Strategy issues – Australia's Financial Reporting Framework

Main issues and concerns and the purpose of this paper

1.1 In broad terms, from the AASB's perspective, the existing financial reporting framework is currently founded on:

(a) using International Financial Reporting Standards (IFRS) as the foundation for Australian accounting standards;

(b) 'transaction neutrality' – to the extent feasible, applying the same requirements to entities in the for-profit, not-for-profit, private or public sectors;

(c) the reporting entity concept[1] whereby entities that have dependent users prepare general purpose financial statements (GPFS); and

(d) two tiers of GPFS (both with the same recognition and measurement requirements, but different levels of disclosure). In this context:

(i) for-profit entities with 'public accountability' (such as listed companies) and governments at the federal, state/territory and local; levels must apply Tier 1;

(ii) not-for-profit private sector entities and public sector entities other than governments can apply Tier 2 and have the option to apply Tier 1; and

(iii) the level of Tier 2 disclosures is determined using a set of disclosure principles based on those used by the IASB in determining the level of disclosures for the *IFRS for SMEs*.

1.2 Other factors that are particularly relevant to a discussion of the existing framework include:

(a) the work of the Financial Reporting Council on mapping the complex web of current financial reporting and auditing requirements for various types of entities in Australia, and the difficulties this poses for entities determining what their reporting requirements are;

(b) the current federal government's emphasis on de-regulation;

(c) the AASB's close relationship with the New Zealand Accounting Standards Board (NZASB) – in the context of for-profit entities, both jurisdictions have the same two tiers of reporting requirements;

(d) the AASB's potential leadership role in helping policymakers to determine which entities should be required to prepare and/or lodge financial statements; and

(e) concerns expressed by some constituents, who have a particular focus on the public sector and other not-for-profit entities, about the financial reporting

1 Statement of Accounting Concepts SAC 1 *Definition of the Reporting Entity* (1990) describes the concept. The 'reporting entity' definition is: "An entity in respect of which it is reasonable to expect the existence of users who rely on the entity's general purpose financial statement for information that will be useful to them for making and evaluating decisions about the allocation of resources. …". The 'general purpose financial statements' definition is: "Financial statements that are intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs" [AASB 101 *Presentation of Financial Statements* and AASB 1053 *Application of Tiers of Australian Accounting Standards*].

requirements available for smaller entities that have some level of 'public accountability' in the general sense of the term.

1.3 The AASB has been working on a number of related matters in an effort to help address concerns about the complexity and effectiveness of the current financial reporting framework and bring about some meaningful reforms to the financial reporting framework. The main purpose of this paper is to draw those matters to the Board's attention and to confirm, or otherwise, the members' support for our planned work. Alternatively, members may identify areas in which they want more information before coming to a decision.

IFRS and transaction neutrality

2.1 There is widespread consensus that IFRS should remain as the foundation for Australian accounting standards and there are currently no plans to change from this principle. Nevertheless, a key function of the AASB under its enabling legislation[2] is to continually monitor the acceptability of IFRS as the basis for Australian GAAP.

2.2 There is also widespread consensus that Australia should continue with its policy of transaction neutrality. The philosophy underlying transaction neutrality is that:

* the accounting should reflect the economic substance of transactions, and there is a presumption that the impact of a different operating environment (such as public versus private sector) on the economic substance would only lead to different accounting due in exceptional cases;
* there are benefits to users from having the same transactions reported in the same way no matter which entity undertakes them (unless the context in which the entity operates effectively changes the economic substance of the transactions) because it provides greater comparability across entity types and reduces the number of different requirements users need to understand; and
* there are economy-wide efficiencies associated with having essentially the same requirements across various entities and sectors because financial reporting professionals can acquire skills that are transportable across entity types; and training and education (at universities and firms) can focus on the one set of requirements.

2.3 However, the considerations for determining when a departure from IFRS is justified are currently set out in the *Process for Modifying IFRSs for PBE/NFP*,[3] which was developed jointly by the AASB and the New Zealand Financial Reporting Standards Board (the predecessor body to the New Zealand Accounting Standards Board) in 2009. Given that the 'Process' document was developed about six years ago and is not applied by the NZASB, the AASB has formed the tentative view that it should be reviewed.

2.4 The NZASB uses the work of the International Public Sector Accounting Standards Board (IPSASB) in setting standards for NFP entities. However, given that IPSASB standards are also based on IFRS, and the AASB's practice of noting the IPSASB's work when it considers whether a departure from IFRS might be justified, the practical differences between the AASB and NZASB approaches may not be significant. The boards have agreed that they will monitor each other's progress on NFP standards.

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2 The *Australian Securities and Investments Act 2001* – in particular, section 227(1).
3 PBE = public benefit entity. The AASB uses the term NFP = not for-profit.

