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Questions and Answers

First Time Adoption of International Financial Reporting Standards—Guidance for Auditors on Reporting Issues

First Time Adoption of International Financial Reporting Standards—Guidance for Auditors on Reporting Issues

International Financial Reporting Standard (IFRS) 1, "First Time Adoption of IFRS" was issued on June 19, 2003 with an effective date of January 1, 2004. IFRS 1 applies when an entity adopts IFRSs for the first time by an explicit and unreserved statement of compliance with IFRSs. In general, IFRS 1 requires an entity to comply with each IFRS effective at the reporting date for its first IFRS financial statements. In particular, it sets out the requirements, and exemptions from the requirements, with regard to an entity's opening IFRS balance sheet that it prepares as a starting point for its accounting under IFRSs. In addition, it requires disclosures that explain how the transition from the previously applied national financial reporting framework to IFRSs affected an entity's reported financial position, financial performance and cash flows.

The 2005 adoption in the European Union of IFRSs endorsed by the European Commission, and the adoption of IFRSs in other countries, have given rise to requests for auditors to audit, review, or otherwise report on various forms of financial and non-financial information during the transition to adopting IFRSs as the entity's financial reporting framework, for example, reporting on the entity's preliminary opening IFRS balance sheet.

The following questions and answers are not authoritative, official, or other pronouncements of the International Auditing and Assurance Standards Board (IAASB) or of the International Federation of Accountants. They have been prepared by an informal group of staff representatives from the IAASB, professional accounting bodies, national standards setters and audit firms for the sole purpose of assisting auditors in addressing common reporting issues arising in relation to the first-time adoption of IFRSs under IFRS 1. IFAC and the IAASB have agreed to include this guidance on their website as a means of making it widely available to auditors in those countries where these common issues are faced. It is hoped that the guidance will avoid unnecessary variations in practice, and that its use will be helpful to auditors and their clients.

The answers have been based on International Standards on Auditing (ISAs) and International Auditing Practice Statements (IAPSs) and should be read in conjunction with the relevant ISAs and IAPSs.

Auditors are invited to forward any comments that they may have on the questions and answers, or any additional questions of a global nature, to Alta Prinsloo at altaprinsloo@ifac.org. Comments received or additional questions submitted will be considered by the above-mentioned group and, if appropriate, amendments processed or answers developed.

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Basic Scenario

The questions and answers are premised on the following basic scenario:

- XYZ Company is a listed company that is adopting International Financial Reporting Standards (IFRSs) for the first time in 2005 and, accordingly, will be applying IFRS 1, "First Time Adoption of International Financial Reporting Standards." It will prepare financial statements in accordance with the previously applied national financial reporting framework in 2004.
- The auditor has an ongoing audit relationship with XYZ Company. The auditor conducted the audit of the 2003 financial statements, which have been prepared in accordance with the national financial reporting framework.
- XYZ Company is planning its conversion to IFRSs and is considering various options for how it will prepare and present information related to its IFRS transition.

The options being considered and their respective reporting implications are described in the questions and answers below

The answers to the questions have been developed based on the above-mentioned basic scenarios, for example the auditor has an ongoing audit relationship with XYZ Company. If an auditor, who does not have an ongoing audit relationship with the company, is asked to undertake work, regard should be given, for example, to ethical and professional requirements. Paragraph 13.14 of the Code of Ethics for Professional Accountants of the International Federation of Accountants (IFAC Code) provides guidance regarding circumstances when the opinion of a professional accountant, other than the existing accountant, is sought on the application of reporting standards or principles to specific circumstances or transactions.

It should also be noted that not all scenarios will necessarily apply in all jurisdictions as financial reporting requirements during the transition may differ. In some circumstances, narrative or quantitative IFRS transition information may be required by standards or regulatory requirements to be included in the company's financial statements or annual report, or to be released separately. In other circumstances, however, the company may voluntarily prepare and issue narrative or quantitative IFRS transition information either for its own internal purposes or for external stakeholders.

It would be useful for the auditor to discuss with those charged with governance of XYZ Company and XYZ Company's management the company's strategy for the release of information related to its IFRS transition. Such discussions might include consideration of the risks and benefits of the timing and nature of the various scenarios discussed below and the implications for the work the auditor believes is appropriate and the form and content of the report by the auditor in each circumstance.

