Guidance for Auditors on First-time Application of IFRSs in the United Kingdom and the Republic of Ireland

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The Auditing Practices Board

THE AUDITING PRACTICES BOARD

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- Standards and guidance for auditing;
- Standards and guidance for the work of reporting accountants in connection with investment circulars; and
- Standards and guidance for auditors' and reporting accountants' integrity, objectivity and independence

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THE AUDITING PRACTICES BOARD

GUIDANCE FOR AUDITORS ON FIRST-TIME APPLICATION OF IFRSs IN THE UNITED KINGDOM AND THE REPUBLIC OF IRELAND

Contents | ***Paragraphs***

Introduction		1 – 12
Objective		1 – 7
Limitations of the Bulletin		8
Responsibilities of the directors		9 – 12
Summary of significant issues covered in the Bulletin		13
Application of ISAs (UK and Ireland): specific issues		14 – 132
ISQC 1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements	15 – 16
200	Objective and General Principles Governing an Audit of Financial Statements	17 – 19
210	Terms of Audit Engagements	20 – 21
220	Quality Control for Audits of Historical Financial Information	22 – 23
240	The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements	24 – 25
250	Section A – Consideration of Laws and Regulations in an Audit of Financial Statements	26 – 54
250	Section B – The Auditor's Right and Duty to Report to Regulators in the Financial Sector	55
260	Communication of Audit Matters With Those Charged With Governance	56 – 59
300	Planning an Audit of Financial Statements	60 – 66
315	Obtaining an Understanding of the Entity and Its Environment and Assessing the Risks of Material Misstatement, and 330 The Auditor's Procedures in Response to Assessed Risks	67 – 70
320	Audit Materiality	71 – 74
510	Initial Engagements-Opening Balances and Continuing Engagements-Opening Balances, and 710 Comparatives	75 – 83
520	Analytical Procedures	84 – 89
540	Audit of Accounting Estimates	90 – 94
545	Auditing Fair Value Measurements and Disclosures	95 – 97

550	Related Parties	98 – 99
560	Subsequent Events	100 – 101
570	Going Concern	102 – 109
580	Management Representations	110 – 112
600	Using the Work of Another Auditor	113 – 114
620	Using the Work of an Expert	115 – 116
700	The Auditor's Report on Financial Statements	117 – 128
720	Other Information in Documents Containing Audited Financial Statements	129 – 132

Review of interim financial information under IFRSs 133 – 155

Appendices

1: *Equivalent Legislative References for Northern Ireland and Comparative Legislative References for the Republic of Ireland*

2: *Example review report*

INTRODUCTION

Objective

1. This Bulletin provides auditors with guidance on issues that may arise when companies (and other entities that are subject to audit) undertake the transition from United Kingdom, or Republic of Ireland, Generally Accepted Accounting Practice (UK/ROI GAAP) to International Financial Reporting Standards (IFRSs)[1].

2. Regulation EC 1606/2002[2] (IAS Regulation) requires European Union companies with securities that are admitted to trading on a regulated market of any Member State to prepare their consolidated financial statements in conformity with IFRSs as adopted for use in the European Union.

3. At the same time as IFRSs take effect in 2005, changes to legal accounting requirements also enter into force in UK and ROI law, arising mainly from the Fair Value Directive and the Modernisation Directive. Consequently, there is substantial complexity in the interaction of legal issues, accounting standards, and auditing requirements.

4. As this Bulletin reflects the requirements of the Companies Act 1985 (CA 1985) it is of direct application to audits of entities that are incorporated in Great Britain. The UK DTI has published 'Guidance for British Companies on Changes to the Accounting and Reporting Provisions of the Companies Act 1985' ("DTI Guidance")[3], which describes the main changes to the CA 1985, as well as highlighting certain practical issues. Appendix 1 of this Bulletin sets out a table of the equivalent legislative references for Northern Ireland and of comparative legislative references for the Republic of Ireland.

5. IFRS 1 'First-time adoption of International Financial Reporting Standards' has been issued to enable preparers to ensure that an entity's first IFRS financial statements, and its interim reports for part of the period covered by those financial statements, contain high quality information that:

   (a) is transparent for users and comparable over all periods presented;

   (b) provides a suitable starting point for accounting under IFRSs; and

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1 IFRSs is a defined term which incorporates all International Financial Reporting Standards, International Accounting Standards (IASs) and Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standards Interpretation Committee of the IASC. Details of all IFRSs can be found at the IASB website at www.iasb.org; IASB publications include helpful executive summaries of the standards. Unless otherwise stated, references in this Bulletin to IFRSs encompass both the IFRSs as issued by the IASB and IFRSs as adopted for use in the European Union (which may not be the same).

2 EC 1606/2002 can be found on the Europa website at http://europa.eu.int/eur-lex/pri/en/oj/dat/2002/l_243/l_24320020911en00010004.pdf. Subsequent EC Regulations adopt specific IFRSs.

3 This can be found on the DTI website at http://www.dti.gov.uk/cld/guidance.doc

(c) can be generated at a cost that does not exceed the benefits to users.

Appended to IFRS 1 is 'Guidance on Implementing IFRS 1', which explains how the requirements of IFRS 1 interact with the requirements of those IFRSs that are most likely to involve questions that are specific to first time adopters. The guidance also includes an illustrative example of how a first time adopter might disclose how the transition to IFRSs affected its reported financial position, financial performance and cash flows as required by IFRS 1.

6. APB published two earlier drafts of this Bulletin in August 2004 and April 2005 to provide auditors with interim guidance. Since then, a number of uncertainties have been resolved and there have been various developments in auditing and financial reporting that are reflected in this Bulletin. In particular:

- The European Commission has adopted the majority of the extant IFRSs and Interpretations, apart from certain parts of IAS 39 on financial instruments and various very recent pronouncements from the IASB.[4]
- Further implementing legislation in the UK and the ROI has been passed,[5] as well as other guidance issued, for example on IFRS and distributable profits.
- Consensus has emerged in Europe about the specific wording to be used in auditor's reports when describing the financial reporting framework.

7. In spite of the progress made in resolving many of the legal and regulatory issues, there are some remaining uncertainties that are relevant to auditors. The APB will therefore continue to keep the situation under review.

Limitations of the Bulletin

8. The Bulletin does not give guidance on every aspect of the introduction of IFRSs in the UK and ROI. Specifically, it does not deal with the following:

(a) *Reporting on the opening IFRS balance sheet and/or the 2004 comparatives:* These represent non-statutory assurance engagements that are beyond the scope of this Bulletin.[6]

(b) *Identification of key differences between UK/ROI GAAP and IFRSs:* While the Bulletin refers to some differences between UK/ROI GAAP and IFRSs as examples, it does not provide a comprehensive list of differences.

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4 Information about adopted IFRSs can be found on the Europa website at http://europa.eu.int/comm/internal_market/accounting/ias_en.htm#comments.

5 See the DTI website at http://www.dti.gov.uk/cld/ for further details.

6 The International Auditing and Assurance Standards Board (IAASB) has issued a non-authoritative paper on the subject 'First Time Adoption of International Financial Reporting Standards – Guidance for Auditors on Reporting Issues', in the form of a series of questions and answers.

(c) *Identification of those company law requirements that still apply to accounts prepared under IFRSs:* In the case of the CA 1985, this is provided in the DTI Guidance.

(d) *The Companies Act 1985 (Operating and Financial Review and Directors' Report) Regulations 2005.*

Responsibilities of the directors

General responsibilities of the directors

9. Under company law, the directors are responsible for preparing financial statements. Implicitly, this requires them to take reasonable steps to ensure that the entity will cope with the introduction of IFRSs, where applicable. The directors, through the entity's management, need to consider the specific impacts of IFRSs on the financial statements and whether proper accounting records will be maintained. The auditor considers whether management has put in place procedures with subsidiaries and branches such that the relevant accounting information will be received by the parent company on a timely basis to enable the group accounts to be properly prepared under IFRSs.

Analysing the impact on the business

10. When preparing an "impact analysis" the entity will need to consider the effect of the introduction of IFRSs on:

    (a) computer and other data systems, internal controls and systems for preparing financial statements, for example systems capable of capturing all requisite information on financial instrument fair values, hedging arrangements and embedded derivatives;

    (b) the financial statements themselves, including interim results in the year of change. For example, how the financial statements should communicate the effect of the introduction of IFRSs to the users of the entity's financial statements;

    (c) business-critical issues that arise from the financial statements, for example the calculation of debt covenants and borrowing powers limitations in the entity's constitutional documents, or the impact on distributable profits where IFRSs are adopted in individual entity financial statements; and

    (d) other regulatory concerns, for example changes to the measurement of regulatory capital as a result of changes in the financial statements.

Management plans that address the issues identified

11. Given the likely pervasiveness of the changes introduced by IFRSs, it is unlikely that any company, group or other entity moving to IFRSs will have financial statements and/or a business so straightforward that no formal plan is necessary. Matters likely to be included in a plan, depending on the size and complexity of the organisation, are:

- Creating an appropriate overall project steering structure.
- Defining the individual projects (for critical accounting policies or line items).
- Planning to resource these projects, including estimates for costs, time, external resources, (eg for input from specialists), staffing levels for the changeover period, hardware capacity and new software.
- Developing a testing and implementation strategy.
- Identifying constraints such as staff availability and the realistic ability to secure further resources.
- Developing a high-level milestone plan to co-ordinate the overall programme of projects.
- Reviewing and updating the plan to reflect actual progress.
- Identifying alternative actions for systems issues which will not be addressed in time (contingency or damage limitation plans).

12. The auditor considers how the impact analysis and management plans affect its risk assessment for the audit during the period of transition from UK/ROI GAAP to IFRSs.

SUMMARY OF SIGNIFICANT ISSUES COVERED IN THE BULLETIN

13. In relation to the audit of IFRS information for the first time, certain issues are likely to be of particular importance. The Bulletin discusses the issues by relevant ISAs (UK and Ireland). The main features of the guidance are as follows:

    (a) There are major implications for audit risk (Paragraph 67)

    (b) Auditors are likely to need to perform additional procedures on comparatives and opening balances for both full year financial statements (Paragraph 75) and interim reports (Paragraph 149)

    (c) The need for audit staff to have appropriate knowledge and understanding of IFRSs (Paragraph 16) and the increased likelihood for the need for consultation with those responsible for technical financial reporting issues (Paragraph 22)

    (d) There are implications for the auditor's consideration of laws and regulations, including:

        (i) The need to consider whether companies have complied with the legal requirement to prepare group accounts in accordance with IFRSs as adopted for use in the EU (Paragraph 28)

        (ii) The requirement for auditors of parent companies to consider whether directors have secured that the individual accounts of subsidiary undertakings prepare their statutory accounts following the same financial reporting framework, unless in their opinion there is a good reason for not doing so (Paragraph 39)

    (e) Going concern issues may arise in relation to the impact of IFRSs on debt covenants (Paragraphs 105 – 109)

    (f) The introduction of IFRSs will give rise to complexities regarding taxation (Paragraphs 51 – 52) and the distribution of profits (Paragraphs 49 – 50)

    (g) Uncertainties for interim reports caused by the possible need for companies to anticipate the adoption of some IFRSs for use in the EU (Paragraphs 152 – 154)

    (h) Careful consideration will need to be given to the tailoring of auditor's reports especially with respect to:

        (i) The need to refer to the applicable financial reporting framework (Paragraphs 119 – 122).

