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Audit Risk And IFRS: Does Increased Flexibility Increase Audit Risk?

By: **Ronald E. Marden** and **Kennard S. Brackney**

Abstract

Recent developments suggest that the United States may be quickly moving toward adopting International Financial Reporting Standards (IFRS). In November 2007, the SEC eliminated the requirement for foreign registrants who submit financial statements in accordance with IFRS as issued by the International Accounting Standards Board (IASB) to reconcile their statements to U.S. GAAP. In May 2008, the AICPA voted to add the IASB to the approved list of accounting standards-setting bodies, effectively giving private companies the option to use IFRS.

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Audit Risk and IFRS

Does Increased Flexibility Increase Audit Risk?

By Ronald E. Marden and Kennard S. Brackney

Recent developments suggest that the United States may be quickly moving toward adopting International Financial Reporting Standards (IFRS). In November 2007, the SEC eliminated the requirement for foreign registrants who submit financial statements in accordance with IFRS as issued by the International Accounting Standards Board (IASB) to reconcile their statements to U.S. GAAP. In May 2008, the AICPA voted to add the IASB to the approved list of accounting standards-setting bodies, effectively giving private companies the option to use IFRS.

The most significant development to date occurred in November 2008, when the SEC issued a proposed road map that would require U.S. public companies to convert to IFRS. The proposal would permit approximately 110 of the largest U.S.-listed companies to early adopt IFRS for 2009 annual filings. IFRS could be mandatory as early as 2014 if certain milestones were to be met by 2011. The milestones include continued improvement of IFRS, revamping of the funding mechanism for IASB operations, and significant progress in the training of U.S. accountants and stakeholders on the IASB standards.

A considerable amount of information is currently available regarding how IFRS and U.S. GAAP differ. The IASB's website (www.iasb.org) offers a detailed summary of each standard, and, other sites, such as Deloitte's IAS Plus (www.iasplus.com), provide helpful tabular summaries on the major differences between IFRS and U.S. GAAP. There has been a limited amount of research, however, on how the adoption of IFRS in the United States would affect the work of independent auditors. Changing to IFRS will impact the audit function and has the potential for increased audit risk as a result of implementation.

IFRS and a Rush to Increasing Judgment

Some members of the Public Company Accounting Oversight Board's (PCAOB) Standing Advisory Group (SAG) are worried that a rapid move to IFRS may overly burden accounting professionals who are already strapped for resources, and these SAG members question whether the IFRS financial reporting framework is of high enough quality to meet the U.S. regulators' and investors' expectations (Sarah Johnson, "PCAOB Told to Plan for Global Standards," CFO.com, October 18, 2007, www.cfo.com/article.cfm/10005769?f=search).

One of the underlying concerns from SAG members is that allowing the widespread use of IFRS may lead to disagreements between auditors and management about whether a company used proper judgment. This issue arises from the idea that because IFRS is more flexible—that is, more principles-based than U.S. GAAP, which is generally considered more rules-based—it allows more judgment by management in deciding how they will comply with IFRS. The Sarbanes-Oxley Act of 2002 (SOX) mandated that the SEC conduct a study on the merits of principles-based standards. The SEC issued its report in July 2003, expressing support for what it called "objectives-based" standards. While a gradual shift to principles-based standards has begun, the SEC's proposal to require adoption of IFRS by U.S.-listed companies within the next few years could dramatically speed up this transition.

Although management compliance with IFRS will become easier given the flexibil-

ity these standards offer, the audit process will likely become more complex. Auditors will now have the difficult task of trying to assess management's judgments on IFRS compliance and the "spirit of the law" rather than assessing compliance based on the established U.S. GAAP set of benchmark rules. Allowing such flexibility may result in a "your judgment against my judgment" standoff between management and auditors. Such a state could lead to increased audit risk if the auditors unknowingly fail to appropriately modify their opinion on financial statements that are materially misstated. This increase in audit risk is due, in part, to the fact that auditors will be involved in assessing an unfamiliar and seemingly more flexible set of standards that could offer company executives more leeway for managing income.

