Chapter 1

An overview of the Australian external reporting environment

Review questions

1.1 Refer to pages 6 to 25 of the text. The main bodies responsible for regulating accounting disclosure in Australia are:

(i) Australian Securities and Investments Commission (ASIC)

Briefly, ASIC is responsible for administering corporations legislation within Australia (which includes various reporting requirements). According to its own website, the role of the ASIC is to enforce and regulate company and financial services laws to protect consumers, investors and creditors.

(ii) Australian Accounting Standards Board (AASB)

The role of the AASB is to develop a conceptual framework. It is also responsible for 'making' accounting standards that have the force of law under the corporations legislation, as well as formulating accounting standards that are to be used by reporting entities that are not governed by corporations legislation, inclusive of entities operating in the not-for-profit sector and public sector entities. The AASB is also responsible for Interpretations Advisory Panels, user focus groups and project advisory panels.

As was indicated in this chapter, however, a great deal of the responsibility for developing accounting standards to be released by the AASB is in the hands of the IASB, as is the development of the conceptual framework. It is to be anticipated that only minor changes would be made to standards being released by the IASB before they are subsequently released within Australia as AASB standards (for example, the changes might involve adding more explanatory material to the Australian standard, or to add additional requirements in relation to not-for-profit or public sector entities). The AASB reports to the Financial Reporting Council (FRC). Once an AASB-released accounting standard is in place, corporate directors are required to ensure that the company's financial statements comply with the requirements of the standard (where applicable).

(iii) Australian Securities Exchange (ASX)

The ASX provides numerous disclosure requirements for entities listed on the securities exchange. The principal aim is to help ensure that information is disseminated in an efficient and timely manner. According to the ASX's website (as accessed July 2012):

> ASX Group (ASX) is an umbrella brand developed to reflect the role of ASX Limited as the holding company of a group with a diverse range of market service activities linked by a common commitment to provide the infrastructure Australia needs to create a globally competitive capital market and a vibrant, robust economy.
>
> ASX Group was created by the merger of the Australian Stock Exchange and the Sydney Futures Exchange in July 2006 and is today one of the world's top-10 listed exchange groups measured by market capitalisation.
>
> ASX is a multi-asset class, vertically-integrated exchange group whose activities span primary and secondary market services, including the raising, allocation and hedging of capital flows, trading and price discovery (Australian Securities Exchange); central counterparty risk transfer (via subsidiaries of ASX Clearing Corporation); and securities

settlement for both the equities and fixed income markets (via subsidiaries of ASX Settlement Corporation).

ASX functions as a market operator, clearing house and payments system facilitator. It also oversees compliance with its operating rules, promotes standards of corporate governance among Australia's listed companies and helps to educate retail investors.

The domestic and international customer base of ASX is diverse. It includes issuers (such as corporations and trusts) of a variety of listed securities and financial products; investment and trading banks; fund managers; hedge funds; commodity trading advisers; brokers and proprietary traders; market data vendors; and retail investors.

In addition to its role as a market operator, ASX relies on a range of subsidiary brands to monitor and enforce compliance with its operating rules. These subsidiaries are:

- Australian Securities Exchange—handles ASX's primary, secondary and derivative market services. It encompasses ASX (formerly Australian Stock Exchange) and ASX 24 (formerly Sydney Futures Exchange)
- ASX Clearing Corporation—is the brand under which ASX's clearing services are promoted. It encompasses ASX Clear (formerly the Australian Clearing House) and ASX Clear (Futures) (formerly SFE Clearing Corporation)
- ASX Settlement Corporation—is the brand under which ASX Group's settlement services are promoted. It encompasses ASX Settlement (formerly ASX Settlement and Transfer Corporation) and Austraclear
- ASX Compliance—is the brand under which services are provided to the ASX Group for the ongoing monitoring and enforcement of compliance with the ASX operating rules. This entity replaces ASX Markets Supervision.

The oversight work performed by ASX's subsidiaries ensures that it provides fair and reliable systems, processes and services that instil confidence in the markets that depend on its infrastructure.

Confidence in the operations of ASX is reinforced by the market supervision and regulatory role undertaken by the Australian Securities and Investments Commission (ASIC) across all trading venues and clearing and settlement facilities, as well as through the Reserve Bank of Australia's oversight of financial system stability. ASIC also supervises ASX's own compliance as a listed public company.

(iv) Financial Reporting Council (FRC)

The FRC oversees the operations of the AASB. It also appoints the members of the AASB (other than the chairperson). The FRC, however, is not to direct the development of accounting standards by the AASB, or to veto accounting standards that are released by the AASB.

