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Report from the ICAEW to the 25th Session of UNCTAD ISAR

Review of practical implementation issues of International Financial Reporting Standards

Case study of the UK

July 2008

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EXECUTIVE SUMMARY

As proposed at the conclusion of the 24th session of ISAR last year, the main agenda item of the 25th session of ISAR will be a review of practical implementation issues of International Financial Reporting Standards (IFRS). This report reviews the UK's experience of IFRS implementation. Key points are:

- Since 2005, companies with shares traded on a regulated market must prepare their consolidated accounts under IFRS (as adopted in the EU) under EU law. The UK government has also given all entities the option of using EU endorsed IFRS in place of UK GAAP in their financial statements. However, voluntary take-up of IFRS has been rare.
- Although there was a widespread belief in the UK in advance of implementation that the conversion process would not be unduly onerous, technical issues emerged which for many companies took a great deal of time to resolve.
- The cost of implementation was substantial, although this varied significantly between companies.
- It is too early to assess rigorously Alternative Investment Market (AIM) companies' experience of migrating to IFRS.
- The Financial Reporting Review Panel, in a preliminary report on IFRS implementation, found a good level of compliance with IFRS, but identified a number of areas for improvement.
- Key lessons learned include:
  - It is never too early to start the transition process, which should be treated like any other major business project and not as a technical accounting issue.
  - Systems may well need to be upgraded.
  - It is important to train all staff affected by the adoption of IFRS.
  - The Board of Directors/Officers should be engaged from the start of the process.
  - A number of business issues must be considered, including the effect of IFRS adoption on management compensation structures, tax, debt covenants and key performance indicators.
  - There needs to be good communication with stakeholders.
  - The extent of disclosure requirements under IFRS needs to be recognised.
  - Auditors need to be fully trained in IFRS.
- The ICAEW made the transition process a key priority for the Institute as a whole and devoted significant resources to the undertaking.
- Fund managers and other analysts in the UK are generally of the opinion that IFRS financial statements provide better and more transparent information for decision making.
- An ICAEW study for the European Commission found that, overall, IFRS implementation had been challenging but successful. IFRS implementation was generally seen as a positive development.
- These findings are supported by academic research, which found IFRS information, where there are differences with UK GAAP, to be value relevant.

Review of practical implementation issues of International Financial Reporting Standards

Case study of the UK

CONTENTS

Review of practical implementation issues of International Financial Reporting Standards

Case study of the UK

A. INTRODUCTION

1. This report presents a review of the issues arising on the implementation of IFRS by the approximately 1,200 UK companies with shares or bonds listed on the Main Market of the London Stock Exchange. Together with other companies listed on a European Union (EU) regulated stock exchange, such companies were required under the EU IAS (International Accounting Standards) Regulation to apply IFRS as endorsed by the EU in their consolidated accounts for financial periods commencing on or after 1 January 2005.

2. EU law also gave Member states the option of permitting or mandating the use of IFRS for all other entities within their jurisdiction. In the UK, all companies were given permission to use IFRS for accounting periods beginning on or after 1 January 2005. The London Stock Exchange required companies listed on AIM, its second tier market comprising over 1,600 UK and overseas companies, to comply with IFRS for financial periods commencing on or after 1 January 2007.

3. The Institute of Chartered Accountants in England and Wales (ICAEW) was commissioned by the European Commission to produce a study of the EU implementation of IFRS in the European Union (www.icaew.com/ecifrsstudy). The study was published by the Commission and the Financial Reporting Faculty of the ICAEW in October 2007 and provided the basis for the Commission's formal report on IFRS implementation, submitted to the EU Council and Parliament in April 2008. That study has been referred to in the preparation of this report to the extent that it throws light on the UK experience of the transition to IFRS.

4. The main objective of this report is to draw lessons learned from the UK experience in converting reporting systems and financial reports from UK generally accepted accounting practice (GAAP) to IFRS in 2005 to contribute to the sharing of experience among countries that are either currently implementing IFRS or intend to do so in the future.

B. UK FINANCIAL REPORTING SYSTEM

Overall requirement to give a 'true and fair view'

5. Company law in the UK for many years required all companies to prepare financial statements each year which give a 'true and fair' view. This concept is not defined in the legislation but it has been generally interpreted as giving a faithful representation of the financial performance of the company for the period, its financial position and where relevant its cash flows at the end of the period. Compliance with GAAP was generally seen as a prerequisite of giving a true and fair view. Although this requirement derives from European law in the shape of the Accounting Directives, its origins lie in the UK.

6. One effect of the introduction of IFRS was that financial statements complying with IFRS were no longer explicitly subject to an overriding requirement to give a true and fair view. Instead, the overriding requirement for such financial statements – in IAS 1, *Presentation of Financial Statements* – was to 'present fairly'. This led to some concern among UK investors that the apparent loss of the overriding true and fair view requirement might lead to deterioration in the quality of financial reporting. Although the Financial Reporting Council (FRC), the UK's independent regulator responsible for promoting confidence in corporate reporting and governance, published (in June 2005) a legal opinion that the 'present fairly' and 'true and fair' requirements were in substance the same, concerns remained. To clarify the position, the Companies Act 2006 incorporates a requirement – which applies to all financial statements, whether or not they are prepared in accordance with IFRS – that the directors must not approve them unless they are satisfied that they give a true and fair view.