This is a substantial change for auditors, and, according to Timothy Flynn, chairman of KPMG International, change can be complicated ("U.S. Warming to IFRS as it Moves on from GAAP," *Financial Times*, September 4, 2008, www.ft.com/cms/s/0/e944709e-7a19-11dd-bb93000077b07658.html). Moving to IFRS will not only affect companies' information systems and financial reporting processes, but also their contractual and compensation arrangements and even their training (particularly for boards of directors and audit committees). IFRS certainly will change the current dynamic between auditors and preparers in the United States. Given that IFRS is less prescriptive than U.S. GAAP, companies will need to produce more detailed and specific disclosures to help explain the presentations and judgments they have made, and auditors may no longer have a detailed set of rules for measuring conformity with IFRS (e.g., the absence of "bright-line" numbers for identifying a capital lease).

Additionally, U.S. GAAP generally includes not only accounting principles and practices, but also the "methods" of applying them (AU 410, Adherence to Generally Accepted Accounting Principles), and IFRS is no different. Consequently, if the rules for establishing conformity with financial reporting are reduced or eliminated, it may become even more difficult for auditors to challenge management's judgments on the methods used to apply the predominantly principles-based IFRS.

According to the IAS Plus website, 115 countries either require or permit use of IFRS by listed companies. A recent survey by Deloitte ("2008 IFRS Survey: Where Are We Today?" May 2008, www.deloitte.com/dtt/cda/doc/content/us_assurance_IFRS_2008%20IFRS%20Survey.pdf) found that 40% of the *Fortune* Global 500 companies are already using IFRS. From the sheer volume of non-U.S. companies using these standards, one might assume that the United States should be able to implement IFRS smoothly as well. Foreign companies have acquired a capacity to make the needed judgments, and auditors have developed an ability to examine the resulting financial statement assertions. It is important, however, to proceed with caution. Cultures and legal systems vary significantly from one country to the next. Many foreign countries do not have an authoritative system of oversight or the disciplinary capacity that the SEC and PCAOB have in the United States. The seemingly successful implementation of these standards in other countries might be a reflection of weaker oversight and regulation of the financial reporting and external audit functions. With its more litigious environment, and its historically strong affinity for rules-based standards, the United States, and auditors in particular, may find the conversion to IFRS to be more of a challenge than observed in other countries.

In the United States, upon a company's adoption of IFRS, the auditor's report will need to identify those circumstances in which reporting principles have not been consistently observed in the current period with respect to the preceding period (AU 420, Consistency of Application of Generally Accepted Accounting Principles and IFRS). The first year that a company switches to IFRS will certainly entail a major change in reporting (more than simply a change from one GAAP treatment to another). While the consistency of reporting over several years may be partly overcome simply by restating prior periods as required by IFRS 1 (*First-Time Adoption of International Financial Reporting Standards*), this may be problematic, for example, when testing the valuation assertions on fair value for prior periods, particularly in cases where there were no established markets. Such a situation could arise if a company elects under IFRS 1 to restate all business combinations prior to the IFRS adoption date. Again, this could leave a wide margin for judgment and potentially subjective manipulation of the financial statements—in other words, increased risk. Auditors will look to reduce these risks by collecting evidence to test the assertions made by management and support the auditor's opinion.

Audit Evidence and Management's Assertions

Whether a company is publicly traded or privately held, auditors will likely have to follow the AICPA's AU 360 on audit evidence (accepted by the PCAOB as an interim standard to be followed if the client is publicly traded) or the PCAOB's currently proposed standard on audit evidence (part of the PCAOB's suite of new auditing standards related to the auditor's assessment of and responses to risk and related conforming amendments). These standards remind auditors that they must obtain sufficient, appropriate audit evidence by performing audit procedures that will provide a reasonable basis for an opinion regarding the financial statements under audit.

One of the PCAOB's proposed standards is "Audit Risk in an Audit of Financial Statements." This statement defines audit risk as the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. This is a function of the risk of material misstatement and detection risk.

The risks of material misstatement (at the assertion level) consist of the following components:

Inherent risk. This refers to the susceptibility of an assertion to a misstatement, due to error or fraud that could be material, either individually or in combination with other misstatements before the consideration of any related controls.

