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Clarification of comments at Public Hearing for the Inquiry into Regulation of Auditing in Australia held on 29 November 2019 and 9 December 2019

As Chair of the Australian Accounting Standards Board (AASB) and a witness before the Committee, I have reviewed the Committee's Hansard Proof Transcripts relating to the public hearings on 29 November 2019 and 9 December 2019 of the Parliamentary Joint Committee on Corporations and Financial Services (PJC) in relation to your inquiry into the regulation of auditing in Australia.

I have noted several matters in the transcripts that relate to the AASB and Australian Accounting Standards, which we believe require further clarification for the PJC to ensure these are considered appropriately.

1. **Hansard Proof Transcript from 29 November 2019, Page 23**

   Statement

   Prof. Guthrie: ….."The nature of the audit and opinion has significantly changed over my time, over those 40 years, from what I would call a true and fair view to now just an opinion on if the accounts are being presented in terms of international accounting standards, which narrows it down significantly."

   Clarification

   Financial reporting requirements in Australia continue to require entities preparing financial statements under the Corporations Act to present a true and fair view, in addition to compliance with both Australian Accounting Standards and International Financial Reporting Standards

   Section 296 of the *Corporations Act 2001* requires an entity's financial report to comply with Australian Accounting Standards and section 297 of the Corporations Act also requires the financial statements to give a true and fair view of the financial position and performance of the entity. In the rare instances where there is a conflict between accounting standards and a true and fair view, the accounting standards are complied with, and additional information must be provided to enable a true and fair view.

Australian Accounting Standard AASB 101 *Presentation of Financial Statements* (which incorporates the International Accounting Standard IAS 1 *Presentation of Financial Statements*), paragraph 13, requires a financial report to present fairly the financial position, financial performance and cash flows of an entity (such as a company) that prepares general purpose financial statements. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Conceptual Framework. The application of Australian Accounting Standards, with additional disclosure when necessary, is presumed to result in a financial report that achieves a fair presentation.

However, consistent with the Corporations Act, AASB 101 paragraph 21 requires an entity to make further disclosures in the extremely rare circumstances where 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 reporting set out in the Conceptual Framework (i.e. to provide useful financial information to the entity's existing and potential investors, lenders and other creditors for their decision-making).

2. Hansard Proof Transcript from 29 November 2019, Page 39

Statement

Mr Edge: I didn't say that. I think I was referring to the FRC in the UK being both the regulator and the standard setter, whereas in Australia we have separate organisations. We have ASIC as a regulator—

Senator WHISH-WILSON: We do, but ASIC plays a role in the setting of—

Ms Peach: No, ASIC does not play a role in setting standards at all.

Senator WHISH-WILSON: None at all?

Mr Edge: No.

Ms Peach: As I noted in my opening statement, the AASB is responsible for setting the standards, and ASIC is responsible for enforcing the standards—quite separate roles.

Clarification

The AASB develops standards through extensive due process, eliciting and considering the views of a broad range of stakeholders. The AASB Due Process Framework for Setting Standards requires appropriate consultation with stakeholders, including other regulators such as ASIC.

In the AASB's submission to the Inquiry, we note that the AASB works with regulators in all sectors of the economy when developing accounting and external reporting standards, as it is the regulators that determine the external reporting requirements for entities that they regulate, including whether financial statements are required to be prepared and, if so, the extent to which the standards are required to be applied.

ASIC staff have raised significant financial reporting issues identified through the ASIC surveillance program with the AASB, and in some circumstances with the IASB.

3. Hansard Proof Transcript from 29 November 2019, Page 74

<u>Statement</u>

Senator WHISH-WILSON: At paragraph 5.1 of your submission, you say we should ask AASB why it removed the requirement for auditor fee disclosures from general purpose financial statements of multinationals. Why do you think it removed that requirement?

Mr Knapp: I don't know. I honestly don't know. Were they pressed by members that were representatives of the big four? I don't know.

Senator WHISH-WILSON: Would that be a commercial-in-confidence thing?

Mr Knapp: I don't know. I just know it's a bad decision.

<u>Clarification</u>

Audit fee disclosure is required for Tier 1 general purpose financial statements and the AASB is proposing to extend this requirement to Tier 2 general purpose financial statements (including for entities that will lose the ability to prepare special purpose financial statements under the AASB's current proposals).

Audit fee disclosure requirements (which are additional to requirements of the International Financial Reporting Standards) currently apply to Tier 1 general purpose financial statements, which are required for publicly accountable for-profit private sector entities such as listed and disclosing entities.[1]

At present, audit fee disclosures are not required of entities preparing general purpose financial statements under Reduced Disclosure Requirements (Tier 2). The removal of these disclosures resulted from the application of the AASB's normal due process, when the Tier 2 requirements were first established in June 2010 as a means of providing simplified general purpose financial reports.

The consultation and feedback from a broad range of stakeholders on the Consultation Paper *Differential Financial Reporting – Reducing Disclosure Requirements* and on Exposure Draft ED 192 *Revised Differential Reporting Framework* took place over a period of some years up to mid-2010, when the AASB issued the Tier 2 reduced disclosure requirements. The audit fee disclosure requirements were assessed by the AASB as not meeting the criteria applied by the International Accounting Standards Board (IASB) and adapted by the AASB to determine whether the information is of particular interest to the users of Tier 2 financial reports. These criteria covered liquidity, solvency, measurement uncertainties, accounting policy choices, disaggregations of amounts presented in the financial statements and the

1 Public accountability is defined in Australian Accounting Standard AASB 1053 *Application of Tiers of Australian Accounting Standards*.

nature and significance of transactions, other events and conditions encountered by the entities. Feedback on the consultation papers supported the removal of audit fee disclosures.

