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**FIRST REPORT TO THE EUROPEAN SECURITIES COMMITTEE AND TO THE  
EUROPEAN PARLIAMENT**

**on convergence between International Financial Reporting Standards (IFRS) and third  
country national Generally Accepted Accounting Principles (GAAPs)**

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## 1. INTRODUCTION AND LEGAL BASIS

This report focuses on the respective work timetables envisaged by national authorities of Canada, Japan and the USA for the convergence between International Financial Reporting Standards (IFRS) and their national Generally Accepted Accounting Principles (GAAPs). It also contains some preliminary information about the convergence efforts by some other third countries.

This report on the work timetables for convergence is required by the two legal measures adopted by the European Commission on 4 December 2006<sup>1</sup> in relation to the use by third country issuers of information prepared under certain internationally accepted accounting standards.

Under *Regulation 1606/2002 of the European Parliament and of the Council of 19 July 2002* (the "IAS Regulation") companies listed on a regulated market of any Member State and governed by the law of a Member State of the European Union are required to apply IFRS as adopted by the EU ('endorsed IFRS') for their consolidated accounts for financial years starting from January 2005.

The requirement to use endorsed IFRS in the European Union was extended to third country issuers making a public offer of securities in the EU by the Prospectus Regulation<sup>2</sup> and to third country issuers with securities traded on an EU regulated market by the Transparency Directive<sup>3</sup>. Under these Directives the issuers must prepare their financial information in accordance either with IFRS or with a third country's national accounting standards (third country GAAPs) that is 'equivalent' to endorsed IFRS. Those requirements were initially subject to a transitional exemption until 1<sup>st</sup> January 2007.

Subsequently, in the light of the efforts of the national accounting standard setters of Canada, Japan, the USA and other jurisdictions, and considering the positive efforts for convergence to IFRS already underway, it was agreed to postpone this date for a further two years. Therefore, on 4 December 2006, the Commission adopted the two legal measures mentioned above under which third country issuers could continue using certain third country GAAPs, for the purposes of the Prospectus Regulation, in all prospectuses filed before 1<sup>st</sup> January 2009 and, for the purposes of the Transparency Directive, for all financial years starting before January 2009<sup>4</sup>.

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<sup>1</sup> 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").

<sup>2</sup> 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').

<sup>3</sup> Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 (the "Transparency Directive").

<sup>4</sup> See Art. 1 of the Commission Decision 2006/891/EC and Art. 35(5A) of the Prospectus Regulation, as amended by Commission Regulation (EC) 1787/2006/EC.

During the period leading up to 2009 the Commission is required by Article 35 of the Prospectus Regulation (as amended by Regulation (EC) No 1787/2006 and by Article 2 of the Decision under the Transparency Directive to inform the European Securities Committee and the European Parliament regularly about the progress on convergence and of progress on the elimination of reconciliation requirements that apply to EU issuers.

## **2. DEFINITION OF EQUIVALENCE**

Establishing a suitable definition of equivalence, for the purpose of determining whether a third country GAAP is 'equivalent' to IFRS, is a crucial element of the work in this area. Under the Prospectus Regulation and the Decision under the Transparency Directive, the Commission is required to establish a definition of equivalence, set up an equivalence mechanism and then determine the equivalence of third country GAAPs in accordance with a specified timetable. These legal measures require the Commission to consult CESR on each of these issues. Following the first consultation, the following definition of equivalence has been proposed by CESR:

*For equivalence's 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.*

This definition is derived from CESR's advice of June 2005 on the equivalence of US, Canadian and Japanese GAAPs. In that advice, CESR explained that equivalent does not mean identical. CESR envisaged that some differences between third country's GAAP and IAS/IFRS would not give rise to differing investment decisions. As a starting point, the Commission considers that such a definition provides appropriate criteria for defining equivalence.

## **3. USE OF THIRD COUNTRY GAAPs IN THE EUROPEAN UNION**

CESR has listed the third country GAAPs that are currently used by the issuers whose securities are traded on a regulated market in the EU. According to CESR, third country issuers using a third country GAAP represent around 5.8 % of the total number of issuers having their securities admitted to trading on EU regulated markets.

In preparing the following table, CESR indicated that some issuers may have been counted more than once if they have securities admitted in more than one country and/or if they have admitted different types of securities in the same or in several Member States.

