



**EQUIVALENCE OF CERTAIN THIRD COUNTRY
GAAP**

AND ON

**DESCRIPTION OF CERTAIN THIRD
COUNTRIES MECHANISMS OF
ENFORCEMENT OF FINANCIAL
INFORMATION**

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FEEDBACK STATEMENT

**OF CONSULTATION ON DRAFT TECHNICAL
ADVICE**

June 2005



FEEDBACK STATEMENT ON THE CONSULTATION ON THE DRAFT TECHNICAL ADVICE ON EQUIVALENCE

1. On April 27th 2005, CESR published for comments a draft technical advice setting out CESR's draft conclusions on the assessment of the equivalence of Generally accepted Accounting Principles (GAAP) in Canada, Japan and the US (together the "third countries") with International Financial Reporting Standards (IFRS) in accordance with the mandate of the European Commission. This draft advice also included the description of the enforcement mechanisms in place in these three third countries.
2. The period for comments expired on the May 27th 2005 and the public consultation also included an open hearing held on May 18th 2005. During the consultation period 27 letters were sent by various organisations. All comment letters received have been published on CESR website, with an indication of the sector of activity of the respondents. A list of the respondents to this consultation is attached in appendix 1.
3. CESR observes that respondents largely supported the approach developed by CESR as well as CESR's conclusion that the three third countries GAAP, taken as a whole, could be considered as equivalent to IFRS subject to remedies. However, several respondents have stressed the risk that additional cost resulting from the application of the proposed remedies might not outweigh the benefits to be expected for investors. This concern is more specifically expressed in relation to remedies that imply the provision of quantified information (disclosure C and supplementary statements). Respondents to the consultation have also underlined some concerns regarding the framework for the application of the remedies.
4. The comments collected through the public consultation have been duly considered by CESR and many of them, in particular as regards the framework for the application of the remedies, have largely informed the redrafting and finalisation by CESR of its technical advice to the Commission. The purpose of this feedback statement, which is published along with the final technical advice to the Commission aims at providing CESR's views on the most important points arising from the consultation and explaining the most important changes introduced in the final technical advice on equivalence.
5. CESR takes the opportunity of this feedback statement for thanking all respondents for their fruitful and constructive contribution.

GENERAL COMMENTS – COST/BENEFITS CONSIDERATION

6. The technical advice on equivalence is an extension of a **Concept Paper** on equivalence published by CESR in February 2005 (ref CESR/04-509c). The purpose of the Concept Paper was to define the methodology and criteria to be used for the technical assessment of equivalence of the three third countries GAAP. Before releasing the Concept Paper, CESR widely consulted on a draft for this paper and published a **first feedback statement** of that first public consultation (ref CESR/05-001 - attached **in appendix 2**). This previous feedback statement already addressed a number of comments that have been reiterated in the consultation on the draft technical advice (e.g. concerning the approach followed by CESR).
7. CESR has considered various concepts and markets' indication for developing its **outcome-based approach** and for arriving at the conclusion that the three countries GAAP could be assessed as equivalent as a whole, subject to various remedies. It would probably have been easier to adopt a black and white approach and either to consider very high-level principles or, on the other hand, to set out an exhaustive reviews of all GAAP difference. CESR observes that some respondents to the consultation support the first approach while others offer comments that would lead to the second approach.

8. In CESR's views, the first approach would have been quite theoretical and would have had very few – yet nothing - to see with a technical assessment in a technical, complex and detailed area such as that of accounting standards. The second approach - a detailed and exhaustive analysis of GAAP differences - would have provided more comfort, but was obviously not realisable in the timeframe allocated - as highlighted by many experts – and its usefulness could be seriously challenged in the considered context, which is fundamentally different from the work conducted by standard setters in convergence projects.

9. From the beginning, **equivalence needed a different, original approach** offering an appropriate balance between these two extremes, as largely explained in the Concept paper and in the technical advice. CESR is convinced that the approach proposed provides a well-balanced solution taking account of the various contextual elements such as: the formulation of the EC mandate (it had to be technical, focused on the significant differences, but also global and holistic), the need to keep a balance between cost and benefits for all market participants, the existence of convergence projects undertaken between national standard setters and the IASB (and their likely results before 2007) and the political willingness in the EU and abroad to seek solutions facilitating global integration of financial markets and harmonisation of regulations.

