



FEE DISCUSSION PAPER
Reporting Issues in relation to
Endorsed IFRS and Possible Implications
for the Audit Report

FOR COMMENT AND RESPONSE
BY 31 MAY 2005

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1. INTRODUCTION

The IAS Regulation (EC No. 1606/2002) requires European listed companies to prepare consolidated financial statements from 2005 (or 2007 in some situations) on the basis of international accounting standards, defined as those IFRS that have been endorsed by the European Commission.

Both in the accounting policies and in the audit report, reference needs to be made to the applicable financial reporting framework; but selecting appropriate text for such a reference is not as straightforward as might be assumed. Europe has moved to global standards and this should be reflected in descriptions of the EU financial reporting framework.

The European Commission supports global accounting standards and ideally the only differences between IFRS and “endorsed IFRS” should be timing differences in the endorsement of standards after the effective date of the standard. The IAS Regulation states in Recital 7: “*IFRS should wherever possible and provided that they ensure a high degree of transparency and comparability for financial reporting in the Community, be made obligatory for use by all publicly traded Community companies*”. FEE published in June 2004 a position paper “Call for Global Standards: IFRS”. FEE is strongly committed to high quality, global financial reporting standards that are neutral and principles-based.

The potential delay between the effective date of an IFRS or IFRIC interpretation and its endorsement in Europe means that “endorsed IFRS” may deviate from “IFRS” (see also Chapter 4.1 below). Moreover, the endorsement of IAS 39 in November 2004 with two carve outs creates a situation where “endorsed IFRS” are different from “IFRS” to the extent the carve outs are applied by a particular company (see Appendix 1 for a more detailed analysis). The reporting implications in relation to both the accounting policies and the audit report need to be considered, in particular how the financial reporting framework should be referred to in a way that is transparent, technically sound and clear to users of the financial statements.

Endorsed IFRS are part of EU regulations. By being part of the law, endorsed IFRS have a different status and authority from IFRS, being the standards of a private body. This difference also plays an important role in the enforcement of the standards.

Companies will in most cases be able to apply full IFRS if they do not choose to use the carve out and adopt new standards in accordance with the transitional arrangements specified in the IFRS, rather than waiting for endorsement. It may be difficult for preparers whose accounts comply with EU requirements but not with all IFRS to make a clear and unambiguous reference to IFRS. Some regard this as a minor issue. If a company has prepared its accounts under endorsed IFRS then both the management and investors will expect it to be able to refer to IFRS. However, there is a risk that investors will be misled, particularly when the accounts of EU companies are used outside the EU where the technicalities of endorsement may not be well understood. It is this risk that is addressed in this paper.

The following questions need to be considered:

- How should the financial reporting framework be referred to in the accounting policies in the notes to the financial statements?
- When the company also complies with full IFRS, should it refer to this fact?
- How should the framework be described in the audit report? Can there be a difference in description compared to the reference to the financial reporting framework in the accounting policies?
- Would the reference to the European financial reporting framework have a clear meaning outside the EU?

In order to meet the objective of transparency for users of financial statements, further guidance is needed for both the accounting policies and the audit report. The European Commission has provided guidance in its 2003 paper concerning certain articles of the IAS Regulation and Fourth and Seventh Directives and the 'Frequently Asked Questions' of November 2004. The IAASB is the appropriate body to issue global audit guidance. It is less clear which body should issue guidance for preparers as far as the accounting policies are concerned.

There is no requirement for a preparer that has applied endorsed IFRS to explain how, if at all, its accounting policies differ from full IFRS (although the accounting policies applied need to be specified). This is a key issue of transparency which will be particularly relevant if the financial statements of European companies are to be used outside the EU.

A further issue is the application of IFRS 1: the relevant Regulation (EC No. 2086/2004) indicates in Article 1.2 that using the carved-out version of IAS 39 does not prevent companies in Europe from using IFRS 1. Other issues addressed in this Discussion Paper include the use of other IFRS not yet adopted for use in Europe; whether there are particular problems in relation to the individual accounts; SEC filing requirements; and interim reporting.

In addressing the various issues at stake and demonstrating their complexity, FEE seeks primarily to stimulate debate and questions in relation to these issues at European and global level. Whilst the Discussion Paper may provide some form of interim guidance, by collecting views of respondents FEE seeks to assess whether a consensus can be achieved. Some form of European guidance may therefore follow the analysis of the comments and responses to the Discussion Paper. The analysis will also be passed to the IAASB for the Board to consider whether international guidance for auditors is appropriate.

Comments on the Discussion Paper and responses to the questions raised are sought by **31 May 2005** and should be submitted by email to Saskia Slomp of the FEE Secretariat: saskia.slomp@fee.be.

2. ACCOUNTING POLICIES

Financial statements need to refer to the applicable financial reporting framework. The IAS Regulation requires EU listed companies to use international accounting standards for their 2005 consolidated financial statements (for some companies only from 2007). Article 4 states:

*“For each financial year starting on or after 1 January 2005, companies governed by the law of a Member State shall prepare their consolidated accounts **in conformity with the international accounting standards adopted in accordance with the procedure laid down in Article 6(2)** if, at their balance sheet date, their securities are admitted to trading on a regulated market of any Member State ...” [Emphasis added]*

“Article 6(2) sets out the legislative mechanism (and criteria) under which an international accounting standard is adopted.”

