

International Financial Reporting Standards (IFRS):

What Internal Auditors
Need to Know

January 2009

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The Foundation would also like to acknowledge the authors of *A Summary of the Common Body of Knowledge 2006 (CBOK)*. The wealth of data collected through the 2006 CBOK survey includes thousands of responses from a diverse global representation of auditors. This living library of knowledge is invaluable to the profession by enabling internal auditors to gain insight into the various professional practices around the world. For further information on CBOK research studies and educational products, please visit the CBOK Web site at <http://www.theiia.org/CBOK>.

PREFACE

This research article seeks to provide insight to internal auditors needing information on International Financial Reporting Standards and how their organization may be impacted. This is not a position paper or official guidance from The IIA. The IARF encourages readers who have questions about this report to contact research@theiia.org for more information.

INTRODUCTION

The International Financial Reporting Standards (IFRS) — a set of global accounting standards developed by the International Accounting Standards Board (IASB) — are quickly becoming the worldwide norm for financial statements in publically traded entities. The IASB is a London-based independent standards body that seeks to promote the consistent practice of accounting by maintaining working relationships with local accounting standard setters.

Many of the standards forming part of IFRS are known by the older name of International Accounting Standards (IAS), which were issued between 1973 and 2001 by the board of the International Accounting Standards Committee (IASC). In April 2001, the IASB adopted all IAS and continued their development, calling the new standards IFRS, which consist of:

- *IFRS* — standards issued after 2001.
- *IAS* — standards issued before 2001.
- *Interpretations originated from the International Financial Reporting Interpretations Committee (IFRIC)* — issued after 2001.
- *Standing Interpretations Committee (SIC)* — issued before 2001.

In addition, the *Framework for the Preparation and Presentation of Financial Statements*² describes some of the principles underlying IFRS.

In a November 2007 global study conducted by the International Federation of Accountants (IFAC), 88 percent of global accounting leaders indicated that convergence to IFRS is important for the economic growth and development within their region¹. Another major driving force behind IFRS has been a need for consistency in accounting and financial reporting on a worldwide basis. Accordingly, IFRS has been adopted in more than 100 countries to date including those within the European Union, the Gulf Cooperation Council, and parts of Asia, Africa, Latin America, and Australia. (An overall status on convergence adoption per country is available at www.iasplus.com/country/useias.htm.)

Europe mandated IFRS as published by the IASB for all public companies beginning in 2005, while in Canada, IFRS will replace Canadian Generally Accepted Accounting Principles (GAAP) for Publicly Accountable Enterprises (PAEs) after Jan. 1, 2011. However, in the United States, the transition to IFRS is just beginning to build momentum. In 2007, the Securities and Exchange Commission (SEC) made the decision to allow non-U.S. based companies to begin filing financial statements using IFRS without reconciliation to U.S. GAAP. Some U.S. SEC filers also will have this option in 2009. It is safe to say that in the United States, IFRS and U.S. GAAP are coming to a crossroads.

And, similar to significant U.S. Sarbanes-Oxley Act of 2002 undertakings, major decisions and considerable work lie ahead to meet the needs of IFRS convergence.

¹ http://web.ifac.org/download/Global_Summary-Results_by_Question.pdf

² <http://www.iasplus.com/standard/framework.htm>

So how will a switch to IFRS impact internal auditors? In general, internal auditors have a responsibility to be well-informed about emerging issues in the accounting and financial arena. In fact, 80 percent of global internal auditors indicated that their function assumes or will assume an important role in the integrity of financial reporting, according to The IIA's Common Body of Knowledge 2006 study. Given this reality, how can an internal auditor truly exercise due professional care without an overall understanding of IFRS and its impact to their organization or client?

This research brief aims to provide internal auditors with a working knowledge of this important challenge facing many companies and to help in planning for the road ahead. Please note that the version of IFRS currently available is for publically traded entities. The IASB is working on a less-complex version for private entities to be available in the first quarter of 2009.

Highlights in this brief:

- IFRS versus U.S. GAAP: What is the difference?
- Internal audit's responsibility in the IFRS process.
- Business impact: key changes to expect from IFRS.
- Proposed timeline for IFRS Convergence in United States.
- Summary and IFRS resources.

IFRS VERSUS U.S. GAAP: WHAT IS THE DIFFERENCE?

An October 2008 survey by the American Institute of Certified Public Accountants (AICPA) found that almost 80% of respondents need to know more about IFRS and about 70% have either no knowledge or just basic knowledge of the standards³. This fact highlights that many U.S. accounting professionals are just now beginning their learning curve on IFRS — and internal auditors in the United States must now begin to proceed down the same path.