1.2 The International Accounting Standards Board (IASB) releases International Financial Reporting Standards (IFRS). IFRS are adopted directly by some countries, whilst others (such as Australia) release standards under the name of their domestic accounting standard setter but based upon the standards issued by the IASB. For a detailed overview of the workings of the IASB, students should review the IASB's website. The IASB also has a committee known as the International Financial Reporting Interpretations Committee (IFRIC) that reviews accounting issues that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance, with a view to reaching consensus on the appropriate accounting treatment. Its recommended treatment is included within 'Interpretations'.

1.3 The auditor acts as an independent reviewer of the financial statements presented by a reporting entity. Being independent, the auditor is expected to provide an objective assessment as to whether, in the auditor's opinion, the financial statements have been prepared in conformity with the various accounting and other reporting rules applicable to the reporting entity. The auditor, in a sense, provides greater credibility to the financial statements and allows financial statement users to rely upon the statements with greater confidence. With greater confidence, the financial statement users may attribute lower risk to a reporting entity, and this in turn may translate to the reporting entity being able to attract funds at a lower cost than may otherwise be possible. Hence, although the reporting organisation will have to pay for the audit, the benefits of attracting greater funds at a lower cost (because of a perception that the information about the organisation is more reliable or credible) might more than offset the costs associated with the audit. In this regard it should be noted that prior to the introduction of legislation which required certain forms of organisations to have their financial statements audited, many organisations chose to have their financial statements audited because of the perceived benefits. Where there are perceived conflicts of interest between different parties within the organisation (for example, between owners and managers) the auditor can act to arbitrate on the reasonableness of the accounting rules and assumptions adopted by the managers.

With this said, it should also be emphasised that an unqualified auditor's report (that is, a report that does not indicate any departure from accepted or mandated accounting procedures) does not give assurance that all transactions have been correctly accounted for, or that the entity is assured of being viable in the future. Also, it is conceivable that the credibility of all audit firms will not be deemed to be the same, such that if financial statement users consider that an auditor is of low 'quality' then an audit report produced by such an auditor may be of limited value. Lastly, it should be stressed that the preparation of the financial statements is the responsibility of management and the auditor will not make any changes to those reports: the auditor's role is to give an opinion on the statements (for example, that they are true and fair and comply with applicable accounting standards).

1.4 This question may be answered in terms of a 'free-market' versus a 'pro-regulation' perspective about the provision of accounting information.

Many academics argue in favour of a free-market approach. By this, we mean that there is a belief the market forces of supply and demand should be allowed to freely operate to determine the equilibrium amount of accounting information to be provided. It is considered in this argument that if the users of accounting reports demand information but it is not being supplied, then this will be priced in to the amount they will charge the firm for the factors of production they supply to the firm (for example, equity capital). If an individual is able to obtain the demanded information then this may lead them to reduce the risk they attribute to the investment, which may translate to a lower required return on their investment. In a sense, the price they pay for the information is the reduction in required return they demand as a result of being provided with the information (which reduced their risk). The firm is predicted to supply information to the point where the benefits of providing the information (perhaps in terms of lower cost of capital) equals the costs of providing the information (which of course assumes that the managers of an organisation have quite a sophisticated grasp of market economics). It has also been argued by proponents of the free-market argument that because there will often be conflict between the various parties associated with an organisation (for example, owners and managers) then accounting reports will be produced which are designed to minimise the conflict and the associated costs of the conflict. It has also been argued that managers are best placed to select accounting methods that best reflect the financial performance and position of their particular organisation, and hence it is inappropriate and inefficient to impose regulation upon them which restricts the accounting methods they might choose to use.

There is also an argument that in the absence of regulation, organisations would still be inclined to disclose information in case various external parties construe that the entity has something to hide (the 'market for lemons' argument).

Advocates of a regulated approach would, by contrast, argue that a free market approach is flawed for a number of reasons. Firstly, the producers of the information cannot typically control its dissemination. Parties, such as competitors, analysts and the like, will obtain the information, but will not directly pay for it (they are deemed to be 'free-riders'). The free-rider problem may, in an unregulated environment, lead to a reduction in the supply of information due to an understatement of demand. Further, although in the long run market forces may operate, it may be that organisations have created significant social costs in the meantime. For example, the disclosure of environmental information within annual reports—that is, pollution emissions, clean-up costs, etc.—is not currently required in Australia. Research evidence, however, suggests that there are many financial statement users who may be interested in such information (for example, to assess the appropriate risk rates). It may be that sooner or later the market will punish those firms that do not provide information (in the absence of information the market may assume that there is bad news to report); however, significant costs may have been imposed on society by this time.

