ED 151 sub 2

From: Hughes, Mark [mailto:Mark.Hughes@canberra.edu.au]
Sent: Monday, 15 January 2007 2:47 PM
To: AASB Mailbox
Subject:

Please find attached a comment letter relating to ED 151.

Please feel free to contact myself or Brian Andrew at brian.andrew@cdu.edu.au
I will be away from 17th Jan-10th Feb inclusive.

All the best,

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Comment letter on certain aspects of Exposure Draft 151

Mark Hughes and Brian Andrew[1]

We would like to thank the Board for giving us the chance to make some comments on ED 151. It is clear that the staff and board members have spent considerable effort developing this exposure draft but we have many concerns about the proposed changes. The reduction in both the quantity and quality of information to investors inherent in many of the changes will inevitably reduce investors' ability to base their financial decisions on published financial information and this is likely to have an adverse impact on Australian capital markets over time.

We would like to offer comments on the arguments presented in the ED's 'Basis for Conclusions', as these are the justification for what follows in the exposure draft. We are particularly concerned with the proposal to allow reporting entities the optional treatment of presenting cash-flows from operations using the indirect method and use this as an exemplar of why the Board might want to reconsider some of the proposals.

Where is the connection between the Conceptual Framework and the Basis for Conclusions?

The ED states that in order to maximize the benefit of adopting IFRS, we need to adopt the same requirements as IFRS and remove any Australian differences, other than additional disclosures. Nevertheless the draft comprises many cases of removal of additional disclosures that exist in current AASB standards. The Board appears to argue that failure to remove differences could lead to different outcomes from those that would be achieved under IFRS but ignores the fact that in most cases Australian accounting standards are superior in quality to IFRS standards, especially the remaining IAS standards that have not been amended or upgraded by the IASB.

The AASB justifies these proposals by stating it "is satisfied that the principle of having the same requirements as IFRSs for for-profit entities is in Australia's best interest and that any associated costs will be exceeded by the potential benefits of comparability between Australian financial reporting and financial reporting under IFRSs elsewhere in the world" (Page v, Preface). This statement, without any evidence or argument to support it, is not a convincing basis for the recommendations in the draft.

Presumably the AASB believes that increased consistency between AASB and IASB standards will lead to reduced costs of capital for Australian firms. This view is in line with the general objective of the CLERP agenda. However, the board has failed to show how reducing the levels of disclosure and/or introducing more choices when accounting for a specific class of transaction will reduce the cost of capital. It is strange that the board seems more concerned with harmonization, rather than striving to increase the quality, of accounting rules.

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Unfortunately, the board's justification ignores the objective of financial reporting as stated in the Conceptual Framework. The *Framework* states that the objective of financial reports is to provide "information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions." (International Accounting Standards Board (IASB), 2001 para 12). The objective says nothing about developing accounting rules that are in 'Australia's best interests', it is focused on the quality of information in the reports and the ability of users to incorporate that information in their decision-making[2]. It is axiomatic that any proposed changes to accounting standards must explicitly analyse the potential impact of the changes on the stated objective of financial reporting. Failure to fully explain and justify all the proposed changes will very likely lead to a negative reaction from many users and a substantial reduction in the quality of financial reports in Australia.

The AASB should focus on improving the quality of accounting standards, both in Australia and on the international stage, rather than seemingly adopting an attitude of consistency between AASBs and IFRS at any cost. Removing requirements for increased disclosures from our standards, where these disclosures do not contradict the IFRS, simply to promote increased conformity with IFRS and their 'lowest common denominator' levels of disclosures is unlikely to bring us closer to the objective set out in the *Framework.*

The Statement of Cash Flows

The Exposure Draft proposes allowing reporting entities the option of using the direct or the indirect method for presenting cash flows from operations. We are surprised by the Board's proposal to open the door to the indirect method when it is well established in the literature 'that the indirect method greatly undermines and diminishes the relevance and mission of the cash flow statement' (Jones et al., 1995, p115).

