



**CESR's technical advice on a mechanism for  
determining the equivalence of the generally  
accepted accounting principles of third countries**

**Consultation Paper**

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## Introduction

### Background

1. The Prospectus Directive and Regulation (“the prospectus regime”)<sup>1</sup> and the Transparency Directive<sup>2</sup> will require the European Commission (“EC or the Commission”) to establish by mid 2008 whether a given third country GAAP is equivalent to IFRS<sup>3</sup>.
2. As a result of the prospectus regime, third country issuers who have their securities admitted to trading on an EU regulated market or who wish to make a public offer of their securities in Europe, are required from 1st January 2007 to publish a prospectus including financial statements prepared on the basis of EU endorsed IFRS or on the basis of a third country’s national accounting standards (third country GAAP) if these standards are equivalent to endorsed IFRS. From the period 1 January 2007 until 31 December 2008, appropriate transitional arrangements apply under Article 35 of the Commission Regulation on prospectuses.
3. Similarly, under the Transparency Directive, from January 2007 third country issuers whose securities are admitted to trading on a EU-regulated market will also have to provide annual and half-yearly financial statements which should either be prepared in accordance with IFRS or third country GAAP equivalent to endorsed IFRS. Appropriate transitional arrangements also apply under Article 26 (3) of that Directive.
4. In December 2006 the EC adopted two measures<sup>4</sup> allowing a two-year transitional period (until January 2009) during which third country issuers can prepare their annual financial statements and half-yearly financial statements in accordance with the accounting standards of Canada, Japan or the United States. The aim of these transitional provisions was to give more time to the standard setters and regulators of those countries to continue with their convergence processes. As other countries are also in the process of converging their national GAAPs to IFRS over various periods of time, the Commission considered it appropriate to allow the same two-year transitional period for these third country issuers to continue preparing their annual and half-yearly financial statements in accordance with a GAAP that is converging to IFRS, provided certain conditions are met.
5. The abovementioned December 2006 measures envisage a different treatment of third country issuers before and after January 2009:
  - Transitional period until January 2009. During this phase, accounting frameworks other than IFRS, Canadian, Japanese or US GAAP may be used subject to certain

<sup>1</sup> Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC

Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements.

<sup>2</sup> Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC.

<sup>3</sup> The term “IFRS” should be understood in this paper as referring to IFRS as adopted by the EU.

<sup>4</sup> Commission Regulation 1787/2006 of 4 December amending Commission Regulation 809/2004 on prospectuses and Commission Decision 2006/891/EC of 4 December 2006 on the use by third country issuers of securities of information prepared under internationally accepted accounting standards (“the Transparency Decision”).

conditions<sup>5</sup>. The decision to accept other accounting frameworks is the responsibility of the competent authority, although recitals in the two measures state that *“To ensure consistency within the Community, CESR should co-ordinate the competent authorities’ assessment as to whether those conditions are satisfied in respect of individual third country GAAP”*.

- After the transitional period, a third country’s GAAP will be acceptable only if it has been determined equivalent to IFRS by the European Commission pursuant to their definition of equivalence which they will establish by 1 January 2008. The Commission will consult CESR on the appropriateness of the definition of "equivalence", the "equivalence mechanism" and the actual determination of equivalence.
6. At least six months before 1 January 2009, the Commission shall ensure a determination of the equivalence of the GAAP of third countries, pursuant to a definition of equivalence and an equivalence mechanism that it will have established before 1 January 2008. In order to start the process for determining equivalence, the EC has asked CESR for advice in several phases. On March 2007 CESR submitted to the European Commission its first advice containing a definition of equivalence. This document now addresses the second element of this process namely advice on establishing a mechanism for determining equivalence.
  7. Once CESR has provided its advice, the Commission must by 31 December 2007 adopt a legal measure, via comitology, on the definition of equivalence and the determination of equivalence (in accordance with article 35.5E of the Prospectus Regulation and article 2.5 of the Transparency Decision).
  8. Within CESR, the operational group CESR-Fin chaired by Paul Koster, Commissioner of the Netherlands Authority of Financial Markets (AFM) has been charged with fulfilling the EC’s request.

### Public Consultation and Timetable

9. Comments are invited on all aspects of this paper but where we anticipate that feedback will be particularly useful, we have directed stakeholders to some issues for particular comment.
10. The consultation period closes on **8 May 2007**. Respondents are invited to send their comments via CESR's website ([www.cesr.eu](http://www.cesr.eu)) under the section "Consultations". CESR acknowledges that this is an extremely short period but it results from the Commission’s deadline to CESR, which is the 1<sup>st</sup> of May. CESR will assess the responses received and revise its proposal if necessary. CESR expects to submit the final advice to the Commission around the end of May. All the responses that have not been labelled as confidential will be published on CESR’s website.

