Accounting standards: new rules, new game

Australia is set to adopt the new international accounting standards but, as **TOM RAVLIC** points out, the proposed changes have serious implications for companies, for shareholders and for analysts trying to make sense of the balance sheet.

What happens if one company reporting a masthead on balance sheet starts publishing accounts sans that very thing which has been an asset in the previous reporting period? Is it still an asset?

These are the types of questions Australian companies will need to be ready to answer as a result of the various changes flowing from the adoption of international accounting standards.

The adoption of the new accounting rules follows a decision by the Financial Reporting Council (FRC), the federal government body that oversees the Australian Accounting Standards Board (AASB), whose job it is to adopt the standards issued by the International Accounting Standards Board (IASB).

The aim is to achieve a common financial reporting platform for reporting periods beginning on or after 1 January 2005, and it will mean that corporate balance sheets, income statements and cash flows will be very different for a range of high-profile companies.

The tranisition is not without controversy chiefly because of the extremely tight timeframe imposed by the Federal Government, the Australian Stock Exchange and other parties to ensure Australia's adoption process is aligned with that occurring within the European Union (EU).

The adoption date was selected after Europe announced in June 2002 that it would adopt IASB standards in January 2005. The EU is committed to adopting the accounting pronouncements as a part of the transition to one seamless financial market. There is already a single currency, the Euro, and one set of accounting pronouncements will mean that users of the financial statements of EU entities listed on the various exchanges peppered throughout continental Europe have a greater chance of being able to understand and compare the market information.

Standards and politics

Standard setting is rarely immune from the ebb and flow of political activity. The EU has indicated it is prepared to delay the approval of proposals on financial instruments—proposals that introduce a greatly deal of transparency to corporate financial statements for reasons that will be outlined later—because key constituents such as the French banking sector are concerned about a move to fair value accounting.

This is a pattern of activity that will repeat itself as the IASB pushes out a greater volume of product in the coming years. It is already bringing criticisms from some parts of the accounting world that the IASB is compromising on its principled stance to ensure approval on critical standards

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is not delayed and the documents are ready by the self-imposed March 2004 deadline.

The other major player in all of this, of course, is the United States, which has what is regarded as the largest, most liquid, generally best regulated market on the planet.

A single set of accounting standards for global use is less important to the gorilla of capital markets because it is the dominant capital market.

Accounting standards produced in the US by the Financial Accounting Standards Board have been the staple fare for those seeking entry into the largest single financial market on the globe.

The US and IASB

The US is a powerhouse in accounting regulation and more water will need to flow under the bridge before its role could be regarded by those outside the US market as being less than the one presently being played by the London-based IASB.

Evidence of this has emerged as a result of the short-term convergence project between the US and the IASB. This project has the goal of eliminating various differences—unkindly referred to as the "low hanging fruit" by some observers—in an effort to minimise the number of reconciliations required in the financial statements of companies engaging in the trading of securities in the US.

A recent exposure draft dealing with the way in which companies need to account for the disposal of assets and the discontinuation of operations is the first of a string of amendments to the IASB's literature that will spring from the joint work being done to lower the compliance burden for companies seeking to enter the US market. This will assume greater political significance once other countries such as Australia are reporting under the common financial reporting platform.

Australia is entering into the global adoption race for reasons not unrelated to securing comparability and consistency of financial reports, but it is more for the reason to make it easier for Australian companies to seek capital in overseas markets, because—as senior business figures and political leaders are fond of reminding the community—Australia has under two per cent of global capitalisation.

It is also asserted that having a separate set of accounting standards in a jurisdiction like Australia will make the country the capital market equivalent of one of Cinderella's three ugly sisters, and cause potential investors to shy away from the market because we use an unfamiliar set of accounting standards. The implication is that some users with the power to influence decisions on the allocation of scarce capital—such as US-based analysts—cannot or will not be bothered investing the time to comprehend.

The effect of all these global rumblings in corporate regulation on users—more specifically accounting standard setting—will be instant confusion for those unfamiliar with the impact of the international literature.

