Ethics, Professional Judgment, and Principles-based Decision Making Under IFRS

By Steven M. Mintz

For almost 40 years, a movement has been under way to establish one set of international accounting standards for all countries around the world in order to facilitate international trade and investment. Since it is no longer unusual to have foreign companies list their stock on the New York Stock Exchange, one common set of accounting standards should go a long way toward increasing the understandability of international financial reports. Until recently, listing rules required that non-U.S. companies must reconcile their financial statements prepared under home country standards to U.S. Generally Accepted Accounting Principles (GAAP). However, the SEC now permits foreign companies to use International Financial Reporting Standards (IFRS), established by the International Accounting Standards Board (IASB), in lieu of the conversion of foreign financial statements to GAAP.

On November 14, 2008, the SEC released for comment a proposed road map for the adoption of IFRS that would monitor progress until 2011, when the SEC plans to consider requiring U.S. public companies to file their financial statements using IFRS. The original implementation date of 2014 was pushed back one year to 2015 to give the SEC more time to study implementation issues. The United States is under a great deal of pressure

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to adopt IFRS because members of the European Union did so in 2005 and many other countries have or will be adopting IFRS by the end of 2011. To date, about 120 nations have adopted IFRS as their home country standards.

The final decision of the SEC to mandate IFRS starting in 2015 will be based on whether those accounting standards are of high quality and sufficiently comprehensive. The SEC's convergence approach is based on the notion of "improve and adopt" IFRS before giving its stamp of approval. The Commission has been assessing whether IFRS develops a high quality of financial reporting relative to the standards that may be replaced. A good example of the convergence process at work is the capitalization of finance costs during the period of construction of an asset. Originally, International Accounting Standard (IAS) 23, *Capitalisation of Borrowing Costs*, and a revised version allowed for capitalization but identified expensing as the benchmark treatment for borrowing costs. In March 2007, the IASB issued another revised version, this time mandating capitalization to bring the standards in line with U.S. GAAP under FASB's Statement of Financial Accounting Standards (SFAS) 34, *Capitalization of Interest Cost.*

In the United States, financial statements should contain useful information in accordance with GAAP and present fairly financial position, the results of operations, and changes in cash flows. GAAP conformity depends on a strong set of ethical values to guide behavior, such as objectivity and integrity and an ability to make professional judgments with respect to the relevance and reliability of financial information. The objectivity and integrity standards in the AICPA Code of Professional Conduct provide guidance on how GAAP conformity issues should be handled and what to do when differences exist between the position of a professional accountant and one's supervisor.

IFRS incorporates a principles-based approach to standards setting rather than the rules-based regime in the United States. Under the principles-based system, consideration should be given to the economic substance of financial data and its representational faithfulness in order to make professional judgments about the usefulness of financial information. On an international level, the Global Code of Ethics issued by the International Federation of Accountants (IFAC), an organization with representation from professional accounting associations around the world, provides guidance similar to the integrity and objectivity standards, but it is predicated on following principles that underlie decision making, such as economic substance over legal form and the "true and fair view override." The latter enables an accountant to deviate from the requirements of an accounting standard to present fairly financial information.

SEC Study of a Principles-Based System

The Sarbanes-Oxley Act called for a study to be conducted by the SEC of the need to adopt a principles-based approach to standards setting to replace the more rules-based system in the United States that is defined by bright-line rules to establish acceptable practices. Critics of a rules-based system point out that bright-line rules enable a company to structure a transaction to achieve technical compliance with the standard while evading the intent of the standard. A good example of allowing bright-line rules to determine proper accounting and financial reporting is the 3% equity requirement that existed for outside ownership of special-purpose entities (SPE) that enabled Enron to avoid consolidating SPE operations with those of the company. Under current standards, the "dispersion of risk" requirement of FASB Interpretation (FIN) 46(R), *Consolidation of Variable Interest Entities*, provides a more conceptual basis to determine when consolidation is appropriate and is more consistent with a principles-oriented approach to standards setting.