2.5 The AASB view is that, before the 'adoption' of IPSASB standards could become a realistic option, the IPSASB would need to be more up to date with IFRS and have an improved governance structure,[4] particularly in the context of the Australian government's policy on using a 'trusted' international standards and processes to streamline regulation.[5]

Board questions

2.6 Does the Board agree that:

* **the AASB should be working on reviewing the process for modifying IFRS for application to not-for-profit entities; and**
* **the arrangement that the AASB and the NZASB monitor each other's progress on NFP standards should be continued?**

The reporting entity concept

3.1 In most jurisdictions, accounting standard setters are responsible for determining the accounting policies to be applied in general purpose financial statements (GPFS). They are not generally involved in determining requirements for other types of reporting or for determining which entities should prepare and/or lodge financial statements. However, a standard setter is clearly affected by government policy decisions about which entities must prepare and/or lodge financial statements because this determines a standard setter's constituency.

3.2 In contrast to its international counterparts,[6] the AASB is also involved to some extent in 'special purpose financial statements' (SPFS). This is because particular standards[7] apply to "each entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act" – which is taken to mean that financial reports prepared under the Corporations Act can be either GPFS or SPFS (depending on whether or not the entity concerned is a reporting entity) . The origin of these broader application paragraphs is a 1995 agreement between the AASB and the Attorney-General's Department to include in standards 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 Attorney-General's Corporations Law Simplification Program.

3.3 The use of the reporting entity concept to differentiate between the corporate entities that prepare GPFS and those that prepare SPFS has become ingrained. Views on the efficacy of the concept in the hands of the preparers differ widely. In 2010, the AASB

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4 The IPSASB is an entity within the International Federation of Accountants.

5 Please refer to: http://www.dpmc.gov.au/sites/default/files/publications/IICA_fact_sheet_%20international_standards_and_risk_assessments.pdf

6 AASB staff have yet to find another jurisdiction that uses the reporting entity concept as a basis for determining which entities should prepare GPFS versus SPFS.

7 AASB 101 *Presentation of Financial Statements*; AASB 107 *Statement of Cash Flows*; AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*; AASB 1031 *Materiality*; AASB 1048 *Interpretation of Standards*; AASB 1053 *Application of Tiers of Australian Accounting Standards*; and AASB 1054 *Australian Additional Disclosures*

proposed[8] that the reporting entity concept not be used in accounting standards for differential reporting purposes; but, apart from being used in its own deliberations, further guidance be developed around the concept primarily for use by policymakers assist them in their decision making about which types of entities should be required to prepare GPFS. Constituents' responses varied widely from strong support for the status quo to strong support for the AASB's proposals. This varied response led the AASB to undertake the empirical research published in AASB Research Report No. 1 *Application of the Reporting Entity Concept and Lodgement of Special Purpose Financial Statements* (2014), which aimed to help clarify whether the existing application of the reporting entity concept is currently providing good financial reporting outcomes.

3.4 The Report's authors and the AASB generally consider that the Report provides firm evidence that having preparers determine whether an entity is a reporting entity is resulting in unsatisfactory outcomes, principally on the basis that:

* the decision about whether an entity is a reporting entity and prepares GPFS or is not a reporting entity and prepares SPFS seems to have no correlation with the key characteristics (as set out in SAC 1) of the entities concerned;
* there is a relatively high incidence of GPFS among companies limited by guarantee (66%) and a relatively low incidence among large proprietary companies (20%); and
* in many cases the recognition and measurement requirements in the standards appear not to have been applied or it is not clear whether they have been applied.

3.5 In view of the Report's findings and the fact that Australia appears to be the only jurisdiction to accept the lodgement of SPFS (as judged by the entities themselves); there is a need for reforms to help ensure that:

* entities are clear on what reporting they have to do; and
* users are clear about the basis on which entities are reporting.

3.6 There is evidence that the Report has not changed the views of many of those who support the status quo. One explanation for the differing reactions to the Report's findings is that some constituents regard the status quo as providing a satisfactory outcome for their particular needs and disclosure concerns, while others have more of a policy focus on the relative impact of the existing framework on financial reporting outcomes. Another explanation is that supporters of the status quo consider there to be other possible causes for the findings, such as inadequate regulatory compliance.

3.7 The Board's tentative decisions so far on this topic include:

* the focus of the application paragraphs in Australian accounting standards should be reconsidered;
* the continuing need for the AASB's SAC 1 should be reconsidered when considering the adoption of the (forthcoming) new IASB Conceptual Framework;
* guidance on the reporting entity concept should be developed by the Board to assist policymakers in their decision making about identifying the types of entities within their jurisdictions that should be required to prepare GPFS;

8 ED 192 *Revised Differential Reporting Framework*

* guidance on the meaning of GPFS should be developed to assist policymakers in understanding the role that GPFS are intended to play; and

* corporate reporting is likely to be the best initial focus for reform (because of its significance and because it is often seen as providing a lead to others[9]), followed by reporting by public and other private sector entities.

