



**UNIVERSITÀ  
DEGLI STUDI  
DI BERGAMO**

**FACOLTÀ DI ECONOMIA**

Dipartimento di Economia Aziendale

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Quaderno del Dipartimento N° 5/ 2009

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**Daniele Gervasio**

## **IAS/IFRS IMPACT ON THE AUDITOR'S ROLE**



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## Introduction

From a close look at the reality around us, we can note that, especially in the economic field, theoretical models tend to be standardised as much as possible to achieve a more homogeneous general system of conceiving markets and trade. .

However, the market, at least from a legal and accounting point of view, , is not a unitary reality and coexists with a plurality of different national systems and regulations.

To try and eliminate accounting barriers between countries, which is one of the causes of dyscrasia between different states and markets, it is necessary to study comparative accountancy between the different legal systems from a comparative standpoint.

In this context, in 2004 IAS/IFRS were introduced in Italy for drafting listed companies' financial statements. The introduction of IAS/IFRS in Italy as in the rest of Europe has led to new issues.

Many scholars have tackled these questions first by studying the harmonisation of accounting systems (Manson, 1978; Gray, 1988; Nobes & Parker, 2008; Alexander & Archer, 2001; Campedelli B. , 1994; Rusconi, 1999; Poselli, 2001; Rossi C. , 2003), then, subsequently, by analysing the introduction of IAS/IFRS in different legal systems (Alexander, Nobes, Caruso, & Ferrari, 2008; Dezzani, Principio IAS 19. TFR: trattamento contabile secondo lo IAS 19, 2007; Dezzani, I principi Ias/Ifrs: il "reddito prodotto" ed il "reddito potenziale", 2007; RosciniVitali, 2003; Zingales, 2008; Bruni, Contabilità del valore per "aree strategiche d'affari", 1999; Poselli, L'evoluzione del sistema informativo di bilancio. Osservazioni critiche, 2006).

The financial statements represent the most importation information medium of a business concern and is normally read by third parties entering into relations with the company and by the company shareholders themselves.

The results of the financial statements are the basis on which the Company's economic value <sup>1</sup> is calculated.

Both the undervaluation of the equity (share capital) and overvaluation of the assets may give a distorted representation of the company's value<sup>2</sup>. As a consequence, these assessments reduce the Market investors' trust<sup>3</sup>.

In this context, the auditor's role, as market investors' trust guarantor, has been widely analysed by different authors over the years (Marchi, 1988; Bruni, *Revisione aziendale e di bilancio*, 2004; Cox, 2006; Campedelli, *Analisi dei rischi rilevanti nella revisione aziendale. Principi e applicazioni*, 1996; Poselli, *Revisione Aziendale*, 2001; Galbraith, 2004; Carnegie & Napier, 2006; Brewster, 2003; Arens, 2006; Toffler, 2003; Rossi & Gervasio, *La Revisione Aziendale, teoria e procedure*, 2008).

This paper will try to analyse the impact of IAS/IFRS on the auditor's role in expressing an opinion on the financial statements.

This question leads to further enquiries concerning the changes that IAS/IFRS have caused on financial statements and, consequently, on the way they are interpreted. This raises issues linked to new audit procedures that should be adopted in order to express a proper audit opinion. Bearing in mind recent financial cracks, we will also assess how the auditor's role can be changed to provide greater assurance to financial markets regarding IAS/IFRS financial statements.

The paper is divided into four sections and a conclusion: the first section analyses the auditor's role in general as financial market guarantor; the second section describes the main impacts of IAS/IFRS on audit procedures; the third section analyses IAS/IFRS critical assessments; the fourth section explains how IAS/IFRS critical assessments influence audit procedures. The paper concludes with an attempt to ascertain whether IAS/IFRS

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<sup>1</sup> Bruni, G. (1999). *Contabilità del valore per "aree strategiche d'affari"*. Torino: Giappichelli Editore.

<sup>2</sup> Amaduzzi, A. (2001). *Obiettivi e valore dell'impresa: misure di performance*. Milano: Il Sole 24 Ore.

<sup>3</sup> Rusconi, G. (1997). *Etica e Impresa*. Bologna: Clueb.

application to financial statements has strengthened the auditor's role or not.

## 1. The role of the statutory auditor

In a liberal economic system, in which the relationship between the various parts of the system must be regulated by criteria of fairness and transparency that are clear to all operators, communication represents a fundamental element. A company's financial statements are one of the main instruments by which the objective is achieved.

In this context, the figure of the auditor acquires fundamental significance during the auditing of companies' financial statements.<sup>4</sup>

Over the last thirty years, the role of the auditor has become increasingly articulated; initially his function was to perform a programme of controls applying codified procedures for an ex post formal control between balance sheet items and physical or documental elements<sup>5</sup>. Subsequently, auditors acquired the role of internal control system evaluators.

Finally, auditors have become evaluators of the whole business system, checking the correct application of the principles of accounting and business<sup>6</sup> economics.

To understand the importance and role of the auditor more thoroughly, we need to consider that auditing consists in checking that accounts have been kept properly and that operational items have been pointed out correctly; the audit concludes by checking that the findings of the accounting entries correspond with the documents of the financial statement and the consolidated financial statements and with the rules governing them<sup>7</sup>.

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<sup>4</sup> Arens, E. B. (2006). *Auditing and assurance services: an integrated approach*. Pearson Prentice Hall.

<sup>5</sup> Campedelli (A cura di). (1996). *Analisi dei rischi rilevanti nella revisione aziendale. Principi e applicazioni*. Italia, Giappichelli.

<sup>6</sup> Bruni (A cura di). (2004). *Revisione aziendale e di bilancio*. Italia, Isedi.

<sup>7</sup> Rossi, G. (2008). *La Revisione Aziendale, teoria e procedure*. Italia, Giuffrè.