“International accounting standards” are defined in Article 2 of the IAS Regulation as *“International Financial Reporting Standards (IFRS) and related Interpretations (SIC-IFRIC interpretations), subsequent amendments to those standards and related interpretations, future standards and related interpretations issued or adopted by the International Accounting Standards Board (IASB).”*

It is interesting that the term “international accounting standards” is given lower case letters and not used as a proper noun. Some suggest it is drafted in this way in the IAS Regulation in order not to provide a direct reference to IFRS but to use a term that is qualified by the need for EU endorsement.

IFRS require disclosures regarding accounting policies. IAS 1.8* requires the notes to include a summary of significant accounting policies. IAS 1.14* requires a statement of compliance with IFRS, and IAS 8.30* requires disclosures about new standards and interpretations issued but not yet effective that have not yet been applied, including reasonable information on the possible impact of the new standard or interpretation.

The European Commission has addressed the issue of how the financial reporting framework should be referred to in the accounting policies on two occasions.

The Commission paper of November 2003, ‘Comments concerning certain articles of the IAS Regulation and Fourth and Seventh Directive’, states:

“The legal requirement in the IAS Regulation is for the accounts to be prepared in accordance with adopted IASs i.e. IASs endorsed by the EU. It is therefore appropriate that this should be made clear in the accounting policies. Following the change of name from International Accounting Standards to International Financial Reporting Standards and consistent with the guidance contained in the ‘Preface to Statements of International Accounting Standards’, such a statement should refer to the financial statements having been prepared ‘... in accordance with all International Financial Reporting Standards adopted for use in the European Union’. However, if the application of adopted IFRSs results in financial statements that also comply with all IFRSs, because no standards have been rejected and all standards issued by the IASB have been endorsed, then it would not be necessary to state “adopted for use in the European Union”, but simply ‘... in accordance with all International Financial Reporting Standards’.”

The November 2003 paper, prepared by the EC services and approved by the ARC, did not foresee the situation of carve outs. Following the announcement of the IAS 39 carve out, the European Commission issued ‘Frequently Asked Questions’ (also approved by the ARC) on 19 November 2004 and included the following material on accounting policies:

* For full quotation see Appendix 2.

“What should a company state in its accounting policies, when it applies the carved-out version of IAS 39? Does the company have to refer to IFRS or to IFRS as adopted by the European Commission?”

Companies that apply the carved out version of IAS 39 should refer in their accounting policies to IFRS “as adopted by the EU”. They should accordingly explain their accounting policies in their financial statements. This principle was already explained in the Commission’s “Comments concerning certain Articles of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards and the Fourth Council Directive 78/660/EEC of 25 July 1978 and the Seventh Council Directive 83/349/EEC of 13 June 1983 on accounting” as released in November 2003.

Accordingly, the auditor should refer in its auditor’s report to the basis on which the accounts have been prepared and is hence in a position to give an unqualified opinion.”

The preferred European Commission wording has changed from “in accordance with all IFRS adopted for use in the EU” to IFRS “as adopted by the EU”.

Some believe that the reference to IFRS is inappropriate, given the text of IAS 1.14: “Financial statements shall not be described as complying with IFRS unless they comply with all requirements of IFRS”¹. However, others argue that IFRS “as adopted by the EU” is not “an explicit and unreserved statement of such compliance” and so is not prevented by IAS 1.14, since the reference to IFRS is qualified.

Further evidence of the first interpretation of the text of IAS 1.14 can be found in IFRS 1² on first time adoption, where it is stated that “financial statements under IFRS are an entity’s first IFRS financial statements if, for example, the entity presented its most recent financial statements containing an explicit statement of compliance with some, but not all, IFRSs”.

IAS 1 was developed before the EC endorsement mechanism was in place and IFRS 1 was developed at a time when the EC endorsement mechanism had not yet resulted in carve outs. The IASB has so far not commented on whether IAS 1.14 could be interpreted as covering IFRS endorsed by the EC.

The preferred wording for the accounting policies to describe compliance with IFRS as adopted by the EU therefore needs to be discussed. Three possibilities have been suggested for the reference to the EU legislative framework:

- a. In accordance with IFRS as adopted by the EU (the European Commission’s suggestion).
- b. In accordance with accounting standards as adopted by the EU.
- c. In accordance with international accounting standards as adopted by the EU.

FEE has noted that much of this debate has arisen from the need to find a short form of words to describe the framework. As an alternative, we suggest a fuller wording as option (d) based on a reference to the standards rather than to the framework, as follows:

- d. In accordance with all those International Financial Reporting Standards that have been adopted by the EU and that apply to the company.

We discuss each of these possibilities below.

¹ For full quotation see Appendix 2.

² For full quotation see Appendix 2.

a) In accordance with IFRS as adopted by the EU

This is the wording provided by the European Commission. Some regard the recommendation of the Commission as the only possible wording for the accounting policies, given that it provides the Commission's own interpretation. It is also the wording that is most familiar to users of accounts having been under discussion, and in limited use, for longer than the alternatives. Those who take a high level view of this issue, which is likely to include many preparers and users of accounts, would expect a form of words that refers to IFRS.

