

20 October 2011

AASB 26 October 2011  
Agenda paper 3.10 - tabled

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Dear Mario

### **Considering the effects of accounting standards**

The Institute of Public Accountants (the Institute) is pleased to respond to the European Financial Reporting Advisory Group's (EFRAG) Discussion Paper on *Considering the Effects of Accounting Standards*.

This submission has been prepared with the assistance of the Faculty of Accounting Regulation, which is one of several consultative committees of the Institute, and a range of other stakeholders in the Australian environment. We hope the submission is useful to EFRAG in its continuing deliberations on the quality of the due process of standard setters.

Our research has found that those consulted believed the standard setting process was currently well served by the approach to due process taken by both the International Accounting Standards Board (IASB) and the Australian Accounting Standards Board (AASB).

The submission also expresses concerns conveyed by constituents about the possible political ramifications of imposing additional layers of due process on standard setters. These concerns are the consequence of political and business leaders pressuring the international standard setter to change standards on financial instruments at a time when the Global Financial Crisis resulted in many entities being forced to reflect falls in market values in their financial statements.

Please don't hesitate to contact the Institute's Head of Research, Tom Ravlic at [tom.ravlic@publicaccountants.org.au](mailto:tom.ravlic@publicaccountants.org.au) if you wish to discuss the submission further or have any queries.

Yours sincerely



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The Institute of Public Accountants

## **Considering the effects of accounting standards**

**An Australian response to the European Financial  
Reporting Advisory Group**



**IPA** INSTITUTE OF PUBLIC  
ACCOUNTANTS

*Partnership beyond numbers*

## CEO's Foreword

The setting of accounting standards may appear esoteric to some members of our community but in truth the process is important. Its outcomes form the chassis on which the reporting of a vast number of entities in Australia and across the world is based. This is a world of great technical complexity that can baffle observers. It is also a place where political battles are fought over the provisions of accounting standards that will change the lens through which significant and powerful entities on the global business stage are viewed.

It is important that the objective of transparent financial reporting in the public interest remains the central focus of standard setters rather than the appeasement of powerful vested interests. The conceptual framework for financial reporting that operated for many years in Australia defined General Purpose Financial Reports (GPFs) as financial reports 'intended to meet the information needs common to users who are unable to command the preparation of reports tailored so as to satisfy, specifically, all of their information needs'. In other words, financial reporting is about protecting those unable because of their status in society or their lack of economic clout to demand information from large corporations in which they may have an interest. These interests can be direct investments through shares or a superannuation fund. The interests may also include but may not be limited to the size of an entity, its industry, the prominence of an entity or its industry within the Australian or global economy, the number of employees it has and what government assistance it may receive such as tax exempt status.

These entities are the legitimate target of the end product of standard setters. While standard setters should understand the effects of their pronouncements on entities for which compliance is necessary there can be no justification for standard setters or regulators bowing to political pressure and vested interests. I am reminded of the debate on share based payment in the United States in this context during the 1990s. The Financial Accounting Standards Board (FASB) in the United States was seeking to introduce a standard requiring share-based payment to be expensed. The standard that was ultimately issued as a result of the failure of the political process and the regulatory process to support the standard setter was a watered down FAS 123. The standard created an option – entities could either expense share based payment or disclose the value of the shares paid in the notes to the financial statements. I note that the former chairman of the Securities and Exchange Commission, Arthur Levitt, stated in his autobiography that the failure of the SEC under his administration to stand beside the FASB was a major regret of his career. It is worth noting that the world now has a standard requiring the expensing of share options that became effective for financial years on or after January 1, 2005, following the creation of the International Accounting Standards Board. The idea had come of age and the self-interested arguments of opponents that won the day in the US all those years ago did not defeat the standard a second time at the international level.

The Institute of Public Accountants is responding to the EFRAG paper given Australia's use of International Financial Reporting Standards (IFRS). This paper has a real prospect of impacting the due process of the International Accounting Standards Board. The process for issuing international standards is already long enough. Any change that unnecessarily lengthens the time it takes for the IASB to issue financial reporting standards will delay improvements in reporting.

Australia will be impacted by any change that may occur as a result of pressure being placed on the IASB to add to its due process. The global process of standard setting and the local Australian standard setting process are intertwined. Australia adopts the standards issued by the IASB – the adoption of which was decided in June 2002 by the Australian Financial Reporting Council. If the IASB slows down the development of standards for whatever reason the progress made by the Australian standard setter in introducing improved reporting is also delayed. This would be regrettable in a fast-moving environment that has become so dependent on high quality financial information.

The Institute is grateful for the support of members of its various Faculty advisory committees. In particular, the Institute would like to thank all of the members of the Faculty of Accounting Regulation who both expressed interest in the document and provided us with some written commentary. Specific

thanks must go to Professor David Boymal, Jan McCahey from PricewaterhouseCoopers, Frank Palmer from Macquarie Bank, Keith Reilly from Grant Thornton, Brad Potter from the University of Melbourne, Dianne Azoor Hughes from Pitcher Partners, Colin Parker from GAAP Consulting, Wayne Lonergan from Lonergan Edwards and Associates and the chairman of the Australian Accounting Standards Board, Kevin Stevenson and John O'Grady from Ernst & Young for making time to share their perspectives with us and assisting us in our thought processes on this occasion.