National GAAP of:	Number of third country issuers listed on a EU regulated market using this GAAP
Argentina	5
Australia	17
Brazil	4
Canada	45
Chile	1
China	20
Columbia	1
Egypt	10
Hong Kong	2
India	70
Indonesia	2
Israel	8
Japan	84
Lebanon	3
Malaysia	3
Mexico	2
Morocco	1
New Zealand	2
Pakistan	1
Peru	3
Philippines	3
Russia	14
Singapore	2
South Africa	9
South Korea	30

Switzerland	4
Thailand	4
Tunisia	1
Turkey	7
US	233
Venezuela	1
Zambia	1
Zimbabwe	1
Total	594

Source: CESR

This information is not exhaustive, as CESR has not been able to obtain the relevant data for all EU regulated markets.<sup>5</sup>

#### **4. UPDATES ON THE CONVERGENCE OF CANADIAN, JAPANESE AND US GAAP TOWARDS IFRS**

##### *US GAAP*

The elimination of the reconciliation requirement to US GAAP for EU issuers is a major objective of the Commission. The SEC has developed a Roadmap setting out the steps leading to the ending of the reconciliation requirement and has indicated that, whilst some measurable progress on priority issues is important, a finite level of convergence is not required for the objective to be met.

In early 2006, the United States' Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) concluded a Memorandum of Understanding (MoU) that outlines a work programme for convergence between US GAAP and IFRS. The MoU divides the convergence work into two main categories depending on their expected time frame for completion. In the short term the aim of the convergence work is to reach a conclusion by 2008 about whether major differences in a small number of key areas should be eliminated through one or more short-term standard setting projects, and if so, complete or substantially complete work in those areas. Overall progress seems to be advancing at a satisfactory pace. Beyond the short term, the MoU provides for the two Boards to work together and make significant progress by 2008 on other major areas where current practices are regarded as "candidates for improvement". Work on most of these seems to be progressing at the pace by which the requirements in the Roadmap should be met in time. This includes the Consolidations project.

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<sup>5</sup> CESR members also identified around 130 third country issuers currently using Member States' national GAAP (e.g. UK GAAP).

CESR has given preliminary information on the progress made on the convergence work programmes of Canada, Japan and the United States, using CESR's advice of 2005 as a basis and indicating both the current situation and the expected developments for 2007/2008. However CESR's report<sup>6</sup> expressly states that it should not be considered as providing any evaluation or assessment of the progress in convergence at this stage but instead gives an indication of the current situation according to information obtained through public sources.

The technical advice identified the main difference in the area of scope of consolidation (IAS 27) where it proposed a supplementary statement as a remedy. The Consolidations project is included in the convergence programme, with a discussion paper expected in summer 2007 and exposure draft in the second half of 2008.

Other potentially significant differences identified by the technical advice (i.e. differences where quantitative indication of the impact was proposed as a remedy) were related to: IFRS 3 - Business combinations, IAS 28 – Investments in Associates (Uniformity of Accounting policies), IAS 36 – Impairment of Assets, IAS 38 – Intangible Assets (Capitalisation of development costs) and IAS 41 – Agriculture (Differences in fair value of specific agriculture items). Business Combinations is included in the Convergence work programmes and the final standards are expected in 2007. IAS 36 – Impairment of assets and IAS 38 Intangible assets are also included in the convergence work programmes, however they are currently at the staff research stage without clear indication of the timetable. IAS 28 – Investment in Associates and IAS 41 – Agriculture are currently not included in the convergence programme.

In 2006 the SEC began reviewing the first filings of IFRS based financial statements by EU companies. SEC officials have since been describing their observations as "information seeking" where things were not clear to them. The questions have focused on the presentation and disclosure of the information in the financial statements.

CESR and the SEC agreed on and published a joint Work Plan on 2 August 2006. This Work Plan is an important step in bringing about operational and supervisory cooperation between regulators to ensure consistent enforcement of IFRS and US GAAP. Furthermore, the Financial Reporting Council (FRC), SEC and the UK Financial Services Authority (FSA) signed on 25 April 2007 a protocol for implementing this [Work Plan between the SEC and CESR](#) as it relates to sharing information on the application of IFRS by issuers listed in the UK and the US.