        (ii) Parent companies adopting IFRSs but also taking advantage of the Section 230 exemption (Paragraphs 42 – 43 and 123 – 124)

        (iii) The use of different financial reporting frameworks for group and parent company financial statements gives rise to separate auditor's reports for these if they are presented in separate sections of the Annual Report (Paragraph 44).

(i) The disclosures required in the year of transition to IFRSs, including:

  (i) Reconciliations of IFRS information to previous GAAP (Paragraph 16)

  (ii) More extensive disclosure of estimation uncertainty (Paragraphs 93 – 94)

(j) Potential difficulties relating to the audit of fair value information (Paragraphs 95 – 97)

APPLICATION OF ISAS (UK AND IRELAND): SPECIFIC ISSUES

14. This section highlights some of the specific issues raised by the introduction of IFRSs in the application of ISAs (UK and Ireland).

International Standard on Quality Control (UK and Ireland)

ISQC 1 'Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements'

15. ISQC 1 requires a firm of auditors to establish policies and procedures designed to provide reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances. ISQC 1 requires firms to assign appropriate staff with the necessary capabilities, competence and time to perform engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

16. Audit staff require knowledge and understanding of IFRSs. In the year of transition it will be particularly important for audit staff to have sufficient knowledge of both UK/ROI GAAP and IFRSs in order to audit the reconciliations between the two required by IFRS 1. Without such knowledge and understanding they may fail to

    (a) detect improper or incorrect reconciling items such as changes in previous estimates or correction of errors;

    (b) consider an omission from the reconciling items or items which have been incorrectly included within other reconciliation amounts; or

    (c) identify incorrect IFRS figures (where UK/ROI GAAP figures have been left unchanged) which may result in no reconciling item being shown at all.

International Standards on Auditing (UK and Ireland)

ISA (UK & Ireland) 200 'Objective and General Principles Governing an Audit of Financial Statements'

Ethical Standards for Auditors

17. If the auditor is asked to assist the directors with their preparations for the introduction of IFRSs, careful consideration will need to be given to the implications of this for the auditor's independence and objectivity.

18. APB Ethical Standard 5 (ES 5) states that for listed companies, or significant affiliates of such an entity, the threats to the auditor's objectivity and independence that would be

created are too high to allow the audit firm to undertake an engagement to provide any accounting services save in certain exceptional circumstances[7]. ES 5 also prohibits audit firms from accepting an engagement to provide a valuation to an audit client where the valuation would both involve a significant degree of subjective judgment, and is material to the financial statements.

19. These prohibitions do not extend to separate engagements to provide assurance to those charged with governance on the application of IFRSs, or to provide advice on accounting policies, or train management in IFRS-related matters. In order to help ensure that engagements of this nature are not confused with the statutory audit, it is advisable for auditors to clarify responsibilities for each engagement in separate engagement letters.

ISA (UK & Ireland) 210 'Terms of Audit Engagements'

Clarifying with directors their responsibilities

20. To avoid confusion as to the respective responsibilities of directors and auditors, concerning the introduction of IFRSs, the auditors communicate formally with the directors to avoid any misunderstandings. The directors are responsible for ensuring that the entity is prepared for the introduction of IFRSs and the auditors will wish to state explicitly in writing that the issue will be considered by them only in so far as it affects their audit responsibilities under statute and ISAs (UK and Ireland). This could be done by updating the audit engagement letter.

21. Particular matters that auditors may wish to clarify in the engagement letter are that the directors are responsible for:

    (a) analysing the impact of the introduction of IFRSs on the business;

    (b) developing plans to mitigate the effects identified by this analysis;

    (c) assessing any impact of the introduction of IFRSs on the appropriateness of adopting the going concern basis in preparing the financial statements; and

    (d) the preparation of financial statements as required under IFRSs, including comparative figures, and the disclosures needed to give a fair presentation and hence give a true and fair view.[8]

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7 'Accounting services' are defined as the provision of services that involve the maintenance of accounting records or the preparation of financial statements that are then subject to audit.

8 The Financial Reporting Council (FRC) has issued a paper "The Implications of New Accounting and Auditing Standards for the "True and Fair View" and Auditors' Responsibilities" which can be found on the FRC website at www.frc.org.uk.

ISA (UK & Ireland) 220 'Quality Control for Audits of Historical Financial Information'

22. ISA (UK and Ireland) 220 addresses consultation, both within the audit team and with others within and outside the audit firm. The auditor considers the need for consultation on those matters deemed critical for an entity in its IFRS financial statements in the year of transition. Consultations are more likely at this time with those responsible for technical financial reporting issues within the audit firm and externally in cases where internal technical expertise is not available.

23. It will also be important at this time to ensure differences of opinion, particularly those on financial reporting issues relating to the application of IFRSs, are dealt with properly. Similarly, the engagement quality control review is likely to focus on the significant judgments made by the engagement team relating to the application of IFRSs.

ISA (UK & Ireland) 240 'The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements'

24. The introduction of IFRSs may lead to significant changes in financial reporting for many entities. Substantial changes to accounting systems may give greater opportunity for aggressive earnings management and, in extreme cases, fraud. Auditors consider the increased risk of fraud in planning and designing the audit procedures to be performed in the year an entity converts to IFRSs.

25. ISA (UK and Ireland) 240 requires the members of the engagement team to discuss the susceptibility of the entity's financial statements to material misstatements due to fraud. In the year of transition to IFRSs, this discussion will encompass the increased risk of fraud and its non-detection arising from the transition in the context of the specific circumstances of the entity.

ISA (UK & Ireland) 250, Section A 'Consideration of Laws and Regulations in an Audit of Financial Statements'

26. ISA (UK & Ireland) 250, Section A states that the auditor should obtain sufficient appropriate audit evidence about compliance with those laws and regulations generally recognized by the auditor to have an effect on the determination of material amounts and disclosures in financial statements. The auditor should have a sufficient understanding of these laws and regulations in order to consider them when auditing the assertions related to the determination of the amounts to be recorded and the disclosures to be made.

27. Some of the relevant sources of law and regulation identified in the footnotes to paragraphs 20 and 20-1 of ISA (UK & Ireland) 250, Section A, are disapplied (or at least partially so) by the requirements of the IAS Regulation, for example the statutory formats in Schedule 4A CA 1985 for group accounts.[9]

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9 The DTI Guidance lists at paragraph 4.21, those provisions in Part VII (Accounts and Audit) of the Companies Act 1985 that still apply.

28. The auditor considers whether an entity falls within the mandatory requirement to prepare its consolidated financial statements in accordance with IFRSs adopted for use in the European Union. This is important because, should any entity fail to follow IFRSs when *required* to do so, auditors would be required to qualify their audit report on the grounds of non-compliance with company law.

The IAS Regulation

29. The IAS Regulation requires certain companies[10] to prepare their consolidated financial statements in accordance with IFRSs adopted for use in the European Union, for accounting periods beginning on or after 1 January 2005. This requirement applies to companies:

    (a) that are subject to the law of a Member State; and

    (b) whose securities are admitted (as at the balance sheet date) to trading on a regulated market (publicly traded companies); and

    (c) that are required by Member State law to prepare group accounts.

30. The IAS Regulation also contains Member State options[11], one of which is to permit or require adopted IFRSs to be used by:

    (a) publicly traded companies, in their individual company accounts; and

    (b) non publicly traded companies, in both, or either of, their group and individual company accounts.

    The UK and ROI have introduced a permissive regime in relation to this Member State option. This means that, from 2005 and until such time as ASB's standards become the same as IASB's, there will be two regimes of Generally Accepted Accounting Practice in the UK and ROI: IFRSs as adopted for use in the EU and UK/ROI GAAP[12].

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10 In the EC IAS Regulation 'company' has the same meaning as in Article 48 of the Treaty of Rome (DTI Guidance, paragraph 4.8).

11 One Member State option allows deferral to 2007 of the mandatory requirement to follow IFRS for companies that already follow an internationally accepted GAAP or those that only have listed debt securities. The DTI has stated that the UK will not take up this Member State option. However, the 2005 ROI Regulations provide for deferral of the obligation to prepare IFRS accounts to 2007 in respect of debt listed securities in the ROI.

12 ASB has begun to effect UK convergence to IFRSs by issuing its first 'convergence standards', namely FRSs 20-26, to bring certain aspects of UK accounting standards more into line with IFRSs in 2005. It has also issued (in March 2005) an Exposure Draft on the future role of the Board, including its approach to convergence with IFRS. See www.frc.org.uk/asb.

Subject to the law of a Member State

31. For companies to be subject to the law of a Member State, they have to be incorporated in a Member State. From 1 May 2004, Member States include the Accession States (i.e. those that joined the EU in May 2004)[13].

32. The corollary to this is that companies incorporated in a jurisdiction outside the EU, e.g. the USA, and hence not subject to any EU Member State's law, will not be subject to the mandatory requirement to follow IFRSs even if they have securities admitted to trading on a regulated market in an EU Member State.

Securities traded on a regulated market

33. There are several regulated markets in the UK and ROI. It should be noted that not all markets on which listed securities are traded are necessarily "regulated markets" as defined by the Prospectus Directive. An example is the Professional Securities Market, which is operated and regulated by the London Stock Exchange. Issuers listed on such non regulated markets are not required to adopt IFRSs.

Required to prepare group accounts

34. As stated in the DTI Guidance, the test as to whether a company is required to prepare group accounts, for the purpose of the EC Regulation, is by reference to the European Seventh Directive, as adopted into the CA 1985. The relevant Sections are 227 for companies and 255A for banks and insurance companies.

35. The CA 1985 has recently been amended (as outlined in Section 5 of the DTI Guidance), to implement parts of the Modernisation Directive and take up some options in the existing Seventh Directive. In particular, there will no longer be a requirement for a company to have a "participating interest" in its investee for a parent/subsidiary relationship to exist.[14]

Voluntary adoption of IFRSs

36. The new legislation allows publicly traded companies to prepare their individual accounts in accordance with adopted IFRSs. The individual accounts of other group companies may also be prepared in accordance with adopted IFRSs, subject to the consistency requirements discussed in paragraphs 38 to 41. Non-publicly traded companies are also able to apply IFRSs as adopted for use in the EU, in:

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13 The complete list of Member States at any time can be found at http://www.europa.eu.int?abc/index_en.htm

14 This amendment is permitted by Article 2.1 of the Modernisation Directive, although the amendment to the 1985 Act does not extend to removing the parallel requirement to have a participating interest in an associate undertaking. The Accounting Standards Board has in turn issued amendments to FRS 2 to bring it into line with the revised parts of the 1985 Act. The requirements in FRS 5 to consolidate quasi-subsidiaries are not relevant to the legal requirement to consolidate.

(a) their group accounts; or

(b) their individual company accounts; or

(c) both their group and individual company accounts.

37. There are no specific formalities required in order to make a voluntary move to IFRSs; however, the CA 1985 has a number of restrictions that are discussed in the following paragraphs.

All companies within a group to report using the same accounting framework

38. Those entities that adopt IFRSs for their group financial statements will prepare those group financial statements under IFRSs regardless of which financial reporting framework is used in the preparation and presentation of the individual statutory accounts of the parent and its subsidiaries. Consequently, the directors of the parent company will need to ensure that management has put systems in place to ensure that all necessary information is available from subsidiaries, on a timely basis, in order to permit proper preparation of IFRS group accounts.