EFRAG's director of research, Mario Abela, also spent time with our policy staff to outline the rationale behind the discussion paper. We thank him for his insights.

I hope the members and staff of EFRAG find this document useful in their continuing deliberations on this issue. I also hope Institute members are stimulated to reflect on and debate the issues that are at the core of developing accounting standards that we as accounting professionals are obliged to comply with.

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## Executive Summary

Accounting standard setting does not occur in a vacuum. Standards are set at a point in time and represent a consensus amongst a particular group of decision makers on what ought to be regarded as generally accepted accounting practice in a particular jurisdiction. The standard setters are themselves a part of society that has particular values and needs at that point. While standards are set in the context of the values held by people around a board table at any given time they may be subject to modification like any law as social mores change.

No standard should be issued without some understanding of its effects. It would be an unfortunate situation where the impacts of a particular accounting standard were not reflected on before it was issued. This reflection must also include the class of entity or entities to which a standard setter would like pronouncements to be applied. Developing standards without having an audience in mind for its application would be an academic exercise. This does not mean that decisions that improve financial reporting should be deferred or abandoned because some sectors of the business or professional communities have vested interests in the introduction or maintenance of certain reporting practices.

This paper examines key aspects of the EFRAG discussion papers and explores the themes related to the analysis of effects of accounting standards and related guidance. The following areas are examined in more detail:

- EFRAG paper: background and contents
- Australia's standard setting regime and effects analysis;
- Evidence gathering tools used by standard setters;
- Adoption of IFRS in Australia: a case study; and
- Standard setting, smaller entities and small business.

Feedback from stakeholders received by the Institute on issues raised by, or related to, the paper includes:

- support for existing due process measures and a general rejection of the proposition that effects analysis be hardwired into each stage of the standard setting process;
- concerns about the place of effects analysis and political motivations of individuals or organizations advocating change to a standard setters due process;
- absence of practicality in the discussion paper's proposed model of effects analysis at each stage of the due process;
- confirmation that costs are usually easier to identify than the benefits that flow from better reporting and more transparent markets;
- threat of due process being slowed down due the consideration of effects that go beyond the normal considerations of financial reporting;
- difficulty in properly assessing the impact of a new proposal on the market place. Any exercise such as field testing will only ever be indicative of how a reporting population may behave;
- a combination of methods to seek feedback continues to be encouraged by stakeholders consulted by the Institute; and
- oversimplification of the reporting population such as that which occurs during debates over small to medium enterprises can lead to poor standard setting. Standard setters must acknowledge the needs of growing businesses and create a regulatory framework that is internally consistent. One example is the Australian Reduced Disclosure Regime (RDR).

Greater attention is required in designing a proxy for the specific population for which a standard setter is setting rules. The classic case is the population for which IFRS for SMEs is intended, as opposed to the application of full IFRS. While the Institute understands proxies or models are used as an illustration for decision making purposes, they can create false expectations in the marketplace. A model that streamlines accounting regulation for publicly accountable and non-publicly accountable

entities is seen as a better outcome as entities have minimal measurement and recognition changes with which to concern themselves.

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## Introduction

The setting of accounting standards contains a process of inquiry that is designed to capture the views of stakeholders on proposals contained within the new or revised accounting standard. There are, however, concerns raised by constituents in local and global standard setting jurisdictions from time to time about the rigor of the standard setting processes and what, if anything, can be done to improve the due process of a standard setter. These concerns will often come following the introduction of new financial reporting pronouncements.

The International Accounting Standards Board has found itself the subject of multiple reviews of its governance structure and due process in recent years. This closer examination of the international standard setter's processes is largely due to its growth in prominence. It has managed to become the provider of choice for accounting standards over the last decade and because of this, it has accumulated fans and critics of its *modus operandi*, including criticisms from Europe.

The EFRAG discussion paper represents another such examination of due process or decision making by a standard setter. It argues for effects analysis to take place at every stage of a standard setting process – a call that has been viewed with some skepticism by stakeholders consulted by the Institute given the fact that its issue comes as standard setters are still dealing with the backwash of the Global Financial Crisis (GFC).

This response to the EFRAG paper explores a range of issues related to the due process of standard setters and what, if anything could be done to improve it.

## The EFRAG paper: background and contents

The EFRAG discussion paper concerns itself with the analysis of the impact proposed accounting standards might have on the financial statements of the entities that apply them. It is a paper that has its genesis in the United Kingdom following moves by the UK Government to introduce new regulations requiring the analysis of regulatory impacts. These regulations were set to affect the accounting standard setting process. The discussion paper was an attempt by the staff of the UK Accounting Standards Board to explore potential means of evaluating proposed accounting standards that did not involve onerous quantification requirements.

