IFRS and Accountants' Liability: Certified Public Accountant
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IFRS and Accountants' Liability

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With the advent of International Financial Reporting Standards' (IFRS) replacement of U.S. GAAP as the foundation for recording and reporting economic events for an enterprise, it is imperative to begin examining the possible effects of this change on legal actions against boards of directors, audit committees, management, accountants, auditors, and consultants. What happens when the switch occurs and the language of business is generally principles-based rather than heavily rules-based? Will the number of lawsuits change? Will the basis of claims change? How should the parties protect themselves from claims?

The United States has been called the most litigious society in the world. This dubious distinction is an outgrowth of our heritage and culture of generally unfettered freedom and a distrust of government. The rights of individuals are respected, including the broad right to seek redress for a perceived harm in a court of law or other dispute-resolution forum. Countries currently using IFRS are not faced with as severe a problem in this regard. Consequently, their experience with IFRS will, in all likelihood, be different from what is expected in the United States subsequent to our adoption of the new standards.

The change to IFRS may not only cause a change in accounting standards, but also, to a lesser degree, in auditing standards and ethics rules. The major effect, however, will be related to a new GAAP. There are currently many similarities between U.S. GAAP and IFRS, and the differences that remain are largely attributable to using principles-based—rather than rules-based—accounting standards for recording, summarizing, and reporting economic events.

IFRS and Liability Traps

The IFRS focus on principles, with little implementation or interpretative guidance, places the burden of justifying the accounting treatment for an economic event squarely on an enterprise's management. This change, a significant departure from practice under U.S. GAAP, should cause management to exercise judgment in many areas of accounting outside the realm of the quantification of estimates inherent in the financial statements under current standards. A greater understanding of the underlying economic substance of transactions will be needed to justify and properly support accounting or reporting decisions.

The enterprise. Management will need to be certain that the enterprise's system of internal control contains procedures for identifying, analyzing, developing, and reviewing nonroutine transactions, in order to establish IFRS-compliant accounting for the underlying economic events. With the current rules-based accounting, for most transactions—but certainly not all—internal accountants would identify the appropriate accounting guidance and match it with the economic event to determine how it should be recorded. Management will likely find it necessary to strengthen the enterprise's accounting staff. In particular, management will need to ensure that the personnel responsible for making determinations as to the accounting treatment of the enterprise's transactions have sufficient understanding of the relevant IFRS provisions—and how they may differ from GAAP—in order to make correct and reliable decisions consistently. The amount of documentation needed to demonstrate a good faith, intellectually honest, effort to conform the accounting to faithfully represent the actual effect of the event on the enterprise will be greater than in the past.

An example outside of the transactional area that will require this same type of reasoned analysis after conversion to IFRS is the determination of the components of consolidated financial statements. Whereas U.S. GAAP focuses on controlling financial interests, IFRS standards use the notion of the "power to control" the enterprise to determine if it should be consolidated. The presumption is that ownership of 50% or more of the voting rights (and potential voting rights) equals control. The concept of de facto control also affects the decision to consolidate. IFRS includes a much greater degree of qualitative analysis than U.S. GAAP.

Management of the enterprise, especially financial management, the board of directors and the audit committee, should not be lulled into believing that their present system of internal control is sufficient to address the changed focus on qualitative measures versus quantitative measures and principles- versus rules-based standards. A proper evaluation is needed before management declares the system adequate. They will be setting themselves up for criticism, if not liability, should the system fail to prevent a material misstatement in the financial statements.

Another trap would be the belief that the use of "judgment" would create a safe harbor from prosecution for material errors. Reasonable people can come to different conclusions based on judgment. Judgment must, however, be reasoned and based on a reviewable analysis of the issues. Simply stating that the determination was subject to judgment will not suffice if the proper framework is not developed to ensure the exercise of reasoned, evidentiary-founded, judgment. To justify its accounting judgments, management will find it more important than ever to develop and document accounting policies for particular types of transactions and balance sheet items and to show that those policies were adhered to in specific circumstances. For nonrecurring transactions, management should be able to demonstrate a consistent approach in order to make it easier to defend judgments made for the accounting used for these transactions, should they subsequently be called into question.

