

The emasculation of accounting standard setting in Australia

The decision that Australia must adopt international accounting standards from 1 January 2005 has significant ramifications for the entire economy. **WAYNE LONERGAN** discusses the impact of this decision on accounting standard setting in Australia.

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The Australian accounting standard setting process has been emasculated by the policy of mandatory adoption of international accounting standards.¹ As a result, Australia's accounting standard setting capacity and position as a centre of accounting excellence has been fundamentally weakened. The inevitable result will be lower quality financial reports in Australia. The seeds of the next and more serious round of corporate collapses have therefore already been sown.

Creating corporate financial stability

The current corporate governance enhancement efforts are focused on increased disclosure, independence and best practice guidelines including the mandatory disclosure of non-compliance in company annual reports.² The laudable aim of corporate governance reform is to create a culture of integrity and trust between the relevant parties and stakeholders—company directors, management, auditors, analysts, fund managers and shareholders.

However, correcting the symptoms (which is what current reforms are focusing on) rather than fixing the underlying causes of the problem is, as always, doomed to failure.

Accounting standards are the backbone of the financial reporting regime

Overlooked in the recent furore, significant and damaging changes to

the very core of our corporate governance system have occurred. The financial reporting regime, encompassing the accounting standard setting process, the relevance and quality of standards and their application, form the basic building blocks for financial reporting and disclosure.

It is only if financial statements are both 'true and fair' that other corporate governance reforms, particularly those focused on disclosure, can have any hope of success.

The financial reporting regime in Australia

Notwithstanding that it still has its serious limitations and deficiencies, Australia's financial reporting regime was until recently among the strongest in the world and was recognised accordingly.

This was a remarkable achievement given the relatively small size of our economy and depth of our capital markets compared to the powerhouse economies of the US, UK, Europe and Asia.

Parliament has delegated the responsibility for preparing and issuing accounting standards for both the private and public sector to the Australian Accounting Standards Board (AASB).³

Compliance with accounting standards is mandatory for reporting entities under the Corporations Act.⁴ Although standards are subject to disallowance by Parliament, in the history of accounting standard setting,

there has only been one partial disallowance by Parliament.⁵

The way we were

Prior to 2000, the accounting standard setting process operated independently, despite its (limited) financial resources being funded by the two professional accounting bodies and the Federal Government. The fundamental objective of the standard setting regime was to maintain a broad public interest perspective and improve the quality of financial reporting and auditing in Australia from both a preparer's and from an end user's perspective.

Input and technical support to the board was provided by the Australian Accounting Research Foundation (AARF) which was established jointly by CPA Australia (CPAA)⁶ and the Institute of Chartered Accountants in Australia (ICAA) in November 1966. The AARF provided the research, technical and secretarial support to the AASB.

The AASB was a part-time board which, with the exception of the Chairman, operated on a voluntary basis.

Some of the advantages of the former system included:

- relative independence (albeit inadequate funding) of the accounting standard setting process
- the development of a world recognised centre of excellence and

pool of intellectual capital relating to technical accounting matters

- the development of a relatively detailed conceptual framework for the development of accounting standards
- close links and interaction with the accounting profession
- relative independence from its funding sources in board selection, agenda setting and research direction.

The features of the previous structure allowed the standard setting process to remain true to its primary objectives of undertaking research into and development of accounting standards and financial reporting issues.

One of the outstanding achievements of the previous structure was that it led to the development of a pool of intellectual capital and an internationally recognised centre of excellence in accounting research and financial reporting. The result was internationally recognised technical pre-eminence in financial reporting with consequent flow-on benefits to Australia's capital markets and cost of capital.

Beyond 2000

In the most significant changes to accounting standard setting arrangements since 1966, the Corporate Law Economic Reform Program Act

1999 as part of the Government's Corporate Law Economic Reform Program (CLERP) fundamentally altered the structure of the accounting standard setting process.

The following changes came into effect on 1 January 2000:

- the establishment of the new Government-appointed 15 member body⁷—the Financial Reporting Council (FRC)
- the FRC being superimposed over the AASB
- the establishment of a new AASB, with the new nine-member (part-time) board being appointed by the newly formed FRC and a full-time Chairman appointed by the Treasurer
- the FRC being responsible for the oversight of the accounting standard setting process for both the private and public sectors, and the broad strategic direction of the AASB.

