THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Audit and Assurance Faculty

technical release

Auditing Implications of IFRS Transition

Audit 03/04

This guidance is issued by the Audit and Assurance Faculty of the Institute of Chartered Accountants in England and Wales in July 2004 to assist auditors to assess and comment on the state of their clients' readiness for the transition to International Financial Reporting Standards and prepare for the auditing implications. This guidance does not constitute an auditing standard. Professional judgement should be used in its application.

SUMMARY

Listed companies in the UK must prepare their financial statements for the year ending 31 December 2005 in compliance with International Financial Reporting Standards (IFRS). The conversion to IFRS will be complex and detailed for many companies and recent research and surveys on the state of preparedness for this important change are not encouraging. The combination of this complexity and the apparent lack of preparation results in an increase in risk for auditors as they prepare to audit financial statements prepared under IFRS.

This technical release (TR), gives guidance on what auditors should expect the management and the audit committees at their clients to be doing as they manage the transition to financial reporting in accordance with IFRS. It also sets out good practice on what auditors themselves should be doing in the period up to the first audit under IFRS.

Most importantly, auditors should be actively assessing the quality of their clients' transition processes and the judgements that are being made to enable the change to IFRS. If they believe that these are not adequate or could potentially not meet the standards they will require in their 2005 audit, they should discuss those issues with their clients as soon as possible to alert them to the potential effect on the reporting timetable or the audit report.

SECTION 1

BACKGROUND

1. Listed companies in the UK have to prepare their consolidated financial statements in compliance with European Union (EU) approved International Financial Reporting Standards (IFRS) for financial years beginning on or after 1 January 2005. The first time that companies will present a full set of IFRS accounts will be for the year ending 31 December 2005. In March 2003, the Department of Trade and Industry (DTI) issued proposals that would allow all other UK companies to adopt IFRS voluntarily from 2005 if they wish. Requirements for companies listed on the Alternative Investment Markets (AIM) are subject to consultation.

2. At the end of March 2004, the International Accounting Standards Board (IASB) published the finalised standards that companies will need to comply with in 2005. However, the Regulation (EC) No.1606 2002 requires that, in preparing their consolidated accounts companies only apply those standards that are endorsed by the EU. Two standards have not yet been endorsed by the EU: IAS32, *Financial instruments: Disclosure and Presentation*, and IAS 39, *Financial Instruments: Recognition and Measurement*, but this should not be a barrier to preparing for the 2005 transition. The International Financial Reporting Interpretation Committee (IFRIC) also publishes interpretations which will be mandatory for the first set of IFRS statements. Prior to the creation of the IFRIC, interpretations were issued by the Standing Interpretations Committee (SIC) and some of their interpretations remain in force.

First-time adoption issues

3. In June 2003, the IASB published IFRS 1, *First-time adoption of international financial reporting standards*. As new standards are published, and existing financial standards improved, there have been, and there are likely to be, continuing amendments to this standard. IFRS 1 sets out how companies should apply IFRS for the first time, requiring one full year of comparative financial information. For 2005 financial statements, this will be the year ending 31 December 2004. The key date of transition at the beginning of this period, 1 January 2004, has already passed. IFRS 1 requires the preparation of an opening balance sheet as at this date. The first set of IFRS compliant statements will also need to include extensive disclosures to explain the transition to IFRS from UKGAAP. If IAS 39 is not adopted, then it is possible that the risk profile and complexity of the statements will change.

The current state of preparedness

4. Research carried out by academics[1] (due to be published later in the year) indicates that:

   - although there is strong support for the principle of common accounting standards throughout Europe, realisation among practitioners in companies and in audit firms about the scale and complexity of the project is still growing;
   - the delay in adoption of all standards by the EU is undermining preparations for change;
   - education is a major issue; there is a shortage of knowledgeable practitioners. Company boards and audit committees may not understand the changes and there are also concerns about how much key users of financial statements, such as banks and analysts, will be aware of the specific impact on individual company results;
   - accountants are accustomed to incremental change, and initially some may find that such major conceptual shifts are difficult to absorb and apply correctly to complex accounting issues. This is likely to increase the risks of mistakes being made in preparation of financial statements and of auditors failing to pick them up;
   - there are concerns that some companies may view the transition as an opportunity to bury bad news; and
   - there is a growing expectation among audit firms that more audit reports will be qualified because companies have not managed the transition process properly and therefore will not be in a position to prepare IFRS compliant financial statements.

