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Speech by John Tiner at the IASB meeting with World Standard setters

Thank you very much for that introduction, may I say that I am extremely pleased to be here today. As mentioned, I am here in my capacity as Chairman of CESR-Fin which is CESR's permanent group of experts in the field of financial reporting.

My main focus today is on the European securities regulators' interest in financial accounting and the important role that CESR is playing in the endorsement, implementation and enforcement of IFRS in the EU as well as on the equivalence of other accounting standards with IFRS.

CESR's objectives are as follows

- **Firstly to Improve co-ordination among securities regulators** - this is achieved mainly through the development of effective operational networks and mechanisms to enhance day to day consistent supervision and enforcement of the Single Market for financial services
- **Secondly to Act as an advisory group to assist the EU Commission** - this is particularly relevant in its preparation of draft implementing measures of EU framework directives in the field of securities. As we will see later, it is in this capacity that CESR-Fin has advised the Commission on equivalence of other GAAPs with IFRS; and
- **Thirdly Working to ensure a more consistent and timely day-to-day implementation of community legislation in the Member States** : this work is carried out by the Review Panel under the Chairmanship of CESR's Vice Chairman.

As I mentioned, CESR-Fin is CESR's permanent operational group of experts in financial reporting. It co-ordinates the work of CESR members in the area of financial reporting, allowing CESR to play an effective role in the implementation and enforcement of IFRS in the EU.

We operate in a world where securities markets are global, but securities regulators are national. It is therefore essential that CESR-Fin has good links on an international level both through IOSCO and with the SEC. CESR and the SEC have agreed terms of reference for enhanced co-operation and collaboration regarding market risks and regulatory projects. Such cooperation will afford the

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opportunity to discuss, at an early stage, issues of regulatory concern in the US and the EU securities market. The intention is to allow CESR and the SEC to develop coherent and converging solutions which are both effective and timely.

CESR-Fin has strong links with the EU Commission in the areas of endorsement and enforcement of IFRS and auditing. CESR-Fin has an observer at the EU Accounting Regulatory Committee (ARC) and is seeking representation at any equivalent EU Auditing Regulatory Committee that the Commission may set up.

EU Commission representatives attend all CESR-Fin meetings and actively participate in all debates - except of course for confidential discussions involving specific individuals or firms. CESR-fin also enjoys good relationships with the various accounting auditing bodies, including the IASB and IAASB.

I think that covers some of the background, now looking more specifically at the endorsement, implementation and enforcement of IFRS.

With the introduction of EC Regulation 1606, the vision under the Financial Services Action Plan of a single set of financial statements for listed companies became a reality, the primary objective being to allow community companies to compete on an equal footing for financial resources available in the capital markets. We are now in the midst of the most radical and important change in financial reporting for a generation. From January 2005 we have had International Accounting Standards (IAS/IFRS) for all EU listed groups - the biggest change in financial accounting since the introduction of the 4th and 7th Company Law Directives. The next two years - 2005 and 2006 - will be crucial as IAS/IFRS are applied by nearly 8,000 listed group companies across the EU.

Now that we are starting to see IAS information and the process becomes more real we can move on to think about consistency of application and interpretation. CESR has made a great deal of progress on coordination of enforcement of the standards, but that will affect only those companies who are clearly not in compliance with the standards; issues of consistent application are far more subtle but just as important. The IASB has a clear objective to set standards that are based on principles and that do not seek to provide detailed answers for every accounting problem although some make well articulated and seasonal arguments for the standards being much too prescriptive producing a kind of hybrid of principles and detail. If we stick with the notion of principles as the standards are intended for global application, it would be impossible for them to deal with that level of detail. Principles based standards rely on the experience and judgement of preparers, auditors and users to be able to apply them to their circumstances, and the pace and scope of the move to IASs in Europe means that experience is very limited.

There is a real danger that local markets, industries, and individual companies will develop application guidance or individual interpretations of standards that will not be consistent, and that



will mean that we will lose the opportunity to have truly comparable accounting across the Union. This is not an easy issue. Principles based standards have the great advantage of encouraging innovation and giving preparers a clear responsibility for their own actions. The alternative is an enormously detailed accounting rulebook that deals with every conceivable circumstance, and preparers who feel obliged to ask regulators for guidance every time they identify a transaction for which rules have not yet been drafted. The more closely we examine accounts and try to second guess the preparers the more we drive towards such a rule book.