The effect of the changes included:

- the AASB becoming answerable to the FRC
- the control of the selection of the board of the FRC and, in turn, that of the AASB being reasserted by the Government
- the control of the direction of Australian accounting standard setting coming under the influence of the FRC and bodies such as the ASX who have partly funded the AASB
- loss of key staff of the AASB and a watering down of the pool of intellectual capital
- the imposition on the AASB of a policy of mandatory adoption of international accounting standards.⁸

The implications were succinctly captured by the former Acting Executive Director of AARF who stated that "It will only be to the detriment of the quality of financial reporting in Australia, and in the corporate sector,

FIGURE 1 THE AASB STRUCTURE PRIOR TO 2000

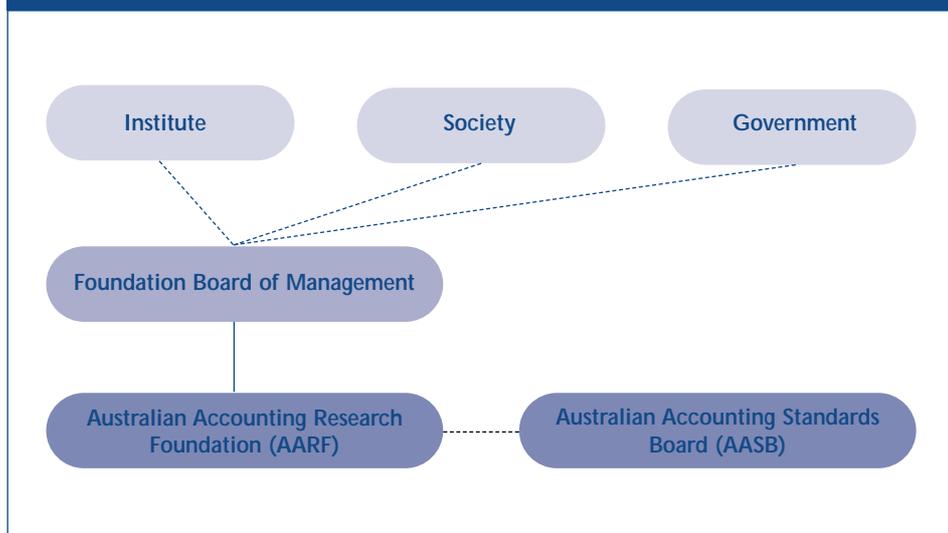
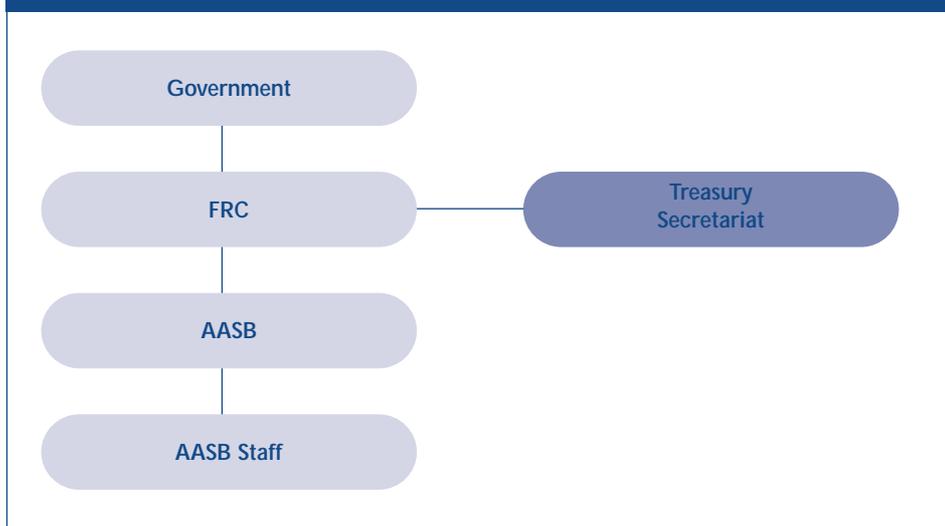


FIGURE 2 THE CURRENT AASB STRUCTURE



the reputation of Australia's capital market and the impact on the cost of capital, if vested interest groups and politics overtake the process under the guise of a broader and more effective constituency involvement and the need for "commercial" standards".⁹

Emasculation of the standard setting process

Issues such as the change in structure, the imposition of a new "boss" over the top of the AASB, the complete change of AASB board membership and the redirection of AASB priorities, although important in their own right, have been overshadowed by the policy of mandatorily adopting international accounting standards (IFRS). The commencement date for mandatory adoption is 1 January 2005.