The 'free-market' approach to financial reporting also ignores issues associated with stakeholders' 'right-to-know' about certain aspects of an entity's operations. Stakeholders without financial resources (and perhaps the 'power' to demand financial information) may simply be ignored in the information dissemination process, yet they may nevertheless be affected by the operations of the organisation. Introducing regulation might also have the effect of increasing confidence in the capital markets, which might be construed as being in the 'public interest'.

1.5 The existence of this differential reporting requirement for small and large proprietary companies is based on the assumption that the limited number of parties with a material interest in 'small' companies would conceivably be able to request information to satisfy their specific needs. However, it is assumed that the majority of stakeholders in 'large' companies do not have this ability.

As organisations become larger there tends to be greater separation between ownership and management (or, as this is often termed, between ownership and control) and owners tend to become more reliant on external reports in order to monitor the progress of their investment. Further, as an entity increases in size, its *economic* and *political* importance increase, and in general this increases the demand for financial information about the entity.

Also, requiring small organisation to fully implement IFRSs imposes a disproportionate burden on them in a situation where the benefits associated with the extensive disclosures do not necessarily exceed the costs. In part, this has been addressed in recent years by the June 2010 release of AASB 1053 *Application Tiers of Australian Accounting Standards*. AASB 1053 introduced a two tier reporting system for entities producing general purpose financial statements. Tier 1 general purpose financial statements are financial statements that comply with all relevant accounting standards. Tier 2 comprises the recognition, measurement and presentation requirements of Tier 1 but substantially reduced disclosure requirements.

In relation to which entities are required to apply Tier 2 reporting requirements, paragraph 13 of AASB 1053 states:

The following types of entities shall, as a minimum, apply Tier 2 reporting requirements in preparing general purpose financial statements:

(a) for-profit private sector entities that do not have public accountability;

(b) not-for-profit private sector entities; and

(c) public sector entities, whether for-profit or not-for-profit, other than the Australian Government and State, Territory and Local Governments.

These types of entities may elect to apply Tier 1 reporting requirements in preparing general purpose financial statements.

Therefore, for example, if a proprietary company is not deemed to be small (thereby not satisfying the 'let-out' provisions included at section 296(1A) of the *Corporations Act*) then it must, at the least, prepare Tier 2 financial statements.

1.6 Generally accepted accounting procedures (GAAPs) are those rules and practices that have changed and developed over time and are accepted at a point of time by the majority of accountants. Across time, generally accepted accounting practices become incorporated within accounting standards, with accounting standards being developed through a consultative process in which many parties from Australia and elsewhere give their viewpoints through formal submissions and other avenues. Accounting standards constitute a subset of GAAPs.

1.7 Within the Directors' Declaration, required pursuant to s. 295(4) of the *Corporations Act*, directors must state whether, in their opinion, the financial statements comply with accounting standards, and that the financial statements give a true and fair view of the financial position and performance of the entity. Importantly, directors must also state whether or not in their opinion there were, when the declaration was made out, reasonable grounds to believe that the company would be able to pay its debts as and when they fall due. Specifically, s. 295(4) states:

The directors' declaration is a declaration by the directors:

(c) whether, in the directors' opinion, there are reasonable grounds to believe that the company, registered scheme or disclosing entity will be able to pay its debts as and when they become due and payable; and

(d) whether, in the directors' opinion, the financial statement and notes are in accordance with this Act, including:

(i) section 296 (compliance with accounting standards); and

(ii) section 297 (true and fair view); and

(e) if the company, disclosing entity or registered scheme is listed—that the directors have been given the declarations required by section 295A.

Should directors make such a declaration fraudulently, carelessly or recklessly, it is possible that they might become personally liable for any outstanding debts of the company.

1.8 The ‘true and fair’ requirement is a qualitative reporting requirement. A current problem is that our qualitative requirement to present true and fair financial statements is very unclear as there is no definitive explanation of what it means. There is no legal definition of ‘true and fair’. Even though the *Corporations Act* requires directors to make sufficient disclosures to ensure that financial statements present a ‘true and fair’ view, it provides no definition of the concept. Nor has the Australian accounting profession provided definitive guidelines relating to truth and fairness.

It is generally accepted that it would be unrealistic to assume that specific disclosure rules or accounting standards could be developed to cover every possible transaction or event. For situations not governed by particular rules or standards, the ‘true and fair view’ requirement is the *general criterion* to assist directors and auditors to determine what disclosures should be made and to consider alternative recognition and measurement approaches. Although there is no definition of ‘true and fair’ in the *Corporations Act*—which is perhaps somewhat surprising—it would appear that for financial statements to be considered true and fair, all information of a ‘material’ nature should be disclosed so that readers of the financial statements are not misled. Also, there would be a general assumption that the financial statements comply with the relevant accounting standards and other generally accepted accounting principles. However, ‘materiality’ is an assessment calling for a high degree of professional judgment.