Summary of the Questions on Reporting Issues

1. How should the auditor report if asked for advice on IFRS accounting policies? For example, XYZ Company's Chief Financial Officer or those charged with governance might ask for the auditor's views on whether the company's proposed accounting policies for revenue recognition in its conversion plan are consistent with the requirements of IFRSs. (See page 6)

2. XYZ Company prepares a preliminary opening IFRS balance sheet as at January 1, 2004, prior to the preparation of its first complete set of IFRS financial statements as at the December 31, 2005 IFRS reporting date. What should the auditor consider if asked to report on this preliminary opening IFRS balance sheet as at January 1, 2004? (See page 8)

3. XYZ Company prepares a set of IFRS financial statements as at December 31, 2004. How should the auditor report if asked to audit or review the IFRS financial statements as at December 31, 2004 (e.g., if the IFRS financial statements as at December 31, 2004 are issued separately from the financial statements as at December 31, 2004 prepared in accordance with the national financial reporting framework)? (See page 13)

4. XYZ Company voluntarily includes narrative transition information with its financial statements as at December 31, 2004 prepared in accordance with the national financial reporting framework. It publishes the narrative information:

   (a) In the notes to the financial statements.

   (b) Elsewhere in the annual report (e.g., in the operating review or management discussion and analysis).

   Should this information be considered within the scope of the audit of the financial statements as at December 31, 2004 prepared in accordance with the national financial reporting framework? What are the auditor's responsibilities? (See page 14)

5. XYZ Company prepares a quantified reconciliation from its financial position and results prepared in accordance with the national financial reporting framework as at December 31, 2004 to IFRS. This reconciliation has been included with the Company's financial statements prepared in accordance with the national financial reporting framework as at December 31, 2004. Should this reconciliation be considered within the scope of the audit of those financial statements? What are the auditor's responsibilities? (See page 16)

6. XYZ Company prepares a full reconciliation to IFRSs at December 31, 2004. It does not issue this reconciliation with its financial statements as at December 31, 2004 prepared in accordance with the national financial reporting framework, but instead makes a separate announcement to the market during calendar year 2005 containing only, for example, the reconciliation of its results prepared in accordance with the national financial reporting framework to IFRSs. What are the auditor's responsibilities with respect to the IFRS financial information that is issued separately from the financial statements as at December 31, 2004 prepared in accordance with the national financial reporting framework, if the company has not asked the auditor to audit or review such information? (See page 18)

7. XYZ Company proposes to prepare stand-alone IFRS interim financial information in accordance with IAS 34, "Interim Financial Reporting" for the six month period ended June 30, 2004. The company's management asks the auditor to review that interim financial information and issue a review report. Can the auditor conduct a review of the IFRS interim financial information for the six month period ended June 30, 2004 and issue a review report? (See page 19)

8. XYZ Company prepares its interim financial information for the six month period ended June 30, 2005 in accordance with IAS 34, "Interim Financial Information." Can the auditor conduct a review of the IFRS interim financial information for the six month period ended June 30, 2005 and issue a review report? (See page 20)

9. What does the auditor need to consider in relation to the audit of XYZ Company's first complete set of IFRS financial statements as at December 31, 2005? (See page 21)

Questions and Answers

Question 1

How should the auditor report if asked for advice on IFRS accounting policies?

For example, XYZ Company's Chief Financial Officer or those charged with governance might ask for the auditor's views on whether the company's proposed accounting policies for revenue recognition in its conversion plan are consistent with the requirements of IFRSs.

Answer to Question 1

The company's management is responsible for the selection and application of accounting policies that are consistent with the company's applicable financial reporting framework. In providing views on whether selected accounting policies are consistent with the requirements of IFRSs, the auditor is providing advice based on the auditor's knowledge of IFRSs and of the company, gained through the auditor's previous audit experience with the company. In providing such input, the auditor is not expressing a conclusion based on the outcome of performing audit or review procedures to obtain evidence regarding the application of the accounting policies to actual transactions and events or the preparation of a complete set of IFRS financial statements.

Paragraph 8.165 of the IFAC Code recognizes that the audit process involves extensive dialogue between the auditor and management and that during this process management often requests and receives significant input regarding such matters as accounting principles and financial statement disclosures. Such technical advice to those charged with governance or management is seen as an appropriate part of the audit process that promotes the fair presentation of financial statements. Paragraph 8.165 of the IFAC Code concludes that the provision of such advice does not generally threaten the auditor's independence. However, in providing such advice, the auditor guards against giving bookkeeping advice and making specific accounting entries, both of which are recognized in the IFAC Code as creating potential self-review threats to the auditor's independence.

Those charged with governance or management may ask the auditor for the auditor's views on the accounting policies selected by the company. The form and content of the auditor's communications can vary. However, when the auditor is asked to provide views in writing, the written communication in these circumstances is restricted to a factual analysis of the company's selected accounting policies and whether they are consistent with the requirements of IFRSs. It is important that any written communication prepared by the auditor avoid including a statement that could reasonably be mistaken for an audit, review or other assurance engagement. For example, it would not be appropriate for the written communication to include a conclusion that suggests that it is based on audit or review procedures, or to express a conclusion on the application of the selected accounting policies because the auditor has not obtained evidence regarding their application to actual transactions and events or the preparation of a complete set of IFRS financial statements. To avoid any confusion regarding the nature of the auditor's advice, the auditor does not use terms such as "audit," "review," "assurance," "verification," or "evidence" in any written communication.

