

# XBRL will be Audited

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## 1 Background

About two years ago, the CFO of a large firm told me that his company would not participate in the SEC's XBRL Voluntary Filing Program until he had assurance over the XBRL (eXtensible Business Reporting Language) that his firm would provide to the SEC. He knew that the SEC did not require assurance, and that the XBRL would be "furnished not filed". None the less, he would not publically participate until he knew that his financial reports in XBRL would not contain any errors. He did this by having his staff perform their own assurance engagement based on the guidance provided by the PCOAB in 2005. When I asked him why, he said "It's not the SEC that requires the assurance; I require the assurance".

Earlier this year the Securities and Exchange Commission (SEC) in the United States released a "Proposed Rule" recommending a timetable for the adoption of XBRL (eXtensible Business Reporting Language) for reporting by SEC registrants. Notably missing from the SEC recommendations is the requirement for reports provided in this new format to be audited or reviewed as is required for current SEC filings.

Concurrently the SEC has been running a Voluntary Filing Program (VFP) in which filing companies have been encouraged to provide XBRL versions of the financial statements. Participants in the SEC's existing VFP are not required to have any assurance provided over their VFP filings. On March 19, 2007, at the SEC Interactive Data Roundtable [page 59 of the transcript: <http://www.sec.gov/spotlight/xbri/xbri transcript031907.pdf>], Chairman Cox of the SEC said that to require assurance over these filings would be "crib death" for the voluntary program, and potentially for their XBRL initiative.

Still smarting from their terrible underestimation of the costs that Sarbanes-Oxley (SOX) would impose on businesses, the SEC has taken every opportunity to emphasis the low cost of XBRL implementation. The shock of assurance costs of SOX, and the fact that assurance over XBRL is such an unknown, has probably been one of the major reasons for the SEC to avoid the subject of assurance over XBRL.

The accounting industry has also, primarily from a lack of a deep understanding of XBRL by their professional standards groups, coupled with "standards overload", have not developed guidance on how to provide assurance over XBRL.

This lack of clarity has resulted in a lack of guidance for industry, and is leading to some people stating that assurance over XBRL filing will not be required, that auditing firms will not want to provide that assurance, or that filing companies will be unwilling to request or pay for such assurance.

The introduction of XBRL for financial reporting to regulators and as the primary source of information used by investors will turn the XBRL "version" of the financial statements into the primary version, or at least the version that investors will rely on. Fundamentally a failure to provide an audit opinion on the version of the financial statements that are used as primary statements by the investor community would certainly undermine the very assumption that there is a need to an audit in the first place.

### **2 Auditor Conservatism**

Auditors by nature are a conservative, cautious bunch. Not only are they trained to be, but their standards specifically state that they are required to be. In addition, when companies fail, frequently shareholders, clients and creditors go looking for the deepest pockets, and frequently that includes the auditors. All firms carry significant reserves for potential legal costs, knowing that any claim, even if not supported by a court, can still result in millions of dollars in costs to the firm.

And of course there is the still-fresh memory of the collapse of Anderson, one of their peers. All the major firms are now homes to large numbers of former Anderson partners and staff, and to these individuals, caution and risk are both real, and have had a painful impact on them.

The best way to minimize the risk of a lawsuit is to ensure that the auditor has traced all financial statement figures all the way back to source transactions. Needless to say this is not possible, and therefore the concept of "materiality" comes into play. All "material" financial statement figures will be confirmed to a level of granularity such that the auditor can have some confidence that the figures are accurate.

So when considering the work to be performed by the auditor, there is a natural desire, from the perspective of minimizing their risk, to expand the scope of audit work to cover as much potential risk as possible.

### **3 XBRL as a new Risk**

If there is anything that is certain, it is that the introduction of XBRL, a new reporting technology that today is fairly poorly understood by either the auditor or the filer, will be viewed as an area of significant potential additional risk. New technology brings new risks. New technology impacting so directly on the role of the auditor, and therefore on the level of risk carried by the auditor, will be perceived as bringing significant additional risk to the auditor.

It will be the auditing standards professionals in the accounting and auditing firms that understand the risk, or at least understand that the uncertainty associated with new technologies applied to financial reporting will increase their risk.

So we should expect the professional standards and risk management functions within the auditing firms to insist on auditing the XBRL as well, or refusing to provide an opinion on the rest of the financial statements in any other format. When the provision of XBRL becomes mandatory, the auditor that says "okay, we'll only audit the html version of the financial statements" will be taking on a huge level of risk.

Picture the court room. On the stand is the audit partner who signed off on the opinion. "So can you please tell the court why you chose not to audit the information that your own literature has been saying for years will be the information that will actually be used by the investor to make investment decisions?" I doubt that is a question that any audit partner will want to have to answer.

It stands to reason then that we should expect auditors to take the most cautious approach when presented with the question of whether to audit the XBRL or not to audit the XBRL.

### 4 Role of the Audit

So what is the role and purpose of the audit? Simply put, to provide an independent opinion on the financial statements as provided by a company. Note that this includes both publicly held and privately held companies, as audits are performed on the financial statements of privately held companies and provided to their financial institutions.