However, as noted in the AASB's submission to the Inquiry, given the heightened focus on audit quality and feedback from the AASB's User Advisory Committee, in the public interest the AASB is currently proposing to extend the audit fee disclosure requirements to financial statements prepared under Tier 2 – see AASB Exposure Draft ED 295 *General Purpose Financial Statements – Simplified Disclosures for For-Profit and Not-for-Profit Tier 2 Entities* (August 2019). The formal comment period has just closed for this Exposure Draft. The AASB will review the submissions received and consider the proposals further during the first half of 2020. If finalised as proposed, all entities lodging financial statements with ASIC (except some small proprietary companies) will be disclosing audit fees.

4. Hansard Proof Transcript from 9 December 2019, Page 30

Statement

Mr Johnson: Yes. There's no silver bullet, sorry, Mr Gorman. The second part of Mr Falinski's question was around the complexity of financial reporting and it's absolutely correct. One of our recommendations is that there be a review as to the financial reporting framework and whether it's meeting the needs of users, broadly put. Chris, did you want to expand on that?

Senator WHISH-WILSON: 'Users' being the public as well?

Mr Johnson: Yes.

Mr George: That's right. Yes. So we would agree with Mr Falinski's comments that financial reporting is incredibly complex. In the last 12 months we've had two new accounting standards come into play. Both have been incredibly complex. We have another one coming in this year which has been incredibly complex. Our clients struggle to understand these accounting standards. We find them complicated. So I'm sure that the general public would find them complicated as well, which really did go to our recommendation of looking at: is the financial reporting framework fit for purpose, and should there be changes made to make it better suit the needs of those users?

Senator WHISH-WILSON: Could you name those two accounting standards?

Mr George: Yes. The two that have already come in were AASB15, which is a revenue accounting standard. The second one is AASB9 on financial instruments, and the new standard for this year is a new leasing standard.

Clarification

Australian Accounting Standards, in accordance with the ASIC Act and the Financial Reporting Council strategic direction, incorporate the International Financial Reporting Standards issued by the International Accounting Standards Board (IASB) to enable international comparability and access to capital. The AASB ensures that the accounting and external reporting standards and guidance it develops, issues and maintains are

principle-based and meet the needs of external report users. Accounting standard complexity arises from the economic complexity of the transactions being reflected.

As noted in the AASB's submission to the Inquiry, Australian Accounting Standards have incorporated the International Financial Reporting Standards issued by the International Accounting Standards Board (IASB) following a broad strategic direction issued by the Financial Reporting Council and with regard to the interest of Australian corporations raising capital internationally as required by the ASIC Act to enable globally comparable financial reporting.

The great variety and complexity of economic activity today means that accounting standards, which attempt to recognise the substance of a transaction's economic outcome, are also complex. Faithful representation of a transaction's economics generally requires estimates of future cashflows expected to be generated, either in measuring the asset recognised on the balance sheet, or in determining whether it is impaired and needs its value adjusted downwards. Accordingly, principle-based accounting standards require application of judgement by both preparers and auditors. We note the general public needs to understand the outcome of the accounting standards, being the disclosures in the financial statements, rather than the accounting standards themselves. The IASB and the AASB are continually reviewing how to assist preparers in making transparent, useful disclosures, rather than boilerplate statements duplicating the accounting standards. For example, the recently released IASB Exposure Draft *General Presentation and Disclosures*, responding to demand from users of the financial statements, proposes improvements to the way information is communicated in the financial statements, with a focus on financial performance and would require more comparable information in the statement of profit or loss and a more disciplined and transparent approach to the reporting of management-defined performance measures.

The new standards issued by the IASB and the AASB (AASB 9 *Financial Instruments*, AASB 15 *Revenue from Contracts with Customers* and AASB 16 *Leases*), now being implemented, are expected to improve financial reporting of financial instruments, revenue and leases respectively, addressing a number of financial reporting issues (including some identified by ASIC's surveillance programs), as follows:

- AASB 16 has a simple premise of recognising leases on the balance sheet of lessees. Such accounting reflects adjustments that investors had routinely been making as the prior standard (AASB 117) was a rule-based standard which preparers used to avoid recognising some liabilities on their balance sheets.

- AASB 9 addresses concerns raised after the global financial crisis that accounting standards recognised impairments of financial instruments too late. The new methodology is a more accurate and transparent reflection of how management assesses its impairments, however as key assumptions rely on future expectations, significant judgement is required.

- AASB 15 was developed jointly by the IASB and the US Financial Accounting Standards Board to ensure revenue is not recognised until control of a good or service has been provided to a customer. To address concerns from regulators about revenue recognition, particularly where multiple performance obligations exist in contracts, AASB 15 has a more detailed methodology for assessing whether revenue should be recognised over time or at a point in time.

If you have any questions regarding this letter, please contact Clark Anstis, Technical Principal Justin Williams, Managing Director or me .

Yours faithfully,

Kris Peach
AASB Chair