The audit activity is documented by relevant reports which express an opinion on the financial statement and on the consolidated financial statement.

Depending on whether a total or partial regularity and fairness are ascertained or lack of such requirements in the financial statements, the opinion can be synthesised as follows:

unqualified opinion;

qualified opinion;

adverse opinion;

disclaimer opinion.

In the case of a qualified, negative or inability opinion, the audit report must clearly and analytically express the reasons for the non-conformity of the financial statements to the rules governing the drawing up of accounts.

Substantially, the content of the audit report is, therefore, the description of the results of the controls carried out. In fact, the audit report must explain whether or not the balance sheet describes the equity and financial situation, the economic result and the changes in the balance sheet according to the accounting standards or the reason behind the inability opinion. At the end, the report must indicate the conformity of all the documents forming the financial statements (the balance sheet, the income statement, the supplementary notes), to the result of the audit of accounting entries and the business reality.

The audit report is of interest to the shareholders, the board of directors and anyone who has requested an audit for the purposes of acquisition, financing or for other purposes, therefore, the audit opinion forms an integral part of the documents of the financial statements and, consequently, becomes part of the stakeholders' store of information.<sup>8</sup>

In general, then it can definitely be said that the opinion expressed by the auditor on the financial statements is not an opinion of the truthfulness, but an opinion of the correctness of the business system; in fact the audit

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<sup>8</sup> Freeman, R. (2007). *Teoria Degli Stakeholder*. Italia: Franco Angeli.

controls are designed to ascertain that all the business facts recorded and entered in the accounts are reflected in the summary documents and then in the financial statements and that the budget evaluations have been made following the correct accounting standards.

The final opinion is defined as being professional, independent and made by a responsible person :

- possessing knowledge and skills certified by registration on the professional role ;
- a third party compared with the company under audit, even if shareholders are responsible for his mandate;
- who undersigns the audit report thus taking responsibility for the control activities.

Therefore, in view of the statements made above, it seems necessary to clarify the responsibility of the statutory auditor for the judgment he must express on the audited financial statements.

In this respect, it seems appropriate to specify that the auditor does not participate in the management or the choices of the business administrators; therefore, he may not criticise the appropriateness of the choices made by the administrators or prevent them from carrying out specific operations. The auditor must only check that the financial statements reflect the effects of the company's operations and that they have been updated as provided by the rules.

Consequently, the responsibility for the drawing up of the financial statements lies with the administrators, while the auditors are responsible for the professional opinion expressed on the financial statements in the audit report<sup>9</sup>.

This responsibility that lies with the auditor, not only as a "worker" but also as a man who is clearly not a public official, but who still performs a function of public interest, also depends on his independence, in the sense of

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<sup>9</sup> Rossi, G. (2008). *La Revisione Aziendale, teoria e procedure*. Italia: Giuffrè.

an instrument by means of which he can demonstrate that he carries out his tasks with objectivity and objectiveness.

So, the auditor's role to provide a guarantee raises some issues that can be identified by two aspects: on the one hand, the importance of a level of independence, characterised by greater powers for auditors and by a regulation of fees which are, in any case, currently granted by the "employer"; that is the company which entrusts the auditor with the task of expressing an opinion on its financial statements. On the other hand, there is a need to raise the quality of the control activity by clarifying the relations between various corporate bodies, defining generally accepted rules of the profession<sup>10</sup>, as well as intensifying the quality controls on auditors themselves by extending the boards of management and control for all groups concerned.

Therefore, the auditor can be identified as an individual or a company which performs a function of public interest as the correctness of the elements and accounts of the financial statements concerns all the civil and economic Community.

## **2. The Auditing of IAS/IFRS financial statements: some details**

In general, the auditor is called initially to identify the inherent risks linked to balance sheet accounts based on the IFRS knowledge of the company's management and on the client's knowledge and his conversion plan (facilitated by the completion of the work programme on the IFRS conversion process); the size and composition of the accounts and the size, volume and complexity of the operations.

Furthermore, the auditor must determine the significant accounts, particularly with regard to their materiality under the two sets of accounting principles, because when checking the initial balance sheet, the opening balances drawn up according to no IAS rules must be taken into

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<sup>10</sup> These ethical rules should define the limits of the auditor's responsibility.



consideration together with the re-exposition accounts for the conversion as well as the opening balance sheet according to IFRS principles; the complexity of operations; the complexity of the accounting treatment introduced by IFRS.

In order to identify in advance the preparation procedures for the first IAS/IFRS balance sheet, the options selected according to IFRS 1 and the options for recurrent accounting processing must be pinpointed and their impact on the opening balance sheet (bearing in mind the dates of application for IAS 32/39 and IFRS 4).

Finally, the auditor must assess the quality of the audits implemented for these preliminary procedures and then verify these controls and "inherent risk" assessments.

Let us now analyse the main revision techniques linked to the most significant and innovative methods of evaluation established by IAS/IFRS.

### 2.1 Company Assets between cost and fair value

According to IAS 16, a fixed asset must initially be valued at cost which includes the costs of "direct attribution" (costs directly attributable to commissioning, import duties and purchase tax). Any depreciation, trade discounts and rebates must be deducted.

From the second year of possession, the optional fair value criterion can be adopted. According to this method, the cost of the asset is aligned with the fair value at the beginning of each financial year, attributing the revaluation to net equity reserve accounts; subsequently, the asset is subject to depreciation and the annual quotas will have a variable value.

In contrast with the provisions of Italian Gaap accounting principles for example, the entry in the accounts occurs when the benefits and risks are assigned to the company regardless of the official transfer of the property.

During auditing procedures, the auditor is expected to understand the method developed by the company to determine the fair value, the related information and the relevant control activities that must be adequate to identify and assess the risk of significant errors regarding assertions and to configure and apply the auditing procedures according to the risks that are identified and evaluated.