7. The FRC recently commissioned a review of the meaning of true and fair from an eminent lawyer, Martin Moore QC. His view, published in May 2008, was that compliance with GAAP was a means to the end of giving a true and fair view, not an end in itself. If it was necessary to depart from GAAP to give a true and fair view, then this should be done. Both company law and IFRS (in IAS 1) permit this, but only envisage its occurrence in extremely rare circumstances. In practice, departures under IFRS are far fewer than was the case under UK GAAP, but mainly because the override tended to be used to depart from out-of-date specific legal requirements related to accounting, whereas overrides of UK accounting standards were and are very rare.

8. Martin Moore also opined that if an accounting standard gave a choice of treatment, the directors/officers should consider carefully which choice would discharge their responsibility to give a true and fair view. IFRS in particular would seem to give an unfettered choice where options exist, on the basis that compliance with the standards would automatically confer a 'fair presentation'. UK law makes it clear that financial statements prepared in accordance with IFRS must also comply with the requirement to give a 'true and fair' view. This arguably leaves UK companies with an additional compliance burden when preparing their financial statements, although the updated legal opinion argues that the concepts of true and fair and fair presentation are in effect identical. Thus, in practice, preparers are unlikely to feel they are bearing an additional burden of compliance.

Regulatory position in the UK

9. Since 2005, companies with shares traded on a regulated market must prepare their consolidated accounts under IFRS (as adopted in the EU, through a complex endorsement process) under EU law. The UK Government has also given all entities the option of using EU endorsed IFRS in place of UK GAAP in their financial statements. This includes subsidiaries of stock market listed parent companies, other private companies (of which there are over two million in the UK), partnerships and self-employed individuals (but not charities).

10. Voluntary take-up of IFRS has been rare, meaning that many groups have had to maintain both UK GAAP and IFRS accounting records. This is generally considered to be principally due to two factors. Firstly, uncertainty over the impact on tax liabilities, given that the starting point for UK tax on trading profits is the accounting profit computed according to either UK GAAP or EU endorsed IFRS as applicable. And secondly the effect of IFRS adoption on distributable profits. The ICAEW, with the Institute of Chartered Accountants of Scotland (ICAS), published definitive guidance on this latter topic, Tech 01/08 *Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 1985*, in February 2008.

11. The low take-up of IFRS needs to be viewed, however, in the context of a commitment to convergence of UK GAAP with IFRS. For many years the Accounting Standards Board (ASB) has sought to mirror developments in international accounting, and the most recent UK Financial Reporting Standards (FRSs) and Urgent Issues Task Force (UITF) interpretations (known as 'Abstracts') have been largely (although not exclusively) taken directly from IFRS and Interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC).

12. Before making further substantive moves towards convergence with IFRS, the ASB is awaiting the outcome of the IASB project on small and medium-sized entities (now 'private entities'). It is likely that this will form the basis of UK GAAP in the future. The use of full EU-endorsed IFRS will probably – depending on the results of further public consultation later in 2008 – be expanded to cover 'publicly accountable' entities, with the IFRS for Private Entities likely to replace UK GAAP for at least larger private sector companies. For the time being the UK's standard for smaller entitles (the Financial Reporting Standard for Smaller Entities (FRSSE) is likely to be retained, albeit after further alignment with IFRS. GAAP is thus likely to continue to be segmented in the UK depending on public interest and size.

13. The UK Central Government and the National Health Service bodies will be adopting EU-endorsed IFRS – subject to some modifications – in their financial statements commencing with the year to 31 March 2010. The UK's 'Whole of Government Accounts' will also migrate

to IFRS from the same date. This is a year later than originally planned, reflecting the amount of time and work involved in converting from local GAAP to IFRS. The date for the transition of Local Government to IFRS is the year to 31 March 2011. The UK Central Government sector will produce 'shadow' accounts under IFRS for periods ending on 31 March 2009, which will be subject to review by their statutory auditors. All in all, this represents a significant expansion of the use of IFRS in the UK.

Sources of UK GAAP

14. The Companies Act 2006 and related regulations (together referred to below as company law and substantially derived from the requirements of the EU accounting directives) require companies to prepare financial statements either in accordance with 'International Accounting Standards' (ie, IFRS) or in accordance with company law.

15. Company law requires the application of generally accepted accounting principles or practice (i.e. UK standards and other sources of UK GAAP). It sets out detailed formats which a company should follow – in contrast to IFRS – when presenting an income statement and balance sheet (there are four permitted formats for the former, two for the latter).

16. Company law also sets out a number of accounting principles which must be followed by UK GAAP reporters, such as:

    a. the presumption that the company is a going concern;

    b. income and expenditure must be included in the period to which it relates regardless of when received or paid (the accruals concept);

    c. accounting policies must be applied consistently within the same accounts and from one period to another; and

    d. the amount of any item must be determined on a prudent basis, in particular only realised profits must be included in the profit and loss account.