10. Considering the **cost/benefits aspects** is particularly difficult in this area. Cost benefit considerations are multi-faceted. When equivalence requirements will enter into force for financial statements as from 2007, EU financial markets will already have two years of experience under IFRS. These standards will then be the benchmark and the accounting language for all investors' on EU markets. This will be completely different from the situation existing in the EU before the adoption of the IFRS. In this future context, the use of third country GAAP will progressively be exacerbated and might imply additional cost for investors that make rational decisions based notably on financial information. Remedies aim at reducing these costs and can be expected to facilitate the visibility and penetration of third country issuers on EU financial markets. It is not ignored that remedies also imply costs for issuers but, in terms of cost/benefits considerations, it should be stressed that the list of significant differences and remedies is limited in the advice to what is really necessary in light of developments on financial markets. As indicated above, other approaches could have led to much longer lists of GAAP differences. It has also to be acknowledged that several of the differences identified as significant will disappear in the medium term, notably as a result of the convergence programs agreed on between the IASB and the considered third countries. Finally, it is also important to indicate that the practical impact of CESR's proposals will largely depend on the situation of the concerned reporting entities. As underlined by several responses, many of the proposed remedies will not be relevant for reporting entities which, under third country GAAP, directly adopt internal accounting policies that produce the same type of financial information as that resulting from the application of IFRS provisions.

11. In conclusion, CESR remains convinced that the proposed assessment of equivalence provides an appropriate balance between costs and benefits for all market participants on the EU financial markets, going forward.

THE FRAMEWORK FOR THE APPLICATION OF REMEDIES

12. Many respondents to the consultation have **called for a more robust and clear framework** for the application of the remedies by the issuer and for the involvement of the auditor in connection with these remedies. There were various comments indicating notably that the criteria to be used by issuers for the application of remedies were not clear or difficult to be applied at company level. More clarity was asked on how the mechanic of remedies should apply.

13. Many respondents have, more specifically, criticised **the so-called "catch all provision"** previously included in paragraphs 17 and 101. In these paragraphs, CESR indicated that, because the list of GAAP differences is not exhaustive (for reasons explained elsewhere), third country issuers would be expected to assess whether there are GAAP differences other than those included in the list proposed by CESR which, at company level, would be significant due to the particular business, operations or financial situation of the issuer. If so, these issuers would be obligated to provide



additional disclosures addressing these other GAAP differences, by reference to the general principles of IAS 1, paragraphs 13 and 15 (c).

14. Taking these comments on board, the final advice has clarified the approach followed by CESR and the structure of the advice. This is now reflected in the following elements:

- a. The final advice clarifies that the criteria referred to by CESR for assessing the significance of GAAP differences are not expected to be used by issuers and auditors respectively for the application and audit of remedies. The criteria used by CESR include consideration of the fact that the differences are commonly found in practice and are relevant for investors' decision making, i.e. whether the investors are able to take similar decisions as if provided with IFRS financial statements.
- b. This assessment results in a list of significant differences and related remedies and it is clear that third country issuers are basically expected to refer to this list.
- c. The idea has been maintained that issuers are responsible for judging whether these differences and remedies are relevant and material to the financial position of the reporting company. Clarification has been added on what relevance and materiality means.
- d. For GAAP differences not included in the list of significant differences, the approach is now that, in addition to the remedies required for the identified significant differences, additional disclosures should be provided in exceptional situations resulting from industry specific elements or from unusual transaction(s) or event(s) giving rise to an unusual accounting outcome in the context of the application of third country GAAP. In the absence of a prescribed remedy in situations as described above, management shall use its judgement in developing and applying a remedy that results in information that is relevant to the economic decision-making needs of users. Applications of such remedies should result in information that is reliable, in that the remedies represent faithfully the additional information required, reflect the economic substance of transactions, other events and conditions, considering the requirements and guidance of IFRS and concepts used in this advice, dealing with similar and related issues.
- e. This limitation of the so-called "catch-all" provision is an important addition. It is worth indicating that, basically, this would be applicable in exceptional situations only. It is also expected that these situations will already be addressed by ad hoc disclosures in reporting based on third country framework

15. Several respondents to the consultation also asked for more **clarification on the differences between the remedies**, especially between disclosures A, B and C. Many respondents have also suggested that more detailed guidance be provided on the precise content of the different remedies, in particular for disclosures. Similar concerns were expressed from the perspective of auditors.