It would be appropriate to include the following in the written communication issued by the auditor:

- A description of the company's selected accounting policies, the relevant IFRS requirements, the facts and circumstances surrounding the company's selection of the accounting policies, and, where necessary, the assumptions made in interpreting those facts and circumstances.
- The auditor's views as to whether the company's selected accounting policies are consistent with the requirements of IFRSs.
- A statement that the company's management is responsible for the selection and application of accounting policies in the preparation and presentation of financial statements in accordance with IFRSs.
- A statement that the auditor's views are given in the context of assisting the company in selecting its policies as part of its transition to IFRSs and that, since the proposed policies have not yet been applied to the first complete set of IFRS financial statements, the auditor will also need to assess the policies in the context of the audit of those financial statements.
- A statement that any difference in facts, circumstances, or assumptions presented may change the analysis and views expressed in the written communication.
- The date up to which the accounting policies have been considered and an acknowledgement that the company's selected accounting policies may need to be adjusted when applied to the first complete set of IFRS financial statements to reflect the effects of:
  - Changes in financial reporting requirements arising from new or revised standards or interpretations subsequent to the date of the auditor's written communication; or
  - Changes to the company's operations.
- A statement that no audit or review procedures have been performed of the underlying transactions or balances and, therefore, the engagement is not intended to be an assurance engagement and the auditor is not expressing an audit opinion or other conclusion conveying assurance.
- A statement indicating for whom the written communication has been prepared (e.g., solely for the information and use of the company's Board of Directors or Executive or Supervisory Board, Audit Committee, or management) and that it should not be used or provided to other parties for any other purpose.

Question 2

XYZ Company prepares a preliminary opening IFRS balance sheet as at January 1, 2004, prior to the preparation of its first complete set of IFRS financial statements as at the December 31, 2005 IFRS reporting date.

What should the auditor consider if asked to report on this preliminary opening IFRS balance sheet as at January 1, 2004?

Answer to Question 2

IFRS 1 requires first-time adopters to prepare an opening IFRS balance sheet at the date of transition to IFRSs (hereinafter referred to as "opening balance sheet"). This is the starting point for its accounting under IFRSs. A company need not present its opening balance sheet in its first complete set of IFRS financial statements. For most companies adopting IFRSs in 2005, the opening balance sheet will be as at January 1, 2004.

In accordance with IFRS 1, a company applies the same accounting policies in its opening balance sheet and throughout all periods presented in its first complete set of IFRS financial statements. Those accounting policies should comply with each IFRS effective at the reporting date for its first complete set of IFRS financial statements (i.e., at December 31, 2005).

For reasons such as those discussed below, the opening balance sheet becomes final only when the first complete set of IFRS financial statements is prepared. Consequently, an opening balance sheet prepared prior to the preparation of the first complete set of IFRS financial statements, hereinafter is referred to as a "preliminary opening balance sheet."

Reporting on the company's preliminary opening balance sheet prior to the company's reporting date for its first complete set of IFRS financial statements (i.e., December 31, 2005) are difficult for several reasons:

- IFRSs have not yet reached the point where a company knows which standards it will apply in 2005. For example, the revisions to International Accounting Standard (IAS) 39 have not yet been finalized, there may be changes to standards or interpretations of the International Accounting Standards Board (IASB), and changes may be made to standards which although not mandatory for 2005 may be permitted to be adopted early. In addition, industry interpretation material has not yet been fully developed. Hence, a company cannot be certain that the accounting policies it applies to prepare a preliminary opening balance sheet will be the same policies that will be applied to the final opening balance sheet when the company prepares its first complete set of IFRS financial statements as at December 31, 2005.
- In Europe, the final position of the European Commission on endorsing individual standards is not yet known.

For these reasons, preparing a preliminary opening balance sheet at any time before December 31, 2005 involves management making assumptions about the standards and interpretations expected to be effective and the accounting policies expected to be adopted when management prepares its first complete set of IFRS financial statements as at December 31, 2005. However, the account balances in this preliminary opening balance sheet may change when the company prepares its first complete set of IFRS financial statements as at December 31, 2005.

Management therefore needs to carefully weigh the advantages and disadvantages of issuing a preliminary opening balance sheet publicly in advance of its first complete set of IFRS financial statements as at December 31, 2005. The earlier it is prepared, the greater the risk that the figures subsequently may need to be revised.

Similarly, auditors will need to decide whether to accept an engagement to report on a preliminary opening balance sheet in advance of the audit of the company's first complete set of financial statements as at December 31, 2005, and whether to restrict the use of that report to the Board of Directors or Executive or Supervisory Board, Audit Committee, or management only. In some circumstances, auditors may be comfortable reporting to those charged with governance or management on the preliminary opening balance sheet because they will understand the inherent limitations of the information. Auditors may be less comfortable reporting if they know that those charged with governance or management intend to release the preliminary opening balance sheet and the accompanying auditor's report publicly. For these reasons, auditors may decide to accept engagements to audit the preliminary opening balance sheet in advance of the audit of the first complete set of IFRS financial statements as at December 31, 2005 only if use of the auditor's report is restricted to those charged with governance or management.