The SEC study notes that imperfections exist when standards are established on either a rules-based or a principles-only basis. Principles-only standards may present enforcement difficulties because they provide little guidance or structure for exercising professional judgment by preparers and auditors. Rules-based standards often provide a vehicle for circumventing the intention of the standard. As a result of its study, the SEC recommended that those involved in the standards-setting process more consistently develop standards on an objectives-oriented basis. Such standards should have the following characteristics:

- Be based on an improved and consistently applied conceptual framework;
- Clearly state the accounting objective of the standard;
- Provide sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis;
- Minimize exceptions from the standard;
- Avoid use of percentage tests (bright lines) that allow financial engineers to achieve technical compliance with the standard while evading the intent of the standard.

("Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System," www.sec.gov/news/studies/principlesbasedstand.htm)

The following statement in the SEC study describes the Commission's position:

> In our view, the optimal principles-based accounting standard involves a concise statement of substantive accounting principle where the accounting objective has been incorporated as an integral part of the standard and where few, if any, exceptions or internal inconsistencies are included in the standard. Further, such a standard should provide an appropriate amount of implementation guidance given the nature of the class of transactions or events and should be devoid of bright-line tests. Finally, such a standard should be consistent with, and derive from, a coherent conceptual framework of financial reporting.

The SEC believes that principles-based standards fail to provide sufficient guidance on the implementation of principles and rely too much on professional judgment. However, even under an objectives-oriented approach, judgments must be made with respect to how such objectives are met, given the underlying conceptual framework for financial reporting. These judgments are predicated on evaluating economic substance over legal form and the representational faithfulness of financial information. Basically, the SEC seems to have adopted the objectives-oriented terminology to distinguish its approach from the principles-based system, even though meaningful differences do not exist.

A more objectives-oriented as well as a principles-based standards regime

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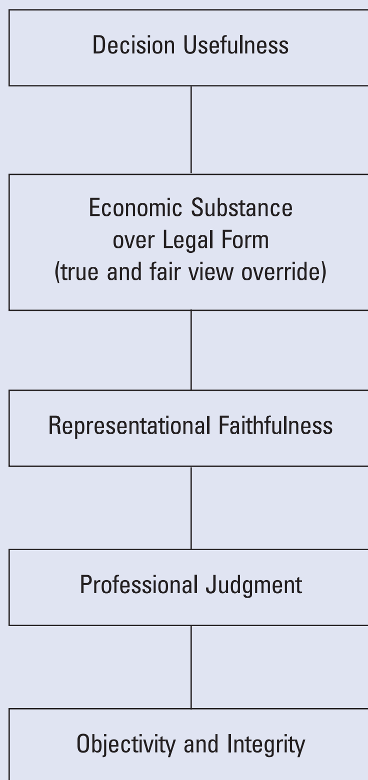
requires professional judgment at both the transaction level (substance over form) and at the financial statement level ("true and fair view" override). It is the latter judgment that is unique to international standards. The IASB's *Framework for the Preparation and Presentation of Financial Statements* (IAS 1), which was reissued on January 1, 2009 (www.ifrs.org/NR/rdonlyres/4CF78A7B-B237-402A-A031-709A687508A6/0/Framework.pdf), provides that if the application of IFRS conflicts with the provisions of the framework so that the financial statements do not "present fairly," then the entity should first consider the salutary effects of providing supplementary disclosures. If the disclosures are insufficient to provide a true and fair view, then the entity may conclude that it must override (ignore or contravene) the applicable accounting standard. IFRS standards anticipate that such overrides would be made only in rare circumstances.



