Chapter 1

An overview of the Australian external reporting environment

Review questions

1.1 The main bodies responsible for regulating accounting disclosure in Australia are:

(i) Australian Securities and Investments Commission (ASIC)

On its website, ASIC describes some of its responsibilities as follows:

We are an independent Commonwealth Government body. We are set up under and administer the Australian Securities and Investments Commission Act 2001 (ASIC Act), and we carry out most of our work under the Corporations Act.

The Australian Securities and Investments Commission Act 2001 requires us to:

- *maintain, facilitate and improve the performance of the financial system and entities in it*
- *promote confident and informed participation by investors and consumers in the financial system*
- *administer the law effectively and with minimal procedural requirements*
- *enforce and give effect to the law*
- *receive, process and store, efficiently and quickly, information that is given to us*
- *make information about companies and other bodies available to the public as soon as practicable.*

The *Corporations Act*, which is administered by ASIC, requires corporations to comply with accounting standards (as per s. 296 of the *Corporations Act*). Hence, the law administered by ASIC requires companies and other disclosing entities to comply with the accounting standards issued by the AASB.

(ii) Australian Accounting Standards Board (AASB)

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

As indicated in Chapter 1, however, a great deal of the responsibility for developing accounting standards released by the AASB is in the hands of the IASB, as is the development of the conceptual framework. It is to be anticipated that only minor changes would be made to standards being released by the IASB before they are subsequently released within Australia as AASB standards (for example, the changes might involve adding more explanatory material to the Australian standard, or to add additional requirements in relation to not-for-profit or public sector entities). The AASB does release accounting standards that are unique to Australia where there is believed to be a need for accounting guidance and the issue has not been addressed by the IASB. The AASB reports to the Financial Reporting Council (FRC). Once an AASB-released accounting standard is in place, corporate directors are required to ensure that the company's financial statements comply with the requirements of the standard (where applicable).

(iii) Australian Securities Exchange (ASX)

The ASX provides numerous disclosure requirements for entities listed on the Australian Securities Exchange. The principal aim is to help ensure that information is disseminated in an efficient and timely manner. Failure to comply with the ASX Listing Rules may lead to delisting from the exchange. The ASX disclosure requirements help to ensure that information about listed entities is disseminated in an efficient and timely manner. The disclosure requirements also reduce the likelihood of individuals prospering through access to privileged information.

The ASX Listing Rules are divided into 20 chapters (details of the listing rules are available on the ASX website at **www.asx.com.au**). Of particular relevance are **Chapters 3** and **4** of the Listing Rules, which relate to continuous disclosure and periodic disclosure, respectively. Listing Rule 3.1 (relating to continuous disclosure) provides the general principle that:

> *Once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information.*

The ASX also established the ASX Corporate Governance Council. The Principles released by the Council, which are now referred to as *Corporate Governance Principles and Recommendations*, were most recently amended and re-released in March 2014 and can be accessed on the ASX website. Companies are required to provide a statement in their annual report disclosing the extent to which they have followed the *Corporate Governance Principles and Recommendations* in the reporting period. Where companies have not followed all of the recommendations, they must identify the recommendations that have not been followed, and give reasons for not following them. This is often referred to as an 'if not, why not?' approach to disclosure.

(iv) Financial Reporting Council (FRC)

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

1.2 The International Accounting Standards Board (IASB) releases International Financial Reporting Standards (IFRSs). IFRSs are adopted directly by some countries, while others (such as Australia) release standards under the name of their domestic accounting standard setter but based upon the standards issued by the IASB. For a detailed overview of the workings of the IASB, students should review the IASB's website. For countries that have decided to adopt IFRSs, such as Australia, a great deal of 'power' for developing accounting standards has been 'surrendered' to the IASB, although the IASB does tend to communicate with national standard-setters when developing accounting standards.

While IFRSs are used in many countries throughout the world, the IASB does not have any direct enforcement powers. Rather, enforcement is the duty of national governments (for example, within Australia, ASIC is primarily responsible for the enforcement of accounting standards).

The IASB also has a committee known as the IFRS Interpretations Committee, which reviews accounting issues that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance, with a view to reaching consensus on the appropriate accounting treatment. Its recommended treatment is included within 'Interpretations'.

1.3 The IASB does not have any direct enforcement powers. For example, in Australia we use IFRS developed by the IASB, but the IASB has no power within Australia to enforce its accounting standards. That power in Australia resides with ASIC. Therefore, although many countries throughout the world claim to be using IFRSs, whether they are actually being applied properly is really dependent upon the enforcement and compliance policies in place within the respective countries. Because some countries have very weak enforcement strategies, the claim that their national organisations are complying with IFRSs is often open to challenge.

