
STANDING ADVISORY GROUP MEETING

AUDIT IMPLICATIONS OF IFRS FINANCIAL STATEMENTS IN U.S. SEC FILINGS

OCTOBER 18, 2007

Introduction

In recent months, the U.S. Securities and Exchange Commission ("SEC" or "Commission") issued both a proposed rule change and a concept release centering around financial statements prepared in accordance with International Financial Reporting Standards ("IFRS"). The proposal and concept release issued by the SEC are as follows:

- Release No. 33-8818, *Acceptance from Foreign Private Issuers of Financial Statement Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP* (Issued July 2, 2007)^{1/}
- Release No. 33-8831, *Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards* (Issued August 7, 2007).^{2/}

^{1/} Release No. 33-8818 is available at <http://www.sec.gov/rules/proposed/2007/33-8818.pdf>. The comment period ended on September 24, 2007.

^{2/} Release No. 33-8831 is available at <http://www.sec.gov/rules/concept/2007/33-8831.pdf>. The comment period will end on November 13, 2007.

This paper was developed by the staff of the Office of the Chief Auditor to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.

Under the SEC proposal, foreign private issuers that prepare their financial statements in accordance with IFRS, as published by the International Accounting Standards Board ("IASB"), would no longer be required to include a reconciliation to U.S. generally accepted accounting principles ("U.S. GAAP").

The SEC concept release seeks feedback on whether the SEC should permit U.S. companies to prepare their financial statements in accordance with IFRS, as published by the IASB, rather than U.S. GAAP. The concept release also seeks feedback on the impact on U.S. companies if they were not provided with this option.

The Standing Advisory Group ("SAG") will be asked to discuss the potential audit implications of (1) removing the U.S. GAAP reconciliation requirement for foreign private issuers and (2) allowing U.S. issuers to prepare financial statements in accordance with IFRS.

This briefing paper consists of two sections. The first section discusses the U.S. GAAP reconciliation, while the second section discusses the audit implications of allowing U.S. issuers to adopt IFRS, including: (a) evaluation of the fair presentation of the financial statements, (b) auditor education, (c) implications related to a firm's system of quality control, (d) transition to IFRS by U.S. issuers, and (e) market implications to auditing firms.

U.S. GAAP Reconciliation

Foreign private issuers are currently required to file with the SEC audited statements of income, financial position, changes in shareholders' equity and cash flows for each of the three past years (two years for first-time adopters of IFRS, as published by the IASB). Foreign private issuers are currently required to reconcile the financial statements that they file with the SEC to U.S. GAAP.

The SEC proposal sought comment on revisions to Form 20-F and Regulation S-X under which the SEC would accept financial statements of foreign private issuers that are prepared on the basis of the English language version of IFRS, as published by the IASB, without a reconciliation to U.S. GAAP. The Commission's proposal indicates that it has "encouraged movement towards a single set of high-quality globally accepted accounting standards as an important goal for the protection of investors and the efficiency of capital markets."^{3/} The proposal also states that the "work towards acceptance of financial statements from foreign private issuers prepared in accordance

^{3/} See SEC Release No. 33-8818, *Acceptance from Foreign Private Issuers*, page 25.

with IFRS, as published by the IASB, without reconciliation to U.S. GAAP seeks to foster the continued movement to a single set of high-quality, globally accepted accounting standards."^{4/}

Many foreign private issuers are audited by foreign associated firms, which are firms domiciled outside of the United States that are associated with an international auditing firm. Foreign firms can be associated with international firms in a variety of ways and, in many instances, members of the association are permitted to use the same or similar firm name. To address certain quality control concerns related to foreign associated firms, in 1999, the American Institute of Certified Public Accountants' SEC Practice Section ("SECPS") issued Appendix K, *SECPS Member Firms With Foreign Associated Firms That Audit SEC Registrants*. SEC Practice Section Requirement of Membership Section 1000.08(n), adopted as part of the Board's interim quality control standards, requires registered firms that were members of the SECPS to seek adoption of policies and procedures by the international auditing firm or individual foreign associated firms, which are consistent with the objectives set forth in Appendix K for SEC registrants.^{5/}

The policies and procedures described in Appendix K are directed toward enhancing the quality of SEC filings by SEC registrants by seeking to involve individuals knowledgeable about U.S. accounting, auditing, and independence standards with SEC filings audited by foreign associated audit firms. The procedures in Appendix K consist of two primary components: (1) procedures for individual SEC filings by SEC registrants that include or incorporate the foreign associated firm's audit report and (2) policies regarding a firm's internal inspection procedures.