1.9 The process for developing accounting standards is explained on the IASB’s website. The IASB releases International Financial Reporting Standards (IFRS). In developing an accounting standard the IASB often initially establishes an Advisory Committee for a particular issue. The Advisory Committee provides advice on the issue to the IASB, after which time the IASB might decide to release a Discussion Document for public review and discussion. The Discussion Document might then be followed by an Exposure Draft, which would also typically be released for public comment (although sometimes they release a ‘staff draft’ which is not released for comment). Following this process the IASB might then release an IFRS. As can be seen, throughout the process of developing an IFRS there is generally plenty of scope for various stakeholders to voice their opinions about the issue. The AASB will provide direct input into the IASB’s accounting standard-setting process. For some topics it is to be anticipated that an accounting standard developed by the AASB might be used as a major basis for the development of an IFRS.

Whether the views of the respective stakeholders are actually reflected in the final IFRS is an interesting issue (and there are various theories that can be used to predict how the views of different stakeholder groups might be reflected in the final IFRS). Students should be encouraged to think about which stakeholder groups they believe would be most likely to influence (or capable of influencing) the accounting standard-setting process.

1.10 The International Financial Reporting Interpretations Committee is a committee of the IASB. It is the official ‘interpretative arm’ of the IASB. The IASB website states that the International Financial Reporting Interpretations Committee (IFRIC) reviews, on a timely basis, accounting issues that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance, with a view to reaching consensus on the appropriate accounting treatment. While IFRIC provides guidance on issues not specifically addressed in IFRS, it also provides Interpretations of requirements existing within IFRS. The Interpretations cover both newly identified financial reporting issues not specifically addressed in IFRSs and issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop in the absence of authoritative guidance, with a view to reaching consensus on the appropriate treatment.

Given that so many countries have now adopted IFRS, a central objective of IFRIC is to achieve consistent Interpretations of IFRS by IFRS-adopters internationally. If IFRS were interpreted differently within each country, the purpose and benefits of promoting one set of global accounting standards would be diminished. Indeed, the aim of global uniformity in interpreting financial reporting requirements has meant that many national standard-setters have disbanded their own domestic Interpretations committees. For example, within Australia, the AASB disbanded the Urgent Issues Group (which was formerly the Australian equivalent of IFRIC) because the AASB considered that disbanding the UIG helped to ensure that IFRS are being adopted consistently on a worldwide basis.

Within Australia, Interpretations issued by IFRIC, and then in turn by the AASB, are given the same authoritative status as accounting Standards. The Interpretations can be found on the websites of the IASB and AASB.

1.11 Within Australia, Interpretations issued by IFRIC and by the AASB are given the same authoritative status as accounting standards by virtue of AASB 1048 *Interpretation and Application of Standards*, issued by the AASB. AASB 1048 clarifies that all Australian Interpretations have the same authoritative status. Australian Interpretations comprise those issued by IFRIC as well as those issued by the AASB, together with those that were issued by the Urgent Issues Group (a former committee of the AASB, which has been disbanded) and that have been retained for use. As the section entitled 'Main Requirements' within AASB 1048 states:

> *This Standard identifies the Australian Interpretations and classifies them into two groups: those that correspond to an IASB Interpretation and those that do not. Entities are required to apply each relevant Australian Interpretation in preparing financial statements that are within the scope of the Standard.*
>
> *In respect of the first group (Table 1), it is necessary for those Australian Interpretations, where relevant, to be applied in order for an entity to be able to make an explicit and unreserved statement of compliance with IFRSs. The IASB defines IFRSs to include the IFRIC and SIC Interpretations.*
>
> *In the second group (Table 2), this Standard lists the other Australian Interpretations, that do not correspond to the IASB Interpretations, to assist financial statement preparers and users to identify the other authoritative pronouncements necessary for compliance in the Australian context.*
>
> *The Standard will be re-issued when necessary to keep the Tables up to date.*

For Interpretations to be mandatory within the Australian context they need to be listed within tables included within AASB 1048. AASB 1048 will be reissued as and when necessary to keep the tables up to date and to give force to newly released Interpretations.

1.12 The functions of the IASB are described on pages 35 to 37 of the textbook as well as on the IASB's website. The IASB's website states:

> In March 2001, the International Accounting Standards Committee (IASC) Foundation was formed as a not-for-profit corporation incorporated in the State of Delaware, US. The IASC Foundation is the parent entity of the International

Accounting Standards Board, an independent accounting standard-setter based in London, UK.