In April 2007, in the framework of the regular yearly EU-US Summit, both sides agreed to take steps towards the convergence, equivalence or mutual recognition, where appropriate, of regulatory standards based on high quality principles. In particular, the focus will be given on the promotion of conditions for the U.S. GAAP and IFRS to be recognized in both jurisdictions. As a confirmation of this agreement, the President of the USA, the President of the European Council and the President of the Commission signed on 30 April an agreement containing the following statement in relation to financial reporting:

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<sup>6</sup> CESR's advice to the European Commission on the work programmes of the Canadian, Japanese and US standard setters, the definition of equivalence and the list of third country GAAPs currently used on the EU Capital Markets (6 March 2007).

*"Financial Markets. Promote and seek to ensure conditions for the U.S. Generally Accepted Accounting Principles and International Financial Reporting Standards to be recognized in both jurisdictions without the need for reconciliation by 2009 or possibly sooner.<sup>7</sup> "*

Following a press statement in April<sup>8</sup>, the SEC, on 20 June 2007 announced its proposal to allow IFRS based financial statements of foreign issuers to be filed without any reconciliation requirement<sup>9</sup>. The comment period was set at 75 days from date of publication in the Federal Register.

The same press statement had also indicated the possibility that the SEC could give US based companies the option of using IFRS for their financial statements instead of US GAAP.

### *Japanese GAAP*

In March 2005 the Accounting Standards Board of Japan (ASBJ) and the IASB launched a joint (convergence) project with the final goal of achieving convergence between Japanese GAAP and IFRS. During the course of this project the ASBJ has been accelerating its revision of Japanese accounting standards to reduce the differences between the two GAAPs. Under this approach the ASBJ and IASB have identified "short-term projects" and "longer-term projects". Short-term projects are scheduled to be concluded by the beginning of 2008. For longer-term projects such as revenue recognition, performance reporting (financial statement presentation), intangibles (including R&D expenses), the scope of consolidation (including Special Purpose Entities "SPEs"), impairment of fixed assets and retirement benefits, the ASBJ has decided to initiate (research) projects in order to align the work with the projects run by the IASB and the FASB.

Following Commission's request, CESR has given preliminary information on the progress made on the convergence work programmes indicating both the current situation and the expected developments for 2007/2008. An overview of issues identified by CESR or on which there is a convergence project is given in annex 2 of this paper.

Three out of the twenty six issues identified by CESR in 2005 were classified as requiring supplementary statements. The three issues and their expected progress regarding convergence are as follows:

- (1) Business combinations (pooling-of-interest method)

A Project Team was launched in December 2006. A research report should be issued in the third quarter of 2007. Depending on the discussion on this research report, a discussion paper may be issued in the fourth quarter of 2007. A recent analysis by the Tokyo Stock Exchange shows that the pooling-of-interest method was not used for any business combination during the first half financial year ended 30 September 2006.

This fact should have an influence on the reconsideration of the pooling-of-interest method.

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<sup>7</sup> Framework For Advancing Transatlantic Economic Integration Between The European Union And The United States Of America - Annex 2 Lighthouse Priority Projects.

<sup>8</sup> SEC Press statement 2007-72 of 24 April 2007.

<sup>9</sup> SEC Open meeting 20 June 2007.

(2) Scope of consolidation (enhanced disclosure and consolidation of SPEs)

A technical committee was established for this issue and deliberations thereon have been initiated.

As for deliberations of the disclosure, the ASBJ released the "Guidance on Disclosure of Certain Special Purpose Entities" on 23 March 2007 being effective for financial years beginning on or after 1 April 2007. As for deliberations of the scope of consolidation, a discussion paper will be released by the end of 2007.

It has to be noted that convergence progress has been made in other areas too:

- In the area of IAS 2 *Inventories* and the question of the use of LIFO method (last-in-first-out) the ASBJ has set up a project team in January 2007 with the aim to get a decision by the beginning of 2008.
- Regarding IAS 36 *Impairment of Assets* the ASBJ has launched a project team in January 2007. The project team aims at submitting a research report to the ASBJ Board by the end of 2007.
- Regarding deliberations on IAS 38 *Intangible Assets* and the question of capitalisation of development costs, ASBJ expects to issue a discussion paper by the end of 2007.

