

## Amending the Application Focus of Australian Accounting Standards

### Purpose

1. The purpose of this paper is to:
  - (a) provide background on the evolution of current application paragraphs of Australian Accounting Standards that include corporate non-reporting entities; and
  - (b) consider arguments for and against a proposal to amend the application paragraphs of those Standards to apply to reporting entities or general purpose financial statements (GPFSS) only, in a separate exercise;

with a view to the Board making tentative policy decisions based on the findings from the research into the application of the reporting entity concept and lodgement of special purpose financial statements (SPFSS).

### Background

2. ED 192 *Revised Differential Reporting Framework* included proposals for:
  - (a) establishing a second tier comprising Reduced Disclosure Requirements for preparing GPFSS;
  - (b) changing the focus of application of Standards to apply to GPFSS only; and
  - (c) clarifying the meaning of GPFSS in an Australian context.
3. In regard to subparagraph 2(c) above, ED 192 proposed to clarify that financial statements with the following features are GPFSS:
  - (a) those that satisfy the conditions below:
    - (i) are publicly available, whether under a legal mandate or voluntarily; and
    - (ii) are either:
      - (A) prepared in accordance with Australian Accounting Standards under a legal mandate or held out to be so prepared; or
      - (B) required to be GPFSS under a legal mandate or held out to be GPFSS; and
  - (b) those held out as having been prepared in accordance with Australian Accounting Standards or held out as being GPFSS to any party.
4. ED 192 further proposed to clarify that the phrase ‘preparation in accordance with Australian Accounting Standards’ means the application of all applicable Accounting Standards in a particular Tier and not application of a subset of Standards.
5. Accordingly, under subparagraph 3(a) above, financial statements required to be prepared under a legal mandate in accordance with Australian Accounting Standards and lodged on a public register would be regarded as GPFSS.
6. The proposals in ED 192, as noted in subparagraph 2(a) above, gave rise to AASB 1053 *Application of Tiers of Australian Accounting Standards*.
7. The comments from constituents on the proposals in ED 192, as noted in subparagraph 2(b) above, led the Board to defer its decision on changing the application

focus of Standards to GPFSs, pending further research into the incidence and nature of special purpose financial reporting. In particular, the Board was concerned about the divergence of views on the ED 192 proposals as to the functionality of the reporting entity concept.

### *The Research*

8. Research has been conducted on the application of the reporting entity concept and lodgment of SPFSs by three professional researchers (one from University of Melbourne and two from Deakin University) over the past three years. AASB Research Report No. 1 *The Application of the Reporting Entity Concept and Lodgment of Special Purpose Financial Statements*, which examines financial statements lodged with the ASIC and with three state-based regulators, is expected to be published by the AASB in May 2014. The Board has been informed about the progress of the research work and interim research results at various meetings during this period.
9. At the February and April 2013 meetings the Board considered the results of the research based on a draft Research Report. The draft Report utilised data relating to entities lodging with the ASIC and Consumers Affairs Victoria. In summary, the draft Report (consistent with the final Research Report) indicated:
  - (a) significant inconsistencies in reporting among lodging entities and a substantial incidence of SPFSs. For example, the findings indicate that nearly 80% of large proprietary companies lodge SPFSs with the ASIC;
  - (b) that recognition and measurement requirements of applicable accounting standards appear not to have been applied by a substantial minority of lodging entities;
  - (c) in respect of large proprietary companies:
    - (i) the quality of accruals (a measure of the quality of the financial statements themselves) is lower for SPFSs than for GPFSs; and
    - (ii) the quality of accruals is higher for SPFSs that evidently applied the recognition and measurement requirements of Standards than for SPFSs that evidently did not apply the recognition and measurement requirements of Standards.

The final Research Report reaffirms the interim results summarised above. In reaching its conclusions, the final Report also benefited from tests carried out on populations of entities lodging with NSW Fair Trading and Fair Trading Queensland.