39. The CA 1985 states (in Section 227C(1)) that the directors of a *parent* company must secure that the individual accounts of the parent and each of its subsidiary undertakings are all prepared using the same financial reporting framework "except to the extent that in their opinion there are good reasons for not doing so"[15]. This provision is intended to provide a degree of flexibility where there are genuine grounds for using different accounting frameworks within a group. Paragraph 4.16 of the DTI Guidance gives some examples of what might constitute 'good reasons'. These examples relate to very specific circumstances and the Guidance notes that the key point is that "the directors of the parent company must be able to justify any inconsistency, to shareholders, regulators or other interested parties."

40. Auditors enquire as to whether the directors have considered the question and documented their reasons and the auditors consider the acceptability of such reasons, including any advice the directors have taken. If the auditors doubt whether the directors are correct in their opinion that there is a 'good reason', the auditors discuss their concerns with those charged with governance. If, having considered the reason given, the auditors continue to have doubts as to whether there is a justification, they may consider seeking legal advice and consider the implications for their audit report.

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15 There are various exemptions to this as laid out in Paragraph 4.14 of the DTI Guidance. The 2004 Regulations also provide a partial exemption (in new Section 227C(5) of the 1985 Act), such that if a parent company prepares both its consolidated and its individual accounts under IFRS, it is not required to ensure that all its subsidiary undertakings also use IFRSs, although it must still ensure that all its GB subsidiary undertakings use the same GAAP as each other, again unless there are good reasons for not doing so.

41. The requirement to have a "good reason" where all companies in a group do not use the same accounting framework is a parent company responsibility; it is not an issue for the directors or auditors of any individual subsidiary as long as the subsidiary has properly followed a legally acceptable GAAP which has been clearly disclosed.

Parent company individual financial statements

42. Under Section 230 of the CA 1985, a parent company need not present its individual profit and loss account, nor certain related notes, where it has presented group financial statements[16]. The DTI Guidance states that taking the Section 230 exemption (which it describes as a publication exemption) should not affect the ability of a parent company to be treated as a "first time adopter" and hence to take advantage of exemptions for first time use under the provisions of IFRS 1.

43. IAS 1 and IFRS 1 both require an "explicit and unreserved statement of compliance with IFRSs" in order to be a first-time adopter. In view of the fact that Paragraph 8 of IAS 1 'Presentation of Financial Statements' requires a profit and loss account to be presented in a set of IFRS financial statements, and in order for the statement of compliance with IFRSs not to be misleading, it will be important for an IFRS parent company (particularly one taking advantage of the IFRS 1 exemptions) to indicate that the compliance statement is based on its full IFRS financial statements, of which those presented are an extract (excluding the profit and loss account and related notes). This impacts the auditor's description of the financial reporting framework in the auditor's report as discussed in the ISA (UK and Ireland) 700 section of this Bulletin.

44. If the group financial statements are prepared under IFRSs but the parent company does not adopt IFRSs in its individual financial statements, the parent and group will present information on different bases. Section 240(2) of the CA 1985 requires group and individual accounts to be published but does not specify whether these accounts should be presented in separate sections of the annual report or combined into a single set of primary statements and notes. Where different financial reporting frameworks are applied, the DTI Guidance notes that using separate sections of the annual report is likely to lead to clearer presentation. The approach taken to the presentation of the parent company financial information will affect the auditor's report (as discussed under ISA (UK and Ireland) 700).

The decision to move is irreversible

45. The CA 1985 makes a company's decision to switch to IFRSs irreversible, except under certain limited circumstances. The exceptions are laid out in new Sections 226(5) and 227(6) to the CA 1985 and relate to where, for example, companies and groups cease to

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16 The Section 230 exemption relates only to the profit and loss account and, by virtue of Section 261(2), the notes to the profit and loss account. The parent individual IFRS financial statements will, however, still need to include the other primary statements and note disclosures required by IFRS, including a cash flow statement and a statement of changes in shareholders' equity.

be publicly traded and when a company becomes a subsidiary of an undertaking that does not prepare its accounts in accordance with IFRSs.

Applicable law: remaining elements of the Companies Act 1985 and related regulation

46. Entities that switch to IFRSs still have to follow aspects of UK company accounting and reporting law, as indicated by the European Commission[17] and by the DTI Guidance (at Paragraphs 4.18-4.21). The auditors need to be aware of which elements of the accounting and reporting provisions of the CA 1985 are still applicable and which are not.[18]

Duty to maintain proper accounting records

47. Auditors are required by Section 237(1) (a) of CA 1985 to investigate whether proper accounting records have been kept by the company and proper returns adequate for their audit have been received from branches not visited by them. That requirement is in relation to the accounting records of individual companies, not the group. Where individual companies within a group have adopted IFRSs, the auditors will need to consider whether the legal responsibility to maintain proper accounting records has been satisfied by appropriate changes in accounting systems and records.

48. If a group's consolidated accounts are prepared under IFRSs, but the individual accounts of all (or most of) the companies within the group remain on UK/ROI or other local GAAP(s), the primary accounting records from which the IFRS consolidated accounts are created may still be based on local GAAP. There is no legal requirement for management to change or adapt accounting systems at the individual company level to capture the new or different accounting information required for IFRS consolidated accounts. The responsibility for ensuring that the necessary information and records are available lies with the parent company's management. In these circumstances, where the requisite adjustments to apply IFRSs to subsidiary financial information is made by way of consolidation adjustments, the group auditor considers whether it is possible to obtain sufficient appropriate audit evidence. If not there may be a limitation on the scope of the auditor's work. (See comments on limitations of scope in the ISA (UK and Ireland) 700 section of the Bulletin).

Distributable profits

49. ISA (UK & Ireland) 250 Section A refers to the laws relating to distributions under Section 263 CA 1985. Group accounts are not relevant to determining the ability of a parent company to make a distribution. However, companies choosing to switch to IFRSs in

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17 The guidance from the European Commission on which elements of the accounting directives will continue to apply to IFRS companies can be found at http://europa.eu.int/comm/internal_market/accounting/docs/ias/200311-comments/ias-200311-comments_en.pdf.

18 The DTI Guidance provides useful guidance to small companies in relation to publication exemptions and abbreviated accounts in Paragraphs 4.25-4.31.

their individual accounts may produce 'relevant accounts' that result in a different amount of distributable profits from the amount that would have been determined under UK/ROI accounting standards[19].

50. The amount of profits a company has available for distribution may change as a result of the transition to IFRSs. When a distribution is being considered, the last set of audited financial statements, which are the relevant accounts for the purpose of Section 270 of the CA 1985, may be under UK/ROI GAAP. Nevertheless, the directors may know that, in the following accounting period (which will already have begun), the changes introduced by IFRSs may have a significant detrimental impact on distributable reserves, thus potentially affecting the directors' assessment of their common law duty not to make a distribution out of capital, as well as their general fiduciary duties.

Taxes Acts

51. Compliance with the Taxes Acts is addressed in ISA (UK & Ireland) 250 Section A. The Chancellor of the Exchequer announced in 2003 that the law would be amended to allow IFRS accounts to be used as the basis of corporation tax assessments for companies (as with distributable profits, only individual financial statements of companies are relevant; group accounts are not used to assess UK corporation tax liabilities). The 2004 Finance Act reflects this move for accounting periods beginning on or after 1 January 2005 and the overall stated aim of Her Majesty's Revenue and Customs (HMRC) is to achieve broadly equivalent tax treatment whether UK/ROI GAAP or IFRS accounts comprise the starting point for corporation tax computations, even where there are material differences in accounting treatment.

52. In the Chancellor's 2004 Pre-Budget Report, the government considered the transitional adjustments arising from certain changes in accounting for financial instruments and decided to defer any tax effects from the transition, in this respect, until the impact could be determined and managed. For most companies, this deferral will operate until accounting periods beginning on or after 1 January 2006 (i.e. for their 2005 accounting periods). In July 2005 it was announced that for tax purposes most transitional adjustments relating to financial instruments will be spread over 10 years from 2006. The position will be reviewed again in 2006 when more information is available and further transitional measures may be introduced. Transactions occurring following transition will be taxed in accordance with IFRSs. Measures were introduced in the Finance Act 2005 to enable securitisation vehicles to continue applying existing UK/ROI accounting standards

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19 Auditors will be aware of the guidance on this subject issued in 2003 by the Institutes of Chartered Accountants in England and Wales and of Scotland, which has been supplemented by guidance on the impact on distributable profits of new pension accounting standards and of new standards (UITF Abstracts) on share-based payment and the presentation of shares in ESOP trusts. Draft guidance has been published on IFRSs and distributable profits, which will also be relevant to the application of converged UK standards. See www.icaew.co.uk or www.icas.org.uk.

for tax purposes for accounting periods ending before 1 January 2007 and to address specific technical issues.[20]

Listing Rules

53. Companies subject to the mandatory application of IFRSs under the IAS Regulation will also be subject to the requirements of the regulated market on which their securities are traded. Where the authorities over such markets make pronouncements in relation to the introduction of IFRSs, regard to these may be relevant in order for the company to maintain its listing.[21]

54. In September 2003 the FSA wrote to the Company Secretaries of all Listed Issuers and amongst other things noted "That a consequence of not being in a position to adopt IFRSs will be that issuers are unable to meet the reporting requirements and deadlines of the Listing Rules. Failure by issuers to submit preliminary or interim results within the required timescale is likely to result in the suspension of the issuer's securities". However, the FSA has subsequently allowed, by concession, that companies' first set of interim accounts under IFRSs may be presented up to 120 days after the relevant period end, rather than the usual 90 days.[22] Companies must inform the market that they are taking advantage of this concession before the end of the half-year period to which the interim accounts relate in order to be claimed. In April 2005 the FSA wrote to the Chief Executives of all Listed Issuers regarding IFRS readiness, reminding them, among other things, that a failure to submit interim results within the required timescale is likely to result in the suspension of the issuer's securities.

ISA (UK & Ireland) 250, Section B 'The Auditor's Right and Duty to Report to Regulators in the Financial Sector'

55. Entities that are required to maintain a certain level of regulatory capital may be affected by the introduction of IFRSs. Auditors consider whether the introduction of IFRSs impacts on their assessment of going concern and on their responsibility to report matters of material significance to a regulator.[23]

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20 HMRC has published guidance on tax and IFRS, with links to legislation and commentary, which can be accessed at http://www.hmrc.gov.uk/practitioners/int_accounting.htm#note15

21 Auditors will be aware that the regime for regulated markets changed in the UK from 1 July 2005 as a result, inter alia, of the implementation of the requirements of the EU Prospectus Directive.

22 The text of the FSA's letter to Chief Executives of listed companies can be found at http://www.fsa.gov.uk/pubs/ceo/ceo_letter_25oct04.pdf.

23 The FSA announced in April 2005 the changes in its regulatory accounting rules in the light of new accounting standards. The changes are published in (Policy Statement) PS 05/5 entitled "Implications of a changing accounting framework" and reflect the introduction of IFRSs. The document can be downloaded from http://www.fsa.gov.uk/pubs/policy/ps05_05.pdf.