The topic became of equal interest to EFRAG over time given that the European continent has faced a range of political challenges in dealing with the standard setting independence of the International Accounting Standards Board. As the IASB's efforts to win the American regulators and standard setters strengthened over time so too did the European resentment to what appeared to be favoritism demonstrated by the IASB. This manifested itself in the number of joint projects being conducted by the IASB and the Financial Accounting Standards Board in the United States. It has also resulted in debate about the IASB's willingness to assist jurisdictions who have adopted IFRS to deal with implementation as opposed to working intensively with jurisdictions that are yet to adopt the product. The IASB has altered its due process to incorporate greater outreach in various regions of the globe in order to capture a broader range of views and enhance its visibility. This outreach initiative provides a greater opportunity for the IASB to alter perceptions of a bias towards specific markets that are yet to adopt the IFRS.

A further factor needing consideration in this analysis is the pressure that grew on the global standard setters as a result of the GFC. This period presented the IASB with serious challenges and was also a time during which Sir David Tweedie<sup>1</sup> considered resignation. The period of the GFC represented a move against an established standard setter following threats by the European

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<sup>1</sup> Sir David Tweedie mentioned this during an interview with the Institute's Head of Research, Tom Ravlic, on February 28, 2011. This was Sir David's last trip to Australia in an official capacity with the International Accounting Standards Board.

Parliament to excise parts of an accounting standard that required entities to mark financial assets to market at the height of the GFC. An important fact to remember is that European law only permits the European parliament to remove a portion of an international standard rather than add requirements or amend it. The IASB amended IAS 39 to permit reclassification of financial assets retrospectively in order to avoid the European Parliament removing the accounting requirements. The effect of this change was to allow those asset balances to be restated using a measure other than market value. It should be noted that this was a situation where the international standard setter was placed under immense pressure that led to it suspending its normal due process. The IASB amended a standard without exposing changes for public comment in order to deal with the European threat.

Recent reviews of the IASB's due process and structure by the Board of Trustees of the IFRS Foundation and others have occurred at the same time as the debate on analysing the effects of accounting standards and has been encouraged by EFRAG's accounting experts. The April 2011 Report of the Trustees' Strategy Review entitled *IFRS as the global standard: Setting a Strategy for the Foundation's Second Decade* raised a series of issues related to the IASB's accountability for its due process. The Foundation's Board of Trustees concluded that there were a series of issues the IASB must continue to monitor and develop to maintain high standards of consultation with stakeholders. Amongst these measures is the use of cost benefit analysis to explain the logic of decisions, which is the subject of the EFRAG paper. At the time of writing the IASB has issued several publications dealing with impact analysis and detailing at the specific standard level the impact of standards. The publications provide information about the due process undertaken by the IASB and the various impacts of a new or revised standard when compared with the previous guidance. These publications have started appearing over the past six months. It is highly probable that the trustees report as well as the IASB's own wish to improve its processes and transparency have led to these analytical reports being published.<sup>2</sup> There are also feedback statements published for the standards for which an effects analysis has been written.

#### *Key points from the EFRAG paper*

At its heart the EFRAG paper proposes that standard setters consider the broadest range of effects possible through the life cycle of each project. The paper uses the term 'effects analysis' in preference to 'impact analysis'. What on the surface appears to be semantics is explained by the authors as an attempt to use a different term so that 'effects analysis' is seen in the narrower context of accounting standard setting. The authors of the paper argue that 'impact analysis' is used in the context of broader regulatory analysis, which normally requires quantified costs and benefits. This is seen by the authors as being inappropriate in the setting of accounting standards. A key reason for this is that it can be difficult to quantify the effects of an accounting standard. Much of the work for which standard setters are responsible for is aimed at increasing the level of transparency to the users of accounts through improving the quality of accounting used and its disclosure. The benefits of this cannot always be quantified in dollar terms. Researchers, however, are able to analyse the market impact of an accounting standard post-implementation and use it to assess whether additional information contained in financial statements and their notes has value relevance.

The paper presents key arguments for and against the further embedding of effects analysis in the standard setting process. Jurisdictions across the globe have ceded aspects of their lawmaking to the IASB and one of the arguments used for the provision of more material dealing with effects analysis are questions of accountability, transparency and credibility. Governments in countries that have adopted IFRS may want evidence that standards have been developed in a thorough fashion. Expansion of effects analysis is also seen as beneficial in the context of the GFC given that the crisis in global financial markets resulted in various statutory authorities and boards questioning the impact of financial reporting standards on the way companies are seen in the market place. Another important

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<sup>2</sup> The IASB published effect analysis documents for IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements and IFRS 12 Disclosure of of Interests in Other Entities on its web site on September 8, 2011. The documents contain features that are called for in the EFRAG discussion paper such as more detail on the impact of an accounting standard that is new or has been revised. The IASB's analysis incorporates a before and after section for major changes, which is an educative tool.

rationale that appears in the discussion paper is that an effective effects analysis process may shield standard setters from claims that accounting rule makers pursue theoretically pure solutions that are not grounded in commercial reality. Evidence that a standard setter has consulted stakeholders, considered feedback and documented the rationale for its decision making is said to provide a defense against critics of the standard setting regime.