The following factors are also relevant in deciding whether to accept an engagement to report on a preliminary opening balance sheet because they can influence whether the auditor will be able to obtain sufficient appropriate evidence regarding the account balances and disclosures in the preliminary opening balance sheet:

- Whether the auditor has completed the audit work on the basis of the national financial reporting framework and IFRS data.
- Whether management's preparations for the conversion to IFRSs appear to be robust and adequate.
- Whether management has made and documented all relevant decisions and choices it needs to make in relation to selecting IFRS accounting policies and bases, including those related to the income statement.
- Whether the preliminary opening balance sheet includes a comprehensive accounting policy note, including all disclosures relevant to the balance sheet and the relevant reconciling information regarding the IFRS adjustments as required under IFRS 1.
- Whether for other reasons it is likely that the figures in the preliminary opening balance sheet will be different from those in the final opening balance sheet prepared when the company issues its first complete set of IFRS financial statements as at December 31, 2005. Revisions of or changes to standards or interpretations of the IASB, or guidance on the application of IFRSs in a particular industry, may give rise to such differences.

Audit engagement

It is possible for an auditor to accept a special purpose audit engagement under International Standard on Auditing (ISA) 800, "The Auditor's Report on Special Purpose Audit Engagements" when the auditor believes that the auditor will be able to obtain sufficient appropriate audit evidence regarding the account balances and disclosures in the preliminary opening balance sheet. As explained more fully below, the auditor needs to consider the reporting implications of the inherent uncertainty in the accounting policies that will ultimately apply when complying with IFRS 1 for the first complete set of IFRS financial statements as at December 31, 2005.

The auditor's opinion on a preliminary opening IFRS balance sheet does not refer to whether it is a true and fair view of, or is fairly presented, in all material respects, in accordance with IFRSs. This is because the preliminary opening balance sheet is a starting point for the company's accounting under IFRSs and the company cannot be certain until it reaches December 31, 2005 that the IFRS accounting policies applied are the appropriate ones in the context of its final opening balance sheet.

For these reasons, it is more appropriate for the opinion to state whether the preliminary opening balance sheet is prepared, in all material respects, in accordance with a described basis of preparation that explains the assumptions management has made about the standards and interpretations expected to be effective and the accounting policies expected to be adopted when it prepares its first complete set of IFRS financial statements as at December 31, 2005. These assumptions will be explained more fully in the notes to the opening balance sheet and therefore it is appropriate to refer to the description in the notes to the preliminary opening balance sheet. The basis of preparation note, which will be expansive, will describe the IFRS adjustments to the audited financial statements as at December 31, 2003 prepared in accordance with the national financial reporting framework. This note will also include all income statement-related policies, since such policies affect the recognition of assets and liabilities.

The following additional language would be appropriate in an auditor's report on a preliminary opening balance sheet:

- Make clear from the title of the report that it is not a report on a complete set of general purpose financial statements, for example "special purpose auditor's report on the preliminary opening IFRS balance sheet."
- Identify the financial information presented (preliminary opening balance sheet and related notes) and indicate the purpose for which it has been prepared by management.
- Include an emphasis of matter paragraph explaining that the IFRS accounting policies applied in preparing the preliminary opening balance sheet may be subject to change.
- Also include in the emphasis of matter paragraph an explanation that under IFRSs only a complete set of financial statements comprising a balance sheet, income statement, statement of changes in equity, cash flow statement, together with comparative financial information and explanatory notes, can provide a fair presentation of the company's financial position, results of operations, and cash flows in accordance with IFRSs.
- Unless the auditor has consented in writing that the auditor's report can be issued publicly, clearly state that the report is solely for the use of the Board of Directors or Executive or Supervisory Board, Audit Committee, or management and should not be provided to other parties.

The following is an illustrative example of an auditor's report with these features**.**

Special Purpose Auditor's Report on the Preliminary Opening IFRS Balance Sheet

To the [Board of Directors or Executive or Supervisory Board, Audit Committee, or Management] of XYZ Company

We have audited the accompanying preliminary opening IFRS balance sheet and related notes of XYZ Company as at January 1, 2004 (hereinafter referred to as "opening balance sheet"). This opening balance sheet is the responsibility of the company's [directors or management]. It has been prepared as part of the company's conversion to International Financial Reporting Standards (IFRSs). Our responsibility is to express an opinion on this opening balance sheet based on our audit.