17. The law then goes on to set out rules on:

    a. fixed assets (those with limited useful lives must be depreciated, investments must be written down if there has been a permanent diminution in value, and goodwill must be depreciated over its useful economic life);

    b. current assets (which must be recorded at purchase or production cost but written down to net realisable value if lower) and the determination of production cost of inventories;

    c. alternative accounting rules (that intangibles but not goodwill may be carried at current cost, tangible fixed assets may be carried at market value as at the date of the last valuation or at current cost, investments may be carried at market value, and current asset investments and inventories may be carried at current cost);

    d. use of fair value for financial instruments; and

    e. required disclosures, including information on average number of employees, staff costs, dividends, accounting policies, off-balance-sheet arrangements, and share capital.

18. There are separate regulations for larger companies and quoted companies which supplement the requirements applicable to all companies.

19. Most of the above requirements apply to UK GAAP reporters only. However, UK companies that prepare their financial statements under IFRS must also consider a number of company law requirements that apply to all companies – such as the requirement to disclose off balance sheet arrangements not otherwise disclosed in the financial statements and narrative reporting requirements.

20. In addition to the law are accounting standards and other pronouncements which together comprise UK GAAP. These are:

- Statements of Standard Accounting Practice (SSAPs), issued from the 1970s by the councils of the UK's principal accountancy bodies and prepared by the original standard setting body the Accounting Standards Committee (operated by the accountancy bodies, but replaced by the independent ASB in 1990);
- Financial Reporting Standards prepared by the current standard setting body (the ASB); and
- UITF Abstracts, prepared by the UITF and issued by the ASB.

21. As noted above, many of the most recent FRSs have been close copies of the equivalent IFRS and many of the recent UITF abstracts have been based on the equivalent IFRIC Interpretations. Some of these UK standards are only mandatory in certain circumstances, in particular if the entity is listed but is not a group and does not use IFRS in its separate financial statements or if it is unlisted but uses the fair value accounting rules discussed above.

22. UK GAAP was widely regarded as being similar to IFRS, but the implementation process highlighted that:

- there were (and still are) a significant number of differences between the two, in terms of both recognition and measurement and in disclosure requirements; and
- that similar – but not identical – language and requirements can add to uncertainty during the transition from national GAAP to IFRS.

Auditors

23. Only registered auditors are permitted to carry out the audit of a company's financial statements. Audit firms must be registered with a Recognised Supervisory Body (RSB).

24. In the UK, the ICAEW is one of a number of professional bodies registered as RSBs. Members of these bodies can apply for registered status and must satisfy various conditions laid down by the RSB – these include compliance with the detailed Audit Regulations and Guidance set out by the RSB, compliance with Professional Indemnity Insurance Regulations and agreement to be monitored by the RSB.

25. In addition any individual who signs an audit report must hold an Audit Qualification as granted by the RSB (this normally involves special training requirements) and must hold a Practising Certificate issued by the RSB.

26. Companies meeting certain size criteria are exempt from a mandatory annual audit. Broadly speaking the audit exemption conditions are met if a company meets both of the criteria for small companies relating to turnover and balance sheet total in its first financial year, or in the case of a subsequent year, in that year and the preceding year. These criteria are for accounting periods beginning on or after 6 April 2008: turnover not more than £6.5 million and balance sheet total (ie, total gross assets) not more than £3.26 million. For companies forming part of a group the size of the group is the important factor.

Other features

27. Financial reporting in the UK also benefits from two additional features of the UK environment: a robust system of corporate governance; and a strong and well-respected accountancy profession.

28. Listed companies, subject to the UK's Combined Code on Corporate Governance, should have an audit committee comprised of independent non-executive directors, at least one of whom should have recent and relevant financial experience. The responsibilities of the audit committee include monitoring the integrity of the financial statements of the company, and

any formal announcements relating to the company's financial performance, and reviewing significant financial reporting judgements contained in them. The audit committee should also review the company's internal financial controls and often the committee also reviews the company's internal control and risk management systems.

29. The six chartered accountancy bodies in the UK and the Republic of Ireland are estimated to have, in the UK, some 270,000 members and nearly 160,000 students. There are also estimated to be in the region of 50,000 members of other accountancy bodies in the UK and Ireland. At 1 January 2008 the ICAEW alone had over 130,000 members.

C. IFRS IMPLEMENTATION ISSUES

30. This part of the report considers two aspects of implementation by UK listed companies in 2005:

- technical issues – the key differences between IFRS and UK GAAP which gave rise to major adjustments; and
- project issues – resourcing, timescales and communication.

31. Reference is then made to early assessments of the experience of AIM companies, which were required to apply IFRS for financial periods commencing on or after 1 January 2007.

Technical issues

32. As mentioned above, there was a widespread and understandable belief in the UK that because UK GAAP and IFRS were similar (each UK FRS contains a brief comparison to IFRS in an appendix), the conversion process would not be onerous. For many straightforward manufacturing or service businesses this may have been the case, but issues emerged which for many UK listed companies – often international and complex organisations – took a great deal of time to resolve.

33. Some of the principal differences between UK GAAP and IFRS in 2005 are highlighted below.

Property, plant and equipment

34. IFRS requires residual values to be re-estimated at least at the end of each period. UK GAAP only requires a residual value estimate to be made at the time of purchase. In practice this did not create a significant implementation issue for most UK companies, but was important for those with major investments in real estate and other significant assets such as ships or aircraft.

35. Computer software assets had to be reallocated from tangible fixed assets under UK GAAP to intangible fixed assets under IFRS.

Intangible assets

36. The major potential issue in relation to intangibles was in the context of business combinations, where IFRS explicitly requires many more intangibles to be identified than UK GAAP.

