believe that the period allowed for comments may not have permitted sufficiently detailed analysis of the proposals. If this is the case, CESR may not receive the necessary input to ensure that its proposals to the European Commission (EC) are technically appropriate and practically feasible and we strongly recommend a further (or extended) consultation period either by CESR or by the EC as part of its determination of implementing measures.

We note that the final technical advice will comprise only CESR's recommendations to the EC. The EC will be responsible for the development of the recommendations into implementing measures that will apply across the European Union. We believe that the input of users, preparers and auditors into the final proposals of the EC will be important in order for the implementing measures to be useful, proportional and, above all, feasible. Particularly in light of CESR's limited consultation period, we ask CESR to advise the EC that an appropriate public consultation period should be provided on any implementing measures. In the meantime, we would be happy to assist either CESR or the EC should any additional clarification be required of the comments that we have provided.

Significant concerns

CESR states that "there should be no remedy of reconciliation" because "a combination of qualitative and quantitative disclosures give better information to investors on the issues it has identified" (Executive Summary, paragraph 6).

In our view, the proposals, if adopted in the form proposed, are not a workable basis for implementing CESR's conclusion that a full reconciliation is not required in the case of the Canadian, Japanese or U.S. GAAP.

The stated standard for assessment is to provide remedies necessary so that an "investor's decision should be unaffected by the use of different accounting standards when assessing their buy, hold [and] sell decision" (ES, paragraph 9).

The general (and overriding) requirement is to identify remedies specific to a reporting entity on the basis of whether a difference between third-country GAAP and IFRSs would be "material to the financial position of the company and so would be significant for the purposes of investors" (ES, paragraph 5).

Unfortunately, we believe that the proposals described in the consultation paper do not provide a suitable framework for the consistent and proper application of judgment to this requirement by management, auditors or a regulator assessing an entity's compliance with the requirement. We expand upon the reasons for our conclusion in Appendix 1.

It may be possible to develop a suitably robust framework that permits consistent judgement to be exercised to identify "significant" differences and the remedy appropriate to each difference. However, we consider that substantial additional development of the proposals is required if this is to be achieved based solely on principles. We believe that this is unlikely to be practicable in the short term.

In the absence of such a framework, in our view, it is highly likely that the presentation of a full reconciliation will be the only approach available to an entity to meet the requirement of the proposal to provide all information that might be material to an investment decision.

Alternatively, in the short term CESR could provide more specific requirements to achieve its objective. For example, we consider that CESR could:

1 Establish specific single remedies for each category of difference and identify the specific remedy applicable to each category of difference. This would require making Disclosure A narrative (qualitative) disclosure only. For those items for which quantification is necessary, Disclosure C should be required.

2 State that, for any item included explicitly in the table that sets out CESR's assessment of major differences, the specified remedy is deemed sufficient (i.e., provide an explicit safe harbour). This would clarify that the specific remedy requirements, including the determination that a difference is "not significant", specifically override the generic requirement to assess, at the level of each reporting entity, the potential significance of a difference to an investment decision. This would require amendment of, among others, paragraph 99, which places all responsibility for determination of the appropriateness of a remedy on the reporting entity (and its auditors).

3 Acknowledge that, for any item not explicitly included in the table that sets out CESR's assessment of major differences, either:

- that no difference need be considered and therefore that no disclosure is required (i.e., an explicit safe harbour); we strongly prefer this alternative; or
- that the general requirement for providing information that might impact an investment decision would apply, and that the effect would be to require Disclosure C for all differences unless the amount of the difference clearly is not material.

In effect, CESR could specify that discussion or quantification of the difference identified by CESR, or any other remedy, is not required unless specified in the guidance. This would be the inverse of the US SEC requirements for reconciliations to US GAAP[1], which state that reconciliation is required unless specific relief is offered. In order to operationalise the approach of "no remedy necessary unless required explicitly", the general objective that "investors should be able to make a similar decision irrespective of whether they are provided with financial statements based on IFRS or on third country GAAP" (paragraphs 28 and following) needs to be put in context, i.e., needs to be made secondary to specific relief. Currently it seems to be an objective imposed on each company, which is likely to be read as overriding CESR's generic assessment (paragraph 99) and therefore the principle will require the functional equivalent of full reconciliation, despite CESR's stated intention of not requiring such a reconciliation.