On 1 April 2001, the International Accounting Standards Board (IASB) assumed accounting standard-setting responsibilities from its predecessor body, the International Accounting Standards Committee. This was the culmination of a restructuring based on the recommendations of the report *Recommendations on Shaping IASC for the Future*.

The IASB structure has the following main features: the IASC Foundation is an independent organisation having two main bodies, the Trustees and the IASB, as well as a Standards Advisory Council and the International Financial Reporting Interpretations Committee. The IASC Foundation Trustees appoint the IASB members, exercise oversight and raise the funds needed, but the IASB has sole responsibility for setting accounting standards.

The International Accounting Standards Board is an independent, privately-funded accounting standard-setter based in London, UK. The Board members come from many countries and have a variety of functional backgrounds.

The IASB is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. In addition, the IASB co-operates with national accounting standard-setters to achieve convergence in accounting standards around the world.

As of July 2012 there were 15 Board members, each with one vote. The Trustees appoint the Board members. The IASC Foundation Constitution (as revised December 2010) provides that:

> The main qualifications for membership of the IASB shall be professional competence and practical experience. The Trustees shall select members of the IASB, consistently with the Criteria for IASB Members set out in the Annex to the Constitution, so that it will comprise a group of people representing, within that group, the best available combination of technical expertise and diversity of international business and market experience in order to contribute to the development of high quality, global accounting standards. The members of the IASB shall be required to commit themselves formally to acting in the public interest in all matters. No individual shall be both a Trustee and an IASB member at the same time. *[Paragraph 25]*
>
> The Trustees shall select IASB members so that the IASB as a group provides an appropriate mix of recent practical experience among auditors, preparers, users and academics. [*Paragraph 27*]

As it develops International Financial Reporting Standards, the IASB follows a rigorous, open due process.

In commenting on the structure of the IASB, the website states:

> The structure is designed to support those features that are regarded as desirable in establishing the legitimacy of a standard-setting organisation: its members are technically expert, represent the wider community and are independent.

The structure achieves its purpose by a balance of the functions of the various parts of the organisation, through the operational relationship shown in the diagram. The composition of the oversight body (the Trustees of the International Accounting Standards Committee Foundation), the advisory body (the Standards Advisory Council) and the interpretative body (the International Financial Reporting Interpretations Committee) represents the wider community by reflecting a diversity of geographical or professional backgrounds and membership of the standard-setting body (the International Accounting Standards Board) is based on the principles of technical competence and independence.

1.13 A taskforce of the Institute of Chartered Accountants in Australia suggested that directors be permitted, as they were some years ago, to elect not to comply with accounting standards if they considered compliance with the standards was not in the interests of presenting true-and-fair financial statements (that is, to reintroduce the 'true-and-fair over-ride system'). Some possible advantages and disadvantages of this initiative would be:

Advantages:

- creates flexibility for those situations where an accounting standard is not particularly suited to particular transactions or circumstances
- allows management to select its own accounting methods, which may enable it to prepare financial statements which more efficiently reflect the financial performance and financial position of the entity. (It is a common argument that imposing accounting standards upon reporting entities and thereby restricting the portfolio of available accounting methods will mean that some accounting methods which are deemed to be particularly appropriate to particular situations may no longer be allowed.)

Disadvantages:

- allows too much flexibility/discretion for managers and therefore would tend to provide some scope for opportunism
- creates problems for inter-firm comparison if some entities elect not to comply with accounting standards
- creates problems in terms of comparing results across periods in which directors elect not to comply with accounting standards
- reduces the objectivity of financial statements.

1.14 There are a number of potential impediments to the international standardisation of accounting standards, including:

- Harmonisation or standardisation requires the release of many exposure drafts, new accounting standards, and the revision of many existing accounting standards. This in itself is very costly. However, there are many other 'indirect' costs. For example, preparers must learn the new rules, as must readers (including analysts and regulators). The costs for a company to switch to IFRS can be significant and could be an impediment to a country embarking on a process of harmonisation.
- To date, there is limited empirical support for the view that standardising domestic accounting standards with International Financial Reporting Standards will actually

lead to inflows of foreign capital. Without such evidence, various parties within a particular country may be less inclined to support the standardisation process.

- A great deal of existing research has sought to explain international differences in accounting standards on the basis of differences in cultures between countries (although as countries embrace IFRS these differences obviously decline). That is, culture seems to explain international variation in accounting standards. For example, some countries may have cultures that are inclined towards secrecy (and therefore, limited disclosures), whereas other countries may have cultures inclined towards transparency (and therefore greater disclosures). To impose the same accounting standards on all (with a particular level of disclosure) ignores these cultural differences and may, in the long run, provide a reason why standardisation may be more successful in some countries than others.