37. Virtually all UK listed companies took advantage of the exemption of IFRS 1 *First Time Adoption of International Reporting Standards* on moving to IFRS and did not restate business combinations prior to the transition date (the start of their comparative year). These companies still had to review business combinations that had occurred in 2004 and 2005. It was notable that in most cases over 50% of the purchase price was allocated to goodwill, notwithstanding the IFRS view of goodwill as the residual amount that cannot be allocated to identifiable tangible and intangible assets such as customer contracts and customer relationships, back orders and beneficial service contracts. In addition, companies were required to switch from amortisation of goodwill to an impairment-only approach (subject to transitional relief under IFRS 1), which in many cases had a significant effect on the financial statements.

38. Some companies, particularly in the pharmaceutical sector, were required to capitalise development costs under IFRS where previously they had been expensing them as permitted by UK GAAP. No transitional relief was available under IFRS 1 in this respect.

Impairment of financial assets

39. UK GAAP permitted the calculation of a general provision for bad debts for which most companies used a flat percentage of good book debts. IAS 39 *Financial Instruments: Recognition and Measurement* requires an analysis for each group of financial assets with similar credit risk characteristics. This analysis may have been prepared routinely by financial services entities, but for some in other sectors represented a major change to the way the provision was calculated. There is anecdotal evidence that many did not change their methodology on the grounds of materiality.

Financial instruments

40. Financial instruments represented perhaps the most challenging area for many UK companies. This was partly because the UK did not have comprehensive recognition and measurement standards in place for financial instruments, but in part because of the complex nature of the relevant international standard, IAS 39, which was widely criticised by first time adopters of IFRS. Virtually all UK listed companies took advantage in 2005 of the exemption in IFRS which was available at the time not to restate their comparative information for the effects of adopting IAS 32, *Financial Instruments: Presentation* and IAS 39. The focus was, therefore, only on the current period in the first IFRS financial statements, but there was still substantial work required to restate the opening balance sheet at the start of the current period.

41. Under UK GAAP most companies were familiar with reporting derivatives on an accruals or realisation basis with a requirement to disclose the fair values in the notes to the financial statements. Banks and similar entities had long been reporting their derivative positions at fair value through earnings, although typically only for their trading portfolio, not for derivatives used for hedging activity.

42. It was also the prevailing practice under UK GAAP to record foreign currency sales or purchases using a forward rate of exchange where the exposure was covered by a forward contract. This meant that currency exchange differences did not arise. The move to recording the transaction at the ‘spot rate’ and dealing with the forward contract as a separate derivative was a major change especially when combined with the onerous requirements for the forward contract to qualify for hedge accounting treatment to avoid earnings volatility.

43. Much time and cost was spent by UK companies in securing, or trying to secure, hedge accounting status for their positions. Discussion with auditors, especially concerning how and how often to test for hedge effectiveness, was an important aspect of activity in this area for most companies. The documentary requirements of IAS 39 to secure hedge accounting (applicable at the time the hedging transaction was entered into, not just at transition, were also much greater than UK companies were used to, adding to the cost of implementation.)

44. One of the biggest challenges for UK companies, however, was in the identification and analysis of embedded derivatives. This was a new concept for the UK to get to grips with. The guidance in IFRS was mainly (but not exclusively) applicable to financial services entities and companies in other sectors struggled to find the relevance of the examples in IFRS to their transactions. In the end, many companies did not identify many positions requiring the separation and valuation of these embedded derivatives but a significant amount of resource was often needed to establish that there was not an embedded derivative that needed to be separated from the host contract.

Deferred taxation

45. UK GAAP only requires deferred tax to be recognised when there is an obligation to pay tax or a right to recover tax as a result of a past transaction. IFRS requires a deferred tax provision in virtually all cases when there is a difference between the accounting book value

and tax base. This led to some significant increases in deferred tax balances, in respect of previously-revalued assets, gains on previous sales which had been deferred by replacing the assets concerned and unremitted foreign profits. IAS 12 *Income Taxes* was found to be a complex standard and in some respects difficult to interpret.

Leases

46. One of the most frequently occurring adjustments to UK accounting was in relation to the benefit of operating lease incentives. IFRS requires these to be spread over the lease term, whereas UK GAAP requires them to be spread over the period until the next rent review. As there are at present no transitional exemptions in IFRS on first time adoption, those incentives where the lease term had not expired needed to be restated on adoption. This led to the reinstatement of some of the benefit which is now being recognised as a reduction of rent expense until the lease term expires. In many cases the lease incentives had already been fully recognised in income under UK GAAP.

47. The definition of a finance lease under IFRS led to some reclassifications of leases which were classified as operating leases under UK GAAP, albeit this was not a common adjustment. Property leases were the main source of concern as IFRS explicitly includes them within the scope of lease accounting and contains detailed guidance on them. Some UK companies had to bring property leases on to the balance sheet (such as racecourse owners and bar owners), resulting in increased financial gearing. One consequence was that some companies had to renegotiate loan covenants with their lenders.

Defined benefit pension schemes

48. UK GAAP required all defined benefit pension scheme actuarial gains and losses to be recognised, but in a statement of total recognised gains and losses outside the income statement. IFRS was amended before 2005, in part to allow this treatment – preferred in principle by the IASB – to continue on adoption of IFRS by UK listed companies. Most of these companies continued to follow the UK GAAP approach.