In some cases, the estimation of the fair value and, therefore, the method used by the company management for its determination, can be simple and reliable. For example, when the management refers to official quotations to determine the fair value of negotiable shares held by the company. Some estimates of the fair value are, however, more complex by nature and include uncertainties regarding future events and their outcome.

In these cases, individual assumptions necessarily become part of the fair value establishment procedure. The auditor's understanding of the estimation process, including its complexity, helps to identify and assess the risk of significant errors so as to determine the nature, timing and extent of the auditing procedures in relation to the identified risks. Auditors must assess whether the fair value calculations and the related budget information have been drawn up in accordance with the regulatory framework applicable to the company's financial information.

Moreover, the auditor has to comprehend this regulatory framework with regard to the financial information applicable to the company, the activities carried out by the company and the economic area in which it deals, together with the results of all the other auditing procedures performed. In addition, he must evaluate the suitability of the accounting principles applied to the assets and liabilities of the balance sheet requiring an estimation of the fair value and the adequacy of the informative notes to the financial statements concerning these estimations and any significant uncertainties associated with them.

The auditor's assessment of the fair value calculations and the evaluation made of the elements of proof depends, to a certain extent, on the auditor's knowledge of the business.

This is particularly true where the assets or the liabilities estimated or the evaluation method applied have particularly complex characteristics.. For example, in the assessment of certain, very complex financial derivatives, there is a risk that different interpretations of the fair value methodology adopted may lead to different assessments. The fair value estimation of certain items such as the cost of research and development "in progress", may require special consideration that is influenced by the characteristics of the enterprise and by its operating system. In addition, understanding the activities performed by the company and bearing in mind the results of other auditing procedures may help the auditor to identify activities for which the company management is obliged to acknowledge losses of value through the fair value method according to the regulatory framework concerning the financial information applicable to the enterprise.

When the management selects a particular method of evaluation from amongst the various methods provided for by law on the financial information applicable to the company, the auditor must understand the reasons behind the choice of that method by discussing it with the directors. During the audit, the auditor may need to acquire, either with the company or autonomously, elements of proof using reports, opinions, estimates and certificates issued by an expert. To decide whether the work of an expert is needed, the auditor must consider:

- the importance of the budget items examined;
- the risk of error, on the basis of the nature and complexity of the issue examined;
- the quality and quantity of other elements of proof made available.

If the auditor calls in an expert, he must obtain sufficient and appropriate proof that the expert's work is adequate for the purposes of the audit and that it is consistent with the International Audit Standards (ISA) n. 620<sup>11</sup>.

It is also necessary to determine whether the definition of fair value to which the expert refers and the method that he uses to determine the fair value are in line with the definition given by the management and with the regulatory framework of the applicable financial information.

For example, the method used by an expert to estimate the fair value of a property investment or of a complex financial derivative, may not be coherent with the evaluation principles provided for by the regulatory framework of financial information. The auditor usually considers these aspects by discussing or reviewing the content of the instructions given or analysing the final report together with the expert.

In accordance with ISA n. 620, the auditor evaluates if the work carried out by the expert provides appropriate elements of proof. The expert is responsible not only for the reasonableness of the assumptions but also the adequacy of the methods used and their proper application. On the basis of his knowledge of the business and the evaluation of the results of other auditing procedures, the auditor must acquire an understanding of the significant assumptions and methods used by the expert, evaluating their adequacy, completeness and fairness. The auditor often assesses these aspects after discussing them with the expert.

## 2.2 Leasing Assets

The criteria for taking account of the goods received in leasing must be based on accounting principles, giving due consideration to the particular characteristics of the contract in force. The auditor must consider that, for financial statements not drawn up according to IAS/IFRS methods (for example, the Italian GAAP method), the leasing must necessarily be

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<sup>11</sup> Bruni (A cura di). (2004). *Revisione aziendale e di bilancio*. Isedi.

included in the accounts with the "capital approach method", while IAS 17 establishes, in addition to this method, the prevalence of the substance of the operation, which is substantiated in the "financial leasing"<sup>12</sup>.

With regard to companies receiving goods by leasing, the auditor must consider the application of the following control procedures:

- a) Verification of the proper accounting and representation in the financial statement of the capital, financial and economic aspects of the contract dealings in accordance with the accounting principles;

In particular, in non-IAS/IFRS financial statements, the auditor must check that the company has registered the lease rates amongst the "costs for enjoyment of goods of third parties". In actual fact, the ownership of the property will only be indicated at the time of redemption, a value being entered in the balance sheet that is well below the real value of the goods; moreover the depreciation of the goods has been calculated only from the date of redemption, on a very small value.

For the IAS/IFRS financial statements, on the other hand, the auditor must verify that for the goods acquired on a leasing contract, the company has entered the depreciated value of the goods in the assets of the balance sheet, while the amount of the residual debt has been entered in the liabilities; the depreciation charge and financial charges is to be entered in the income statement.

- b) Verification of the existence of the goods and its condition of use;
- c) direct confirmation by the lessor of the debt due for leasing rates, interests, duration of the contract and other relevant data;
- d) verification of the proper representation in the balance sheet of the necessary information relating to the terms of the leasing contract, financial commitments undertaken by the company, etc.

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<sup>12</sup> Alexander, N. (2008). *Financial Accounting*. Pearson.



### 2.3 Impairment test

Corrections for a loss of value do not represent a novelty for accounting principles or a new requirement. However, both the European and national accounting standards (Italian Gaap for example) contain only a few specific and detailed indications supporting this general principle. IFRS rules, on the other hand, provide explicit provisions on the reduction of the value and the principle can be summarised as follows: if circumstances occur that indicate a possible loss of value of an asset, it is necessary to verify its ability to generate cash flows through its use or sale<sup>13</sup>. This verification will produce an amount which must be compared with the carrying value of the assets and, if the carrying value is higher, the difference will be detected as the correction of value.