We expect this proposal will lead to a lower quality accounting standard. There is considerable evidence that the indirect method is widely adopted by companies that are allowed this option. For example, Cinch et al., (2000) refer to a survey conducted by the AICPA in 1992 that found 97.5% of companies surveyed used the indirect method. Broome (2004) reports similar figures. There is no reason to believe that Australian reporting entities would behave differently to American companies and so we would expect to see a substantial move to this format even though there is no reason to do so based on cost of the presentation. The literature is full of studies of opportunistic behaviour by management which lowers the quality of disclosures and allows the manipulation of accounting accruals and the indirect method of presenting cash flow statements supports this type of opportunistic behaviour by management (for example Dechow and Dichev (2002), Francis et al (2005)). Thus, we can expect that users will lose easily understandable information that does not contradict the IFRS and that investors will be more exposed to opportunistic behaviour by management.

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[2] When we talk about quality, we refer to the ability of users to incorporate the information into their decision-making processes. Higher quality accounting standards should lead to better decision-making processes.

The high rate of use of the indirect method by American companies is particularly interesting, given that the FASB recommends the direct method over the indirect method, presumably because it believes this method provides better quality information. The majority of American companies seem to have ignored the FASB's preference.

Broome (2004) suggests the direct method can be more expensive for companies to use, compared to the indirect method, probably because of the requirements for presentation in the US standard . The American standard on cash flows, SFAS 95, and the IASB standard IAS 7 have similar biases which favour the indirect method. Both standards require companies to prepare the indirect method as a reconciliation in the notes if they use the direct method. If companies choose to use the indirect method in the statement of cash-flows, they are not required to present the direct method in the notes. This situation greatly increases the attractiveness of the indirect method, as it reduces the amount of work to be carried out by the preparers.

Unfortunately, there does not appear to be much empirical research into the quality and information content of the direct method compared to the indirect method. We suspect this is because companies within a country are either forced to use the direct method (Australia and New Zealand) or predominantly use the indirect method when given the option. What research there is tends to support the direct method over the indirect method. Cinch et al (2000) report a number of studies which indicate a range of financial statement users prefer the direct method to the indirect method. Jones et al. (1995) shows that pressure from the ASX, the ultimate user group, was responsible for the adoption of the Statement of Cash Flows in Australia. They also claim a wide range of user groups in Australia preferred the direct method over the indirect method when presenting cash flows from operations.

Frino and Jones (2005) found that the introduction of AASB 1026, the former Australian standard, was associated with a reduction in the bid-ask spread for ASX listed Australian companies that had not previously presented cash-flow information. This reduction was more pronounced for those companies with a low correlation between reported cash flows from operations and estimated cash flows from operations[3]. This indicates something of the possible importance of information contained in cash flow statements at the moment as many studies have found that there is a low correlation between short-term operating cash flows and profits and that inter-temporal differences between these two measures can convey useful information about firm solvency and the capacity of shareholders to make abnormal short-term returns from this difference. Further, Hribar and Collins (2002) show that estimates of cash flows from operations are likely to be substantially different to reported figures when companies engage in a range of reasonably common transactions such as

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[3] Before AASB 1020 was introduced, reporting entities had to produce a Statement of Sources and Applications of Funds. This statement did not concern itself with cash flows and was discarded in the aftermath of the spectacular collapses of the early 1990s, when many users and other commentators demanded information related to movements of cash, rather than the more nebulous concept of funds. Users previously had to try to estimate the cash flows from operations. This was often done by making adjustments to the reported figures in the balance sheet and the income statement. There was often a substantial difference between the reported figure, due to the introduction of AASB 1020, and the estimated figure.

undertaking mergers and acquisitions, discontinuing operations and dealing with foreign currency translations.

Other authors argue that the indirect method is difficult to understand as it ‘requires a myriad of special adjustments to income’ (Mello-E-Souza, 2006 p1). As academics teaching accounting students, we have some understanding of the complexity of these adjustments and especially the need to remove short-term accruals from the published profit figure in estimating cash from operations reported under the indirect method. We very much doubt that users, especially retail investors, but also some professional analysts, are able to exactly calculate the cash collected from customers, the borrowing costs paid and the amount paid to suppliers and employees using the information in the general purpose financial reports where the indirect method is used. Frino and Jones (2005) cite previous studies which support our concern on this point.