The paper also outlines four key principles for the consideration of effects. These principles are as follows:

- *Principle 1: Explain Intended Outcomes: Standard setters should explain intended outcomes of a proposed accounting standard or amendment in terms of their objective of serving the public interest by contributing positively to delivering improved financial reporting. This should be done at the agenda setting stage;*
- *Principle 2: Encourage input on anticipated effects: Constituents should be actively encouraged to provide input on anticipated effects, which should be considered against the standard setter's objective;*
- *Principle 3: Gather evidence: The evidence gathered should demonstrate that the proposals faithfully represent the underlying economic reality and produce information that has utility for users. Effects should be quantified where such quantification is practicable and is likely to be useful for decision making, and,*
- *Principle 4: Consider effects throughout the due process: Consideration of the effects of an accounting standard or amendment should occur throughout the standard setting process; it should be embedded in that process and not considered as a single event.*

These principles would then be applied during the standard setting due process. The paper describes the standard setting due process as having the following five stages:

- A. When an agenda proposal on the project is considered by the standard setter;*
- B. When a discussion paper is issued for public consultation (this effects analysis is an update to 'A'; to reflect the latest information available);*
- C. When an exposure draft is issued for public consultation (this effects analysis is an update to 'B'; to reflect the latest information available);*
- D. When a final standard or amendment is issued (this effects analysis is an update to 'C' to reflect the latest information available); and*
- E. For new accounting standards and major amendments, a 'post-implementation review' is required, which is an analysis of 'actual effects' that should be performed and published when the pronouncement has been applied for at least 2 years, together with the publication of an associated document setting out the key elements of the review; a post-implementation review is not required for minor amendments.*

It is argued by the paper's authors that the effects analysis must occur at each stage in order to ensure all of the views of constituents, as well as any practical evidence obtained during the gathering of evidence of effects, is reflected in any final analysis.

## Australia's standard setting regime and effects analysis

Reviews of standard setting and its effectiveness have periodically taken place in Australia. Australia's standard setting structure for accounting has been subject to a government review at least once a decade since the early eighties. A seminal government review of Australian accounting standard setting that resulted in the greatest structural change in accounting regulation was launched in 1997. This review was a part of the then Federal Government's Corporate Law Economic Reform Program (CLERP). The CLERP paper proposed the introduction of a stakeholder based oversight body known as the Financial Reporting Council, the creation of a permanent secretariat for a standard setting board, as well as laying the basis for the future adoption of a global reporting framework.

As part of the discussion paper on potential changes to the Australian system the government of the day offered some observations on cost-benefit analysis.<sup>3</sup> Accounting standards are delegated legislation in Australia and therefore subject to the same requirements all laws must meet when they are being developed. Each piece of legislation must be accompanied by a regulatory impact statement (RIS) that provides a justification for the existence of the law in Australia. Accounting standards are treated no differently in this respect. It is a procedural and legal requirement for laws to be tested in Australia.

"The costs of compliance with accounting standards are increasingly becoming an issue. To some extent this is understandable given the growing sophistication of financial transactions which accounting standards seek to address. In particular, accounting standards are complex in many cases because the underlying financial transactions they are dealing with are complex," the 1997 Treasury paper stated.

"Although rigorous and detailed accounting standards assist in establishing greater transparency in the market, thereby ultimately reducing the costs of capital for business as a whole, it is important that the costs of compliance with accounting standards, not only to corporate and the business community, but also to the economy as a whole, do not exceed the benefits. In this regard, it should be noted that while the owners of an enterprise bear the direct costs of compliance they are also the ultimate beneficiaries of a well informed market."

Federal Treasury noted that the costs of compliance can be difficult to quantify but some of the costs include:

- collection and storage of raw information;
- retrieval of information;
- presentation of data;
- analysis and interpretation of standards and their translation to an entity's particular financial statements; and
- reviews of compliance with accounting standards.

Federal Treasury's paper was issued at a period of time of an expression of great angst from corporate Australia about the general trends in change in accounting standard setting. Embedded throughout the paper are references to establishing involvement in the process by a range of stakeholder groups that had previously felt disenfranchised even though the Australian Accounting Standards Board at the time held consultative group meetings and had a due process that was based on assessing written responses to exposure drafts. It is significant to note that the push to introduce IFRS at that time followed significant campaigning from various business groups, some experts in accounting firms and professional accounting bodies.<sup>4</sup>

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<sup>3</sup> The Corporate Law Economic Reform Program was a name given to a series of law reforms that were an attempt to reform a range of areas of corporate regulation. Accounting Standards was the first of several areas that were targeted.

<sup>4</sup> The angst that was expressed by the business community flowed from the challenging work done by the then Australian Accounting Research Foundation, or AARF, on the conceptual framework in the early 1990s.

### *Regulatory impact analysis*

The Australian Government has an agency residing in the Department of Finance and Deregulation called the Office of Best Practice Regulation (OBPR). The OBPR was set up to monitor development of new law and ensure that it is subject to a rigorous analysis before being accepted as law and subject to implementation. Government agencies are put through a thorough process that requires them to submit a RIS that contains an outline of the costs and benefits of a specific regulation and what other options were considered by a board, regulator or statutory authority at the time of developing a law. The Australian Accounting Standards Board (AASB) is a statutory authority that is bound by that process along with its auditing counterpart, the Auditing and Assurance Standards Board (AUASB).