However, even if one accepts the argument set out above that a qualified reference to IFRS is not prohibited by IAS 1.14, the construction has two further shortcomings:

- Some may be misled by the ambiguity of the phrase “IFRS as adopted by the EU”. It can be read either as “those IFRSs which have been adopted by the EU”, which would be correct, or as “IFRS, which has been adopted by the EU”, which would not. If this is not clear in English, we also foresee translation problems in other languages.
- Internationally, the term “IFRS as adopted by” a particular authority could mean anything from a small number of standards or statements to the whole body of IFRS. A country that chose to adopt only a part of IFRS may cite the EU approach as a precedent for use of the term when it would be very misleading. How different from IFRS could “IFRS as adopted by” in a country be before it became misleading?

b) In accordance with accounting standards as adopted by the EU

This reference would have the technical advantage that it avoids referring to IFRS, and thereby does not enter into the debate as to whether “IFRS” can be used given the requirements of IAS 1.14 and IFRS 1, as discussed above. However, as also discussed above, there are many users of accounts who would not understand the omission of a reference to “IFRS”. Moreover, the reference is close to the wording suggested by the Commission of “as adopted by the EU”. However, the wording could potentially be interpreted as referring to the Accounting Directives rather than to IFRS, and might be misleading from this point of view.

Many believe that the phrase “accounting standards as adopted by the EU” would only be well understood by a specialist readership and that a more detailed explanation needs to be given in the notes to the accounts. This highlights the importance of a detailed description of the accounting policies and framework as a means of providing clarity to the users of the financial statements. One other disadvantage is that the reference does not use the term “international”.

c) In accordance with international accounting standards as adopted by the EU

This reference would be even closer to the text of the IAS Regulation and has in addition all the advantages referred to under (b) “accounting standards as adopted by the EU”. The question of a breach of IAS 1.14 does not arise since it is not using the term “IFRS”. However, some might simply think it uses an out of date term for IFRS, albeit with lower case letters, and those who believe “international accounting standards” and IFRS are the same will suffer the ambiguity described in relation to (a). Some may also understand “international accounting standards” to refer to international accounting standards other than IFRS, such as US GAAP.

d) In accordance with all those International Financial Reporting Standards that have been adopted by the EU and that apply to the company

An alternative to the earlier options would be to use a longer form of wording, by making explicit reference to all applicable standards rather than to the framework as a whole. In this construction the word “*all*” is added to give greater weight to the expression and to provide assurance to the reader that all adopted standards have been considered. The restriction to applicable standards is necessary because some adopted standards may not apply to a company’s business. This form of wording does not suffer the shortcomings of the options above. It can be translated into many languages with minimal risk of misunderstanding. The main shortcoming is that it is a longer form of words which loses the simplicity of the other alternatives so that users without a financial reporting background may not understand the significance of the terms used.

If a longer form of words is considered to be the best solution in principle, it should be noted that there are further alternatives to consider. For example, the applicable accounting framework could be referred to by a precise reference to the IAS Regulation and related regulations. However, the more technically correct the phrase, the more difficult it becomes to communicate to the non-specialist reader.

Issues to consider

- 1. How should companies refer to the financial reporting framework used in preparation of their financial statements? Do you favour (a) “in accordance with IFRS as adopted by the EU”, (b) “in accordance with accounting standards as adopted by the EU” or (c) “in accordance with international accounting standards as adopted by the EU”? Alternatively would you favour the longer form of words (d) “in accordance with all those International Financial Reporting Standards that have been adopted by the EU and that apply to the company”?**
- 2. Which would be the appropriate body in Europe or internationally to issue guidance on how the financial reporting framework should be referred to in the accounting policies in the notes to the accounts?**

For the remaining part of this Discussion Paper, we use the term “in accordance with endorsed IFRS”, as a convenient term which does not imply any preference for options a), b), c), or d).

Disclosure of departure from full IFRS

For new standards and interpretations issued but not yet effective and not yet applied, IAS 8.30 requires the possible impact to be disclosed. Companies might also be expected to disclose the difference between endorsed IFRS and full IFRS. There is however no requirement in this respect. Many see it as a key issue of transparency that a preparer that has applied endorsed IFRS explains how, if applicable, its accounting policies differ from full IFRS. Such an explanation could be in narrative form if the relevant data was not available to permit an explanation in numerical form. Some also believe this disclosure to be particularly significant when a preparer has chosen not to apply full IFRS as a matter of preference. They believe the reasons for this choice should be clearly disclosed.

Explanation of the difference might be particularly relevant if the financial statements of EU companies are to be used outside the EU. A number of European securities regulators have emphasised the importance of users understanding departures from full IFRS.

Issue to consider

3. Should a requirement for preparers to provide an explanation as to how their policies depart from full IFRS be introduced? If so, by whom?

Companies in compliance with full IFRS and endorsed IFRS

When companies are in a situation where they comply with full IFRS³ as well as with those standards as adopted in the EU, to what extent are they allowed to make clear that they are in full compliance with all IFRS? In this situation, the financial reporting framework could be referred to as follows:

- In accordance with endorsed IFRS (whatever would be preferred solution of options a), b), c), or d)).
- In accordance with IFRS
- In accordance with IFRS and (or “including”) endorsed IFRS.