Appendix K provides that a foreign associated firm's policies and procedures should address the performance of procedures with respect to certain SEC filings by SEC registrants that are clients of foreign associated firms by a person or persons knowledgeable in accounting, auditing, and independence standards generally accepted in the United States. The procedures are performed to provide assistance to the partner of the foreign associated firm responsible for the audit and the foreign

^{4/} Ibid.

^{5/} On April 16, 2003, the Board adopted certain pre-existing auditing standards as its interim quality control standards to be used on an initial, transitional basis. PCAOB Rule 3400T describes the quality control standards that the Board adopted at that time. The interim quality control standards are available at www.pcaob.org/standards. Appendix K, which is part of the interim quality control standards, is attached as Exhibit A to this briefing paper.

associated firm. The procedures performed by the filing reviewer should generally include the following:

- Reading the document to be filed with the SEC;
- Discussing with the audit partner-in-charge of the engagement the (a) engagement team's familiarity with and understanding of the applicable U.S. auditing, accounting, financial reporting, and independence standards, including independence requirements, (b) the significant differences between: (i) the accounting and financial reporting standards used in the presentation of the financial statements included in the filing and those applicable in the United States, and (ii) the auditing and independence standards of the foreign associated firm's domicile country and those applicable in the United States, and (c) any significant auditing, accounting, financial reporting, and independence matters that come to the attention of the filing reviewer, including how any such matters were addressed and resolved by the audit partner-in-charge of the engagement; and
- Documenting the results of the procedures performed.

In addition, Appendix K provides that the foreign associated firm's inspection procedures should address the review of a sample of audit engagements performed by foreign associated firms for clients that are SEC registrants. Such reviews may be performed as part of an annual inspection program of the international organization or the individual foreign associated firms. The inspection reviewers should be knowledgeable in U.S accounting, auditing, and independence standards and relevant SEC requirements.

Based on the procedures performed, the inspection reviewers should determine whether anything came to their attention to cause them to believe that (a) the financial statements were either not presented in conformity with U.S. GAAP or were not properly reconciled to U.S. GAAP, (b) the audit engagement was not performed in accordance with the standards of the PCAOB, (c) the document filed with the SEC did not comply as to form of the financial statements with pertinent SEC rules and regulations for such filings, (d) the foreign associated firm did not comply with the applicable U.S. independence standards, or (e) the foreign associated firm did not comply with procedures consistent with those in Appendix K.

Appendix K also states that a foreign associated firm's policies and procedures should provide that disagreements between the filing and/or inspection reviewer and the

audit partner-in-charge of the foreign associated firm should be resolved in accordance with the applicable policy of the international organization or of the filing or inspection reviewer's firm.

Responses of Global Firms to IFRS Reporting

In June 2002, legislation was passed to require that all European Union companies listed on a regulated market, including banks and insurance companies, prepare their financial statements in accordance with IFRS, as adopted by the European Commission. As a result of this legislation, EU companies had a set date by which to transition to IFRS, thus, auditing firms had to prepare to audit financial statements prepared in accordance with IFRS. Other countries are also adopting IFRS, which has led some global auditing firms to create global offices to consult on IFRS issues and implementation. Those global offices, in some cases, perform the filing reviews noted in Appendix K for filings that include financial statements prepared in accordance with IFRS.

Discussion Questions –

1. To what extent does Appendix K (the filing review and inspection procedures) enhance the effectiveness of the audit performed on the financial statements of foreign private issuers?
 - Have the auditing procedures applied to the U.S. GAAP reconciliation pursuant to Appendix K resulted in increased consistency in the application of IFRS by foreign private issuers?
2. If the SEC were to remove the U.S. GAAP reconciliation requirement for those foreign private issuers that prepare financial statements in accordance with IFRS, what changes, if any, would be needed for Appendix K?
3. What auditing issues might arise if the SEC removed the U.S. GAAP reconciliation requirement for those foreign private issuers that prepare financial statements in accordance with IFRS? Would any other amendments or additions to PCAOB standards be necessary?