16. CESR has adopted a **principle-based approach** for the development of a possible framework for the application and audit of remedies. **Further guidance** might be necessary on different issues, such as the objective and content of the disclosure requirements for each significant GAAP difference, the industry specific issues, a review of disclosure requirements under third country GAAP or possible guidance for the auditing procedure. However, **CESR believes that, at this stage, it should not go beyond an initial principle-based framework**. The reasons for this are explained in the final advice. Additional guidance can be developed either on the basis of an additional mandate to CESR or through coordination of regulatory practices of CESR Members, at Level 3 of the Lamfalussy process. The later solution has the advantage of providing the necessary flexibility considering the important and quick changes that are expected to take place in the area of financial reporting over the next few years, and to benefit from experience acquired with application of IFRS in the EU. Whichever approach is adopted, application guidance will need to be consistent with the principle-based approach of this advice.

17. As regards the **definition of disclosure remedies, important clarifications** have been brought in the final advice. Instead of three different kinds of disclosures, **CESR is now proposing only two categories of disclosures (A and B)**. The previous disclosures A and B have been merged in disclosures A and the previous disclosures C are now re-labelled disclosures B.

18. The two categories of disclosures include narrative and quantitative elements; but this is not the essential difference. The crucial difference between the two lays in the fact that the second category implies re-measurement of relevant transactions or events under IFRS. It is not the case with the first category of disclosures, which is more an extension of disclosures provided under third country GAAP, with the purpose of allowing investors to fully understand the transaction(s) and event(s) and their accounting treatment under these GAAP, so as to reach a level of information that could be afforded under IFRS.

19. **Further clarifications** have also been added to the definition of supplementary statements as remedies applied in very limited situations (as highlighted in the advice). There are also several other - very specific - clarifications and precisions added to various sections of the advice, as a response to comments received.

20. Concerning the **auditing aspects**, several improvements have been made to the text, notably for removing the previous indications which might have led respondents to be confused regarding the delimitation of the respective role and responsibilities of the auditor and the issuer.

21. Some commentators suggested that it would not be appropriate to give the possibility to have **two audit reports** (one on the third country GAAP financial statements and one on the remedies). These commentators favour the inclusion of remedies in the notes to the third country GAAP financial statements and the production of only one audit report covering the whole set.

22. CESR is not convinced that there is one-size-fit-all solution in this respect. There might be situations where the third country GAAP financial statements will have been prepared at a time when securities were not yet publicly offered on EU markets. In this case, remedies will be prepared a posteriori, for previous financial years (in a separate statement); this could lead to having de facto two audit reports. Besides, it cannot be excluded that, even when only one audit report is delivered, the auditor might have to present two separate audit opinions (one related to the third country GAAP financial statements and one related to the remedies). This leads CESR to keep an open position on this issue, as indicated in the final advice.

COMMENTS ON THE TECHNICAL ASSESSMENT

23. Some respondents commented and provided additional information on different specific points of the technical analysis developed in the detailed tables of the assessment. Considering the level of detail of these comments, it is not possible to review all of them through this feedback statement. Only the important changes are highlighted hereafter.

24. CESR used many of these very useful comments for improving the description of the technical accounting issue or the drafting of the assessment of significance.

25. As regards **Canadian GAAP**, the additional precisions received from the AcSB (Canadian accounting standard setter) notably led to removing some issues from the detailed list of GAAP differences, but without changing fundamentally the assessment because most of these issues were already assessed as not significant.