At a high-level, IFRS are principle-based standards and, therefore, offer much less detail than U.S. GAAP. In fact, IFRS currently fit into just one book; a stark contrast to the numerous volumes of U.S. GAAP paperbacks. Because of the lessened amount of guidance provided by IFRS, these standards require more judgment and interpretation by accounting professionals than U.S. GAAP.

Changes to revenue recognition rules and accounting for research and development costs (R&D) are among the areas with major differences between U.S. GAAP and IFRS. Below is a summary⁴ of the major accounting technical differences between IFRS and U.S. GAAP.

³ http://www.aicpa.org/download/news/2008/IFRS_Poll_Results.pdf

⁴ “Buckle Up (on the road to IFRS)” <http://www.deloitte.com/us/ifrs/buckleup> (September 2008). Copyright Deloitte Development LLC, used with permission.

The Topic	The Change	The Implication
Meet that long-lost relative	Consolidation policy. Entities are consolidated based on assessing risks and rewards, as well as governance and decision-making activities.	More entities may be consolidated. Entities that may need to be assessed for consolidation include those where there is a significant equity investment, such as joint ventures, special purpose entities, and franchisees.
Are you afraid of commitment?	Provisions. Under IFRS, a liability is recognized when an entity has a demonstrable commitment — a different standard from under U.S. GAAP.	Liabilities will be recognized and measured differently. Examples include restructuring charges, onerous contracts, uncertain tax provisions, litigation, and asset retirement obligations.
Recognizing the unrecognizable	R&D. Internal costs to develop a product now must be capitalized.	Development costs will be deferred and amortized. Entities will need to identify and track costs that should be capitalized as assets, assign useful lives, amortize the assets, and evaluate them for impairment.
Is the price right?	Asset impairment. Impairments are recognized based on an asset's recoverable amount — the higher of its fair value and value-in-use.	Impairment charges will be recognized earlier and measured differently. They also are required to be reversed if the conditions that led to the impairment no longer exist.
Is the value fair?	Financial instruments. Fair value measurements may be different and are not always based on exit value. Assets are derecognized based primarily on an assessment of risks and rewards. The debt and equity components of contracts are required to be separated.	Financial assets and liabilities will be measured differently. It will be more difficult to derecognize financial assets because qualified special purpose entities no longer matter. Instruments with debt and equity elements will be accounted for differently.
Depreciation isn't simple anymore	Property. Assets are depreciated on a component basis, and an asset's residual value is revalued each period. There is also an option to revalue property.	The computation of depreciation will be more complicated. Also, the measurement of an asset may be different.
What's 2+2?	Less guidance. IFRS is less reliant on bright lines and detailed rules than U.S. GAAP.	CFOs will need to focus more on the economics underlying transactions and events. This will eliminate accounting arbitrage and result in more judgment in applying standards. Examples of areas where more judgment is required include financial statement presentation, property, leases, revenue recognition, consolidation policy, provisions, intangibles, and financial instruments.

INTERNAL AUDIT'S RESPONSIBILITY IN THE IFRS PROCESS

Conversion to IFRS should be managed like any other large-scale project — sufficient time must be incorporated into the project plan, proper resources must be secured, and all key players must be involved for critical decision making. While the IFRS project will live in the accounting/finance area, internal auditing must be a key player in this important initiative because of its pervasive impact on the organization's internal control environment and Sarbanes-Oxley documentation process, among other reasons. Here are ways internal auditors should seek to get involved in its organization's IFRS project:

- 1. During the pre-implementation phase.** The accounting/finance department should be in charge of the entire IFRS project (i.e., from the project's initiation through its execution and post-implementation phases). Therefore, the first internal audit action step is to review the organization's IFRS project plan to ensure the company is prepared appropriately to undertake the project. Internal auditors should ensure the project is designed and scoped adequately and managed effectively and efficiently. Procedures to be performed include ensuring proper controls, performing readiness testing, reviewing the communication plan, testing the change management program's adequacy, and reviewing management's budget for inclusion of necessary expenses. By beginning the IFRS conversion project with a thorough pre-implementation review, internal auditors will likely give the project a better chance of success.
- 2. During the transition phase.** Internal auditors should work closely with external auditors throughout the IFRS implementation process and help to identify the processes, systems, and controls impacted by IFRS. After identifying affected items, internal auditors should make appropriate updates on process documentation to make sure affected areas and controls function properly in the new IFRS environment. In addition, internal auditors will be responsible for testing controls along with ensuring Sarbanes-Oxley monitoring processes are adjusted properly, if applicable.
- 3. During the post-implementation phase.** After the implementation phase, internal auditors should validate the process around newly created IFRS financial statements by providing assurance to management that the revised internal control structure is working properly and yields accurate financial reports. At a minimum, this involves the testing of high-risk areas for accuracy, as well as making sure certain controls are in place for the continuous monitoring of IFRS regulatory changes.

