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Report on convergence between International Financial Reporting Standards (IFRS) and third country national Generally Accepted Accounting Principles (GAAPs) and on the progress towards the elimination of reconciliation requirements that apply to Community issuers under the rules of these third countries

1. INTRODUCTION AND LEGAL BASIS

In July 2007 the Commission reported on the respective work timetables envisaged by national authorities of certain third countries for converging their national Generally Accepted Accounting Principles (GAAPs) towards International Financial Reporting Standards (IFRS)¹. In this second report the Commission services now examine the actual progress made by third countries, firstly, on their convergence programmes and, secondly, towards eliminating any rules on reconciliation requirements that apply to Community issuers listed in the jurisdictions of these third countries. In preparing this report emphasis has been placed on assessing third country GAAPs which are being used by a large number of issuers listed on EU markets (as identified by CESR)² and whose respective national authorities have clearly demonstrated their commitment towards IFRS.

These reports are required by the two legal measures adopted by the European Commission on 4 December 2006³ in relation to the use by third country issuers of information prepared under certain internationally accepted accounting standards.

Since 1 January 2005 companies listed on a regulated market of any Member State of the EU and governed by the law of a Member State have to use IFRS as adopted by the EU for preparing their consolidated financial statements⁴.

The Prospectus Regulation⁵ and the Transparency Directive⁶ respectively extend this requirement to third country issuers making a public offer of securities in the EU and those whose securities are traded on an EU regulated market. In view of the efforts of the national accounting standard setters of third countries and considering the positive efforts for convergence to IFRS already underway, the EU postponed the entry into force of this requirement until January 2009. During this year (2008) the Commission will, following advice from the Committee of European Securities Regulators (CESR), be taking the decision on which third country GAAPs are equivalent to IFRS as adopted by the EU.

¹ Commission report of 6 July 2007 (COM(2007) 405 final)

² See table (number of third countries issuers listed on a EU regulated market and using that GAAP) on pages 4-5 of the Commission report of 6 July 2007

³ Commission Regulation (EC) No 1787/2006 of 4 December 2006 and Commission Decision (EC) No 2006/891 of 4 December 2006 (the "Decision under the Transparency Directive").

⁴ Regulation 1606/2002 of the European Parliament and of the Council of 19 July 2002 (the "IAS Regulation")

⁵ Commission Regulation (EC) No 809/2004 of 29 April 2004 (the "Prospectus Regulation"). This Regulation implements Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 ("The Prospectus Directive").

⁶ Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 (the "Transparency Directive").

2. THIRD COUNTRIES ALREADY USING IFRS

The Commission services believe that a common set of high quality accounting standards for financial reporting worldwide is a major step forward to promote the efficiency of international capital markets. The Commission services further recall the EU objective that this financial reporting language should be IFRS. The Commission services strongly welcome the fact that a number of jurisdictions have already fully adopted or implemented IFRS and therefore, as regards these countries, consider that no decision on equivalence is necessary. The countries concerned include, for instance, Australia, Hong Kong, New Zealand, Singapore and South Africa. Israel has made IFRS mandatory for all listed companies except for banks and dual listed companies as from January 2008. In these cases there should be an explicit and unreserved statement of such a compliance with IFRS in the audited financial statements. On 6 February 2008, the International Organisation of Securities Commissions (IOSCO) issued a statement in which it recommended, inter alia, that annual and interim financial statements prepared in compliance with IFRS as issued by the IASB should clearly state that this is the case⁷.

3. DETERMINATION OF EQUIVALENCE

In December 2007, following advice from CESR, the Commission adopted the Regulation establishing a mechanism setting out the criteria under which the decision on equivalence of third country GAAPs will be taken (the "Equivalence Mechanism Regulation")⁸. In addition to proposing which GAAPs are to be equivalent⁹, the Commission may also make proposals in relation to other GAAPs which, whilst not equivalent today, are converging or committed to adopt IFRS. In such cases, the Commission may propose to allow third country issuers to use their GAAPs in the EU for a transitional period ending no later than 31 December 2011, provided specific conditions are met¹⁰. This Regulation also establishes the following definition of equivalence:

The Generally Accepted Accounting Principles of a third country may be considered equivalent to IFRS adopted pursuant to Regulation (EC) No 1606/2002 if the financial statements drawn up in accordance with Generally Accepted Accounting Principles of the third country concerned enable investors to make a similar assessment of the assets and liabilities, financial position, profit and losses and prospects of the issuer as financial statements drawn up in accordance with IFRS, with the result that investors are likely to make the same decisions about the acquisition, retention or disposal of securities of an issuer.