ISA (UK & Ireland) 260 'Communication of Audit Matters With Those Charged With Governance'

56. Auditors may identify issues related to the introduction of IFRSs which they consider they should report to those charged with governance. These may be matters which need to be formally communicated because they represent material weaknesses in internal control. However, in addition, they may report other matters which have come to light as a result of the enquiries made about the introduction of IFRSs. For example, where, after making enquiries, the auditors conclude that management has not sufficiently considered all the potential impacts of the introduction of IFRSs, or that management do not have a "good reason" for individual companies in the group not preparing their individual accounts using the same accounting framework (paragraph 39).

57. The auditors also consider all relevant aspects of the financial reporting framework, covering not only IFRSs but also those statutory and regulatory requirements which still apply. Auditors consider whether the accounting policies adopted by an entity in its first IFRS financial statements comply with the requirements of IAS 8, which includes a hierarchy of sources of guidance where no IFRS or Interpretation is available. Where IFRSs are silent on a subject it would be permissible for entities to continue to follow existing practice as long as it did not run counter to similar standards or the IASB's 'Framework for the Preparation and Presentation of Financial Statements'.

58. Auditors consider the qualitative aspects of financial reporting in the context of IFRSs and in particular the selection of accounting policies. When auditors identify that an entity has adopted an accounting policy that was not available to it under UK/ROI GAAP, where it could have continued to apply its existing policy, they draw such circumstances to the attention of those charged with governance.

59. The disclosure requirements in respect of the transition to IFRSs, as required by paragraphs 38-43 of IFRS 1, are substantial. As well as auditing the disclosures given by the entity for compliance with the standard, auditors consider whether the entity's approach to disclosure leads to information that is as clear as possible, given the complexity of the exercise. The overall requirement for fair presentation will be of particular importance in the transition period.

ISA (UK & Ireland) 300 'Planning an Audit of Financial Statements'

60. The introduction of IFRSs is likely to be a major factor in the planning of the audit for the year of implementation. Auditors consider how their audit plan is likely to be affected by the change and how to ensure that all members of the audit team are fully briefed and have sufficient knowledge of IFRSs.

Initial risk assessment at the planning stage

61. Audit risk is likely to be increased in the year of transition to IFRSs. As part of their risk assessment process, auditors ascertain by enquiry of management:

- The major changes likely to the entity's financial statements due to the introduction of IFRSs.
- The impact of the introduction of IFRSs on key systems which generate specific accounting information.
- The extent to which fair value accounting has been adopted for certain items, including financial instruments.

62. Auditors also direct their enquiries more specifically in order to understand management's views on:

    - Any increased risk of error in accounting information or other information supporting items in the financial statements.
    - The potential impact, if any, on the going concern basis.
    - The possible impact on specific financial statement amounts or disclosures.

63. The auditor's conclusions from these initial inquiries may be that no particular procedures need to be performed, that is, where the entity's management considers that the effect on the financial statements is minimal and the auditor's judgment is that, based on its knowledge of the business and its systems, the conclusion is reasonable. In the far more likely situation where management identifies the introduction of IFRSs as being of potential financial statement significance, the auditors obtain an understanding of management's impact analysis and detailed plans to deal with the introduction of IFRSs.

64. In considering the entity's 'impact analysis', the auditors might, for example, enquire about factors such as:

    - Whether the impact analysis was carried out systematically and the quality of records documenting that process.
    - Whether all significant business units were involved in the process.
    - The skills, knowledge and experience of the staff involved in the impact analysis.

65. In considering management's statements about plans and implementation progress, auditors might, for example, consider whether:

    - Financial reporting and systems replacement/modification projects are being led by staff with experience of such projects (whether internal or provided by external advisors).
    - Resources have been committed to the projects identified, whether relating to systems changes or financial reporting issues.

- Information or test results are available, whether generated internally or obtained from external IT suppliers, on relevant accounting systems.
- Timescales have been allocated to the projects identified.
- Progress against plans is being monitored rigorously and regularly.
- Slippage against the plan has resulted in positive action or reprioritisation

Lack of any of the above may indicate a higher risk that plans or progress reports are unreliable.

Comparatives and opening balances

66. At the planning stage auditors consider the work required on opening balances and comparatives. (See the discussion on ISA (UK and Ireland) 510 and ISA (UK and Ireland) 710 below.)

ISA (UK & Ireland) 315 'Obtaining an Understanding of the Entity and Its Environment and Assessing the Risks of Material Misstatement' and ISA (UK & Ireland) 330 'The Auditor's Procedures in Response to Assessed Risks'

67. The increase in overall audit risk in the year of transition of an entity to IFRSs is likely to be substantial (and some increase is also possible in the periods leading up to the change). Some of the main factors leading to the increase in audit risk are as follows:

- In 2005/6 companies will have limited practical experience of working with IFRSs. The application in the UK and ROI of existing accounting standards is based on experience that has built up over many years; this accumulated knowledge base does not exist for IFRSs.
- One of the major difficulties faced by both preparers and auditors is the identification of all differences between the old and new accounting frameworks. Although UK and ROI accounting standards are, in some ways, similar to IFRSs, there are some major differences, for example in relation to accounting for business combinations, and a large number of smaller differences that are less immediately obvious (so that some may assume some old and new standards are the same when in fact they are not). Moreover, the interaction between different IFRSs, for example IFRS 1 and the other IFRSs, is complex.
- Major changes may be necessary to financial reporting systems and the controls over them, in order to produce the necessary information for IFRS financial statements. As well as increasing the risk of error, this also increases the opportunity for fraud.
- There may be opportunities for aggressive earnings management by companies. For example, management may wish to set an advantageous starting figure for earnings under IFRSs in the year of transition, conscious of the implications for future years. This could involve setting the figure as *low* as possible in a year of such a major

change, while attention is focussed on the changeover itself, so giving leeway for flattering increases in earnings in future years.

- Recent changes to IFRSs, some of which are being introduced into UK/ROI GAAP as well, bring new challenges for auditors and preparers. In particular, the valuation of certain items, such as employee share options and non-traded financial instruments, are subject to many variables and can be subjective.
- Entities applying IFRSs for the first time are required by IFRS 1 (paragraph 41) to distinguish between GAAP changes and the correction of prior period errors when describing the changes to their financial statements. There is a risk that past errors may not be disclosed as such.
- There are a number of possible consequences of implementing IFRSs, including changes to a company's tax base and charge, restrictions on or reductions to distributable profits and breaches of accounts-based debt or similar covenants. All these could have substantial implications for the financial statements and even, perhaps, for the ability of the company to remain a going concern.

68. As noted above under ISA (UK and Ireland) 240 and below under ISA (UK and Ireland) 540, directors and managers will need to be aware of the greater risk of error and opportunities for fraud that could arise where an entity has to make major adaptations to its systems or where the systems are functioning incorrectly. The extent of change and the urgency may cause a relaxation of formal testing and program change control procedures.

69. Auditors use the entity's impact analysis and detailed plans for the implementation of IFRSs to aid identification of risks of misstatement in the IFRS financial statements.

70. Auditors consider extending their risk assessment procedures as a result of the introduction of IFRSs and in particular consider:

    (a) making enquiries of any consultants used by the company, (whether internal teams or external consultants), about the success or otherwise of the IFRS conversion process, the problems identified and how they were remedied and the areas of main concern for the business; and

    (b) investigating changes in systems and controls that have been implemented as part of the IFRS conversion project.

ISA (UK & Ireland) 320 'Audit Materiality'[24]

71. The definition of 'material' in IAS 1 'Presentation of Financial Statements' (which is in line with the IASB's 'Framework for the Preparation and Presentation of Financial Statements') is:

    "Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor."

72. UK and ROI accounting standards do not define 'materiality' or 'material'. However, the discussion of materiality in the ASB's Statement of Principles (paragraphs 3.28 – 3.32) includes the following:

    "An item of information is material to the financial statements if its misstatement or omission might reasonably be expected to influence the economic decisions of users of those financial statements, including their assessment of management's stewardship.

    Whether information is material will depend on the size and nature of the item in question judged in the particular circumstances of the case..."

73. As these definitions of 'material' are not inconsistent with each other auditors adopt the same approach to determining materiality for an audit of IFRS financial statements as for an audit of UK/ROI GAAP financial statements[25]. However, the application of IFRSs may impact the benchmark upon which materiality has been calculated (eg profit before tax may be reduced) giving rise to a potential need to adjust the recording of uncorrected misstatements of prior periods (see section on ISA (UK and Ireland) 520)

74. One aspect to be considered in light of possible pressure on management to achieve a particular result is highlighted by Paragraph 8 of IAS 8 (December 2003), in the context of the application of accounting policies:

    "IFRSs set out accounting policies that the IASB has concluded result in financial statements containing relevant and reliable information about the transactions, other events and conditions to which they apply. Those policies need not be applied when the effect of applying them is immaterial. However, it is inappropriate to make, or leave

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24 In January 2005 the APB published an exposure draft of a revised version of ISA (UK and Ireland) 320. See www.frc.org.uk/apb for details.

25 An exception to this is related parties: see paragraph 99 for details.

uncorrected, immaterial departures from IFRSs to achieve a particular presentation of an entity's financial position, financial performance or cash flows."

ISA (UK & Ireland) 510 'Initial Engagements – Opening Balances and Continuing Engagements – Opening Balances' and ISA (UK & Ireland) 710 'Comparatives'

Opening balances and comparatives under IFRSs and the impact on the audit

75. The issues of comparatives and opening balances for any particular year's audit are closely linked. It is unlikely to be possible to audit the first financial statements under IFRSs without performing procedures on the opening IFRS balance sheet[26] and then rolling these forward to the 2005 comparative figures and ultimately the 2005 figures themselves. For a 31 December preparer, the opening IFRS balance sheet will be as at 1 January 2004 (ie. the 31 December 2003 balance sheet as previously published under UK/ROI GAAP, but converted to IFRSs).

76. In this context, however, it is important to note that Section 235 of CA 1985 does not bring the comparative figures of the previous year, presented alongside the current period financial statements, within the scope of the auditor's report, nor does the auditor's report make direct reference to the comparative figures. Nevertheless, IAS 1 requires comparative figures to be presented (as they are by UK and Irish company law under UK/ROI GAAP) and auditors have specific responsibilities with regard to opening balances to the extent they affect and determine current period figures in the financial statements.

77. Overall, it is unlikely that the usual level of audit work for continuing engagements, as outlined in ISAs UK & Ireland) 510 and 710, will be sufficient to ensure that opening balances in the year of transition to IFRSs are not materially misstated. The additional work required to be carried out will depend on the nature and complexity of the changes on a case-by-case basis. ISA (UK and Ireland) 510 and ISA (UK and Ireland) 710, which deal with the audit of opening balances and comparatives for incoming auditors, provide useful guidance on additional procedures.

78. In light of the expected pressure on time and resources in the 2005 reporting season, auditors are encouraged to carry out relevant procedures on the IFRS opening balance sheet and 2005 comparatives, to the extent these are necessary for completion of the audit on the 2005 financial statements, as early as possible. Companies may wish their auditors to give some level of private or public assurance on 2004 figures. This work will constitute an engagement separate from the statutory audit; however, auditors can use

26 It is important to distinguish between ISA (UK and Ireland) 510 opening balances, which refers to the current period opening balance sheet, and the opening IFRS balance sheet as required by IFRS 1, which refers to the opening balance sheet, as described here.

any such work, updated and amended as necessary, for the purposes of the procedures required by ISAs (UK & Ireland) 510 and 710.

