



CONCEPT PAPER ON

EQUIVALENCE OF CERTAIN THIRD COUNTRY

GAAP

AND ON

DESCRIPTION OF CERTAIN THIRD

COUNTRIES MECHANISMS OF

ENFORCEMENT OF FINANCIAL

INFORMATION

FEEDBACK STATEMENT

January 2005



FEEDBACK STATEMENT ON THE CONSULTATION ON THE DRAFT CONCEPT PAPER ON EQUIVALENCE

1. On October 22nd 2004 CESR published for comments a draft Concept Paper which set out the various principles by which CESR intends to work under a mandate received from the European Commission whose objective is (i) to assess equivalence between certain third country GAAP (Canadian GAAP, Japanese GAAP and US GAAP) and IAS/IFRS and (ii) to describe the enforcement mechanisms in place in the considered three countries.
2. The period for comments expired on the 22nd December 2004 and the public consultation also included an open hearing held on 23 November 2004. During the consultation period 24 letters were sent by various organisations. All comment letters received have been published on CESR website.
3. CESR observes that the draft Concept Paper generally received large support from those who responded to the consultation and participated in the open hearing.
4. An in-depth analysis of all comments received lead to CESR making some changes to the Concept Paper the final version of which is published on CESR website (ref CESR 04-509C) along with this feedback statement (ref CESR 05-001) providing the views of CESR on the most critical points raised by respondents to the public consultation.
5. CESR takes the opportunity of this feedback statement for thanking all respondents for their fruitful and constructive contribution.

Consultation process

6. This feedback statement is part of CESR transparent working process that CESR will continue to follow in the next step of preparing and finalising its advice to the European Commission on the issue of equivalence. In particular, as part of its public consultation practices, CESR has set up an ad hoc Consultative Working Group of market participants having varied background and sound knowledge of and experience in accounting and financial reporting issues. The list of members of the Group has been published on CESR website (www.cesr-eu.org).
7. As the Concept Paper is only the first phase in the process under this specific mandate, CESR wants to confirm that further consultation will also be conducted, involving as many market participants as possible, on the technical advice which will propose more detailed indications on the equivalency and possible remedies, where relevant. This second consultation is expected to start in May 2005.
8. It is difficult for CESR to have an exhaustive and relevant view of the opinion of all market participants on the issue of equivalence and on the most appropriate ways to address situations of non-equivalence or quasi-equivalence. Making detailed cost-benefits analysis or widespread surveys, as suggested by some respondents, would be highly resources-consuming and would not allow CESR to collect all relevant information necessary for the preparation of a technical advice in this matter especially on technical accounting aspects. Therefore, collecting evidence from all market participants, especially from investors and third country issuers, will continue to be made through widespread consultations on draft papers and advices. CESR also welcomes any contribution any interested party would like to make to the process before finalisation of draft papers for consultation.
9. In particular, CESR invites investors, third country issuers and auditors to continue to provide any indication on what is necessary and realisable for ensuring a proper and reliable functioning of securities market as regards financial information disclosed by third country issuers using third country GAAP.



10. As indicated in the Concept paper, CESR will use information received from third countries as a response to questionnaires sent to them. In the framework of CESR public consultation practice, these responses will in principle be posted on CESR website.

Definition of equivalence

11. Some respondents to the consultation asked clarifications on the definition of equivalence, in particular about the idea that “third country GAAP can be declared as equivalent to IAS/IFRS when financial statements prepared under such third country GAAP enable investors to take similar decision in terms of whether to invest or divest, as if they were provided with financial statements prepared on the basis of IAS/IFRS”.

12. In CESR’s view, the point is to know what the impact of GAAP differences on investor’s decision is. If, after analysis of general principles and significant differences between a given third country GAAP and IAS/IFRS, it appears that financial information provided by third country issuer leads to a different investors’ interpretation of the issuer’s financial position and results, then it can be assumed that investors’ decisions regarding investment/divestment in securities of this issuer could hardly be “similar”. This is of course a general and abstract exercise that CESR will conduct very carefully, considering all evidence available from all market participants.