There are a number of reasons why mandatory adoption is a fundamentally flawed policy:

- we don't yet know what it is we have mandatorily agreed to adopt, as the IFRSs are still being developed
- it undermines Australia's ability to influence the IASB by undermining our negotiating power
- it discourages Australia's corporates, accounting profession and users from making submissions to the AASB or the IASB (i.e. "why bother, we're going to follow it anyway")

- it effectively abdicates our legislative setting role to an overseas-based board on which we have only one member (whose place is not guaranteed) and whose already limited say (one voice in 14) is further undermined by Australia's policy of mandatory adoption
- it forces Australia to adopt standards some of which contain flaws (or may contain flaws, because the standards Australia has committed to adopting have not yet been finalised) or fail to take into account considerations that may be immaterial in (say) the European context but which are very important to the Australian economy
- it makes Australia become a "me too" borrower and place of investment in the world's capital markets, thus eliminating Australia's ability to distinguish its financial reports from those of other adopters of IFRS including such well known capital markets as Honduras, Trinidad and Tobago, and Barbados
- it forces on all Australian reporting entities additional costs and changes, whereas IFRSs in virtually all other countries only apply (assuming they are adopted) to listed public companies.

Convergence or adoption?

The AASB's commitment to the international harmonisation of

Australian accounting standards commenced in April 1996 with the release of Policy Statement 6 "International Harmonisation Policy". The harmonisation process was referred to as "a process which leads to those standards being made compatible, in all significant respects, with the standards of other national and international standard-setters".¹⁰

This was superseded by the revised Policy Statement 4 "International Convergence and Harmonisation Policy" in April 2002. This set out the AASB strategy for the fulfilment of its function of contributing to the development of a single set of accounting standards for world-wide use, and harmonisation of Australian accounting standards with those issued by the IASB, the International Federation of Accountants' Public Sector Committee and other IASB liaison members' standard setting bodies.¹¹ At this stage, the process the AASB was committed to was a gradual convergence and harmonisation of accounting standards.

Only three months after the release of the revised Policy Statement 4 outlining AASB's commitment to international harmonisation, the FRC announced the mandatory adoption of IFRS by all Australian companies.

The FRC Bulletin 2002/4 dated 3 July 2002 stated that "from 1 January 2005, the accounting standards applicable to reporting entities under the [Corporations] Act will be the standards issued by the International Accounting Standards Board (IASB)", thereby eliminating the need for Australian accounting standards, and making the AASB largely irrelevant for the private sector. Furthermore, in the broad strategic direction to the AASB for 2002-03, the FRC advised that the AASB should "work towards adoption in Australia of accounting standards that are the same as those issued by the IASB".

In only a matter of months, the FRC directives had altered the AASB's committed process of "convergence" and harmonisation to one of "adoption". This change occurred notwithstanding that the FRC Bulletin¹² and the FRC's broad strategic direction¹³ both contain a "best

interests” proviso. Interestingly, the AASB was still referring to its strategies for bringing standards into line with international standards as “convergence” until as late as May 2003, but has since reflected the term “adoption” in its official documentation.¹⁴

“Globalisation” of the standard setting agenda

There is a clear need for convergence in accounting standards internationally, in particular across the major capital markets in the world. However, there is a very large gap between mandatory adoption and sensible convergence.

Australia’s best position would be to maximise its benefits from being part of an international convergence of standards, while at the same time preserving the best bits of its own financial reporting regime.

The implementation of a new financial reporting regime will not be easy. This is evident from the experience of the AASB in dealing with harmonisation issues since 1996. The timeframe for the full adoption of standards for Australian companies, including comparative figures for 2004 is, at best, very ambitious.

Furthermore, the IASB is planning to re-issue 32 of the existing 34 IFRSs. Fourteen standards are subject to improvement¹⁵ and consequential editorial change will need to be made to most other IFRSs. In addition, new standards were planned to be issued prior to 1 January 2005, but these new standards will now be delayed.