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<sup>5</sup> According to the revised Article 35.5A (c) of the Prospectus Regulation (and the similar provision in the Transparency Decision) these conditions are:

- (i) The third country authority responsible for the national accounting standards in question has made a public commitment, before the start of the financial year in which the prospectus is filed, to converge those standards with IFRS;
- (ii) That authority has established a work programme which demonstrates its intention to progress towards convergence before 31 December 2008; and
- (iii) The issuer provides evidence that satisfies the competent authority that the conditions in (i) and (ii) are met.

## Mechanism for determining equivalence

### *Extract of the Commission's mandate*

The Commission requests CESR to advise on a suitable mechanism for determining the equivalence of a third country GAAP. This is not an assessment of which GAAPs are equivalent, but of the mechanism, or procedure, for making that assessment. CESR is asked to provide advice on these matters by 1<sup>st</sup> May 2007.

### *Application - Comparison of disclosures and measurement principles*

11. The process for determining equivalence should be initiated by an application to the European Commission by the standard setter seeking equivalent status of its accounting principles.
12. The application should include an honest assessment of whether disclosures and measurement principles required by the third country GAAP concerned are materially the same as IFRS and where they are not an assessment of the differences. CESR considers that this assessment should be done in the first instance by the standard setter of the country seeking equivalence, as this body is in the best position to compare its own standards with IFRS.

**Question 1: do you agree that CESR's suggested method for handling applications for equivalence is the best way? In cases where the standard setter is not in a position to initiate and/or substantiate an application, do you have any concrete suggestions as regards the solution of such a situation and in particular, who could undertake the abovementioned assessments?**

13. With regard to the comparison of measurement principles, CESR considers that it is only necessary that the third country GAAP principles be allowed under IFRS for these to be considered acceptable. Consequently, the principles concerned do not need necessarily to be the same as those an IFRS issuer might have chosen in the circumstances. This is in line with the spirit of a GAAP being equivalent not the same as IFRS.
14. CESR considers that the assessment of technical differences between the standards would be best performed as part of a convergence programme aiming at some later date to eliminate such differences but this does not necessarily have to be the case. Consequently CESR believes a mechanism should be designed to operate independently of "convergence" or "adoption" programmes and does not assume that a third country GAAP must be involved in one of these to be found equivalent if adequate alternative remedies to align principles and disclosures can be identified. CESR believes this approach is conducive to the equivalence mechanism being as "fair" as possible to all third country issuers whilst still encouraging issuers from third countries who seek access to EU markets to progress towards the use of IFRS.
15. The degree of detail regarding the technical differences that standard setters should provide will vary a great deal depending on the nature of the GAAP concerned. However in the absence of any specific guidance on the level of information required, the level of detail included in CESR's 2005 assessment of the equivalence of the GAAP of Canada, Japan and the US (CESR/05-230b) might be a good indication of the level of detail CESR would envisage the local standard setter's assessment providing. Notwithstanding, in order to



achieve a consistent and objective approach CESR is prepared to consider whether it should issue guidance on the information it would expect from local standard setters.

**Question 2: do you think that CESR should publish guidance on the information that it would consider satisfactory to ensure an informed decision?**

#### ***Remedies for significant GAAP differences***

16. Even in cases where the standard setter identifies significant differences between measurement and recognition principles and between disclosure requirements under the two sets of accounting principles, CESR believes it is still possible for a third country GAAP to be considered equivalent to IFRS if those differences identified can be rectified at company level by non-complex disclosures. For the avoidance of doubt CESR envisages that such disclosures will be in the third country GAAP concerned and designed to rectify at GAAP level any significant differences to IFRS. CESR does not consider that such rectification can be achieved by any form of "reconciliation" to IFRS, nor can the equivalence provisions be satisfied by any such remedy.
17. Any additional disclosure requirements for rectification of the target GAAP should again in the first instance be suggested by the standard setter of the country seeking equivalent status. These disclosures should not be so numerous or fundamental as to render the original accounts prepared by the issuer meaningless or too difficult to follow for an "informed private investor".
18. The suggestion that such additional rectification disclosures might be used to enable a third country GAAP to be considered equivalent to IFRS does not imply that such rectifications will always be necessary. A third country GAAP may already be based on or very close to IFRS or a previous convergence programme between the third country GAAP and IFRS might have reached a point where no material differences are considered to exist any more. In all such cases a decision that no additional disclosures are required could legitimately be reached.