49. Most of the other UK listed companies adopted the 'corridor' approach to recognition, meaning that most actuarial gains and losses are not recognised in the financial statements. To the extent they are recognised under IFRS, they must be included as part of net income/profit for the year.

Consolidation of group entities

50. Some UK listed companies found that the number of entities they were required to include in their consolidated accounts changed on the adoption of IFRS. This was primarily because IFRS has different principles from UK GAAP on the exclusion of subsidiaries from the consolidation with IFRS being more restrictive on when exclusion is appropriate. Another reason for the change was the difference between the definitions of a 'quasi-subsidiary' under UK GAAP and a 'special purpose entity' under IFRS.

Project issues

51. Several important issues emerged from the implementation process, discussed below under the headings:

- timing;
- cost;
- IFRS expertise; and
- systems.

Timing

52. In a 2003 survey of business by the ICAEW undertaken to highlight the state of readiness for IFRS, less than half of respondents were aware of the impact IFRS would have on their company or its financial statements. Only a third of respondents rated their organisation's understanding of the implications of IFRS as 'very' or 'fairly' good. Only 70% of respondents stated that they would definitely be prepared in time for 2005.

53. In a 2004 survey, 81% of respondents were aware of the publication of the EU IAS Regulation (compared to 66% in 2003). Just over half were aware of the International Accounting Standards Board (IASB) timetable for delivering the promised 'stable platform' of 2005 standards (33% in 2003) and only a third were aware of the EU endorsement process. 45% rated their organisation's understanding as good and 39% believed that their organisation was ready for IFRS.

54. These statistics suggested that work to prepare for IFRS were well-underway, but that greater effort was needed, especially by the time of the 2004 survey, given the requirement to restate comparatives for 2004. The survey results indicate that – despite the encouragement of regulators, auditors and the ICAEW – many companies left the process of preparation and communication until a later stage than was ideal, perhaps as the volume of work required was under-estimated. In some cases this may have added to the costs and pressures of implementation, although external reporting deadlines were rarely missed.

Cost

55. It is clear that the cost of implementation was substantial, although this varied significantly between companies. Evidence on truly incremental costs is limited. However, the ICAEW survey of EU implementation of IFRS indicates that incremental implementation costs for EU listed companies ranged from an average of €0.5 million (for companies with a turnover of less than €500 million) to €3.4 million (for companies with a turnover in excess of €5,000 million). Incremental recurring costs of implementation were estimated at between €0.1 million and €0.6 million for these turnover ranges. The survey indicated that costs were proportionately higher for smaller listed companies than their larger counterparts.

IFRS expertise

56. Most companies faced a lack of practical IFRS expertise within their financial reporting teams. This was not surprising given that UK companies had not previously needed to possess any IFRS knowledge, but it undoubtedly slowed the conversion process and led to a greater reliance on external advisors, adding to the cost of implementation.

57. Larger listed companies invested heavily in staff training to enable them to tackle the conversion exercise with confidence and to minimise the risk of material errors. Smaller listed companies tended to place the conversion process in the hands of a few key staff, reducing training costs, but increasing the demands on those involved.

58. Companies also found that auditors were sometimes slow to respond on technical issues, as a result of a desire to ensure a consistent message was conveyed to clients with common problems. In many cases issues had to be referred to audit firms' technical committees, slowing the process further.

Systems

59. Many companies upgraded their systems to deal with IFRS conversion. Some instituted a system of shadow accounts which would maintain individual financial statements in UK GAAP for statutory reporting and taxation purposes. Others decided that their accounting system would be used solely for IFRS compliance and that any adjustments back to local GAAP would be managed 'off-line'. A third approach was to keep the existing systems producing UK GAAP information and build a consolidation module that would control the adjustments required to produce IFRS compliant consolidated accounts of the group. In each case substantial costs were incurred in connection with the systems upgrades.

The AIM experience

60. It is too early to assess rigorously the experience of companies listed on AIM of migrating to IFRS. It would appear anecdotally that, like many companies listed on the Main Market, a significant number of AIM companies started their preparations at a late stage, but that even so the process ran remarkably smoothly, with reporting deadlines met. AIM companies are however often listed owner-managed businesses, with fewer resources available, and consequently many are thought to have found the challenge of IFRS implementation particularly daunting.

61. AIM companies did enjoy some advantages over the first wave of UK IFRS adopters. Firstly, they were helped by the greater familiarity of the whole financial community with IFRS concepts and vocabulary, and in particular with the greater familiarity of auditors, gained since 2005. Thus advisors were able to anticipate where the problem areas would be. Secondly, the transactions entered into by many AIM companies are relatively straightforward; in particular, they are likely to have needed to account for fewer complex financial instruments.

D. IFRS ENFORCEMENT ISSUES

62. The UK regulatory authorities have a policy of seeking to avoid authoritative interpretations of IFRS. There is a strongly held view in the UK that the IASB is the standard setter and that in a principles-based system it would be inappropriate to provide local variations for UK companies through regulatory decisions.

Securities Regulators

63. The Financial Services Authority (the FSA) regulates most financial services markets, exchanges and firms in the UK. The FSA co-operates with the Financial Reporting Review Panel (FRRP – discussed below) over monitoring and enforcement in relation to financial information published by UK listed companies, and is a member of the Committee of European Securities Regulators (CESR).

