



**International Federation of Accountants**

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# **Agenda Item**

# **J.1**

**Committee:** IAASB Consultative Advisory Group

**Meeting Location:** Toronto

**Meeting Date:** September 4-5, 2008

## **Applicable Financial Reporting Framework Described by Reference to Another Established Framework**

### **Objectives of Agenda Item**

1. The objective of this Agenda Item is to obtain the views of the Representatives on the proposed revised guidance in ISA 700 (Redrafted) dealing with an applicable financial reporting framework described by reference to another established framework, such as International Financial Reporting Standards.
2. This paper contains the relevant paragraphs from proposed ISA 700 (Redrafted), which is scheduled for approval at the June 2008 IAASB meeting (see IAASB CAG Reference Paper to Agenda Item D.3). It also contains the report back on comments raised by the Representatives on this matter at the March 2008 IAASB CAG meeting.

### **Task Force**

3. The ISA 700 (Redrafted) Task Force members are:

Diana Hillier – Chair, IAASB Member

Sylvia Smith – IAASB Technical Advisor

### **Background**

4. At the same time as applying the Clarity conventions to ISA 700 (Amended as a Result of ISA 800 (Revised)),<sup>1</sup> the IAASB proposed that it be amended to address the implications for the auditor's report of the increasing use of financial reporting frameworks described by reference to, but modified from, International Financial Reporting Standards (IFRS). The proposed amendment, which introduced new guidance on the auditor's evaluation of whether the financial statements adequately refer to or describe the applicable financial reporting

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<sup>1</sup> In October 2006, the IAASB approved the Close Off Document of ISA 800 (Revised), "Special Considerations—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement" and related conforming amendments in the "old style" (i.e., following the IAASB's current drafting conventions).

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framework, was included in the exposure draft of proposed ISA 700 (Redrafted)<sup>2</sup> (published November 2007).

5. The main element of the proposal was that, if the applicable financial reporting framework is described in the financial statements as being a modified version of another established framework (e.g., “IFRS as adopted in [Jurisdiction X]”), the auditor’s evaluation of the adequacy of the description includes consideration of whether the description may be misleading if there is insufficient transparency about the differences between the applicable financial reporting framework and the other established framework. The proposal followed closely the proposed amendment to International Accounting Standard (IAS) 1<sup>3</sup> in the Annual Improvements Exposure Draft of the International Accounting Standards Board (IASB) (published October 2007) (see Appendix 1), though it also sought to generalize the relevant consideration to other frameworks.

#### *International Accounting Standards Board*

6. In June 2008, IAASB staff reported to the IAASB that the IASB had approved thirty-five of the forty-one amendments proposed as part of its Improvements project. The proposed amendment to IAS 1 did not form part of the approved amendments. After publishing the approved amendments in May 2008, the IASB staff planned to reassess the scope and process for future improvements before taking the six excluded amendments to the IASB for redeliberation.

#### *International Organization of Securities Commissions (IOSCO)*

7. In February 2008, the Technical Committee of IOSCO issued a Statement on Providing Investors with Appropriate and Complete Information on Accounting Frameworks Used to Prepare Financial Statements, which dealt with the matter of financial reporting frameworks described with reference to IFRS (see Appendix 2).

#### *Responses to IAASB’s Proposal in Exposure Draft of Proposed ISA 700 (Revised and Redrafted)*

8. Responses to the IAASB’s proposal in the exposure draft of proposed ISA 700 (Revised and Redrafted) were mixed. Those who did not support it were concerned that the threshold that would trigger a reporting response was too low and, as a result, would lead to a proliferation of either Emphasis of Matter paragraphs or qualified opinions. In addition, some were concerned that the focus on whether the description “could be misleading” could be interpreted as implying that the underlying financial information in the financial statements (e.g., the entity’s reported financial position, results and cash flows) was misleading; however,

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<sup>2</sup> Exposure draft of proposed ISA 700 (Redrafted), “The Independent Auditor’s Report on General Purpose Financial Statements.”

<sup>3</sup> International Accounting Standard (IAS) 1, “Presentation of Financial Statements.”