EU listed companies are required to prepare their financial statements in accordance with endorsed IFRS and should therefore at a minimum be expected to confirm compliance with the EU legislative framework. The question is whether it is possible to refer only to “in accordance with IFRS” without mentioning adoption in the EU, in the case of full compliance with all IFRS. The Commission’s November 2003 paper seems to suggest that this is possible, but states “and all standards issued by the IASB have been endorsed”, which could be interpreted as a condition. In the ‘Frequently Asked Questions’ document of November 2004, this possibility is no longer mentioned. Companies are likely to prefer to refer to “in accordance with IFRS” when their financial statements are used outside the EU, particularly to meet market expectations or requirements of the SEC.

However, full compliance may occur in one year but not in subsequent years due to new types of transaction or the timing of adoption of new IFRS. On the latter point, the IASB could help by allowing sufficient time for endorsement processes when setting the effective dates of new standards and interpretations. Often companies will be able to apply full IFRS⁴ by early adoption of IFRS that are not yet endorsed, as long as there is no conflict with the Accounting Directives or existing endorsed IFRS (see Chapter 4.1).

Reference to IFRS only may not provide a clear enough statement that the obligation of compliance with the legislative financial reporting framework has been fulfilled. If a simple reference to IFRS is not possible and companies have to refer to “in accordance with endorsed IFRS”, they may wish in addition to state that their financial statements are “in accordance with IFRS”. Some argue that reference to two sets of standards would be very confusing to the reader: they are of the opinion it is sufficient that the notes to the financial statements explain the accounting policies used. An alternative approach might be to use a longer form of wording referring to the individual standards and making clear that these include those standards that have been adopted by the EU.

³ As described under IAS 1.14 to mean compliance with all the requirements of IFRS.

⁴ Full IFRS usually includes endorsed IFRS, unless there are such differences between a new (not yet endorsed) standard and an existing endorsed standard that one cannot apply both. This situation is not further examined in this paper.

Companies should consider that, even if they are currently in compliance with endorsed IFRS and IFRS, it is possible that concurrent compliance may not be possible in the future (although early adoption of new standards and interpretations will often be possible). Companies should consider the impact of reporting compliance with full IFRS in one year and the risk of then being obliged to drop that reference in a later year. It may be better either to refer only to endorsed IFRS or to be explicit that compliance with full IFRS only arises because of the company's particular circumstances in that year.

Issues to consider

- 4. If companies are in full compliance with IFRS should companies be able to refer to the financial reporting framework:

 - **I. In accordance with endorsed IFRS**
 - **II. In accordance with IFRS**
 - **III. In accordance with IFRS and (or “including”) endorsed IFRS?****
- 5. If III is opted for, should companies provide an explanation as to why they are in compliance with both?**
- 6. If a company is in full compliance with IFRS, should it be obliged to say so when referring to the applicable framework?**
- 7. What is the preferred form of words in the accounting policies if compliance with full IFRS cannot necessarily be maintained in later years?**

The discussion above relates to situations where differences between full and endorsed IFRS are not relevant to the company, or where the company is able to adopt early, unendorsed standards, parts of standards or IFRIC interpretations⁵ that are not in conflict with endorsed IFRS or the Accounting Directives. Situations where companies intend to adopt parts of IFRS or IFRIC interpretations that are not endorsed, and where adoption conflicts with the Accounting Directives, will generally arise in specialist areas and need to be considered on a case-by-case basis. The first such example is the use of the IAS 39 fair value option, which would be in conflict with the Accounting Directives. In order that this paper should focus on the general case rather than on such a specialised issue, we have treated such situations as outside its scope.

⁵ See Appendix 1.

3. AUDIT REPORTS AND OPINIONS

Both Article 51.a.1⁶ of the Fourth Directive and ISA 700 (Revised)⁷ require references in the audit report to the applicable financial reporting framework. In addition, where the financial reporting framework (e.g. IFRS) is supplemented - but not contradicted - by further regulatory requirements, ISA 700 (Revised) requires reference to both the framework and the requirements. Endorsed IFRS are the reporting framework legally applicable in the EU as discussed above.

International Auditing Practice Statement 1014 “Reporting by Auditors on Compliance with IFRS”⁸ addresses financial statements prepared in accordance with IFRS and a national financial reporting framework. It requires the auditor to consider compliance with each framework individually and, in the report, to refer to both frameworks. If the company refers to two frameworks but has complied with only one (with for example a reconciliation to the second framework), the audit report would need to be qualified over non-compliance with the second framework.

Applying these requirements to the subject of this discussion, it is clear that the audit report should refer to the same frameworks as the company’s accounting policies, assuming of course that this reference is not misleading. Where the only framework applied is endorsed IFRS, this is the required reference. Where the financial statements comply both with IFRS and with endorsed IFRS, the report should refer to both frameworks. However, if the company uses an ambiguous form of words that suggests compliance with both frameworks when this is not the case, the auditor will need to include a qualification relating to the non-compliance.

The wording used in the accounting policies may supplement the reference to the framework with more detail, for instance in describing the use of the carve outs and as yet unendorsed standards. The audit report may use simplified, shorter wording for the reference to the financial reporting framework and, although this does not need to be identical, it must be clear to the reader that the accounts have been prepared and audited under the same financial reporting framework.