The application of IFRS 1

79. Auditors refer to the requirements of IFRS 1 in order to assess whether the directors of the audited entity have dealt with the opening position correctly. Companies that are classed as 'first-time adopters' of IFRSs are those making an explicit and unreserved statement of compliance with IFRSs when presenting their first annual financial statements under IFRSs. Broadly, IFRS 1 requires first-time adopters to prepare an opening balance sheet under IFRSs at the date of transition, which is the beginning of the earliest period for which an entity presents full comparative information under IFRSs in its first IFRS financial statements.[27]

80. The opening IFRS balance sheet should be prepared in accordance with IFRSs that are in force as at the reporting date[28] (IFRSs which are not yet mandatory can also be adopted if early adoption is permitted by the IFRS in question). IFRS 1 therefore requires IFRSs to be applied as if they always had been. The exceptions to this rule are that:

    (a) the transitional arrangements in each IFRS should not be followed;

    (b) IFRS 1 gives specific exemptions to the general rule on retrospective adjustment for all standards; and

    (c) IFRS 1 also prohibits retrospective application of certain IFRSs.

81. Broadly speaking, entities have a choice in applying some, all, or none of the exemptions to retrospective restatement given in IFRS 1 but must disclose which exemptions have been taken. Auditors consider the completeness and accuracy of the disclosure of the exemptions in the financial statements and consider whether the consequential implications for the opening balance sheet and restated comparatives have been taken into account (for example, if past business combinations have not been restated as permitted by IFRS 1, there may be consequential requirements to amend the opening balance sheet figures for assets and liabilities recognised in the business combination, including goodwill). This will be necessary in order for the auditors to assess whether the closing balance sheet at the reporting date has been properly prepared, not merely to assess whether comparative information has been properly presented.[29]

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27 Hence, for a 2005 first-time adopter that is a 31 December preparer, the date of transition will be 1 January 2003.

28 So for 2005 first-time adopters that are 31 December preparers, the reporting date is 31 December 2005.

29 IFRS 1 was published with application guidance which will be useful to both preparers and auditors in applying IFRS 1 in practice.

82. Auditors consider whether only differences between UK requirements and IFRSs are included as reconciling items in the opening balance sheet and comparatives. In particular, corrections of errors and revisions of estimates in past results should not be included as reconciling items from UK/ROI GAAP to IFRSs, but should be accounted for as required by IAS 8.

Different first-time adoption dates

83. In the light of implementation difficulties regarding, for example, distributable profits, it is highly likely that many UK listed groups may choose not to move their parent and subsidiary individual financial statements to IFRSs at the same time as their consolidated financial statements. Similarly, where there is a "good reason"[30] some subsidiaries may remain under UK GAAP while the rest of the group's subsidiaries move over to IFRSs. IFRS 1 gives guidance (at paragraphs 24-25) on situations where parents and subsidiaries become first-time adopters at different times.

ISA (UK & Ireland) 520 'Analytical Procedures'

Analytical procedures as risk assessment and substantive procedures

84. Whilst analytical procedures are still likely to be important to the auditor, the lack of historical information in relation to a particular entity arising through the wholesale change in its accounting basis means that additional care will be required in the auditor's use of analytical techniques. As well as a lack of historical data for a particular company or group, industry figures and information may not be available other than on a UK/ROI GAAP basis. A related issue is that some IFRSs require prospective application, so there will be no restated comparative figures for analytical review purposes. Analytical procedures might therefore be of reduced effectiveness throughout the audit.

85. Auditors consider whether they need to perform additional, alternative, substantive procedures in order to compensate for the inability to carry out certain analytical procedures that have been used as substantive procedures in the past. The usefulness of analytical procedures in the overall review of the financial statements may also be weakened and lead the auditors to conclude that additional alternative procedures are necessary.

Analytical procedures in the overall review at the end of the audit

Uncorrected misstatements

86. One of the principal considerations when carrying out the overall review of the financial statements is "The potential impact on the financial statements of the aggregate of uncorrected misstatements (including those arising from bias in making accounting estimates) identified during the course of the audit and the preceding period's audit, if

30 See paragraph 41.

any". Where the adoption of IFRSs gives rise to a lower level of materiality than that used under UK/ROI GAAP the auditors consider whether their evaluation of misstatements identified in the prior year audit needs to be revised.

87. The reference to the uncorrected misstatements of previous periods is of particular relevance in the context of paragraph 41 of IAS 8:

> "Financial statements do not comply with IFRSs if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are authorised for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period."

88. The decision to leave errors uncorrected in the prior period will have been based on an assessment of materiality in the context of UK/ROI GAAP. That assessment will now be made in the context of IFRS figures. Auditors, therefore, examine the schedule of unadjusted differences from the prior period audit and consider whether retrospective restatement is necessary because of a combination of the requirements of IAS 8 in this respect and the reassessment of materiality in the context of the IFRS figures. As well as quantitative aspects, auditors also consider qualitative factors in forming their judgment.

89. One point of difference between IFRSs and UK/ROI GAAP is in relation to how errors are corrected. IAS 8 (revised December 2003) requires all errors to be corrected by prior period adjustment. Accounting standards only relate to material items, so by definition IAS 8 is referring to all material errors. The UK standard, FRS 3 'Reporting Financial Performance', requires only 'fundamental errors' to be corrected in this way, all others being corrected through the profit and loss account in the period in which they are discovered.[31] Auditors consider whether any errors discovered during the course of the audit of the first IFRS accounts, which relate to prior periods, should be corrected by prior period adjustment. As required by IFRS 1, any restatement of errors made under previous GAAP should be clearly differentiated (in the entity's explanation of the transition to IFRSs) from items relating to the restatement of prior year comparatives to comply with IFRSs.

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31 The previous version of IAS 1 made a distinction between fundamental errors and other material prior period errors. The distinction has been eliminated because the definition of fundamental error was difficult to interpret consistently.

ISA (UK & Ireland) 540 'Audit of Accounting Estimates'[32]

Errors vs. changes in estimate

90. Accounting estimates are dealt with in IAS 1 and IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'. The IAS 8 definitions of 'changes in accounting estimates' and 'prior period errors' are fundamental to the decisions that management have to make when differentiating between circumstances giving rise to either a retrospective restatement of an error, or prospective application of a change in an accounting estimate.

91. Care should be taken that management does not use hindsight when assessing the calculation of estimates for comparative information as IFRS 1 specifically prohibits the restatement of estimates at the date of transition to IFRSs or in comparative figures, unless objective evidence is available to show that the estimates were in error. The principle set out in IFRS 1 is that an entity's estimates under IFRSs at the date of transition to IFRSs shall be consistent with estimates made for the same date under previous GAAP (after adjustments to reflect any differences in accounting policies), unless there is objective evidence that those estimates were in error.

92. Where IFRSs require estimates to be made that were not required under UK/ROI GAAP, the lack of track record and management experience in making such estimates will lead to greater risk of misstatement. Auditors consider whether additional audit procedures are required with regard to such estimates.

Disclosure of estimation uncertainty

93. IAS 1, at paragraph 116, requires disclosure in the financial statements of information about the key assumptions concerning the future and other key sources of estimation uncertainty at the balance sheet date that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.[33] These disclosures relate to the estimates that require management's most difficult, subjective or complex judgments. The disclosures required by IAS 1 are different to, and may be more extensive than, those required by paragraph 55(b) of FRS 18. The Basis for Conclusions to IAS 1 indicates the IASB's expectation that disclosure in accordance with this requirement would be made in respect of relatively few assets or liabilities (or classes of them).

94. IAS 1, at paragraph 113, also requires an entity to disclose in its financial statements the judgments, apart from those involving estimations, management has made in applying

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32 In January 2005 the APB published an exposure draft of a revised version of ISA (UK and Ireland) 540. See www.frc.org.uk/apb for details.

33 This disclosure requirement does not apply to assets and liabilities measured at fair value based on recently observed market prices.

the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements, for example whether the substance of the relationship between the entity and a special purpose entity indicates that the special purpose entity is controlled by the entity. Auditors consider extending their evaluations of these types of disclosure, bearing in mind they go beyond the requirements of FRS 18.

ISA (UK and Ireland) 545 'Auditing Fair Value Measurements and Disclosures'

95. IFRSs require certain assets and liabilities to be recognised at fair value rather than historical cost. Incorporating more fair values in financial statements (also reflected in recent changes to ASB standards), may give rise to difficulties for auditors, particularly on transition to IFRSs, for example:

    - Paragraphs 16-19 of IFRS 1 permit companies to elect to use fair value at transition as deemed cost for some assets, such amounts will not previously have been audited.
    - IFRS 2 'Share-based Payment' does not prescribe particular techniques for valuing employee (and other) share options, but sets out general requirements for valuation, which require management and possibly external expert judgment in selecting a model and adapting it to the particular circumstances. This is in the context of several complicating factors, such as the fact that established models are not necessarily suited to non-traded options, a lack of established techniques and standards against which the auditors can judge an expert's work and the difficulty in obtaining and assessing some of the inputs to any valuation model, such as share price volatility.
    - IFRS 3 'Business Combinations' and IAS 38 'Intangible Assets' require many more intangibles to be fair-valued separately from goodwill than is currently the case under FRS 10. Auditing valuations of unique intangibles is likely to be particularly difficult due to subjective assumptions and the potential to use different techniques which might give different answers.
    - Fair value information is required for leases of land and buildings under IAS 17 'Leases' (Paragraphs 14-19). On first-time adoption, entities may need to look back many years to obtain the information, in turn raising potential audit issues.

96. Even though the EC has "carved out" some aspects of fair values from IAS 39 'Financial Instruments: Recognition and Measurement', fair value measurements are still required for many financial instruments.[34] Application guidance has been issued by the IASB on IAS 39; guidance has also been issued by the ASB on whether and to what extent the full

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34 In June 2005 the IASB published an amendment to the fair value option in IAS 39. In July 2005, the European Commission's Accounting Regulatory Committee supported the Commission's proposal to endorse the "IAS 39 Fair Value Option", which should lead to a removal of one part of the carve-out, but (as at November 2005) the difference with respect to hedge accounting remains.

version of IAS 39 can be applied in Europe.[35] Given the complexity of the issue, auditors consider whether an entity has made full and clear disclosure of the extent to which it has applied IAS 39.[36]

97. Guidance on the audit of fair values in financial statements has been introduced for the first time in the UK and Ireland by ISA (UK and Ireland) 545. The standard anticipates the types of difficulties noted above and attention is drawn, in particular, to the following paragraphs of the standard.

- Paragraph 10 requires the auditors to assess the management process for determining fair values and the controls over it, recognising management's primary responsibility for producing the relevant fair value information.
- Paragraphs 17 and 56 require consideration by auditors of the entity's use and disclosure of fair value information according to the relevant financial reporting framework. The issue of disclosure is particularly important as several of the standards discussed above have substantial disclosure requirements.
- Paragraph 24 deals with situations where alternative valuation methodologies are permitted by accounting standards, requiring auditors to consider the suitability of those used.
- The importance of the work of an expert in the context of fair values is highlighted in Paragraphs 29-32.
- Paragraph 39 addresses the auditor's evaluation of the significant assumptions used by management.