The purpose of the impairment test is to ensure that the tangible assets are not entered in the budget at a value exceeding their recoverable amount. The provisions of the principle that indicate the methods for determining such a correction, and the relevant calculations, are detailed and fairly complex. This is the reason why during auditing it is important for the auditor to rely on the experts' reports.

If the auditor makes use of the work of an expert, he must obtain sufficient and appropriate elements of proof that the expert's work is adequate for the purposes of the audit and that it is consistent with International Audit Standard n. 620<sup>14</sup>.

### 2.4 IAS 19 Employee Benefits

Point n.2 of the introduction to IAS 19 identifies five categories of employee benefits :

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<sup>13</sup> Alexander, N. (2008). *Financial Accounting*. Pearson.

<sup>14</sup> According to the document, the auditor must assess whether the work of the expert constitutes an appropriate test element in asserting the report of the budget to which it relates.

1. short-term benefits (within 12 months) for the remuneration of services rendered by employees in the financial year (wages, holidays, social contributions, etc.);
2. post-employment benefits (such as pensions, medical coverage, etc.) classified in two subcategories based on their economic substance :
  - defined contribution plans: the employer pays a default amount of contributions to a separate fund and he has no legal obligation concerning the payment of further contributions, if the fund does not have sufficient assets to provide the benefits to employees, for the current and previous periods;
  - defined benefit plans: all the post-employment plans which do not fall within the description of defined contribution plans;
3. other long-term benefits (other benefits for senior members of staff such as bonuses for seniority, loyalty bonus, etc.) that differ from post-employment benefits and severance benefits at the end of professional relationships and which are not due within 12 months from the end of the period in which the employees render the related services;
4. termination benefits - i.e. "parachute" contracts, severance payments, allowances for resignation, early retirement, etc.;
5. salary benefits in the form of shares of the company's capital.

The duty of an auditor or firm of auditors regarding the validation of the opening balance is to examine the procedures put into effect to identify the types of benefits to employees and classify these benefits.

Furthermore, it is the auditor's task to perform an audit (evaluation or control of data or procedures):

- an actuarial assessment (with basic information, actuarial assumptions and recalculations);
- an assessment of the IFRS restatement at the transition date.
- an assessment of the corresponding notes to the financial statements.

Given the highly technical nature of these impacts, actuarial experts must be involved in the audits. Also in this case, if the company subjected to an audit relies on an external actuary, ISA 620 is to be applied.

### 3. IAS/IFRS Critical ratings

The introduction in the Italian legal system of IAS/IFRS accounting standards, following the decision of the European Union in 2002, was a "Copernican revolution" in the drawing up of financial statements, especially for the actual purpose of this accounting document.

These new principles have advantages and disadvantages, but an important result has been achieved: they have created a "corpus" of fundamental accounting rules that are coordinated and recognised internationally on a qualitative level in response to the need for greater clarity and comparability of budgets in order to provide the public with increasingly effective and true information.

Nevertheless, the recent financial crisis has made it clear that, until today, the scale and quality of accounting information have proved to be inadequate in enabling financial statement users to judge the appropriateness of the decisions taken by administrators.

So if the estimates are not verifiable, the managers will use this non-accountability" in order to manipulate the results of the financial statements as appropriate.

In addition, the financial crisis has been accelerated by a serious lack of confidence in the financial statements, as an instrument for representing the actual state of health of a company.

The loss of confidence in financial statements has made the market lose an essential reference to which the "core" ratings of debt and risk financial instruments can be anchored. This can be said to be one of the main causes (in addition to the lack of cash flow) which prevents prices (including stock

exchange prices) from expressing reliable indications of value. The IAS/IFRS are, in fact, a still largely unfinished accounting system. It is now the standard setters' duty to remedy the situation. In the latter context, the real challenge is the regulated application of current accounting principles. Let us now see the main critical points linked to the most important methods of IAS/IFRS evaluation.

### 3.1 The concept of Fair Value

It is important to underline that the concept of fair value constitutes the main element of innovation introduced by International Accounting Standards, applied as an alternative to the model of historical cost. The traditional accounting model is based on historical cost, as "a sure parameter", instead of the current value that, in some cases, provides less legal certainty and, therefore, may lead to some risks.

The adoption of fair value involves a transition from a structure of "income produced in the exchange and for the exchange" to a wider configuration of income that can be defined as "potentially produced income". The reason for this is because on one hand, it entails the entry in the balance sheet of values appropriate to the market value or to the changes in the use of the capital elements, while on the other hand, it involves registering the profits and losses arising just from the variations in the value that have taken place during the financial year, in the income statement.<sup>15</sup> So by sanctioning the prevalence of the principle of competence over that of prudence, the fair value opens the way for continuous revaluations and devaluations of some elements of the capital and recording of profits that are not realised. It is usually thought that the figures shown with the cost method, net of depreciation, are reliable, sure, but obsolete, and do not allow a company's actual net worth to be calculated. In fact, the net worth has

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<sup>15</sup> Rossi, C. (2003). Riflessi sulla tradizione economico-aziendale italiana della nuova strategia contabile elaborata dall'Unione Europea. *Il Nuovo Management*, 1-27.

changed from the moment of the acquisition of goods due on the basis of experience and self-generated goodwill. On the contrary, the figures shown at fair value are volatile and change with each balance sheet, taking into account the external quotations, thus making the results of the business subject to modifications of the market.

Basically, we can say that the fair value has a greater relevance compared with the historical cost, as it does not provide only data that statistically reproduce events and reports regarding the past, but it allows the investor to obtain dynamic, forward-looking information, in other words containing a set of evaluations and forecasts on the income and financial prospects of the company.

