

Insight

January 2008

Can I use my local GAAP? Recent developments in equivalence of non-EU accounting standards

On 21 December 2007, the Commission adopted Regulation (EC) No 1569/2007 (the "2007 Regulation"). This is of interest to issuers that are subject to the requirements of the Prospectus Directive or the Transparency Directive and use accounting standards of non-EEA countries ("third countries").

The 2007 Regulation sets out the procedure for determining which third country accounting standards should be treated as equivalent to International Financing Reporting Standards ("IFRS") for the purposes of disclosure obligations under the Prospectus and Transparency Directives. It also provides further transitional exemptions for certain third country standards that are not equivalent to IFRS. This would allow third country issuers to continue to use eligible non-equivalent third country standards for the purposes of the Prospectus and Transparency Directives until the end of 2011.

Background

The Prospectus Regulation requires up to three years of historical financial information to be included in a prospectus. Those financial statements must be drawn up in accordance with IFRS (as adopted in the EU in accordance with Regulation 1606/2002 – "EU IFRS") or with third country accounting standards that are equivalent to EU IFRS. Financial information drawn up in accordance with a third country's Generally Accepted Accounting Principles ("GAAP") that are not equivalent to EU IFRS must be

restated if the prospectus concerns equity securities or non-equity securities with a unit denomination of less than €50,000, while in the case of wholesale securities the prospectus must contain a narrative statement of the differences between the non-equivalent GAAP and EU IFRS.

Similarly, the Transparency Directive requires all issuers (including those incorporated outside the EEA) whose securities are admitted to trading on a regulated market to publish annual and sometimes also half-yearly financial statements, which must be drawn up in accordance with EU IFRS. However, third country issuers may be permitted to comply with the obligation by using statements drawn up in accordance with equivalent third country standards.

These obligations to use IFRS or equivalent third country standards were originally intended to apply from the beginning of 2007. However, in the light of ongoing convergence programmes (in particular, the convergence work being carried out by the International Accounting Standards Board and the US standard setter, the Financial Accounting Standards Board), the Commission postponed its



In Brief

- The European Commission has adopted a Regulation setting out the basis and procedure for assessing the equivalence of third country GAAPs with IFRS.
- By 30 June 2008, the Commission will propose measures specifying those GAAPs of non-EU countries that are to be considered as equivalent to IFRS, with effect from 1 January 2009.
- CESR has issued a consultation paper proposing that US GAAP should be considered as equivalent. It also makes recommendations in relation to Japanese and Chinese GAAPs, and CESR will consult shortly on the equivalence of Canadian, South Korean and Russian GAAPs.
- The Regulation also gives the Commission the power to allow non-EU issuers to use non-equivalent GAAPs in the EU for a transitional period ending in 2011.

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The 2007 Regulation is welcome in that it offers greater certainty for third country issuers using GAAPs that are in the process of convergence with IFRS and for those whose national standard setter is to adopt IFRS.

equivalence assessments. Accordingly, in December 2006 it adopted a Regulation and a Decision which allow third country issuers to continue using certain third country accounting standards for financial information required under the Prospectus and Transparency Directives. These current exemptions, which apply to US, Canadian and Japanese GAAPs and to any other third country standards in respect of which there is a realistic programme to converge with IFRS, will expire at the end of 2008.

The 2007 Regulation: definition and assessment of equivalence

The Regulation and Decision adopted in December 2006 also require the Commission to take the necessary steps to ensure that equivalence assessments are made by the middle of 2008. The 2007 Regulation represents the first of those formal steps by defining equivalence and setting out the procedure by which the assessments will be made.

Third country standards will be regarded as equivalent to EU IFRS if they enable investors to make a similar assessment of the assets and liabilities, financial position, profit and losses and prospects of an issuer as would IFRS, with the result that investors are likely to make the same investment decision. This confirms that the approach will be outcome-based rather than requiring a line-by-line analysis of the difference between standards.

The equivalence of the accounting standards of a particular third country will be assessed by the Commission, either on its own initiative or in response to a request by a Member State competent authority, a third country market supervisor or the authority responsible for the standards. Prior to making a determination, the Commission will seek the advice of the Committee of European Securities Regulators ("CESR").

The recitals to the 2007 Regulation also advise that EU issuers should be able to use EU IFRS in a third country whose accounting standards are determined to be equivalent. In the original Commission proposal, a provision requiring reciprocity of this kind had been included in the draft Regulation itself. However, this was opposed by some Member States who were concerned that an insistence on reciprocity could harm EU markets by making them less attractive to foreign issuers. The provision has now been down-graded to a recital, but its political force remains to be seen. The issue remains controversial, with the European Parliament in particular likely to be vigilant that issuers from third countries do not receive more advantageous treatment in the EU than EU issuers do in the third countries in question.