⁷ IOSCO Technical Committee Statement on Providing Investors with Appropriate and Complete Information on Accounting Frameworks Used to Prepare Financial Statements

⁸ Commission Regulation 1569/2007 of 21 December 2007 establishing a mechanism for the determination of equivalence of accounting standards applied by third country issuers of securities pursuant to Directives 2003/71/EC and 2004/109/EC of the European Parliament and of the Council

⁹ Art. 3 of the Commission Regulation 1569/2007

¹⁰ Art. 4 of the Commission Regulation 1569/2007

4. CONVERGENCE OF THIRD COUNTRY GAAPS TOWARDS IFRS AND REMOVAL OF THE RECONCILIATION REQUIREMENTS FOR EU ISSUERS

In December 2007 the Commission requested CESR to provide technical advice regarding US, Japanese and Chinese GAAP with a view to assessing whether they could be considered as equivalent to IFRS. Further to CESR's advice, the Commission services make the following observations.

US GAAP

Convergence

In 2006 the United States' Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) concluded a Memorandum of Understanding (MoU) which reaffirmed their objective for convergence between US GAAP and IFRS and outlined the work programme for this purpose. In its latest advice to the Commission, CESR confirmed that all the main differences which it identified in its advice to the Commission in 2005 have been addressed by both boards. A table detailing this convergence work is given in the annex.

The issues that were identified in 2005 by CESR as main differences and also discussed in last year's report have been addressed under the convergence work programme between IASB and FASB¹¹ As regards the IFRS 3 - Business combinations, the final revised standard was issued by the FASB in December 2007 and by the IASB in January 2008. The other main issues, including IAS 27, IAS 36 and IAS 38 are still in progress under the convergence work programme.

The Commission services take note that the two boards are not intending to converge on each and every detail which would be impractical, but instead are aiming at convergence in principle. Since IFRS standards are more principles-based and US standards are more rules-based, it is clear that their respective wordings will continue to differ because IFRS will always be less prescriptive than US GAAP.

The Commission services concur with CESR that the work on converging US GAAP and IFRS has advanced at an appropriate pace. On that basis Commission services agree with the recommendation of the CESR technical advice for finding US GAAP equivalent to IFRS for use in EU markets. In reaching this conclusion, the Commission services recall the following key remarks by CESR:

- The IASB and FASB have publicly committed to convergence between IFRS and US GAAP.
- A mechanism has been set up within the two bodies to make sure that new standards or interpretations issued do not create new differences between the two sets of standards.
- The two boards are going to issue joint standards in future.

¹¹ The main issues identified by CESR included: IAS 27 (as regards scope of consolidation), IFRS 3 - Business combinations, IAS 36 – Impairment of Assets, IAS 38 – Intangible Assets (as regards capitalisation of development costs).

- There is concrete evidence of active work between the two standard setters.

Removal of the reconciliation requirement

The Commission services recall the EU objective of a single set of high quality global accounting standards for listed companies and the best way to promote the efficiency of international capital markets.

A recent report by the Economic and Monetary Affairs Committee of the European Parliament states that convergence would be sufficient if a company's accounts produced in accordance with IFRS could be accepted and recognised under US GAAP without any significant extra costs to companies¹².

The Commission has therefore welcomed the US Securities and Exchange Commission's (SEC) decision¹³ to abolish the reconciliation to US GAAP for foreign companies using IFRS as published by the IASB for financial years ending after 15 November 2007.