1.15 This is a very interesting issue. As we could appreciate, the decision by the FRC would have resulted in great costs to Australian business in terms of learning about new accounting requirements and in changing accounting systems so as to accommodate the new requirements. Whether the associated benefits exceeded the costs is a difficult issue to support one way or the other. There is a general view held by bodies such as the IASB that it is preferable that every country ultimately should have the same accounting standards in place. This will make international comparison of performance easier. There is also a view that international standardisation will increase the inflow of foreign capital. (Is this a reasonable assumption that is supported by any empirical evidence?) Another view is that the process will reduce the reporting costs of Australian companies that are required to provide reports to foreign jurisdictions.

1.16 There were many significant changes as a result of Australia adopting IFRS. Page 31 of the text provides a number of examples. These changes had a significant impact on profits and assets in some entities. Given the magnitude of the impact of adopting IFRSs on corporate financial statements, it would have been useful for reporting entities to tell financial statement readers, in advance, about the consequences of adopting IFRSs for subsequent corporate financial performance and financial position reporting. This would have reduced the 'shocks' that were felt when the IFRS-compatible financial statements were first applied. To this end, the AASB issued an exposure draft in December 2003 entitled ED 129 'Disclosing the Impacts of Adopting Australian Equivalents to IASB Standards'. This exposure draft culminated in the release of AASB 1047 in April 2004. The accounting standard required the reporting entity to provide, in advance, an explanation of the impacts of the adoption of IFRSs on the financial statements of the reporting entity. The standard ceased to operate following first-time adoption of IFRSs. Within the accounting standard, which has since been withdrawn, it was stated:

> *Adoption of IASB Standards in 2005 may have significant impacts on the accounting policies of Australian reporting entities and their reported financial position and financial performance. The aim of this Standard is to provide users of financial reports with relevant and reliable information in the period leading up to 2005 about the impacts of changes in accounting policies resulting from implementing Australian equivalents to International Financial Reporting Standards (IFRSs), that is, AASB equivalents to IASB Standards.*

Subsequent to the release and subsequent withdrawal of AASB 1047, the AASB released AASB 1 *First Time Adoption of Australian Equivalents to International Financial Reporting*

Standards. This standard, which applied to the first reports released after the initial adoption of IFRSs, required (par. 38) that:

> *An entity shall explain how the transition from previous GAAP to Australian equivalents to IFRSs affected its reported financial position, financial performance and cash flows.*

Challenging questions

1.17 (a) One motivation for providing a set of figures using a preferred-accounting approach is that management may honestly believe that the particular accounting requirements embodied within a particular accounting standard are not appropriate to a particular entity, and that they do not allow management to appropriately report its entity's performance and financial position. Alternatively, management may seek to provide a separate set of figures to highlight a result that is favourable. In practice, differentiating between the various motivations may not be an easy task.

(b) The approach adopted by QBE is not, strictly speaking, in contravention of the *Corporations Act*. Section 297 requires the directors to add such information and explanations as will give a true-and-fair view. If directors maintain that the additional information is necessary to give a true and fair view then they are not in contravention of the law.

However, they could appear to be emphasising, inappropriately, particular figures over and above those that would be generated with the adoption of the applicable accounting standards.

1.18 As mentioned in Chapter 1, there is no clear definition of 'true and fair'. Although the *Corporations Act* makes it a requirement that financial statements be true and fair, it does not define what this qualitative requirement actually means. Hence, it would be particularly difficult to prove that financial statements were *not* true and fair. This view is consistent with the views of McGregor (1992, p. 70), as quoted on page 21 of the textbook.

1.19 Answers vary with years and company chosen.

1.20 There have been several key changes in financial reporting regulation since 1997 that reflect a movement away from self-regulation by the accounting profession to a government-regulated model. Prior to CLERP reforms, the Australian Accounting Research Foundation (AARF), a body funded jointly by CPA Australia and the Institute of Chartered Accountants, had a significant role in standard setting. The AARF's Public Sector Accounting Standards Board issued standards for the Australian public sector. This role has since been taken over by the AASB. The AASB reports to the FRC, whose members are appointed directly or indirectly by the Treasurer. The AARF formerly provided the secretariat to the AASB; the AASB now has its own secretariat. The responsibility for the Auditing and Assurance Standards Board was also transferred from the AARF to the AASB. Hence there has been a move away fro a private sector entity (AARF – now disbanded) developing accounting standards to a government body (AASB) developing accounting standards.