It should also be noted that national law in some Member States may also impose additional accounting requirements. For example, in some countries the auditors also report on the parent company accounts, which may be prepared under national laws and accounting standards. In these circumstances, the auditor will be faced with the need to consider compliance with up to three frameworks and to report on each.

Companies and their auditors may instead consider it more straightforward to have separate audit reports on each of the financial reporting frameworks under which they report - for instance endorsed IFRS or IFRS and US GAAP for consolidated accounts and local GAAP for the individual accounts.

Some maintain that, if a company uses a certain reference to the applicable financial reporting framework in its accounting policies, the audit report also needs to refer to the applicable financial reporting framework in the same way. Otherwise it would be very confusing for the reader of the financial statements.

Others believe that there is no need for the accounting policies describing the applicable financial reporting framework in the notes to the accounts and in the auditor’s report to be the same. Under this approach, the notes to the accounts can include a longer-form discussion explaining the framework

⁶ As introduced by the Modernisation Directive (2003/51/EC).

⁷ For full quotation see Appendix 2.

⁸ For full quotation see Appendix 2.

adopted, whereas the audit report is not the appropriate location for more than a brief identification of the framework. The audit report could, for example, include a cross reference to the note to the accounts where further detail is given. In these circumstances, the question arises as to whether audit reports should use a standard, generally accepted reference to the framework, regardless of the wording and further description in the accounting policies, or whether the audit report text can be tailored, at least in the introductory paragraph, so that it is consistent with the text used by the company.

Issues to consider

- 8. Should audit reports be required to use a standard, generally accepted phrase to refer to the framework applied in the EU?**
- 9. Should the reference to the financial reporting framework be the same in the notes to the accounts as in the audit opinion or are differences acceptable?**
- 10. If your answers to 8 and 9 lead to a conflict (e.g. a standard phrase that has not been applied in the notes to the accounts), which of the two is more important?**

4. OTHER ISSUES

4.1. *Other IFRS not (yet) adopted for use in Europe*

There may be a delay between the effective date of an IFRS and the adoption of the IFRS in Europe (approximately 9 months). In addition, there may be future cases where an IFRS or an IFRIC interpretation is not endorsed. In those cases where there is a conflict with an endorsed standard or with the Accounting Directives, it is impossible to use a standard in advance of its adoption for use in Europe or to use a non-endorsed standard or a non-endorsed interpretation.

The November 2003 EC paper states in this respect (2.1.3, ‘IASs not yet endorsed and IASs rejected by the EU’):

“Where it applies, the IAS Regulation requires that accounts be prepared in accordance with endorsed IASs i.e. IASs adopted by the EU further to the IAS Regulation. Accordingly, if a standard is not endorsed it is not required or in certain instances not permitted to be applied by a company preparing its accounts further to the IAS Regulation.”

To the extent that a standard which has not yet been endorsed by the EU is not inconsistent with endorsed standards and is consistent with the conditions set out in IAS 1 paragraph 22 it may be used as guidance.”

The specific situations that can occur in relation to the reference in the accounting policies are described above in Chapter 2.

4.2. *IFRS 1*

Regulation No. 2086/2004 states in Article 1.2:

“Companies shall be regarded as “first time adopters” in accordance with paragraph 1. Reference in IFRS 1 to IAS/IFRS shall be construed as references to IAS/IFRS as adopted by the Commission on the basis of Regulation (EC) No 1606/2002.”

In the ‘Frequently Asked Questions’ of November 2004 the issue is also addressed, as follows:

“Can first time adopters who apply IAS 39 as endorsed in the European Union take advantage of the exemptions laid down in IFRS 1?”

Yes, companies that prepare for the first time their financial statements in accordance with international financial reporting standards (IFRS) and apply IAS 39 in the version annexed to this Regulation should be considered as “first time adopters” in accordance with IFRS 1. The purpose of IFRS 1 is that costs for the transition towards full IAS/IFRS should not outweigh the benefits for the users of financial statements. This reasoning continues to apply in the case of moving towards full application of IAS/IFRS as endorsed under the IAS Regulation.”

“Accordingly, references in IFRS 1 to IAS/IFRS, which was adopted by Commission Regulation (EC) No 707/2004, have to be understood as references to IAS/IFRS as adopted on the basis of Regulation (EC) No 1606/2002. This has been explicitly laid down in Article 1 (2) of the Regulation on IAS 39 – rather than only in the preamble to the Regulation – in order to give legal clarity to the financial market.”

IFRS 1 applies when an entity adopts IFRS for the first time by an explicit and unreserved statement of compliance with IFRS. In general, IFRS 1 requires an entity to comply with each IFRS effective at the reporting date for its first financial statements.

So within Europe, due to the above-mentioned Regulation, IFRS 1 shall be used for first time appliers using the carved-out IAS 39.

The question remains as to whether or not IFRS 1 can also be used according to the requirements of stock exchanges and stock exchange supervisors outside Europe. Under the terms of IFRS 1, it can be used only if all IFRS are complied with. If a company uses the carve out of certain hedge accounting provisions, it is not applying IAS 39 in full and it cannot claim that all IFRS have been complied with. Hence IFRS 1 could not be used in the absence of the Regulation. This issue should be covered in discussions between the EC and the IASB/SEC.