Alternatively, the final guidelines adopted by the EC based on CESR's recommendations could be that Disclosure C remedies are required for all items for which CESR has not proposed a specific remedy.

[1] See instructions to items 17 and 18 of Form 20-F.

If CESR elects to specify a list of those differences that are "significant" as we propose, then we recommend that it may wish to establish a mechanism through which the list may be updated based on both developments in the standards and developing understanding of the information needs of EU investors.

We expand upon our significant comments and recommendations in an appendix under the following headings:

- Identification of differences and required remedies

  As described above, we consider that the concepts of additional differences that are significant to European investors and the determination of appropriate remedies are too vague to permit consistent judgements to be made as to what is significant and what is the appropriate remedy. In our view, the consultation paper does not provide a sufficiently robust framework for the determination of differences that are significant from the perspective of the individual reporting entity, or for the determination of which remedy is appropriate to an identified difference.

- Basis of preparation of *pro forma* statements

  We have general concerns as to the usefulness and understandability of the *pro forma* statements and quantitative disclosures (Disclosure C) proposed by CESR. In particular, the consultation paper does not provide a framework for the *pro forma* statements (i.e., the supplementary statements would not be "in accordance with" either the relevant national GAAP or with IFRSs). We are concerned that a mixture of partially restated *pro forma* statements and quantitative disclosures alongside third-country GAAP financial statements will provide very little useful information even to sophisticated users.

- Relevant auditing / assurance standards

  We believe that a separate audit opinion is not appropriate on these disclosures under at least US GAAS, PCAOB standards, or International Standards on Auditing. Instead, we support strongly the view that the remedies should be included as note disclosures to the national GAAP financial statements, and accordingly, any auditor's report would cover such information in the context of the financial statements taken as a whole. However, positioning the remedies in the financial statements will not eliminate the need for a sufficiently objective framework as this will continue to be required both by management and by the auditors. Auditors will require a basis on which to form an opinion as to the completeness and appropriateness of the disclosures provided, in the context of the financial statements taken as a whole. The development of a sufficiently objective framework will require a number of the issues identified in this letter and appendix to be resolved.

- Independence – Respective responsibilities of management and auditor

  In our view the consultation paper does not define clearly the division of responsibilities between the entity's management and auditor. It appears that the paper may require the auditor to exercise judgments and responsibilities as part of the preparation of the remedies. These judgments and responsibilities properly belong to management alone. In accordance

with IFAC (and also EC) independence guidance, auditors avoid engagements that involve self-review as they can represent independence threats. As any assurance over remedies is likely to be provided on the basis of the assurance and independence requirements of jurisdictions other than the EU, the relevant requirements of those jurisdictions also should be considered including, for example, those of the PCAOB, SEC, AICPA as well as Canadian and Japanese requirements.

- Completeness of CESR's equivalence assessment

  In several respects, the paper acknowledges that CESR's assessment of equivalence and its consideration of differences is incomplete, specifically with regard to interim financial statements and financial instruments. We would welcome the opportunity to comment on issues once CESR completes its initial assessment. In addition, we have some initial comments regarding the differences identified by CESR and the remedies proposed which we have included in Appendix 2. Our comments are based only on a partial analysis of the US GAAP differences identified by CESR, and highlights areas where we believe that CESR's analysis of these differences may lack appropriate detail, where it may be inconsistent with our understanding of the GAAP differences or GAAP differences exist that have not been identified by CESR.

* * *

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 IFRG Limited

KPMG IFRG Limited

Appendix 1

Expansion on our significant comments

This appendix expands upon and explains our significant comments and recommendations in the covering letter.