On the other hand, this system relies heavily on the free discretion of directors, so that it does not protect the stakeholders from the risk of improper over-estimations with the consequential entry in the budget of dubious or even non-existent capital gains. These problems, which it would be wrong to overlook, must be resolved by implementing appropriate and specific controls.

Indeed, it must be emphasised that it is not the fair value that offers less guarantees compared with cost, but is the seriousness of the editors of a financial statement and that of the controllers which offers the greatest guarantees: therefore, the auditors will be called to pay greater attention and to carry out better and more specific controls.

On the other hand, even the budgets compiled using only the cost are often drawn up without regard for the most basic rules and indicate unrealistic and untruthful activities<sup>16</sup> or even activities that are not what they are made out to be.

Even the cost, if incorrectly interpreted, is not representative of the business reality.

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<sup>16</sup> Many times we forget that even in the Italian GAAP, for example, the immobilization, material, intangible and financial, the date of the closure of the financial year, is permanently of value less than that determined using the cost, must be entered in this lowest value and, therefore, must be devalued.



Therefore, it can be said that like the cost, the fair value must be correctly interpreted and represented. It is an estimate, like all the assessments of financial statements and, as an estimate, it must respect the general principle that presides over the formation of the financial statements: in other words, it must provide a true and fair view.

The report on this regulation states that the true and fair view requires editors of financial statements to determine the estimates correctly and to represent the result. This does not mean asking the editors for, or promising readers of financial statements an objective truth, that is unattainable with regard to the estimated values. Basically, the estimates are expected to be reliable<sup>17</sup>.

Therefore, we can certainly conclude that the fair value is more significant than the historical cost in relation to investment decisions; on the other hand, with regard to reliability, the historic cost certainly provides more guarantees than the fair value.

This justifies the reason why in the current economic climate, wide reference is made to the fair value, i.e., the current market values in order to limit the impact that the crisis of the financial markets can produce on corporate budgets, in particular with regard to derivatives.

In a situation in which the value of the stock market shares has recorded significant losses in recent months, without, however, finding immediate correspondence in the reduction of companies' performance margins, it may be that the market quotation is not the most correct reference to be taken into consideration to estimate the fair value.

To remedy, even if only temporarily, this misalignment between the value deducible from the market and the fair value, it has been proposed to extend the case in question using technical evaluations (mark to model)<sup>18</sup>. The "fair value" dogma wavers because the "mark to market" principle is far from perfect and it was right to suspend it temporarily given the current

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<sup>17</sup> RosciniVitali. (2003). *Ias e fair value: motivazioni della scelta*. FiscoOggi.

<sup>18</sup> Zingales. (2008, ottobre 15). I nodi del mark to market e le modifiche agli accordi di Basilea. *Norme e Tributi*.

market situation. However, we must not exaggerate in the opposite direction. The possibility that "mark to market" could condemn solvent companies does not mean that all insolvent companies are in this situation because of the "mark to market". On the contrary, the vast majority are insolvent due to inappropriate financial or business choices, but they like to use "mark to market" as a scapegoat. Therefore, it is important that a temporary solution does not become permanent, to the disadvantage of market transparency.

### 3.2 Leasing and the prevalence of economic domain over the legal domain

Another principle characterising the IAS/IFRS system is the principle of the prevalence of economic domain over legal domain. This principle states that to be reliable, information must accurately represent the facts concerning the company; for this purpose it is necessary that "the transactions and other events are relevant and represented in accordance with their substance and economic reality and not only in accordance with their legal form"<sup>19</sup>. Therefore, within the framework of international accounting standards, it is established that the situations in which the correlation between the substantial and the formal legal business operation is not perfect, the preponderant criterion for entry in the accounts is represented by economic substance. The actual importance of the criterion within the non IAS/IFRS accounting system (the Italian GAAP for example), is significantly reduced compared with the IAS/IFRS system: in fact, on an applicative level, it works only if it is not in conflict with other regulations, , therefore, in a residual way. This derives from the fact that the principle in question has been inserted in a legal context inspired by completely different concepts such as those of formality, the schematic quality and rigidity of the system: it is not just by chance that some speak of

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<sup>19</sup> Dezzani, F. (2007). I principi Ias/Ifirs: il "reddito prodotto" ed il "reddito potenziale". *Impresa c.i.* (10), 1329.

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"prevalence of the legal form over the economic substance"<sup>20</sup>. A practical reference concerning the varying scope of the principle in question in the two accounting systems is certainly represented by the way leasing operations are dealt with in the accounts. In the non IAS/IFRS system (Italian GAAP for example), the leasing operations have always been introduced with the capital approach, not permitting the emergence of the operation over the form itself. In international accounting practices (IAS 17), the financial method has, as always, been provided for. In fact, IAS 17 provides for the accounting by entering the depreciated value of the goods in the Assets of the balance sheet, while the amount of the residual debt must be written in the liabilities. Thus, the depreciation allowance and the financial charges must be entered in the income statement.

Basically, the provision absorbs the goods in leasing into those belonging to the company; this is because, from a financial point of view, in other words for those who have an interest in receiving information on the profitability and company cash flows – it is only possible to understand if the risks and benefits of the goods pass into the user's hands, while it is indifferent as to whether it corresponds to a formal ownership of the goods.

The two methods for setting off the leasing lead to different ratios in the analysis of the budget the level of indebtedness of the company with the setting off of the leasing according to the financial method is higher than it would be in the budget calculated with the capital method for the lease. Furthermore, the capital approach produces distortive effects in financial and patrimonial positions, since the fixed assets, as well as their depreciation, are understated, obscuring in the financial statements the real extent of the assets used in the production process, as well as the real cost of financing. On the other hand, the costs for the "enjoyment of third party goods" will be overestimated in the income statement.