13. In this approach, CESR takes into account the cost that would represent for investors the need to have reliable, comparable and understandable financial information (which is basically quantitative) when such information is prepared under different reporting rules. The objective of possible remedies and restatement is precisely to alleviate the burden of cost that this situation will represent for investors who, going forward will progressively consider IAS/IFRS as normal reporting framework in Europe (i.e. their common language for understanding financial statements).

14. It is clearly not possible to consider all possible reactions of all investors. First, a practical analysis will not be possible without having a complete view of significant GAAP differences (this will come after the second stage of the equivalence assessment). Secondly, investors’ decisions integrate many other considerations that cannot be encompassed in an equivalence exercise. Even when provided with exactly the same information, different investors might still take completely different decisions. This is why CESR choose to conduct a technical, focused on accounting aspects, assessment of equivalence. This is the only credible way for providing a relevant advice to the European Commission.

15. The real difficulty is for CESR to limit its analysis to significant GAAP differences. The Concept Paper clarifies how this will be delivered.

Should the advice make distinctions between investors?

16. The draft Concept Paper indicated (par. 7) that “*a basic assumption for assessing the equivalence is to consider that investors on European markets will have a reasonable knowledge of IAS/IFRS as these standards will be used by European listed companies as from 2005*”. This par. 7 also acknowledged that “*Canadian, Japanese and US GAAP are already used to varying extents in EU markets*”.

17. CESR believes that it is extremely difficult to gather convincing evidence on investor’s real knowledge of accounting standards.

18. CESR observes that respondents to the consultation have diverging views on whether it could be assumed that investors have sound knowledge of IAS/IFRS and of third country GAAP. However, CESR believes that a basic assumption for assessing the equivalence is to consider that investors on European markets will have a reasonable knowledge of both IAS/IFRS as explained below. CESR also assumes that rational investors in securities of third country issuers will have a reasonable knowledge of reporting environment of considered third countries, as reporting framework in EU

and in third Countries are not as such required to be identical under Prospectus and Transparency Directives.

19. CESR does not take for granted that investors have *now* a reasonable knowledge of IAS/IFRS but considers that such knowledge will progressively be widespread in Europe once these standards will become common accounting language for publicly accountable entities in Europe. It is a clear objective of Transparency and Prospectus Directives that, in the year 2007, third country issuers should not be allowed to continue using third country GAAP that are not equivalent and this is consistent with the objective of the Regulation 1606/2002 on the use of international accounting standards in Europe, which is to have all entities whose securities are traded on regulated markets reporting under IAS/IFRS.

20. It will be a challenging (and costly) exercise for investors to get acquainted with IAS/IFRS. This must be taken into account and investor's access to financial markets would be reduced if, at the same time they would have to reach, keep or upgrade the same level of knowledge of third country GAAP (safe if equivalent to IAS). This would reduce the transparency of markets, reduce the interest in off-shore investment or raise significantly the cost of investment activities.

21. Under Prospectus and Transparency Directives, information is accessible to all investors, professional and retail ones. In this framework, financial statements must be equally accessible and understandable for all investors, on equal footing. There is actually no conceptual justification for stating that financial statements prepared under GAAP could be differently equivalent depending on who reads these financial statements. The test of equivalence is clearly at the level of GAAP.

22. On this basis, CESR will keep its initial approach not to make a distinction between investors. The Final Concept Paper clarified that only 'direct investors' in securities of third country issuers admitted to trading in EU are considered and not investors through indirect investment vehicles.

Should the advice make distinctions between different third country issuers?

23. Some respondents to the public consultation suggested that a distinction between third country issuers should be made in the framework of equivalency assessment.

24. Par. 8 of the Draft Concept Paper indicated that "*CESR's advice will not differentiate between segments of the regulated markets, such as bond issuers and equity issuers*".

25. Again, CESR believes that the test of equivalence is at the level of GAAP. Therefore, pronouncements on equivalence should not depend on the type of securities issued by third country issuers. In other words, CESR does not intend to develop a different technical advice on equivalency according to the fact that the issuer has issued bonds or shares or other financial instruments. CESR will not either attempt to identify and assess on certain reporting requirements that may exist for specific market segments. These aspects have been clarified in the Final Concept Paper (par 12 of Final Concept Paper).