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this was never the intent. Some were concerned that the proposal would necessitate onerous quantification of the differences, or posed practical difficulties if management did not have an obligation to make such disclosures.

9. The IAASB CAG discussed a preliminary analysis of the abovementioned responses in March 2008.
10. The IAASB reviewed the comments on the exposure draft, the Representatives' comments, and a proposed revised ISA in June 2008. The IAASB noted that the auditor's evaluation of the adequacy of the description of the applicable financial reporting framework includes consideration whether there is a risk that users may misunderstand the basis on which the financial statements are prepared. If the applicable financial reporting framework is described by reference to another established framework, users may mistakenly assume that the applicable financial reporting framework is the same as, or at least very similar to, the other established framework. If the differences between the applicable financial reporting framework and the other established framework are not significant in the context of the entity's financial statements, users are unlikely to misunderstand the basis on which the financial statements are prepared. If the differences are significant in the context of the entity's financial statements, there is a risk that users may misunderstand the basis on which the financial statements are prepared. However, such risk is reduced when there is transparency about the applicable financial reporting framework and how it differs from the other established framework.

#### Revised Proposed Guidance to Be Presented at the September 2008 IAASB Meeting

11. The Task Force revised the proposed guidance to focus on the risk that users may misunderstand the basis on which the financial statements are prepared. In summary **(see extract from proposed ISA 700 (Redrafted)<sup>4</sup> that follows the bullets below)**:
  - Paragraphs A11-A12 explains the risk of misunderstanding.
  - Paragraph A13 explains that the risk of misunderstanding is likely to be lower if the differences between the applicable financial reporting framework and the other established framework are likely to be known and understood by intended users since the authorized or recognized standards setting organization, or the relevant legislator or regulator, has identified the differences as part of an established and transparent development process involving deliberation and consideration of the views of a wide range of stakeholders; and the financial statements are likely to be used primarily within the particular jurisdiction. Paragraph A38 indicates that, in such circumstances, if the risk of misunderstanding is in fact low the description of the applicable financial reporting framework is adequate without further explanation.

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<sup>4</sup> Proposed ISA 700 (Redrafted), "Forming an Opinion and Reporting on Financial Statements."

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- Paragraph A14 provides examples of how the risk of misunderstanding can be reduced. The first is that management may be able to describe the applicable financial reporting framework without reference to the other established framework; paragraph A38 explains that, in these circumstances, the description of the applicable financial reporting framework is adequate without further explanation.
- The other example in paragraph A14 of how the risk of misunderstanding might be reduced is that the financial statements may include a description of the differences between the applicable financial reporting framework and the other established framework that are significant in the context of the entity's financial statements.
- Paragraphs A39 and A40 deal with the circumstances where the applicable financial reporting framework has to be described by reference to the other established framework. Paragraph A40 explains that, if the differences between the applicable financial reporting framework and the other established framework are not significant in the context of the entity's financial statements, the description of the applicable financial reporting framework without further explanation is likely to be adequate. In this case, intended users are unlikely to misunderstand the basis on which the financial statements are prepared because the financial statements would be substantially the same whether they were prepared in accordance with the applicable financial reporting framework or the other established framework.
- Paragraph A40 explains that, if the differences between the applicable financial reporting framework and the other established framework are significant in the context of the entity's financial statements, the auditor's evaluation of the adequacy of the description of the applicable financial reporting framework involves consideration of whether the financial statements include a description of the differences. It contains the following examples:
  - If the financial statements include a description of the differences, the risk of misunderstanding is reduced and, accordingly, the description of the applicable financial reporting framework is likely to be adequate.
  - If the financial statements do not include a description of the differences, the auditor may conclude, in accordance with ISA 706 (Revised and Redrafted),<sup>5</sup> that it is necessary to draw intended users' attention to the applicable financial reporting framework, noting that differences between the applicable financial reporting framework and the other established framework may be significant in the context of the entity's financial statements and, therefore, also to an understanding of the context in which the auditor's opinion is expressed.

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<sup>5</sup> ISA 706 (Revised and Redrafted), "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report."