(3) Uniformity of accounting policies (overseas subsidiaries and associated companies)

Following the release of Practical Issues Task Force (PITF) No. 18 (May 2006), accounting policies applicable to foreign subsidiaries will be unified substantially with those applicable to parent companies. PITF No. 18 will be applied from April 2008 (earlier application encouraged). As for associated companies, the ASBJ launched a project team in January 2007. Based on the deliberations an exposure draft may be released by the end of 2007.

In the first two accounting sessions between experts of the European Commission and the Japanese FSA, the progress of the work program was discussed. According to the Project Plan in January 2008, 7 out of 16 projects or sub-projects will have reached the final project status and 2 (possibly 5) will be in the deliberating phase towards finalisation at the Board level.

*Canadian GAAP*

In January 2006, the Accounting Standard Board of Canada (AcSB) decided to move financial reporting for Canadian publicly accountable enterprises to IFRS. The definition of publicly accountable enterprises currently includes listed companies and entities which raise funds from the public, such as banks and insurance companies.

The AcSB's Implementation Plan for incorporating IFRS into Canadian GAAP published on 30 June 2006 assumes that IFRS will be implemented as from 1 January 2011. This timeline should be finalised by 31 March 2008 following a progress review currently underway.



## 5. CONVERGENCE WORK BY OTHER THIRD COUNTRIES

### *Chinese GAAP*

In February 2006, the Ministry of Finance of the People's Republic of China (the 'MoF') formally announced the issuance of the Accounting Standard for Business Enterprises ('ASBE'). These ASBEs cover nearly all topics under current IFRS, though some exceptions to IFRSs are noted. These standards, which became effective from 1 January 2007, are mandatory for all listed Chinese enterprises. Other Chinese enterprises are also encouraged to apply these standards.

The MoF and the IASB have acknowledged that convergence is an ongoing process. The MoF identified a number of accounting issues that might help to provide input for the IASB in finding solutions for IFRS projects currently undertaken in the area of disclosure of related party transactions - particularly the 'state controlled enterprises exemption' - (the IASB published an Exposure Draft on 22 February 2007), business combinations of entities under common control, and fair value measurement.

In November 2006 the Ministry of Finance of China has issued limited **implementation guidance** on 32 of the 38 Accounting Standards for Business Enterprises (ASBEs) that it adopted in February 2006, effective for 2007 financial reports of Chinese listed companies. The MOF guidance is currently available only in Chinese.

### *Indian GAAP*

In March 2006, the Indian Prime Minister announced that his government will introduce comprehensive new company legislation that will include aligning Indian accounting standards with IFRS. The new law will replace the existing 50-year-old Indian companies law and has the objective of promoting greater transparency and efficient governance.

The Institute of Chartered Accountants of India (ICAI) has set up a task force to explore the possibility of fully adopting all International Financial Reporting Standards, without modification, as Indian standards. It will develop a concept paper on adoption of IFRS in India.

### *Russian GAAP*

The Government decision for Russian listed Companies to move towards IFRS was taken in 2002. Under this plan, the listed companies in Russia were required to prepare consolidated financial statements using IFRS starting in 2004. The individual company financial statements of members of the group would continue to be prepared using Russian GAAP. For banks, also individual banks were required to prepare IFRS financial statements in addition to Russian GAAP statements. Currently, only banks are required to prepare their consolidated accounts under IFRS and the individual accounts under the local GAAP. There has been no progress since 2005 as regards the requirement for listed companies to prepare accounts under IFRS; the companies are preparing their accounts under the local (Russian) GAAP, which still contains certain differences from the IFRS. In addition to the statutory GAAP, some listed companies report also under IFRS (or US GAAP) on a voluntary basis.

## 6. CONCLUSIONS

In this first report the Commission draws encouragement from each of the timetables of the authorities of Canada, Japan and the US in respect of the work being carried out under the convergence programmes.

With regard to the US, the Commission takes note of the progress on convergence. Furthermore the Commission welcomes statements made by SEC officials which explain that they are "not seeking to dictate interpretations of IFRS"<sup>10</sup> and notes that their reviews of the first year's filings of IFRS financial statements by European issuers have centred on matters of presentation and disclosure. Further to the understanding reached between the US and the EU on 30 April, the Commission also welcomes the SEC's announcement of proposed rule changes to allow IFRS based financial statements to be filed without any reconciliation requirement. The Commission attaches great importance to the SEC's work on its Roadmap for the removal of the reconciliation requirement to US GAAP and this will be a key focus of the Commission's report in April 2008. With the EU and US timetables for equivalence having now been aligned, both have the possibility to monitor closely developments in the other jurisdiction. In this context, there is a clear need to deepen the co-operation between the European Commission and the SEC. There should be regular meetings between Commission and SEC officials to establish staging posts and take stock of developments.

