The ABC of IFRS financial statements

On 1 January 2005, Australia will formally adopt new international accounting rules but, as **TOM RAVLIC** points out, some of the rules as they relate to a company's financial statements need better understanding.

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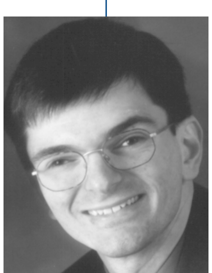

Whatever happened to spelling out in a simple, easy-to-understand narrative how a company's financial statements will be affected by the move to international financial reporting standards taking place over the next two years?

This is the question each of us must carefully ponder because very few examples of impact assessments emerging over the past six months as a result of an accounting standard mandating narrative disclosure are written in a way that can be understood by every conceivable user of general purpose financial reports prepared by entities in this country.

An accounting standard issued by the Australian Accounting Standards Board asks companies to detail the areas of change in accounting policies that will occur because of the infusion of new accounting rules and the likely impacts of those changes on financial statements. At the heart of the task is a fundamental question that will be asked by readers of financial statements: how different will my company look after the reporting changes are implemented?

The failure of many entities to grasp the fundamental question that they were being asked by the accounting standard setters – which was to describe the impact of accounting standards on their entity – has resulted in disclosures that are written in an accounting dialect so foreign that it is useless to anybody who has lost their professional accountants' equivalent of the Berlitz foreign language phrasebook.

The disclosures that are meant to clarify how new accounting standards force you to paint the picture of what you owe, own and have done with resources under your control on behalf of shareholders in some instances may as well not be there at all.

Remuneration expenses

Consider the fairly simple proposition of a new accounting standard that requires companies to expense the portion of a remuneration package that takes the form of a stock option or a similar kind of instrument. The impact for any company that has equity-based elements in remuneration packages for directors, executives and employees is easy to articulate.

A simple way of explaining this follows. The options or shares given to directors, executive and employees will appear in the income statement as an expense for the first time. It will reduce the company's net reported result.

Bear in mind that these two sentences explain what the standard does in 31 words and they describe accurately what the impact of the accounting standard will be when international standards become effective in Australia.

Some companies such as Mincor Resources NL have kept it simple. "Under AASB 2 Share-Based Payment, equity-based compensation to employees will be recognised as an expense in respect of the services received. This will result in a change to the current accounting policy, under which no expense is recognised for equity-based compensation," the Mincor Resources disclosure, which appears in the company's financial statements for the year ended 30 June 2004, states.

That disclosure weighs in at 41 words and is a fairly simple explanation of what will happen when the new accounting rules on remuneration come into play.

Medical Monitors Limited provides the same basic information relating to the standard, but takes it further by describing the manner in which the amount deemed as an expense arising from share-based payment works its way to the income statement.

"Equity-based compensation in the form of shares and options will be recognised as an expense in the period during which the employee provides related services. The consolidated entity does not currently recognise an expense for options or shares issued to employees, unless the options were issued in consideration for past services performed," Medical Monitors' disclosure on the impact of this standard says.

"On adoption of IFRS the consolidated entity will recognise an expense for employee options and shares and will amortise the expense over the relevant vesting period."

While analysts might appreciate the thumbnail reference to the way in which the expense will work its way into the income statement, the user of financial statements who sits outside the analyst community may find the concept of vesting foreign.

Defining what the vesting period is within the disclosure may have been useful if the company deems it necessary to raise the detail of how the expense will be calculated. The mere mention of the period without explaining the piece of accounting dialect used means the conversation being had with the average user of financial statements is less effective than might otherwise be the case.

Not enough of the words describe in a simple fashion what impact the standard will have on the financial statements of the company requirements.

Medical Monitors is a mild case of jargon addiction. M2M Corporation Limited's disclosure – and the way in which the company has taken the trouble to load it with complex terms within the space of 131 words – is something else to behold.

"The entity previously engaged in the practice of allocating to its employees shares and share options as part of their remuneration packages. AASB 2 'Share-Based Payments' require that these payments and also payments made to other counterparties in return for goods and services shall be measured at the more readily determinable fair value of the good/service or the fair values of the equity instrument," M2M Corporation's disclosure on what the implications of this new standard on expensing remuneration says.

"This amount will be expensed in the statement of financial performance. Where the grant date and the vesting date are different the total expenditure calculated will be allocated the two dates taking into account the terms and conditions attached to the instruments and the counterparties as well as management's assumptions about probabilities of payments and compliance with and attainments of the set out terms and conditions."