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- In extreme cases, the differences may be so significant in the context of the entity's financial statements that there is an unacceptably high risk that intended users may misunderstand the basis on which the financial statements are prepared. In some cases, this may be so even if the financial statements include a description of the differences. If the auditor concludes, in such circumstances, that the reference to the other established framework in describing the applicable financial reporting framework is misleading, the auditor would express a modified opinion in accordance with ISA 705 (Revised and Redrafted).

#### **Extract from Proposed ISA 700 (Redrafted) to Be Presented at the September 2008 IAASB Meeting** **Revised Proposed Guidance Dealing with An Applicable Financial Reporting Framework Described by Reference to Another Established Framework**

##### **Requirement**

15. The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework. (Ref: Para. A5-A14)

##### **Application and Other Explanatory Material**

##### *Financial Reporting Framework Described by Reference to Another Established Financial Reporting Framework*

- A11. An authorized or recognized standards setting organization, or relevant law or regulation, may describe the applicable financial reporting framework by reference to the financial reporting framework of another authorized or recognized standards setting organization (the "other framework"). For example, the applicable financial reporting framework might be described as "International Financial Reporting Standards as adopted by [industry supervisor or regulator] for the use of [industry] in [jurisdiction X]."
- A12. In such circumstances, users may mistakenly assume that the applicable financial reporting framework is the same as, or at least very similar to, the other framework. Therefore, when there are differences between the applicable financial reporting framework and the other framework that are significant in the context of the entity's financial statements, there is a risk that users may misunderstand the basis on which the financial statements are prepared. For example, if the applicable financial reporting framework omits the financial reporting standard of the other framework on accounting for the effect of hyperinflation, and the entity has significant components that operate in a hyperinflationary environment, the effect of such a difference on the entity's financial statements is likely to be significant.
- A13. The risk of misunderstanding is likely to be lower if:
- The differences between the applicable financial reporting framework and the other framework are likely to be known and understood by intended users since the authorized or recognized standards setting organization, or the relevant legislator or regulator, has identified the

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differences as part of an established and transparent development process involving deliberation and consideration of the views of a wide range of stakeholders; and

- The financial statements are likely to be used primarily within the particular jurisdiction.

A14. In other circumstances, the risk of misunderstanding can be reduced if, for example:

- Management is able to describe the applicable financial reporting framework without reference to the other framework (e.g., “Financial Reporting Standards of [jurisdiction X]”); or
- The financial statements include a description of the differences between the applicable financial reporting framework and the other framework that are significant in the context of the entity’s financial statements.

A36. As indicated in paragraph A10, the financial statements may represent compliance with the applicable financial reporting framework and, in addition, disclose the extent of compliance with another financial reporting framework. As explained in paragraph A53, such supplementary information is covered by the auditor’s opinion as it cannot be clearly differentiated from the financial statements.

- (a) If the disclosure as to the compliance with the other framework is misleading, a modified opinion is expressed in accordance with ISA 705 (Revised and Redrafted).
- (b) If the disclosure is not misleading, but the auditor judges it to be of such importance that it is fundamental to the users’ understanding of the financial statements, an Emphasis of Matter paragraph is added in accordance with ISA 706 (Revised and Redrafted), drawing attention to the disclosure.

A37. As indicated in paragraph A11, an authorized or recognized standards setting organization, or law or regulation, may describe the applicable financial reporting framework by reference to the financial reporting framework of another authorized or recognized standards setting organization. If the applicable financial reporting framework is described as such in the entity’s financial statements, the auditor’s evaluation of the adequacy of the reference to or description of the applicable financial reporting framework includes consideration of the risk that intended users may misunderstand the basis on which the financial statements are prepared.

A38. In the circumstances in paragraph A13 in which the risk of misunderstanding is in fact low, or where the applicable financial reporting framework can be described without reference to the other framework (see paragraph A14), the reference to or description of the applicable financial reporting framework is adequate without further explanation.

A39. In other circumstances, the risk of misunderstanding is influenced by whether the differences between the applicable financial reporting framework and the other framework are significant in context of the entity’s financial statements.