5. This research is supported by the findings of recent surveys:

   - a survey by PricewaterhouseCoopers[2] of listed companies in Europe indicated that one in ten companies had not begun their IFRS project, with less than a third of companies having IFRS transition projects fully set up and running.

[1] Stella Fearnley, Tony Hines, Annette Gillies and Caroline Willett from Portsmouth Business School are carrying out a study of attitudes and beliefs in the UK about IFRS with company directors, auditors and regulators. The same individuals have been re-interviewed after a two-year gap.
[2] The results of the PwC survey can be found in its publication, *International Financial Reporting Standards, Ready to take the plunge* (May 2004)

- another survey carried out by ATOS KPMG Consulting[3] revealed that 26% of all UK companies have said that they will not be ready for the 2005 deadline.

- a survey carried out by Accountancy Age in May 2004 highlighted that finance staff in UK listed companies were less prepared for the impact of IFRS than they were three months earlier because companies had previously underestimated the impact of the transition to IFRS. The survey revealed that nearly a third of FTSE350 companies were still unsure of how to rate the readiness of their staff.

- most recently, in July 2004, a survey carried out by the ICAEW[4] indicated that while 77% of listed companies state that they are prepared for IAS, most of these (61%) report that they are only 'fairly well prepared', suggesting that there is still some work to do.

6. Analysts and investors are also starting to engage with companies on the transition to IFRS, as they will soon have to work with revised financial information. The way that such information is presented will influence investors' views of companies' transparency and preparedness. Some feel that transition to IFRS may have a substantial effect the way company performance is viewed, For example a report published by Fitch Ratings[5] states that, *"it cannot rule out the possibility that the additional disclosure and information contained in the accounts could lead to rating changes due to an improved perception of risk based on the enhanced information available."* Almost certainly, more enquiries are likely to emanate from the markets in the near future.

IFRS are different

7. It is easy to make a high-level comparison of UK GAAP and IFRS and conclude that there are few major differences; however there are many important detailed differences, many of which will be discovered only by a thorough analysis of a company's transactions and exposures. Matters that need to be considered include:

   - changes brought by the move to IFRS will mean a major change in the actual format of the accounts;

   - differences in definitions may mean that items previously classified in one way will need to be classified differently;

   - some items that are not recognised under UK GAAP are recognised as assets or liabilities under IFRS, whilst others may cease to be recognised;

   - some items may have to be measured differently in the accounts of an individual subsidiary and in the consolidated accounts;

   - more extensive disclosure requirements will result in greater data capture needs; and

   - some changes in accounting policies may require accounting systems to give different information.

8. The transition to IFRS is also made more difficult by the changes to company law. A number of the regulations supersede parts of the Companies Act, resulting in some complex reporting and disclosure requirements.

9. However, it is not the purpose of this TR to give a comprehensive description of the differences between IFRS and UK GAAP. Readers requiring such information are referred to the ICAEW's publication, *The Convergence Handbook* which will be revised and updated later this year.

[3] The results of the ATOS KPMG Consulting survey are published in its publication, *International Financial Reporting Standards, the challenge facing businesses* (June 2004)
[4] The results of the ICAEW survey are published in a document, *Closing the GAAP* (July 2004)
[5] The Fitch Ratings research results are published in its special report entitled, *Mind the GAAP* (May 2004)

SECTION 2

PURPOSE OF TECHNICAL RELEASE

10. With the technical complexity of IFRS, the tight transition timescales and the apparent lack of current preparedness, there will be an increase in risk for the review of interim information and the audit of 2005 financial statements of listed companies. The adoption of IFRS brings new challenges for management and auditors. The review of interims typically places greater reliance on techniques which will be difficult to apply in an environment where there is limited history and where other material, such as management accounts, may be prepared on a different accounting basis. With the adoption of new accounting policies and accounting estimates, there is an increased risk of error. In this context it should be noted that IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires entities to correct all material prior period errors by restating the relevant amounts in the prior period financial statements. This will potentially result in more restatements of financial statements than we have been accustomed to in the UK as FRS 3 *Reporting financial performance* requires restatements for material adjustments only where they arise from the correction of fundamental errors, a subtle but potentially significant difference in wording. The APB, with whom the Faculty has liaised in preparing this TR is currently drafting guidance on the effect of the introduction of IFRS and the requirements of auditing standards. It expects to issue a Bulletin in August 2004.