Granularity of the assessment

26. Some respondents to the consultation suggested that CESR should not engage in a technical analysis of differences between accounting standards, and should instead focus on major differences of broad accounting principles.

27. CESR does not believe that a high-level analysis of equivalence would be enough for delivering a sound technical advice on GAAP equivalence. Although the Concept Paper has made it clear how CESR will limit its analysis, notably to significant GAAP differences.

28. Considering the definition of equivalence given in par. 1 of the Concept Paper, CESR must necessarily have an idea of what GAAP differences are, which requires going beyond broad structural concept of accountancy. Indeed, broad concepts can be equivalent and more detailed

standards be totally different, and vice-versa. In both cases, investors or issuers would not be satisfied and CESR's advice would not be based on reasonable basis.

29. A fundamental element of financial reporting is that published financial statements are the final output of computation of numerous and complex operations. Depending on the way these operations are accounted for and presented, this final outcome could give a completely different image, information to investors. A wealthy and profit making entity under one given GAAP could become a completely indebted and loss making entity when reporting under another GAAP. Knowing this economic fact is fundamental for markets' confidence and efficiency. Considering broad accounting principles only will never cater for this market's needs and the equivalence objective of Directives would not be fulfilled.

30. The mandate given by the EC to CESR defined the framework and objectives of the work to be conducted by CESR. It notably indicated that "the assessment should also be carried out independently of whether the third country concerned already recognises IAS/IFRS as equivalent to their domestic GAAP". For that reason, possible **regulatory reciprocity** will not be considered by CESR for deciding on possible equivalence or non-equivalence.

31. CESR hopes very much that convergence projects between GAAP and IAS/IFRS will be taken forward expeditiously and will contribute to a large reduction of divergences.

Scope of GAAP assessment

32. Some commentators suggested CESR to consider a broader basis for assessing GAAP equivalence than **purely IAS/IFRS as endorsed at EU level**.

33. The EC mandate in this regard is however very clear and CESR is not entitled to take account of other aspects such as other EU disclosure requirements for annual management reports.

34. These comments call for the following more specific clarifications.

35. To the extent possible, CESR will take account of **how GAAP are practically implemented and applied..** However, the timeframe for delivering the advice does not allow CESR to conduct an in-depth analysis of these aspects and CESR looks greatly to market participants for providing any relevant and significant evidence in this regard. It is important this is also an important question of enforcement of financial reporting (see Section 2.2 of the Concept Paper in this regard).

36. As indicated in par. 42 of the Draft Concept Paper, "*CESR will only consider third country GAAP applicable as at 1st January 2005 for financial years starting after this date. This will therefore not encompass future standards (e.g. standards whose application is dated after 1st January 2005, or draft standards)*¹." This again reflects the mandate given by the EC to CESR.

37. However because the equivalence issue will only become relevant after the transitional period of the Transparency and Prospectus Directive, i.e. as of 1st January 2007, the report to the EC on possible equivalence or non-equivalence will take note of significant changes to third country GAAP that would be effectively implemented in the meantime.

38. For that reason, the questionnaires sent by CESR to third countries for gathering information on GAAP and GAAP equivalence is also enquiring about (i) any additional or different enforceable standards whose date of application would be after 1st January 2005 and (ii) possible significant changes in GAAP that are expected to take place before 1st January 2007.

¹ Footnote 2 of the final Concept Paper clarified that CESR believes reasonable to assume that the endorsing regulation(s) of IFRS 2 and IFRIC 2 to 5 will be published (for application as of 1st January 2005). These standards will therefore be included in the assessment.

39. As regards the scope of assessment, it is also necessary to clarify another point raised by some commentators. CESR has been mandated to assess the equivalence vis-à-vis IAS/IFRS as endorsed for EU, which means that **CESR will not check whether third country GAAP ensure a proper financial reporting in se**, but whether these GAAP are equivalent to IAS/IFRS as endorsed for EU. In the equivalence project, IAS/IFRS represents an undisputable benchmark. CESR does not intend to pass value judgement on IAS/IFRS themselves.