All of the changes are set to occur in a 'big bang' because the first time application criteria set down in the IASB's rules on adopting International Finance Reporting Standards (IFRS) from scratch mean that companies will only get the luxury of retained earnings adjustment if they adopt everything at once. If a company adopts individual IASB standards outside the general scope of first time adoption, it would have to take any expense to the bottom line directly.

There is an additional first-time application complexity in Australia with the fact that the AASB is uncomfortable in issuing accounting standards for early application that do not have references in pre-existing Australian accounting standards.

Legislative problems

This is the so-called legal impediment that exists because Australia's legal jurisdiction requires the accounting standards to be passed by the Federal Parliament before they can be given the backing of law. A further problem for the AASB is that its activities are also dependent on the IASB living up to the work program it has set to finalise the IFRS.

This tight timetable, the volume and the varying impact of the changes mean companies themselves will have to demystify the cosmetics of financial reporting when they communicate them to users, analysts and retail shareholders. Some of the changes will puzzle users that bother to look beyond the bottom line figure and whether the company has deemed it safe to pay shareholders a dividend.

It is also worth remembering that in all likelihood there should be no change in the underlying economics of a company's activity.

Some things companies call assets will disappear. Some items never considered assets previously will be forced onto balance sheets. Items that are presently not recorded on balance sheets as liabilities will appear and some items classified as equity in accounts will morph into debt when international accounting standards are implemented.

This may sound abstract and less than useful if stated out of the context of basic analysis of a company's balance sheet. However, think about the various ratios used by some retail investors to analyse companies. Anything that increases or decreases the numbers dealing with liabilities or equity will change the way in which the uninformed investor sees a company's results. Removing assets may well increase the gearing of a company in favour of the debt side of the equation. Adding assets might send the balance the other way.

Calculations determining a company's return on assets might look better than previously if particular asset balances are stripped away. What some companies do with leasing arrangements when they purport to sell properties to another party and then lease them back has that effect under current accounting practices.

The same effect will result when an entity is forced to drop an asset off its opening IFRS balance sheet. Lose an asset due to numerical liposuction mandated by international accounting standards and the return on equity calculations are also sent in another direction.

More specifically, adhering to the new financial statement methodology will also place derivatives and similar financial instruments on the balance sheet for the first time. There may be disclosures dealing with financial instruments in the notes to the financial statements, but that—as the old hands in the accounting profession will often say—is no substitute for the appearance of those financial arrangements in the balance sheet.

Hedging problems

Companies with hedging arrangements, for example, will find that not all of the financing arrangements they have in place will qualify for hedge accounting under a stricter reporting regime. This will result in financial statement volatility because some transactions exposed to foreign currency fluctuations may no longer have an arrangement that has the effect of shielding the company from the effects of foreign currency fluctuations.

As well, the accounting for resetting preference shares is likely to result in most companies having those arrangements placed in the equity part of the balance sheet and classifying them as a liability.

Equity classification has been somewhat common because the literature in Australia is worded a little differently from the international accounting standard, which has led to merchant bankers (among others) building financial arrangements to ensure they don't have to classify these instruments as liabilities.

Users are often the last people thought about when these transactions are consummated between the companies, the merchant banks or other players. A user will need to factor into their analysis of an entity the fact that a large number may have flipped from one part of the accounts to the other.

Users will for the first time also see a number hit the bottom line that represents the expensing of share options as a part of the remuneration packages for company executives, company directors and employees.

This is one area where the methodology is still subject to some professional debate and it has already resulted in the IASB backing off one method of calculating the expense following pressure from around the globe. A requirement to expense remains on the agenda.

There will be no more goodwill amortisation as a part of a new impairment testing approach. The usual systematic hit to the bottom line will disappear and a write-down will only occur when the company assesses whether parts of its business are going badly.

This could result in a fairly severe write-down if a company has a particularly bad year. The same is true for all assets that will be subject to the new impairment regime.

The issue of identifiable intangible assets—like the masthead mentioned at the commencement of this discourse—is a convenient window through which to observe the types of issue sophisticated and unsophisticated users will have when IFRS is adopted in Australia.

Tangible problems for intangibles

Companies such as News Corporation, Coca-Cola Amatil and the Ten Network (among others) have sizeable values on their balance sheets attributed to things they regard as being identifiable intangible assets. These numbers represent brand names, mastheads, bottling agreements and any of a range of contracts or concepts from which a company derives its cash flows.