3.7 The Board has been mindful that there are many stakeholders with an interest in the financial reporting framework, including the Commonwealth Treasury and state/territory governments as policymakers, the FRC and regulators such as the Australian Securities and Investments Commission (ASIC) as well as the users, preparers and auditors of financial statements and that the AASB's actions can impact on them. For example, the ASIC's Regulatory Guide 85 *Reporting requirements for non-reporting entities* and many entities lodging financial statements with the ASIC would be affected by a change to the application paragraphs of standards.

3.8 The Board has also been conscious that some policymakers appear to give insufficient thought to the basis for, and implications of, the financial reporting requirements they impose on the entities they regulate – for example, they impose requirements to prepare GPFS without appreciating how costly that might be relative to the benefits to be achieved or whether a much more targeted set of financial information might better suit their regulatory objectives.

3.9 Even though the AASB's 'statutory' role is essentially focused on setting out what entities report, not which entities report (which is the responsibility of some of the stakeholders mentioned above):

* the AASB's role in relation to having a conceptual framework is consistent with developing guidance on the reporting entity concept and GPFS for the benefit of policymakers; and

* unless the AASB takes a leadership role, there is a concern that there will no impetus for reform.

3.10 The AASB is also mindful of the current emphasis on de-regulation and reducing cost burdens to businesses and individuals and that, in order to achieve any meaningful reforms to the financial reporting framework, any outcomes to be advocated by the AASB would need to be de-regulatory overall. Accordingly, the AASB has acknowledged that, if publicly lodged financial statements are to be GPFS, there would probably need to be:

* some trade off with the population of entities required to lodge and that the AASB might have to provide policymakers with some leads on how that trade off might be achieved. In that context, the AASB has been researching information that would allow us to benchmark to other jurisdictions that have adopted IFRS; and

* transitional arrangements that facilitate the migration from SPFS to GPFS. In that context, the AASB has been consulting with constituents about the likely major barriers to transition and how they might be overcome.

3.11 In respect of benchmarking to other jurisdictions, so far, information has been sought from Canada, Japan,[10] Korea, Malaysia, New Zealand, and the UK on matters such as:

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9 For example, financial reporting by co-operatives has borrowed heavily from the *Corporations Act 2001* requirements.

second or further tiers of GAAP; the basis for those tiers (such as the *IFRS for SMEs* or previous domestic GAAP); and the thresholds used to determine which entities apply the various tiers.

Board questions

3.12 Does the Board agree that the AASB should be:

- **taking a leadership role in helping policymakers to determine which entities should be required to prepare and/or lodge financial statements, including:**
  - **re-focusing the reporting entity concept to something that policymakers consider in determining which entities should prepare/lodge financial statements;**
  - **developing guidance on the meaning of GPFS to assist policymakers in understanding the role that GPFS are intended to play;**
  - **investigating the financial reporting frameworks in other jurisdictions to generate information that would inform Australian policymakers' decisions on revising their requirements on which entities should lodge GPFS; and**
  - **consulting with constituents on facilitating the transition from SPFS to GPFS;**
- **commencing with a focus on corporate reporting policy and then addressing the issues with policymakers in respect of other types of entities?**

Please note that outcomes of the above work would be brought to the Board for consideration and any proposed changes would be the subject of the AASB's usual due process.

Tiers of GPFS

4.1 Constituents concerns about the burden on entities preparing GPFS and the IASB's work on developing its *IFRS for SMEs* to address similar concerns were triggers for the AASB to consider the need for a second tier of GPFS requirements.

4.2 The AASB examined a number of different options[11] for a second tier of GPFS and ultimately settled on the Reduced Disclosure Requirements, which involve the same recognition and measurement requirements as Tier 1 and reduced disclosure requirements based on the principles used by the IASB in determining the level of disclosures for the *IFRS for SMEs*. The principles[12] are applied to each new IFRS as they are issued. AASB 1053 *Application of Tiers of Australian Accounting Standards* was issued in 2010 and sets out the application of each tier.

4.3 The AASB did not rule out introducing the *IFRS for SMEs*, either as an additional form of Tier 2 or in place of the Reduced Disclosure Requirements, but noted that the intention would be to reconsider its use only if it were to become a widely-accepted form of GAAP internationally.

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10 Although Japan has not fully adopted IFRS, listed entities can elect to apply IFRS instead of J-GAAP.