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<sup>20</sup> Dezzani, F. (2007). I principi Ias/Ifirs: il "reddito prodotto" ed il "reddito potenziale". *Impresa c.i.* (10), 1329.

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The capital of operative method privileges the contractual aspects of leasing operations, without considering either the commitment to buy, or the aspect connected to the financing.

It is clear, therefore, that the capital approach contrasts with the true legal nature that is indeed recognisable in a particular form of financial intermediation reflected in a quite atypical contract, with mainly a financing function.

### 3.3 The subjectivity of the evaluation in impairment test

The regulated application of the international accounting principles, in other words the phase that the English call the enforcement of IAS/IFRS principles, in times of crisis, means, above all, guaranteeing that the impairment test is exercised correctly. This can be guided by economic issues, or by budget targets. Of course, the test is reliable when it is guided only by economic factors; this happens when it is able to represent the company's prospective economic conditions objectively, although they are uncertain, through a rigorous process of "mark-to-expectations". The impairment test should be able to allocate as quickly as possible, in the company's financial statements, the real loss of value actually suffered due to bad financial investments and not yet fully apparent, relying on private information available only to the managers.

So the problem is to prevent the impairment test from becoming a subjective process with which companies can keep overstated assets in the budget. The audit firms are called to face this challenge of austerity and discipline, as well as the supervisory authorities for listed companies, the national accountancy bodies in their guiding role for the regulated application of IAS/IFRS rules and, finally, the advisers called to assist companies in the performance of impairment tests. All of them should promote greater quality in the impairment test which is too often carried out in an approximate way and with inadequate skills, on the basis of very



fragile evaluations and without the necessary evidence of data coming from outside, in forms that are often self-referential.

### 3.4 IAS 19 Employee Benefits (The "manipulation" of Employee Benefits)

IAS 19 requires that liability is updated, to take into account of the time that will pass before actual payment, a period that entails a reduction in the sum owed. As the updating brings the evaluation forward, it seems right to consider also the fact that the payment will be for a larger amount than the one currently set aside. In other words, if the evaluation is moved forward in time, it is logical to consider the impact of all the elements involved in this future projection. This approach appears to be the most convincing, also with regard to the setting up of international accounting standards, and the objectives pursued. To interpret IAS/IFRS correctly, it is always necessary to dwell not only on the operational methods of applying the rules, but also and above all on the informational objectives that this legislation is designed to achieve.

As far as the risk of "manipulation" of the financial statement results is concerned, resulting from a choice of an "ad hoc" value of the parameters of the actuarial model, we can say that the risk actually exists. In certain cases, the choice and the correct quantification of some of the variables needed for the evaluation can lead to very different estimates (while respecting the requirements of IAS 19). The changes in the rates (within credible values) may cause a reduction of the liability by as much as 15%-25%<sup>21</sup>. In this respect, it is clearly necessary for observations to involve a greater degree of objectivity.

IAS 19 allows the actuarial calculation to be excluded if the benefit of the information provided to the user of the financial statements is not very relevant compared with the cost incurred for calculating it.

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<sup>21</sup> Dezzani. (2007). Principio IAS 19. TFR: trattamento contabile secondo lo IAS 19. *Il Fisco* (37), 1-54.



The logic of IAS is theoretically correct, because, after determining the debt accrued at the end of the year, it seeks to calculate the outlays there will be in the future, in correspondence with the staff leaving the company and then updates all the details at the time of the financial statements.

The weak point lies perhaps in the complexity of the actuarial calculations required, based on the seniority of the population, on the rate of the company's turnover, on staff leaving incentives and on many other parameters analysed in previous chapters; finally, the complexity is even more closely linked to the volatility of the result obtained that is sensitive to even slight changes in the parameters of estimation.

#### 4. The effect of critical IAS/IFRS ratings on the audit process

The innovation introduced by IAS/IFRS accounting standards not only requires a new way of managing a company's information assets, but also a reconfiguration of application systems according to a logic as far as possible compliant with IAS. This logic also has repercussions on auditing, the main aim of which is to obtain evidence of the correspondence of the business year budget to the formal and essential requirements of "clarity" and language and "fairness" in the application of the fundamental principles of editing. In other words, the audit report expresses the professional opinion on the accuracy and veracity of the financial statements in representing the company's situation.

According to G. Bruni, the question of fair presentation does not depend only on the individual and selected criteria of evaluation applied, but on the relationship between an overall vision of the company's situation and its representation in the respective balance sheet accounts. The problem for those who must verify and analyse the budget is to have the cultural and

professional capacity and the necessary experience to fully understand the complex company phenomenology<sup>22</sup>.

In this field it is also to be considered that the difficult economic and marketing conditions, produced by the serious financial and economic crisis have recently been added to the complexity of the calculations and the provisions of the international principles. . This is particularly relevant in the drawing up of audit reports, forcing the auditor to rely more heavily on an expert's report, as provided for by the International Audit Standard n. 620.

An auditor's training and experience prepare him on general business matters , but we cannot expect the auditor to have the knowledge of someone who has been specially trained or empowered to exercise another profession or activity like that of actuary or engineer for example.

When the auditor avails himself of the work of a specialist, employed by the audit firm, he must use this work assuming that his employee has performed the task as an expert, rather than as an audit assistant (in which case the provisions of ISA 220 "Quality Control for Audit Work " will be applied).

Consequently, in these circumstances, the auditor must implement appropriate procedures to evaluate the quality of work done by their expert and the results achieved, but it is not normally necessary for the auditor to check the competence and specialisation of the employee for each task.

The auditor must assess substantially whether the results of the expert's work are properly reflected in the financial statements or support the assertions by checking the sources of the data used, the working methods adopted and their coherence with the previous periods, in addition to the results of the expert's work, in the light of a general knowledge concerning the activities performed by the company.