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

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

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

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

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

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

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

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

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

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

1.7 AASB 1053 *Application Tiers of Australian Accounting Standards* provides a two-tier reporting system for entities producing general purpose financial statements. Tier 1 general purpose financial statements are financial statements that comply with all relevant accounting standards. Tier 2 comprises the recognition, measurement and presentation requirements of Tier 1 but substantially reduces disclosure requirements.

Each Australian Accounting Standard will specify the entities to which it applies and, where necessary, sets out disclosure requirements from which Tier 2 entities are exempt. Complying with Tier 1 requirements will mean compliance with International Financial Reporting Standards as issued by the IASB. Conversely, entities applying Tier 2 reporting requirements would not be able to state that their reports are in compliance with IFRSs (because of the reduced disclosure).

In identifying which entities shall apply Tier 1 reporting requirements, paragraph 11 of AASB 1053 states:

> *Tier 1 reporting requirements shall apply to the general purpose financial statements of the following types of entities:*
> ***(a)*** *for-profit private sector entities that have public accountability; and*
> ***(b)*** *the Australian Government and State, Territory and Local Governments.*

In relation to 'for-profit private sector entities' (which would include, for example, listed companies) we need to have some definition of 'public accountability' given its centrality to the above requirement. Appendix A of AASB 1053 defines it as follows:

> *Public accountability means accountability to those existing and potential resource providers and others external to the entity who make economic decisions but are not in a position to demand reports tailored to meet their particular information needs.*

The definition of 'public accountability' reproduced above provides a general principle. Appendix A to AASB 1053 provides practical application guidance. It states:

> *A for-profit private sector entity has public accountability if:*

(a) *its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or*

(b) *it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks.*

Paragraph B2 of Appendix B to AASB 1053 further states:

The following for-profit entities are deemed to have public accountability:

(a) *disclosing entities, even if their debt or equity instruments are not traded in a public market or are not in the process of being issued for trading in a public market;*

(b) *co-operatives that issue debentures;*

(c) *registered managed investment schemes;*

(d) *superannuation plans regulated by the Australian Prudential Regulation Authority (APRA) other than Small APRA Funds as defined by APRA Superannuation Circular No. III.E.1 Regulation of Small APRA Funds, December 2000; and*

(*e*) *authorised deposit-taking institutions.*

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

Tier 2 reporting requirements shall, as a minimum, apply to the general purpose financial statements of the following types of entities:

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

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

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

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

Therefore, for example, if a proprietary company is not deemed to be small (thereby not satisfying the 'let-out' provisions included at section 296(1A) of the *Corporations Act*) then it must, at the least, prepare Tier 2 financial statements. Such financial statements would be referred to as complying with Australian Accounting Standards—Reduced Disclosure Requirements.

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

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

The directors' declaration is a declaration by the directors:

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

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

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

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

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

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

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

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

1.11 The process for developing accounting standards is explained on the IASB's website. Figure 1.2 also provides an overview of how accounting standards are developed by the IASB. The IASB releases International Financial Reporting Standards (IFRS). In developing an accounting standard the IASB often initially establishes an Advisory Committee for a particular issue. The Advisory Committee provides advice on the issue to the IASB, after which time the IASB might decide to release a Discussion Document for public review and discussion. The Discussion Document might then be followed by an Exposure Draft, which would also typically be released for public comment (although sometimes they release a 'staff draft' which is not released for comment). Following this process the IASB might then release an IFRS. As can be seen, throughout the process of developing an IFRS there is generally plenty of scope for various stakeholders to voice their opinions about the issue. The AASB will provide direct input into the IASB's accounting standard-setting process. For some topics it is to be anticipated that an accounting standard developed by the AASB might be used as a major basis for the development of an IFRS. Following the release of an accounting standard there is also typically a 'post-implementation review' to determine whether the accounting standard is being interpreted and applied in the manner intended, or whether there is a need to amend the accounting standard or release an Interpretation through the IFRS Interpretations Committee.