We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the opening balance sheet is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the opening balance sheet. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the opening balance sheet. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the opening balance sheet as at January 1, 2004 has been prepared, in all material respects, in accordance with the basis set out in Note 1, which describes how IFRS have been applied under IFRS 1, including the assumptions management has made about the standards and interpretations expected to be effective, and the policies expected to be adopted, when management prepares its first complete set of IFRS financial statements as at December 31, 2005.

Without qualifying our opinion, we draw attention to the fact that Note 1 explains why there is a possibility that the opening balance sheet may require adjustment before constituting the final opening IFRS balance sheet. Moreover, we draw attention to the fact that, under IFRSs, only a complete set of financial statements comprising a balance sheet, income statement, statement of changes in equity, and cash flow statement, together with comparative financial information and explanatory notes, can provide a fair presentation of the company's financial position, results of operations, and cash flows in accordance with IFRSs.

This report is intended solely for the information and use of the [Board of Directors or Executive or Supervisory Board, Audit Committee, or management] of the company in connection with its conversion of the basis of the preparation of the financial statements to IFRSs. It should not be used for any other purpose or provided to other parties.

AUDITOR
Date
Address

Review engagement

A review engagement, by its nature, is likely to be insufficient to provide evidence that management has selected and appropriately applied IFRS accounting policies in its preliminary opening balance sheet. There will not be an audited complete set of IFRS financial statements as at December 31, 2003, or comparatives for the preceding period, as this will be the first period for which IFRS data is prepared.

For this type of engagement, the company will still be at an early stage of its preparation of the first complete set of IFRS financial statements as at December 31, 2005. The company may find that it needs to enhance or otherwise modify its conversion procedures or to amend the IFRS accounting policies it selects and applies as it gains experience in preparing the first complete set of IFRS financial statements as at December 31, 2005. Furthermore, from the auditor's perspective the limited procedures performed in a review may not be appropriate to identify issues in the selection and application of the IFRS accounting policies or to identify the risks of material misstatement in the transition from the national financial reporting framework to IFRSs. Thus, the possibility exists that the auditor may identify misstatements in the preliminary opening balance sheet when the auditor subsequently performs audit procedures in relation to the comparative IFRS financial information as at December 31, 2004 issued as part of the first complete set of IFRS financial statements as at December 31, 2005.

For these reasons it may not be possible for the auditor to obtain the moderate level of assurance expected in International Standard on Review Engagements (ISRE) 2400, "Engagements to Review Financial Statements" that the preliminary opening balance sheet is free of material misstatement. Consequently, to obtain sufficient appropriate evidence in order to provide a meaningful conclusion it is likely that some audit procedures will need to be performed on the underlying national financial reporting framework account balances and disclosures and IFRS adjustments.

Agreed-upon procedures engagement

An auditor may also be able to undertake agreed-upon procedures engagements with respect to the conversion of certain transactions or account balances. However, an agreed-upon procedures engagement would not be appropriate where audit or assurance-type judgment is required, since such engagements would be conducted under the ISAs, ISREs or International Standards on Assurance Engagements (ISAEs), as appropriate in the circumstances. As described in International Standard on Related Services (ISRS) 4400, "Engagements to Perform Agreed-upon Procedures Regarding Financial Information," performance of agreed-upon procedures results in a report on factual findings that includes a statement that the procedures do not constitute either an audit or a review and, as such, no assurance is expressed, as well as a statement that had the practitioner performed additional procedures, an audit or a review, other matters might have come to light that would have been reported. Therefore, an agreed-upon procedures engagement cannot lead to an opinion or conclusion on whether transactions or account balances have been prepared in accordance with or comply with relevant IFRSs.

Question 3

XYZ Company prepares a set of IFRS financial statements as at December 31, 2004.

How should the auditor report if asked to audit or review the IFRS financial statements as at December 31, 2004 (e.g., if the IFRS financial statements as at December 31, 2004 are issued separately from the financial statements as at December 31, 2004 prepared in accordance with the national financial reporting framework)?

Answer to Question 3

For many of the same reasons given in relation to reporting on the preliminary opening balance sheet in Question 2, auditing or reviewing the company's IFRS financial statements as at December 31, 2004 remains a difficult area. A company will still not be certain that the accounting policies applied in the IFRS financial statements as at December 31, 2004 (or other narrative or quantitative IFRS reconciling information) will be the same policies that will be applied when the company prepares its first complete set of IFRS financial statements as at December 31, 2005. The uncertainty regarding the IFRSs that will apply at December 31, 2005 will begin to lessen the closer one gets to that date. In addition, the company may be further along in its IFRS transition preparations and, by then, have implemented robust policies and procedures regarding the conversion of transactions and account balances to IFRSs.

In making a decision whether to accept an engagement to report on the company's IFRS financial statements as at December 31, 2004, the auditor may conclude that certain conditions that might have previously led the auditor to conclude that it was not possible to obtain sufficient appropriate audit evidence regarding the company's preliminary opening balance sheet no longer exist. Nevertheless, the uncertainty regarding the accounting policies that will be in place on the company's reporting date (December 31, 2005) remains and, therefore, the reporting considerations as discussed in Question 2 still apply.