11. The guidance in this TR aims to help auditors to both assess and comment on their clients' transition process and their state of IFRS preparedness. Accordingly it provides auditors with guidance in three key areas:

    - what auditors should expect management to be doing;
    - what auditors should expect audit committees to be doing; and
    - what the auditors themselves need to consider.

    Each section includes key questions that auditors might wish to consider.

12. Although primarily directed at auditors, management and audit committees may also find parts of this guidance useful.

SECTION 3

WHAT AUDITORS SHOULD EXPECT MANAGEMENT TO BE DOING

Clarification of directors' responsibilities

13. The directors' responsibility for running a company implicitly requires them to take reasonable steps to ensure that the company implements IFRS successfully without material impact on the business. The directors will need to review the impact on the business and ensure that there are appropriate plans to train the staff, update the accounting systems, and implement changes in reporting encompassing all significant business units.

Communication Requirements

14. There is increasing pressure on companies to demonstrate their IFRS preparedness. The Committee of European Securities Regulators (CESR) recommended in the *European Regulation on the application of IFRS in 2005* (issued in December 2003) that:

    - companies explain, in their 2003 Annual Report, how they intend to carry out the transition to IFRS, with listed companies being encouraged to explain in a narrative format the key differences between their present accounting policies and the ones that they know with sufficient certainty that they will have to apply under IFRS;
    - once a company is able to quantify the impact of the change on its 2004 financial statements in a sufficiently reliable manner, it is encouraged to disclose the relevant quantified information;
    - companies start to apply the IFRS recognition and measurement principles for interim financial reports in 2005, including the comparative information from the corresponding previous period; and
    - the first complete set of 2005 financial statements be prepared and presented under IFRS by listed companies in Europe, should have at least one year of comparatives.

15. The Financial Services Authority has agreed to the CESR recommendations by virtue of its membership and has drawn attention to them in its monthly newsletter, LIST! (November 2003) outlining them as best practice for companies.

Assess the need for resource and identify training requirements at an early date

16. The need for resources depends on the complexity of the accounting and system issues. At the beginning of the process it is essential that companies carefully assess and plan for the number and skills of staff required for a timely and effective transition. The business will need to assess the training required by the employees, which should extend beyond the finance function. This assessment should include the needs of the company's subsidiaries, which will differ depending on the degree of centralisation or devolution of the group's accounting functions. Overseas businesses may present particular challenges. Needs will differ between EU and non-EU operations, depending on the extent to which a jurisdiction has already adopted IFRS.

Identify gaps between current accounting policies and IFRS

17. It is important that the transition process starts with a comprehensive comparison between the business' current accounting policies and the requirements of IFRS. Some policies will need to change and new policies will need to be set. Management will have a choice in the selection of some policies. Companies should also assess the financial impact of the accounting policy changes so that informed decisions can be made.

Identify changes in financial data and additional information to meet the revised disclosure requirements

18. Once the accounting issues have been identified, the impact on systems and processes can be assessed. Any changes will need to be implemented in a sustainable way. If a company assembles information in a less than rigorous and structured way for 2005 (planning more changes later) risk will be increased. The areas that companies should consider include:

    - the need to revise and rollout updated IFRS group accounting manuals;
    - the need for changes in the capture of data which may be more complex than companies realise;

- alignment with current system projects as amendments to existing accounting systems may be required to cope with the new data needs;
- the format of group reporting packs and preparation of consolidated accounts, for instance capturing segmental information;
- whether individual business units will report in accordance with IFRS for group reporting purposes or whether the business units will provide information to the central team who will then convert this to IFRS;
- whether the central project team has sufficient knowledge of the local accounting practices of the group's subsidiaries, to plan for the transition;
- whether the company has resources with the appropriate level of skills and expertise to generate all the financial data required under IFRS; and
- whether assistance will be required from external advisors.