#### ***CESR consultation and assistance to the EC***

19. The assessment required by the mechanism both of the appropriateness of the rectification disclosures and their non-complexity, should be performed by CESR before providing advice to the European Commission on the equivalence or otherwise of the third country GAAP being assessed. In order to inform its view prior to giving any such advice, CESR would expect to seek reactions from market users regarding the third country GAAP and the proposed rectifications via public consultation. CESR assumes that rational investors who invest in securities issued by third country issuers reporting under their local GAAP will have a reasonable knowledge of the GAAPs concerned and a reasonable idea of the major rectifications needed to give them the same level of investment relevant information as a set of IFRS accounts. Accordingly, CESR's assistance to the Commission will be strongly informed by this public consultation process and if any deficiencies in the rectifications suggested are uncovered by it, will suggest these are taken up with the local standard setter concerned prior to the equivalence process being taken any further. Finally, the length of any such consultation period would depend on any deadline imposed by the Commission on CESR providing its advice.

#### ***EC determination of equivalence – Definition of equivalence***

20. An "overall" assessment of equivalence should be made in the final instance by the European Commission via a comitology process once all other steps have been fulfilled.

According to Article 35.5E of the Commission Regulation 809/2004 on prospectuses and Article 2.5 of the Commission Decision 2006/891/EC of 4 December 2006:

*“At least six months before 1 January 2009, the Commission shall ensure a determination of the equivalence of the Generally Accepted Accounting Principles of third countries, pursuant to a definition of equivalence and an equivalence mechanism that it will have established before 1 January 2008 in accordance with the procedure referred to in Article 24 of Directive 2003/71/EC. When complying with this paragraph, the Commission shall first consult the Committee of European Securities Regulators on the appropriateness of the definition of equivalence, the equivalence mechanism and the determination of the equivalence that is made.”*

21. CESR has already provided the Commission with the definition of equivalence that it thinks should be used when making the determinations of equivalence (paragraphs 25-30 of CESR's advice 07-138). CESR defined that, for equivalency purposes, 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.
22. CESR's definition implies that the two equivalent sets of accounts lead to a similar investment decision at the time when that assessment is made. Therefore, any necessary remedies identified as part of the equivalence process should be applied in any set of accounts actually produced by a third country issuer using the GAAP deemed equivalent, except of course in cases where the necessary rectification is clearly not applicable to the issuer.
23. The definition also implies that the existence of a convergence or adoption programme by the third country standard setter concerned which intends to eliminate at a point in the future the significant differences between the local GAAP and IFRS or to replace the local GAAP entirely with IFRS cannot be considered an appropriate alternative to the rectification process suggested by this advice. Similarly if an issuer using a GAAP deemed to be equivalent subject to certain rectification disclosures fails to provide such disclosures in the first set of accounts produced after the transitional period, those accounts cannot be considered appropriate for filing within the EU. Such an approach is indicated as Appendix 1.
24. Some market participants have suggested that an alternative model would be that in those cases where a convergence or adoption programme is in place and is being followed by the local standard setter, a short cut methodology is put in place whereby a GAAP could be considered equivalent as long as overall its disclosures and measurement principles are sufficiently converged with IFRS. As with all other GAAPs deemed equivalent this decision may need to be revisited periodically to ensure sufficient proximity of the GAAPs concerned to IFRS. This is not an alternative CESR is advocating, as it believes such a model might fail to give investors all of the relevant information that might otherwise be available to them but is prepared to ask market participants for their views. Such an approach is indicated as Appendix 2.

**Question 3: Which of the two approaches indicated above (and in the Appendices) do you think is most appropriate? Please provide your reasons.**

**Question 4: recital 8 of the Commission Regulation 1787/2006 and recital 7 of the Commission Decision 2006/891/EC of 4 December 2006 state that “the progress of the convergence process should be closely examined before any decision on equivalence is taken”. Do you think the existence of a convergence programme between the assessed third country' GAAP and IFRS should play any role in the determination of equivalence, other than facilitating the comparison between the standards and identifying the necessary rectifications?**