10. At the February and April 2013 meetings, the Board discussed possible policy implications arising from the research and a tentative roadmap for addressing those implications, and made tentative decisions including the following:
  - (a) in light of the high incidence of SPFSs amongst lodged financial statements, there is doubt as to whether the reporting entity concept is being applied as intended in accordance with SAC 1 *Definition of the Reporting Entity* in identifying entities that should prepare GPFSs;
  - (b) as the exemption from lodgment of financial statements of grandfathered large proprietary companies does not stem from accounting standards, if any changes were to be made to the lodging requirements applicable to such entities, they would need to arise from legislative change;
  - (c) the reporting entity concept should continue to be used as the basis for identifying entities that, in concept, should be subject to general purpose financial reporting

requirements. The concept would be used by the Board as the basis for its own deliberations on matters relating to general purpose financial reporting and for its discussions with others in the financial reporting environment. Accordingly, at this meeting, the Board tentatively decided that SAC 1 would not be part of the AASB Framework if there were to be a change of application focus from reporting entity to GPFs but that material based on SAC 1 could be made available in another form for general use in the identification of entities that should be required to prepare and lodge GPFs (whether under Tier 1 or Tier 2);

- (d) in regard to the role of the Board as a standard setter:
    - (i) its mandate should be to set accounting standards for GPFs under Tier 1 and Tier 2; and
    - (ii) reporting requirements for SPFs should be outside its mandate and should be a matter for consideration by preparers and identified users and regulators who are not dependent on GPFs;
  - (e) staff should liaise with regulators, including the Treasury, the ASIC, the Australian Charities and Not-for-profits Commission (ACNC) and relevant State government bodies, with a view to coordinating the Board's and those regulators' efforts in dealing with the issues emerging from the research;<sup>1</sup> and
  - (f) an Exposure Draft should be developed, based on a redeliberation of the ED 192 proposals in relation to the change of the application focus of Australian Accounting Standards from 'reporting entity' to 'GPFs' and the clarification of GPFs in the Australian context, and include any amendments to those proposals that might arise from the Research Report and the liaison with other regulators in regard to any proposed transition.
11. The discussion in this paper mainly relates to the tentative decisions cited at subparagraphs 10(d) and 10(f) above. In particular, it focuses on the manner in which the tentative decision in subparagraph 10(d) could be implemented.

### **Current application paragraphs**

12. Most Australian Accounting Standards apply to reporting entities or GPFs. They include the following application paragraph (emphasis added):
- “This Standard applies to:**
- (a) each entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act and that is a reporting entity;**
  - (b) general purpose financial reports of each other reporting entity; and**
  - (c) financial reports that are, or are held out to be, general purpose financial reports.”**
13. Currently there are seven Standards that also apply to entities required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act, whether they are reporting entities or not. These Standards are:
- AASB 101 *Presentation of Financial Statements*;
  - AASB 107 *Statement of Cash Flows*;
  - AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*;

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<sup>1</sup> Staff have been liaising with many of these regulators (particularly the ASIC and Treasury) in relation to the development and the Research Report and the communication strategy around the Report's release.

- AASB 1031 *Materiality*<sup>2</sup>;
- AASB 1048 *Interpretation of Standards*<sup>3</sup>;
- AASB 1053 *Application of Tiers of Australian Accounting Standards*; and
- AASB 1054 *Australian Additional Disclosures*.

These Standards generally include the following application paragraph:

**“This Standard applies to:**

- (a) each entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act;**
- (b) general purpose financial statements of each reporting entity; and**
- (c) financial statements that are, or are held out to be, general purpose financial statements.”**