Among the numerous issues required to be resolved before mandatory adoption, the AASB will at the minimum need to address the following:

- reconciliation of differences between the Australian and the different (in parts) and less detailed international conceptual framework
- the amendment of virtually every existing accounting standard in Australia
- the introduction of several new standards where no previous standard

existed (that these gaps should be filled is unarguable)

- how to deal with situations where there are no current international equivalent standards for specific industries for which a dedicated Australian standard currently exists (for example, the extractive and life insurance industries).

The harmonisation dream

Proponents of the mandatory adoption of international accounting standards claim that Australia needs to adopt IFRS because:

- the European Union (EU) is also adopting international accounting standards and Australia cannot afford to be out of step with the major capital market that the EU represents¹⁶
- Australian investors will benefit from the superior quality of IFRS, giving rise to high-quality financial reports¹⁷
- Australian industries will save the cost of having to reconcile financial accounts between the different reporting regimes
- Australia’s small capital market means that we need to conform to IFRS in order to attract international capital.

The reality is that the international harmonisation of accounting standards has yet to happen.

The European Union has announced that listed companies of member states will adopt IFRS for the purpose of consolidated accounts from 1 January 2005. However, new and/or modified standards will be subject to endorsement by the European Commission. Thus claims that the EU has adopted IFRS overstates the position. What it has agreed to do, and this is a long way short of mandatory adoption, is to adopt IFRS if and when approved by the EU.

Many nations currently permit the use of IFRS domestically, but Australia stands out by having committed itself to a process whereby the domestic accounting regime will fully convert to IFRS for both listed and unlisted companies.

Will the USA come to the party?

Convergence between the USA and IFRS is already underway,¹⁸ and is a highly desirable outcome. However, full adoption of IFRS is a very different proposition.

The USA is the largest single market in the world, representing over 50% of the world’s market capitalisation. Pragmatically, it is highly unlikely that the largest market in the world will ever surrender control and sovereignty over financial reporting to an international body which it does not control.

There are practical reasons why many in the USA will resist the adoption of IFRS in the USA. For instance, adopting IFRS will:

- create a much more level playing field between US and European companies (thus reducing the competitive advantage presently enjoyed by US companies)
- allow emerging companies better access to the US capital market, thereby increasing the demand for, and hence cost of, capital while simultaneously diluting the quality in the pool
- make substantially obsolete the existing technical knowledge base of the US accounting profession.

The reality is that to be a truly international set of accounting standards, the IFRS needs to get the USA on board. For the USA, the full adoption of IFRS would result in incurring significant costs, risk jeopardising confidence in the USA capital market, and largely destroy the existing educational base, skills and accounting and legal precedent in the USA. While convergence between the two will continue to occur over time, from a US perspective full compliance with IFRS will be strongly opposed.

The reality of IFRS

Australia’s accounting conceptual framework is more detailed than that of the IASB. Comments by leading academics including Professor Peter

Wolnizer of the University of Sydney and Professor Bob Walker of the University of NSW confirm that Australia's accounting standards are being weakened by moves to bring them into line with IFRS. According to Professor Walker, "there have been a number of initiatives which have been removed in the process of harmonising with international accounting standards—that process has actually weakened some of our reporting rules".¹⁹

The superiority of Australia's financial reporting regime represents an important competitive advantage relative to the rest of the world.²⁰

Given that the Australian equity market represents only just over 1% of the global capital markets, mandatory adoption of IFRS is likely to result in the loss of Australia's competitive advantage in attracting international capital. Accordingly, the likely result is a higher cost of capital for Australian companies.

Furthermore, the IASB is more likely to be swayed by the interests of other more important and larger nations than Australia. This is particularly the case as the adoption of the new and/or modified IFRS in the EU is conditional upon the endorsement of the European Commission.

Is Australia barking up the wrong tree?

If access to capital is what Australia wants, there appears little rationale for the mandatory adoption of IFRS. Even in the event of the full adoption of IFRS in Australia, companies seeking to raise capital internationally are still likely to want access to the largest provider of equity funds, the US market.

IFRS advocates argue that adoption of international standards will lead to capital inflows, higher trade volumes and growth in Australia's capital markets. Past experience in attracting international companies to list in Australia does not support this view. For example, the ASX's 'China Concept' initiative in the 1990s resulted in an increase of less than 1% in the number of listed companies, the large majority of which were spectacularly less than successful.