A principles-based approach to decision making is illustrated by emphasizing economic substance over legal form in lease transactions. In the United States, SFAS 13, *Accounting for Leases*, establishes rules that can undermine the substance-over-form concept. For example, if any one of four lease criteria is met, then capitalization treatment leads to recording an asset and liability on the books of the lessee using the present value of future lease payments, including any guaranteed residual value. One problem with the rules-based criteria for capitalization is they rely on implementation guidance (bright-line rules) that can be manipulated. A company might engineer a lease transaction in such a way as to achieve the desired objective of keeping the liability off its books rather than faithfully representing the underlying economic substance of the transaction. For example, to keep the liability off its books, the lessee simply does not have to guarantee to pay the residual value to the lessor. Consider the following: Present value of lease payments (excluding residual value) is $107,000; fair value of leased asset is $120,000; present value of residual value equals $2,000. If the residual value is unguaranteed, then applying the 90%-of-fair-value test for capitalization leads to a $108,000 amount (90% of $120,000) versus the $107,000 present value, and, assuming none of the other criteria are met, the lease is recorded as an operating lease. Had the residual value been guaranteed, then the 90% test would have resulted in capitalization of the lease ($109,000 > $108,000).

International accounting standards apply a principles-based approach to lease accounting. IAS 17, *Leases*, provides that if the substance of the transaction is effectively to transfer ownership to the lessee, then it is accounted for as a purchase and sale (capitalization). The standard does establish criteria that guide capitalization but their application relies on professional judgment. For example, the lease term must be for the *major part* of the economic life of the leased asset, rather than the 75%-of-the-economic-life test in the United States, and the present value of the minimum lease payments must be at least equal to *substantially all* of the fair value of the leased asset. In reality, it is difficult to see how these vaguer standards produce better results, given that one company might decide that the major part is greater than 50% of the useful life of the leased asset, while another may say it is 75% or more. The different applications of the standards can lead to a lack of comparability in financial reports. The problem is that even in a principles-based environment, rules might factor into the judgments made, thereby effectively negating the more conceptual principles approach. Still, if the accounting for leases does not conform to financial reporting requirements in the judgment of the auditor, then the true and fair view override could lead to capitalizing a lease to ensure that economic reality is portrayed.

Principles-based standards can be too generic and, as opposed to rules-based systems, they do not address every controversial issue but keep considerable ambiguity about such major processes as recordkeeping and measurement. As noted in the SEC study, a potential drawback of the principles-based approach is a lack of precise guidelines, which could create inconsistencies in the application of standards across organizations. One example is IAS 16, *Property, Plant and Equipment*. According to the standard, property, plant, and equipment can be accounted for under the cost method or the revaluation method. Specific rules do not exist to guide when one method should be used as opposed to the other. Moreover, the revaluations are made at fair value, with little guidance to help determine this amount, except that "fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction." The question is whether determinations of fair value can be made objectively over time and with sufficient precision.

Representational Faithfulness

On May 29, 2008, the IASB and FASB jointly issued an exposure draft on a conceptual framework underlying international financial reporting ("Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information," www.fasb.org/draft/ed_conceptual_framework_for_fin_reporting.pdf). The

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objective is to develop a common conceptual framework for financial reporting. Once adopted, it will supersede Statement of Financial Accounting Concepts (SFAC) 1, *Objectives of Financial Reporting by Business Enterprises*, and 2, *Qualitative Characteristics of Accounting Information*, issued by FASB. Such a framework is essential to fulfilling the boards' goal of developing standards that are principles-based, internally consistent, and internationally converged and that lead to financial reporting that provides the information that capital providers need to make decisions in their capacity as capital providers. The process is involved and lengthy because comments from accounting professionals and organizations around the world on the exposure draft must be evaluated prior to making a decision on the final joint conceptual framework. The boards are in the process of issuing revised exposure drafts on various elements of the conceptual framework based on comments received. On March 11, 2010, FASB and the IASB issued an exposure draft on the reporting entity concept ("Conceptual Framework for Financial Reporting: The Reporting Entity," www.ifrs.org/Current+Projects/IASB+Projects/Conceptual+Framework/Conceptual+Framework).