Action Items for Internal Audit Executives

IFRS is more than an exercise for the accounting/finance department — its impact is far-reaching, affecting areas from internal controls and sales to research and development. As a result, chief audit executives (CAEs) have a responsibility to become educated on IFRS and its impact for the organization. CAEs must proactively reach out to their organization's finance executives by partnering with them in the IFRS conversion project and work closely with external auditors in the beginning of the conversion process. Because the audit committee may have limited knowledge on IFRS and its effects, CAEs must be prepared to educate this group on the importance of internal audit's role in the process. Finally, CAEs must incorporate the IFRS project in the internal audit plan, allocating the necessary time and resources.

BUSINESS IMPACT: PLANNING FOR INTERNAL AUDITORS

While identifying the need for convergence to IFRS, and the responsibility to make the appropriate accounting treatments falls within the accounting/finance arena, internal auditors do play an important role in the IFRS transition process. Being a key player, internal auditors must have an overall understanding of the major accounting changes - as the accounting changes will have a ripple affect through the company's internal control structure, among other affected areas. Convergence to IFRS will have an impact on the processes which lead to the recording of a specific transaction and necessitate re-engineering of those processes and the related internal controls. Thus, internal auditors should participate in the diagnosis and the inventory of processes impacted by IFRS convergence. Particularly internal auditors should review those processes which need re-engineering to assess the extent of necessary changes and whether internal controls are re-designed effectively and efficiently to address the new risks associated with the new process. Depending on the industry, those processes needing re-engineering may differ however it is important to draw attention specifically onto one area which requires full redesign (when applicable) and that is Research and Development.

In view of this, the internal auditor can help to ensure that broader business impacts are identified and monitored. Areas for consideration include:

- **Production/R&D.** Information from production/R&D personnel will drive accounting on a broad range of topics, including defining normal capacity and measurement of inventories, determining components of property, plant, and equipment, and distinguishing between research and development phases, etc.
- **Market communication.** Financial communications will have to address changes in presentation of financial information, as well as the fundamental change towards fair value accounting and its impact on traditional ratios and key performance indicators.
- **Legal.** Internal legal staff need to support accounting staff in interpreting contractual terms and conditions in accordance with IFRS. Hence, organizations might need to revise their processes and systems when entering into, drafting, approving, or monitoring contracts.
- **Treasury.** Detailed hedge documentation and ongoing effectiveness testing is required to achieve hedge accounting under IFRS.
- **Human resources.** The volatility caused by IFRS might mean that the calculation base for certain types of compensation (e.g., profit sharing, bonuses, and share option awards) needs to be adjusted.
- **Taxation.** The tax department will have to work closely with accounting staff to examine the IFRS impact on the new financing structures implemented within the group.
- **Marketing and sales.** IFRS will impact a number of areas, such as managing the brands and trade marks now recognized on the balance sheet; determining the net realizable value of inventories; and reviewing sales contracts for revenue recognition issues, conditions of sale, and embedded derivatives.

Other areas for internal audit consideration include:

- Sarbanes-Oxley compliance and monitoring fraud risks pertaining to financial data manipulation during subsequent years due to a lack of expertise from those traditionally involved in the convergence process.
- The impact of eXtensible Business Reporting Language (XBRL). In some countries, like Singapore, The Netherlands, Australia, and New Zealand, XBRL is driving the implementation of IFRS and doing so on a much broader basis than existing GAAP. In addition, in December 2008, the SEC voted to require U.S. public companies and mutual funds to use interactive data for financial information (for compliance deadlines visit www.sec.gov).