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

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

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

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

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

> *This Standard identifies the Australian Interpretations and classifies them into two groups: those that correspond to an IASB Interpretation and those that do not. Entities are required to apply each relevant Australian Interpretation in preparing financial statements that are within the scope of the Standard.*
>
> *In respect of the first group (Table 1), it is necessary for those Australian Interpretations, where relevant, to be applied in order for an entity to be able to make an explicit and unreserved statement of compliance with IFRSs. The IASB defines IFRSs to include the IFRS Interpretations Committee and SIC Interpretations.*
>
> *In the second group (Table 2), this Standard lists the other Australian Interpretations, that do not correspond to the IASB Interpretations, to assist financial statement preparers and users to identify the other authoritative pronouncements necessary for compliance in the Australian context.*
>
> *This Standard (see Table 3) also updates references to the Framework for the Preparation and Presentation of Financial Statements in other Standards to refer to an amended version of the Framework, as identified in this Standard.*
>
> *The Standard will be re-issued when necessary to keep the Tables up to date*.

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

1.14 The functions of the IASB are described in Chapter 1as well as on the IASB's website. The IASB's website (as accessed May 2016) states:

Mission Statement

Our mission is to develop International Financial Reporting Standards (IFRS) that bring transparency, accountability and efficiency to financial markets around the world. Our work serves the public interest by fostering trust, growth and long-term financial stability in the global economy.

- IFRS brings transparency by enhancing the international comparability and quality of financial information, enabling investors and other market participants to make informed economic decisions.
- IFRS strengthens accountability by reducing the information gap between the providers of capital and the people to whom they have entrusted their money. Our standards provide information that is needed to hold management to account. As a source of globally comparable information, IFRS is also of vital importance to regulators around the world.
- IFRS contributes to economic efficiency by helping investors to identify opportunities and risks across the world, thus improving capital allocation. For businesses, the use of a single, trusted accounting language lowers the cost of capital and reduces international reporting costs.

We are a not-for-profit, public interest organisation with oversight by a Monitoring Board of public authorities. Our governance and due process are designed to keep our standard-setting independent from special interests while ensuring accountability to our stakeholders around the world.

Our objective

To develop a single set of high-quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles.

How do we achieve our objective?

- An independent standard-setting board, overseen by a geographically and professionally diverse body of trustees, publicly accountable to a Monitoring Board of public capital market authorities.
- Supported by an external IFRS Advisory Council, an Accounting Standards Advisory Forum of national standard-setters and an IFRS Interpretations Committee to offer guidance where divergence in practice occurs.
- A thorough, open, participatory and transparent due process.
- Engagement with investors, regulators, business leaders and the global accountancy profession at every stage of the process.
- Collaborative efforts with the worldwide standard-setting community.

1.15 There are various arguments that could be raised to support, or oppose, directors being able to deviate from accounting standards.

In support of directors being allowed to deviate from accounting standards, it could be argued that people within an organisation might be able to better determine which method of accounting provides the most efficient representation of the organisation's financial performance and position—rather than being required to apply a 'one-size-fits-all' approach to accounting. There are also arguments that various market-based incentives would encourage managers to adopt those accounting methods that best reflect a firm's financial performance and position.

In opposition to directors being able to deviate from accounting standards, it could be argued that if different organisations use different accounting methods then it will be very difficult to compare the financial performance and position of different organisations at a point in time. Also, it is very possible that managers would choose accounting methods opportunistically. That is, depending upon the circumstances, they might elect to choose those accounting methods that provide a desired accounting result, rather than selecting accounting methods in an objective manner. Regulation to reduce this tendency might be desirable.

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

- Harmonisation or standardisation requires the release of many exposure drafts, new accounting standards, and the revision of many existing accounting standards. This in itself is very costly. However, there are many other 'indirect' costs. For example, preparers must learn the new rules, as must readers (including analysts and regulators). The costs for a company to switch to IFRS can be significant and could be an impediment to a country embarking on a process of harmonisation.
- To date, there is limited empirical support for the view that standardising domestic accounting standards with International Financial Reporting Standards will actually lead to inflows of foreign capital. Without such evidence, various parties within a particular country may be less inclined to support the standardisation process.
- A great deal of existing research has sought to explain international differences in accounting standards on the basis of differences in cultures between countries (although as countries embrace IFRS these differences obviously decline). That is, culture seems to explain international variation in accounting standards. For example, some countries may have cultures that are inclined towards secrecy (and therefore, limited disclosures), whereas other countries may have cultures inclined towards transparency (and therefore greater disclosures). To impose the same accounting standards on all (with a particular level of disclosure) ignores these cultural differences and may, in the long run, provide a reason why standardisation may be more successful in some countries than others.