The case for domestic standards

The ability of Australia's representation at the IASB to influence the development and tailoring of IFRSs will inevitably be outweighed by the views of larger countries. Furthermore, submissions directly to the IASB by Australian companies are largely not forthcoming, while submissions by the large Australian accounting firms are influenced by their larger international "sister" (or more accurately "parent") firms.

In short, despite Australia's present official representation on the IASB, there is no guarantee that Australia will be actively engaged in the process of future accounting standard development. The possibility of a lack of future involvement will inevitably be exacerbated by the diminution in Australia's role as a centre of excellence.

It is also necessary to maintain a dynamic domestic standard setting capacity to create a competitive advantage. A superior set of domestic standards represents a significant advantage for a capital-needy economy like Australia, that will otherwise have to compete in the global capital market as a "me too" borrower and as a price taker.

However, the strongest argument yet for domestic standards is for reasons of sovereignty. As delegated legislation (accounting standards have the force of law), control over Australian accounting standards should remain in Australia. The fact that the Australian financial reporting regime is required to fully adopt IFRS (as and when released and amended) effectively means that the Australian Parliament has abrogated its legislative power²¹ over Australian companies to the IASB, which resides outside of Australia and on which Australia has only one vote (which is not guaranteed).

The demise of the UIG?

The Urgent Issues Group (UIG) plays an important role in the context of Australian standard setting. The primary responsibility of the UIG is to review, 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 a consensus as to the appropriate accounting treatment in the context of Australian accounting standards.

Like accounting standards, the UIG consensus views have to be followed. The success of the UIG has been its ability to provide interpretations for topical accounting issues on a timely basis.

The decision to adopt IFRS seriously undermines the UIG. The UIG's international "equivalent", the International Financial Reporting Interpretations Committee (IFRIC) will have the primary responsibility to provide interpretations on accounting issues²² which the UIG will have to follow. However, unlike its Australian counterpart, the process of obtaining international consensus typically takes IFRIC a period of almost a year, by which time the contemporaneous issue at question has long been replaced by another.

The long-term viability of an international consensus group that cannot release timely guidance is questionable. It follows that the UIG has been made largely irrelevant by its subordination to its relatively slow moving international counterpart.

Implications for corporate financial soundness

The process of international harmonisation of accounting standards does not in itself jeopardise Australia's financial reporting regime.

However, the mandatory adoption by Australia of IFRS has caused an upheaval in the financial reporting regime in Australia.

The policy of mandatory adoption has seriously damaged Australia's position as a world leader in accounting standard setting.

The unfortunate reality is that by weakening Australia's position as a centre of excellence and undermining Australia's standard setting role, the seeds of destruction for the next round of corporate collapses have already been sown.

Can Australia rescue its position?

Australia's position can only be rescued by treading a delicate path of supporting the IASB, given its laudable

FIGURE 3 THE DISADVANTAGES OUTWEIGH THE POTENTIAL UPSIDE

Adopting IFRS	
<p>Disadvantages</p> <ul style="list-style-type: none"> • Loss of independent accounting standard setting capability • Loss of accounting intellectual capital • Diluted financial reporting regime • Control of standard setting handed to IASB • Loss of sovereignty over part of Australia's delegated legislation • Loss of Australia's competitive advantage in attracting global capital • Adoption of standards that have no guaranteed international acceptability • Enforceability of IFRS is problematic • Australia has limited influence over IASB • Weakened role of UIG 	<p>Advantages</p> <ul style="list-style-type: none"> • Distant prospect of internationally accepted standards

long-term objectives, while adopting the best features of the international standards and the global convergence program. Effectively, this represents a reversal of the policy of mandatory adoption of international standards.

Though it may seem counter-intuitive to some, stepping back from the policy of mandatory adoption will actually strengthen the IASB's negotiating position with the reactionary and recalcitrant members of its constituency. Simply put, Australia should pursue a policy whereby international standards will not be adopted unless they are of the highest quality.

Australians should also be actively (not just nominally) involved in international projects in which we have significant experience and intellectual capital, for instance in the valuation of intangibles, extractive industries and accounting for joint ventures.