The Commission services note that despite the SEC rule change ending the reconciliation to US GAAP, there will be instances where EU issuers listed in the US will be required to reconcile to IFRS as published by the IASB during a transitional period of two years. Whilst recognising that such an exercise would be far less onerous than reconciling to US GAAP, and that it would only affect a very small number of EU companies¹⁴, the Commission services recall that the EU objective is to eliminate all reconciliation requirements falling on EU issuers listed in the US and the Commission will continue to pursue this goal during the above-mentioned transitional period.

Japanese GAAP

Convergence

In August 2007 the Accounting Standards Board of Japan (ASBJ) and the IASB jointly announced an agreement to accelerate convergence between Japanese GAAP and IFRS ("Tokyo Agreement"). This will entail eliminating by 2008 the differences set out in CESR's advice to the Commission of June 2005. The remaining differences are to be removed before 2011. However, any IFRS issued at some future date and becoming applicable after 2011 will be outside the scope of the Tokyo Agreement. A table detailing this convergence work is given in the annex.

Removing the differences identified by CESR in its 2005 advice will mean that the ASBJ will have to issue 11 new (or final) standards before 2009. By the end of 2007, 5 projects had been finalised. The remaining 6 projects have reached either Discussion Paper stage (DP) or Exposure Draft stage (ED) with the aim to be finalised by the end of 2008¹⁵.

¹² Report on International Financial Reporting Standards (IFRS) and the Governance of the International Accounting Standards Board (IASB) (2006/22248(INI)) of 5 February 2008

¹³ "Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP" (Final Rule)

¹⁴ The Commission understands that currently this would only apply to one EU issuer.

¹⁵ Finalised by the end of 2007: Share-based Payments; Scope of consolidation; Uniformity of accounting policies concerning overseas subsidiaries; Inventories (except for elimination of LIFO);

Whilst the timetable for reaching this objective seems ambitious, the Commission services have no indication that the ASBJ would not complete these projects, as set out in the Tokyo Agreement, on time.

Further, the Japanese authorities have indicated that they will put in place a mechanism that would ensure more or less simultaneous adoption of new standards issued by the IASB.

CESR has advised that by June 2008 the Commission should consider Japanese GAAP equivalent unless there is no adequate evidence of the ASBJ achieving to timetable the objectives set out in the Tokyo Agreement.

The Commission services recognise that the ASBJ is making serious efforts to meet the targets outlined by the Tokyo Agreement and expects that the implementation of new standards will indeed take place in accordance with the timetable. Accordingly, the Commission services consider it appropriate to make the proposal for its equivalence unless, if by that time, there is no adequate evidence of the ASBJ proceeding in accordance with the timetable of the Tokyo Agreement.

Removal of the reconciliation requirement

The Japanese authorities do not require any reconciliations for EU issuers which prepare their financial statements using IFRS as adopted by the EU.

Chinese GAAP

Convergence

In 2006, the Chinese authorities decided to incorporate IFRS into their legislation whilst, in certain cases, making amendments to take account of local circumstances. These Accounting Standards for Business Enterprises ('ASBEs') which became applicable in 2007 cover nearly all topics under current IFRS, though some exceptions to IFRS do exist. According to the Chinese Ministry of Finance, there are three major differences with IFRS ("related parties", "reversals of impairment" and "common control transactions") and two of these matters are under discussion with the IASB. There are also other differences which are of a lesser significance. However, no specific timetable has been as yet been set to resolve them.

All these differences are set out in a table in the annex.

Currently Chinese companies are in the process of preparing and presenting their first ASBE-based financial statements (for the year 2007). In the meantime the Ministry of Finance has issued both mandatory interpretations and less formal guidance for applying the standards.

Construction contracts. To be finalised by the end of 2008: Business Combinations (ED planned for Q2 2008); Uniformity of accounting policies of associates (ED published in Q4 2007); Asset retirement obligation (ED published in Q4 2007); Post retirement benefit (ED planned for Q1 2008); Disclosure of financial instruments at fair value (ED planned for Q1 2008); Investment property (ED planned for Q2 2008).