Election to Adopt U.S. GAAP or IFRS

Although the Financial Accounting Standards Board ("FASB") and IASB are working towards convergence of their respective standards, there are still differences between the two sets of standards. Moreover, under IFRS, when standards do not address a matter, a company would consider whether analogous situations are

addressed by IFRS and, if not, a company would develop an accounting practice that is consistent with the IASB Framework. A company could consider pronouncements of other standards-setters that use a similar conceptual framework to develop accounting standards in addition to other sources, such as prevalent practice.

In the SEC's releases, the SEC noted several areas in which IFRS either does not have comprehensive standards, or has no standards. Limited or no standards could result in substantial diversity in practice. For example, the SEC noted the following:

- IFRS provides limited guidance on the accounting for insurance contracts and, in some areas, defers to pre-existing jurisdictional accounting principles.
- IFRS provides limited guidance related to the accounting for exploration activities by the extractive industries (e.g., oil & gas and mining), which would allow issuers to apply guidance from other sources.
- IFRS does not include specific guidance for the presentation of the income statement, which may result in numerous statement formats and subtotals using various caption headings.
- IFRS allows the presentation of any measure on a per share basis if the figure is reconciled to a line item on the income statement, which could result in the inclusion of alternative measures (e.g. earnings before interest, taxes, depreciation and amortization, or EBITDA) in the financial statements.
- IFRS does not have standards on the accounting for common control mergers, recapitalizations, reorganizations, acquisitions of minority interests, and similar transactions.

Discussion Question –

4. Are there specific differences between U.S. GAAP and IFRS that are so significant that they pose unique challenges for U.S. auditors? Do any provisions of IFRS pose auditability concerns?

Evaluation of the Fair Presentation of the Financial Statements

In addition to conforming changes to the PCAOB interim standards that might be required if the SEC were to allow U.S. issuers to prepare financial statements in accordance with IFRS, more substantive changes may be required.^{6/} For example, audit reports on U.S. GAAP financial statements include an opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of a company in conformity with GAAP. The PCAOB interim auditing standard, AU sec. 411, *The Meaning of Present Fairly in Accordance with Generally Accepted Accounting Principles*, provides direction on the auditor's evaluation of whether the financial statements are presented fairly. AU sec. 411.04 states:

The auditor's opinion that financial statements present fairly an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles should be based on his or her judgment as to whether (a) the accounting principles selected and applied have general acceptance; (b) the accounting principles are appropriate in the circumstances; (c) the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation (see section 431); (d) the information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed (see section 431); and (e) the financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.

Discussion Question –

5. Is the guidance contained in AU sec. 411.04 sufficient for audits of financial statements in accordance with IFRS? What other amendments or additions to PCAOB standards might the Board need to consider if issuers were allowed to prepare IFRS financial statements?

^{6/} This briefing paper is for discussion purposes only and may not outline all changes that would be necessary if U.S. issuers were allowed to prepare financial statements in accordance with IFRS and if the U.S. GAAP reconciliation requirement were eliminated for those foreign private issuers that prepare financial statements in accordance with IFRS, as published by the IASB.

Auditor Education

Current auditing standards require an audit to be performed by persons having adequate technical training and proficiency. Most colleges and universities offering accounting programs design those programs to provide students with the competencies needed to pass the CPA exam, which is based on U.S. GAAP. Were the SEC to allow U.S. issuers to prepare financial statements in accordance with IFRS, colleges and universities would likely need to develop programs to train new graduates on IFRS. Additionally, auditing firms would need to train their current partners and staff to audit financial statements prepared in accordance with IFRS.

Discussion Questions –

6. What steps would colleges and universities need to take to train new graduates to audit financial statements of issuers prepared in accordance with IFRS? What is the timeline to complete the task likely to be? What changes in the CPA exam, if any, might be required?
7. What would be the major issues for auditing firms to consider to adequately train current partners and staff to audit financial statements of issuers prepared in accordance with IFRS?
8. What lessons can U.S. auditing firms learn from the adoption of IFRS in other jurisdictions?