Identify the impact on business issues and manage these

19. The company's other business needs should be considered, including:

- review of bank covenant arrangements and negotiating amendments as required;
- review deal structures;
- communication plan to discuss the impact of transition to IFRS with analysts and shareholders;
- prepare 2004 and 2005 budgets on an IFRS basis and explain the differences from UK GAAP;
- establish the impact on reserves and dividend policy;
- re-assess impact on taxation and current structures;
- the impact on remuneration and incentive schemes; and
- the particular consequences for regulated business and their capital adequacy.

Planning the transition process

20. In planning their transition process, companies should bear the following in mind:

- getting commitment throughout the organisation (including the board, audit committee, business units, IT, human resources, investor relations);
- training relevant staff in IFRS;
- identifying the data needed to generate the IFRS statements;
- building pro formas for financial statements, budgets, and reporting packages;
- converting systems or developing pragmatic solutions as necessary;
- testing the systems;
- parallel running the new systems; and
- reporting "live" IFRS information.

Implementation

21. The actual transition process should include:

- preparation of opening balance sheet under IFRS (as at 1 January 2004);
- preparation of the comparative figures for December 2004 under IFRS (closing balance sheet and income statement);

- preparation of the interims in 2005, with comparatives;
- live IFRS reporting for the 2005 accounts; and
- running the business under IFRS.

22. The appendix sets out a fuller timetable on how this might proceed.

Operating and Financial Review (OFR)

23. In May 2004, the DTI published a consultative document on the draft regulations on the OFR and the Directors' Report. The draft regulations would require companies to publish an account of its business, objectives and strategy, a review of developments over the past year and a description of the main risks with their annual financial statements. It would also need to cover prospects for the future. It is also proposed that in addition to their current duties in respect of directors' reports, auditors should report whether, in their opinion, the directors have prepared the OFR after due and careful enquiry. The implications of these requirements are likely to coincide with the first set of IFRS financial statements in 2005. This will therefore place further additional burden on companies and auditors as the financial commentary in the OFR will need to be based on IFRS data.

Additional Considerations for US registrants

24. There are additional specific considerations for US registrants which need to be considered:
    - the introduction of IFRS will coincide with the first year of application of Section 404 of the Sarbanes-Oxley Act to foreign private issuers. This requires management to report on the effectiveness of their systems of internal control over financial reporting and auditors to attest to that assessment. Auditing Standard 2, issued by the Public Company Accounting Oversight Board in the US, sets a high standard for the quality of companies' processes and procedures, their documentation and management testing. Achievement of this benchmark may be challenging for the IFRS transition processes, in particular where companies are working with limited resources to tight reporting timetables.
    - companies will be converting their UK GAAP accounts to IFRS for 2005. Historically those not producing full US financial statements will have included in their 20F filings a bridging reconciliation of their key financial data from UK GAAP to US GAAP. From 2005 onwards, this bridging statement will need to reconcile the IFRS data and comparatives to US GAAP basis. This further reconciliation will provide additional challenges. This reconciliation should be considered as part of the transition project so that unexpected anomalies do not arise later in the project, closer to the date of first IFRS reporting.

Subsidiaries

25. The consolidated accounts of listed groups must be prepared in accordance with IFRS. Although companies that comprise the group do not have the same requirement, they will have the option of doing so. In the long term, this will help to simplify the consolidation process.

26. Where all of a company's subsidiaries are based in the UK, management will need to ensure that the transition issues are properly managed by the whole group. There are choices in IFRS, as with UK GAAP, and management should be making policy decisions for the consolidation. Auditors will need to confirm whether or not similar policies are being applied in respect of each subsidiary.

27. Overseas subsidiaries may present some problems depending on whether IFRS are allowed, required or prohibited in the countries in which the subsidiaries operate. Where IFRS are allowed or required, subject to timing issues, the situation will be similar to that of a UK subsidiary. Where IFRS are not allowed, then there are two potential problems. Firstly, there will be a need for additional accounting to allow the financial statements to be restated for consolidation purposes. Secondly, consideration will need to be given to whether or not the local management have IFRS expertise to be able to prepare the restated figures.

Internal audit

28. Management will need to consider what role the internal audit function may be able to fulfil in the transition process. Internal audit may be well placed to assist with the project management of the transition process and, in particular with the planning and design of the project plan, its execution, monitoring, evaluation and completion.