Control risk. This is the risk that a misstatement due to error or fraud could occur in an assertion that could be material, either individually or in combination with other misstatements, and that might not be prevented or detected on a timely basis by the company's internal control. Control risk is a function of the effectiveness of the design and operation of internal control.

EXHIBIT
Differences in Use of Fair Value: IFRS versus U.S. GAAP

Issue	IFRS	U.S. GAAP
IAS 2: Inventories	Recognize recovery in value after write-down	Ignore recovery in value after write-down
IAS 16: Property, plant, and equipment	May choose fair value (FV) measurement basis	Not permitted to use FV measurement basis
IAS 18: Revenue (multiple-element arrangements)	Have flexibility to estimate an element's FV	Need vendor-specific objective evidence to establish element's FV
IAS 19: Employee benefits	Not required to report plan's funded status in balance sheet	Report plan's funded status in balance sheet
IAS 21: Changes in exchange rates	May choose to translate equity items at current rate	Not permitted to translate equity items at current rate
IAS 29: Hyperinflation	Restate to current purchasing power, then translate at current rate	Not permitted to restate or use current rate (for all assets and liabilities)
IAS 32: Financial instruments (presentation)	■ Bifurcate convertibles into liability and equity components based on relative FVs ■ Recognize instruments issued to related party at FV	■ Not permitted to bifurcate convertibles ■ Not required to recognize instruments issued to related party at FV
IAS 36: Asset impairment (long-term assets other than goodwill)	■ Recognize loss of value ■ Recognize recovery in value in certain situations	■ Recognize loss of value only if book value exceeds *undiscounted* future cash flows ■ Not permitted to recognize recovery in value
IAS 38: Intangible assets	May choose FV measurement basis (if active market exists)	Not permitted to use FV measurement basis
IAS 39: Financial instruments (recognition and measurement)	■ FV guidance applies to investments in private entities ■ FV option restricted to cases of accounting "mismatch" ■ Derivatives defined more broadly, so wider	■ FV guidance does not apply to investments in private entities ■ FV option not restricted to cases of accounting "mismatch" ■ Fewer instruments qualify, so fewer measured at FV
IAS 40: Investment property	May choose FV measurement basis	Not permitted to use FV measurement basis
IAS 41: Biological assets	■ Report living assets at FV less estimated costs to sell ■ Report produce at FV less costs to sell	■ Report living assets at lower of cost or market ■ May report produce at FV less cost to sell if conditions are met
IFRS 3(R): Business combinations	■ Recognize contingent assets at FV if reasonably estimable* ■ Not required to recognize goodwill and noncontrolling interest at FV	■ Recognize contract-based contingent assets at FV* ■ Recognize goodwill and noncontrolling interests at FV

Note: The differences identified above are in "current" values, broadly defined.

* In April 2009, the FASB issued Staff Position FAS 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies,* requiring U.S. companies to recognize all contingent assets (and liabilities) arising in a business combination for which the acquisition date FV can be reasonably estimated.

Inherent risk and control risk are the company's risks; they exist independently of the audit.

Detection risk. This is the risk that the procedures performed by an auditor will not detect a misstatement that could be material, either individually or in combination with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. The level of detection risk is reduced through the performance of substantive procedures. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the risk of material misstatement at the assertion level. The greater the risk of material misstatement, the less detection risk can be accepted.

As an example, estimation accounts—such as accounts needing fair value assessments—are inherently more risky than most other accounts. Accounts in which judgment is used in the application of significant accounting principles, especially those used for determining management's estimates and assumptions (e.g., in fair value accounting), are addressed in the proposed PCAOB standard "Identifying and Assessing Risks of Material Misstatement." Because this will be new territory for auditors, and because they will be making these risk assessments based on a new reporting standard (IFRS), they must also follow the PCAOB's proposed standard on "The Auditor's Responses to the Risks of Material Misstatement." Particularly with an inherently risky area, such as fair value accounting, auditors must ensure that the knowledge, skill, and ability of engagement team members with significant responsibilities are commensurate with the risks of material misstatement and provide the appropriate level of supervision. The auditor must also evaluate whether the company's selection and application of significant accounting principles (i.e., IFRS), particularly those related to subjective measurements and complex transactions, indicate a bias that could lead to material misstatement of the financial statements. If auditors believe there is a potential bias and risk of material misstatement, they must lower their detection risk and adjust the nature, timing, and extent of their substantive procedures.