Implications Related to a Firm's System of Quality Control

A firm's system of quality control encompasses the firm's organizational structure and the policies adopted and procedures established to provide the firm with reasonable assurance of complying with professional standards. Under QC sec. 20, *System of Quality Control for a CPA Firm's Practice*, a firm has a responsibility to ensure that its personnel comply with the professional standards applicable to its accounting and auditing practice.^{7/}

QC sec. 20 provides that a firm's quality control policies and procedures should encompass various elements, including elements of personnel management and engagement performance. Personnel management encompasses hiring, assigning personnel to engagements, professional development, and advancement opportunities. QC sec. 40, *The Personnel Management Element of a Firm's System of Quality Control*

^{7/} The PCAOB adopted Quality Control Sections 20 through 40 as part of its interim quality control standards.

– *Competencies Required by a Practitioner-in-Charge of an Attest Engagement*, states that policies and procedures should be established to provide the firm with reasonable assurance that, among other things, those hired possess the appropriate characteristics to enable them to perform competently and that work is assigned to personnel having the degree of technical training and proficiency required in the circumstances.

Engagement performance encompasses all phases of the design and execution of the engagement. The firm's quality control policies and procedures should cover planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement. Policies and procedures also should be established so that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate.

Discussion Question –

9. What are the possible implications related to a firm's system of quality control, including its training needs, if U.S. issuers choose to prepare financial statements in accordance with IFRS?

Transition to IFRS by U.S. Issuers

Issuers may experience increased risks to the quality of financial reporting during a transition from U.S. GAAP to IFRS, and auditors will have to consider such risks in planning and performing their audits. For example, some differences between U.S. GAAP and IFRS might require substantial systems modifications to obtain and summarize financial information to be consistent with the new accounting. Such system modifications might have a corresponding effect on internal control effectiveness. In addition, accounting and financial system personnel and audit committee members might need to learn a new accounting framework, and there could be increased risk of errors and financial reporting fraud. Furthermore, an issuer would need to understand the IFRS accounting framework to perform a detailed analysis of certain transactions or events, like determining whether leases are appropriately classified or whether all embedded derivatives have been identified and appropriately accounted for.

Discussion Question –

10. What other financial reporting risks might be associated with the transition from U.S. GAAP to IFRS? What are the implications to the integrated audit of financial statements and internal control over financial reporting?

Market Implications to Auditing Firms

The cost of training U.S. auditors to become proficient in the application of IFRS, in a timely manner, in addition to their existing training responsibilities, could be substantial. As a result, some auditing firms may decide that they cannot offer their clients the option of obtaining opinions for financial statements prepared in accordance with IFRS.

Discussion Question –

11. Are there potential market implications if some audit firms would not (or at least would not initially) provide audit services to U.S. issuers who prepare their financial statements in accordance with IFRS?

* * *

The PCAOB is a private-sector, nonprofit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

EXHIBIT A

.45 Appendix K—SECPS Member Firms With Foreign Associated Firms That Audit SEC Registrants

.01 The Section acknowledges that SECPS member firms that are members of, correspondents with, or similarly associated with international firms or international associations usually do not control their international organization or individual foreign associated firms.¹ However, the Section adopted the membership requirement set forth in SECPS §1000.08(n) to obtain the assistance of SECPS member firms in their seeking to enhance the quality of SEC filings by SEC registrants² whose financial statements are audited by foreign associated firms. This assistance consists of SECPS member firms seeking adoption of policies and procedures by their international organizations or individual foreign associated firms that are consistent with the following objectives:

- a. *Procedures for Certain Filings by SEC Registrants*—The policies and procedures should address the performance of procedures with respect to certain SEC filings by SEC registrants that are clients of foreign associated firms by a person or persons knowledgeable in accounting, auditing, and independence standards generally accepted in the U.S., independence requirements of the SEC and ISB, and SEC rules and regulations in areas where such rules and regulations are pertinent (the “filing reviewer”). The procedures are performed to provide assistance to the partner of the foreign associated firm responsible for the audit (the “audit partner-in-charge of the engagement”) and the foreign associated firm. Such filings are limited to registration statements, annual reports on Form 20-F and 10-K, and other SEC filings that include or incorporate the foreign associated firm’s audit report on the financial statements of an SEC registrant.