The OBPR has a set of criteria for assessing the adequacy of a RIS. Any new law that is subject to the requirements of the OBPR must have a RIS that contains the following:

- Definition of the problem that needs to be fixed. This includes the size of the problem, evidence existing laws are not dealing with it adequately, any risks that the problem or issue poses to the community and a case for the government to take action.
- Key objectives of a proposal need to be clearly stated so they can be understood by readers.
- Analysis of alternative options to deal with the particular regulatory problem. This may include non-regulatory, self-regulatory and co-regulatory options. This is to ensure that a proposal being placed before the government and the Commonwealth Parliament is one of several options that have been considered by the relevant policy makers.
- An analysis of impacts that must include an account of the stakeholders affected by the measures proposed, costs and benefits of all of the various options considered, consideration of the impact of the change on all areas of the economy, a quantification of the costs and benefits and a recognition of the impact of the various options on individuals and business.
- A description of the consultation that took place including the stakeholders consulted, including the provision of the opinions of parties that disagreed with the preferred solution.
- State the conclusion and recommended option for the regulatory change. The OBPR will expect the recommended option to be supported by evidence within the RIS.
- A description of the implementation of the recommended regulatory change and also how that regulatory change will be monitored and reviewed.<sup>5</sup>

The auditing and accounting boards are exempted from complying with the requirements to prepare a RIS when the document that they are issuing is essentially an international document. In other words the process for effects analysis is deemed redundant. This is because the boards are complying with a government policy to adopt the standards of an international body<sup>6</sup>. The two boards are still required

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Corporations used to accounting for a range of transactions using particular rules were confronted with a possible principles-based accounting regime that could have resulted in leases previously kept off balance sheets being put on because of the definitions of assets and liabilities that were to apply. This situation would have led to an end to off-balance sheet leasing arrangements. Controversies such as this resulted in a great deal of resentment in the corporate sector towards the standard setting fraternity. This contributed to the push by the corporate sector for the adoption of IFRS and the eventual change in the financial reporting regime that came into effect via CLERP 1.

<sup>5</sup> A more detailed appraisal of the role of the Office of Best Practice Regulation and its guides to the development of regulatory impact statements can be found at [www.obpr.gov.au](http://www.obpr.gov.au).

<sup>6</sup> In the case of the Australian Accounting Standards Board it is principally charged with the task of adopting the IFRS issued by the London-based IASB. These standards are developed by the IASB with a focus on for-profit entities. The AASB will then add any Australian-specific requirements for not-for-profit and government entities. The Auditing and Assurance Standards Board (AUASB) uses the standards of the International Auditing

to formulate a RIS when they are developing unique Australian accounting or auditing standards. These are lodged with the OBPR and reviewed for compliance with the OBPR's framework. The documents are published on a website so that interested parties are able to read the effects analyses. It should be noted that the the OBPR is able to publicly state when a statutory authority or other government body has failed to meet the standards or requirements set down by the OBPR.

#### *Results of consultation on the general notion of effects analysis*

No concern was expressed by constituents consulted by the Institute about the general concept of analysing the possible impact of accounting standards on entities and the broader community. All constituents consulted agreed with the concept of the ideas of standard setters and regulators being tested with the community before standards are issued. There were, however, concerns raised in relation to the manner in which the process for effects analysis could be used by groups or individuals with vested interests. It was also considered unnecessary to have the notion of effects analysis hardwired at each stage of the standard setting process. Support was generally expressed for the current processes undertaken by the AASB in the development of a standard.

The capacity of powerful business interests such as banks and other financial institutions to influence the standard setting process globally was cited as a major issue for some stakeholders. It was acknowledged that these entities were able to use their influence outside of standard setting circles to seek amendments to standards that were perceived as being detrimental to a sector. This occurred during the GFC when the banking sector in Europe was hit hard by the movement in the fair values of the assets they held. Significant lobbying took place to achieve a change to the accounting standards because they argued that the impact of the standards as they existed was detrimental to the sector. The instance of elements of the business community lobbying the US Congress in the 1990s during the height of the powers of 'Silicon Valley' corporations on the issue of expensing share options was raised as an example of how certain effects such as an increase in expenses were seen by companies in the high tech sector as a threat. The chairman of the US Securities and Exchange Commission at the time, Arthur Levitt, later stated in his biography that the failure of the Commission to stand by the US standard setter's resolve to force expensing of share options at the time was for him a major regret.

A further matter raised uniformly by stakeholders was that there was always the potential to identify costs. It was common to encounter references to the costs of systems upgrades, costs of training and costs of communicating the change to a range of stakeholders. It was uniformly agreed that while the public interest was served by improved reporting that was not easily quantified. However, the absence of quantification of benefits was not seen as a good enough rationale for a standard setter to abandon a proposal to issue a new or revised standard. In other words, there is an overarching demand to ensure the public interest is served by the standard setting process.

Stakeholders expressed concerns about what they should do with information arising from consultation that suggested companies may lose value on the share market if transactions were reported in a different way that better portrayed the economic effects on a company. An effects analysis that is conducted broadly may uncover concerns from preparers that their financial statements will be cast differently and shareholders may choose to sell their shares based on a poorer reported result. Most of those consulted agreed that a standard setter should act in the public interest and not change a proposed accounting standard because of the complaints or concerns of a sectional interest.