26. Specific comments received on **Japanese GAAP** were also useful for reviewing the description of some technical issues and for re-assessing the conclusion on some issues in IAS 12 (deferred tax assets and “non-performing loans”), IAS 19 (the issue of “return of substitutional portion”), IAS 32 and IAS 36 (the issue of “significant decline”). CESR notes from the indications received in relation to Japanese GAAP that some GAAP differences should disappear in the near future as a result of a short

term convergence project with IAS¹. These are important elements that will be followed up by the early warning mechanism, as explained in the advice. It is also noted that several remedies may not have to be applied because in practice, reporting entities can choose accounting policies that are already similar to IFRS. This is an encouraging element, which should facilitate the application of equivalence requirements in practice.

27. There were also some comments and information in relation to **US GAAP** that have been taken on board.

28. The issue of **SPEs** has been the subject of larger comments, mainly expressed in relation to US GAAP, but CESR has re-assessed that question for the three GAAP, as it was previously mentioned as a significant difference calling for supplementary statements in the three GAAP.

29. In the final advice, CESR has underlined that the issue of consolidation of Special Purpose Entities (SPE) in the three third countries is very complex, being based on principles combined with additional guidance that altogether make the third country framework close to IFRS in most cases. The status of Qualifying SPEs (QSPEs) is slightly different as being essentially addressed in connection with provisions on derecognition of assets. Exemptions provided in this context for QSPEs could lead to their possible non-inclusion in consolidated balance sheet and income statements.

30. Experience shows that definition of scope of consolidation is an issue that has far reaching consequences on financial position and results. It could be a significant difference if entities considered as subsidiaries under IAS 27 are excluded from consolidation. The potential impact of differences – when the entity has material assets, liabilities or operations - requires supplementary statements in these exceptional cases, because additional disclosure is not sufficient to enable investors to figure out the pervasive impact of scope exclusion. CESR is therefore proposing that supplementary statement should be provided for non-consolidated QSPE (that would either have been consolidated under IFRS).

31. Regarding **IAS 36**, on the issue of the impairment test, comments received have led to a strengthening of the disclosure requirement as a remedy. On this matter, the key issue considered is to know whether there is a test similar to that of IFRS for checking the need of impairing an asset. If such a test is not applied under GAAP, although there would be indications that the asset needs to be considered for impairment under IFRS, then a disclosure implying re-measurement (disclosure B in the new nomenclature) is necessary (because no impairment is shown at all). On the contrary, once an asset is considered for impairment, CESR believes that the exact calculation of the impairment could be addressed by a remedy of disclosure without re-measurement, for equivalent information (considering other disclosures provided under GAAP). Previously, the second approach was proposed for all circumstances.

32. In diverse situations, commentators have underlined the **merits of accounting solutions in third countries** compared to the orientations taken by the IASB in IAS/IFRS. As indicated in the advice, CESR was mandated to compare third country GAAP with IFRS as endorsed in the EU and not to express any opinion on the quality of/or preference for any specific set of accounting standards, be they those set by the IASB or by the relevant authorities in the third countries, or those endorsed by the EU. This however remains an important issue which is expected to be addressed through international convergence towards one single set of high quality global standards.

33. CESR has also been invited by respondents to consider some **industry specific standards**, such as those applicable to some insurance companies. Although we consider that industry specific issues deserve due attention (see above paragraph 16), it was not possible to extent the assessment to these standards in the timeframe allocated to CESR and in the context of the EC mandate. This might need to be addressed through future work on equivalence (see above paragraph 16).

¹ On IAS 2 (mandatory application of LOCOM), on IAS 27 (uniformity of accounting policies) and IAS 40 (Investment Properties).



OTHER ISSUES

Should the advice make distinctions between different third country issuers?

34. Some respondents to the consultation asked that CESR makes such a distinction in its advice.

35. As indicated in the feedback statement to the consultation on the Concept Paper (ref CESR/05-001, paragraph 36) CESR believes that it is not possible to do so for the following reasons. Under the EC mandate, the test of equivalence is at the level of accounting standards. In addition, IAS/IFRS standards are designed for use in the preparation and presentation of general purpose financial information. Within IAS/IFRS, no distinction is made in terms of accounting and reporting provisions, depending on the quality of the user of the information. CESR has considered investors in general in the approach of GAAP equivalence.