IFRS 1 requires that the first complete set of IFRS financial statements should include at least one year of comparative financial information prepared in accordance with IFRSs, although a company can elect to present additional years of comparative financial information in accordance with IFRSs. Unless XYZ Company has elected, or is required for regulatory purposes, to prepare additional years of comparative financial information, the company will not have the comparatives for the financial statements as at December 31, 2004 that are required in accordance with IFRSs. In addition, the IFRS accounting policies will still be based on management assumptions regarding the IFRSs that will apply at the company's IFRS reporting date (December 31, 2005). For these reasons, the guidance in the answer to Question 2 regarding the elements of the auditor's report is relevant in these circumstances. The auditor's opinion on the IFRS financial statements as at December 31, 2004 refers to whether the financial statements are prepared, in all material respects, in accordance with a described basis of preparation that explains the assumptions management has made about the standards and interpretations expected to be effective and the accounting policies expected to be adopted when it prepares its first complete set of IFRS financial statements as at December 31, 2005.

Question 4

XYZ Company voluntarily includes narrative transition information with its financial statements as at December 31, 2004 prepared in accordance with the national financial reporting framework. It publishes the narrative information:

(a) In the notes to the financial statements.

(b) Elsewhere in the annual report (e.g., in the operating review or management discussion and analysis).

Should this information be considered within the scope of the audit of the financial statements as at December 31, 2004 prepared in accordance with the national financial reporting framework? What are the auditor's responsibilities?

Answer to Question 4(a)

A company may be required by regulation to, or voluntarily may, make public disclosures of IFRS transition information in connection with its financial statements as at December 31, 2004 and interim financial information for the six month period ended June 30, 2005. For example, in Europe, the recommendations of the Committee of European Securities Regulators (CESR) encourage disclosures as early as possible in 2005 regarding the transition to IFRSs.

Even if this narrative IFRS transition information may not be required by national financial reporting frameworks, if presented in the notes to the financial statements it would likely be considered by a reasonable user to be an integral part of the company's financial statements. This situation is comparable to the disclosure of the extent of compliance with IFRSs described in International Auditing Practice Statement (IAPS) 1014, "Reporting by Auditors on Compliance with International Financial Reporting Standards." IAPS 1014 explains that a note to the financial statements containing disclosures about compliance with IFRSs is treated no differently from any other note to the financial statements. All such notes contain management assertions and the auditor obtains sufficient appropriate audit evidence with respect to the assertions. Hence, the narrative information is audited and covered by the auditor's report on the financial statements. No specific reference would need to be made to the narrative information in the auditor's report.

IAPS 1014 explains that, with respect to such additional information disclosed in the notes to the financial statements, the auditor considers whether assertions made are accurate and not misleading. If the auditor believes that the narrative information is materially inaccurate or incomplete to the extent that it could mislead a reasonable user, and management does not amend it, the auditor expresses a qualified or an adverse opinion. IAPS 1014 also notes that, even if the narrative information is not misleading, the auditor may decide to modify the auditor's report in other circumstances by adding an emphasis of matter paragraph. The use of an emphasis of matter paragraph, however, is not a substitute for issuing a qualified opinion or an adverse opinion on compliance with the national financial reporting framework when disclosures are misleading.

Answer to Question 4(b)

Narrative IFRS transition information that is not included with the financial statements but is presented elsewhere in the annual report (e.g., in the operating review section or in management's discussion and analysis) is not covered by the auditor's report per se. Rather, it would be considered "information in documents containing audited financial statements" as described in ISA 720, "Other Information in Documents Containing Audited Financial Statements."

ISA 720 limits the auditor's responsibilities to reading the other information contained in the annual report to identify inconsistencies with the audited financial statements and misstatements of fact.

In this particular circumstance, however, it is appropriate for the auditor to perform further procedures because the narrative information is so closely associated with the company's financial statements. In addition, the auditor may have provided advice or performed other procedures in relation to the company's selection and application of IFRS accounting policies and the company's policies and procedures for its transition to IFRSs. Furthermore, the auditor will be auditing the company's IFRS financial statements in future. For these reasons, because of the nature of the narrative information, it would be appropriate for the auditor to perform additional procedures beyond simply reading the information even though not required by the ISAs.