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

1.18 There were many significant changes as a result of Australia adopting IFRSs. These changes had a significant impact on profits and assets in some entities. For example, when Australia adopted IFRSs in 2005 there was a dramatic change in how we accounted for intangible assets. Many intangible assets that were previously recognised as assets now have to be expensed and greater restrictions were imposed in relation to revaluing intangible assets. Further, the rules relating to amortising goodwill were changed (goodwill was no longer to be amortised, but instead was subject to annual impairment testing). Given the magnitude of the impact of adopting IFRSs on corporate financial statements, it would have been useful for reporting entities to tell financial statement readers, in advance, about the consequences of adopting IFRSs for subsequent corporate financial performance and financial position reporting. This would have reduced the 'shocks' that were felt when the IFRS-compatible financial statements were first applied. To this end, the AASB issued an exposure draft in December 2003 entitled ED 129 'Disclosing the Impacts of Adopting Australian Equivalents to IASB Standards'. This exposure draft culminated in the release of AASB 1047 in April 2004. The accounting standard required the reporting entity to provide, in advance, an explanation of the impacts of the adoption of IFRSs on the financial statements of the reporting entity. The standard ceased to operate following first-time adoption of IFRSs. Within the accounting standard, which has since been withdrawn, it was stated:

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

Challenging questions

1.19 If directors believe that particular accounting standards are not appropriate, they have the option of highlighting this fact and explaining why. Specifically, paragraph 23 of AASB 101 *Presentation of Financial Statements* states:

> *In the extremely rare circumstances in which management concludes that compliance with a requirement in an Australian Accounting Standard would be so misleading that it would conflict with the objective of financial statements set out in the Framework, but the relevant regulatory framework prohibits departure from the*

requirement, the entity shall, to the maximum extent possible, reduce the perceived misleading aspects of compliance by disclosing:

(a) *the title of the Australian Accounting Standard in question, the nature of the requirement, and the reason why management has concluded that complying with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements set out in the Framework; and*

(b) *for each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to achieve a fair presentation.*

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

1.21 Answers vary with the years and company chosen.

1.22 No. Accounting standards do not, and realistically could not, provide guidance for all transactions and events that might arise within an organisation. For situations not covered by accounting standards, the guidance provided within the *Conceptual Framework for Financial Reporting* will potentially provide relevant principles that could/should be applied. Included within such principles would be the requirement that financial reports should provide all material information—obviously this will require a degree of professional judgement.

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

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

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

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

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

- Even in the absence of regulation, there are private economics-based incentives for the organisation to provide credible information about its operations and performance to certain parties outside the organisation, otherwise the costs of the organisation's operations would rise. This view is based on a perspective that the provision of credible information allows other parties to monitor the activities of the organisation. Being able to monitor the activities of an entity reduces the *risk* associated with investing in the entity, and this in turn should lead to a reduction in the cost of attracting capital to the organisation.
- It has also been argued that there will often be conflicts between various parties with an interest in an organisation, and accounting information will be produced, even in the absence of regulation, to reduce the effects of this conflict.
- If an entity that borrows funds also agrees to provide regular financial statements to the providers of the debt capital (the debtholders), this ability to monitor the financial performance and position of the borrower will reduce the risks of the lender. This should translate to lower costs of interest being charged and hence provide an incentive for the borrower to provide financial statements even in the absence of regulation.
- Managers of the organisation will be best placed to determine what information should be produced to increase the confidence of external stakeholders that the information being presented reflects the financial position and performance of a reporting entity (thereby decreasing the organisation's cost of attracting capital). Regulation that restricts the available set of accounting methods will decrease the efficiency with which information will be provided. This in turn leads us to question whether the 'one-size-fits-all' assumption inherent in the requirement that all entities apply the same accounting standards is applicable or appropriate in all circumstances particularly where there are major differences between the various organisations applying the accounting standards.
- Certain mandated disclosures will be costly to the organisation if they enable competitors to take advantage of certain proprietary information.
- Even in the absence of regulation, external parties would demand that financial statement audits be undertaken. If such audits are not undertaken, financial statements would not be deemed to have the same *credibility* and, consequently, less reliance would be placed on them. If reliable information is not available, the risk associated with investing in an organisation might be perceived to be higher, and this could lead to increases in the cost of attracting funds to the organisation.