ISA (UK & Ireland) 550 'Related Parties'

98. Auditing standards on related parties are closely linked to the underlying accounting framework. From 2005 two accounting frameworks will be in use in the UK and Ireland – IFRS (including IAS 24 "Related party disclosures") and UK/ROI GAAP (including FRS 8 "Related party disclosures"). To accommodate the differences between the two frameworks, ISA (UK and Ireland) 550 has separate parts for use where the financial statements being audited are intended to comply with IAS 24 and FRS 8 respectively.

99. Although the requirements of IAS 24 and FRS 8 are broadly similar, there are a number of differences that may have an impact on the auditor's evaluation of the adequacy of the disclosure of related party transactions. These differences include:

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35 This guidance is available on the ASB website at http://www.asb.org.uk/images/uploaded/documents/ASB%20Guidance%20on%20Applic%20of%20IAS%2039%20-%20attach%20to%20262.pdf.

36 The FSA wrote to listed companies in October 2004 warning them on clarity of disclosure on this issue. The letter is at http://www.fsa.gov.uk/pubs/ceo/ceo_letter_25oct04.pdf.

- The use of different, but similar, definitions of terms such as related party transaction.
- IAS 24 requires disclosure of an outstanding balance between an entity and its related parties even if there have been no transactions between those parties within the reporting period. FRS 8 does not require such disclosure.
- IAS 24 requires the disclosure of related party transactions and outstanding balances in separate financial statements of a parent, investor or venturer. FRS 8 provides an exemption for such disclosure.
- IAS 24 does not reflect that aspect of the FRS 8 definition of materiality which, uniquely, requires assessment of materiality from the point of view of the related party as well as the point of view of the reporting entity.
- Both standards require disclosures of controlling parties. IAS 24 does not contemplate the situation where an entity does not know the identity of its ultimate controlling party and, therefore, does not have the requirement, which is included in FRS 8, to disclose that fact.

ISA (UK & Ireland) 560 'Subsequent Events'

100. IAS 10 'Events After the Balance Sheet Date' and the recent UK/ROI standard FRS 21 of the same title are substantially the same as SSAP 17 'Post-Balance Sheet Events'. The main difference, which has been facilitated by a change in company law, relates to the treatment of dividends declared after the end of an accounting period but before the accounts are approved. Under UK/ROI GAAP, until now, these have been treated as a liability in the accounts of the period just passed, but in future they will only be disclosed as they do not meet the recognition criteria of a liability at the period end.

101. FRS 21 (along with enabling changes to UK legislation) will change UK accounting practice to bring it into line with IAS 10. This will affect single entity accounts and so may affect a parent company in a group which relies on the receipt of dividends from subsidiaries to distribute on to its own shareholders. The change in treatment of dividends paid may affect the period in which the receipt of the dividend can be recorded in the parent's 'relevant accounts'. This may be relevant to the assessment of compliance with laws and regulations under ISA (UK and Ireland) 250 Section A as discussed above.

ISA (UK & Ireland) 570 'Going Concern'

Foreseeable future

102. IAS 1 requires that management make an assessment of the entity's ability to continue as a going concern. IAS 1 addresses going concern on a similar but not identical basis to FRS 18 'Accounting Policies', the relevant UK/ROI standard. Guidance regarding 'the future period to which the directors have paid particular attention in assessing going concern' differs slightly between IAS 1 and FRS 18, as do the detailed disclosure requirements.

103. It is technically possible for management to meet the requirements of IAS 1 by looking forward 12 months from the balance sheet date rather than 12 months from the date of approval of the financial statements. However, this is only possible in circumstances where there is no other information available about the future. If, in such circumstances, the directors do not disclose the length of the future period to which they have paid particular attention, ISA (UK and Ireland) 570 requires the auditors to disclose the length of the period considered in an emphasis of matter paragraph within their report.

104. For UK listed companies, Listing Rule 9.8.6R(3) requires the annual report and accounts to include a statement by the directors that the business is a going concern with supporting assumptions or qualifications as necessary. The rule refers to guidance on the interpretation of this point issued by ICAEW[37]. This guidance is closely aligned to the requirements of ISA (UK and Ireland) 570. It is unlikely that any reason will arise for management to change their approach to the assessment of going concern due to the switch from FRS 18 to IAS 1.

Borrowing powers and debt covenants

105. Listed companies may have limits, in their Articles of Association or other constitutional documents, on the extent to which they can borrow funds without obtaining specific shareholder consent. These provisions are usually expressed by reference to the consolidated financial statements, generally an adjusted net assets position. The legal drafting usually uses, as the starting point before adjustments, balances on share capital and reserves as a proxy for net assets.

106. Similar, but more extensive, financial covenants are often found in debt instruments and borrowing agreements, including those for straightforward bank loans and overdrafts. As well as limiting borrowing, these will often include limits on ratios between interest and earnings and even absolute minimum levels for tangible net assets.

107. Both of these types of arrangement may be affected by the introduction of IFRSs through:

    (a) increases in the type and extent of liabilities recognised, for example in relation to financial instruments measured at fair value; and

    (b) changes in the value of net assets, again through the recognition of new assets or liabilities or the use of new measurement bases.

108. Where applicable, the auditors consider whether the directors have made provision to obtain approval for an increase in the company's borrowing powers from the shareholders in general meeting in sufficient time for the introduction of IFRSs. In the case of financial covenants in debt agreements, auditors consider whether clauses exist

37 Guidance on Going Concern and Financial Reporting for directors of listed companies in the United Kingdom, ICAEW November 1994. http://www.icaew.co.uk/index.cfm?AUB=TB21_67522.MNXI_67522

that allow the use of 'frozen GAAP' (i.e. GAAP that was being used when the agreement was signed is continued for the life of the agreement for covenant purposes, ignoring new accounting requirements); where there is no clause allowing the use of 'frozen GAAP', the auditors consider, in their review of going concern, whether any necessary renegotiation of covenants has taken place in good time and any risk of default by the borrower or termination by the lender as a result of the change in the financial statements caused by the introduction of IFRSs.

109. Where any breach of an undertaking to a lender has taken place before the year end, the auditors consider whether the liability to which it relates has been treated correctly as current or non-current in the balance sheet, depending on the requirements of Paragraphs 65-67 of IAS 1.

ISA (UK & Ireland) 580 'Management Representations'

110. In the periods leading up to the period of transition, auditors may in many cases require, as part of their audit evidence, management assurances on matters such as the potential impact of the introduction of IFRSs on the business. The auditors consider obtaining written representation on these points.

111. In the year of transition, auditors may wish to use the management representation letter to clarify the responsibilities of the directors in relation to the transition to IFRSs. Specific representations are likely to be required by auditors that the directors have obtained all necessary information from subsidiaries that have not adopted IFRSs, to enable adjustments to be made to their financial statements for the purposes of consolidation into the group accounts.

112. Auditors consider the need to obtain representations on management's intentions for future actions, where these will have a direct impact on the accounting treatment of certain items. For example, the treatment of non-current assets held for sale arises from management intention to sell the assets.

ISA (UK & Ireland) 600 'Using the Work of Another Auditor'

113. Co-operation between the principal auditors and the other auditors will be vital in the year of transition to IFRSs. This is particularly the case where the subsidiaries (and parent) are following UK/ROI or another national GAAP in their financial statements, but the group financial statements are prepared under IFRSs. While this is no different, in theory, from those existing situations where a UK/ROI parent owns foreign subsidiaries that report locally under other accounting frameworks, in 2005 there may be substantially more group companies than in the past preparing their statutory accounts under one accounting framework, but reporting for consolidation purposes to the parent under another.

114. Principal auditors consider the extent to which they will need to instruct the other auditors about the need to perform additional procedures and provide information relevant to the

transition. The principal auditors also consider whether they will need to perform further procedures in relation to the other auditors' work, which may require additional visits to the other auditors. The principal auditors may wish to ascertain whether other auditors have made enquiries about the introduction of IFRSs in relation to the entities they are auditing, particularly in those subsidiaries which comprise major parts of the group's business. This will be relevant whether or not the subsidiary entities in question are required to follow IFRSs; their results will still be required to be included in the group accounts of a parent following IFRSs.

ISA (UK & Ireland) 620 'Using the Work of an Expert'

115. There is likely to be a wider range of circumstances in which auditors consider the need to use the work of an expert because of the increased use of valuations in IFRSs as noted under ISA (UK and Ireland) 545 above.

116. Auditors consider the need to use the work of an expert as early as possible in the planning process in the year of transition, to ensure that expert advice can be obtained in a timely fashion. However specialised the work of an expert, auditors assess it and consider the impact of this assessment on the audit report in the context of ISA (UK and Ireland) 620.

ISA (UK & Ireland) 700 'The Auditor's Report on Financial Statements'

'True and fair'/'present fairly'

117. IAS 1 requires management to prepare financial statements that 'present fairly' the financial position, performance and cash flows of the company. However, the CA 1985 continues to require the auditors to report whether the financial statements give a true and fair view. (A company following UK/ROI GAAP will still be required to prepare financial statements that present a true and fair view.) New Section 262(2A) of the CA 1985 makes clear that the terms "present fairly" and "true and fair view" should be read as having the same meaning. There is, therefore, no discrepancy between the standard management brings to bear in its preparation of IFRS financial statements and the auditor's opinion on them.[38]

118. Section 235 of CA 1985 includes a new requirement (Section 235(1A)) for the auditor's report to identify the financial reporting framework applied in the preparation of the financial statements. It is important to appreciate the context in which this reference is made, the DTI Guidance notes that "The requirement that an audit opinion states whether the annual or consolidated accounts give a true and fair view in accordance with the relevant financial reporting framework clarifies the context in which the audit opinion was given, it does not represent a restriction of the scope of that opinion".

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38 A view supported by the Financial Reporting Council (FRC) in its paper "The Implications of New Accounting and Auditing Standards for the "True and Fair View" and Auditors' Responsibilities".

Reference to the financial reporting framework

119. The requirement for IFRSs to be adopted for use in the EU gives rise to a potential for differences to exist between IFRSs as issued by the IASB and IFRSs as adopted for use in the European Union. While there has been considerable attention given to IAS 39 'Financial Instruments: Recognition and Measurement' (where the EC has adopted a so-called 'carved-out' version), the difference between the effective date of a standard established by IASB and when that standard is adopted into EU law, for the purposes of the IAS Regulation, may also give rise to further differences in the future.

120. Differences between IFRSs as issued by the IASB and IFRSs adopted for use in the European Union raise an issue concerning the description of the financial reporting framework a company is following in both the financial statements and the auditor's report thereon. The APB's view is for auditors to express an opinion in the terms 'true and fair view, in accordance with IFRSs as adopted for use in the European Union'.[39]

121. Many companies will be in a position of complying with both IFRSs as issued by the IASB and IFRSs as adopted for use in the European Union[40]. Consequently, the entity may also wish the auditors to express an opinion in terms of 'true and fair view, in accordance with IFRSs'. In these circumstances, it is preferable to state separately a second opinion with regard to full IFRSs to avoid confusing readers of the auditor's report and to leave intact the opinion required by law on compliance with IFRSs as adopted by the EU. The example auditors' reports set out in Bulletin 2005/4 'Auditor's Reports on Financial Statements' illustrate this point (see for example Appendix 1, Example 7).