14. As noted above, based on the application paragraphs of AASB 1053, that standard also applies to corporate non-reporting entities<sup>4</sup>. However, ED 248 *Amendments to AAS 1053 – Transition to and between Tiers, and related Tier 2 Disclosure Requirements* issued in March 2014 clarifies that AASB 1053 only applies to GPFs and that clarification may be seen as imposing a restriction on the scope of AASB 1053<sup>5</sup>.
15. The ASIC’s regulatory guide RG 85 *Reporting requirements for non-reporting entities* (July 2005)<sup>6</sup>, paragraph 3.5, notes that Australian Accounting Standards AASB 101, AASB 107, AASB 108 and AASB 1048 “apply in full to all entities required to prepare a financial report in accordance with Chapter 2M of the [Corporations] Act, whether they are reporting entities or not”. In addition, paragraph 2.5 of the regulatory guide states that: “... the recognition and measurement requirements of accounting standards must also be applied in order to determine the financial position and profit or loss of any entity preparing financial reports in accordance with the [Corporations] Act”.

### **History of application paragraphs that include corporate non-reporting entities**

16. As noted above, some Australian Accounting Standards have application paragraphs that include corporate non-reporting entities. The first of these application paragraphs was introduced in AASB 1034 *Information to be Disclosed in Financial Reports* issued in 1996. In undertaking a program of harmonising accounting standards with International Accounting Standards (IASs), the Boards (AASB and PSASB)<sup>7</sup> decided in the joint meeting of 3 December 1998 to reissue AASB 1018 *Statement of Financial Performance* to be applicable to “all entities lodging financial reports under the Corporations Law”. In a similar manner, in their meeting of 10 November 1998, the Boards decided to make the reissued AASB 1034 applicable to “entities required to prepare financial reports in accordance with Chapter 2M of the Corporations Law”.

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2 AASB 1031 applies to entities preparing financial statements in accordance with Australian Accounting Standards, which would include those standards required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act. In December 2013, the AASB 1031 status was changed to an interim Standard pending withdrawal, but the interim standard still has the same application paragraph.

3 Application of AASB 1048 is subject to the application paragraphs in each Interpretation.

4 This is because, in a manner similar to AASB 1048, AASB 1053 is currently seen as being related to all Australian Accounting Standards, some of which apply to corporate non-reporting entities.

5 Discussion of ED 248 in the light of comments received is on the agenda for May 2014 meeting (agenda item 17).

6 RG 85 replaced the ASIC Information Release [IR 00/025] *Reporting requirements for non-reporting entities* (July 2000). The information release had similar guidance as RG 85 but with reference to the Accounting Standards applicable at the time.

7 Australian Accounting Standards Board and Public Sector Accounting Standards Board of the Australian Accounting Research Foundation.

*Why did the Boards decide to make the scope extension?*

17. The changes to the application paragraphs of AASB 1018 and AASB 1034 noted above relate to a 1995 agreement between the AASB and the Attorney-General's Department to include in an Accounting Standard the disclosure requirements of Schedule 5 to the Corporations Regulations, which applied to all entities required to prepare financial reports in accordance with the Act. The aim was to avoid overlap/duplication and have largely one source of requirements for the content of financial statements and was part of the Corporate Law Economic Reform Program<sup>8</sup>
18. To initiate the process of adopting the requirements of the outgoing Schedule 5 through accounting standards, the Invitation to Comment *Proposals to Revise Schedule 5 to the Corporations Regulations and Consider Replacement by an Accounting Standard* was jointly prepared by the AASB and the Commonwealth Attorney-General's Department and issued in November 1993. The document sought views on whether the Schedule 5 disclosure requirements should be omitted from the Schedule, retained in the Schedule or included in an AASB Accounting Standard.
19. The submissions received were generally supportive of incorporating the Schedule 5 disclosure requirements into an AASB Accounting Standard. Accordingly, the AASB issued Exposure Draft ED 67 *Information to be Disclosed in Financial Reports* in December 1995. The ED included the revised proposed disclosure requirements that were based on the Schedule 5 disclosure requirements. The issue of the Accounting Standard arising from ED 67 was to be coordinated with the repeal of Schedule 5 of the Corporations Regulations. Repeal depended on whether the individual requirements of Schedule 5 were dealt with in an acceptable way in the Accounting Standard.
20. It was proposed that the Accounting Standard arising from ED 67 would apply to entities required by the Corporations Law to prepare financial statements. In December 1996, AASB 1034 was issued. Paragraph 6 of the section on the 'Development of the Standard' noted:

*"The Standard will apply to entities required by the Corporations Law to prepare financial statements. This is to reflect the current requirements of the Corporations Law, including amendments to the Corporations Regulations which require large proprietary companies to apply the requirements of Schedule 5. As a result, the application of the Standard is not confined to reporting entities and other entities which prepare general purpose financial reports. The Board is currently examining the application of Standards generally to various classes of entities required to prepare and lodge financial statements in accordance with the Corporations Law. Once that review is complete, the application of the Standard may be amended."*
21. AASB 1034 replaced Schedule 5 to the Companies Regulations. It prescribed specific disclosures for particular assets and liabilities, equity, revenues and expenses, executives' remuneration, auditors' remuneration, economic dependency, dividends and franking account balances. The Standard did not prescribe the format of financial statements and

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<sup>8</sup> By way of background, in Australia, basic company disclosure requirements in relation to items to be included in the body of the 'profit and loss account' and 'balance sheet' were initially included in the Schedule 9 to the *Uniform Companies Act of 1961*. Schedule 9 was replaced by Schedule 7 of the *Companies Regulations* in 1982 on the introduction of the *Companies Act and Codes*, which in turn was further amended in 1986 to include fixed formats for the profit and loss account and the balance sheet. Schedule 7 was replaced by Schedule 5 to the Corporations Regulations on commencement of the *Corporations Law* in 1991.

instead, required preparers to determine the formats and the line items. The Standard, however, established principles for determining the manner in which items were to be classified and presented in financial statements.

22. Amendments were also made in February 1997 to AASB 1017 *Related Party Disclosures* to make it consistent with Schedule 5 requirements. However, unlike AASB 1034, which applied to all entities required to prepare financial statements under the Corporations Law, the amended AASB 1017 only applied to reporting entities or GPFSS.
23. AASB 1034 (1996) stated that some of the disclosure requirements contained in that Standard were ultimately to be relocated to other Accounting Standards as they were relevant to matters covered by other Standards. Harmonisation with IASs between 1996 and 1999 led to further changes to the disclosure requirements of Australian Accounting Standards and many of the ‘old’ Schedule 5 requirements were amended, deleted and relocated to align with the IASs. The Standards that included the requirements that came from Schedule 5 were made applicable to both reporting entities and non-reporting entities that are required to prepare financial reports under the Corporations Law. In addition, in the process<sup>9</sup> undertaken in 2010 jointly with NZ to remove as many non-IFRS disclosure requirements as possible, all the remaining Schedule 5 requirements were deleted or changed and located in AASB 1054.
24. AASB 1034 was revised in 1999 to harmonise with IAS 1 *Presentation of Financial Statements*. The revised Standard with the new title of “Financial Report Presentation and Disclosure” continued to apply to all entities required to prepare financial statements under Chapter 2M of the Corporations Law. In similar harmonisation efforts, AASB 1018 *Statement of Financial Performance* was reissued and AASB 1040 *Statement of Financial Position* was made in October 1999. These Standards applied to all entities preparing financial statements under Chapter 2M of the Corporations Law. AASB 1001 *Accounting Policies* reissued in March 1999 and AASB 1026 *Statement of Cash Flows* reissued in October 1997, however, only applied to reporting entities or GPFSS.
25. Pursuant to adoption of IFRSs in Australia, the scopes of AASB 101, AASB 107, AASB 108, AASB 1031 and AASB 1048 included all entities required to prepare financial statements under Part 2M of the Corporations Act. The scopes of AASB 1053 (2010) and AASB 1054 (2011) also include non-reporting entities required to prepare financial reports in accordance with Part 2M of the Corporations Act.