1.21 Various organisations in the public and private sector are required to follow IFRS. For example, in the Australian private sector, the following types of entities are required to follow IFRS:

- listed entities
- unlisted public companies
- large proprietary companies
- small proprietary companies if directed to by shareholders or the ASIC.

The companies that are more likely to realise the proposed benefits [that follow from using IFRS] of comparability, reduced barriers, reduced reporting costs and reduced costs of capital are those companies that are listed on foreign securities exchanges, in particular exchanges in countries that have also adopted international financial reporting standards; companies followed by analysts; and companies with subsidiaries in countries using international financial reporting standards. It is difficult to believe that small proprietary companies would have achieved any real benefits from being required to change to IFRS.

1.22 This is a question that has been asked to stimulate debate. There is no absolute answer. Students should consider whether it does make sense to encourage all countries of different cultures, histories and religions to conform with particular corporate disclosure regulation when there is no expectation that there should be any form of global uniformity in corporations legislation or business laws. Wouldn't uniformity of business laws also help the international transfer of capital? Should the Australian government seek to change Australian business laws so that they become consistent with major trading nations, and should this happen even if we think our rules are superior prior to any convergence? Or do we accept that cultural, religious, historical and other reasons preclude changing corporate laws when such impediments were not sufficient to stop the global push towards converging accounting regulations? Is there some lack of consistency here?

1.23 Proponents of a free-market perspective on accounting regulation typically believe that accounting information should be treated like other goods, with demand and supply forces being allowed to operate to generate an optimal supply of information about an entity. In support of this view it is argued that:

- Even in the absence of regulation, there are private economics-based incentives for the organisation to provide credible information about its operations and performance to certain parties outside the organisation, otherwise the costs of the organisation's operations would rise. This view is based on a perspective that the provision of credible information allows other parties to monitor the activities of the organisation. Being able to monitor the activities of an entity reduces the *risk* associated with investing in the entity, and this in turn should lead to a reduction in the cost of attracting capital to the organisation.
- It has also been argued that there will often be conflicts between various parties with an interest in an organisation, and accounting information will be produced, even in the absence of regulation, to reduce the effects of this conflict.
- If an entity that borrows funds also agrees to provide regular financial statements to the providers of the debt capital (the debtholders), this ability to monitor the financial performance and position of the borrower will reduce the risks of the lender. This

should translate to lower costs of interest being charged and hence provide an incentive for the borrower to provide financial statements even in the absence of regulation.

- Managers of the organisation will be best placed to determine what information should be produced to increase the confidence of external stakeholders that the information being presented reflects the financial position and performance of a reporting entity (thereby decreasing the organisation's cost of attracting capital). Regulation that restricts the available set of accounting methods will decrease the efficiency with which information will be provided. This in turn leads us to question whether the 'one-size-fits-all' assumption inherent in the requirement that all entities apply the same accounting standards is applicable or appropriate in all circumstances particularly where there are major differences between the various organisations applying the accounting standards.
- Certain mandated disclosures will be costly to the organisation if they enable competitors to take advantage of certain proprietary information.
- Even in the absence of regulation, external parties would demand that financial statement audits be undertaken. If such audits are not undertaken, financial statements would not be deemed to have the same *credibility* and, consequently, less reliance would be placed on them. If reliable information is not available, the risk associated with investing in an organisation might be perceived to be higher, and this could lead to increases in the cost of attracting funds to the organisation.
- In the absence of regulation, organisations would still be motivated to disclose both *good* and *bad* news about an entity's financial position and performance. Such a perspective is often referred to as the 'market for lemons' perspective (Akerlof 1970), the view being that in the absence of disclosure the capital market will assume that the organisation is a 'lemon'. That is, *no information* is viewed in the same light as *bad information*. Hence, even though the firm might be worried about disclosing bad news, it is assumed that the market might make an assessment that silence implies that the organisation has very bad news to disclose (otherwise, it would disclose it). This 'market for lemons' perspective provides an incentive for managers to release information in the absence of regulation, as failure to do so will have its own implications for the organisation. That is, 'non-lemon owners have an incentive to communicate' (Spence 1974, p. 93).

1.24 The international standardisation of financial reporting does assume that a 'one-size-fits-all' approach is appropriate. That is, it assumes that globally, all users of financial statements have the same demands and expectations in relation to financial information. This does seem to be somewhat naïve and does ignore a great deal of literature that suggests that different cultures have different information demands and expectations. A number of researchers have explicitly questioned the relevance of 'Western-style' standards to the needs of people within developing countries, or the relevance of 'Anglo-American' standards in 'continental European' countries. Is it really appropriate, for example, that a manufacturing organisation in China adopt the same accounting standards as a service organisation in Australia? Also, is it really appropriate that a Chinese producer of steel shall use the same use the same accounting standard to account for inventory as would an Australian surfboard manufacturer? This will be a matter of opinion, but are these two 'inventories' that similar? Are the information requirements of users the same despite the nature of the inventories or the institutional environments being so different? Further, accounting standards are expected to foster comparability on an international basis between different entities- but how often would we want to compare the inventory of an Australian surfboard manufacturer with a steel producer in China?