Some also argue that IFRS 1 can be applied twice, once within the EU legal financial framework under the above-mentioned Regulation and once outside the EU framework when there is subsequently full compliance with all IFRS. However, this will cause problems with the transitional provisions, notably the retroactive application of certain standards such as IAS 39 will be difficult - if not impossible - to restore. In addition it may be very confusing for the reader. Others regard this issue as a purely theoretical one.

The UK accounting standard setter, the ASB, refers in its press release of 11 October 2004 to another potential problem when the carve-out IAS 39 may eventually be brought in line with a revised version of IAS 39: What should be done with the hedging requirements not applied so far in relation to comparative figures?

4.3. Individual and Consolidated Accounts

The IAS Regulation only requires the use of endorsed IFRS for certain consolidated accounts. There is a Member State option to extend the scope of the requirement to other companies or to allow the use of endorsed IFRS for other companies for both consolidated and individual accounts. No different situation exists here, and again the situations identified in Chapter 2 apply. A clear identification of the financial reporting framework is necessary. If the use of IFRS is allowed for the individual accounts, there is no need to refer to the Directives or national GAAP because the IAS Regulation “overrules” the Directives.

In many countries, separate audit opinions/reports are provided on the individual and consolidated accounts. The introduction to IFRS will in this respect not give rise to new reporting issues.

4.4. SEC Filing Requirements

Since companies are allowed to use IAS 39 unamended (but without the fair value option), the EC considers that convergence with US GAAP and SEC requirements is not relevant: compliance with full IFRS is a choice of the company. As application of full IFRS is possible, there are no SEC implications because companies that apply IAS 39 without reference to the carve outs may state that they are in compliance with full IFRS (and do not have to refer only to accounts prepared “in accordance with endorsed IFRS”).

For companies that choose to use the carved out version of IAS 39 and that wish to qualify for the proposed SEC exemption allowing two years' comparatives instead of the usual three, there is a possibility that these companies will have to prepare separate full IFRS accounts.

In the November 2004 'Frequently Asked Questions', a specific question is included addressing the issue:

“How does the Commission respond to concerns that the US SEC would not accept IAS financial statements as a basis for reconciliation to US GAAP in cases where a company applies IAS 39 as adopted by the European Commission?”

For the time being, European companies applying IFRS have to reconcile to US-GAAP whether they use full IFRS or IFRS as adopted by the European Commission. Since there is no full fair value option in US GAAP, there can be no grounds for asking for additional reconciliation on this issue from listed companies that must apply IFRS from 1 January 2005.

On hedge accounting, a company listed in the US may elect to apply the carved out provisions since there are no contradicting rules in the Accounting Directives. In any event, since the hedging provisions under IAS 39 are substantially different from those under US GAAP, companies would normally have to reconcile the effects of hedge accounting – whichever course is followed.

For this reason, the Commission considers that first time adopters applying IFRS as adopted by the European Commission should be eligible to benefit from the new SEC proposal that would permit foreign private users for their first year of reporting under IFRS to file two years rather than three years of statements of income, changes in shareholders' equity and cash flows prepared in accordance with IFRS, with appropriate related disclosure.”

The EC would need to negotiate with the SEC the formal recognition of this position.

4.5. Interim Reporting

In December 2003, CESR recommended in its publication on the application of IFRS in 2005, “Recommendation for Additional Guidance Regarding the Transition to IFRS”, that from 1 January 2005 any published interim financial statements should be prepared on the basis of endorsed IAS/IFRS. CESR states:

“Where the issuer is required to, or chooses to, present half-yearly and quarterly financial information, it is preferred that such information is prepared on the basis of the accounting framework to be applied at year end, i.e. the IAS/IFRS framework. In this approach, the issuer will then have the possibility to adopt one of the following alternative methods for the presentation of the interim information:

- *Either to fully comply with IAS 34 requirements⁹*
- *Or to present interim financial data as required by the national reporting rules and prepared on the basis of IAS/IFRS recognition and measurement principles which will be applicable at year end.”*

The Transparency Directive (2004/109/EC) will need to be implemented by Member States by 20 January 2007. The Directive addresses the requirements for half-yearly financial reports and an interim (quarterly) management statement. Once implemented, listed companies preparing consolidated accounts will need to prepare their half-yearly financial reports on the basis of IAS 34.

⁹ It is understood that IAS 34 “Interim Financial Reporting” is an optional standard. If it is applied, the company has to publish either a full set of financial statements (as complete as annual financial statements) or condensed financial statements under the conditions of the paras 9 and 10 of IAS 34.

The same issues as far as the accounting policies and review report arise as for the annual financial statements. As an alternative, reference might be made to IAS 34 instead of to “in accordance with endorsed IFRS”. This may even be more appropriate since IAS 34 sets out how IFRS are to be applied in the context of interim financial statements. In many countries the review report is not mandatory and only the issue of referring to the financial reporting framework arises.