29. The box on the following page outlines some key questions that auditors might wish to consider asking of management.

What auditors might wish to ask their clients' management

- *Have they properly estimated the degree of resource with the necessary skill and knowledge required to manage the transition process?*
- *Do they have sufficient access to the specialist expertise that will be required, valuations, for example?*
- *Have they properly estimated the magnitude of change inherent in the transition process?*
- *Are they fully aware of the timetables and deliverables?*
- *Have they started the transition process?*
- *Is there effective project management with senior management commitment and sponsorship?*
- *Are they undertaking a thorough diagnostic exercise to understand the accounting policy changes necessary before moving into the detail of restatement processes?*
- *Is the entire group of companies (not just the head office) sufficiently involved in the process?*
- *Where IFRS are being adopted by individual companies, do they understand that there are other implications of IFRS transition including reviewing deal structures, analysing the impact on reserves and dividends, and re-assessing impact on taxation?*
- *Are they considering how to build their data collection architecture and process for the future? Spreadsheets are not a long-term option.*
- *Are they communicating to third party stakeholders as soon as they have an understanding of the impact of the IFRS transition?*
- *Is a realistic view being taken of the 2005 reporting timetable, given the challenge of the IFRS transition to the company?*
- *Has management put into place robust mechanisms to prevent and detect anyone taking advantage of the IFRS transition to deliberately misstate financial reports?*
- *If the company is a US registrant, are they planning for the additional challenges that they will have to meet?*

WHAT AUDITORS SHOULD EXPECT AUDIT COMMITTEES TO BE DOING

30. The board has overall responsibility for the preparation of the financial statements. These are existing responsibilities set out in company law and the Combined Code. In practice, the board usually delegates this responsibility to the audit committee who then has an oversight responsibility for the preparation of the accounts. This framework is confirmed and established through detailed terms of reference by the board. Auditors should engage early with the audit committee at their client in relation to the transition to IFRS to discuss the quality and progress of the transition project.

The audit committee's responsibilities

31. The audit committee will need to make recommendations to the board concerning the approval of IFRS compliant interim and full year financial statements. This will require them to consider both the overall effectiveness of the company's implementation plan and whether its normal responsibilities in relation to financial statements has been satisfied. The audit committee may wish to formally clarify its role in the transition process and the degree of involvement it needs to have in the detailed considerations.

Specific training

32. The audit committee should satisfy itself that there are sufficient skilled staff with the relevant knowledge in place to take the company through the transition process. It should also ensure that its own members receive the necessary training so that they fully understand the transition process and are able to properly discharge their responsibilities.

Steps needed prior to transition to IFRS

33. In monitoring and reviewing reports on the company's internal financial controls and risk management systems, the audit committee should have regard to the anticipated impact of IFRS transition on these systems. They should expect to receive regular reports from the IFRS implementation project team so that they can monitor progress.

34. The audit committee should identify the matters that it anticipates will affect its consideration of financial statements prepared in accordance with IFRS. This will normally include:

    - the selection and adoption of IFRS compliant accounting policies;
    - the impact of IFRS on areas of accounting involving significant levels of judgement;
    - the clarity and compliance of disclosures and explanations relating to the implementation of IFRS; and
    - compliance with IFRS accounting standards, stock exchange and other legal requirements.

35. The box on the following page outlines some key questions that auditors might wish to consider asking audit committees.

What auditors might wish to ask of audit committees

- *Is the audit committee clear on its role and the degree of its involvement in the transition to IFRS?*
- *Has the audit committee considered whether there is sufficient training for the company's staff and its own members to develop their knowledge and skills?*
- *Has the audit committee reviewed the underlying accounting policy changes?*
- *Is the audit committee able to challenge management's choice of accounting policies and the robustness of the transition process?*
- *Is the audit committee aware of the requirements of IFRS and the CESR recommendations?*
- *Is the audit committee receiving regular reports on progress from the implementation project team?*
- *Has the audit committee considered the overall effectiveness of the company's implementation plan?*
- *Has the audit committee reviewed other matters that may affect the financial statements?*
- *When the audit committee reviews draft IFRS financial statements, will it consider whether the disclosures are appropriate in the light of the accounting policies chosen?*
- *Is the audit committee alert to the risk of the transition to IFRS being taken as an opportunity to deliberately misstate financial reports?*
- *Is the audit committee satisfied that the effect of the changes on transition to IFRS is being effectively communicated to external stakeholders?*

SECTION 5

WHAT AUDITORS THEMSELVES NEED TO CONSIDER

36. Auditors need to liaise with their clients regularly throughout the IFRS transition process to understand their client's ability to generate robust IFRS financial statements and to monitor progress being made against the timetable.