The procedures performed by the filing reviewer should generally include the following:

- (1) Reading the document to be filed with the SEC with particular attention given to compliance as to form of the financial statements (and related schedules) and auditors’ report with the applicable accounting and financial reporting requirements for such filings by the SEC registrant.
- (2) Discussing with the audit partner-in-charge of the engagement:
 - (i) the engagement team’s familiarity with and understanding of the applicable U.S. auditing, accounting, financial reporting, and independence standards, including independence requirements of the SEC and the ISB;
 - (ii) the significant differences between: (a) the accounting and financial reporting standards used in the presentation of the financial statements included or incorporated in the document to be filed with the SEC and those applicable in the U.S., and (b) the auditing and independence standards of the foreign associated firm’s domicile country and those applicable in the U.S.; and
 - (iii) any significant auditing, accounting, financial reporting, and independence matters that come to the attention of the filing reviewer when performing the procedures described above, including how any such matters were addressed and resolved by the audit partner-in-charge of the engagement.
- (3) Documenting the results of the procedures performed.

¹ For this purpose, a foreign associated firm is a firm domiciled outside of the United States and its territories that is a member of, correspondent with, or similarly associated with an international firm or international association of firms with which the SECPS member is associated.

² See Appendix D, SECPS §1000.38, “Definition of an SEC Engagement” for purposes of determining compliance with the membership requirements of SECPS §1000.08e, f, g, h, i, k, m, n, o and p.

The procedures performed by the filing reviewer described above do not relieve the audit partner-in-charge of the engagement of any of the responsibilities for the performance of the audit of, and the report rendered by the foreign associated firm on, the financial statements included in the document to be filed with the SEC. Also, the filing reviewer does not assume any of the responsibilities of the audit partner-in-charge of the engagement or of any concurring reviewer.

Because of the limited nature of the procedures described above, it is recognized that the filing reviewer can not and does not assume any responsibility for detecting a departure from, or noncompliance with, accounting, auditing, and independence standards generally accepted in the U.S., independence requirements of the SEC and ISB, or SEC rules and regulations.

- b. *Inspection Procedures*—The policies and procedures should address the review of a sample of audit engagements performed by foreign associated firms for clients that are SEC registrants. Such reviews may be performed as part of an annual inspection program of the international organization or the individual foreign associated firms. The reviews of engagements should be performed by a person or persons knowledgeable in accounting, auditing, and independence standards generally accepted in the U.S., independence requirements of the SEC and ISB, and SEC rules and regulations in areas where such rules and regulations are pertinent (the “inspection reviewer”). The need for knowledge of relevant specialized industry practices should be considered.

Based on the procedures performed, the inspection reviewers should determine whether anything came to their attention to cause them to believe that:

- (1) the financial statements were not presented in all material respects in conformity with accounting principles generally accepted in the U.S. or, if applicable, the footnote reconciliation of the financial statements to U.S. GAAP did not include appropriate treatment of the material reconciling items,
 - (2) the audit engagement was not performed in accordance with auditing standards generally accepted in the U.S.,
 - (3) the document(s) filed with the SEC did not comply as to form of the financial statements (and related schedules) with pertinent SEC rules and regulations for such filings,
 - (4) the foreign associated firm did not comply with the applicable U.S. independence standards, including independence requirements of the SEC and ISB with respect to the SEC registrant, or
 - (5) the foreign associated firm did not comply with procedures consistent with those described in .01a. above.
- c. *Disagreements*—The policies and procedures should provide that if the filing or inspection reviewer and the audit partner-in-charge of the engagement have conflicting views as to the resolution of matters that came to the attention of the filing or inspection reviewer when performing the procedures for certain filings or inspection described above, that disagreement should be resolved in accordance with the applicable policy of the international organization or of the filing or inspection reviewer’s firm.