### **Application to corporate non-reporting entities – The Way Forward**

26. The scope of those Australian Accounting Standards that apply to corporate-non reporting entities could be amended to apply to reporting entities/GPFSS only:
  - (a) independent of other remaining proposals in ED 192 such as clarification of GPFSS in an Australian context (including the replacement of SAC 1 with a guidance for other regulators); or

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<sup>9</sup> Under this process, the AASB and the NZ FRSB published proposals to harmonise Australian and New Zealand financial reporting standards based on IFRSs for the purpose of eliminating many of the differences between the Standards in each jurisdiction relating to for-profit entities applying IFRSs as adopted in Australia and New Zealand. The differences related to independent modifications made to IFRSs by the two jurisdictions on transition to IFRSs. In Australia, this process resulted in publication of AASB 1054 containing disclosure requirements that were additional to IFRSs and amendments to a number of Australian Accounting Standards.

- (b) together with other remaining ED 192 proposals as a package.
27. Arguments for amending the application paragraphs of those Standards that also apply to corporate non-reporting entities in a separate, early, exercise are as follows:
- (a) The AASB's mandate should be to set accounting standards for GPFs under Tier 1 and Tier 2. Promulgation of Standards for GPFs is a principle that exists independent of any shortcomings in implementation of the reporting entity concept in practice and separate from any future guidance that might be issued to help eliminate those shortcomings.
  - (b) No other Standard setter<sup>10</sup> uses the reporting entity concept for differential reporting purposes in the application paragraphs of its standards in the manner employed in Australia to cater for reporting requirements of a class of entities that do not prepare GPFs. Changing this focus is an issue that is independent of the other remaining ED 192 proposals.
  - (c) It would clarify the role of the AASB as the standard setter for GPFs and the role of other regulators (and users) in determining reporting requirements for preparing SPFs. With the benefit of hindsight, while rationalising disclosures for corporate reporting entities has been a sound move, extending the scope of some accounting standards to encompass corporate non-reporting entities might not be seen as having been technically consistent with SAC 1 *Definition of the Reporting Entity* and SAC 2 *General Purpose Financial Reporting* that were extant at the time.
  - (d) It could act as a catalyst for progressing the next stages of financial reporting reforms in a coordinated manner with other regulators based on policy decisions to be made arising from the findings of the Research Report. These could include dealing with issues such as the high incidence of SPFs on public registers, rationalisation of regulations including measures for deregulation of those lodging entities in respect of which there are no users (or potential users) dependent on their financial statements.
  - (e) It would not disrupt the current arrangements by other regulators as they generally have guidance or requirements in place for preparation of financial statements by non-reporting entities in the form of regulatory guides or legislative requirements.
28. Arguments against amending the application paragraphs of those Standards that also apply to corporate non-reporting entities in a separate, early, exercise are as follows:
- (a) It would make sense to implement all remaining ED 192 proposals as a package as they are interrelated. It does not seem logical to make reporting entities/GPFs the focus of accounting standards without first providing further guidance on the meaning of GPFs in an Australian context.
  - (b) Changing the focus of Standards to apply solely to reporting entities/GPFs without coordinated measures by other regulators would not affect the status quo in regard to the subjectivity in assessing whether an entity is a reporting entity or not.
  - (c) Dealing with the anomaly of SPFs being lodged on a public register would be facilitated by an AASB clarification that public availability of financial statements prepared in accordance with applicable accounting standards would make them GPFs.

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<sup>10</sup> To the extent Staff are aware.

## **Staff view**

29. Staff are of the view that amending the application paragraphs of the Standards that apply to corporate non-reporting entities as the first stage of progressing remaining ED 192 proposals is warranted for the reasons outlined in paragraph 27.
30. In particular, staff consider that such amendments can be made independently of the other remaining ED 192 proposals and would send an important signal regarding the role of AASB as the standard setter for GPFSs; in contrast to the role of other regulators (and users) in determining reporting requirements for preparing SPFSs.
31. Staff also consider that such amendments could act as a catalyst for progressing the next stages of financial reporting reforms in a coordinated manner with other regulators based on the policy decisions to be made arising from the findings in the Research Report.