Audit firm's process

37. In commenting on a client's transition, it is possible that such work, or output thereof, will ultimately form part of the audit evidence on which the audit opinion on the first IFRS statements will be based. Our Faculty publication, *Audit Quality*, emphasises that audit quality is about professionals reaching appropriate judgements in difficult and complex circumstances and that it depends on a number of control factors, including firms' processes. Audit firms will need to ensure that auditors are competent to perform IFRS assignments during the transition.

Auditors need to have a knowledge base

38. The complexity of the transition to IFRS will increase the level of audit effort required to reach a conclusion on the first IFRS financial statements. Audit firms need to ensure that they have sufficient appropriately skilled resource, amongst both audit engagement partners and audit staff. A particular feature of this change will be that the accumulated familiarity with UK GAAP built up over years of practical experience will no longer be relevant. It will take time before there is a similar instinctive understanding of IFRS.

39. The transition to IFRS represents a significant transformation in the knowledge and skills required by auditors. Audit firms need to provide the appropriate level of training to equip their people to perform audit work with skill and care, and with the ability to make sound judgements in reaching audit conclusions. Review partners will also need to be trained to enable them to carry out their work with the necessary knowledge required for a competent review of the audit team's work. When auditing a group with overseas businesses, the IFRS competence and training of the wider audit team need to be assessed and addressed as required.

40. IFRS continues to evolve with the publication of interpretations by the IFRIC which will be mandatory for the first IFRS financial statements and with the publication of new standards by the IASB for which early adoption will be encouraged. Auditors need to keep abreast of these developments and ensure that clients are preparing their first IFRS financial statements on the appropriate IFRS basis.

Audit documentation needs to provide a clear audit trail of the judgements and conclusions reached

41. Firms will need to consider whether their approach and audit work programmes need to be amended and updated for an IFRS environment.

42. The transition to IFRS will require auditors to place more reliance on the work of experts in more complex areas such as valuations of employee share options or non-traded financial instruments. They will therefore need to obtain sufficient appropriate audit evidence of the work that has been carried out by the experts and how they have arrived at their judgements. Auditors will need to assess the adequacy of the judgement made by the experts for the purposes of an audit. The impact of this assessment will need to be recorded clearly. Auditors should refer to the requirements of SAS 520[6] *Using the work of an expert*.

Communication responsibilities

43. The auditor needs to have continuing communication with management, the board and its audit committee to ensure that they are all fully aware of their responsibilities and the scope and progress of their company's transition project. In particular the auditor needs to consider:

- whether the transition project is capable of ensuring complete and accurate quantification of the accounting policy differences at the date of transition;
- how embedded is the transition process within the company's business; and
- the principles of SAS 610[7] *Communication of audit matters to those charged with governance (revised)* suggest that the auditors should provide the board or audit committee with their appraisal of the quality of the company's IFRS transition project and IFRS readiness, highlighting those issues that may impact the audit of the first IFRS financial statements.

[6] to be superseded by ISA620 *Using the work of an expert*
[7] to be superseded by ISA260 *Communication of audit matters to those charged with governance*

44. These matters will ordinarily be discussed initially with management in order to clarify facts and issues, and to provide management with the opportunity to provide further information and explanation.

Planning

45. When planning their work, auditors need to:

- agree with management the nature of, and timetable for, auditor involvement, assistance and reporting throughout the transition process;
- determine the nature, extent and quality of audit evidence they will need to support the judgements made and conclusions reached by management in the transition to IFRS and in their preparation of the first set of IFRS financial statements. They should communicate their information needs to management;
- consider the particular issues affecting the audit of restated comparative figures; and
- consider to what extent unadjusted audit differences, arising on UK GAAP audits at the transition balance sheet date and for the comparative period, that do not eliminate on transition to IFRS, impact on the audit opinion on the first IFRS financial statements. In so doing, the auditor will need to consider the level of audit materiality in respect of IFRS financial statements in accordance with SAS 220[8] *Materiality and the audit*.