Ultimately, an entity's financial statements are the responsibility of management. Management is responsible not only for the fair presentation that reflects the nature and operations of the entity, but also for ensuring the statements are in conformity with a financial reporting framework, be it U.S. GAAP or IFRS. In doing this, management implicitly or explicitly makes assertions regarding the recognition, measurement, and presentation of information in the financial statements and related disclosures. Auditors collect evidence to test these assertions by using professional judgment and exercising professional skepticism in evaluating the quantity and quality of audit evidence, and thus its sufficiency and appropriateness, to support the audit opinion (AU 360).

Based on the authors' conversations with audit partners and managers from several of the largest public accounting firms, perhaps the biggest problems facing auditors when financial statements are presented using IFRS may be the assertions regarding valuation, particularly fair value. In addition, in PCAOB Staff Audit Practice Alert No. 3, "Audit Considerations in the Current Economic Environment" (December 5, 2008), the PCAOB explains that recent events in the financial markets and the current economic environment may affect companies' operations and financial reporting and, in turn, may have implications for audits of financial statements and internal control over financial reporting. Audit risks that may have been previously identified may become more significant, or new risks may exist due to current events (e.g., those affecting the economy, credit, and liquidity). Among other things, the current uncertainties in the market and economy may create questions about the valuation, impairment, or recoverability of certain assets and the completeness or valuation of certain liabilities reflected in financial statements.

Fair Value Measurement in IFRS

In SFAS 157, *Fair Value Measurements*, FASB defines fair value as the exit price for an asset or liability, preferably a market-based exit price. SFAS 157 gives a hierarchy for establishing fair value that prioritizes a quoted market price for an identical item. When a quoted market price for an identical item is unavailable, companies must look to other market-based inputs to form a reasonable estimate of fair value. In the absence of other market-based inputs, companies may apply their own assumptions about how market participants normally price such items. (The current financial crisis has prompted questions about the determination, even the relevance, of fair values for financial instruments in distressed or inactive markets. For more on these concerns, see "The Role of Mark-to-Market Accounting in the Financial Crisis," *The CPA Journal*, January 2009.)

The IASB does not currently have an equivalent to SFAS 157, though it is moving quickly to establish comparable guidance as part of its convergence program. The IASB expects to issue a final standard on fair value measurement in 2010. In response to the financial crisis, as an interim measure, the IASB is taking steps to improve company disclosures on fair value measurements of their financial instruments. Specifically, in March 2009, the IASB issued *Improving Disclosures about Financial Instruments* (amendments to IFRS 7, *Financial Instruments: Disclosures*), which adopts the fair value measurement hierarchy given in SFAS 157 and requires companies to disclose information about their use of each of the three levels of inputs for determining fair value. The amendments are effective for annual periods beginning on or after January 1, 2009.

IFRS and U.S. GAAP employ a similar notion of fair value. The main way in which these two reporting systems differ is in the specific items to which fair value measurement must be, or may be, applied. The *Exhibit* provides a summary of the key differences in use of fair value reporting between IFRS and U.S. GAAP. This analysis identifies the IASB statements that require or permit fair value reporting and compares the IFRS treatment to U.S. GAAP. It views fair value broadly to include measurements determined as of the reporting date and measurements that use market inputs. Of the existing IASB standards, 13 differ in the use of fair value reporting from U.S. GAAP. The analysis found 19 total differences in these standards. For 15 of the

19 differences, IFRS requires or permits the use of fair value reporting in situations where U.S. GAAP does not. In contrast, there are just four cases where U.S. GAAP requires or permits fair value reporting and IFRS does not.