Equally, steady progress towards eliminating the need for reconciliation depends to a significant degree on the trust and communication that exist among regulators. Co-operation and information-sharing among regulators needs to be enhanced, and thus Commission fully supports the work plan of the SEC and CESR, which includes dialogue about the implementation of IFRS. Recognizing that IFRS are principles-based standards, regulators should give full consideration to the positions of their international counterparts regarding application and enforcement of IFRS, and seriously endeavour to avoid conflicting conclusions.

Regarding Japan, the release in October 2006 of the "ASBJ Project Plan" focusing on projects specifically related to convergence is welcome. In releasing the ASBJ Project Plan, primary emphasis has been placed on mapping out the work to be completed by the end of 2007, and also on clarifying the prospects of convergence status as of the beginning of 2008. Priority was given to initiatives related to the 26 issues for which the remedies were advised by CESR in their advice to the Commission in 2005. The Commission is encouraged by these positive developments but stresses that it is necessary to keep up the pace of, (and in certain areas even accelerate, convergence activities. In order to achieve the objectives as defined by the work program the Japanese authorities have to keep the level of convergence activity very high and provide accurate and complete information on progress, including any delays if they arise.. The program is ambitious but achieving its objectives is an important basis for the equivalence decision.

The Commission welcomes the Canadian announcement, in 2006, on the adoption of IFRS for financial reporting for Canadian publicly accountable enterprises and the indication of the 1 January 2011 as that date for such a changeover. The Commission trusts that this or even an earlier date and timeline for moving to IFRS for incorporating IFRS into Canadian GAAP will be confirmed in 2008.

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<sup>10</sup> Speech by John A. White, Director, Division of Corporate Finance (SEC), London, 15 January 2007

As regards China, the issuance of the ASBEs which cover nearly all topics under existing IFRS (though some exceptions to IFRSs are noted) is seen as a positive step. The Commission encourages the Chinese authorities to continue work on convergence and would welcome a detailed timetable setting out the key stages envisaged to be reached in the near future.

In India, the decision to align Indian accounting rules with IFRS coupled with a newly created task force to explore the possibility of adopting of IFRS in full is encouraging. The Commission would welcome further information on these plans for adopting IFRS without modifications and especially with regards to the timeframes for reaching any key stages which might be envisaged in the near future.

As regards Russia, recent discussions with the Russian authorities confirm that the Government decisions for Russian listed Companies to move towards IFRS and to bring Russian GAAP in line with international standards are still on the agenda. The Commission hopes that the current obstacles which have slowed down this work will soon be resolved. The Commission would welcome further clarifications as regards the possibilities for quickly resuming the work and, once work has restarted, timeframes for bringing Russian GAAP in line with IFRS.

The Commission will continue to closely monitor and regularly inform the European Securities Committee and the European Parliament about the progress in convergence as regards Canadian, Japanese and US GAAP, as required by Article 35(5A) of the Prospectus Regulation and Article 2(2) of the Decision under the Transparency Directive. Issues related to convergence feature in the discussions in the Regulatory Dialogues and there are regular staff level contacts between the Commission and the authorities of the third countries concerned. The Commission will also regularly keep the European Securities Committee and the European Parliament informed as regards the development of regulatory discussions and the amount of progress in the convergence to IFRS of other third countries referred to in Article 35 (5A(c)) of the Prospectus Regulation and Article 1 (c) f the Decision under the Transparency Directive. Such regular information is an obligation under Article 35(5B) of the Prospectus Regulation and Article 2(3) of the Decision under the Transparency Directive.

The EU is the largest jurisdiction making use of IFRS and has a strong interest in moving forward towards worldwide standards. The Commission therefore welcomes all initiatives which pave the way for IFRS to become the global standards.

Annexes: IASB - FASB Roadmap, Project plan concerning the development of Japanese Accounting Standards, Canadian convergence work programme.