The foregoing examples are not inclusive of all of the instances where judgment is involved in complying with IFRS principles when determining the proper recording, summarization, and presentation of financial data in financial statements. In addition, it is management who will face this problem initially because management is primarily responsible for the selection of accounting standards and financial reporting.

The independent auditor. Auditing IFRS-based financial statements involves many more challenges than auditing U.S. GAAP statements, primarily because of the issues previously discussed with regard to management's application of principles rather than rules. The independent auditor is responsible for performing an audit in accordance with GAAS (whether U.S. GAAS or International Auditing and Assurance Standards) and issuing a report on those financial statements, if appropriate. When judgment is applied to determine the accounting for a transaction, a valuation reserve, or the composition of the financial statements, an auditor must evaluate the judgment used by management to determine that it is IFRS-compliant. As a result, of course, the auditor must be familiar with the differing treatment of certain transactions under U.S. GAAP and IFRS, and the auditor must be proficient at determining whether IFRS principles have been appropriately and correctly applied by management in preparing an enterprise's financial statements.

The proposed transition period to IFRS will test an auditor's ability to both ascertain whether management's accounting judgments are reasonable and supportable and communicate any identified deficiencies to management and the audit committee.

Auditors have always needed to understand an entity and its environment, including how its internal control system relates to the application of standards when recording transactions and when judgment is involved in the financial reporting process. This understanding is a prerequisite to an adequate design of auditing procedures for assessing the recording and presentation of any changed, new, or unique transactions, as well as the composition of the financial statements. The methodology used by management to determine the proper accounting for a given situation will take on more importance in an audit because of the often more extensive application of judgment under IFRS standards.

An auditor will need to assess management's judgments when applying IFRS standards and quantify, in words or numbers, the lower and upper limits of the range of acceptable conclusions. Because judgments are involved, the chance of an error occurring is greater. Management's conclusion should fall within the range of acceptable answers determined independently by the auditor. Precision will often not be possible, but reasonable accuracy should be achievable. An auditor must apply reasonable professional judgment in the analysis and document the basis for the judgment and audit conclusion. While the auditor currently has the same responsibilities under U.S. GAAP, the proposed transition period to IFRS will test an auditor's ability to both ascertain whether management's accounting judgments under IFRS are reasonable and supportable and communicate any identified deficiencies to management and the audit committee when necessary.

As with management, it does not suffice to simply say that judgment was involved and that reasonable people can come to different conclusions in defense of a materially wrong decision. The judgment must have an adequate foundation and be reasonable based on the underlying facts and circumstances.

Many professional liability cases against accountants that go to trial—and that is, to be sure, only a small minority of the cases that are brought—are decided by juries. In deciding whether the accountant should be held liable to the plaintiff, the jury is not required to use professional standards as the basis for its decision. Rather, the jury must decide if the accountant acted as a reasonably prudent and competent accountant would have in the same circumstances. Though the jury is free to consider professional standards as evidence, those standards are not binding on it, and liability can be found even where, for example, an auditor has conducted the engagement in literal conformity with U.S. GAAS. It is not an exaggeration to say that, in many cases, accountants are subject to having their exercise of professional judgment second-guessed by a jury acting in the context of an uncovered fraud and informed by conflicting expert opinions.

Auditors are also subject to having their professional judgments scrutinized by regulators who may not accept those judgments and may seek sanctions against auditors whose judgments are deemed to have been faulty. The SEC's Advisory Committee on Improvements to Financial Reporting issued a progress report in February 2008 (available at www.sec.gov/rules/other/2008/33-8896.pdf) that contains a thorough discussion of the role of professional judgment. The report noted that many in the auditing profession perceive regulators as failing generally to respect professional judgment when determining whether to bring enforcement actions against auditors. After extensively reviewing the types of judgments accountants must make in connection with financial statements, the committee recommended that the SEC develop a framework for accounting judgments and that the PCAOB develop a framework for auditing judgments, with an emphasis on critical and good-faith thought processes and documentation. Because IFRS is less prescriptive than U.S. GAAP, a transition to IFRS would only increase the role of professional judgment as well as the need for such a framework in order to provide guidance to both the auditors who make judgments and the regulators responsible for reviewing those judgments.