APPENDIX 1 – ENDORSEMENT OF IAS 39 WITH TWO CARVE-OUTS

On 19 November 2004 the European Commission adopted a regulation endorsing IAS 39 “Financial Instruments: Recognition and Measurement” with the exception of certain provisions on the use of the full fair value option and or hedge accounting (the so called “carve outs”). The Commission also adopted a political declaration stating that it expects the IASB to bring forward the necessary amendments to the current full fair value option by December 2004 and to the provisions on hedge accounting by September 2005. Use of IAS 39, apart from the ‘carved out’ sections, will be legally binding for all listed companies in the EU from 1 January 2005.

The European Commission press release of 19 November 2004 describes the two carve outs:

- The carve out of the full fair value option is based on observations from the European Central Bank and prudential supervisors represented in the Basel Committee of banking supervisors. Article 42.a of the Fourth Company Law Directive (Directive 78/660/EEC) does not allow full fair valuation of all liabilities; the main category of liabilities excluded from fair valuation is companies fair valuing their own debt. Companies are therefore not allowed to use the full fair value option. Neither can Member States require mandatory use of the carved out fair value provisions.
- The carve out of certain hedge accounting provisions reflects criticism by the majority of European banks, which argued that IAS 39 in its current form would force them into disproportionate and costly changes both to their asset/liability management and to their accounting systems, and would produce unwarranted volatility. However, because there is no existing EU law on this issue, individual companies may apply the ‘carved out’ hedge accounting provisions. A Member State may also make these provisions mandatory under its national rules.

This means that as far as the carve out of certain hedge accounting provisions is concerned, a company is always allowed to use the unamended paragraphs of IAS 39, since IAS 39 is not rejected by reference to the European public good or true and fair view. Member States could go as far as mandating the use of these unamended paragraphs of IAS 39. However companies are not allowed to use the full fair value option since there is a conflict with Article. 42.a of the Fourth Directive (which should have been implemented by Member States by 1 January 2004).

Since the full fair value option is only an option in IAS 39 (and still subject to amendment, since the IASB has not yet decided on the exact text), companies have the option of complying fully with IAS 39 and thus with IFRS. The compromise solution as discussed at the IASB Round Table on the fair value option of 16 March 2005 has been well received. Therefore this carve out is expected to have only a very limited life.

Three situations can be distinguished:

- a) Companies that comply with IAS 39 (not using the carve out of certain hedge accounting provisions and not using full fair value option provisions, or for which these provisions are not applicable) and thus with IFRS: most companies will continue to prepare IFRS financial statements unaffected by the carve-out paragraphs.
- b) Companies that decide to use the carve out of certain hedge accounting provisions, i.e. “in accordance with endorsed IFRS”: they *cannot* claim to be in full compliance with IFRS.

- c) Companies that comply with IAS 39 *and* use the full fair value option provisions: these companies are in compliance with IFRS but their accounts are not “in accordance with endorsed IFRS” (for market information purposes only – since the situation is not allowed within the EU for statutory accounts).

This topic is addressed in the main part of this Discussion Paper.

A further instance of no-endorsement may occur in the case of IFRIC 3 ‘Emission Rights’. EFRAG published draft negative endorsement advice for public consultation on 22 February 2005. The same issue arises here as to what extent companies that wish to can apply IFRIC 3, as well as the related issues of compliance with full IFRS.

APPENDIX 2 – FULL QUOTATIONS OF RELEVANT ACCOUNTING AND AUDITING STANDARDS AND REQUIREMENTS

IAS 1.8: “A complete set of financial statements comprises:

- (a) a balance sheet;
- (b) an income statement;
- (c) a statement of changes in equity showing either:
 - (i) all changes in equity, or
 - (ii) changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders;
- (d) a cash flow statement; and
- (e) notes, comprising a summary of significant accounting policies and other explanatory notes.”

IAS 1.14: “An entity whose financial statements comply with IFRSs shall make explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with IFRSs unless they comply with all the requirements of IFRSs.”

IAS 1.103 (a) “The notes shall:

- a) present information about the basis of preparation of the financial statements and the specific accounting policies used in accordance with paragraphs 108-115;”

IAS 8.30: “When an entity has not applied a new Standard or Interpretation that has been issued but not yet effective, the entity shall disclose:

- (a) this fact; and
- (b) known or reasonably estimable information relevant to assessing the possible impact that application of the new Standard or Interpretation will have on the entity’s financial statements in the period of initial application.”

IFRS 1: “IN2 The IFRS applies when an entity adopts IFRSs for the first time by an explicit and unreserved statement of compliance with IFRSs.

[...]

3. An entity’s first IFRS financial statements are the first annual financial statements in which the entity adopts IFRSs, by an explicit and unreserved statement in those financial statements of compliance with IFRSs. Financial statements under IFRSs are an entity’s first IFRS financial statements if, for example, the entity:

- (a) presented its most recent previous financial statements:
 - (i) under national requirements that are not consistent with IFRSs in all respects;
 - (ii) in conformity with IFRSs in all respects, except that the financial statements did not contain an explicit and unreserved statement that they complied with IFRSs;
 - (iii) containing an explicit statement of compliance with some, but not all, IFRSs;
 - (iv) under national requirements inconsistent with IFRSs, using some individual IFRSs to account for items for which national requirements did not exist; or
 - (v) under national requirements, with a reconciliation of some amounts to the amounts determined under IFRSs;
- (b) prepared financial statements under IFRSs for internal use only, without making them available to the entity’s owners or any other external users;
- (c) prepared a reporting package under IFRSs for consolidation purposes without preparing a complete set of financial statements as defined in IAS 1 Presentation of Financial Statements; or
- (d) did not present financial statements for previous periods.”