64. Whilst CESR does not issue guidance or interpretation of IFRS, it co-ordinates the approach to enforcement within the EU, publishing standards on enforcement activity and recommendations for action by national enforcers, such as the *Recommendation for additional guidance regarding the implementation of International Financial Reporting Standards (IFRS)*, published in December 2003 (www.cesr.eu). It is however left to independent administrative authorities in each member state to carry out the enforcement activity. In the UK this task falls principally to the FRRP.

65. CESR's role extends to maintaining a database of enforcement decisions, including decisions *not* to take enforcement action, for reference by national enforcers.

Auditors

66. The statutory audit requirement in UK company law is a powerful tool in the enforcement process and minimises the risk of material misstatement. Under UK company law, auditors must state in their report whether the financial statements show a true and fair view, as well as whether they follow the relevant financial reporting framework.

67. Accounting policies in practice tend to be agreed with the auditors. The auditors must be satisfied with the presentation of the financial statements, including for example the disclosure of unusual items, line items used in the primary financial statements and the level of disclosure in the notes to the financial statements.

Financial Reporting Review Panel (FRRP)

68. In the UK an independent body, the FRRP, reviews the financial statements of publicly quoted and large private companies for compliance with company law and with applicable accounting standards. Reviews are carried out on a sample basis, according to certain risk criteria, so not all financial statements are examined each year. As explained below, the FRRP also reacts to direct complaints and press comments. The FRRP can ask directors to explain apparent

departures from requirements. If the FRRP is not satisfied by the directors' explanations, it aims to persuade the directors to adopt a more appropriate accounting treatment. The directors may then voluntarily withdraw their financial statements and issue a replacement set that correct the matters in error.

69. Depending on the circumstances, the FRRP may accept another form of remedial action – for example, correction of the comparative figures in the next set of annual financial statements. Failing voluntary correction, the FRRP can apply to the court for an order to secure the necessary revision of the financial statements although to date it has never had to do this.

70. The FRRP selects financial statements for review in a number of ways. First, the FRRP discusses with the FSA and the FRRP's own Standing Advisory Group which sectors of the economy are under strain or likely to give rise to difficult accounting issues. The FRRP then chooses a number of sectors and reviews a selection of accounts in each. The FRRP is also developing its own risk model to identify cases where accounting problems are more likely, for example because of poor corporate governance. The FRRP looks at specific topical accounting issues and also responds to complaints from the public, the press and the financial community. In all cases, other than those precipitated by a complaint, the selection is based on the FRRP's assessment of the risk of non-compliance and the risk of significant consequences if there is non-compliance.

Report on IFRS Implementation

71. In December 2006 the FRRP published a preliminary report on implementation of IFRS in the UK (FRRP Press Notice 98).This reported a good level of compliance with IFRS but identified a number of areas for improvement which might be useful for other countries to be aware of prior to their implementation of IFRS. These are summarised in the table below.

Accounting policies	*Tendency to use descriptions for disclosure of accounting policies which had been copied word for word from the standards. In some cases the accounting policies disclosed had not been applied in the accounts as they were not relevant to the company.*
Judgements	*Disclosures relating to subjective or complex judgements made by management were often bland and uninformative (disclosure of key areas of judgement and estimation uncertainty is a requirement of IFRS). In some cases there were no disclosures.*
Goodwill	*Many financial statements did not disclose the factors that gave rise to goodwill as required by IFRS.*
New standards	*Not all companies reviewed disclosed new standards and interpretations which had been issued but which were not yet effective and their likely impact on initial application.*
Related parties	*Failure to recognise that under IFRS, key management personnel are related parties for disclosure purposes in a wider set of circumstances than under UK GAAP.*
Other disclosures	*Recommendations were also made regarding various less serious omissions in disclosures.*

72. The report was based on the review of a sample of financial statements. There is no perceived need for a mechanism within the UK to check all financial statements which are filed with the London Stock Exchange.

E. SOME LESSONS LEARNED

73. The adoption of IFRS by all EU listed companies provides valuable information for other countries introducing IFRS, even though the experience of individual companies varied substantially.

The process

74. A key message for preparers of accounts is that it is never too early to start the transition process, especially because when they present their first IFRS financial statements (which for listed companies are likely to be interim statements) they will need to present comparative IFRS information for the prior year. The process should therefore begin no later than the start of the year before IFRS adoption is mandated, and preferably earlier, to ensure that all data required is captured. In the UK, and presumably elsewhere in other EU Member states, this was frustrated to some degree by the fact that the EU had to endorse the IASB's standards and interpretations and this was not completed until a relatively late stage. Where such an endorsement process is established, the time required to endorse existing and pending standards should be factored into any implementation timetable by the relevant authorities.

75. The IFRS conversion process should be treated like any other major business project, and not as a technical accounting issue. A robust project plan from the outset was invariably a prerequisite for a smooth transition to IFRS. Companies typically had initial meetings with their auditors at which likely significant issues were identified, leading to production of a table of the items in their financial statements and the degree that these would be impacted by IFRS adoption using an 'ABC' (or similar) grading - 'A' representing items likely to have major issues and or impact on conversion to IFRS, 'B' representing modest impact or issues, and 'C' representing items which were unlikely to be significantly affected. This was designed to focus the company's attention on the key areas affecting them and to enable them to budget the time needed in each case.