So in conclusion, it has to be noted that the complexity of the international practice makes it essential to involve an expert just to enable the auditor to

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<sup>22</sup> Bruni (A cura di). (2004). *Revisione aziendale e di bilancio*. Isedi.

elaborate a professional opinion about the accuracy and truthfulness of the financial statements in the representation of the business situation.

#### 4.1 The Financial Crisis of 2008

Another important element of the effect of IAS/IFRS critical ratings on the auditing process is the financial crisis of 2008 that hit companies adopting the accounting principles of fair value in the yearly balance sheet. This generates some indirect and dreaded aspects, amongst which we can mention, above all, the generation of artificial volatility as an effect of fair value accounting. In addition, mention can also be made of the increase of responsibilities and risks involving company administration and control bodies and an increase in the risks weighing on the investors of an inappropriate application of the accounting principles.

The reason for this is the nature of the IAS/IFRS, being standards based on principles and not on rules. The application of principles as opposed to the application of rules, requires discretion (suffice it to mention, for example, the principle of the prevalence of economic domain over legal domain): the principles, in fact, merely establish "what to do" without going into detail about "how to do it".

The absence of rules in a crisis on the financial markets generates insecurity in directors and auditors. The natural desire of business administrators and the board of control is to limit the exposure to risk of budget choices, judged ex-post to be excessively conservative (as the crisis worsens) or excessively aggressive (in the case for example in which the devaluations of the budget lead to a drastic reduction in dividends), and, in any case, an answer must be found in a complex accounting system, still to be put in place.

The crisis has made it more evident that the interpretation of the principles to ensure proper accounting representation is quite different to just the simple application of detailed accounting rules. Indeed, it requires more

judgement and more competence; it cannot be delegated as much in its application or controls and requires more transparency in order to justify the choices made; it is more easily subject to errors and, therefore, requires more rigorousness.

In the second week of October 2008, IASB intervened on the question of accounting principles. The Agency adopted a measure according to which, under exceptional circumstances, the ban imposed by IAS 39 concerning the transfer of financial activities from the fair value category to another category in which the accounting is made following the depreciated cost method can be lifted.

The amendment of the accounting principles represented the response to an urgent need to prevent companies from having to enter the losses accrued immediately in the phase of exceptional market depreciation.

All this indicates that IAS/IFRS lead to assessments that do not fully meet the need for a fair view in the financial statements.

The question is what value can the audit opinion have if the object on which it is based is not entirely true? To answer that question it is necessary to understand the value of an audit opinion.

#### 4.2 The Value of an Audit Opinion

The auditing of a balance sheet can be defined as a set of controls and procedures which, with a succession of logical steps, allows the auditor to affirm the conformity of the financial statements to the rules of editing, interpreted and complemented by generally accepted accounting principles<sup>23</sup>. The professional opinion of the auditor on the clarity, truthfulness and correctness of the representation of the profit, financial and patrimonial situation of the company under audit, concerns both the

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<sup>23</sup> Campedelli (A cura di). (1996). *Analisi dei rischi rilevanti nella revisione aziendale. Principi e applicazioni*. Torino,: Giappichelli.

evaluation of the reliability of the financial statements as well as the efficacy and efficiency with which the company has been administered. To be able to affirm that, the auditors must verify each item of the budget, by studying and checking the existence, the completeness and the methods of evaluation, acquiring each element of proof deemed necessary for the purpose.

However, auditing cannot provide an absolute guarantee of the reliability of the financial statements as it is designed to provide reasonable assurance that the entire budget is not vitiated by significant errors.

For this purpose, attention must be paid to the auditor's responsibility for mistakes, fraud or illicit acts because too often non-practitioners believe that auditors must discover all the mistakes, fraud or illegal acts.

As ISA n.240 says *"The auditor is responsible for the planning and implementation of audit to obtain reasonable assurance that the budget is devoid of significant errors, whether caused by errors or fraud. Because of the nature of the documentation of auditing and characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, certainty of having discovered the significant errors. The auditor must not plan and carry out the auditing to obtain reasonable assurance that he has discovered the errors not significant in order to the financial statements, whether caused by errors or fraud".*

It is, therefore, possible for an auditor to carry out an audit in accordance with the revision principles and issue an unqualified opinion but, the financial statement may, in any case, contain significant errors.

The auditor is not, therefore, liable if he issues an unqualified opinion about a budget that also contains significant errors, unless failure to discover these errors is due to negligence or incompetence.

However, the degree of diligence that must be applied by auditors has still to be defined. The prevailing theory tends to consider that the minimum



limit of diligence to which an auditor should refer coincides with the application of the audit standards, as the ISA themselves suggest<sup>24</sup>.

In practice, however, it is rather binding to believe that non-compliance with the revision principles is always evidence of negligence. It would indeed seem more appropriate to consider the principles as a guideline to which a judge may decide to refer in an attempt to assess the diligence of the auditor's behaviour.

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<sup>24</sup> ISA 200 "Objective and General Principles Governing an Auditing of Financial Statements"

## Conclusions

In the light of the introduction of IAS/IFRS principles, this paper has investigated the role of the auditor as a professional whose function is essentially to reduce the gap in information and credibility between the demand and supply of financial instruments<sup>25</sup>; he acts, therefore, as a gatekeeper<sup>26</sup>, who reduces the agency cost of corporate governance<sup>27</sup>.

In fact, the auditor has less incentives to deceive the public as his profit depends only on remuneration for his professional services and in the possibility of obtaining additional appointments dependent on the maintaining of his reputation.