What does that mash of big words actually mean? Why does the reader need to leave the disclosure somewhat puzzled as to what is actually happening? The above disclosure is arguably an example of a failed attempt to communicate the implications of moving to international financial reporting standards dealing with the expensing of an element of remuneration because it is loaded with too many words while, of course, still being technically accurate. Not enough of the words describe in a simple fashion what impact the standard will have on the financial statements of the company but they do describe the technical requirements of the standard.

Telstra's disclosures

Telecommunications giant Telstra managed to outshine all of the above examples in the disclosure dealing with accounting for expensing Share-Based remuneration.

"We currently recognise an expense for all restricted shares, performance rights, deferred shares, and Telstra shares (consisting of "directshares" and "ownshares") issued. This expense is equal to the funding provided to the Telstra Growthshare Trust to purchase Telstra shares on market to underpin these equity instruments, and is recognised in full in the statement of financial performance when the funding is provided," Telstra's disclosure reads.

"We do not currently recognise an expense for options issued. For further information regarding our employee share plans, refer to note 19."

The Telstra disclosure continues.

"On adoption of AASB 2, we will recognise an expense for all Share-Based remuneration, determined with reference to the fair value of the equity instruments issued. A transitional adjustment to recognise the difference between the expense recognised for AGAAP and the fair value of all equity instruments issued will be made retrospectively against opening retained earnings at transition date. We currently apply a similar concept of expensing share-based remuneration in our USGAAP reconciliation. For information on the approach applied in the USGAAP reconciliation, refer to note 30(k)."

Telstra's disclosures are written in a manner that is designed to be warm – the communications player uses the pronoun 'we' at every opportunity rather than the less endearing 'Telstra'. The finance and accounting team has sought to not just rely on proforma wording produced by accounting firms in order to expedite the task of producing disclosures in a highly demanding disclosure environment where short cuts might be welcomed by corporate compliance staff wanting to move on to the next regulatory headache.

The strength in Telstra's disclosure does not emerge solely from the language it employs. It describes the types of schemes that will be affected by the provisions in the accounting standard, and by doing so makes the disclosure more lively for those needing or wanting to understand exactly the position Telstra may be in when a fully compliant set of financial statements is issued by the company for the financial year ending 30 June 2006.

The strength in Telstra's disclosures does not just rest with the company's use of language in an attempt to personalise the process of transitioning to a new body of accounting standards. The company actually refers to the kinds of equity-based remuneration it issues to the directors and executives of the company, whereas all of the previous examples – including the brief 31 word benchmark that started this – failed to explore those issues in a way that addresses the kinds of deals the company itself has entered into.

The Telstra disclosure brings all of the technical developments to life. A reader of the Telstra disclosures should be able to walk away with a reasonable understanding of how the company will be affected by the introduction of the new standard.

Another positive feature of this particular disclosure is the fact the company points the reader to other parts of its financial statements where further information on remuneration lives.

The disclosure provided by Telstra on its readiness to transition to IFRS and the technical implications of moving to international accounting standards is interdependent with other disclosures and the company has been smart enough to acknowledge that fact.

Examples of the same kind of phenomenon can be found across most topic areas of accounting. Another fairly simple issue – the new accounting requirements that apply to goodwill – is given a very different treatment from one entity to another.

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New impairment standard

Some companies have just described the fact that straight-line amortisation, which essentially means hitting the bottom line with goodwill expense in equal portions, over a period not exceeding 20 years, is dead. Corporations will need to assess the value of their operations as a whole using a new impairment standard. Goodwill will need to be written down when a company's operations are judged to have been hit by some kind of misfortune – self-inflicted or otherwise.

Gregory Industries Limited describes this shift in accounting in a reasonable way although it is laden with jargon. "Goodwill acquired in a business combination will not require amortisation, but instead be subject to impairment testing at least annually. If there is any impairment, it will be recognised immediately in the statement of financial performance.

This will result in lower amortisation expenses, and therefore higher earnings on an annual basis, but increased volatility of results in the event of impairment," Gregory Industries' disclosure states.

A1 Minerals Limited, a resource company, provides a very short précis of this new part of the accounting framework in the context of new asset impairment rules. "Impairment of assets (other than exploration and evaluation expenditure) will be determined on a discounted basis, with strict tests for determining whether goodwill and cash-generating operations have been impaired," the resources company says.

Gregory Industries Limited and A1 Minerals Limited have placed the bare minimum in terms of disclosure in this particular area when compared with the disclosure on this topic prepared by Insurance Australia Group (IAG). "The IAG Group will not restate the accounting for business combinations transacted prior to 1 July 2004, as permitted under first time adoption. Goodwill will not be amortised but will be tested for impairment at least annually.