Review of general principles

40. Taking account of comments received, the final Concept Paper (par. 20) has clarified how the **four principles** will be considered in the assessment work (i.e. that CESR will check whether the three third countries GAAP contain or are based on these principles).

41. Several respondents proposed that GAAP should not systematically be declared as non equivalent if they do not cover all **topic** regulated by IAS/IFRS. As indicated in par. 27 of the Draft Concept Paper, the test in this case will be to see whether this possible lack is relevant at the level of issuers and raises a significant concern to the investors. This aspect should be usefully addressed through ad-hoc remedies.

42. As noted by one respondent, topics might be covered by additional specific guidance and not necessarily by GAAP. This however raises an issue of enforceability and compliance, which is a requisite for an assessment of equivalence at GAAP level (at individual case level, on the contrary, the problem could be solve when guidance are complied with).

43. As regards the assessment of **objectives** of IAS/IFRS versus GAAP, the idea is clearly to look at the final outcome in practice, and not to check line by line the wording. This has been clarified in the final Concept Paper (see par. 36).

Technical assessment

44. CESR observes that respondents had diverging views on how “**significant**” **GAAP differences** could be determined. Some suggested looking at all possible GAAP differences, whereas others called for a review that would not go beyond broad accounting principles. However, most respondents supported CESR’s approach as set out in par 47 of the Draft Concept Paper, as practical and consistent with the definition of equivalence and the mandate of the European Commission. The section of the Concept Paper that deals with “significance” (point 2.1, section C.3) has therefore not been changed.

45. A difficult question raised by some respondents is to know from how many significant differences could GAAP be declared as not equivalent. It is not possible to answer to that question at the level of a Concept Paper, because it will manly depend on the nature, the significances and the reach of considered GAAP differences. This will be further addressed in the draft technical advice.

Consequence of non-equivalence

46. Some respondents are concerned that the **outcome of the equivalency assessment** might include instances of non-equivalence that could be solved by remedies, instead of a binary solution of equivalence (with no remedy) or non-equivalence (implying restatement). However, many respondents supported the approach proposed by CESR which reflects the need for flexible solutions in circumstances where the outcome cannot be purely black or white from a technical point of view.

47. It will not always be possible, in a technical advice such as the one that CESR must deliver, to declare GAAP as completely equivalent or not equivalent if the technical assessment shows a number of significant differences which would lead investors to different decisions if they are not provided with additional elements of information or explanations. It is extremely difficult, in this case, to find an objective and overarching criteria for deciding if a complete restatement is necessary (this might

be too much and too expensive) or if no additional explanation is necessary. All in all, the proposed approach ensures a useful balance between cost for issuers and benefits for investors and corresponds to a technical reality of differences between GAAP.

48. It should be observed that CESR's approach in this regard is presents some similarity with the IOSCO standing resolution on the assessment of international accounting standards. CESR observes that its proposal on the three **remedies** received a large support from respondents to the public consultation, as this notably presents a balanced alternative to an approach allowing only restatement where third country GAAP are not be recognised as equivalent.

49. Some respondents suggested keeping disclosures as only alternative remedies. CESR believes that a fundamental difficulty with disclosure is to know what this could exactly encompass. A simple description of significant differences between GAAP and IAS/IFRS is quite useless as such descriptions will already be provided in CESR technical advice and by many accounting literature. Narrative disclosures like these risks to rapidly end up in "boiler plate" with lengthy texts were essential explanations get bogged down in theoretical details. Because financial information is quantitative by nature, mere narrative explanations will never suffice for proper and effective information of investors if these explanations are not supported or completed by quantitative indications on the impact of the mentioned significant GAAP differences. It has however to be made clear that CESR does not intend to propose long and very detailed requirements and will instead propose a reasonable solution balancing implied additional cost for issuers and expected benefits for investors. The public consultation on the technical advice will give all market participants the opportunity to comment on this.

50. Responding to requests expressed by some commentators, the final Concept Paper has clarified the nature of the remedy "**supplementary statements**" (see paragraph 63 of the final Concept Paper).