*Filters at country and issuer levels*

25. CESR considers that a pre-requisite for any GAAP to be recognised as equivalent is that "filters" at the country level, and audit assurance and enforcement at the entity level are sufficient for investors to be able to rely on them. For the purposes of establishing equivalence, CESR assumes that third country GAAPs are properly applied including the provision of any rectifying disclosures necessary. CESR further assumes that the necessary filters for ensuring market confidence are in place for third country issuers using or participating in the EU capital markets.
26. CESR understands recital 8 of the Commission Regulation 1787/2006 and recital 7 of the Commission Decision 2006/891/EC of 4 December 2006 as confirming CESR's view, highlighting the need not only of a technical parity between the standards, but also that the standards are adequately implemented:
- "The future assessment of equivalence should be based on a detailed technical and objective analysis of the differences between IFRS and third country accounting standards, as well as on the concrete implementation of these GAAP compared to IFRS."*
27. One of the key filters set out by CESR in its June 2005 advice 05-230b relates to the audit of the financial statements concerned. Under the framework of articles 45 and 46 of Directive 2006/43/EC of the European Parliament and of the Council on statutory audit of annual accounts and consolidated accounts ("the 8<sup>th</sup> Directive"), the Commission, in co-operation with the Member States, is assessing the equivalence of third country legislation with the 8<sup>th</sup> Directive in relation to two areas: the first area relates to auditing standards and requirements on the independence and objectivity of auditors; the second area refers to the systems of auditor's public oversight, quality assurance and investigations and penalties. In the absence of comitology measures granting equivalent status, a third country auditor who audits a third country company with securities admitted to trading on a regulated market will be required to register in a Member State and will be subject to its requirements. As far as CESR is aware such requirements would exist and apply to a third country issuer and its auditor whether such an issuer uses its own local GAAP, another equivalent third country GAAP or IFRS.
28. Consequently CESR believes compliance with the 8<sup>th</sup> Directive should be a relatively easy thing to establish about any jurisdiction that is applying for its GAAP to be recognised as equivalent. As the assessment also covers the main areas of control over possibly the key filter over the production of financial information it also serves as a reasonably objective proxy for any other specific assessment of the filters. CESR believes a step along these lines needs to be factored into the determination of equivalence of third country GAAP with IFRS because a key consideration for investors deciding parity between financial statements will be their overall reliability, and key to that decision is the robustness of the audit conducted on them.
29. For the avoidance of doubt CESR wishes to clarify that even if the legislation of a third country is not considered equivalent to the 8<sup>th</sup> Directive, the GAAP of such country can still be deemed equivalent if all the other steps in the mechanism are fulfilled. However, for an issuer from that country to be able to file in the EU financial statements (under its own local GAAP or IFRS), its auditor will have to be registered in a Member State and comply with the requirements of that State. This would also be considered to satisfy this assessment of filters step in the equivalence mechanism.
30. Finally, CESR also acknowledges that other filters, such as the corporate governance regime applicable to a third country issuer, will play a role in an investor's decision making process. However such areas are often highly issuer or business specific and as such are more difficult to assess objectively. CESR also considers that it is not unreasonable for an investor to make his own mind up about such factors based on his own risk appetite as, in



the absence of Community legislation in this area relevant to EU issuers, he would have to do for an equivalent EU issuer.

**Question 5: Do you agree that filters are important and that they should be reflected in any equivalence mechanism? If so, do you think the CESR's model correctly reflects how consideration of the filters should be incorporated into the mechanism?**

*Auditor assurance regarding the remedies*

31. Any additional rectification procedures deemed necessary to render a GAAP equivalent to IFRS would be known at the time an audit on the year end accounts of any third country issuer using the GAAP is to be performed. Therefore the necessary work can be planned into the audit process to enable these additional disclosures to be audited. It should therefore go without saying that any rectification procedures suggested in Steps 1 or 2 of the mechanism (see the annexed chart) should be included within the scope of the audit of any set of accounts actually produced by a third country issuer using a third country GAAP that has been deemed equivalent.

