Curtis C. Verschoor, CMA, Editor

IFRS Would Escalate Ethical Challenges for Accountants

Switching the standards for financial statements from a rules-based system such as U.S. GAAP to a principles-based system such as IFRS could create greater ethical challenges for accountants. More professional judgment will be needed, creating more ethical gray areas that could be used to rationalize methods that show a company's financial position as being better than it may truly be.

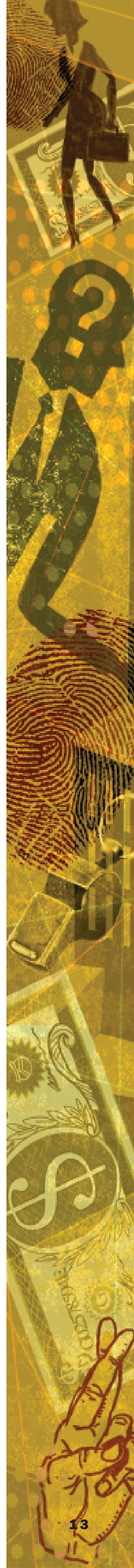
The global thrust of economic activity has been a reality for decades. Financial markets have shown how events in one country or economic area affect entities elsewhere in the world. Despite such globalization, the accounting principles used to measure and report on economic activity have remained mostly fragmented. U.S. Generally Accepted Accounting Principles (GAAP) had long been perceived as the gold standard. Competition from foreign financial markets and companies headquartered in foreign countries led to the establishment of the International Accounting Standards Committee (IASC) in 1973. This organization promulgated international standards until 2001 when it was replaced by the International Accounting Standards Board (IASB), which began issuing International Financial Reporting Standards (IFRS).

Until 2007, the Securities & Exchange Commission (SEC) in the United States required foreign companies under its purview who used IFRS to reconcile the resulting statements with GAAP principles. Controversy erupted in November 2008 when the SEC published a road map for total conversion to IFRS by 2011. The SEC fosters promotion of IFRS as a single set of globally accepted accounting standards. It asserts this would benefit U.S. investors by helping them better understand and compare foreign investment opportunities without needing to gain familiarity with myriad national accounting standards. Efforts to achieve convergence between IFRS and GAAP have proceeded throughout this period, but significant differences still exist.

The benefits of convergence to large multinational corporations and audit firms, as well as the potentially monumental costs of converting reporting structures from one basis to another, have received their share of attention. Less understood is the highly likely expansion of ethical challenges for both preparer accountants and for auditors involved with the financial statements of public companies. IFRS is being considered as just an option for privately held or not-for-profit entities in the U.S. Many foreign countries only use IFRS for public companies and also pick the portions of IFRS they choose to adopt while rejecting the remainder.

Even if the treatments of specific issues by IFRS and GAAP can be converged, there's a structural divide between the fact that IFRS is based on principles and U.S. GAAP has become increasingly rules-based. The intensely litigious atmosphere that businesses face in the U.S. has led to independent audit firms defending their performance in court by using the premise that their client's accounting treatment wasn't at material variance with one or more specific accounting rules.

The dependence on rule compliance in the U.S. has resulted in financial presentations that weren't always fair, transparent, or full disclosures of economic circumstances. Use of IFRS would take away this reliance on rules and require both preparers and auditors to use more professional judgment to apply general principles to specific fact situations. Greater use of judgment would



allow weaker accounting principles to drive out those of higher quality. Also, attorneys would have greater leeway in court to assert that much of this increased professional judgment was faulty, which is likely to increase the cost of litigation, the major reason that dependence on accounting rules flourished to begin with.

If required to follow IFRS, corporate accountants are likely to face mounting ethical pressures from their management to develop and follow a rationale for seeing the financial results of their organization in absolutely the most favorable light. The current rationale of "there isn't anything that says our way isn't in accordance with GAAP" will no doubt be expanded to "our interpretation of the accounting principle is just as logical as your interpretation." Independent audit firms will find it easier to agree with their clients.

