

S Société

F Française

des Analystes

F Financiers

re de l'EFFAS

Le Président

John TINER
Chairman of CESR Fin
CESR
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Dear Sir,

The French Society of Financial Analysts, SFAF (Société Française des Analystes Financiers), is pleased to submit its contribution as part of the consultation undertaken by the Committee of European Securities Regulators (CESR) on its Concept Paper on the Equivalence of Certain Third Country GAAP and on the Description of Certain Third Countries Mechanisms of Enforcement of Financial Information (Ref: CESR/04-509).

SFAF represents 1,700 members in France and is itself a member of the European Federation of Financial Analysts Societies (EFFAS). Financial analysts are among the principal users of corporate financial statements and therefore wish to express their opinion on the implementation of new regulation in the field of accounting in Europe.

For this reason, our society, through its Accounting and Financial Analysis Commission, is keen to respond to your consultation on the equivalence of third country GAAP.

General comments

SFAF supports the efforts made by CESR and the European Commission to deal with this issue in a clear and transparent way. The draft Concept Paper is seen as an essential framework, from which can be built the desired convergence of main international accounting standards. For this reason, this document has to offer to regulators, decision-makers and users of financial statements the keys to the understanding of what is meant by equivalence and the degree of comparability between figures published according to different standards.

Though conceptual, this paper should also strive to give practical answers to those who on a daily basis will be confronted with the problem of understanding, analysing and interpreting figures computed according to references deemed equivalent, but producing different, mainly quantitative, but also qualitative results.

We appreciate the focus put on the protection of the European investors in the mandate of the European Commission, as well as in the Concept Paper. They will be the main users of financial accounts established according to third country GAAP. They are those who might profit from new investments opportunities, but, at the same time, will bear the costs associated with the necessary conversions or adaptations from one set of standards to another.

Unfortunately no investor nor one of their representatives has expressed an opinion on the equivalence of accounting standards when CESR first consulted market participants on June 29, 2004 in preparation of its Concept Paper. Most of the answers came from those, who in case of non-equivalence will directly or indirectly bear the costs of restatement. European analysts' opinion should be granted a particular attention, since their interests are on this topic closely linked with those of investors. If financial analysis of third country companies' accounts become tedious and costly because equivalence is granted too easily, this will have direct repercussions on costs borne by investors. For the sake of the debate, we hope more Europeans investors will express their opinion at this important step of the implementation of the mandate.

We shall now elaborate on a series of issues, dealt with in the Concept Paper, which have attracted our attention.

1. A more pragmatic approach to the definition of equivalence

We believe that the proposed definition of equivalence is too general and might lead to numerous different interpretations, which will not be helpful to those whom CESR and the European Commission rightfully aim to protect: investors.

Furthermore, it does not seem adapted to the reality of international stock markets, where listing abroad practically never happens on an equal basis. There is usually a wide discrepancy between the original market, which trades high volumes and thereby drives the price of the secondary market located in a third country. The following market minority shareholders, not fully aware of foreign accounting standards, deserve particular measures of protection.

The Concept Paper states 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 at least similar decisions” (paragraph 1) and later that “this implies for example that the typical range of decisions by an investor regarding listed stocks (buy, sell, hold), should not be affected by the use of third country GAAP compared with using IAS/IFRS” (paragraph 3). However, nothing is said on how CESR will proceed to assess potential changes in investors’ decisions. Moreover, a simple economic rule requires that on a free market there are always as many buyers as sellers, so how can we say that, globally, investors have changed their opinion from “buy” to “sell”? Here it seems necessary to differentiate according to various categories of investors, that are yet to be defined by CESR. Perhaps some factors like liquidity measured according to volumes exchanged or spreads can be seen as indicators of a global change in behaviours – supposing the effect of financial standards can be isolated – but this approach first needs to be documented by reliable academic research.

CESR does not really explain how the general definition of equivalence will be used to decide whether two sets of standards are equivalent. We believe that this fundamental concept should appear at the centre of the methodology used to judge third country standards. We therefore strongly support a cost-benefit approach focussing on the interests of the European investors.

This more pragmatic approach to the definition of equivalence gives a clear and understandable decisional rule, which can be used at different levels to assess third country GAAP.

Rational investors take investment decisions based on their estimation of expected returns. Figures, together with other types of relevant information, are integrated in their estimations as they are published. On the one hand, we can assume that if investors are given all necessary additional disclosures and partial reconciliations, they are able to form similar expectations in different sets of standards. On the other hand, this operation is not costless, and this changes investors’ expected profits, therefore their investment strategy. For this reason, we believe that understanding the issue of equivalence under the angle of the cost for investors of shifting from a third country GAAP to IFRS is a more pragmatic and effective approach and is more consistent with their practices.

This would lead us to think that standards can be considered equivalent if they are associated with similar costs for investors. However one should not neglect the positive effects of the diversification of portfolios. The widespread CAPM model has shown that the more diversified investments are, the greater the benefits for investors. Among the three third country GAAP under review some offer interesting opportunities of geographical, but also technological diversification. This potential benefit should be studied by CESR after the release of the final version of the Concept Paper, in parallel to a thorough study of costs.

These costs should be clearly stated as a limit to equivalence at the level of the Concept Paper. When dealing with several sets of standards, they are of various kinds. Investors and/or financial analysts have to spend time and money for their initial learning of the third country set of standards. Then they should invest in continuous training in order to adapt to changes decided by the third country regulator, which might or might not go in the direction of convergence. Even though they invest in these fixed costs, it is fair to say that European investors remain confronted with a higher risk of misinterpreting third country standards than local investors. Finally, since Europeans are not likely to have access to markets as deep as in the third country, their investment in these fixed costs will not be as profitable : third country investors will always profit from higher scale effects. International investors will not compete on a level playing field.

