

# **INTERNATIONAL PRIMARY MARKET ASSOCIATION**

## **Concept Paper on Equivalence of Certain Third Country GAAP and on Description of Certain Third Countries Mechanisms of Enforcement of Financial Information**

IPMA is the trade association which represents the interests of the international banks and securities firms which underwrite and distribute international debt and equity securities in the primary market. It has 52 members representing the leading underwriters and dealers in all of the world's major financial centres.

IPMA welcomes the opportunity to respond to this Concept Paper, which we see as an important step in the development of CESR's response to the Commission's mandate on this matter. More generally, we strongly support an approach to policy formulation that gives stakeholders a timely opportunity to comment on and contribute to the analytical approach taken to an issue. In our view, this maximises the potential both for CESR drafting resources and industry response mechanisms to be used efficiently, and for the subsequent draft advice to be broadly 'fit for purpose', allowing the consultation on this advice to focus on matters of detail. Consequently, we believe that by publishing this Concept Paper for consultation CESR has established a best practice standard of policy formulation, and would encourage CESR and other EU institutions to adopt this approach more generally.

Turning to the matter at hand, many accounting standards are conventions, which require the treatment of financial information in one of several different possible manners. For example, the choice between LIFO and FIFO treatment for inventory (Last in, first out and First in, first out) is not objectively right or wrong. Similarly, the discount rate used to present value future cash flows cannot be scientifically determined to have one single, correct number at any given time. Users and preparers of financial reports need a rule, consistently applied, so that they can present a coherent, consistent and reasonably accurate report of the company's financial position and results for a given period.

Therefore, it is inevitable that different national GAAPs have different conventions and as a result produce different entries, and that financial reports prepared in accordance with different GAAPs will produce different numbers. That does not mean that accounts prepared in accordance with one set of accounting standards are better or more accurate than those prepared in accordance with a different set of accounting standards. Instead, the important thing in comparing different accounting standards is whether accounts prepared in accordance with them enable the user, an investor in the company's securities, a bank, a vendor contemplating extension of credit or the tax authorities or prudential regulators, to reach a valid judgment about the financial position and results of the company.

Overall we support CESR's proposed approach, but we do have a number of comments. These are set out below in the form of answers to some of the questions posed in the paper. We are particularly concerned about the reaction of third country issuers to the proposed approach to early warning mechanisms, and we have summarised our view of this perspective below. Answers to some of the specific questions then follow.

## Third country issuers

We are well aware from the many previous communications from CESR that we share a joint objective of deep, liquid and well regulated capital markets in Europe. Clearly maintaining a strong presence of non-EU issuers in these markets is important – not just because of the contribution to market diversity but also because EU regulators can be more confident about the level of regulatory protection for investors when investor access to non-EU markets is achieved via EU regulated markets and participants.

The equivalence of third country accounting standards to EU endorsed IAS / IFRS, represents one of the key challenges for third country issuers emanating from the Financial Services Action Plan. The benefits of the FSAP to these issuers, such as the potential to streamline regulatory requirements and perhaps more straightforward access to all member states, are putative at present and the experience thus far for these issuers is almost a ‘salami slicing’ exhaustive effect from all the difference regulatory measures they need to be able to work with, and the regulatory uncertainty that currently prevails.

We think that this presents a particular challenge to CESR in this exercise on equivalence. Much of CESR’s proposed approach is very sensible. However, in the present circumstances we think CESR needs to put a premium on preparing advice that minimises uncertainty on how the determination of equivalence will work in practice. The key issue in this respect is CESR’s advice on early warning mechanisms. The current draft advice holds out the prospect of continuous reviews of equivalence under the auspices of a specially constructed body. While we understand the thinking behind this approach, the practical impact from the perspective of non-EU issuers is that the decision on equivalence will never be final, and much of the current uncertainty, that this CESR exercise is meant to relieve, will remain. We are quite sure that CESR and the Commission do not mean this to be an outcome. We also understand that any decision on equivalence can never hold for all time and needs to be open to review in the face of significant changes to third country or EU accounting standards. However, we wonder if there might be some other way of delivering a satisfactory early warning mechanism and touch on this further in our answers to the questions below.

## **Questions from the Concept Paper**

### *1. Do you agree with the proposed definition of equivalence and reference to investors’ needs?*

We are entirely in agreement with CESR that equivalence should not mean "identical". However, we are not sure that a focus on ‘enabling investors to take at least a similar decision’ is practical, in that it diverts attention to the equality of the decision rather than the information used to make that decision. We think that a more straightforward way of capturing the same idea might be to focus on the extent to which investors feel comfortable that they have sufficient reliable information on which to base investment decisions in general on that company. Equivalence then comes down to whether or not investors see a need to undertake supplementary due diligence, where that due diligence would not be needed if the financial statements had been prepared under IAS/IFRS.

We have attached a copy of a recently published Cass Business School report that draws out investor views of different accounting standards. There are two points to note:

- It is clear that US and Canadian GAAP, and IAS/IFRS are seen as equivalent;

- For Japanese GAAP, further due diligence is sought.

*(questions after paragraph 6)*

2. *Do you agree with this approach?*

We broadly agree with this approach. In particular, we agree strongly that the technical assessment should focus only on significant differences. In practice, we wonder whether it will be necessary to conduct any of the detailed technical assessment in Part C of the paper, in those circumstances where the GAAP under consideration is shown to be equivalent following the review set out in Part B of the paper. The Part B review is very thorough. If the GAAP under consideration meets the four characteristics of understandability, relevance, reliability and comparability, any difference in topic coverage is unlikely to cause an investor to see a need to undertake further due diligence, and the objectives are broadly in line with those for IAS/IFRS, then it is difficult to see what a detailed technical analysis might add – apart from further work for CESR.