The flexibility of interpretation inherent in the application of a principles-based system like IFRS rather than GAAP rules is highly likely to allow the possibility of differing financial presentations of a similar fact circumstance in another company. This is a telling reason why conversion to IFRS principles may not be in the best interests of the shareowners of U.S. corporations. An important basis of the financial reporting system is the principle of consistency of presentation among similar entities. This concept is a fundamental standard of full and fair disclosure, and investors may have greater difficulty separating the effects of differences in accounting from those measuring underlying performance.

Before final consideration of a requirement that IFRS be used in the U.S., the SEC presented in February 2010 a number of milestones in a work plan to be accomplished by 2011. This plan anticipates conversion to IFRS after 2015. The stated issues requiring consideration are many and far-reaching:

- Whether IFRS is sufficiently developed and consistent.
- Ensuring an independent body sets accounting standards.
- The extent of investors' understanding of IFRS and its differences from GAAP.
- Determining the effect of standards change on tax laws and other legal requirements.
- Understanding the impact on companies, including contractual changes, governance, and potential litigation.
- Determining whether responsible people have sufficient preparation to make the conversion.

For guidance in applying the *IMA Statement of Ethical Professional Practice* to your ethical dilemma, contact the IMA Ethics Helpline at (800) 245-1383 in the U.S. or Canada. In other countries, dial the AT&T USADirect Access Number from www.usa.att.com/traveler/index.jsp, then the above number.

Absent from this comprehensive listing of possible barriers to the adoption of IFRS is any consideration of the ethical structure needed to guide both accountants and auditors in the new environment. Ethics seem to be conveniently forgotten as new developments arise.

For the preparer community of accountants, the *IMA Statement of Ethical Professional Practice* contains a specific Standard of Credibility, which notes that IMA members have a responsibility to:

1. Communicate information fairly and objectively.

2. Disclose all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, analyses, or recommendations.

3. Disclose delays or deficiencies in information, timeliness, processing, or internal controls in conformance with organization policy and/or applicable law.

In contrast to accounting, the global independent auditing community has no similar standard of truth. In the United Kingdom, the auditors' report states qualitatively that the financial statements "give a true and fair view" of economic reality. But in the U.S., generally accepted auditing standards only require the auditor to state that the financial statements follow the GAAP rules and "present fairly in conformity with GAAP" without any assurance that is qualitative in nature. As mentioned above, there are numerous examples where

continued on page 18

Ethics

continued from page 12

following the U.S. rules failed to properly show true and fair economic reality. Elimination of accounting rules is likely to result in a substantial increase in such presentations.

In the U.K., the Companies Act of 2006 provides that directors may not approve publication of financial statements unless they do in fact present a true and fair view. Observers there are concerned that this standard of accountability could be watered down if American auditing practices not requiring qualitative assurance are used more widely. Sarbanes-Oxley Act Section 302 provides that managements of publicly held companies must certify that their financial statements do "fairly present in all material respects" without any mention of GAAP as a criterion. But the SEC hasn't provided guidance that this requirement does in fact surpass and exceed GAAP requirements.

Convergence of accounting principles is an important part of a work plan and road map for adoption of a single set of high-quality globally accepted accounting standards. Not to be forgotten is the absolute requirement for global convergence on the subject of an independent auditor's ethical responsibility for assuring that financial statements do in fact fairly present economic reality.

QUESTION: Do you object to adoption of global accounting guidance that is principles-based? Now is the time to make your opinions heard! **SF**

Curtis C. Verschoor, CMA, is the Emeritus Ledger & Quill Research Professor at the School of Accountancy and MIS and an honorary Senior Wicklander Research Fellow in the Institute for Business and Professional Ethics, both at DePaul University, Chicago. He is also a Research Scholar in the Center for Business Ethics at Bentley University, Waltham, Mass., and an IMA member. John Wiley & Sons has published his latest book, Audit Committee Essentials. *His e-mail address is curtisverschoor@sbcglobal.net.*