ISA 720 deals with identified inconsistencies and misstatements of fact as follows:

- If, as a result of reading the narrative information or any other procedures performed, the auditor concludes that an amendment is necessary to the narrative information to correct a material inconsistency, the auditor should notify the company's management and ask that they correct such information. If the company refuses to make an amendment, the auditor should consider including an emphasis of matter paragraph in the auditor's report, describing the material inconsistency or taking other actions, such as not issuing the auditor's report or withdrawing from the engagement (depending on the particular circumstances and the nature and significance of the inconsistency).
- In the unlikely event that the auditor considers that the financial statements need amendment in the case of an identified inconsistency, the auditor should notify management. If the company refuses to make an amendment, the auditor should modify the auditor's report by expressing a qualified or an adverse opinion.
- If the auditor considers that the narrative information contains a material misstatement of fact, the auditor should discuss the matter with the appropriate level of management in order to determine whether valid differences of judgment or opinion exist. If after such discussions the auditor still considers that there is an apparent misstatement of fact, the auditor should request management to consult with a qualified third party, such as the company's legal counsel, and consider the advice received. If management continues to refuse to correct the misstatement of fact, the auditor is advised to consider taking further action, such as notifying those charged with governance in writing or seeking legal advice.

Question 5

XYZ Company prepares a quantified reconciliation from its financial position and results prepared in accordance with its national financial reporting framework as at December 31, 2004 to IFRS. This reconciliation has been included with the Company's financial statements prepared in accordance with the national financial reporting framework as at December 31, 2004.

Should this reconciliation be considered within the scope of the audit of those financial statements? What are the auditor's responsibilities?

Answer to Question 5

Whether the reconciling information should be considered to be within the scope of the audit of the financial statements depends on the circumstances and the auditor's judgment of the impression given to the reader. In some jurisdictions, regulation regarding IFRS transition may require that such information be audited regardless of where it is located. In many other jurisdictions, however, regulation may not be so specific.

Certain supplementary information, by its nature or how it is presented, would be considered by a reasonable user to be closely associated with the audited financial statements and, for that reason, covered by the auditor's report. The auditor therefore needs to consider whether this is so in the case of the reconciling information.

Supplementary information showing a quantified reconciliation of the audited financial statements prepared in accordance with the national financial reporting framework, to IFRSs is, by definition, closely related to those financial statements. Consequently, there is likely to be a strong argument that a reasonable reader would consider such reconciling information to be closely associated with the audited financial statements. Therefore, if the reconciling information is not intended to be covered by the auditor's report, the auditor will need to be satisfied that the presentation of the reconciling information clearly differentiates it from the audited financial statements.

If the reconciling information is included in the notes to the financial statements, it would be difficult to differentiate it sufficiently from the audited financial statements and therefore it would be considered to be covered by the auditor's report. Consequently, the auditor will need to obtain sufficient appropriate audit evidence to assess management's assertions regarding that information. In this case, it would be appropriate to include an emphasis of matter paragraph in the auditor's report explaining that the IFRS accounting policies applied in the preparation of the reconciling information may be subject to change, that is, similar to the emphasis of matter paragraph in the illustrative report in Question 2. If the auditor concludes that the reconciling information is misleading the auditor applies the guidance in IAPS 1014.

If management and the auditor agree that the reconciling information should be presented in the annual report but not as an integral part of the audited financial statements, the auditor will need to consider whether it is sufficiently differentiated from the audited financial statements. For example, if the reconciling information is included on pages adjacent to the financial statements, and not clearly labeled as distinct from the audited financial statements, or if it is linked to the notes to the audited financial statements by page reference, a reasonable user might presume it is an integral part of the audited financial statements. In such circumstances, consideration will need to be given to how the reconciling information could be repositioned and labeled so that it is sufficiently differentiated from the audited financial statements. However, despite the fact that ISA 720 limits the auditor's responsibilities to reading the reconciling information in documents containing financial statements, as discussed in the answer to Question 4(b) with respect to narrative transition information, it is appropriate for the auditor to perform further procedures on this information because it is so closely associated with the company's financial statements.

The implications for the auditor's report are similar to those discussed in the answer to Question 4. If the auditor concludes that the reconciling information is misleading, the auditor applies the guidance in IAPS 1014.

Question 6

XYZ Company prepares a full reconciliation to IFRSs at December 31, 2004. It does not issue this reconciliation with its financial statements as at December 31, 2004 prepared in accordance with the national financial reporting framework, but instead makes a separate announcement to the market during calendar year 2005 containing only, for example, the reconciliation of its results prepared in accordance with the national financial reporting framework to IFRSs.

What are the auditor's responsibilities with respect to the IFRS financial information that is issued separately from the financial statements as at December 31, 2004 prepared in accordance with the national financial reporting framework, if the company has not asked the auditor to audit or review such information?

Answer to Question 6

If the company makes a separate announcement to the market and the information is not contained in documents containing audited financial statements, the auditor does not have any responsibility to search for such information.

However, if the auditor becomes aware of a material inconsistency with previously published audited financial information or a material misstatement of fact, the auditor should discuss the matter with those charged with governance and management. If no amendment is made, it would be prudent for the auditor to seek legal advice.