Using A-IFRS impairment methodology the balance of goodwill shown in this report of $1.455 million is supportable," the IAG disclosure says.

"The IAG Group had a goodwill amortisation expense for the year to 30 June 2004 of $91 million. The elimination of the requirement to amortise goodwill under A-IFRS will increase reported profits, subject to any impairment charge that may be required."

While these are mere snapshots of a raft of disclosures that have been included in company reports over the past six months as a result of the standard, they do illustrate the stark differences between companies where transparency and clarity is concerned.

What are the reasons for disclosures being full of jargon and less than effective as tools of communication in this context, where the rules that apply to each of them are essentially the same?

Keeping it simple

There are probably several commonsense explanations for the dearth of simplicity of expression in the financial statements. One of the most profound reasons for the preponderance of big words in disclosures that not many people outside professional circles understand is rather simple.

Companies and, more particularly, their directors receive very privileged access to explanations of what the accounting dialect known as the Australian equivalent of international financial reporting standards (IFRS) means. Boards of directors are educated by a company's senior management and external advisers the company engages to help with IFRS transition work such as the external auditors and, indeed, lawyers.

This menagerie of experts – internal and external to the entity in question – spends an enormous amount of time pumping information into the minds of directors in order to ensure that they do have some degree of understanding of what the accounting requirements are before they commit their signature to a set of financial statements or any other document containing financial information such as a prospectus.

The code contained in the accounting dialect set down in the accounting standards has been cracked for the directors by the experts engaged to boil it down to some degree of workability. Any education received by a director on the changes and impacts of accounting standards would have some bearing on the way the concepts are articulated by them in disclosures sent out to the market place.

A challenge then exists for those who are in possession of what is for them new knowledge about how accounting will work under a new suite of accounting pronouncements. How do they explain it to those people that have not had the benefit of educational sessions with the experts brought in to help support the board of directors as it fulfils its governance role?

In some cases they are explaining things poorly because they come to the task with a knowledge that outsiders watching the company – including shareholders in that category – have not received.

Complex standard setting

There is an issue lurking beneath the surface in this particular context and that is the open contempt accounting standard setting has shown to simplifying the way standards are expressed and communicated. Several generations of standard setters have developed accounting standards for sophisticated users, which then makes it inevitable that a labyrinth of complexity will need to be navigated by those experienced with the literature.

When the documents created by companies and their advisers are complicated, then it stands to reason that those without the necessary intellectual firepower present within their organisation to interpret the standards will struggle to explain them in terms understood by outsiders. If standard setters are incapable of thinking simply, then what hope is there for those that have to apply the documents and subsequently be responsible for the translation of accounting requirements to those holding shares and intending to invest in their company?

The Australian marketplace may be witnessing compliance weariness at the same time as companies are being asked to talk about international standards. A typical listed company has to keep track of the Corporate Governance Council recommendations put out by the Australian Stock Exchange as well as any further regulatory changes brought about by the introduction of the ninth tranche of the Corporate Law Economic Reform Program.

The volume of change may have given corporate executives and company directors less time to think about whether what they are telling the market will be understood by the average reader of the financial statements. It may also reflect the fact that so much material has had to be written over the past 12 months and very little reflection on the readability of this material has taken place.

Some disclosures may have also been rendered less readable or less informative as a result of the intervention of external advisers. It is understood some listed companies have experienced resistance from their audit firms when they have sought to have more colloquial wording in disclosures on international accounting standards. That may be a result of the fact auditors had to put the disclosures through their mechanical review and test whether certain things were verifiable by external parties.

While the points raised above are included as speculation as to why disclosures end up being convoluted and incomprehensible to the average investor – and perhaps confusing to analysts – they do not absolve the companies from the cardinal sin that has been committed.

A company's disclosure on such a fundamental issue such as the change in accounting requirements and how the company will look to outsiders should be crafted in simple terms, but the past reporting season has brought out numerous examples of entities that have not bothered to think about the core business impact. They have instead engaged in a recitation of technical terms that would mean little to most people who may choose to browse through financial statements in the hope that they might learn something.

A failure to use simpler language – and describe in basic narrative the impact these accounting standards have – means the market is poorer for the fact that the companies even bothered to comply with a rule that said they must say something reflecting on the impact of new standards on their financial statements. That is regrettable in circumstances where the documents being referred to are general purpose financial statements that are meant to cater for the information needs of the broadest possible base of readers. J