11 For a summary of AASB's deliberations see http://www.aasb.gov.au/admin/file/content102/c3/Differential_Reporting_Project_Update_28_07_2014.pdf

12 Available at: http://www.aasb.gov.au/admin/file/content102/c3/Tier_2_Disclosure_Principles.pdf

4.4 The key differences between the AASB's Tier 2 and the *IFRS for SMEs* are that the latter: (a) has modified and re-expressed some of the IFRS recognition and measurement requirements; and (b) is reviewed roughly every three years and, based on recent experience, generally not updated for recent IFRS developments. The AASB's reasons for its approach to Tier 2 GPFS are set out in AASB Consultation Paper *Differential Financial Reporting – Reduced Disclosure Requirements*.[13]

4.5 The AASB planned to undertake a post-implementation review of Tier 2 once sufficient information is available for empirical or other type of analysis. Staff are yet to commence a formal review, but recent consultation indicates that:

* the level of adoption of Tier 2 GPFS requirements among companies limited by guarantee (not-for-profit entities) and subsidiaries of Tier 1 entities is reasonably widespread;
* the level of adoption among other types of companies, including large proprietary companies is very low – with the likely reasons being that many are content with preparing SPFS (and, in particular, because Tier 2 requires consolidation) and the general level of disclosure is still viewed as burdensome.

4.6 In relation to the point about the general level of disclosure still being viewed as burdensome, it is relevant to note that recent changes to IFRS have sharply increased the overall level of disclosure under both Tier 1 and Tier 2. A prime example is the level of disclosure in IFRS 15 *Revenue from Contracts with Customers* compared with IAS 18 *Revenue* and IAS 11 *Construction Contracts*. The result is that even the Tier 2 AASB 15 disclosure requirements would be regarded by many as being more burdensome than the Tier 1 or Tier 2 AASB 118 and AASB 111 disclosure requirements.

4.7 In view of the above, recent Board discussion indicates that it would be appropriate to review the principles used in determining the level of Tier 2 disclosures with a view to further reducing the level of disclosure requirements. Given the constant level of change in IFRS, this exercise is probably more urgent than other aspects of any post-implementation review of AASB 1053.

Board questions

4.8 Does the Board agree that the AASB should plan to work on:

* **in the short term, reviewing the principles used in determining the level of Tier 2 disclosures with a view to further reducing the level of disclosure requirements; and**
* **once the relevant data is available (for example, lodged financial statements of companies for the 2013-2014 and 2014-2015 year ends), an analysis (including empirical analysis) of the take up of Tier 2 by entity type.**

Addressing other complexity issues

5.1 When the IASB first proposed its *IFRS for SMEs*, the AASB issued Invitation to Comment ITC 12 'Request for Comment on a Proposed Revised Differential Reporting Regime for Australia and IASB *Exposure Draft of A Proposed IFRS for Small and Medium-sized Entities*'.

13 Available at: http://www.aasb.gov.au/admin/file/content105/c9/AASB_Consultation_Paper.pdf

5.2 Among the many issues raised in ITC 12 was the possible need for a third tier of simpler reporting requirements for smaller NFP private sector entities on the basis that:

* such entities might find application of the *IFRS for SMEs* (or similar) burdensome on cost-benefit grounds; and

* there is generally no NFP equivalent to the outright exemption from reporting that exists in the for-profit corporate sector (such as for 'small' proprietary companies).

5.3 Based on recent discussions with constituents and discussions at Board meetings, there is also a sense that any research into having a third tier of reporting requirements should involve consideration of NFP entities in both the private and public sectors (not just the private sector as contemplated in ITC 12). The framework recently created in New Zealand includes Tier 3 (simple format accrual-based for entities with $2m or more of expenses) and Tier 4 (simple format cash-based for entities with $125k or more of operating payments) for NFP entities in either the private or public sectors.[14]

5.4 Consideration would need to be given to whether any possible third tier of reporting would be regarded as GPFS. To date, the Board has considered the Reduced Disclosure Requirements as setting out the minimum disclosure needed to justify the 'GPFS' label.

5.5 The findings in AASB Research Report No. 1, highlight that certain types of entities, such as charities that can accept donations from the public and enjoy tax exempt status have particular types of financial accountabilities. Any research into a possible third tier of reporting would need to have regard to those factors.

Board questions

5.5 Does the Board agree that the AASB should plan to work on determining the need for a third tier of reporting, which would involve considerations such as:

* **the nature of the entities that might apply a third tier;**

* **the principles that would be applied in determining simplifications that might be made to recognition, measurement, presentation and/or disclosure requirements; and**

* **how a third tier fits into the Board's notion of GPFS?**

14 The existing New Zealand Tiers 3 and 4 for for-profit entities will not apply after March 2015.