If the company asks the auditor to provide assurance on this separately announced financial information, the conditions and reporting implications outlined in the answer to Question 2 still apply.

Question 7

XYZ Company proposes to prepare stand-alone IFRS interim financial information in accordance with IAS 34, "Interim Financial Reporting" for the six month period ended June 30, 2004. The company's management asks the auditor to review that interim financial information and issue a review report.

Can the auditor conduct a review of the IFRS interim financial information for the six month period ended June 30, 2004 and issue a review report?

Answer to Question 7

It is not advisable, and may not be possible, to provide a review report on the IFRS interim financial information for the six month period ended June 30, 2004.

The company will still be at an early stage of its preparation of the first complete set of IFRS financial statements as at December 31, 2005. The company may find that it needs to enhance or otherwise modify its conversion procedures or to amend the IFRS accounting policies it selected and applied as it gains experience in preparing the IFRS financial statements as at December 31, 2004

There will not be an audited complete set of IFRS financial statements as at December 31, 2003, or comparatives for the preceding interim period, as this will be the first period for which IFRS data is prepared.

Furthermore, from the auditor's perspective, the limited procedures performed in a review may not be appropriate to identify issues in the selection and application of the IFRS accounting policies or to identify the risks of material misstatement in the conversion from the national financial reporting framework to IFRSs. Thus, the possibility exists that the auditor may identify misstatements in the IFRS interim financial information when the auditor subsequently performs audit procedures in relation to the comparative IFRS financial information as at December 31, 2004 issued as part of the first complete set of IFRS financial statements as at December 31, 2005.

For these reasons, it may not be possible for the auditor to obtain the moderate level of assurance expected in ISRE 2400 that the IFRS interim financial information is free of material misstatement. Consequently, to obtain sufficient appropriate evidence in order to provide a meaningful conclusion it is likely that some audit procedures will need to be performed on the underlying national financial reporting framework account balances and disclosures and IFRS adjustments.

See Question 5 regarding the auditor's responsibilities if XYZ Company discloses IFRS interim financial information for the six month period ended June 30, 2004 alongside its interim financial information for the six month period ended June 30, 2004, which has been prepared in accordance with the national financial reporting framework.

Question 8

XYZ Company prepares its interim financial information for the six month period ended June 30, 2005 in accordance with IAS 34, "Interim Financial Reporting."

Can the auditor conduct a review of the IFRS interim financial information for the six month period ended June 30, 2005 and issue a review report?

Answer Question 8

The auditor should be able to provide a review report on the IFRS interim financial information for the six month period ended June 30, 2005 prepared in accordance with IAS 34.

The uncertainty regarding the IFRS accounting policies should be significantly reduced by the time the June 30, 2005 interim review will be required, particularly for those companies preparing semi-annual interim financial information (as is required in most jurisdictions in Europe). Furthermore, comparative IFRS interim financial information for the six month period ended June 30, 2004, as required by IFRSs, can be prepared.

In order to have an appropriate basis for the review of the IFRS interim financial information for the six month period ended June 30, 2005, the auditor will need to have audited the opening balance sheet and IFRS financia1 statement adjustments as at December 31, 2004 before conducting the review of the interim IFRS financial information.

Question 9

What does the auditor need to consider in relation to the audit of XYZ Company's first complete set of IFRS financial statements as at December 31, 2005?

Answer to Question 9

When the company prepares its first complete set of IFRS financial statements as at December 31, 2005, all of the uncertainty regarding the accounting policies as at the IFRS reporting date will be resolved and the auditor can report on these financial statements in accordance with ISA 700, "The Auditor's Report on Financial Statements."

IFRS 1 requires certain reconciliations to be included in the first complete set of IFRS financial statements. Thus, information reconciling the financial statements prepared in accordance with the national financial reporting framework with those prepared in accordance with IFRSs will be included within the scope of the audit of, and covered by the auditor's opinion on, the first complete set of IFRS financial statement as at December 31, 2005.

IFRSs require comparative financial information to be included in the financial statements. As discussed in ISA 710, "Comparatives," the auditor's responsibilities in relation to the comparative financial information depends on whether those comparatives are considered to be corresponding figures (in which case the auditor's report only refers to the financial statements of the current period), or comparative financial statements (in which case the auditor's report refers to each period for which financial statements are being presented). The approach influences the work effort of the auditor with respect to the prior period amounts (the extent of audit procedures performed on corresponding figures is significantly less than for the audit of the current period figures).

Regardless of the approach, it is very unlikely that the auditor can obtain sufficient appropriate audit evidence regarding the IFRS financial statement account balances and disclosures as at December 31, 2005 if the auditor has not also obtained sufficient appropriate audit evidence on the opening balance sheet and the IFRS financial statement adjustments as at December 31, 2004. Therefore, the auditor's work in relation to the comparative financial information considered to be corresponding figures will be substantially different in this circumstance from what is described in ISA 710.