- In the absence of regulation, organisations would still be motivated to disclose both *good* and *bad* news about an entity's financial position and performance. Such a perspective is often referred to as the 'market for lemons' perspective (Akerlof 1970), the view being that in the absence of disclosure the capital market will assume that the organisation is a 'lemon'. That is, *no information* is viewed in the same light as *bad information*. Hence, even though the firm might be worried about disclosing bad news, it is assumed that the market might make an assessment that silence implies that the organisation has very bad news to disclose (otherwise, it would disclose it). This 'market for lemons' perspective provides an incentive for managers to release information in the absence of regulation, as failure to do so will have its own implications for the organisation. That is, 'non-lemon owners have an incentive to communicate' (Spence 1974, p. 93).

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

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

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

- International investors are better able to understand the financial performance and position of local companies.
- Tied to the above point, there is an expectation that standardisation will facilitate greater capital inflows.

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

Arguments against include:

- All convergence and standardisation benefits will come at a cost. Such costs include the costs of educating accountants to adopt a new set of accounting standards and the costs associated with changing data-collection and reporting systems. Such costs will be borne by large listed companies, as well as large proprietary companies, not-for-profit entities and local governments. These last three categories of reporting entities are relatively unlikely to benefit from such things as increased capital inflows. Yet they will still incur significant costs
- International differences in culture bring into question the relevance of IFRS across all countries. Perera (1989, p. 43) argues that culture is a powerful environmental factor affecting the accounting system of a country and, therefore, that accounting cannot be considered to be 'culture free'. Perera (1989) argues that IFRSs themselves are strongly influenced by Anglo-American accounting models and, as such, International Accounting Standards tend to reflect the circumstances and patterns of thinking in a particular group of countries. He argues therefore that IFRSs are likely to encounter problems of relevance in countries with different cultural environments from those found in Anglo-American countries.
- It is misleading to indicate that there is global standardisation of financial reporting when there are differences in enforcement mechanisms across countries. For example, do we expect compliance with IFRSs to be enforced equally by Australian regulators and regulators in poor, developing countries? Nevertheless, organisations in these countries might all state that they have adopted IFRS (in many cases because of the reputation benefits associated with applying IFRS). In essence, there will not be standardisation despite statements indicating the contrary.

1.28 Defining accounting as 'the language of business' arguably provides a very restricted perspective of the role or function of accounting. Accounting can, and should be, a much richer process. Such a definition would imply that only business entities have a responsibility to provide an 'account' of their activities, and that any such account would be restricted to a financial account. By contrast, if we link the function of 'accounting' with the broader notion of 'accountability', then we will link accounting to perceptions of organisational responsibilities and these responsibilities do not need to be considered only in terms of their being of a 'business' nature.

As the chapter argues, we can take a broader perspective of the role of 'accounting', and of a corporate report (and corporate reporting), and this broader perspective would see the role of accounting as being to inform relevant stakeholders about the extent to which the actions for which an organisation is deemed to be responsible (which in itself is a controversial issue as people can have very different views about the responsibilities of organisations) have actually been fulfilled. Reporting provides a vehicle for an organisation to fulfil its requirement to be 'accountable'. Such accounts do not all have to be prepared in financial terms. For example, if an organisation is considered to be accountable for its water consumption, or its greenhouse gas emissions, then such 'accounts' may be presented in physical terms. If a company is considered to be responsible for the people who are making its products in developing countries, then it might produce 'accounts' about how the organisation is ensuring that factory workplaces in developing countries are safe for the employees. Therefore accounting can, and arguably should, take on broader ethical perspectives, rather than being restricted to business considerations.

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

- Preface
- Comparison with International Pronouncements
- Objective
- Scope
- Application
- Definitions
- Application guidance
- Effective date and transition requirements.

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

1.30 Simply showing how reported profits have improved over ten years as a basis for showing how financial performance has improved is a very naive approach. Accounting standards, and therefore rules for calculating profits and other measures of financial position and performance, change across time and sometimes these changes can have significant implications for various income and expense items. Many of the accounting standards in place now are quite different from the accounting standards in place ten years ago, such that the same set of transactions and events will generate different expenses and income (and therefore profits) now than they would have generated under the standards in place ten years ago. That is, to use a sporting analogy, the 'rules of the game' have changed such that the 'scores' recorded now under the current rules will be very different from the 'scores' that would have been recorded ten years ago. As such, without adjustment it actually makes little sense to compare numbers that have been recorded under different rules with numbers that are reported now—the 'scoring system' has changed.