76. A dedicated project manager needs to be given the appropriate authority to undertake the work and appropriate resources need to be provided to meet the costs and time of conversion, including IFRS expertise. The choice is between recruiting experienced, IFRS-knowledgeable employees or relying on external advisors – the auditors, subject to independence constraints, and other professional and training firms. As IFRS knowledge is needed on an ongoing basis after implementation, recruitment or the thorough training and retention of existing employees may be regarded as the most desirable options. Using in-house expertise also means that the ability to take quick corrective action as delays and problems are identified is enhanced.

77. All staff involved in the accounting process need to be made aware of how the change to IFRS will impact their work. Meetings held at an early stage were successfully used to inform staff of what was expected of them and to listen to their views. Often staff will have valid operational points to make, such as system limitations, which can then be investigated.

78. As fair value plays a significant part in IFRS there needs to be an early assessment of whether external non-finance expertise is required to produce the necessary valuations.

79. In some industries there was a sharing of thoughts and issues through regular meetings of representatives from leading companies in the same sector, sometimes including their auditors. This helped to ensure some consistency of approach for industry-specific issues and assisted those charged with implementation.

Systems

80. Systems may well need to be upgraded, for example to deal with the extensive fair value data required under IFRS, particularly in the area of financial instruments. If systems changes are to be made these need to be specified very early on in the project to allow time for development, testing and corrective action to ensure that the system is ready for operation when required. The time taken to achieve this should not be under-estimated.

81. Many companies met project deadlines by 'workarounds' – the use of spreadsheets to produce certain figures and disclosures which are not embedded in the accounting systems. Whilst this may have been necessary in the first instance it is generally not desirable because companies had to do further work in the following year to bring information within their normal accounting systems. There is also an increased risk of error.

Training

82. It is important to train all staff affected by the adoption of IFRS. This is not limited to finance teams but extends to budget holders and any other internal or external stakeholder who needs to understand and interpret IFRS accounting information, or who is rewarded based on such information. The early involvement of the human resources department is likely to be necessary to ensure training is carried out efficiently and comprehensively.

Governance

83. The Board of Directors/Officers should be engaged from the start of the process. IFRS adoption has the potential to significantly affect earnings and net assets and senior management need to be aware of this early on. There are indications that directors of many EU listed companies are more involved in financial reporting decisions than under previous national accounting regimes.

84. The company's auditors should also be consulted early on in the process where key judgements and estimations will be required, to ensure that no last minute revisions of the financial statements will be necessary.

85. In the UK, listed companies appoint audit committees to liaise with the external auditors, consisting primarily of non-executive directors. The audit committee will be involved in the selection of appropriate accounting policies and as IFRS permits alternative treatments in many cases and requires significant exercise of judgement this will be a time-consuming task requiring an initial period of training of the committee members in IFRS principles.

Business issues

86. The company must consider the effect that IFRS adoption will have on, amongst other things:

- management compensation structures (profits may become more volatile under IFRS adoption especially if the company is exposed to the extensive use of fair values for financial instruments);
- taxation implications;
- debt covenants based on financial statement ratios; and
- key performance indicators (KPIs), which may need to be amended as a result of the switch to IFRS.

Communication with stakeholders

87. The regulatory authorities encouraged UK listed companies to provide an indication of the impact of IFRS on their 2005 results and financial position in their 2003 financial statements, and to publish restated numbers for 2004 at the time of, or soon after, the publication of the UK GAAP financial statements. It was particularly important to explain differences between the IFRS numbers and the figures previously reported under national GAAP very clearly to the Board, analysts and other stakeholders, because of their unfamiliarity with IFRS concepts, vocabulary and requirements.

Disclosures

88. The priority of many companies preparing for IFRS in 2005 was applying the recognition and measurement requirements of IFRS and ensuring that their systems were capturing the accounting information needed. Once faced with producing the first annual report and

accounts under IFRS, it became evident that the disclosure requirements of IFRS were far more extensive than those of UK GAAP and, as discussed above, the Financial Reporting Review Panel survey showed that many companies did not fully comply with the IFRS requirements. It is generally recognised that the quality of disclosures improved in the second year of IFRS implementation.

Audit firms

89. Auditors need to be fully trained in IFRS with exposure to likely implementation issues to ensure that client questions and suggested accounting policies can be responded to in good time and with robust supporting arguments. In the UK, trainee accountants had begun to study IFRS before the UK implementation but inevitably lacked the practical experience and depth of knowledge necessary to be confident in dealing with clients' questions. Qualified accountants had attended courses in IFRS but understandably lacked the depth of knowledge and application experience.

90. Now that IFRS is used much more widely around the world, it may be feasible for local audit teams to gain IFRS experience before assisting companies in their jurisdictions with implementation issues. This could be achieved by secondment, or where this is impracticable, by case studies based on the experience of IFRS conversion in other countries.

F. THE ROLE OF ACCOUNTING INSTITUTES: THE ICAEW AS AN EXAMPLE

91. Contributing to the IFRS transition process was made a key priority for the ICAEW as a whole in the two or three years before IFRS reporting became a reality. It was the main theme taken up by the ICAEW President and involved all parts of the ICAEW, working together to raise awareness of the issues and provide practical assistance.