Meeting the challenge of fraud

46. In recent years there has been increasing concern amongst investors about the problem of aggressive earnings management which has changed the focus of thinking around fraud. Whilst misappropriation of assets is still an issue, the potential for aggressive earnings management fraud is often more likely to be a material risk of misstatement in the financial statements. Auditors will need to be alert to increased opportunities for the manipulation of the first set of accounts on the transition to IFRS. Specific risk areas include:

- the restatement of the opening balances;
- increased pressure on management to deliver results;
- some aspects of IFRS which introduce more choices; and
- increased use of fair values.

Assistance with IFRS transition

47. Auditors may be asked by management to give assistance with their IFRS transition project as a separate engagement to the audit. There are many areas where auditors can valuably assist their clients' transition to IFRS, using their wider knowledge of developments and their particular knowledge of their clients' circumstances. Such assistance could include:

- providing training on IFRS;
- commenting on areas where changes in accounting policy or disclosure are likely;
- assisting with preliminary diagnosis of the impact on financial reporting and accounting systems;
- reviewing accounting issue papers prepared by the client;
- providing technical guidance on IFRS standards and advising on the interpretation of IFRS;
- reviewing and discussing transition project scope, and governance, including roles and responsibilities; and
- reviewing early draft IFRS financial statements.

48. However, auditors will need to consider carefully what work they agree to do to ensure their independence and objectivity is not compromised. It is possible that work done in the transition to IFRS will form part of the evidence on which the audit opinion will rely. Most importantly the final decision on the appropriateness of accounting policies to be adopted must be that of the directors.

[8] to be superseded by ISA320, *Materiality and the audit*

Early assurance

49. Auditors may also be called upon by management to give early assurance on the company's state of readiness or on IFRS information that is produced prior to the company's first IFRS financial statements. There may also be requests for public reporting. Areas where management may ask for such early assurance could include:

    - confirmation of appropriateness of accounting policies and interpretation of IFRS;
    - confirmation of appropriateness of additional disclosures in 2004 financial statements relating to their company's IFRS transition; and
    - audit or review of the transition balance sheet, 2004 full year or interim IFRS information.

50. Auditors will need to consider to what extent clients' requests for early assurance or private reports can be met through the auditors continuing technical advice in the context of the statutory audit, or whether a separate audit or review engagement, an agreed upon procedures engagement or an assurance engagement is appropriate in the circumstances. There are limited procedures for review engagements, and on their own, they may not be sufficient to provide evidence that management has selected and appropriately applied IFRS policies in its IFRS balance sheet.

51. In considering the nature and timing of such engagements, auditors should be conscious of the fact that there are inherent difficulties in giving such early assurances and care is needed:

    - it may be difficult to report at an early stage because of the impact of continuing IFRS interpretation prior to the company's first IFRS reporting date;
    - auditors need to have regard to the quality of the base data from which the IFRS information has been prepared, and whether this has been audited;
    - auditors will need to consider the scope, rigour and completeness of the company's transition to IFRS at the time of the assignment;
    - the absence of comparative data will limit the effectiveness of analytical review that the auditors are able to do as part of their work;
    - the opening balance sheet is prepared using its best knowledge of the expected standards, interpretations, facts and circumstances that will be applied when the company prepares its first full time financial statements. The possibility cannot be excluded that the accompanying preliminary/initial balance sheet may have to be adjusted; and
    - only a complete set of financial statements can give a true and fair view or fairly present the financial information, results and cash flow.

52. The International Federation of Accountants (IFAC) is currently developing guidance on such reports, which will shortly be available on their web site (www.ifac.org). The IAASB also has this matter under review.

53. The box on the following page outlines some key considerations for auditors.

Considerations for auditors

- *Have you and your audit staff received sufficient IFRS training and do you have an adequate knowledge base to perform IFRS assignments?*
- *Have you agreed the timing of your involvement with your client's IFRS project with management?*
- *Have you considered the type of engagement that is appropriate depending on the involvement that the client has requested?*
- *Can you confirm and evidence that your independence and objectivity has not been compromised?*
- *Have you agreed the terms of the engagement and the form of any early reporting with management?*
- *Have you communicated your information needs to the company?*
- *Have you considered the implication of the IFRS transition for the preparation of the OFR?*
- *Have you considered whether the company has mechanisms in place to prevent or detect fraud particularly in the following areas: restatement of comparative data, the choices made on accounting treatments and the use of fair value?*
- *Do your working papers record properly and accurately your judgements and conclusions?*
- *Have you considered whether you need additional management representations on the IFRS financial statements, especially where management assumptions are key to valuations of assets and liabilities?*
- *Have you considered any concerns you may have on the timeliness and quality of the transition process and the potential consequences to the company? In particular, are you satisfied that your client's conversion project is capable of complete and accurate quantification of GAAP differences?*
- *Do you have a communication plan to enable you to discuss issues with the board, audit committee and management?*