CESR-Fin has taken the initiative to help with the development of robust and coordinated enforcement across the EU by establishing a framework for discussion and information sharing among European enforcement agencies. There is clear interest in extending that type of framework among all securities regulators who accept the use of IFRS by third country listed companies, and I strongly support initiatives in IOSCO along those lines. It is in everyone's interests for the standards to be applied interpreted and enforced consistently in all major capital markets, and for investors to have confidence in financial information from listed companies.

I think that the EU markets need to start using IAS information with a declared objective to strive towards consistency, and CESR will be monitoring progress and trying to develop further guidance and supervisory techniques to help achieve that. The auditors, of course, have a key role to play here and the Big 4 firms will be most acutely aware of the potential for differing applications. I would urge them to be alert to different national approaches and to talk to regulators where they have concerns that practice is diverging. National regulators and accounting standard setters must also guard against the natural, and to some extent understandable, tendency to consider that the issues they are addressing are unique to their local environment, whereas in reality an identical or similar issue may have arisen in another EU Country which has interpreted differently.

There is also an important role here for the IASB. While it will be possible to deal with most issues of differing application at a company level, it is inevitable that significant numbers will need to be considered by IFRIC, and of those some will require formal interpretation. I understand that the IASB is increasing resources to deal with this anticipated increase in demand. I would urge those planning the IFRIC workload to assess emerging issues on a practical basis, and deal first with those that regulators and others have identified as of immediate practical importance rather than those that pose the most interesting technical challenge. My sense is that we will need clear and timely guidance on a range of relatively straightforward issues during this transition phase.

There is now the real opportunity to take a major step towards our long term goal of having global financial reporting standards, consistently interpreted, applied and enforced, across all the major capital markets. As economies and markets around the world continue to become evermore related to one another, it is incumbent upon regulators and accounting standards setters to facilitate the easy flow of capital and access to new and wider investor markets. Of course, this must be done



carefully and with a close eye on confidence and investor protection in domestic markets, but I believe the momentum is with us. Convergence of accounting between the three major capital markets of the world: EU, US and Japan is clearly heading in the right direction and this should lead to companies in one marketplace being able to access investors in other markets without incurring the costly exercise of performing reconciliations to the local GAAP. I would urge that the convergence agenda be premised on the basis of a principled-based approach. Indeed it seems to me that if we are to take a major step towards globally applied financial reporting standards, it will never be possible to make progress if every conceivable issue is to be covered by a rule. A principle-based system plays to common sense, good judgement and the taking of responsibility and, in my mind, these characteristics underpin the integrity and the reliability of the capital market.

This is an opportunity we must not let slip. With sufficient vision, determination and co-operation amongst all concerned, it should be possible to both build the technical arguments for open access and deliver the political case for reciprocity of access across the major financial markets. In this way companies will have access to a wider pool of capital, without incurring substantial additional costs, investors will benefit from a wider pool of equivalent financial reporting information, which will help ensure that financial resources flow to those firms where it is most appropriate, securities regulators can ensure more easily that financial reporting information reflects company activities and the whole of society gains from a lower cost of capital.

As its contribution CESR-Fin has been reviewing the equivalence to IFRS of three major GAAPs: Canada, Japan and US with a view to advising the European Commission on whether third country issuers should be permitted to use the standards for Prospectuses and financial accounts issued in the EU. CESR-Fin published its final advice for the Commission at the end of June this year and I think it has some important messages for standard setters as they start to move forward on their convergence agenda.

CESR-Fin is of the view that "equivalent" should not be defined as meaning 'identical'. In CESR-Fin's view a third country's GAAP can be declared as equivalent when financial statements, prepared under such GAAP, enable investors to take similar decisions in terms of whether to invest, hold or divest, as they would using financial statements prepared on the basis of IAS/IFRS. Differences of detail between a third country's GAAP and IAS/IFRS which would not give rise to differing investment decisions are not relevant in defining equivalence. Of course, this makes the rather heroic, although in the circumstances we think reasonable, assumptions that investors act rationally based on the information they have been provided with. This definition of equivalence is an outcome-based approach, and market responses to accounting differences are considered particularly relevant for our assessment of significance

Given the way CESR-Fin defined equivalence in the Concept Paper, CESR-Fin was only concerned with assessing whether there were significant differences between third country GAAP and IAS/IFRS.



Differences considered were those commonly found in practice or known to be significant as such by the financial and audit community in Europe and in third countries. Though there may be a long list of individual differences between the GAAPs, we were only concerned with the significant differences, which would affect investor behaviour.