Efforts, by organisations such as the IASB, to standardise international financial reporting also assumes that different countries will employ the same enforcement mechanisms - and this is also somewhat naïve. If countries have differing levels of enforcement with respect to IFRSs then it is misleading to suggest that we can achieve international standardisation given that lack of enforcement means that countries (and companies) can state that they have complied with IFRS when this might not the case. Global standardisation would require standardisation of corporate laws as they relate to compliance with accounting standards - and such standardisation of regulatory bodies would be unlikely. (It should be remembered that whilst the IASB develops accounting standards, it has no power to enforce their application. Enforcement is a local issue.)

1.25 There are various arguments 'for' and 'against' the international standardisation of financial reporting. Arguments for include:

- International investors are better able to understand the financial performance and position of local companies.
- Tied to the above point, there is an expectation that standardisation will facilitate greater capital inflows.
- Also tied to the above point, standardisation will make it easier for local companies to list on foreign stock exchanges.
- Companies listed on several security exchanges would only need to produce one set of financial statements and this will have implications for cost savings.
- The accounting and auditing staff employed by international organisations will be better able to move to other member companies, and this will have implications for the efficient operations of an entity.
- There will be cost savings in the accounting-standard setting function. Rather than individual countries duplicating the efforts of other countries, the majority of functions of the standard-setting process will be centralised at the IASB which is headquartered in London.

Arguments against include:

- All convergence and standardisation benefits will come at a cost. Such costs include the costs of educating accountants to adopt a new set of accounting standards and the costs associated with changing data-collection and reporting systems. Such costs will be borne by large listed companies, as well as large proprietary companies, not-for-profit entities and local governments. These last three categories of reporting entities are relatively unlikely to benefit from such things as increased capital inflows. Yet they will still incur significant costs
- International differences in culture bring into question the relevance of IFRS across all countries. Perera (1989, p. 43) argues that culture is a powerful environmental factor affecting the accounting system of a country and, therefore, that accounting

cannot be considered to be ‘culture free’. Perera (1989) argues that IFRSs themselves are strongly influenced by Anglo-American accounting models and, as such, International Accounting Standards tend to reflect the circumstances and patterns of thinking in a particular group of countries. He argues therefore that IFRSs are likely to encounter problems of relevance in countries with different cultural environments from those found in Anglo-American countries.

- It is misleading to indicate that there is global standardisation of financial reporting when there are differences in enforcement mechanisms across countries. For example, do we expect compliance with IFRSs to be enforced equally by Australian regulators and regulators in poor, developing countries? Nevertheless, organisations in these countries might all state that they have adopted IFRS (in many cases because of the reputation benefits associated with applying IFRS). In essence, there will not be standardisation despite statements indicating the contrary.

1.26 Students should be encouraged to review a number of accounting standards to see for themselves whether there is a common format for presenting accounting standards. As they will see, whilst there is some variation in formats, a typical accounting standard will have the following sections:

- Preface
- Comparison with international pronouncements
- Objective
- Application
- Scope
- Definitions.

Depending upon the issue being addressed within the particular accounting standard the accounting standard might also have sections addressing various recognition (and derecognition) and measurement issues, as well as possibly having sections addressing specific classification, presentation and/or disclosure issues. The standard might also include an Appendix with illustrative examples, and the ‘basis for conclusions’ that accompanied the development of the standard.

1.27 It was interesting to see the former chairperson of the AASB be so critical of the decision by the FRC in 2003 that Australia should adopt IFRS in 2005. Some of the criticisms included:

- There was a limited amount of time available for reporting entities to learn the requirements prior to having to implement them. This criticism seems very valid. The timetable was extremely short and really did not appear to give enough time to allow most companies sufficient time to adjust to the new requirements.
- The decision to adopt IFRS was made when significant changes were to be made to IFRS and the actual form of many of the accounting standards was reasonably unknown. Again, this seems a reasonable criticism. One can only speculate about the wisdom of committing to a set of rules that was about to undergo major change.
- Because of the tight timetables, comparative amounts should not be required for 2004 financial statements. This is an interesting criticism. On the basis of the costs involved, the criticism is probably valid. Although it would be useful for financial

statement readers to have two years of data prepared on the same basis, any perceived usefulness must be weighted against the expected costs.