51. Taking account of comments received, the Final Concept paper has also clarified how the **responsibility for application of remedies** will work. In this regard, the Final Concept Paper (par 67 to 71) makes it clear that a list of applicable remedies should be provided, GAAP by GAAP (where relevant), clarifying the reporting requirements for third country issuers in general. Then, comes the question of which remedy has to be provided in practice by each issuer. This will depend on the particular business profile and accounting policies of the reporting company. For instance, it should not be expected that an issuer provides a remedy for a given significant GAAP difference that is of no relevance for it. It is only at that second level that third country entities will be responsible for the application of remedies. At that level the materiality criteria (as defined in the reporting framework) will have to be considered by the third country issuer (and by its auditor).

52. Consultees' views are varied as to the appropriateness and extend of an **audit of remedies**.

53. A majority of respondents supports CESR's view that the assurance provided by an audit of the remedies is a key element for building and raising investors' confidence in financial reporting.

54. As regards the nature of the auditor's opinion on remedies, CESR believes, at this stage, that the same level of assurance should be provided on remedies as with the original third country financial statements (this aspect has been précised in par 58 of the Final Concept Paper). More prescriptive indications on the terminology to be used for such opinion should be part of broader EU projects on audit.

55. Another issue raised by respondents to the consultation is the **presentation of remedies** in issuers' prospectuses or periodic reporting. CESR does not want at this stage to be too prescriptive as to the form and presentation of remedies.

56. Remedies must always be presented in a clear, complete and consistent way, using plain language. Remedies can be integrated into third country financial statement or be presented as a separate statement, subject to the assurance as described in paragraph 57 of the final concept paper.

In the later case, remedies must always be published along with third country GAAP financial statements for reporting purposes on EU financial markets.

Early warning mechanisms

57. Consultees' reactions on CESR proposals related to the early warning mechanisms were also varied.

58. Taking into account concerns and questions raised by consultees, the final Concept paper

- a. clarifies why CESR proposes to have a body, appropriately funded and accountable for this task (see par. 71 and 72 of Final Concept Paper);
- b. justifies the proposed periodicity of reviews (see par. 75 of Final Concept Paper), and

Description of enforcement mechanisms

59. Some respondents to the consultation expressed diverse views on the relation that should/could be established between the declaration of third country GAAP equivalence, the enforcement in place in the considered third countries and the possibility for third country issuers to use GAAP labelled as equivalent without being incorporated or listed in the country where these GAAP are developed and enforced.

60. On this issue, the Draft Concept Paper indicated that *"It should however be noted that there are in practice cases where a third country GAAP is applied by an issuer not regulated by that third country (e.g. a non-US issuer applying US GAAP). This might raise broader enforcement issues that have not been covered by the mandate given to CESR. This concept paper does not deal with these important enforcement aspects and is therefore limited to the assessment of GAAP equivalence in the most common situations, i.e. third country GAAP as applied and enforced in that third country"*. (Par 10, Draft Concept Paper).²

61. CESR continues to believe that consideration of the enforcement regime operated by a third country will be an important factor in determining the enforcement approach. However, the mandate from the Commission was clear in that CESR is asked to describe the relevant enforcement systems, rather than assess them. CESR has already plans to consider the link between enforcement systems and the use of GAAP, as part of the planned work of CESR-Fin Sub-Committee on Enforcement.

62. Finally, CESR observes that Prospectus and Transparency Directives are clear as to the generic requirements for third country issuers to provide, in EU, audited financial information as prepared under IAS/IFRS or under a third country GAAP considered as equivalent to IAS/IFRS.

² As indicated further in section 2.2.3 of the Draft Concept Paper, CESR was mandated by the Commission to only describe the enforcement mechanisms in place in three countries. For that reason and in combination with the tight timetable set for the finalisation of the mandate, CESR will concentrate on these three countries and on the description side at this stage. However, the Concept Paper also stated that beyond giving a technical advice to the European Commission under the mandate on equivalence, it will remain a generic issue for CESR to co-ordinate the approach of its members to the enforcement of financial statements of third country issuers. This could be part of the future activities of CESR's operational group on financial reporting (CESR-Fin), and more particularly of the CESR-Fin Sub-Committee on Enforcement (SCE).



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