Here are some examples of how XBRL specifically facilitates IFRS convergence:

- XBRL provides an explicit map of the relationships between U.S. GAAP and IFRS GAAP concepts.
- XBRL provides an explicit set of reusable relationships and links between U.S. GAAP and IFRS GAAP.
- XBRL enables companies and investors to know which concepts are the same and which ones are different.
- XBRL enables companies to easily access and analyze the detail transaction-level information necessary for the conversion to IFRS.
- XBRL enables companies to implement a more automated and controlled process for IFRS reporting that is also sustainable rather than manual.
- XBRL provides the metadata needed so that companies and investors know if a number is relevant to U.S. GAAP or IFRS GAAP.

TIMELINE FOR IFRS CONVERGENCE IN THE UNITED STATES

Although the SEC will decide whether or not to mandate the use of IFRS in 2011, planning ahead is critical to any successful project, especially one that will demand a significant amount of time and resources. As a result, it is important that internal auditors stay at the forefront of this issue due to the time involved in planning and executing the conversion process. In addition, internal auditors should be aware of how the SEC's proposed timeline for convergence to IFRS will affect their organization's priorities and be prepared to tackle these challenges head on.

SEC Proposed Timeline for Moving Companies to IFRS	
Date	SEC Action
End of 2009	A limited group of large companies will be given the option to use IFRS. SEC estimates 110 U.S. companies will be able to take advantage of the offer.
2011	SEC will evaluate the progress of achieving proposed milestones and decide whether to mandate adoption of IFRS. If IFRS is mandated, the commission will implement a staged roll-out approach, starting with the largest public companies first.
2014	If IFRS requirements are adopted in 2011, the first wave of companies will be mandated to report financial results using international accounting standards.
2016	If IFRS requirements also are adopted in 2011, all public companies will be mandated to report financial results using international accounting standards.
Source: The SEC⁵	

SUMMARY

A shift from country-specific GAAP to IFRS is proving to be an inevitable move for virtually all organizations around the world. As more organizations make this significant switch, others will be compelled to follow in their footsteps for ease of comparability, among other reasons. Internal auditors, therefore, need to be prepared to contend with the broad-reaching effects this important regulatory change will have on their organization.

Because the IFRS conversion process will differ by organization depending on size, industry, and the degree of change from country-specific GAAP to IFRS, it will be important to analyze the impact of IFRS on a case-by-case basis. As a result, internal auditors should start by determining when their organization will have to comply with IFRS and initiate conversations with senior financial management accordingly. Secondly, internal auditors must make certain they have a seat at the table during preliminary discussions on the IFRS conversion process. Consequently, accounting, internal audit, and IT executives should begin conversations as early as possible to plan ahead for a switch to IFRS. Critical decision points during these conversations should include the need for and timing of IT system upgrades, how and when to secure proper accounting and audit expertise, and obtaining board or audit committee support for the project's overall needs.

As evidenced, internal auditors must be proactive regarding their involvement in the IFRS conversion project, and this involvement must begin as early as possible. Finally, internal auditors should continue to monitor IFRS developments, staying abreast of the latest information as this important international topic continues to develop globally.

RELATED RESOURCES

For the latest information on IFRS, internal auditors can visit the following Web sites or read the following publications:

- *Internal Auditor* magazine's: "Getting Up To Speed with IFRS" (October 2008).
- The Association of Chartered Certified Accountants (ACCA)' *Impact of IFRS in Europe* report, available at www.accaglobal.com/publicinterest/activities/research/reports/global_integration/rr_105.
- The IASB Web site, www.iasb.org. This Web site provides the latest information on IFRS.
- The IASPlus.com Web site, www.iasplus.com/country/useias.htm. This Web site provides a description on the use of IFRS by country jurisdiction.
- Ernst and Young's Web site: [http://www.ey.com/Global/assets.nsf/International/IFRS_2008_Update/\\$file/2008_IFRS_Update.pdf](http://www.ey.com/Global/assets.nsf/International/IFRS_2008_Update/$file/2008_IFRS_Update.pdf). This document provides an overview of the upcoming changes in standards and interpretations.
- The IIA's XBRL Research Report, *XBRL What's in It for Internal Auditors* (February 2009): www.theiia.org/research/research-reports/
- The XBRL International Web site (for the latest information on XBRL), www.xbrl.org/Home/
- ITAudit "Got XBRL?" (June 10, 2007): <http://www.theiia.org/ITAuditArchive/index.cfm?iid=541&catid=21&aid=2681>
- ITAudit "Using XBRL: Audit and Control Implications" (Aug. 10, 2007): <http://www.theiia.org/ITAuditArchive/index.cfm?catid=21&iid=552>

In addition, auditors can visit The IIA Web site for a list of IFRS training courses, <http://www.theiia.org/iia-training/>

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