The consultant. Large enterprises with sophisticated accounting staffs will be capable of making judgments about the application of IFRS without any assistance from third parties. Most enterprises, however, will not possess that internal capability. For the initial adoption and continuing use of IFRS, most enterprises will retain outside consultants. These consultants will be susceptible to the same pitfalls as management. They must apply reasoned judgment and document any conclusion they reach.

The recent *Stoneridge* [*Stoneridge Investment Partners LLC v. Scientific Atlanta, Inc.*, 128 S.Ct. 761 (2008)] decision and near-privity rules may exclude consultants from the class of potential defendants because they generally would not be making representations directly to investors, whereas auditors do via their audit opinions. They could, however, be held liable to clients who are unable to get timely financing or otherwise suffer adverse consequences because the consultants have erred in making recommendations for an accounting treatment under IFRS, or for otherwise mishandling the U.S. GAAP-to-IFRS transition. Conceivably, if the enterprise was sued on the basis of errors made by the consultants, that enterprise might be able to maintain a claim directly against the consultants, though the bases for such a suit might be a bit shaky. In addition, consultants perceived to have "deep pockets" might be sued as a matter of course if there are material misstatements anywhere in the financial statements.

This "transition auditing" period will carry a higher level of risk than auditing does currently, as both management and auditors will grapple with a financial reporting system that differs from the system to which they are accustomed.

Liability: How Much of a Difference Will IFRS Make?

Regardless of the relative merits of IFRS and U.S. GAAP, IFRS will require accountants to make judgments with less detailed guidance than the rule-based U.S. GAAP approach has traditionally provided. If IFRS is indeed less prescriptive than U.S. GAAP and requires a different approach to financial reporting in some areas, will the result be greater liability exposure for accountants?

Auditors, of course, do not make the initial determination as to how a transaction will be recorded on an enterprise's books; that is (or at least is *supposed* to be) management's function. But auditors exercise considerable judgment in the design and execution of the audit and in deciding how much work will be done with respect to particular transactions. Moreover, auditors must determine whether the accounting used by management is reasonably supported by the factual circumstances, audit evidence, and relevant accounting authorities. Under IFRS, auditors will not have a list of rules with which to evaluate management's accounting decisions.

While the bases for lawsuits against accountants—in particular, financial statement auditors—are many and varied, a number of the most serious claims have arisen out of management frauds which have not been detected by auditors. In many of these cases, the problem has been a too ready acceptance of management's assertions or a failure to understand deficiencies in the internal control environment and their effect on the financial statements.

Of course, IFRS in and of itself will not remedy this situation. As discussed above, auditors will still be required to have an understanding of the internal control environment and design their audit procedures based on an assessment of the various risks presented by the enterprise's business and management. Regardless of the source of the accounting principles, an auditor who fails to detect that an enterprise's financial statements have been distorted by a fraudulent scheme or that a company has been victimized by management or employee thefts will still have litigation exposure. At least in the audit area, the quality and extent of audit procedures and the judgments made by auditors will still be the main factors in determining the extent of litigation risk.

Nevertheless, the U.S. GAAP-to-IFRS transition will probably add, at least in the short term, to litigation risk in the United States. Familiar rules for issues such as revenue recognition will be supplanted or at the very least supplemented by principles embodied in IFRS. Enterprises may have to adjust their methods of inventory valuation and may have to reassess possible contingencies affecting their financial statements, to name just two examples. Aside from the challenges this will pose for management, auditors will likely have to undertake more extensive audit procedures to test the reasonableness of the financial reporting determinations made by management in implementing the U.S. GAAP-to-IFRS transition. This "transition auditing" period will carry a higher level of risk than auditing does currently, as both management and auditors will grapple with a financial reporting system that not only differs from the system to which they are accustomed, but that will require a substantial number of accounting judgments to be made within a relatively short period—all with, in most cases, less detailed guidance than currently provided by U.S. GAAP.

Finally, IFRS itself, like U.S. GAAP, is not static and is continually being revised in response to the changing financial environment. Thus, U.S. accountants will not only have to adjust to making principle-based determinations as to whether the financial reporting in question faithfully represents the transactions at issue, they will have to do so within the context of a body of principles that is continuing to undergo revision as the convergence between U.S. GAAP and IFRS proceeds. Eventually, as familiarity with IFRS increases throughout the U.S. accounting profession, the increased risks posed by the U.S. GAAP-to-IFRS transition should subside. But, as demonstrated by the continuing calls for auditor liability caps in jurisdictions that have already embraced international standards, even familiarity with IFRS will hardly eliminate litigation risk.