1.31 In short, the answer is 'no'. Financial reports provide a measure of financial performance as calculated using the accounting standards in place at that particular time. That is, 'performance' as reported in measures such as 'profits' only really make sense within the context of the financial accounting rules in place when the profit was calculated. There are many aspects of organisational performance that are not captured in measures of financial performance. For example, generally accepted accounting principles, as reflected in accounting standards and other financial accounting conventions, typically ignore various aspects of social and environmental performance. Therefore, to gain insights into other aspects of performance—such as social and environmental performance—requires that attention be directed to other forms of 'accounts' and reports other than financial accounting/financial reports. For example, many organisations provide sustainability reports that provide various pieces of information about the impact of an organisation on the societies and environments in which it operates.

1.32 What this question should demonstrate is that we will all have different perspectives about the responsibilities and accountabilities of organisations. If we were to believe that the over-riding responsibility of an organisation is to maximise its profits for the benefits of shareholders, then we might believe that an organisation needs only to produce a financial account/financial report and provide this to shareholders. No other reports/accounts would be deemed necessary.

Different students will have different perspectives about corporate responsibilities and accountabilities; what is important is that they are able to link the perceived responsibility with the type of 'accounts' they believe the organisation *should* produce.

For example, if we were to believe that a multinational clothing company, which sources its products from developing countries, has a responsibility for ensuring that the employees working within the supply chain (in the developing countries) have safe working conditions, then we would expect the organisation to provide an account of the actions it is taking to monitor the workplace conditions of employees in the supply chain (and remember, 'accounts' do not have to be prepared in financial terms). As another example, if we were to believe that a company is responsible for its greenhouse gas emissions, then we would expect an account of a company's emissions, together with information about strategies being adopted by the company to reduce those emissions.

1.33 Arguably, we cannot (or at least, *should not*), consider the practice of accounting without giving some attention to corporate responsibilities and accountabilities. The broader (narrower) our perspective of corporate responsibilities, the broader (narrower) our perspective of the accountabilities of an organisation, and therefore the greater (fewer) the amount and variety of accounts we believe should be provided. As we increase our perspectives of corporate responsibilities (and therefore, increase our perceptions of accountability), the broader the group of stakeholders to whom we believe we need to provide an 'account' about our performance.

As the chapter states, if we were to accept that an entity has a responsibility (and an accountability) for its social and environmental performance, then we, as accountants, should accept a duty to provide 'an account' (or a report) of an organisation's social and environmental performance—perhaps by way of releasing a publicly available corporate social responsibility report. If, by contrast, we considered that the only responsibility an organisation has is to maximise its financial returns (profits), then we might believe that the only account we need to provide is a financial account.

1.34 There is logic in the claim. While many countries might claim that their organisations are applying IFRSs, the IASB has no enforcement powers. Rather, enforcement is the responsibility of the corporate regulators in each particular jurisdiction. If a country has poor enforcement powers, perhaps because it is relatively poor economically, and if it has a relatively untrained accounting profession, then there might be a greater likelihood that the financial reports being generated within that country are relatively unlikely to comply with accounting standards. Hence, claims that a country has adopted IFRSs must always be accepted with caution.

1.35 The financial statements would be considered to be 'true and fair' if the assets were disclosed at a total of $31 million even if they could actually be sold for $70 million. Compliance with accounting standards and other generally accepted accounting conventions (including the convention that all 'material' information shall be presented) will normally ensure that the financial statements are deemed to be 'true and fair'. It is not necessary that financial statements provide fair values of assets, although there is a requirement that if assets are recorded at cost then the net realisable value of the assets must not be below that cost (otherwise an impairment loss shall be recognised).

1.36 Lehman (1995) takes a very broad perspective of 'accounting' and one that links the practice of 'accounting' with the broader issues of corporate responsibility and accountability. In terms of his perspective that accounting provides a 'means for defending actions', he would appear to be referring to the role of accounting in providing objective information about the performance of an organisation (not just restricted to financial performance) and whether this reported performance matches the expectations held by different stakeholders. In terms of accounting 'identifying which actions one must defend', the view would be that accounting should provide an objective account of how an organisation has performed across various facets of performance (for example, financial, social, environmental), and the impacts it has created, which in turn might require further commentary from management in justifying such impacts.

In terms of the view that accounting should 'form part of a public account given by a firm to justify its behaviour', this appears to be embracing the view of accountability promoted by researchers such as Gray, Owen and Adams (1996)—as referred to in the chapter—that organisations have a duty to provide an account of the actions for which the organisation is held responsible. Such accounts do not need to be restricted to 'financial accounts'.