A40. If the differences are not significant in the context of the entity’s financial statements, the reference to the applicable financial reporting framework without further explanation is likely to be adequate. If, however, the differences are significant in the context of the entity’s financial statements, the auditor’s

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evaluation of the adequacy of the reference to or description of the applicable financial reporting framework involves considering whether the financial statements include a description of the differences. For example:

- (a) If the financial statements include a description of the differences as described in paragraph A14, the risk of misunderstanding is reduced and, accordingly, the reference to or description of the applicable financial reporting framework is likely to be adequate.
- (b) If the financial statements do not include a description of the differences, the auditor may conclude, in accordance with ISA 706 (Revised and Redrafted), that it is necessary to draw intended users' attention to the applicable financial reporting framework, noting that differences between the applicable financial reporting framework and the other framework may be significant in the context of the entity's financial statements and, therefore, also to an understanding of the context in which the auditor's opinion is expressed.
- (c) In extreme cases, the differences may be so significant in the context of the entity's financial statements that there is an unacceptably high risk that intended users will misunderstand the basis on which the financial statements are prepared. In some cases, this may be so even if the financial statements include a description of the differences. If the auditor concludes, in such circumstances, that the reference to the other framework in describing the applicable financial reporting framework is misleading, the auditor would express a modified opinion in accordance with ISA 705 (Revised and Redrafted).

[A complete set of the material to be presented at the September 2008 IAASB meeting can be accessed at <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0143&ViewCat=0968>. A copy of proposed ISA 700 (Redrafted), scheduled for approval in September, is included in Agenda Item D as an IAASB CAG Reference Paper.]

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#### Report Back – March 3-4, 2008 CAG Proposals

12. Below is an extract from the minutes of the March 3-4, 2008 CAG meeting<sup>6</sup> related to the discussion of the preliminary analysis of the responses to the proposal that was included in the exposure draft of proposed ISA 700 (Redrafted), and an indication of how the IAASB Task Forces or the IAASB responded to the Representatives' comments.

Representatives' comments	IAASB Task Force/IAASB response
<p>The Representative commented as follows:</p> <ul style="list-style-type: none"><li>Ms. Sucher noted that her understanding is that the responses to the proposed amendment to IAS 1 are not positive. She also noted that the ISAs should be framework neutral, but that the relevant guidance in proposed ISA 700 (Redrafted) is based on the proposed amendment to IAS 1.</li></ul>	<p>The IAASB agreed to amend the proposed guidance so that it is "framework neutral" and, as a result, it is no longer based directly on the proposed amendment to IAS 1 and does not refer to it.</p> <p>The revised proposed guidance being considered at the September 2008 IAASB meeting focuses on whether there is a risk that users may misunderstand the basis on which the financial statements are prepared. It explains that such risk is mitigated when there is transparency about the applicable financial reporting framework and how it differs from the framework to which it refers. <b>See paragraph 11 above.</b></p>
<ul style="list-style-type: none"><li>Mr. Johnson was concerned about the implications for the auditors – he was not sure how the auditors will apply the requirement and guidance in proposed ISA 700 (Redrafted) if the reporting entity is not required to quantify the difference between the modified IFRS framework and IFRS. He also questioned how comparison amongst jurisdictions is possible without quantification of the difference. Mr. Damant also supported quantification of the difference where this might be possible, but he appreciated that such a quantitative reconciliation would frequently not be possible since it would imply a full reconciliation to the original IFRS.</li></ul>	<p>The IAASB continues to believe that quantification of the differences between the applicable financial reporting framework and the framework to which it refers is not necessary. The aim is to be transparent about, and avoid any confusion regarding, the applicable financial reporting framework, rather than to provide a reconciliation to the other established framework. As a result, the revised proposed guidance clarifies that it is not necessary to quantify the differences. <b>See paragraph 11 above.</b></p>

<sup>6</sup> The minutes will be approved at the September 4-5, 2008 CAG meeting.