This method for assessing comparison of GAAP can also be described as a direct comparison of standards and it avoids the complications that would follow from considering the differences in how standards are interpreted and applied.

Assessment of GAAP equivalence is only one part of the total investor's decision-making framework. Our approach was therefore based on the presumption that what we call 'filters' at country level, such as effective corporate governance structures and enforcement mechanisms for financial reporting, and audit assurance and enforcement mechanisms at entity level, are sufficient for investors to rely on. In other words, CESR-Fin assumes that third country GAAP are applied and complied with properly. This means that the necessary filters for ensuring market confidence are also in place for third country issuers using or participating in the EU capital markets.

It is important to emphasise that CESR-Fin's assessment of equivalence is based on the assumption that appropriate quality assurance enforcement, and other filtering arrangements at a third country level and that audit assurance at a listed entity level are effective for investor purposes.

Our conclusion was that Canadian, Japanese and US GAAP, taken as a whole, are equivalent to IAS/IFRS, subject to the following:

- companies, which have subsidiaries such as Special Purpose Entities (SPEs), which are not consolidated for third country GAAP purposes, but are required to be consolidated for the purposes of IAS/IFRS, report a pro-forma balance sheet and profit and loss account on their local GAAP basis, but including the unconsolidated subsidiaries.
- companies reporting under Japanese GAAP which have either accounted for mergers by the pooling of interest method and/or have consolidated subsidiaries on the basis of GAAPs which are not consistent with either IAS/IFRS or any of the third country GAAPs, report a pro-forma balance sheet and profit and loss account on the basis of IAS/IFRS covering business combinations and consistent accounting policies, respectively.
- Japan and the US adopt accounting policies for the expensing of stock options on a basis equivalent (i.e. not necessarily identical) to IAS/IFRS, for implementation on or before 1 January 2007. We understand that Japan is considering proposals to adopt such a standard according to this timetable and that the US has recently adopted a standard that in most cases will be applicable as from 2006.



- in respect of certain specified IAS/IFRS and if applicable, in addition to the above-mentioned remedies, there be additional disclosures of sometimes a descriptive nature and sometimes a quantitative nature.

The need to apply these 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 purposes of investors. For example, none of the GAAPs have an equivalent standard to IAS 41, Agriculture. Therefore an investor, who was considering investing in a listed entity involved to a significant extent in agriculture, would look for specific remedies in this field.

Let us be clear, we are not asking for any GAAP/IFRS reconciliations as remedies for any areas of significant difference between Canadian, Japanese & US GAAP. Academic research has indicated, and our consultative working group supported this approach, that investors prefer additional disclosures as a remedy for any significant difference between IAS/IFRS and local GAAP. Therefore our remedies focus on disclosures. Let me provide you with some more detail about these disclosures in relation to the remedies for specific significant differences between IAS/IFRS and the individual GAAPs. They fall into two categories as follows:

A. **Additional narrative and/or quantitative disclosures** augmenting the disclosures already provided pursuant to third country GAAP. This disclosure includes elements such as an explanation of the accounting treatment applied under third country GAAP, additional explanations on assumptions, valuation methods, economic data and the hypothesis used under third country GAAP and the disclosure of the fair value of assets that might not be required under third country GAAP e.g. the consideration of impairment of assets.

B. **Quantitative indication** of the impact of an event or transaction, had this event or transaction been accounted for following IAS/IFRS provisions. Such quantification should provide the gross and net of tax effect of the difference on the profit and loss or on the shareholders' equity of the issuer, as applicable e.g. the treatment of negative goodwill.

Supplementary statements will be required where the differences in measurement or recognition are complicated or numerous, or in cases where a required specific statement might not be presented. The purpose of presenting supplementary statements is to facilitate investors' understanding of the full implications of a significant difference in accounting standards. An example would be where the scope of consolidation is very different from that in IAS/IFRS.

There are two interesting points here that standard setters should take into account as they develop their convergence programme. First, a very clear message that investors see limited value in



reconciliations because they make the misleading implication that a set of accounts prepared under one accounting framework can easily be turned into a set of slightly different accounts under another framework. That underlines the point that we can only make progress on getting the same accounting answers by converging the accounting standards.

The second and even more important message is that the list of issues that CESR-Fin believes requires remedies is actually relatively short, and is a small subset of the list of technical differences between the standards. There are a number of reasons for this.

- CESR-Fin's project defined equivalence relatively narrowly. We were interested only in the needs of investors, not other stakeholders in the financial reporting process
- We looked only at the position of an investor making investment decisions about a single company, not making comparison between two companies in the same industry
- We looked only at standards that would change investment decisions and formed no views on whether one standard was better than another.