Identification of significant differences and required remedies

The concepts of additional differences that are significant to European investors and the determination of appropriate remedies are too vague to permit consistent judgements to be made as to what is significant and what is the appropriate remedy. In our view, the consultation paper does not provide a sufficiently robust framework for the determination of differences that are significant from the perspective of the individual reporting entity, or for the determination of which remedy is appropriate to an identified difference.

Preliminary indications from member firms of KPMG International in the relevant jurisdictions are that, in the absence of specific "safe harbour" or an agreed framework for judging significance to an investor, CESR's overarching requirement for an entity to present appropriate remedies for each difference that is significant to its particular circumstances are likely to result in the functional equivalent of a full reconciliation, despite CESR's statement that this is not its intention.

The consultation paper proposes that an entity present appropriate remedies for each difference that is significant to its particular circumstances (paragraph 77) based on the preparer's and auditor's judgement about whether the items are material to the financial statements taken as a whole.

The paper provides a list of "major" differences between each third-country GAAP and EU-adopted standards, but notes that the list is not intended to be exhaustive (paragraph 101). The paper also provides a list of potentially "significant" differences, drawn from the major differences, but then notes that the list may not be exhaustive and that the identified significant differences will not necessarily be relevant or material for all reporting entities (paragraphs 96, 97).

For each of the differences identified as potentially significant, proposed remedies are included, but the paper requires that the entity should consider which is the appropriate remedy and notes that the appropriate remedy may be other than that proposed (paras 65,77). In addition, we believe that the distinction between the narrative element of remedy Disclosure A and remedy B is not clear.

The paper provides only the following general guidance, "for evaluating [the significance of possible entity-, industry- or event- specific circumstances that could lead to the conclusion that there are other GAAP differences that are significant for investor's decision making], the concepts used and described in this document can be used as reference" (paragraph 106). The paper proposes that the general requirement of IAS 1 *Presentation of Financial Statements* (paragraphs 13 and 15(c)) should apply.

We do not believe that a general requirement for the disclosure of additional information in one GAAP can be applied to financial statements whose framework is a different GAAP. In practice, many GAAPs (including US GAAP) contain similar general disclosure requirements but the content of those financial statements differ from one another. This illustrates that, similar to the concept of a "true and fair view", such disclosures are GAAP-specific.

In particular, CESR explains that one of the considerations it has included in its assessment of whether a remedy is required is the cost / benefit to users of financial statements (paragraph 65). In our view, it is difficult if not impossible for a company to consider such a cost / benefit analysis as part of the identification of significant differences relevant to it and therefore to have a basis for concluding which remedies are required and sufficient to meet the general requirement (paras 32, 70).

The absence of a robust framework for evaluating disclosure remedies may lead to inconsistent reporting and we do not consider that this approach is in the best interests of investors. The covering letter sets out our alternative proposals.

The absence of a robust framework will impact also on the consistency with which CESR's members are able, in their role as regulators, to monitor compliance with the requirements.

Preparation of pro forma statements and other disclosures

We have general concerns as to the usefulness and understandability of the *pro forma* statements and quantitative disclosures (Disclosure C) proposed by CESR.

In particular, the *pro forma* disclosure suggested by the consultation paper will not be prepared in accordance with a particular, single accounting framework (i.e., the supplementary statements would not be "in accordance with" either the relevant national GAAP or with IFRSs). We are concerned that a mixture of partially restated *pro forma* statements and quantitative disclosures alongside third-country GAAP financial statements will have very little informational usefulness even to sophisticated users. CESR acknowledges this limitation and the risk of creating expectation gaps (paragraph 93).

While we do not necessarily support a requirement for comprehensive reconciliations in the case of the third country GAAPs under consideration, we propose that CESR develop a framework that can be more easily understood. As we explain briefly below we consider in particular that CESR should reconsider the proposed use of IFRS 1 *First-time Adoption of IFRSs* in preparing the *pro forma* statements and other disclosures (paragraph 92).