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Representatives' comments	IAASB Task Force/IAASB response
<p>Nevertheless, the IASB text did not make it clear how the difference could be reported qualitatively, apart from the separate requirement that the non-application of certain IFRS would be noted.</p> <ul style="list-style-type: none"> <li>Ms. Todd McEnally did not think that it is necessary to quantify the difference. She cautioned against the auditor assuming the responsibility to address financial reporting deficiencies in an audit client, or being put in the position of the regulator. She believed that it is necessary for the reporting entity to provide the disclosures necessary to neutralize financial reporting deficiencies, and was hoping that others would step forward to solve the problem.</li> </ul>	
<ul style="list-style-type: none"> <li>Sir Bryan noted that the IASC Foundation is concerned about jurisdictions eroding IFRS by way of carve out, and that the proposal of the International Accounting Standards Board (IASB) is an important aspect in avoiding this. The real issue, however, is whether the investor community is being misled. He agreed that this is a difficult call for the IAASB and encouraged it to give appropriate weight to the views of the various constituencies.</li> </ul>	<p>The IAASB reviewed the comments on the exposure draft, the Representatives' comments, and a proposed revised ISA in June 2008. The related meeting material can be accessed at:</p> <p><a href="http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0142&amp;ViewCat=0948">http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0142&amp;ViewCat=0948</a></p> <p>More than half of the respondents to the exposure draft of proposed ISA 700 (Redrafted) supported including guidance on this matter in ISA 700 (Redrafted) and, following discussion of the various comments, the IAASB confirmed that it continues to believe that it is in the public interest to address in the ISAs the matter of an applicable financial reporting framework described by reference to another established framework, if practicable. As explained above, the revised proposed guidance focuses on whether there is sufficient transparency about the basis on which the financial statements are prepared to avoid readers being misled. <b>See paragraph 11 above.</b></p>

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#### **Action Requested**

13. The Representatives are asked for their views on the proposed revised guidance in ISA 700 (Redrafted) dealing with an applicable financial reporting framework described by reference to another established framework, such as International Financial Reporting Standards.

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### Appendix 1

#### Proposed Amendments to IAS 1

(Available from the website of the International Accounting Standards Board at <http://www.iasb.org/NR/rdonlyres/AB986651-373A-4249-847D-96C2C255FD06/0/IASB2006OmnibusEDsectionIAS1ReportingcompliancewithIFRSs.pdf>)

#### **Introduction and Invitation to Comment**

In this Exposure Draft the International Accounting Standards Board proposes to insert in IAS 1 *Presentation of Financial Statements* disclosure requirements for entities that refer to International Financial Reporting Standards (IFRSs) in describing the basis on which their financial statements are prepared but are not able to make an explicit and unreserved statement of compliance with IFRSs. Such an entity would be required to make disclosures about how its financial statements would have been different if prepared in full compliance with IFRSs.

The Board invites comments on the proposed amendments to IAS 1. It would particularly welcome answers to the question set out below. Comments are most helpful if they indicate the specific paragraph, contain a clear rationale and, when applicable, provide a suggestion for alternative wording.

The Board is not requesting comments on matters in IAS 1 not addressed in the Exposure Draft.

#### **Question**

Do you agree with the proposal for new disclosure requirements? If not, why?

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##### **Proposed amendments to IAS 1 *Presentation of Financial Statements***

In the Standard, paragraph 14A is added. Paragraph 105 is amended (new text is underlined). For ease of reference, paragraph 14 is included although no changes are proposed to it.

##### **Overall considerations**

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###### **Fair presentation and compliance with IFRSs**

- 14** An entity whose financial statements comply with IFRSs shall make an 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.
- 14A** When an entity refers to IFRSs in describing the basis on which its financial statements are prepared but is not able to make an explicit and unreserved statement of compliance with IFRSs, the entity shall:
- (a) describe each difference between the basis on which its financial statements are prepared and IFRSs that are applicable to its financial statements; and
  - (b) describe how its reported financial position and performance of the entity would have differed if it had complied with IFRSs.
- 105** Notes are normally presented in the following order, which assists users in understanding the financial statements and comparing them with financial statements of other entities:
- (a) a statement of compliance with IFRSs (see paragraph 14) or description of differences from IFRSs (see paragraph 14A);
  - (b) a summary of significant accounting policies applied (see paragraph 108);
  - (c) supporting information for items presented on the face of the balance sheet, income statement, statement of changes in equity and cash flow statement, in the order in which each statement and each line item is presented; and
  - (d) other disclosures, including:
    - (i) contingent liabilities (see IAS 37) and unrecognised contractual commitments; and
    - (ii) non-financial disclosures, eg the entity's financial risk management objectives and policies (see IFRS 7).