CESR has recommended that ASBEs would now qualify to be accepted on transitory basis in the EU as they are converging to IFRS whilst a final decision on ASBEs should be postponed until there is more information regarding adequate implementation of the ASBEs. From its own more recent contacts with the Chinese authorities the Commission services have obtained initial information indicating that Chinese GAAP is being properly implemented. Chinese ASBEs should therefore benefit from the transitional period (up to the end of 2011) under Article 4 of the Equivalence Mechanism Regulation.

Removal of the reconciliation requirement

The Chinese authorities do not require any reconciliations for EU issuers which prepare their financial statements using IFRS as adopted by the EU.

5. CONVERGENCE WORK BY OTHER THIRD COUNTRIES

The Commission has sent a second request to CESR for technical advice with a view to assessing the convergence efforts by certain other countries and thus whether they could benefit from the temporary exemption as set out under Article 4 of the Equivalence Mechanism Regulation. Subject to CESR's advice on third countries, the Commission services can at this stage already make the following observations.

Canada

The Accounting Standards Board of Canada (AcSB) has published an "Implementation Plan for Incorporating IFRSs into Canadian GAAP". In March 2008, following a public consultation, the AcSB confirmed the changeover date to IFRS of January 1, 2011. On that date IFRS will replace Canadian GAAP for Publicly Accountable Enterprises. The AcSB has explained that only in very exceptional circumstances would it modify any IFRS, such as for example the extra guidance that may be required for not-for-profit organisations.

Subject to technical advice by CESR, the Commission services consider that Canadian GAAP could qualify as a GAAP which will be subject to adoption of IFRS under Article 4 of the Equivalence Mechanism Regulation with the effect that it will be accepted in the EU without any requirement for reconciliation until the end of 2011.

South Korea

In March 2007 the Korean Financial Supervisory Commission and the Korean Accounting Institute announced a road map for the adoption of IFRS into the national framework for financial reporting (termed Korean IFRS or "K-IFRS"). The Commission services note that the South Korean authorities already intend to allow listed companies, with the exception of financial institutions, to use IFRS as from 2009. All listed companies will be required to prepare their annual financial statements under K-IFRSs from the start of 2011.

Subject to technical advice by CESR, the Commission services consider that Korean GAAP could qualify as a GAAP which will be subject to adoption of IFRS under Article 4 of the Equivalence Mechanism Regulation with the effect that it will be accepted in the EU without any requirement for reconciliation until the end of 2011.

6. MONITORING

In the coming years the Commission will continue to monitor the situation and, with the technical assistance of CESR, assess the ongoing efforts by third countries converging to IFRS or intending to adopt IFRS. In this respect, the Commission will in 2011 report to Parliament and the ESC. The actual timing of the report will largely depend on the pace of those developments.

7. CONCLUSIONS

With regard to the US, the Commission services, having considered CESR's advice, agree with CESR's recommendation that US GAAP should be viewed as being equivalent to IFRS.

The removal of the reconciliation requirement to US GAAP is a major step forward. As regards companies that will henceforth need to reconcile to 'IFRS as published by the IASB', although less onerous and affecting only a very small number of European issuers, the Commission services expect that all efforts will be made to solve the issue of the carve-out of IAS 39 which will result in 'IFRS as adopted by the EU' to be identical to 'IFRS as published by the IASB'. In this context the IASB is encouraged to play a full role.

As regards Japanese GAAP, the Commission services believe that, at this stage, Japan is on track to meet the criteria for equivalence and, unless there is evidence that the ASBJ will not meet the targets set out in the new convergence timetable on time, expects to make a proposal on that basis.

As regards Chinese GAAP (ASBEs), the Commission services recall that 2007 has been the first year for preparing financial statements using ASBEs and from the initial information obtained to date, believes that they are being properly implemented. As regards Canadian GAAP and South Korean GAAP, both of these countries are encouraged to vigorously continue their efforts to fully converge to/or adopt IFRS by 2011 or earlier. On the basis of these findings the Commission services are of the opinion that issuers using the national GAAP of these three countries should benefit from the exemption as set out in Article 4 of the Equivalence Mechanism Regulation.

Annexes: Tables on respectively, US GAAP - IFRS, Japanese GAAP – IFRS, Chinese ASBE – IFRS (source: CESR)