The Fourth Directive, Article 51.a.1 states:

“The report of the statutory auditors shall include:

- a) *an introduction which shall at least identify the annual accounts that are the subject of the statutory audit, **together with the financial reporting framework that has been applied in their preparation;***
- b) *a description of the scope of the statutory audit which shall at least identify the auditing standards in accordance with which the statutory audit was conducted;*
- c) *an audit opinion which shall state clearly the opinion of the statutory auditors as to **whether the annual accounts give a true and fair view in accordance with the relevant financial reporting framework** and, where appropriate, whether the annual accounts comply with statutory requirements; the audit opinion shall be either unqualified, qualified, an adverse opinion or, if the statutory auditors are unable to express an audit opinion, a disclaimer of opinion;*
- d) *a reference to any matters to which the statutory auditors draw attention by way of emphasis without qualifying the audit opinion;*
- e) *an opinion concerning the consistency or otherwise of the annual report with the annual accounts for the same financial year.”*

ISA 700 (Revised) states:

- “39. *An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view or are presented fairly, in all material respects, **in accordance with the applicable financial reporting framework.***
40. *When expressing an unqualified opinion, the opinion paragraph of the auditor’s report should state the auditor’s opinion that the financial statements give a true and fair view or present fairly, in all material respects **in accordance with the applicable financial reporting framework** (unless the auditor is required by law or regulation to use different wording for the opinion, in which case the prescribed wording should be used).*
41. *When International Financial Reporting Standards or International Public Sector Accounting Standards are not used as the financial reporting framework, the reference to the financial reporting framework in the wording of the opinion should identify the jurisdiction or country of origin of the financial reporting framework.*
43. *To advise the reader of the context in which the auditor’s opinion is expressed, the auditor’s opinion identifies the applicable financial reporting framework on which the financial statements are based. When the applicable financial reporting framework is not IFRSs or International Public Sector Accounting Standards (IPSASs), the auditor’s opinion also identifies the jurisdiction or country of origin of the applicable financial reporting framework. The auditor identifies the applicable financial reporting framework in such terms as:*
 - *“... in accordance with International Financial Reporting Standards” or*
 - *“... in accordance with accounting principles generally accepted in Country X...”*
44. *When the applicable financial reporting framework encompasses legal and regulatory requirements, the auditor identifies the applicable financial reporting framework in such terms as:*

“...in accordance with International Financial Reporting Standards and the requirements of Country X Corporations Act.”

The independent auditor's report in ISA 700 (Revised) refers in the management responsibilities to IFRS. The opinion reads as follows:

Opinion

"In our opinion, the financial statements give a true and fair view of (or "present fairly, in all material respects") the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards."

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

IAPS 1014 states:

"5. A note describing the accounting policies used may state that the financial statements have been prepared in accordance with both IFRSs and a national financial reporting framework. For financial statements to have been prepared in accordance with more than one financial reporting framework, they must comply with each of the indicated frameworks individually. A set of financial statements that has been prepared in accordance with one financial reporting framework and that contains a note or supplementary statement reconciling the results to those that would be shown under another financial reporting framework has not been prepared in accordance with that other framework. This is because the financial statements do not include all the information in the manner required by that other framework. The financial statements must comply with both financial reporting frameworks simultaneously and without any need for reconciling statements if they are to be regarded as having been prepared in accordance with both. In practice, simultaneous compliance with both IFRSs and a national financial reporting framework is unlikely unless the country has adopted IFRSs as its national financial reporting framework or has eliminated all barriers for compliance with IFRSs.

7. If management insists on indicating that the financial statements have been prepared in accordance with both IFRSs and a national financial reporting framework, the auditor's report refers to both frameworks. However, the auditor considers each financial reporting framework separately. If a matter results in failure to comply with one of the frameworks, but does not cause a failure to comply with the other framework, then the auditor expresses an unqualified opinion on compliance with that framework and a qualified opinion or an adverse opinion on compliance with the one framework. If the auditor is of the opinion that the failure to comply with one of the financial reporting frameworks causes the financial statements to fail to comply with the other financial reporting framework, the auditor issues a qualified opinion or adverse opinion on compliance with both frameworks."

It also addresses financial statements prepared in accordance with a national financial reporting framework with disclosure of the extent of compliance with IFRS. A relevant paragraph in this respect:

"11. A note to the financial statements containing disclosure about compliance with IFRSs may not contain misleading information such that the financial statements fail to comply with the national financial reporting framework. If the auditor is of the opinion that a reference to compliance with IFRSs is not misleading, the auditor may express an unqualified opinion on compliance with the national financial reporting framework. In certain circumstances, the auditor may decide to modify the auditor's report by adding an emphasis of matter paragraph to highlight the note that references compliance with IFRSs. The use of an emphasis of matter paragraph is not a substitute for issuing a qualified opinion or adverse opinion on compliance with the national financial reporting framework when disclosures as to compliance with IFRSs are misleading such that the financial statements fail to comply with the national financial reporting framework."