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##### Basis for Conclusions

*This Basis for Conclusions accompanies, but is not part of, the draft amendments.*

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- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in proposing amendments to IAS 1 *Presentation of Financial Statements*.
- BC2 An entity might refer to IFRSs in describing the basis on which its financial statements are prepared without describing those statements as complying with IFRSs. For example, the accounting policies may be described as being 'in accordance with IFRSs as adopted/modified for use in [country X]'. In some situations, a financial reporting framework based on IFRSs and the complete set of current IFRSs may not be significantly different. In other cases, however, the differences may significantly affect the reported financial position or performance of an entity. Consequently, references to IFRSs in describing the basis on which the financial statements are prepared may mislead users. Some users might expect there to be a close relationship between financial statements based on IFRSs and those in compliance with IFRSs. Furthermore, users may be unable to identify the differences between a financial reporting framework based on IFRSs and the complete set of current IFRSs.
- BC3 The Board proposes that, when an entity refers to IFRSs as the basis of its financial reporting framework but does not make an unreserved statement of compliance with IFRSs, it should disclose each instance when IFRSs are not complied with, that is applicable to its financial statements. It should also describe (but need not quantify) the effect, on the statement of financial performance and statement of financial position, of the difference between complying with the accounting required by IFRSs and the accounting treatments applied by the entity. Such disclosures would enable users to judge the usefulness of the information presented and the significance of those differences for the financial statements. It would also help users to interpret those statements and assess their comparability with those of other entities.

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### **Appendix 2**

#### **Statement Issued by the Technical Committee of IOSCO**

On February 6, 2008, the Technical Committee of IOSCO issued a Statement on Providing Investors with Appropriate and Complete Information on Accounting Frameworks Used to Prepare Financial Statements. The Statement noted the following:

“As accounting standards around the world continue to converge and as cross border capital market activity increases, it can no longer be assumed that investors will automatically be familiar with the jurisdiction in which an issuer company is based and the accounting standards that have been used. Furthermore, there may be a growing tendency for investors and other users of financial statements to assume that all accounts are generally comparable, even when they are prepared in accordance with very different generally accepted accounting principles (GAAPs). This tendency exists particularly in circumstances where national standards assert that they are based on but do not fully implement International Financial Reporting Standards (IFRS), i.e., when IFRS have been modified or adapted to the particular circumstances of a national market. The IOSCO Technical Committee is concerned that investors run the risk of making investment decisions without a full understanding of financial statement data if they are not fully aware of the basis on which financial statements are prepared, and of the accounting standards that underpin the company’s policies.

The risk of misunderstanding can be mitigated by making sure that the information regarding the company’s accounting policies and the reporting framework on which they are based is fully and appropriately described in the financial statements and that investors and other users can readily get access to the accounting standards and other authoritative literature which underpin the policies. To that end the Technical Committee recommends that all annual and interim financial statements that are prepared on the basis of national standards that are modified or adapted from IFRS and published by publicly traded companies should include at a minimum the following statements, (which should be tailored to the company’s circumstances and the markets in which securities may be traded):

1. A clear and unambiguous statement of the reporting framework on which the accounting policies are based;
2. A clear statement of the company’s accounting policies on all material accounting areas;
3. An explanation of where the accounting standards that underpin the policies can be found;
4. A statement that explains that the financial statements are in compliance with IFRS as issued by the IASB, if this is the case; and
5. A statement that explains in what regard the standards and the reporting framework used differ from IFRS as issued by the IASB, if this is the case.”