Unless there is a real, rather than nominal, participation in these projects and unless the AASB, the accounting profession and users generally are prepared to reject any IFRSs that compromise quality for the sake of international (and, in particular EU) acceptance, then Australia's position as a centre of excellence is doomed, our intellectual capital will be dissipated, and our accounting

standards and our capital markets will be further weakened.

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NOTES

1 International Accounting Standards are now known as International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB).

2 Under ASX Listing Rule 4.10, companies are required to provide

a statement in their annual report disclosing the extent to which they have followed the best practice recommendations set out in the ASX Corporate Governance Council "Principles of Good Corporate Governance and Best Practice Recommendations" in reporting periods commencing after 1 January 2003.

3 The statutory power of the AASB to make accounting standards is by virtue of s334 of the Corporations Act 2001 (Cth).

4 The Corporations Act requires all disclosing entities, public companies, large proprietary companies and registered schemes to prepare financial reports in accordance with accounting standards s292 and s296.

5 The Senate passed a resolution on 17 February 2000 disallowing paragraphs 6.3 and 6.4 of Accounting Standard AASB 1015 "Acquisitions of Assets".

6 Previously known as the Australian Society of Certified Practising Accountants (ASCPA).

7 *FRC Bulletin* 2003/1-11 April 2003.

8 Under the strategy adopted by the Financial Reporting Council (FRC) at its meeting on 28 June 2002 and publicly announced on 3 July 2002 (refer *FRC Bulletin* 2002/4, 3 July 2002 available on the FRC's website www.frc.gov.au), the Australian Accounting Standards Board (AASB) is obligated to work towards the full implementation of International Accounting Standards (now known as International Financial Reporting Standards (IFRS)) in Australia in respect of financial years commencing on or after 1 January 2005: Alfredson (2002).

9 Pound (2000).

10 Policy Statement 6 (1996), paragraph 1.2.

11 Policy Statement 4 (2002), page 4.

12 *FRC Bulletin* 2002/4, 3 July 2002.

13 *FRC Bulletin* 2002/5, 15 December 2002, Broad Strategic Direction provided by the Financial Reporting Council to the Australian Accounting Standards Board for 2002-03, paragraph c.

14 AASB plans for adopting IASB standards by 2005 (last updated 22 July 2003).

15 According to the AASB plans for adopting IASB standards by 2005 (last updated 22 July 2003), there are 14 IASB standards denoted as List B—proposed "improved" IASB standards scheduled to be reissued.

16 The EU has recently endorsed all but two of the existing IFRS (the exceptions being IAS 32 and 39 on Financial Instruments). Given that 14 of these standards are subject to improvement, and are likely to be significantly amended, it should be a matter of concern that:

(a) existing IFRS identified for improvement have nevertheless been approved in their existing form, and

(b) opposition to market valuing derivatives and other financial instruments is so entrenched in Europe that not even the limited requirements of, and the wide range of choices permitted by, the existing IAS 39 is acceptable to the EU.

17 Proponents of mandatory adoption conveniently overlook factors such as the fact that the IASB does not even have a standard on materiality, the massive internal inconsistencies in IAS 39, and numerous other technical issues.

18 In a memorandum of understanding known as "The Norwalk Agreement" (18 September 2002) the Financial Accounting Standards Board (FASB) and IASB "pledged to use their best efforts to:

(a) make existing financial reporting standards fully compatible as soon as practicable; and

(b) co-ordinate their future work programs to ensure that once achieved, compatibility is maintained".

19 Synnott and Dagge (2002).

20 This is not just a matter of observation of capital flows over the past 20 years; it has also been noted by other commentators, for example, Addison and Leo (1998): "The certainty and transparency of the information contained in Australian financial reports has facilitated investment, opened doors to foreign governments, and generally improved the image of Australian business."

21 "In rare and exceptional circumstances, the AASB may decide that adoption of an IASB standard is not consistent with main objects of Part 12 of the Australian Securities and Investments Commission Act 2001" (AASB plans for adopting IASB standards by 2005; last updated 22 July 2003). Clearly the AASB has adopted a policy of mandatory adoption and the FRC reference to best interests is no more than maintaining ultimately the right of Parliament to form a different view.

22 Although the IASB has stated that "its intention is to minimise the number of interpretations and to amend standards rather than issue interpretations"; AASB Action Alert No. 64, August 2003. J

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