As the disclosures are for the benefit of users, we recommend strongly that CESR consult more widely with those users to ensure that the final requirements are understandable and useful to them on a cost-benefit basis. On the basis of that consultation, CESR should develop and explain more clearly the basis of preparation of the *pro forma* statements and additional disclosures.

Application of IFRS 1

In addition to the more general concerns noted above, we have significant practical concerns with the proposed application of IFRS 1 in the preparation of the *pro forma* statements and quantitative disclosures. CESR proposes that the *pro forma* statements (and other remedy disclosures) are prepared,

> *"consistently with the principles stated by IFRS 1. On this basis entities can elect not to present remedies for past transactions that, in accordance with the exemptions provided by IFRS 1, would not have to be restated to IFRS 1 if the reporting entity would be an IFRS reporting entity. However, investors will need to have a clear knowledge as to whether those standard are applied retrospectively or not. Therefore issuers should provide the disclosures required by IFRS as to how the exemptions are used."*

The entity will not be a first-time adopter and, under CESR's proposals, would be applying the requirements of IFRS 1 both notionally and partially, as there will be elements of the standard that will not be followed. IFRS 1 is intended to be applied only once to a complete set of financial statements. It is not designed to be applied in the manner proposed by CESR.

This leads to practical questions such as:

- what is the date of transition for the purposes of such notional application?
- Is this date fixed the first time that the entity uses IFRS 1 notionally, or is the entity a notional first-time adopter in each period in which it presents remedies?
- How are subsequent changes in IFRS requirements reflected (i.e., what are effective dates and transitional requirements for subsequent changes, and are these governed by the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*)?

In addition, the application of IFRS 1 necessarily will be selective, for example the entity will not be applying policies consistently. It also is unclear how CESR intends a number of the exemptions and exceptions to be applied, for example in the areas of:

- unconsolidated subsidiaries (IFRS 1, Appendix B paragraph B2(j))
- non-restatement of certain business combinations (IFRS 1, Appendix B)
- share-based payments

Even with the proposed disclosures of how the exemptions have been used, we are concerned that the interaction of the exemptions and exceptions in IFRS 1 combined with the partial restatement of selected aspects of third-country GAAP information will not provide meaningful information in the case of either *pro forma* statements or other quantitative remedy disclosures.

We believe that CESR should consider this proposal further. If CESR concludes that the relief in IFRS 1 should be applied by analogy, then we believe that specific guidance is required to

ensure that the proposed remedies are prepared consistently and that they provide users with useful, understandable information.

Relevant auditing / assurance and ethical standards

The consultation paper proposes that remedies also should be subject to audit, providing the same level of assurance as for the financial statements (paragraph 104). Any assurance presumably would be given in accordance with the standards applicable in the jurisdiction in which the report was issued. It is not clear to us that this issue has been considered.

We believe that a separate audit opinion is not appropriate on these disclosures under at least US GAAS, PCAOB standards, or ISAs.

Instead, we support the view that the remedies should be included as note disclosures to the national GAAP financial statements, and accordingly, any auditor's report would cover such information in the context of the financial statements taken as a whole.

We believe that this approach can achieve the objective of auditing the remedies to the same level of assurance as the financial statements. Revised ISA 700, *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*, issued by the IAASB in January of this year, clarifies that the auditor's opinion on the financials statements covers all supplementary information included in the notes to the financial statements. Inclusion of information relating to GAAP differences in the notes to the financial statements is also accepted practice in some jurisdictions. For example, some Canadian companies listed in the United States that prepare their financial statements in accordance with Canadian GAAP currently include a note to the financial statements with adjustments and disclosures that would be required in order to present the financial statements in accordance with US GAAP.

However, positioning the remedies in the financial statements will not eliminate the need for a sufficiently objective framework against which to assess the adequacy of these remedies. The development of a sufficiently objective framework will require a number of the issues identified in the covering letter and this appendix to be resolved.

We also are concerned that the proposal contemplates the application of auditor judgment in place of the judgment and responsibilities of management (see following section).