36. It could be argued that some remedies might be exceptionally more important for investors in equity securities than for investors in debt or derivative securities. However, remedies are all relevant for ensuring understanding of third country financial statements; and basically, such statements have to be produced for all issuers of securities under Prospectus and Transparency legislation.

Extension of the transitional period beyond 2007

37. Under the current Prospectus and Transparency legislation, third country issuers can continue to use their local GAAP until 1st January 2007. Some respondents to the consultation expressed support for an extension beyond 2007 of the transitional period, at least for issuers using Canadian, Japanese and US GAAP as these GAAP have now been declared as equivalent subject to limited remedies.

38. To them, such an extension would allow further consideration of standard changes in third countries around 2007 as well as more consistency with the timetable set out in the “roadmap” discussed between the European Commission and the US SEC (the objective of this “roadmap” is to allow elimination of the reconciliation requirements - for foreign issuers using IFRS for reporting purposes in the US - as early as possible, but no later than 2009).

39. Equivalence issues certainly interact with broader considerations such as those underlined by consultees, and CESR’s advice has largely acknowledged this fact. However, CESR understands its mandate as requiring an advice on equivalence as based on a technical comparison and assessment of accounting standards as of 1st January 2005. The consideration mentioned above, although very pertinent, would take CESR too far away from the specifications of its mandate. It should be reminded that, pursuant to the EC mandate, the advice includes indications on an “early warning mechanism” whose primary function is precisely to monitor the expected or planned standards’ changes after 1st January 2005.

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Appendix 1 – List of respondents to public consultation on CESR draft technical advice on equivalence

dates :	activity :	name :	
30 May. 2005	Banking	Austrian Economic Chamber	DETAILS
30 May. 2005	Banking	Canadian Bankers Association	DETAILS
30 May. 2005	Banking	Credit Suisse Group	DETAILS
03 Jun. 2005	Banking	E&Y	DETAILS
30 May. 2005	Banking	Eli Lilly and Company	DETAILS
30 May. 2005	Banking	IPMA	DETAILS
30 May. 2005	Banking	LIBA	DETAILS
31 May. 2005	Government regulatory & enforcement	Accounting Standards Board of Canada	DETAILS
02 Jun. 2005	Government regulatory & enforcement	EFRAG	DETAILS
30 May. 2005	Government regulatory & enforcement	Financial Services Agency, Japan	DETAILS
30 May. 2005	Government regulatory & enforcement	Ministry of Economy, Trade and Industry of Japan	DETAILS
30 May. 2005	Insurance, pension & asset management	New York Life	DETAILS
30 May. 2005	Insurance, pension & asset management	Swiss Re	DETAILS
30 May. 2005	Issuers	GMAC	DETAILS
30 May. 2005	Issuers	Goldman Sachs International	DETAILS
30 May. 2005	Issuers	Kellogg Company	DETAILS
30 May. 2005	Issuers	Nippon Keidanren (Japan Business Federation)	DETAILS
30 May. 2005	Legal & Accountancy	Accounting Standards Board of Japan	DETAILS
30 May. 2005	Legal & Accountancy	AICPA Center for Public Company Audit Firms	DETAILS
30 May. 2005	Legal & Accountancy	Deloitte Touche Tohmatsu	DETAILS
03 Jun. 2005	Legal & Accountancy	FEE	DETAILS
02 Jun. 2005	Legal & Accountancy	Institute of Chartered Accountants in England and Wales	DETAILS
30 May. 2005	Legal & Accountancy	KPMG IFRG Limited	DETAILS
30 May. 2005	Legal & Accountancy	PricewaterhouseCoopers	DETAILS



30 May. 2005	Legal & Accountancy	The Japanese Institute of Certified Public Accountants	DETAILS
30 May. 2005	Regulated markets, exchanges & trading systems	London Stock Exchange	DETAILS
30 May. 2005	Regulated markets, exchanges & trading systems	Luxembourg Stock Exchange	DETAILS



**APPENDIX 2 – FEEDBACK STATEMENT OF CONSULTATION ON CESR CONCEPT PAPER ON
EQUIVALENCE**

Ref.: CESR/05-001

**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)*".² 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.

² 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).³

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.

³ 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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