SECTION 6

POTENTIAL EFFECTS ON 2005 FINANCIAL STATEMENTS

54. Auditors will need to assess carefully the degree of complexity of the transition to IFRS for each of their clients. They will also carefully assess the adequacy of their clients' process to make that transition. Research and surveys, referred to earlier, suggest that it cannot be taken for granted that all companies will complete their IFRS transition for 2005 in a timely and rigorous manner.

55. Where auditors believe that their client's IFRS transition will fall short of the standard they will require for their audit, they need to consider the possible consequences.

56. The company may need to extend the timetable for the production of its 2005 financial statements to give additional time for further work to be performed by themselves or by their auditors. This could have an effect on the timing of their preliminary announcement to the Stock Exchange and the timing of the annual general meeting.

57. The auditors may decide that it is necessary to qualify their audit report on the 2005 financial statements where they believe that IFRS has not been correctly applied. In practice it is to be hoped that any such disagreement between the auditor and the client could be resolved. It is more likely that any such qualification will be in the nature of a limitation of scope because auditors believe that the transition process has been insufficiently robust to enable them to carry out their audit to their satisfaction.

58. If auditors believe that there is a likelihood that either the reporting timetable needs to be extended or that their report could be qualified, they should discuss this with management and the audit committee of their client, as soon as possible.

59. The Faculty will continue to monitor this area and, if necessary, will provide further guidance in the lead up to the 2005 reporting dates.

APPENDIX – KEY MILESTONES

Timescales	Key financial reporting milestones	Actions for auditors
Second quarter 2004	Interim financial information for six months to 30 June 2004	Discuss IFRS transition with client management and Audit Committees, including selection of accounting policies, controls over the IFRS transition process, and the consequences of failure. Discuss with client whether assurance is required on IFRS information prior to first full IFRS financial statements and agree specific terms of engagement.*
Third Quarter 2004	Finalise IFRS accounting policies, including IFRS 1 options and policies selected under standards optional for adoption in 2005. Prepare transition balance sheet Establish comparatives for IFRS interim financial statements for six months to 30 June 2004.	Discuss IFRS accounting policies with the client in advance of year end. Agree timing of involvement Review extent of IFRS knowledge and experience of engagement teams – consider need for further IFRS training programmes and procedures necessary to ensure quality of IFRS-related audit work.
Fourth Quarter 2004	First IFRS comparatives: balance sheet at 31 December 2004 and income statement for the year to 31 December 2004 required as comparatives to the first IFRS financial statements.	Perform additional work on IFRS opening balance sheet where agreed with the client.*
First Quarter 2005	Publish 2004 UK information. If information is sufficiently reliable, entities may wish to publish proforma IFRS information alongside the 2004 UK GAAP financial statements.	Review IFRS information in 2004 annual report, depending on whether included within the financial statements or as "other information".
30 June 2005	End of first IFRS interim period: Prepare interim financial information under IFRS, including comparatives for the period to 30 June 2004, and all reconciliations between UK GAAP and IFRS as required by IFRS 1.	Where requested by the client, review interim financial information in accordance with APB Bulletin 1999/4. Consider impact of IFRS implementation on effectiveness of analytical procedures, and hence any additional work necessary in order to provide review opinion.
From December 2005	Annual financial statements for year to 31 December 2005 presented under IFRS, including comparatives for year to 31 December 2004, and all reconciliations between UK GAAP and IFRS required by IFRS 1.	Full scope audit, based on Auditing Standards issued by the APB applicable for 2005 – ISAs (UK and Ireland).

* Companies may request their auditors to perform work and report on IFRS financial information in advance of the 2005 interim/annual financial statements. Any such engagement should be carefully considered, taking into account the matters set out in this technical release.

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