Transitional exemptions under the new Regulation

The new Regulation also allows the Commission to adopt further measures permitting issuers to continue using financial statements drawn up in accordance with third country accounting standards that are not equivalent to EU IFRS for the purposes of the Prospectus and Transparency Directives after 1 January 2009 if one of three specified conditions is satisfied. Those conditions are:

1. before 30 June 2008, the relevant standard setter has made a public commitment to converge those standards with IFRS before the end of 2011, and has established a comprehensive and realistic convergence programme to that end that is properly resourced and effectively implemented;
2. before 30 June 2008, the relevant standard setter has made a public commitment to adopt IFRS before the

end of 2011, and effective measures are taken to secure the complete transition to IFRS by that date; or

3. before 31 December 2008 the third country concerned has reached a "mutual recognition agreement" with the EU.

It is not yet clear whether any exemptions will be granted on the basis of a "mutual recognition agreement" between a third country and the EU. Neither the Commission nor CESR has yet given any indication of whether eligible agreements exist. Any exemption granted under this provision cannot extend beyond the end of 2011, and may be revoked by the Commission before that date if the relevant condition on which it is based ceases to be satisfied (for example, if a convergence programme is no longer effectively implemented or a commitment to adopt IFRS is abandoned). Measures specifying which third country standards, if any, will benefit from a further exemption will be adopted in the latter half of 2008.

Future developments

The next significant step will be the adoption by the Commission of a Regulation stating which third country standards are already equivalent to EU IFRS. This must be done by the end of June 2008. Last month CESR issued a consultation paper which included the following proposals:

- that US GAAP should be considered as equivalent to IFRS;
- that Japanese GAAP should be considered equivalent unless the Accounting Standards Board of Japan fails to provide adequate evidence that it will achieve its stated convergence programme to timetable;
- that there is not yet sufficient evidence about the application of Chinese GAAP to consider it equivalent.

CESR suggests that the Commission should grant a transitional exemption in respect of this GAAP until there is sufficient evidence to enable a determination to be made.

A CESR consultation on the equivalence of other GAAPs (including Canadian, South Korean and Russian) is expected to follow shortly.

US developments: acceptance of IFRS for foreign private issuers

From the US perspective, a significant step forward in the 'roadmap' towards the convergence of international accounting standards also took place on 21 December 2007, when the SEC adopted a final rule on the acceptance from foreign private issuers of financial statements prepared in accordance with IFRS for financial years ending after 15 November 2007. The new rule will come into effect on 4 March 2008 and can be seen as the first step towards a single global accounting standard based upon IFRS. It should be emphasised, however, that the new rule applies only to IFRS, as issued by the IASB, and will not necessarily apply to EU IFRS to the extent that it differs from IASB standards. This is a matter of concern to the European Commission, which will continue to press the SEC to accept the use of EU IFRS by EU issuers for US regulatory filings.

Final comments

The 2007 Regulation is welcome in that it offers greater certainty for third country issuers using GAAPs that are in the process of convergence with IFRS and for those whose national standard setter is to adopt IFRS. These issuers can now expect to be permitted to use financial statements drawn up in accordance with such a GAAP until 2011 or the completion of the convergence project or adoption of IFRS (if earlier).

Non-EU issuers using US GAAP can be reasonably certain that they will be able to continue to use their financial information

without restatement to comply with EU disclosure requirements after the end of 2008. It is highly likely that the Commission will decide that US GAAP is equivalent to EU IFRS. In the unlikely event that US GAAP is not equivalent, it would almost certainly be the subject of an extended exemption. This could be based on the convergence work between the IASB and the FASB. Alternatively, an exemption might be justified by a "mutual recognition agreement" based on the change in SEC rules to allow the use of IFRS financial statements by foreign private issuers, although the application of the new SEC rule to IFRS as issued by the IASB, but not necessarily to EU IFRS, might prove an obstacle.

However, those third country issuers using accounting standards that are unlikely to benefit from an exemption, and that are not the subject of the current or projected CESR consultation, may face the need to restate their accounts for EU regulatory disclosures (choosing either IFRS or US or another GAAP which can be considered to be equivalent). If they do not restate their accounts, such issuers might consider whether to lobby their standard setter to apply for an equivalence assessment. Alternatively, such issuers might avoid possible restatement requirements entirely by accessing EU markets in a way that does not trigger obligations under the Prospectus Directive and the Transparency Directive. For example, securities can be admitted to trading (without a general public offer) on a listed, "exchange-regulated market" such as the LSE's Professional Securities Market (PSM), or the Euro MTF market of the Luxembourg Stock Exchange. These markets fall outside the scope of the Prospectus and Transparency Directives and the applicable exchange rules do not require the use of IFRS or an EU approved equivalent standard for financial information either in listing documents or under their continuing reporting obligations.

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