It was also considered by some stakeholders that any further requirement for effects analysis would create a delay in the process for issuing final pronouncements. Effects analysis was seen by some stakeholders as a euphemism for slowing down a standard setting process by adding a further layer of bureaucracy. It was also noted by some commentators that the EFRAG paper was strong on the

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and Assurance Standards Board (IAASB) – a body that operates under the auspices of the International Federation of Accountants (IFAC) as the basis for its pronouncements. Similarly, the AUASB will add to the IAASB standards in order to ensure that the domestic rule of law is catered for in the document.

concept of expanding effects analysis but did not contain sufficient practical guidance on how a standard setter ought to implement an additional element to their due process. A contrary view was also expressed on this matter. One commentator stated that standard setters were doing much of what EFRAG was suggesting and that the notion of greater effects analysis should not be viewed as a major threat to standard setters.

## Evidence gathering tools used by standard setters

The Institute consulted stakeholders about the merits of the various processes used by standard setters to gather evidence in the standard setting due process. While stakeholders were happy with general requirements for effects analysis there were diverse views presented on the value of various means of evidence gathering in the standard setting regime. It was agreed by stakeholders that the current consultation regime in Australia appeared sufficient to deliver an understanding of the potential impacts on any new proposals issued by the AASB.

### *Written exposure draft responses*

Written correspondence providing comments on a proposal for a new or revised standard remains a staple of the due process in Australia. It is a key method used to collect the views from parties interested in the development of a particular accounting standard. The letters will not represent the views of an entire sector, however, as this method of engagement requires stakeholders to find the time to draft responses.

Since the adoption of IFRS the response to domestic standards has noticeably declined. However, it is still possible to receive large numbers of submissions on specific domestic topics. From time to time there are attempts by some commentators to encourage a large number of people to submit the same letter as a part of a letter writing campaign. These letters are typically short and do not address the substance of issues raised. This was an approach taken by some constituents to the debate on differential reporting. Mass letter campaigns have attracted a range of views. One perspective is that the correspondence should be collated by the standard setter as one letter given there is no added technical or problem solving value. Another perspective aired during the consultation process on effects analysis by stakeholders was that each letter should be counted as one contribution to the debate like a vote in a poll. This clashed with a view presented by other stakeholders that the standard setting process was not a popularity contest and was meant to be an attempt to set good accounting regulation.

### *Project advisory panels*

Project advisory panels consist of individuals that have specialist knowledge in a topic area. While they may have a slightly different name these groups of experts are used by the Australian Accounting Standards Board and the Auditing and Assurance Standards Board in Australia to test ideas with specialists or enthusiasts in a specific area. This takes place in order to ensure that the standard setters develop a standard that is relevant to the current market place. Groups of experts will usually be consulted when the standard setters are developing a document to ensure critical areas are covered before a document is released into the public domain. These groups are generally seen as productive and essential to the standard setting process.

### *Round tables and outreach*

Over the past decade there has been an increasing tendency for accounting standard setters to make use of the concept of a 'round table' discussion. These forums provide an opportunity for stakeholders to debate the issues with standard setters and also with fellow stakeholders. Some commentators see these as an effective means of communicating with standard setters while others view them as a 'lazy way out' of drafting a submission to the standard setter. One point cannot be overlooked in these circumstances. The round table format represents a physical manifestation of the standard setter listening to constituents.

The current format for round tables is different to the way in which standard setters previously used the round table process. There was a time when standard setters used the process of hearings to examine an individual's or organisation's submission to the standard setter on a specific issue. It was not unlike the process that we associate with the various parliamentary committees in the Australian Federal and State Parliaments. Those committees will typically invite a group or individual to speak to their submission and be questioned by the committee as a part of the gathering of evidence for an inquiry. Oral evidence is documented in the form of a transcript and is considered alongside written submissions.

The Institute of Public Accountants has both convened and participated in high level round tables. The Institute has found that the use of round tables is effective for obtaining high level feedback and assessing the general environment in relation to a specific standard or policy. While it is true that a round table is not a substitute for a written submission that may contain research evidence, the capacity for the views of stakeholders to be tested by a standard setter is valuable. The Institute has in the past facilitated round tables with senior accounting regulators from across the globe and each of these was seen as being valuable by the standard setters and participants involved found it to be useful.<sup>7</sup>

A recent interaction between the Australian Accounting Standards Board and its broad constituency is worth mentioning in this context. The Australian standard setter held a complimentary day long symposium on not-for-profit developments that was designed as an update of the board's work in the area but also an opportunity for some interaction with stakeholders. This approach provides the standard setter with some feedback on proposals that may still be embryonic.

Feedback can also be provided to the AASB via presentations that board members and technical staff deliver at conferences across the country. Such conferences occur on a frequent basis and may provide similar kinds of feedback as would be gained from a round table.

### *Web surveys*

Web surveys are also used by standard setters but on a far more limited scale. We encountered mixed reviews from organizations that had used web surveys to obtain feedback on financial reporting issues. While they are useful to test ideas and proposals, the web survey it is not seen as a substitute for other elements of the standard setting due process.