Of course, it is possible to derive an approximation of the elements which make up the cash flow from operations. These elements include cash collected from customers, cash payments to suppliers and employees etc. However, this raises the obvious question of why we would adopt an accounting standard that forces users to undertake complex analyses in order to produce figures that are an approximation of the underlying position. We suggest that critics of this view attempt to derive the

- amount of cash collected from customers,
- borrowing costs paid, and
- cash paid to suppliers and employees

for reporting entities with fairly simple operations, such as Woolworths or Coles, then try it for entities that are slightly more complex, such as Macquarie Airports etc. The aim of this exercise is not to say the analysis can’t be done, it is to illustrate how much more analysis users need to undertake in order to obtain information that currently exists and will be lost, if the majority of reporting entities in Australia adopt the indirect method of reporting cash flow from operations. Extrapolating from Frino and Jones (2005), we suggest that a move from the direct to the indirect method will increase information asymmetry in the market, as many users are unable or unwilling to expend the time and effort on obtaining the information that is currently presented in the direct method. Frino and Jones (2005) suggest an increase in information asymmetry will lead to an increase in the bid-ask spread. This increase in uncertainty will likely increase investment risk and can be expected to lead to higher costs of capital.

Under these circumstances it appears likely that the Board’s objective of reduced costs of capital will not be met.

It is hard to see how the introduction of the indirect method is going to reduce the required rate of return (the cost of capital for Australian companies) demanded by overseas investors. These investors are presumably used to dealing with the indirect method for calculating cash flows from operations. Possibly the Board is concerned they will be put off by the direct method of calculating cash flows from operations. However, the indirect method format is currently available to those investors as a note to the statement of cash flows, so removal of the direct method is not going to give these investors any information they don’t already have. However, adoption of the

indirect method will disadvantage Australian investors, who currently have access to both the direct and indirect formats for estimating the cash flow from operations. These investors can be expected to demand a higher rate of return, if only because of the increase in uncertainty and information asymmetry that will arise when Australian reporting entities move to the indirect method.

At risk of labouring the point, reductions in the cost of capital are only going to occur if the market believes the new information set is better than the previous one.

Recommendation

We suggest the proposal be reworded so that the direct method is retained as the method to be used in Australia with the indirect method reported in a note. However, if reporting entities are allowed to use the indirect option in the statement of cash-flows itself, they must also present the direct method in the notes. This treatment is not ideal, as it still leaves the potential for companies to use the indirect method in the statement of cash-flows. However, it ensures that users have the ability to access the information available under the direct method in a format which is available to them today, and it imposes the same cost on companies, regardless of reporting format chosen. Should we be concerned about the cost of forcing companies to use the direct method? Not at all, as this cost can easily be absorbed by companies reducing the number of glossy pictures and other non-essential marketing devices used in the production of the annual reports. We are unaware of research showing that Australian companies have suffered any competitive disadvantage due to the extra cost of preparing both the direct and indirect methods.

The need for users to understand the variables that affect the cash flows from operations has increased, and will continue to increase, as we move to fair value accounting. The link between income and cash flow from operations has been weakened, due to the increasing use of fair value accounting, and the need for users to be able to understand the variables that impact on operating cash flows has correspondingly increased. Many Australian companies are reporting figures in income that will not generate operating cash flows for many years. We conducted a preliminary analysis of the financial reports of the top 50 companies listed on the ASX and found that approximately 40% of these companies have recognised income from revaluations due to AASB 141, Agriculture; AASB 139, Financial Instruments; or AASB 140, Investment Properties in the income statement.

Given this change, the AASB should strongly advocate the mandatory use of the direct method. Any other approach would reveal a lack of commitment to high quality accounting standards and the same sort of inconsistency displayed by the FASB when it recommends the direct method, but allows the indirect method, and designs the standard in a way that promotes the use of the less informative indirect method.

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