Management, audit committees, independent auditors, and consultants should understand the additional liability that they may face when confronted with the change from a rules- to a principles-based system of accounting.

Some Ways to Avoid the Liability Traps

Management, independent auditors, and any consultants advising on the application of accounting will have to demonstrate that their judgments were based on a sound foundation of facts and were reasonable. They must be intellectually honest in applying the IFRS standards to the fact pattern. The following is applicable to all of the primary parties involved in determining the standard to apply:

- Remember that the primary purpose of the analysis is to determine the right application of the principle—not the one that most favors the enterprise.
- Gain a good understanding of the principles that may apply in a given situation.
- Obtain a good understanding of the facts and circumstances underlying the transaction or issue.
- Analyze the facts, circumstances, and applicable principles, applying reasoned professional judgment and intellectual honesty.
- Determine if the accounting is a reasonable representation of the underlying economic event.
- Document the process used, the facts and circumstances considered, the principles evaluated as applicable to the facts and circumstances, the bases for the ultimate conclusion reached, and any alternative conclusions considered with the reason why they were not applicable.

An auditor needs to assess the results of any judgments made by management in the accounting and reporting process, determining if management's conclusions are within the range of reasonable conclusions. Where within a reasonable range of results do management's conclusions fall? If management's conclusions always increase net income or some other profitability measure, the auditor should consider that pattern when forming an opinion on the enterprise's financial statements. Many of these factors are, of course, currently important under U.S. GAAP. But the transition to IFRS—and the differences between U.S. GAAP and IFRS—will place increasing emphasis on the quality of the accounting judgments made by the enterprise's management, as well as the auditor's ability to determine if those judgments are appropriate and reflect a consistent treatment of specific transactions and, more generally, the various components of the financial statements prepared by management.

With the increased use of principles-based rather than rules-based accounting and the increased application of reasoned judgment in preparing financial statements, management's integrity will become ever more important to the audit process. Auditors will need to assess management's integrity, and any circumstances that cast doubt on that integrity should be pursued and evaluated in light of management's ability to override a system of internal control.

Boards of directors and, especially, audit committees must be at least familiar with IFRS and question management about the effect of their implementation on the enterprise's financial statements. The audit committee should discuss the judgments used in preparing the financial statements with the enterprise's management and impress upon them the importance of using reasoned judgment and intellectual honesty when establishing the accounting principles and estimates used in the enterprise's financial statements. They must also inquire about the documentation of the process and conclusions that management reached.

Using Professional Judgment

The use of IFRS is a question of when, not if. Management, audit committees, independent auditors, and consultants should understand the additional liability that they may face when confronted with the attendant change from a rules- to a principles-based system of accounting. Management, audit committees, independent auditors, and consultants must be sensitive to the differences between IFRS and GAAP, and to the even more critical role that judgment may play in an IFRS accounting regime. They also need to be aware that these judgments—involving the application of principles in a changing environment—will lead to greater risks of errors in judgment and, in a litigious society, to increased liability risks. Although IFRS holds out the promise for more accurate financial reporting, all parties involved must be cognizant of the significant risk of increased litigation accompanying the transition to IFRS. Auditors must focus more than ever before on the judgments that management makes in preparing its financial statements—any questionable circumstance related to management's integrity needs to be scrutinized whenever found, whether in the planning, execution, or reporting phases of a GAAS audit.

Many CPAs will consult with management when initially converting from U.S. GAAP to IFRS and when subsequently determining the proper GAAP to apply to changed or new transactions. These consultants will face the possibility that they may become defendants in any potential litigation growing out of their client's issuance of false and misleading financial statements.

Intellectual honesty, reasoned judgment, and proper documentation of the process and conclusions reached are needed—first, to ensure that the appropriate accounting and estimates are used in financial reporting and, second, to demonstrate that reasonable business judgment was used in the process to protect the enterprise, its board, and management. ❑

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