Let me give you an example of how those judgements were formed. The US and IASB standards on accounting for share based payments both have the objective of expensing stock options but have differences in the way that expense is calculated. We took the view that investors would take different investment decisions if one GAAP did not require expensing but would be unlikely to change their judgment if differences in the detail of how the expense was calculated gave rise to a different income statement charges. This was largely because it was not clear to us that either standard was intrinsically better than the other and the most important principle was to have an expense. In other areas we took the view that no one has a good accounting answer and so there is nothing to be gained from restating from one framework to another and I will come back to that issue later.

I would argue that the issues for which CESR-Fin believes that remedies are needed should be at the very top of the standard setters' convergence agenda. They are not necessarily the most interesting issues technically (although there is no doubt that issues like accounting for SPEs are very difficult) but they are those that our project has highlighted as the most immediately important for investors. My sense is that the convergence work at the moment is focussing on areas where all accounting frameworks could be improved rather than on these issues of radically different treatments. There is no doubt that accounting for business combinations or insurance for example needs to be improved and harmonised across the world, but there is also a need, I think, to deal with more basic issue like eliminating LIFO as a basis of inventory valuation or getting consistent accounting for investment properties. I would urge you all to download the CESR-Fin report from our website (www.CESR-eu.org) and see whether you can make progress on the issues we have identified.



I said earlier that there were some areas where we took the view that no one's standards were better than the others'. The most important example of this is in the area of accounting for financial instruments. Here I should declare an interest. The FSA is of course a prudential regulator of banks, insurance companies and other financial institutions as well as being a securities regulator and we have a close interest in the way that those institutions account for their financial assets and liabilities. Indeed our stated objective is to promote the convergence of accounting regulatory and economic measures of capital in the regulated sectors.

It is no secret that the process of endorsing IAS 39 for use in the EU was not straightforward, and a great deal has been done over the last few months to overcome the continuing obstacles to full endorsement of the standard, notably in the application of the fair value option. However, I am concerned that we have a standard that is very difficult to understand and that does not always meet the securities regulators' objective of being capable of consistent application, interpretation and enforcement. Indeed, as David Tweedie often says, anyone who says they understand the standard clearly hasn't read it.

The global standard setters rightly have accounting for financial instruments high on their agenda, but they often appear to be focussed too closely on the longer term objectives of finding the Holy Grail - a coherent and consistent system of universal fair value. I have long supported that aim but I have to say that I do not think we are getting any closer to achieving it. When I first joined the FSA we were debating the subject and working on the assumption that a standard might be in place by 2005. Five years later the problems - notably those surrounding the calculation of fair values for illiquid instruments, and how to treat changes in fair values where instruments are not actively traded - have got more difficult, and the solution looks even further away.

Resources to deal with financial instrument issues are hard to find in all areas and I have some sympathy with those who argue that the limited staff available should not be asked to spend their time on endlessly amending IAS 39. However, I think that there is still merit in looking further at some of the big issues in IAS 39 with a view to trying to get a simpler and more principles based standard that could help to inform the wider fair value debate. There are issues in the standard that will still be difficult even if we move to fair value (for example loan loss provisioning, FX risk and cash flow hedging) and the world would surely be a better place if the fair value hedging rules were simplified.

The one area which concerns me a great deal from an accounting, regulatory and investor reporting point of view is the valuation of illiquid financial instruments, determining how and when to recognise profits or losses from such instruments and whether, when and how to adjust values for changes in market liquidity and price volatility. This is a very important and topical



issue. We at the FSA are concerned that liquidity risk is properly reflected in the valuation. We will be doing further work on this subject in the coming months and will be speaking to the industry about this.

This session appears on your agenda as a keynote speech, and there are some points that I would like to emphasise as the key issues that we as securities regulators believe standard setters should be addressing. You are all aware that this is a crucial time for accounting. We have an opportunity to make real progress towards converged global accounting standards that help investors make informed decision and enhance market confidence. We in Europe have taken a step towards that goal that would have been unthinkable ten years ago. The world's standard setters are now dealing with some of the most difficult technical issues surrounding complex transactions, and that is important work. However, as I have explained, there are also important practical issues on some of the existing standards where we will need your help both to make sure that the standards are applied consistently and to converge practice and eliminate options. My message to you is not to assume that the technically demanding work is always the highest priority

Thank you for your attention