With the issuance of SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, U.S. GAAP now offers the option of using fair value for certain financial assets and liabilities. IFRS grants a fair value option for a wider range of assets, including property, plant, and equipment (IAS 16); intangible assets (IAS 38); and investment properties (IAS 40). IFRS also requires fair value measurement for certain items where U.S. GAAP does not, such as financial instruments issued to a related party (IAS 32), investments in private entities (IAS 39), and biological assets (IAS 41). Furthermore, due to differences in the details of standards, IFRS is more likely to result in the use of fair value measurement for certain items, such as inventories (IAS 2); individual elements in multiple-element arrangements (IAS 18); and components of hybrid financial instruments (IAS 39).

The potential for assets and liabilities that are not traded in public markets to be reported on a fair value basis is greater under IFRS than under U.S. GAAP. Items for which IFRS requires measurement at fair value but a quoted market price is unlikely to be available include investments in private entities (IAS 39); financial instruments that qualify as derivatives under IFRS, but not under U.S. GAAP (IAS 39); and biological assets (IAS 41). Items for which IFRS provides the option for fair value measurement but a quoted market price is unlikely to be available include property, plant, and equipment (IAS 16) and investment properties (IAS 40). In addition, recognition of impairment losses, which requires a write-down to the higher of fair value less cost to sell or present value, is much more likely under IFRS (IAS 36).

What all this means is that the application of these fair value principles under IFRS would require a company's management to use considerable judgment in making estimates about the future, and the role of valuation experts in the preparation of financial statements would increase significantly. The implication is that IFRS may be far more complex and challenging in its application compared to the existing classification of accounting standards. The PCAOB has responded to this predicament by releasing Staff Audit Practice Alert No. 2, "Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists" (December 10, 2007).

Other Judgment Areas in IFRS

There are a number of other issues besides fair value that auditors will need to address. For example, due to the more principles-based nature of IFRS, judgment will play a more critical role in presentation and reporting. Companies will need to carefully document their judgments and provide appropriate disclosures in their financial statements to inform users of the decision processes and outcomes. Some of the other key issues where greater judgment may be required in reporting under IFRS include the following:

- Classification of interest and dividends in the statement of cash flows (IAS 7),
- Identification of leases requiring capitalization (IAS 17),
- Recognition of revenue in multiple-element arrangements (IAS 18),
- Recognition of revenue for sales on unusual terms (IAS 18),
- Determination of control and the need to consolidate (IAS 27), and
- Evaluation of the criteria for capitalizing development costs (IAS 36).

While these judgments have been applied in other countries for some years now, they will be new to many U.S. auditors. As mentioned above, the more litigious environment in the United States, combined with the historical preference for rules-based standards, may create some difficulties for U.S. companies and auditors in adapting to a more principles-based form of reporting. Auditors evaluating whether a company's disclosures are complete, accurate, and in conformity with IFRS will need to be aware that a financial statement disclosure that is not in accordance with IFRS (or U.S. GAAP) could be considered a misstatement.

The cost of training U.S. auditors to become proficient in auditing the application of IFRS, on top of their existing training responsibilities, could be substantial. Perhaps more importantly, auditors will have to be carefully educated in how to look for new potential IFRS accounting loopholes. Companies will need to be concerned with how their audits are conducted and how their external auditors will respond to the additional needs for information, staff, and training. This convergence of standards has the potential to mirror the uncertainty, lack of guidance, and scarcity of knowledgeable staff that companies and auditors faced when first implementing SOX (e.g., the section 404 provisions).

Does Increased Flexibility Increase Audit Risk?

The reliability of audit evidence is influenced by its source. Reliance on management's professional judgment, even under the current rules-based standards, has led to one financial fiasco after another (e.g., Enron and WorldCom). This shift toward a more principles-based approach has the potential to actually increase the likelihood of allowing manipulations to go undetected longer, allowing managers to shape the standards to suit their desires, resulting in even more future financial scandals. When considering the reasons SOX was passed, it seems dicey to expect deceitful corporate executives to suddenly take up the cause of honest financial reporting no matter what set of accounting principles they follow.

Without the rules-based "bright lines" to evaluate compliance with a given standard, it may become more difficult for auditors to exercise and document due professional care, particularly when the evidence will increasingly be based on management's judgment. At present, there is not a lot of interpretive guidance for auditors to follow when using IFRS. "Judgment" and "intent" are difficult to document and even harder to prove in a court of law, which may prove to be a risky proposition for auditors. ❑

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