### *Stakeholder visits and individual consultations*

There are occasions when the standard setters will meet with individual stakeholders to discuss contemporary issues. This can be done at any time, although when done as part of a due process, it is to seek greater clarity on the point of view presented to the standard setter. These meetings can be held at either the request of the standard setter or a stakeholder group. Stakeholders highlighted the

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<sup>7</sup> The Institute hosted a round table featuring Ian Mackintosh, the IASB vice-chairman, on September 2, 2011. This session provided excellent feedback on attitudes to various issues the IASB was contemplating and formed the basis for the Institute's submission to the IASB's agenda consultation.

usefulness of these meetings in providing a forum to discuss confidential issues related to company reporting that may otherwise not be brought to the standard setter's attention.

### *Field testing*

Field testing is used in Australia but, from discussions with stakeholders, it is done so sparingly, given the commitment that it requires of companies and entities involved. The Institute of Public Accountants was a participant in an exercise to road test the initial draft of the IFRS for SMEs standard. This involved taking three companies of varying sizes and complexity and transposing their current circumstances into the picture that would be given by IFRS for SMEs. It is rare that these exercises occur given the amount of work that is required. Accounting firms may support clients that are prepared to engage in field testing but firms themselves will not tend to make it a priority to recruit clients to become involved in global field testing exercises. Results from processes like field tests can be useful but should be viewed as being indicative only, given the small sample that is usually a part of such as exercise.

## **Adoption of IFRS in Australia: a case study**

The decision to adopt IFRS in Australia was made in June 2002 by the Financial Reporting Council. No regulatory impact analysis was done at the time, which meant significant impacts of the move to IFRS on the tax affairs of global companies, impact of IFRS as it relates to prudential regulation, and the compliance burden on not-for-profit entities were not evaluated. Subsequent discussions were had in all of these areas prior to and following the implementation of the IFRS directive.

One of the areas of contention was the impact of the move to IFRS on companies that had depended on accounting standards that existed at that time to qualify under the tax rules related to thin capitalisation.

### *Thin capitalisation*

Provisions related to thin capitalisation in tax law met conditions of regulatory impact as the purpose was to reduce the compliance burden on entities where valuation of assets was concerned. Federal Treasury stated in a paper on the issue released in November 2006<sup>8</sup> that there were "clear benefits associated with valuations for thin capitalisation purpose being determined by reference to these standards". Federal Treasury highlighted the following areas:

- *AIFRS are comprehensive, transparent and objective (although it is acknowledged that some standards are not finally settled).*
- *It reduces compliance costs for entities subject to the thin capitalisation rules, as the same set of accounts will satisfy both their corporate reporting and thin capitalisation requirements.*
- *As an adoption (albeit with some modifications) of standards operating in many overseas countries, it improves comparability of Australian and overseas financial reporting. In many instances, it is likely that multinational entities subject to Australia's thin capitalisation rules will also operate in countries which have adopted IFRS.*

"The use of accounting standards in determining values under the thin capitalisation rules was expected to reduce compliance costs for most entities, as the tax values are more closely aligned with accounting principles and practice and it is generally not necessary to make separate valuations for thin capitalisation purposes," the paper stated.

The adoption of IFRS did create a complication in what was perceived to be a perfect model of compliance burden reduction. IFRS imposed a range of requirements that previously did not exist in

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<sup>8</sup> The Federal Treasury discussion paper *Thin Capitalisation: Application of Accounting Standards* can be accessed by visiting the following link:

<http://www.treasury.gov.au/documents/1179/PDF/Discussion%20paper%20-%20final.pdf>

what was known as Australian Generally Accepted Accounting Practise, abbreviated to AGAAP. AGAAP was used to generate tax figures. When standards changed the figures companies relied on for tax law compliance were dramatically altered.

A major change in accounting that caused an outcry amongst corporations in Australia was the introduction of a specific accounting standard on intangible assets. Previous accounting was based solely on standards related to financial reporting for assets. Intangibles and tangible assets were deemed by practitioners to be covered in this instance. It led to a growth in valuation practices given advice from firms that intangibles could be revalued. Such revaluations could assist an entity to boost its asset values for both financial reporting purposes and for the purposes of thin capitalisation.

Companies realised that the shift to IFRS might maintain the linkage between the tax law and the accounting standards but they also learnt that a permissive previous accounting regime in the area of intangible assets had become stricter. Companies were stung by the application of stronger guidance on intangible assets that resulted in their asset base being written down. IAS 38 required companies to write down the value of assets to their acquisition cost. Some of the financial statements analysed by Federal Treasury at that time produced the following results:

- *Approximately \$6 billion write down of intangible assets (based on data from eight companies in the beverage and media sectors).*
- *Approximately \$1.3 billion increase in deferred tax liabilities (based on data from seven companies in the beverage and media sectors).*
- *Approximately \$0.7 billion write-down of impaired assets (based on data from six companies in the beverage, media and mining sectors).<sup>9</sup>*

Each of the companies to which those write downs applied would have found itself in a state of concern about their compliance with thin capitalisation rules and the potential for inquiries from the Australian Taxation Office about their compliance.

A key point in the thin capitalisation scenario was that the regime had only changed in 2001 following industry consultation about the manner in which figures were calculated. Federal Treasury noted that industry experts were consulted in the development of the changes and that the thin capitalisation rules were in effect at the time of the decision made by the FRC.