Variable costs can be an even greater handicap. In financial markets, it is of great importance to be able to understand information instantly and take the corresponding investment decisions as quickly as possible. Financial information very often cause wide movements in financial markets in the first minutes after which it is published. Time spent by Europeans investors to understand figures established in third country standards will hinder them to take a decision in time. This constitutes another competitive disadvantage for European investors, which is very costly. Other variable costs are the calculations and adjustments needed to “translate” figures into IFRS, which will be the main reference for all European investors.

For very large international institutional investors having the means to finance the necessary skills to deal with different accounting standards, the competitive disadvantage towards third country investors should be rather small, but they are also those, who have a direct access to non-EU markets and do not really need to have foreign securities listed in Europe.

Smaller mainly European investors will have to bear all the costs listed above, which might not be compensated by the benefits from a wider diversification.

Individual investors might be confused by all the changes occurring in the accounting standards in the European Union and be misled by figures not published according to IFRS or their local GAAP.

2. Knowledge of accounting standards

The IFRS represent a great change for European financial analysts for which they are not entirely ready. A survey on financial analysts in the UK conducted by KPMG (published mid November 2004) has shown how uneasy they feel about IFRS (a summary is available on <http://www.kpmg.co.uk/news/detail.cfm?pr=2087>). When asked whether they felt confident enough that they would be able to distinguish between changes that are the result of underlying business performance and those due to accounting changes, 46 % expressed doubts, 40% of the analysts surveyed rated their current knowledge of IFRS as poor. 69% said that they had not received any training.

The assumption that European investors know the IAS/IFRS standards is therefore a strong one, on which the Concept Paper is built. This approach is justified on the long run, but less on the short run. European analysts and investors have to deal with a great variety of different sets of standards (local GAAP and IFRS). Investors, investments firms, companies and regulators are going through a complete change, which will take years before it is fully understood by every producer and user of financial information : IFRS will enter into force progressively not showing their whole impact at first, then market practices will have to converge to a single interpretation of the standards in order for them to lead to full comparability, as initially intended by the European legislator.

For similar reasons, making the assumption of a good knowledge of third country sets of standards is not realistic neither for financial analysts, nor for investors in general. A similar survey as the one conducted by KPMG on IFRS and UK financial analysts focussing on third country GAAP would prove it.

3. Remedies

The different remedies proposed might correspond to specific needs when trying to understand differences in accounting standards, but we consider them as exceptional solutions to particular cases. The rule must be equivalence, with a very limited number of remedies, if differences between third country standards and IFRS can be easily understood by investors. Otherwise the best solution for the European investor is restatement.

This is the approach of the Prospectus Regulation (cf. footnote 5 of the Concept Paper). Paragraph 20.1 of Annex 1 states that “For third country issuers, such financial information must be prepared according to the international accounting standards adopted pursuant to the procedure of Article 3 of Regulation (EC) No 1606/2002 or to a third country’s national accounting standards equivalent to these standards. If such financial information is not equivalent to these standards, it must be presented in the form of restated financial statements”.

However the European Commission asked CESR if there are other intermediary situations, which could be solved by appropriate remedies.

CESR should be careful not to shift away from the words and the intentions of the regulation, which describes only two possibilities for third country standards : equivalence or complete restatement. Though we agree that in some cases this approach might seem a little extreme, it should remain the rule and not the exception as suggested by CESR in paragraph 60: “[restatement] might apply where the differences with third country GAAP are so widespread fundamental and material that there can be circumstances where no other remedy will enable them to be deemed equivalent”.

4. Political aspects

Having a too wide vision of equivalence at a technical level might have direct consequences at a political level. This, in itself, justifies keeping in mind the political goals while looking at the technical aspects.

For mainly practical reasons, financial analysts have clear preference for the convergence of international accounting standards as opposed to the equivalence, even on a reciprocal basis. Important avoidable costs come from the unnecessary coexistence of numerous different sets of standards in Europe, but also worldwide. By moving quickly on the track of equivalence in Europe, one will confuse users of financial accounts and at the same time reduce the incentive for third countries to converge towards the international reference, since their companies and investors will be authorised to use their GAAP in the world's second financial centre.

Having similar accounting systems at least on both sides of the Atlantic and possibly elsewhere should be the objective of political leaders, if they wish to see financial markets thrive and offer more efficient and cheaper financing to the economy. The European Union has made a great step in this direction, when choosing to adopt the IAS/IFRS for consolidated accounts of publicly financed companies. Other countries should be encouraged to follow the same path. This is why equivalence should be analysed and used as a tool to achieve international convergence. Only with a restrictive understanding of this concept will the European Union be able to keep the pressure on third countries to achieve convergence.

Conclusion

The Concept Paper takes the right approach by focussing on European investors and defining the concept of equivalence and the methods and criteria to be used. This will be very useful to users of financial accounts, but needs to be further developed in order to be more practical.

Moreover, one should not make abstraction of the great changes the European financial market participants are going through with the arrival of the IFRS. Investors and analysts do not yet feel confident with the new standards and very few know much about third country GAAP. Introducing more confusion with a loose understanding of the concept equivalence will not help the transition to a common accounting system in the European Union. We are therefore in favour of a restricted use of remedies.

For all the reasons discussed above, we strongly believe that equivalence must be granted based on a cost-benefit analysis focussing on European Investors. This is the most coherent way to assess possible changes in behaviours that equivalence might produce.

We thank you for the opportunity given to us to stress the importance for investors and financial analysts of the process of convergence of international accounting standards and will be pleased to participate in the technical assessment of the three third country standards. We remain available for any further information.

Yours faithfully,



Franck CEDDAHA
Chairman of the Accounting
and Financial Analysis Commission



Alain CAZALE
Chairman of SFAF