92. Significant resources were devoted to this undertaking, including work started in 2003 on converting the examination syllabus for entry to the ICAEW to IFRS and creating a new IFRS certificate and related learning materials (available to non-ICAEW members), both of which were delivered in 2004.

93. The ICAEW provided speakers at a number of high profile events on the transition, including conferences organised by the London Stock Exchange and business groups, and with the help of the ICAEW regional structure organised smaller scale events for its members around the country.

94. In a very early move, soon after the EU's financial reporting strategy was announced in 2000, key differences between UK GAAP and IFRS were identified in a high profile ICAEW project run by prominent IFRS experts David Cairns and Professor Chris Nobes, and published in conjunction with the UK standard setter.

95. To highlight the state of preparedness and the issues early movers were encountering, detailed surveys by the ICAEW's research department were published on its website in 2003, in 2004 and again in 2005. These attracted considerable press attention which helped to communicate issues to a wide UK audience.

96. A live case study of the ICAEW's own transition to IFRS was prepared and published with a comprehensive initial report and restatements in April 2004. An update together with the restatements for the 2004 financial statements were published in April 2005 and full IFRS financial statements were published from 2005 onwards, in an attempt to lead by example.

97. More recently, with further movement to IFRS imminent in the UK and internationally, the ICAEW has established a new Financial Reporting Faculty, which will be open to non-ICAEW members and will provide a range of information and services for IFRS (and UK GAAP) users from late 2008 (www.icaew.com/frf).

G. OVERALL ASSESSMENT OF IFRS IMPLEMENTATION

98. Notwithstanding the various issues highlighted earlier in this report, 2005 financial statements were produced to a high standard by UK IFRS reporters and, without exception, within the

time frames required. Fund managers and other analysts in the UK are generally of the opinion that IFRS financial statements provided better and more transparent information for decision making. A survey by PricewaterhouseCoopers in June 2006 found that almost two-thirds of 75 UK fund managers surveyed believed that IFRS adoption had improved company reporting. These fund managers were responsible at the time for £2 trillion of funds, representing nearly 50% of the market.

99. The ICAEW study for the European Commission supports this favourable assessment. Its conclusions, all applicable to the UK market, included the following:

- there was widespread agreement that IFRS has made financial statements easier to compare across countries, across competitors within the same industry sector and across industry sectors; and

- IFRS implementation had been challenging but successful; there was no general loss of confidence in financial reporting and IFRS implementation was generally seen as a positive development for EU financial reporting.

100. The ICAEW report also noted that at roundtables used to test and explore the preliminary findings of the project:

- success tended to be expressed more in terms of measurement, rather than disclosure;

- the experience of smaller quoted companies was often very different from larger companies because, for example, of limited resources and a lack of prior experience of IFRS; and

- participants – who included auditors, preparers and regulators – expressed concern about the complexity of the standards and over the likely increase in the pace and direction of change in IFRS, referring in particular to the greater use of fair values. These concerns, coupled with awareness of the scale of the effort involved in IFRS implementation and concerns about some aspects of current IFRS, were reflected in a general lack of appetite at the time for any wider application of full IFRS.

101. Academic research also supports the conclusion that UK companies' financial statements prepared in accordance with IFRS show increased value relevance (ie, a stronger correlation between share prices and the information in the accounts). The presumption is that value relevant information is helpful to investors in making buy, sell or hold decisions. A study prepared for the ICAEW report to the EC – Joanne Horton (London School of Economics) and George Serafeim (Harvard Business School), '*Value relevance of the International Financial Reporting Standards (IFRS): investigations of the transitional documents for UK, Spanish, French and Italian companies*' – looked at the information provided by UK companies when they first adopted IFRS. At this point companies had to provide reconciliations of their last published financial statements prepared using UK GAAP with the revised numbers using IFRS. It was therefore possible to check the value relevance of the additional IFRS information. The study found that the IFRS earnings adjustment was value relevant to the share price and to the stock return (ie, the change in the share price) and that the IFRS equity (ie, net assets) adjustment was value relevant to the stock return.

102. A further assessment of the capital market impacts of IFRS, provided in July 2008 for the purposes of this report to the UN by Joanne Horton and George Serafeim, and available from the ICAEW, refines the conclusions of their earlier report.

H. CONCLUSION

103. The process of transition to IFRS was challenging, and involved substantial efforts, particularly by preparers and their auditors. The switch to IFRS was nonetheless achieved successfully by both fully listed and, as far as can be ascertained at the time of writing, by AIM listed companies. It has in general received a favourable response from analysts and other users and has improved the comparability of UK financial statements with those of other EU companies and non-EU IFRS reporters.

104. Experience of IFRS application continues to improve, and enforcement activities have not so far identified significant problems in the quality of application of the new standards. Much remains to be done however, for example to embed IFRS within systems and reporting processes, to build up understanding of IASB standards – their principles, the scope for judgement and their shortcomings – and to develop common sector practice.

105. Debate continues in the UK over the wider application of IFRS, principally through the convergence of UK GAAP with IFRS (and in particular, by utilising the pending IFRS for Private Entities), and the process of extending IFRS to the public sector is now underway. There is little doubt that IFRS will in future form the basis of all UK financial reporting.