The tax dilemma needed to be resolved after the overarching policy decision to adopt IFRS, for financial reporting periods beginning on or after 1 January 2005, was taken by the Australian FRC. This was the result of having no regulatory impact analysis done in a formal fashion at the time the adoption directive was discussed and decided on by the FRC in June 2002. A rudimentary environmental scan involving parties with expertise in a broad range of disciplines could have identified linkages between accounting requirements and other laws that needed to be considered as a part of the decision to adopt IFRS. This was not done at the time and as such created issues that were still being dealt almost five years after the issuance of the directive to adopt IFRS.

It is arguably more critical to engage in the analysis of regulatory impact when an overarching policy directive is being considered rather than dealing with an analysis of individual pronouncements. A jurisdiction would find it difficult to maintain credibility if it were to decide to carve out sections of accounting standards based on pressure group preferences for accounting treatments once it has decided to adopt the full suite of IFRS.

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<sup>9</sup> These figures appear in the Federal Treasury paper cited earlier.

## Standard setting, smaller entities and small business

During the Institute's consultation on the EFRAG paper one significant issue emerged in the area of standard setting that merits inclusion because it is significant to the area of accounting for smaller entities and small business. The use of arbitrary notions of big and small, publicly accountable and not publicly accountable, according to some stakeholders, can lead to poor standard setting outcomes. This was specifically raised in the context of IFRS for SMEs<sup>10</sup>. The standard was written for entities that are defined as being not publicly accountable and contains vastly different accounting treatments on some issues to those in the full book of IFRS. IFRS for SMEs does not provide guidance for all possible transactions with which a smaller entity might be dealing at a point in time. One stakeholder outlined their concern that standard setters have been oversimplifying the notion of a smaller entity as a tool for standard setting which has resulted in an absence of consideration for what might happen if entities engaged in complex transactions not catered for in IFRS for SMEs. IFRS for SMEs has been criticized by some commentators for having the potential to create two classes of accountants: people that use the smaller book and those that use the larger volume of IFRS.

The same is said to be true for the process of setting auditing standards. Some stakeholders have stated that the audit standard setting process has lost sight of the fact that auditors of smaller entities need to understand how to audit complex transactions as much as they need to understand the audit processes and procedures for simple ones. It is argued that the use of the notion of big and small audits, for example, could create a tiered profession in the audit discipline and result in auditors that lose growing clients.

While the Institute understands proxies or models are used as an illustration for decision making purposes they can create false expectations in the marketplace. A model that streamlines accounting regulation for publicly accountable and non-publicly accountable entities is seen as a better outcome as entities have minimal measurement and recognition requirements with which to concern themselves.. Complex reporting typically results from entities engaging in complex transactions. A smaller book of accounting guidance does not remove the need for further advice to be sought once an entity moves beyond the kinds of transactions for which a standard such as IFRS for SMEs has been designed.

The same is true for the area of audit. While audit was not a part of the EFRAG discussion paper the same standard setting characteristic was noted by stakeholders, that the use of the notion of small entity audits and large entity audits creates the potential for auditors in smaller practices to not see themselves as a part of the broader audit discipline but as part of a subset that deals only with smaller entities.

## Conclusion

The Institute found that there was support for the existing standard setting due process mechanisms domestically and internationally during its examination of the issue of effects analysis in the standard setting process. It was found that some Australian stakeholders held concerns about the impact of any move to build more due process measures into place. There is evidence that the IASB is prepared to make changes to its processes to improve the engagement with its global stakeholder base. Changes in recent times include the publication of effects analysis documents by the IASB, which appears to have been prompted by the review undertaken by the IFRS Foundation. There is no need for external pressure to further enhance the due process of the standard setter whilst the IASB has the willingness to take action to change processes incrementally over time.

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<sup>10</sup> The Institute of Public Accountants has previously written to the Australian Accounting Standards Board and argued against the adoption of IFRS for SMEs in Australia following an extensive due process. Most of the Institute's constituents supported compliance with the full recognition and measurement criteria of IFRS with a reduced disclosure regime existing for entities that are deemed to have no public accountability.

Consultation methods currently used by standard setters were generally supported by stakeholders consulted by the Institute. Written submissions are still considered to be a primary source of feedback to a standard setter seeking to understand the impact of a proposed new or revised accounting standard. Working groups or project advisory panels are used to identify key problems in an industry as projects are in the development phase. These groups are seen as effective in ensuring industry concerns are identified and addressed before an exposure draft is issued for public comment. The Institute obtained mixed feedback from stakeholders consulted about the role of round tables in a due process. Most respondents agreed that round tables provide an opportunity to hear a range of views in one forum during which views can be challenged. Other stakeholders believed the round table format can be used by some stakeholder groups as a means to avoid allocating time to drafting a submission or a 'lazy man's way out'. Commentators holding this view prefer only those individuals or organisations that have provided written submissions to be present at forums so that the standard setters can test the views presented in writing further.

One suggestion to emerge from the consultation process conducted by the Institute is for standard setters to be mindful of using simplistic modeling when debating issues related to smaller entity reporting. Standard setters need to be mindful that the use of simplistic models for discussions related to differential reporting do not create a false impression of the reporting environment for which the standard setter is seek to provide guidance.

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