3. *What characteristics should a difference between IAS/IFRS and third countries GAAP have to be perceived as significant for an investor?*

Our answers to the previous questions touch on this point. We believe the focus should be only on major differences of principle (such as the absence of a requirement for consolidated accounts, or the exclusive use of historic cost accounting), where this would cause an investor to need to undertake further significant due diligence.

4. *Do you consider other general aspects should be taken into account for the assessment of equivalence?*

No further comment.

*(Questions after paragraph 7)*

5. *Do respondents believe that EU investors can be assumed to have a good knowledge of third country GAAP or that IAS/IFRS should be assumed to be the only benchmark?*

The focus of this paper, quite rightly, is on those investors (or representatives of investors) that ‘have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence’. In practice, we think that these EU investors will use either US/Canadian GAAP or IAS/IFRS as a benchmark, depending upon their present and future investment patterns. Moreover, in terms of knowledge base, although we suspect that Japanese GAAP (and to a lesser extent Canadian GAAP) is less well known, and the attached Cass Business School report would tend to support this, we do think that the investors in question can be assumed to have the capacity to develop their knowledge of different accounting standards as required.

6. *Should this issue have an impact on the assessment of equivalence, and if so, how?*

We think that the assumed knowledge base of the investors in question and the potential they can be assumed to have to develop further knowledge, supports an approach to assessing equivalence that concentrates on very significant differences of principle.

7. *Do you think that CESR should distinguish between professional and individual investors in assessing equivalence?*

CESR should maintain the current focus of the paper which is on professional / sophisticated investors. Many unsophisticated investors will not understand even basic accounts and should be assumed to be investing under advice from professionals who do understand accounting standards.

*(Questions after paragraph 32)*

8. *Do you believe that the three elements mentioned above are relevant and sufficient for conducting a review of general principles?*

Yes. We agree that the European Commission's 'four characteristics', together with the topics covered by, and the objectives of, IAS/IFRS are both relevant and sufficient for this review.

9. *Do you have other views on how to take investors' needs into account in a global assessment?*

Nothing further to add to our comments above.

10. *Do you believe that the review of general principles as described above is appropriate and sufficiently complete?*

We have no further comment.

11. *Do you have comments on the articulation between the technical assessment and the review of the general principles, which are both parts of the global assessment?*

Please see our answer to question 2.

*(Questions after paragraph 49)*

12. *Do you agree with the proposed approach for identifying significant differences between third country GAAP and IAS/IFRS?*

13. *Do you see other specific elements to be considered for defining what the significant differences are?*

We agree strongly with the conclusion reached by CESR in paragraphs 47 and 48, on the basis of the very sensible discussion in paragraph 46, that it should limit its analysis to 'the differences commonly found in practice or known to be significant as such by the financial and audit community in Europe and in third countries', and that 'a convergence program in a third country may provide helpful input'.

*(Questions after paragraph 54)*

*14. Do you agree that there may be three potential outcomes from the assessment process, as described above?*

We strongly agree.

*15. Do you agree that an auditor's opinion should cover the original third country GAAP financial statements and the additional remedies? Which level of comfort should be provided for the additional remedies (equal to full audit?)*

We agree with the LIBA response on this issue which says that 'We agree that the auditor's opinion should cover the original third country GAAP financial statements and we agree in principle that any additional information should also be subject to full audit. We would however ask that cost-benefit considerations be taken into account in considering what additional audited information may be required. This is particularly pertinent where information may be required in a third country, but is not currently subject to a full audit (information in the Management's Discussion and Analysis for SEC filings in the US, for example).'

*(Questions after paragraph 59)*

*16. Do you believe that these three different kinds of remedies (as set out in paragraphs 55-59) are appropriate or whether one or more of them would be enough in all circumstances?*

One or more of these remedies should be sufficient depending upon the circumstance. However, we think that sole use of disclosure will be the most proportionate remedy in most cases, given the assumptions about the sophistication of the investor base.

*17. Are the three remedies sufficiently clear? If not, please provide us with alternatives.*

No further comment.

*(Questions after paragraph 64)*

*18. Do you agree with this approach?*

We agree that the primary judgement on the appropriate remedy should lie with the company, and welcome CESR's attempt to avoid prescription on this matter. Nevertheless, we think that some form of non-prescriptive guidance (CESR's? competent authority? National standard setter?) on what remedies could be considered in particular circumstances might play a useful role in reducing uncertainty for at least some issuers. We would be happy to discuss this point further with you as we are aware of the potential for guidance to inhibit flexibility in practice. We do have some concern that any requirement for endorsement by the issuer's accountants might lead to significant additional costs for issuers. We are happy to work with CESR to investigate this point further. If the costs are found to be significant, then there may be additional benefits from the use of some

form of guidance on the remedies. We believe this approach should be maintained so that there is no requirement for an accountant's endorsement.

*(Questions after paragraph 70)*

*19. Do you agree with this approach?*

We refer to our comments at the beginning of this response. As set out in paragraph 48 of the concept paper 'CESR recognises that accounting practices are converging'. Against this background, it is not at all clear that the approach set out in paragraphs 65 to 70 is at all proportionate – both in terms of the uncertainty it creates and the regulatory costs involved. Once a GAAP is deemed to be equivalent, or has had remedies applied to it, then changes to that GAAP and IAS / IFRS are not likely to be inconsistent with convergence. In these circumstances, the 'early warning' should be able to be limited to a high level check that the policy for convergence has not changed.

22 December 2004

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**December 2004**

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