A company reporting something it regards as being an asset on its balance sheet at the current time could be viewed as providing the market with decision-useful information. It has acknowledged that any revenue it gains in the future from related activities is dependent on the intangible asset—the existence of which is clearly spelt out in the financial statements.

A company might regard a masthead, for example, as an asset employed in the generation of revenue on an ongoing basis and treats this in the same way as it treats property, plant and equipment.

Some commentators and interest groups such as the Group of 100 argue this is an appropriate method of dealing with an asset—tangible or intangible—that is used in the business.

Assets are defined in the Australian statements of accounting concepts as being 'future economic benefits controlled by the entity as a result of past transactions or other past events'. An intangible asset—a brand or masthead, for example—is used in the business to secure ongoing cash flows in the same way a tangible asset is used in a production line. Surely this qualifies the intangible asset for recognition on a balance sheet and a subsequent revaluation?

Those intangibles that have been internally created will need to disappear from the balance sheet. International standards do not permit internally created intangibles to sit on a balance sheet.

They also do not permit revaluations —a reassessment of the values of assets held by a company—to be booked in the case of intangible assets unless it can be proven there is an active secondary market from which independently derived prices can be obtained.

The intangible assets standard, known as IAS 38, is a conservative one. When international standards are adopted, it will reflect the mindset that a transaction must exist in order to establish a reliable measure for reporting purposes.

Not all intangible assets fall into that category. If you were lucky enough to have bought a masthead for your company, you could book it on your balance sheet at cost without trouble. The only problem is that you would not be permitted to revalue it and it would remain on the financial statements at historic cost if there's no secondary market. A further complication in the intangible assets area is the introduction of a rigorous impairment test.

The impairment test

The identifiable intangibles in general terms will no longer have to be amortised on a systematic basis. They would instead be the subject of an impairment test that could result in the intangible asset being written down, or written off completely, depending on whether the company's operations have been irreparably damaged by a trigger event such as a change in economic conditions, a slump in sales, the defection of a team of creative people to another company or general obsolescence of company equipment or goods.

Some intangibles, however, that are bought as part of a takeover or merger deal will need to be booked and written off over a short time period. Included in such items are patents or similar documents that have a finite time period about them, customer lists and backorders.

The general push from various commentators has been to ensure that long-lived intangible assets do not have an amortisation requirement against them, but that shorter-lived intangible assets such as backorders are properly disclosed and written off.

One of several reasons for the imposition of a write-off rule for the shorter-lived intangible assets is to ensure that companies do not abuse the impairment rule and just roll up things they should be listing separately into the goodwill number so they quarantine their bottom line from charges resulting from some asset write-downs.

It is often said some companies try to find ways of identifying all sorts of intangible assets in order to avoid booking a large goodwill number that will be amortised over time.

The opposite device will exist when the new standards are implemented and this requires the more sophisticated users to ask questions about a company's operations and whether a goodwill write-down should have taken place.

The area of intangible assets is of great interest for another reason. It is often argued that accounting standards such as IAS 38 should not be adopted by this country because the approaches to accounting for intangibles are very different, unacceptable to some Australian corporations and conceptually unsound.

These arguments might have some merit if the debate was one of introducing a high quality accounting framework by January 2005. That is not the case.

What we are going to see unfold is the adoption of what is expected will be a common financial reporting platform from which all countries can start. The IASB has never said its standards will be high quality right from inception, and it has retained much of the old crop of standards because it does not have time to change every accounting standard before the January 2005 deadline.

Quality will only be brought about over time. It is often forgotten in discussions that the debate about a holistic, quality framework would fall on deaf ears at the current time because there is a desire to have all countries and all companies reporting in accordance with one set of standards.

In the meantime, the analyst and retail investor will need to keep an eye out for things that look very different and ask the company to explain what, if anything, has changed since the introduction of international accounting standards. One hopes companies will have had sufficient time during the implementation phase to come up with a reasonable response. ■

The Institute has made several submissions on the proposed changes to Australian accounting standards. Copies of the submissions are available from the Institute or can be viewed on the website.

Continued from page 40

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