The audit provides comfort to the regulator and investor that the financial statements, when taken as a whole (an important concept that we'll come back to) provide a fair and accurate representation on the state of the business. Various regulators require audits of companies' financial statements, and banking institutions require audited financial statements from their non- public clients.

It is worth remembering that to the reporting company the audit itself is overhead of the purest type. It is a cost of doing business that cannot be avoided, and with Sarbanes-Oxley it can no longer be offset by financial benefits identified by the auditor while performing related or even unrelated engagements. This naturally creates conflict between the company purchasing audit services (and what they are willing to pay) and the extent of work that the auditor feels compelled to perform in order to provide the audit opinion.

The client wants to keep audit fees to an absolute minimum, yet also wants to ensure that adequate work was performed to enable them to sign their SOX declarations with confidence. Again we go back to the courtroom. This time the CFO is in the witness box, and it is the CFO's turn to feel uncomfortable. "So can you please explain to the court why you thought it would be acceptable to only have assurance on the printable version of the accounts, but not on the version that is actually used by investors? What were you trying to hide?"

With this picture firmly in mind, while they will not want to see any increases in their audit fee, it is pretty clear that CFOs will either agree to inclusion of the XBRL in the audit scope, or they may even ask for the XBRL submissions to be included in the scope of the audit.

Clients and auditors may simply decide that there is too much risk in providing unaudited XBRL to the SEC, regardless of the SEC's currently not requiring such an audit.

### 5 The SEC's Game

The SEC does not want to state categorically that XBRL data is subject to a requirement for assurance. They have gone so far to as to recommend that the XBRL that is required to be provided by companies will actually be treated as "furnished", as is currently the case with the Voluntary Filing Program.

In an extract from the SEC's proposed rule on Interactive Data (XBRL), page 63, they state "We expect that each filer would be in the best position to determine the appropriate manner in which to assure the accuracy of the interactive data it would be required to submit and the viewable interactive data that would result. We also expect that software providers and other private sector third parties would help develop procedures and tools to help in that regard. As an adjunct to those private sector efforts, we plan to make available to filers, on an optional basis, the opportunity to help assure accuracy by making a test submission with the Commission or using software we provide to create viewable interactive data."

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Basically the SEC is saying that it is up to the filer to determine the level of assurance that they require, thus being able to say to the markets that XBRL does not require assurance, and therefore the unknown expenses associated with an audit are not the responsibility of the SEC to estimate.

## 6 What Assurance Might Look Like

The author does not represent any accounting or auditing firm, but did spend four years as an active member of the AICPA and XBRL International working groups on assurance and XBRL. Contributing to these discussions and the outputs of these two groups has led to the following thoughts.

Auditors will include the XBRL instance documents that will be provided to the SEC as part of their audit scope. They will, for a first year or two struggle with the concept of materiality. What is material in the XBRL world? The mis-tagging of a piece of information might be material if it influences the analysis of reported information.

Companies should expect the auditor to begin by including the processes that exist to create the XBRL version of the financial statements (and footnotes) as part of the SOX 404 internal controls review. This should, frankly, be an insignificant addition to the overall audit.

With regard to the stability of the XBRL mapping, today there is an assumption that once a company has created a template for tagging their financial statements (having mapped all financial statement line- items to their respective XBRL elements) that there should be few changes to the tagging in future periods. However, a company may chose to change their tagging, and such a change of tagging between periods, while perfectly accurate XBRL, may raise auditor flags, and therefore become "material".

So, should the auditor look at every financial statement element and confirm the choice of XBRL taxonomy element? Were every line item on a financial statement checked to source, this would impose a significant burden on the auditor and company. Would any change to the default XBRL element labels to reflect the actual labels or line item titles used by the filer constitute a material change worthy of review? Will all changes to the presentation order or calculations be considered "material"? Thus we should expect to see auditors determining how they will perform their sampling of which elements they will review in detail.

As a rule of thumb, companies should expect that all company specific extension elements will be treated as material, and the requirement for the extension will need to be documented by the company. Discussions within the various XBRL assurance working groups seemed to arrive at a consensus that where a company creates an extension element instead of using an existing taxonomy element that represents the same accounting principle, such extension elements would "cause a problem for the auditor" and may impact the auditor's willingness to provide a clean opinion.

So, companies should be asking their auditors early in the process to explain exactly how they will be including XBRL in their audit, and the expected impact that this will have on overall audit cost and activity, and they should also ensure that the auditor is able to clearly provide them with a list of all information that will be required by the auditor to make the audit of the XBRL as smooth as possible (bearing in mind that the auditor cannot participate in any of the XBRL creation or tagging choices made by the company).

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Auditing of XBRL will happen, and companies should take the opportunity presented by the lead-in time before XBRL is mandatory to ensure that their assurance provider is as ready as they will need to be.

### **RAAS Consulting Ltd Risk Management, Sustainability, XBRL**

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This article first appeared as a blog entry on the Hitachi XBRL blog in September 2008.