The definition of qualitative characteristics of useful information in the May 2008 exposure draft is important because this aspect of the conceptual framework has a direct bearing on making judgments in a principles-based system, with respect to what makes information useful for decision making. According to the draft, for financial information to be useful it must possess the two fundamental qualitative characteristics—relevance and faithful representation. Relevant information is capable of making a difference in decision making by virtue of its predictive or confirmatory value. To be useful in financial reporting, information must be a faithful representation of the economic phenomena that it purports to represent. Faithful representation is attained when the depiction of an economic phenomenon is complete, neutral, and free from material error. Financial information that faithfully represents an economic phenomenon depicts the economic substance of the underlying transaction, event, or circumstance, which is not always the same as its legal form. Faithful representation does not imply total freedom from error in the depiction of an economic phenomenon because the economic phenomena presented in financial reports generally are measured under conditions of uncertainty. Therefore, most financial reporting measures involve estimates of various types that incorporate management's judgment. To faithfully represent an economic phenomenon, an estimate must be based on the appropriate inputs, and each input must reflect the best available information. Completeness and neutrality of estimates (and inputs to estimates) are desirable; however, some minimum level of accuracy also is necessary for an estimate to be a faithful representation of an economic phenomenon. For a representation to imply a degree of completeness, neutrality, or freedom from error that is impracticable would diminish the extent to which the information faithfully represents the economic phenomena that it purports to represent. Thus, to attain a faithful representation it sometimes may be necessary to explicitly disclose the degree of uncertainty in the reported financial information.

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One difference between the exposure draft and the conceptual framework in the United States is to define the qualitative characteristics of useful information to include faithful representation. Rather than being considered an element of reliability, as in the United States, the faithful representation of economic phenomena is a foundational element of useful information in the joint framework. The IASB confirmed these distinctions at its board meeting on September 15, 2009.

Objectivity and Integrity

A strong set of ethical values is needed to make reasoned assessments about representational faithfulness and to support the professional judgments needed to ensure that financial information reflects the economic substance of transactions in a principles-based system. Accountants should avoid any temptation to slant measurements one way or the other. Instead, the proper accounting should be objectively determined, and pressure to do otherwise should be resisted by maintaining one's integrity. Given the importance of representational faithfulness and professional judgment in a principles-driven approach to standards setting, accounting professionals need guidance on just what their ethical obligations are in making such judgments. The AICPA Code of Professional Conduct and the Global Code of Ethics provide such guidance.

Rule 102 of the AICPA code obligates members to maintain objectivity and integrity, be free of conflicts of interest, and not knowingly misrepresent facts or subordinate judgment to others. Integrity means to observe both the form and the spirit of technical and ethical standards; circumvention of those standards constitutes subordination of judgment. The usefulness of information is enhanced by objectivity and integrity because they enable an accounting professional to withstand pressure by a superior to put the best face possible on the financial statements rather than have the statements reflect economic reality. Interpretation 102-4, "Subordination of Judgment by a Member," requires that if differences exist with one's supervisor with respect to a disagreement or dispute relating to the preparation of financial statements or the recording of transactions, the member should follow certain steps to ensure that the situation does not constitute a subordination of judgment. One such step is to determine whether the desired treatment by the supervisor reflects the use of an acceptable alternative and does not materially misrepresent the facts. Little guidance is provided in the interpretation on acceptability judgments.

On an international level, the International Ethics Standards Board for Accountants (IESBA) that was established by IFAC issued a revised Code of Ethics for Professional Accountants (Global Code) that became effective on January 1, 2011. The

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revised code establishes ethical requirements for professional accountants performing services in the global business arena (www.ifac.org/publications/international-ethics-standards-board-for-accountants/code-of-ethics).