Independence – respective responsibilities of management and auditor

CESR proposes that:

> *"the need to apply the [pro forma statement] remedies on a company level should be judged by the issuers and their auditors on the basis of whether they are material to the financial position of the company and so would be significant for the purpose of investors." (paragraph 77)*

"the first judgement for the application of the remedy should be made by the reporting entity and assessed by the auditors as to its appropriateness in the particular circumstances of the reporting entity." (paragraph 99)

"auditor's involvement is also considered necessary in those situations for evaluating possible entity-, industry- or event- specific circumstances that, to the knowledge of the auditor, could lead to the conclusion that the there are other GAAP differences that are significant for investor's decision [making]." (paragraph 106)

In our view the consultation paper does not define clearly the division of responsibilities between the entity's management and auditor. It appears that the paper may require the auditor to exercise judgments and responsibilities as part of the preparation of the remedies. These judgments and responsibilities properly belong to management alone. In accordance with IFAC (and also EC) independence guidance, auditors avoid engagements that involve self-review as they can represent independence threats. As the assurance over remedies will be provided in other jurisdictions, then the independence guidance in those jurisdictions will apply including for example those of the PCAOB, SEC, AICPA as well as Canadian and Japanese requirements.

The inappropriate dual role is illustrated in the paper in the diagram that follows Paragraph 32, which shows the auditor as part of both the company's assessment and as a "filter".

We believe that the proposals should state clearly that the preparation and completeness of the additional disclosures and supplementary statements are the sole responsibility of entity's management. The auditor then is responsible for forming an opinion on those disclosures and supplementary statements in the context of the financial statements taken as a whole. If independence issues are to be avoided, then the requirements should avoid placing any primary responsibility for identification of significant differences in the case of a particular entity on the auditor if that auditor subsequently is responsible for forming an opinion on the resulting disclosures.

Completeness of CESR's equivalence assessment

In several respects, the paper acknowledges that CESR's assessment of equivalence and its consideration of differences is incomplete, specifically with regard to interim financial statements and financial instruments.

We consider that CESR should describe how and when it will complete its assessment of equivalence and the identification of significant differences. In the meantime, as the consultation paper currently requires filers and their auditors to consider all possible differences, not just those that CESR have identified on the list and assessed as significant, we believe that CESR should clarify that management are exempt from performing such an assessment, and provide the auditor exemption from providing assurance thereon.

Appendix 2

Illustrative comments on US GAAP/IFRS comparisons

While we have performed only a partial analysis of the US GAAP differences identified by CESR, our comments below illustrate some significant concerns with the completeness and conclusions of the analysis prepared by CESR.

"Non-equivalence" of Special Purpose Entities (SPEs)

The blanket requirement for a *pro forma* balance sheet and income statement prepared "as if" certain SPEs are consolidated subsidiaries is likely to cause significant difficulties in practice, as this area is often very subjective in nature under IFRSs. We agree that for vehicles that have a natural "carve-out" in US GAAP (e.g., Qualifying Special Purpose Entities (QSPE) structures exempted from FASB Interpretation number FIN 46R) the proposed requirement may be appropriate. However for vehicles that have been subjected to a risk-and-rewards-like evaluation under FIN 46R, we believe that this approach substantially is equivalent to the risk-and-rewards approach of SIC 12. CESR should consider further whether it can restrict explicitly to QSPEs the types of vehicles that would result in supplementary disclosures.

Specific comments related to technical assessment of US GAAP equivalence

Standard	Item	Comments
IFRS 2, Share-based Payment	B	As CESR notes, in some case the remedy of disclosure may be provided largely by disclosures already required by the third country GAAP. We believe this is the case for share-based payments.
IFRS 3, Business Combination	D and E	*Proposed remedy* CESR proposed "Disclosure C" as a remedy but it is unclear whether disclosure is required only in the year of acquisition or also in subsequent periods. If the intent is to disclose the effect of the difference on an ongoing basis, then we believe that it would require significant efforts by the entity to track the information for the subsequent periods. Additionally, it is unclear whether this applies to previous business combinations. We believe CESR should require that disclosure cover only the period of the acquisition. Additionally, if the FASB and IASB complete their planned joint project on business combinations, this disclosure should be eliminated. *Completeness of differences* We believe that the summary of differences is incomplete, as it