122. For a minority of companies compliance with IFRSs as issued by the IASB may not ensure compliance with IFRSs as adopted for use in the European Union. Such situations will require auditors to consider carefully how to refer to the financial reporting framework in their audit reports. Auditors may need to take legal advice depending on the precise circumstances. However, the overriding requirement, in all circumstances, is for the *company* to provide full and clear disclosure of the accounting policies that have been adopted, so that users of financial statements can make an informed assessment about

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39 This is also the consensus view that has emerged across Europe following a consultation paper issued by FEE (the Fédération des Experts Comptables Européens). More details can be found at www.fee.be.

40 In relation to IAS 39 the ASB has produced guidance on what it believes to be the correct approach to the situation in the UK and Ireland. It is assumed, for the purposes of this Bulletin, that most companies:
(a) will follow the more restrictive hedge accounting rules in the IASB's IAS 39, as recommended by the ASB; and
(b) will not use the 'full fair value' option in the IASB's IAS 39 (although the European Commission may be about to endorse a revised version of the full fair value option which will remove this particular difference).
Consequently, the majority of companies are expected to be in compliance with both full IFRSs and the EU carved-out version.

what the company has done and how its results are affected by the decisions it has made. Consequently, auditors consider carefully the disclosure made and, where it is in their view deficient:

(a) discuss the relevant disclosures with those charged with governance; and

(b) consider the implications for their report.

Group accounts and the parent's own individual financial statements

123. As described in the ISA (UK and Ireland) 250 section of this Bulletin, the introduction of IFRSs may give rise to issues regarding the presentation of the parent company financial statements where different accounting frameworks are applied and/or the Section 230 exemption is applied. To address this, companies may decide to present the financial statements in separate sections of the annual report.

124. Where companies adopt the separate sections approach, separate audit reports will be prepared for the group and parent company financial statements and, as recommended by the DTI Guidance, where advantage has been taken of the Section 230 exemption, the reference to the framework used in the auditor's report needs to make clear that it is "IFRSs as adopted for use in the European Union *and as applied in accordance with the provisions of the 1985 Act*".[41] An illustrative example of an auditor's report on parent company accounts prepared under IFRSs and using the Section 230 exemption is set out in Appendix 1, Example 11 of Bulletin 2005/4.

Statements of compliance with and departures from IFRSs

125. An unqualified opinion may be expressed only when the auditors are able to conclude that the financial statements give a true and fair view in accordance with the identified financial reporting framework. In all other circumstances the auditors are required to disclaim an opinion or to issue a qualified or adverse opinion. Accordingly, the auditors do not express an unqualified opinion that financial statements have been prepared in accordance with IFRSs if the financial statements contain any departure from IFRSs and the departure has a material effect on the financial statements.

126. When the auditors report on whether the financial statements have been prepared in accordance with IFRSs and those financial statements contain a material departure from IFRSs, such a departure results in a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements[42]. In the light of paragraph 41 of IAS

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41 See Paragraph 43 regarding the need to explain the company's approach.

42 Paragraph 17 of IAS 1 (revised December 2003) allows an entity to depart from the requirements of a standard in the rare circumstances that management concludes that compliance with the requirement would be so misleading that it would conflict with the objective of fair presentation. A departure from the requirements of a particular IFRS made under the provisions of paragraph 17 of IAS 1does not constitute a departure from IFRSs for this purpose.

8, auditors consider whether failure to correct misstatements produces financial statements that are so seriously misleading that an adverse opinion is required, rather than a qualified opinion.

Limitations of scope

127. As noted in the section on ISA (UK and Ireland) 250 individual companies within the group may continue to prepare their financial statements under UK/ROI GAAP and adjustments required to bring the group financial statements into line with IFRSs may be made only as consolidation adjustments. In such circumstances, the auditors pay particular attention to whether this approach is adequate in order to permit the auditors to form an opinion on the consolidated financial statements.

128. Given the pervasive nature of the change to the basis of accounting, it may be the case that the auditors will be subject to a limitation of scope if the entity simply adjusts the information provided in consolidation schedules by accounting systems based on UK/ROI GAAP. Auditors, therefore, assess whether the company has put in place new or adapted accounting systems to record the information required for consolidated financial statements to be prepared under IFRSs to the necessary level of detail and accuracy for the auditors to obtain sufficient audit evidence. Where this is not the case, the auditors consider the implications for their audit report.

ISA (UK & Ireland) 720 "Other Information in Documents Containing Audited Financial Statements"

129. Companies that are subject to the mandatory application of adopted IFRSs are unlikely to wish to wait for the first period of application (accounting periods beginning on or after 1 January 2005) to communicate with users of their financial statements about the likely impact of the change. The Committee of European Securities Regulators (CESR) has issued a Recommendation to regulators to give guidance for listed companies on this point.[43] The FSA has drawn the attention of publicly traded companies to the Recommendation in an article in its publication LIST!, and in its letter to Chief Executives dated 15 April 2005.

130. Commentary following the publication of the CESR recommendation has indicated that there are likely to be variations in practice in the periods leading up to 2005:

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43 The recommendation can be downloaded from the CESR website at www.cesr-eu.org. Broadly, the CESR guidance suggests various ''milestones'' of disclosure leading up to 2005. The milestones coincide with the publication of the 2003 annual financial statements, the 2004 annual financial statements, the 2005 interim financial statements and the 2005 annual financial statements. At each milestone, publicly traded companies are encouraged to provide investors with certain specified information.

(a) some companies may provide disclosures about the transition to IFRSs at the same time and alongside their 2004 published interim and annual financial statements; whereas

(b) other companies may provide such information separately and at different times.

131. Where such information is issued in conjunction with the financial statements, the auditors have regard to the requirements of ISA (UK and Ireland) 720. Where companies disclose such information in the notes to the financial statements, the auditors consider the implications for their report.[44]

132. Paragraph 36 of IFRS 1 requires one year of comparatives to be given under IFRSs, paragraph 37 considers the situation where older comparative financial information is also presented under the previous GAAP of the entity. Such presentation is permitted, but the standard requires it to be clearly labelled as not being prepared under IFRSs as well as a description to be given of the main adjustments that would be required for the information to be compliant with IFRSs (such adjustments do not need to be quantified).

44 IAPS 1014, published by the IAASB, provides guidance on this matter.

REVIEW OF INTERIM FINANCIAL INFORMATION UNDER IFRSs

133. This section sets out guidance for auditors undertaking an engagement to review interim financial information in accordance with Bulletin 1999/4 "Review of Interim Financial Information" on interim financial information published before a company's full annual financial statements are published under IFRSs for the first time.

Listing Rules[45]

134. The Listing Rules require that the accounting policies and presentation applied to interim figures must be consistent with those in the latest published annual accounts, save where they are to be changed in the subsequent annual financial statements, in which case the new accounting policies and presentation should be followed, and the changes and reasons therefore should be disclosed in the interim report. Accordingly, for listed companies that are adopting IFRSs in their annual financial statements, interim financial information for the accounting period must also be prepared using the new accounting policies and presentation that follows from the adoption of those standards.

135. The Listing Rules also require that the interim financial information must contain enough information to enable a comparison to be made with the corresponding period of the preceding financial year.

Accounting Standards[45]

136. Under UK/ROI GAAP, the guidance in the ASB's Statement "Interim Reports" is persuasive rather than mandatory. Under IFRSs, however, there are specific requirements governing the content and presentation of interim reports, which may result in significant changes for some companies.

137. The FSA has indicated[46] that, in line with the recommendation of the Committee of European Securities Regulators (CESR), issuers should prepare 2005 interims on the basis of the IFRS measurement and recognition principles that are expected to apply at the year end and comparatives should be restated. The FSA reiterated this view in June 2005[47], stating that this should include IFRSs not yet adopted for use in the EU but which are expected to be adopted in time to be applied to the full 2005 financial statements.

138. IAS 34 "Interim Financial Reporting" has been adopted for use in the EU. However, as the IAS Regulation applies only to annual financial statements, and given the FSA's statement described above, the standard is not considered mandatory in respect of interim financial statements.

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45 Reference should be made to the Listing Rules, IFRS 1 and IAS 34 for full details of the specific requirements in relation to interim financial reports.

46 December 2004 edition of List!

47 June 2005 edition of List!

139. IAS 34 requires that if an entity's interim financial report is in compliance with it, that fact shall be stated. IAS 34 also states (in paragraph 19) that an interim financial report shall not be described as complying with International Financial Reporting Standards unless it complies with all IFRSs. Thus, the choice of following only endorsed standards or anticipating unendorsed standards in the interim financial statements will mean that care will be required as to what a company claims to be compliant with. The overriding consideration should be for full and clear disclosure of both the standards followed and any uncertainties about the likely adoption of any new or revised IFRSs that are followed before their adoption by the EU.

140. For companies that adopt IAS 34 ''Interim Financial Reporting'' for their interim report, that standard prescribes the minimum content of an interim financial report and the principles for recognition and measurement in complete or condensed financial statements for an interim period.

141. IFRS 1 requires that, if an entity presents an interim financial report under IAS 34, the interim financial report include reconciliations of the figures reported under previous GAAP to the IFRS figures, giving sufficient detail to enable users to understand the material adjustments to the balance sheet, income statement and cash flow statement. Even where an entity is not reporting under IAS 34, this information is likely to be necessary in order to give a clear picture to the market about the impact of IFRSs.

Guidance for auditors

142. The review procedures outlined in Bulletin 1999/4 assume that the auditor has audited the latest annual financial statements and has reviewed the corresponding financial information for the preceding year. The adoption of IFRSs gives rise to some particular issues in relation to the auditor's review of the interim financial information in the year of adoption. These include the extent to which the auditor needs to perform procedures on:

    (a) adjustments made to the opening balance sheet and comparative information to reflect the adoption of IFRSs; and

    (b) new systems, or changes to existing systems, that generate financial information needed to reflect IFRSs.

143. Members of the engagement team need to have obtained an understanding of IFRSs commensurate with their responsibilities and sufficient as a whole to perform the engagement competently. When assessing the risks of material misstatements the auditors consider the possible effect of management's lack of experience of accounting under IFRSs (see paragraph 67).

144. Paragraph 20 of Bulletin 1999/4 addresses the situation when the auditor did not audit the previous financial statements. It notes that Auditing Standards require the auditors to obtain sufficient appropriate evidence that opening balances do not contain errors or

misstatements which materially affect the current period's financial statements and obtain an understanding of, and where appropriate test, accounting and internal control systems.

145. Similarly, paragraph 38 of Bulletin 1999/4 addresses changes in accounting policy. It states that:

> "Auditors review the adjustments and disclosures made. If the auditors do not consider that accounting policy changes have been properly reflected in the financial information, they consider the implications for their review report."

146. The illustrative procedures set out in Appendix 2 of Bulletin 1999/4 include:

> "(q) considering whether the classification and presentation of disclosures is appropriate and in accordance with Stock Exchange requirements, including consideration of the proper presentation of comparative figures, changes thereto and disclosure thereof."

147. When performing a review of interim financial information for which IFRSs have been adopted for the first time, the auditor considers whether the relevant requirements of paragraphs 38 to 46 of IFRS 1 have been complied with, reviewing the adjustments and disclosures made in accordance therewith. These requirements include disclosure of details of changes to the comparative figures.