The Global Code provides clearer guidance than Interpretation 102-4 on the conflict resolution process when differences exist with one's supervisor. Specifically, the following steps should be taken: 1) determine the relevant facts of each position, 2) identify the ethical issues involved, 3) assess the fundamental principles related to the matter in question, 4) consider established internal procedures, and 5) identify alternative courses of action. Having considered these issues, the accountant should determine the appropriate course of action that is consistent with the fundamental principles identified. The determination of relevant principles should be made in light of judgments about representational faithfulness and economic substance over form.

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Decision Making in a Principles-Based System

As previously mentioned, a principles-only approach may provide insufficient guidance to make the standards reliably operational. As a consequence, principles-only standards require preparers and auditors to exercise significant judgment in applying overly broad standards to more specific transactions and events, and often do not provide a sufficient structure to frame the judgment that must be made. The result of principles-only standards can be a significant loss of comparability among reporting entities. Furthermore, under a principles-only standards-setting regime, the increased reliance on the capabilities and judgment of preparers and auditors could increase the likelihood of retrospective disagreements on accounting treatments. In turn, this could result in an increased litigation with regulators for both companies and auditors.

A framework to make professional judgments in a principles-based system is presented in the *Exhibit*. The benefits of the framework include the following: 1) it incorporates elements of professional judgment based on standards of objectivity and integrity, 2) judgments are consistent with evaluations of the representational faithfulness of financial information, and 3) the framework emphasizes economic substance over legal form in providing useful financial information. The framework should help to provide the structure needed in a principles-based system to compensate for the lack of detailed, but often, overly technical rules-based standards that rely less on professional judgment and more on finding a way around the rules.

Management and Auditors

The impending adoption of IFRS and its principles-based approach will obligate auditors to assess management's determinations with respect to how the financial statements conform to IFRS and the underlying principles of economic substance over legal form and representational faithfulness. Given the degree of judgment required in applying basic principles to fact situations, the legal liability of auditors may be ratcheted up one level when compared to the rules-based system that may provide more defensibility in a court of law.

Richard C. Jones points out in his July 2010 article in *The CPA Journal* ("IFRS Adoption: Some General Issues to Remember") that in an annual report prepared under IFRS, management must take responsibility for—or make an assessment regarding—whether the financial statements were prepared in accordance with IFRS guidance, as required by IAS 1. If compliance with applicable IFRS guidance would result in issuing financial reports containing misleading information, management can depart from the IFRS requirement and apply an accounting or reporting approach that would allow for fair presentation (true and fair override). If a company makes this determination, it will have to provide detailed disclosures explaining the reason for departing from the specific IFRS guidance.

Ronald E. Marden and Kennard S. Brackney point out in their June 2009 article in *The CPA Journal* ("Audit Risk and IFRS: Does Increased Flexibility Increase Audit Risk?"), which addresses the complexities of making audit judgments in an IFRS-compliant environment, that even though management compliance with IFRS will become easier, given the flexibility those standards offer, the audit process will likely become more complex, because auditors will need to assess management's judgments on IFRS compliance and the spirit of the law rather than assess compliance based on the established U.S. GAAP set of benchmark rules. The result may be to pit auditor judgment against management judgment and to increase audit risk if the auditors knowingly fail to appropriately modify their opinion on financial statements that are materially misstated. The increase in audit risk is due, in part, to the need for auditors to assess an unfamiliar and seemingly more flexible set of standards that could offer company executives more leeway in managing income.

One possible result of more principles-based standards is legal actions against boards of directors, audit committees, management accountants, and external auditors. In the United States, the first line of defense for auditors is to show that they exercised a reasonable level of care in conformity with Rule 201 (General Standards) of the AICPA Code of Professional Conduct. That standard is met by demonstrating adherence to rules-based GAAP in preparing and reporting financial information. Under the principles-based approach, the auditors' defense should include not only adherence to IFRS but also the application of judgment in applying those standards in a particular instance. An adequate foundation must exist to make such judgments and enhance supportability in a court of law. The framework developed in this article should help in that regard. ❑

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