		does not refer to different treatment of contingent consideration. Under US GAAP, contingent consideration is part of purchase price when additional consideration is issued or becomes issuable whereas under IFRSs contingent consideration is part of purchase price at the date of acquisition if payment is probable and can be measured reliably.
IAS 17, Leases	B	*Description of issue* We believe that CESR should clarify that under IAS 17 it is *unrelated* third party guarantees that are included in minimum lease payments *in the lessor's calculation.*
IAS 19, Employee Benefit Arrangements	A	*Proposed remedy* CESR has proposed "Disclosure A" as a remedy but the description of the issue refers to various differences of detail between US GAAP and IFRSs. We believe that it would be helpful if the description of the issue is more specific and whether the proposed remedy includes description of required disclosure of type A. *Completeness of differences* The analysis does not refer to the recognition of termination benefits payable. Under IFRSs, the recognition criteria is announced voluntary redundancy to the extent of expected take-up whereas under US GAAP, a liability is recognised only when an employee accepts the terms of an offer.
IAS 27, Consolidation	A	*Proposed remedy* CESR's proposed remedy of a Supplementary Statement should specify which accounting framework would be applicable. Item 2 of Executive Summary implies reporting a *pro forma* balance sheet and profit and loss account on the local basis GAAP, but including the unconsolidated subsidiaries. If the entity should be reporting on its local GAAP basis in these supplementary statements, then we believe that CESR should specify that such information is on a local GAAP basis, "except for", for example, the consolidation of certain SPEs as described above.
IAS 28, Investments in Associates	B(1)	In our view, the Assessment of Significance and Remedy seem contradictory as Assessment indicates disclosure only is appropriate while a "Disclosure C" remedy calls for a quantitative analysis of the impact. Given that these are investments in which the investor does not have control over the investee, it may not be practicable for the investor to obtain

		the information needed to determine the effect of conforming accounting principles.
IAS 31, Investments in Joint Ventures		*Description of issue* We do not agree with CESR's conclusion that US GAAP applies proportional consolidation to investments in joint ventures. In general, US GAAP requires the application of the equity method to investments in joint ventures.
IAS 32, Classification of Financial Instruments	B(1)	*Description of issue* We believe this is a very broad generalisation of US GAAP liability/equity issues. At a minimum, it should be noted that mandatorily redeemable preference shares generally are recorded as liabilities, while other types of preference shares may qualify as equity.
IAS 38, Intangible Assets	B	*Proposed remedy* CESR has proposed "Disclosure C" as a remedy but we believe that this could cause a significant amount of reconciling work for an entity and it may not be feasible for a company to determine the amount of development costs it would have capitalised in previous periods had it been applying IAS 38. *Accuracy of differences* We do not believe CESR's statement that "Development costs and purchased IPR&D are expensed under US GAAP" is entirely accurate. Under US GAAP, there are exceptions, for example, for development costs related to internal-use software (SOP 98-1) and websites (EITF 00-2), and software development costs (Statement 86) which are capitalised.
IAS 40, Investment Properties	A	*Proposed remedy* It is unclear to us whether CESR is expecting investment property disclosure of fair value and all the related assumptions, and other information. We understand that IFRSs requires disclosure of fair value, even when the cost model is used, but Disclosure B seems to require disclosure of significant assumptions, etc. In our view, Disclosure A seems to be the more appropriate remedy i.e. provide the fair value information required by IFRSs for entities accounting for such property on a cost basis. We believe that Disclosure B goes beyond what compliance with IAS 40 requires.
IAS 41, Agriculture	A	*Proposed remedy* CESR has proposed "Disclosure C" as a remedy, yet we believe

		that the description of the issue is very generic and it is unclear to us what information would need to be disclosed. We believe thatCESR should provide more specific information on the disclosure.