Although his role requires him to act as a third party, the auditor is chosen and remunerated by the audited company. This may affect his skill and integrity, as the auditor through his opinion, may seek the consent of the audited company. So the danger may be summed up by the proverb "Whose bread I eat, his song I sing".<sup>28</sup>

The question then is to minimise the danger that the relationship between the auditor and the audited company may cause to the quality of the audit opinion. If we consider the latest financial cracks such as Enron, Worldcom and Parmalat, we can say that the danger is real. The auditing and accounting failures of these cases have brought public trust in the auditor's profession<sup>29</sup> to an all time low.

However, the whole thing has led to significant steps to ensure the auditors' honesty<sup>30</sup>. Over the last few years, regulations have been introduced in order to extend the auditors' liability and limit the conflict of interests

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<sup>25</sup> We know that IAS/IFRS are mainly applied to financial statements of listed companies

<sup>26</sup> Cox, J. D. (2006). The Oligopolistic Gatekeeper: The U.S. Accounting Profession. After Enron: Improving Corporate Law and Modernizing *Securities Regulation in Europe and the U.S. Paper No.117*. Oxford: Duke Law School Legal Studies.

<sup>27</sup> Presti, G. (2007). La responsabilità del Revisore. *Banca borsa titoli di credito* (2), 160.

<sup>28</sup> Presti, G. (2007). La responsabilità del Revisore. *Banca borsa titoli di credito* (2), 160.

<sup>29</sup> Brewster, N. (2003). Unaccountable: How the Accounting Profession Forfeited a Public Trust. *Hoboken: John Wiley & Sons.*, 283.

<sup>30</sup> Galbraith, J. K. (2004). The Economics of Innocent Fraud: Truth for Our Time. *Allen Lane*.

between the auditors and the audited companies. Amongst these regulations mention should be made of the Sarbanes-Oxley Act in the U.S.A., the Business Corporation Act in Canada, the Securities and Investment Commission Act in Australia, the Company Law Reform Bill in the U.K. and the recent law on the auditor's tax liability in Italy. All this brings greater attention to financial markets, providing a better guarantee for the stakeholders rather than the company management.

However a question arises, "Will this mean that accountants will be trained to focus on the "boulder" of financial performance at the expense of the "pebbles" of people management, quality and thought leadership"?<sup>31</sup>

If this were the case, auditors and accountants may not be ready to change their social contracts and their roles. This would lead to a reduction in the appointments of the more successful audit firms, with a consequent opening of the way to auditors with less experience. This could lead to a drop in the level of professionalism rather than a development of the same.<sup>32</sup>

From this point of view, the introduction of new auditing procedures linked to the expression of an audit opinion on IAS/IFRS financial statements may lead to further uncertainties regarding the auditor's role and position.

In fact, as described, IAS/IFRS lead to some critical factors in evaluations that do not allow the auditor to express himself with absolute certainty on the true and fair view of the financial statements. For example, if there is no reference market, it becomes difficult to express an opinion on the fair value or the impairment test not to mention the evaluation of employees' benefits that are linked to complex parameters on which it is difficult to make an objective judgement.

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<sup>31</sup> Toffler, B. L. (2003). *Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen*. New York: Broadway Books.

<sup>32</sup> Carnegie, G. D., & Napier, C. J. (2006). The Portrayal of accounting and accountants following the Enron Collapse. *Eighth Interdisciplinary Perspectives on Accounting Conference*. Cardiff.

All this makes auditors trust and put their professionalism in the hands of "experts", who may give them objective parameters for valuing IAS/IFRS accounts. However, a question still remains: who chooses and judges the expert's work? As far as the points mentioned above on the role of the auditor are concerned, it would be easy to assign experts who are "Friends" so that they direct their evaluations towards results required by the auditor or by the audited company.

Consequently, the experts' work in the evaluation of accounts on IAS/IFRS financial statements also becomes of public interest. In this case too, the extension of the expert's liability and reputation may restrain personal evaluations, driving them towards the maximum impartiality of judgment. It can, therefore, be stated that the greater use of experts' work in the auditing of IAS/IFRS financial statements may lead to a "sharing" of the responsibility amongst more people. This may bring more reassurance: the assessments are based on the trustworthiness and professionalism of more than one person. To survive on a market on which the transparency of the balance sheets and the assessments reign supreme, the people involved tend to be as objective as possible to ensure stakeholders. .

It is also true, however, that sharing responsibility with more people may lead inevitably to a reduction of professionalism. So auditors leaving most of the evaluations on IAS/IFRS accounts to experts, are led to reduce their own duties as far as possible. The question still remains concerning the incidence of the expert's work in auditing of IAS/IFRS financial statements. This issue leads perhaps to a broader problem that the "Masters" were already trying to solve in the last century: i.e. the truthfulness of financial statements<sup>33</sup>.

How can an IAS/IFRS financial statement, based on assessments that are not always objective, express a true and fair view? Consequently, how can an auditor issue a clear opinion on something that perhaps is not so clear?

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<sup>33</sup> Zappa, G. (1950). *Il reddito di impresa. Scritture doppie, conti e bilanci di aziende commerciali*,. Milano: Giuffrè,. Amaduzzi, A. (1962). *Sviluppi delle teorie contabili. Rivista dei Dottori Commercialisti* (4).

These issues may seem provocative but they are important for understanding the auditor's role on the financial market. So further research must be carried out on the truthfulness of IAS/IFRS financial statements and on audit procedures.



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Dipartimento di Economia Aziendale  
Università degli Studi di Bergamo  
Via dei Caniana n° 2  
24127 Bergamo  
Tel. 0039-35-2052526 - 538  
Fax -0039-35-2052549

La Redazione ottempera agli obblighi previsti dall'art. 1 del D.L.L. 31.8.1945, n. 660 e successive modifiche

Stampato nel 2009  
presso la Cooperativa  
Campus Italia s.c.  
di Bergamo