*On going information from the standard setter*

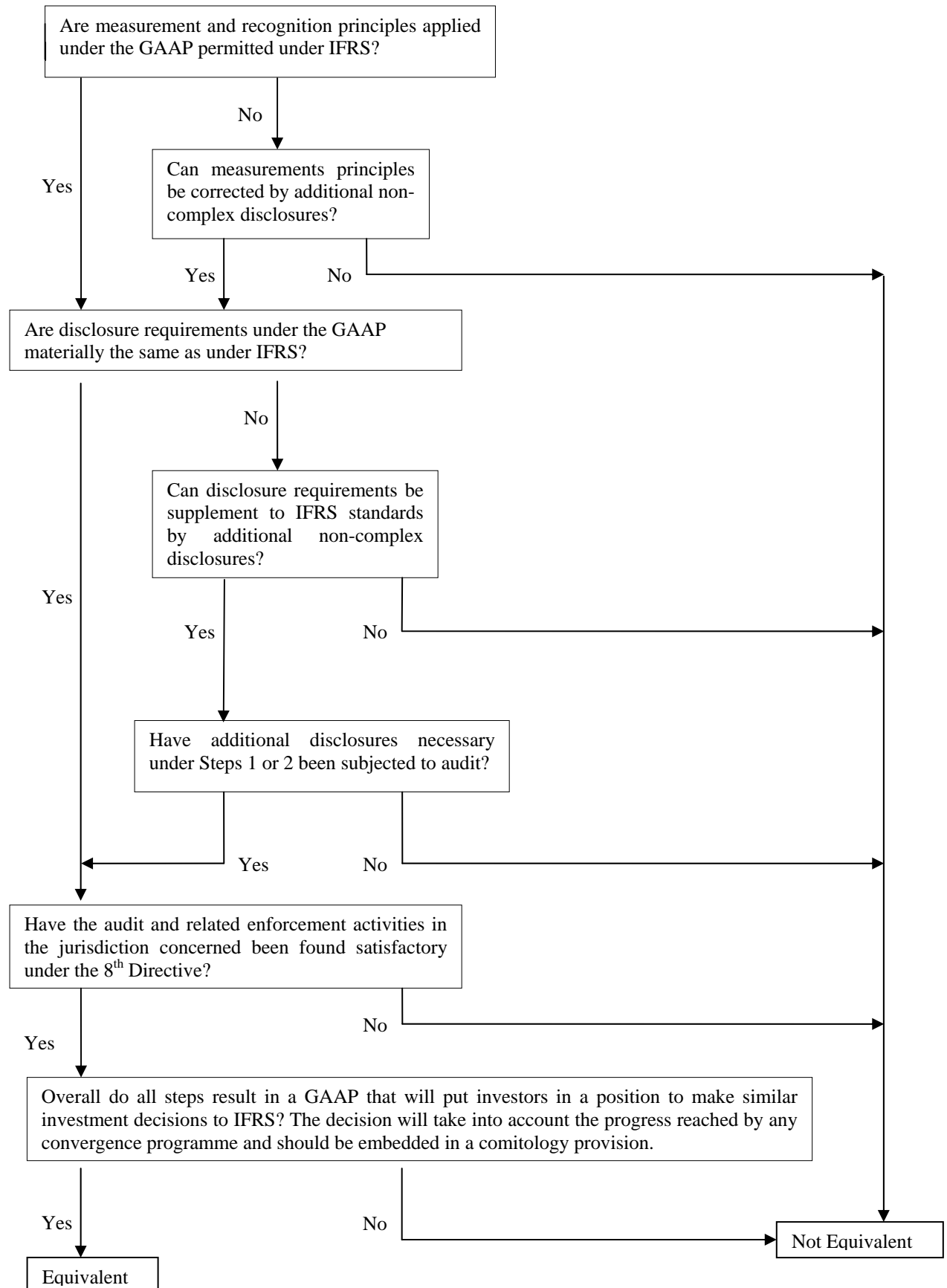
32. Each time the local standard setter of an equivalent GAAP or the IASB issues a new standard, the local standard setter will need to submit to the European Commission (with a copy to CESR) an impact assessment of that new standard unless it has been issued jointly with the IASB. Any positive determination of equivalence by the Commission should be conditional on the local standard setter concerned agreeing to provide this information and update any rectification disclosures as appropriate for the effects of the new standard. CESR assumes that any new standards would include suitable transitional periods before their requirements take effect to allow issuers time to accommodate any necessary rectification disclosures in their accounts.

**Question 6: Do you agree with this proposal? Do you have any suggestions as regards the procedure for providing the envisaged impact assessments which avoids a period of uncertainty for issuers while these are being made?**

*Enforcement in the EU of equivalent GAAP*

33. The GAAP equivalence process does not pre-empt enforcement activity in relation to issuers who use the equivalent GAAP. According to article 24.4 (h) of Directive 2004/109/EC of the European Parliament and the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market ("the Transparency Directive"), EU enforcers must have the powers to examine the financial statements to ensure they are drawn up in accordance with the relevant reporting framework and to take appropriate measures in case of discovered infringements.

## Appendix 1



## Appendix 2