148. Guidance for the auditor in relation to opening balances and comparatives and the impact on the audit of the annual financial statements is given in the section of this draft bulletin dealing with ISA (UK and Ireland) 510 and ISA (UK and Ireland) 710. This guidance indicates that overall, it is unlikely that the usual level of audit work for continuing engagements, as outlined in ISAs (UK and Ireland) 510 and 710, will be sufficient to ensure that opening balances in the year of transition to IFRSs are not materially misstated and additional procedures, such as those for incoming auditors (for which guidance is given in ISAs (UK and Ireland) 510 and 710) will be required.

149. Paragraph 75 includes the statement that "It is unlikely to be possible to audit the first financial statements under IFRSs without performing procedures on the opening IFRS balance sheet and then rolling these forward to the 2005 comparative figures and ultimately the 2005 figures themselves." The auditor is unlikely to be able to issue a review conclusion on interim financial information until these procedures have been performed and the auditor has considered the results.

New systems, or changes to existing systems, that give rise to financial information needed to reflect IFRSs

150. In addition to the guidance in paragraph 20 of Bulletin 1999/4, the illustrative procedures set out in Appendix 2 of Bulletin 1999/4 include:

"(i) enquiring about changes in the company's procedures for recording, classifying and summarising transactions, accumulating information for disclosure, and preparing the financial information;"

The adoption of IFRSs will require some companies to change, or introduce new, accounting systems (e.g. to record the information necessary for compliance with IAS 39 "Financial Instruments: Recognition and Measurement" or IFRS 2 "Share-based Payment"). As noted above, where this is the case, the considerations for the auditor are similar to those where the auditor did not audit the previous financial statements. In particular, the auditor needs to obtain an understanding of, and where appropriate test, accounting and internal control systems to determine whether those systems provide the necessary information to enable the preparation of financial statements in accordance with the new accounting policies.

Reference to financial reporting framework in the auditor's review report

151. In the section on "Directors' responsibilities" in the review report the auditor adds a paragraph emphasising the fact that IFRSs as adopted in the EU have been followed for the first time. The precise wording adopted by the auditor will depend on the nature and level of disclosure made by the directors in the interim financial report. Example wording of an interim review report is set out in Appendix 2.

152. As noted in Paragraph 139 above differences may exist between the effective date of a standard established by IASB and when that standard is adopted by the European Union, for the purposes of the IAS Regulation. In such circumstances companies may face a situation, when preparing interim information, where an IFRS that has been issued by the IASB has yet to be formally adopted for use in the EU. The company may wish to anticipate the standard's adoption in its interim report, in the expectation that the EC will have adopted the standard in time for its application in the company's annual financial statements.

153. As it is possible that any standard may not be formally adopted within the relevant timescale, this approach carries certain risks, and the auditors discuss the decision with those charged with governance to ensure they are aware of those risks. The position of the particular pronouncement in the adoption process (including existence or otherwise of adoption advice by EFRAG (the European Financial Reporting Advisory Group)) will be relevant in assessing these risks. Again, disclosure by the company on this point should be very clear, to ensure that readers of the interim review understand which standards the company is complying with.

154. Where a company anticipates the adoption of a new or revised IFRS by the EC which has a significant impact on the company's results, the auditors consider the disclosures made by the company and may conclude that it is appropriate to highlight the uncertainty in their report. Illustrative wording of this nature is given in the example interim review report in Appendix 2.

Reporting timetable

155. As noted in paragraph 54 the FSA has given companies a concession relating to the timing of the publication of their first set of half yearly accounts under IFRSs.

APPENDIX 1

EQUIVALENT LEGISLATIVE REFERENCES FOR NORTHERN IRELAND AND COMPARATIVE LEGISLATIVE REFERENCES FOR THE REPUBLIC OF IRELAND.

Legislative references in Northern Ireland

The legal requirements in Northern Ireland are very similar to those in Great Britain. The following table shows the corresponding references to those contained in the Bulletin in relation to Great Britain.

Legislative references in the Republic of Ireland

The principal legislation relating to the form and content of group accounts is contained in the Companies (Amendment) Act 1986 and the European Communities (Companies: Group Accounts) Regulations 1992 (SI 201of 1992), which implement the EU Seventh Directive and amend certain provisions of the Companies Acts 1963 to (then) 1990 relating to group accounts.

Implementation of the IAS Regulation in the Republic of Ireland follows a broadly equivalent approach to that in the United Kingdom, with the exception that application of the requirement to prepare accounts following IFRS has been deferred until 2007 in the case of listed debt securities. The following table shows the comparative legislative references to those contained in this Bulletin in relation to Great Britain.

Bulletin Paragraph Reference	***GB Legislation Reference (all references to Companies Act 1985)***	***Equivalent NI Legislative Reference***	***Comparative ROI Legislative Reference***
4	The Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004 (Statutory Instrument 2004/2947) - *Implement the IAS Regulation, the Accounts Modernisation and Fair Value Directives.*	The Companies (1986 Order) (International Accounting Standards and Other Accounting Amendments) Regulations (Northern Ireland) 2004 (Statutory Rule 2004/496)	European Communities (International Financial Reporting Standards and Miscellaneous Amendments) Regulations 2005, SI 116 of 2005. European Communities (Fair Value Accounting) Regulation 2004, SI 765 of 2004
8(c)	The Companies Act 1985	The Companies (Northern Ireland) Order 1986	The Companies Acts 1963 to 2003.

Bulletin Paragraph Reference	***GB Legislation Reference (all references to Companies Act 1985)***	***Equivalent NI Legislative Reference***	***Comparative ROI Legislative Reference***
27	Schedule 4A CA 1985	Schedule 4A of the Companies (Northern Ireland) Order 1986	Schedule Part 1, Companies (Amendment) Act 1986
34	S 227 – requirement to produce consolidated accounts companies	Article 235	S 150 Companies Act 1963
34	S 255A –requirement to produce consolidated accounts banks and insurance companies	Article 263A	S 150 Companies Act 1963
39	S 227C(1) requirement that the directors of a parent company should ensure that all the individual companies (including the parent) within a group follow the same accounting framework "except to the extent that in their opinion there are good reasons for not doing so" .	Article 235C (1)	S 150 Companies Act 1963
39 (footnote 15)	S 227C (5) –provision of partial exemption re. S 227C(1)	Article 235C (5)	S 150(C) (1) Companies Act 1963, as amended by European Communities (International Financial Reporting Standards and Miscellaneous Amendments) Regulations 2005
42	S 230 – publication exemption for Profit and Loss account.	Article 238	S 3(2) Companies (Amendment) Act 1986
42 (footnote 16)	S 261 (2) – publication exemption – notes to Profit and Loss	Article 269 (2)	Schedule Part IV 23 Companies (Amendment) Act 1986
44	S 240 (2) – requirement for consolidated and individual accounts to be published together	Article 248 (2)	S 150 Companies Act 1963

Bulletin Paragraph Reference	*GB Legislation Reference (all references to Companies Act 1985)*	*Equivalent NI Legislative Reference*	*Comparative ROI Legislative Reference*
45	S 226(5) decision to switch to IFRS irreversible except where companies and groups cease to be publicly traded.	Article 234 (5)	S 148 (5) (b) and (c) Companies Act 1963, as amended by European Communities (International Financial Reporting Standards and Miscellaneous Amendments) Regulations 2005
45	S 227(6) – decision to switch to IFRS irreversible except where company becomes a subsidiary of an undertaking that does not prepare its accounts in accordance with IFRS.	Article 234 (5) and Article 235 (6)	S 148 (5) (a) Companies Act 1963, as amended by European Communities (International Financial Reporting Standards and Miscellaneous Amendments) Regulations 2005
47	S 237 (1) – auditors required to investigate whether proper accounting records kept	Article 245(1)	S 194 Companies Act 1990
49	S 263 – laws relating to distributions	Article 271	Part IV Companies Act 1983
76	S 235 – comparatives not within scope of auditor's report	Article 243	S 193 Companies Act 1990
117	S 262 (2A) – terms – "present fairly" and "true and fair view" read as having the same meaning.	Article 270 (2A)	Schedule 1, 1(B) – European Communities (International Financial Reporting Standards and Miscellaneous Amendments) Regulations 2005
118	S 235 (1A) – auditor's report to identify financial reporting framework applied in the preparation of the financial statements	Article 243 (1A)	S 8 (4) Companies Act 1990, as amended by European Communities (International Financial Reporting Standards and Miscellaneous Amendments) Regulations 2005

APPENDIX 2

EXAMPLE REVIEW REPORT

INDEPENDENT REVIEW REPORT TO XYZ PLC

Introduction

We have been instructed by the company to review the financial information for the [three months] [six months] [nine months] ended ... which comprises [specify primary financial statements and the related notes that have been reviewed].[48] We have read the other information contained in the interim report and considered whether it contains any apparent misstatements or material inconsistencies with the financial information.

Directors' responsibilities

The interim report, including the financial information contained therein, is the responsibility of, and has been approved by the directors. The directors are responsible for preparing the interim report in accordance with the Listing Rules of the Financial Services Authority.

As disclosed in note X, the next annual financial statements of the [group/company] will be prepared in accordance with IFRSs as adopted for use in the European Union***. [This interim report has been prepared in accordance with International Accounting Standard 34, "Interim Financial Reporting" and the requirements of IFRS 1, "First Time Adoption of International Financial Reporting Standards" relevant to interim reports.][49]

The accounting policies are consistent with those that the directors intend to use in the next annual financial statements. [There is, however, a possibility that the directors may determine that some changes to these policies are necessary when preparing the full annual financial statements for the first time in accordance with IFRSs as adopted for use in the European Union. This is because, as disclosed in note Y, the directors have anticipated that [new] [revised] IFRS X, which has yet to be formally adopted for use in the EU will be so adopted in time to be applicable to the next annual financial statements.][50]

Review work performed

We conducted our review in accordance with guidance contained in Bulletin 1999/4 issued by the Auditing Practices Board for use in the United Kingdom. A review consists principally of making enquiries of [group] management and applying analytical procedures to the financial information and underlying financial data and based thereon, assessing whether the disclosed

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48 Review reports of entities that do not publish their interim reports on a web site or publish them using 'PDF' format may continue to refer to the pages of the interim report.

49 This wording should be tailored accordingly to reflect the approach adopted by the directors (see Paragraphs 138 – 141).

50 This wording should be tailored accordingly to reflect the approach adopted by the directors and the disclosures given in the interim report (see Paragraphs 139 and 153).

accounting policies have been consistently applied unless otherwise disclosed. A review excludes audit procedures such as tests of controls and verification of assets, liabilities and transactions. It is substantially less in scope than an audit and, therefore, provides a lower level of assurance. Accordingly, we do not express an audit opinion on the financial information.

Review conclusion

On the basis of our review we are not aware of any material modifications that should be made to the financial information as presented for the [three] [six] [nine] months ended ....

ABC & Company *Designation*
Date *Address*

***** Subsequent to this Bulletin being printed the Accounting Regulatory Committee (ARC) of the European Commission indicated that it was supportive of the following standard formulation for use in the notes to the accounts and in the auditor's report "...in accordance with International Financial Reporting Standards as adopted by the EU" or (abbreviated version) "in accordance with IFRSs as adopted by the EU". The ARC wording differs slightly from that used in the Appendix and auditors may wish to use the ARC's wording in their reports.** ***(See APB Press Notice No. 25 of 21 December 2005)***

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