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**DISCIPLINE OF
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The Secretary
Parliamentary Joint Committee on Corporations and Financial Services
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Canberra, ACT, 2600.

Re: INQUIRY INTO NAUSTRALIAN ACCOUNTING STANDARDS

Dear Committee members;

We note that your Inquiry centres on ‘consistency of the proposed standards with the law and on ensuring there are no unforeseen anomalies’ as we move to an IFRS-based accounting standards regime.

We begin this submission with a brief summary of recent press concerns on the subject of this submission. Recent financial press commentaries (e.g. Lee and Buffini, ‘Accounting Regulators Clash on Rules’, *AFR*, 11 January 2005, pp. 1 and 6, Lee, ‘Survey faults CEOs on reporting rules’, *AFR*, 18 January 2005, p.6 and (say) by Keith Alfredson ‘International accounting rules a dream’, *AFR*, 14 January, p. 74) have debated aspects of the transition from national accounting standards to a regime based on *IFRSs*.

The emphasis in that recent debate has entailed possible inconsistencies between interpretations of those IFRSs by the national standards setting bodies (such as the AASB) and the international sub-committee (IFRIC) charged with responsibility for interpreting IFRSs. The recent letter by Keith Alfredson ('International accounting rules a dream', *AFR*, 14 January, p. 74) summarises the issues raised in those press items. He concludes that 'My solution is to get rid of the UIG and let the onus of responsibility firmly sit with those who have the legal responsibility: boards of directors and auditors. This will work only if the IFRSs prove to be of high standard and principles-based and those applying them wish to live by principles and have the fortitude to apply them.'

With that preamble our submission now addresses seriatim the matters raised in the JPCCFS *Invitation Letter*, viz:

1. Whether the proposed standards [Australian Accounting Standards tabled in the Senate on 30 August and 16 November, 2004] are consistent with the Corporations Act, 2001, and its regulations (as required under S. 334(1) of the Act;

The underlying substance of the issue raised by this question hinges on how the 'true and fair view' phrase is to be interpreted in respect of the 'proposed standards (Australian Accounting Standards tabled in the Senate on 30 August and 16 November, 2004). This is to be considered on the basis of the *objectives* of the Corporations Act (as reiterated in the CLERP 9 deliberations (see Committee reference *Issue No. 2 below*)).

We take it as given, that as far as it concerns accounting information, providing serviceable information regarding the wealth and progress of a company to the public at large is an all encompassing objective of the Corporations Act. That objective is to be pursued through *true and fair* statements of *financial performance* and *financial position*. The objective is thus met by necessarily satisfying the true and fair criterion as a general *principle*, rather than complying with rules expressed as standard accounting procedures to be followed. We have argued elsewhere (Clarke, Dean and Oliver, *Corporate Collapse: Accounting, regulatory and ethical failure*, CUP, 2003) that the AASB Standards previously in force did not meet that criterion. And despite claims made in

respect of IFRSs we hold the view that the IFRS (effectively still rules-based) standards do not do so either.

In this respect in our submission on 11 March, 2004 to the PJCCFS ‘CLERP 9’ Hearings we noted:

3. *Principles- v. rules-based reporting system.* There is an implied premise in many of the submissions to the CLERP 9 Bill of the need to move towards the ideal of a *principles-based system* of regulation generally, and especially in respect of matters like auditor independence and the setting and monitoring of accounting and auditing standards. Regarding the latter the IASB’s IFRSs are generally (although we have some reservations outlined below) perceived to represent the closest thing to a principles-based regime - with reference to true and fair state of affairs and the need for current value information to inform investors – reliable, relevant and comparable data – proxied by fair value reporting (e.g CLERP 9 *Discussion Paper*, September, 2002, p. 112). US Standards in contrast are categorised as possessing the archetype elements of a rules- based (black letter) system of reporting, whilst Australia’s regime is categorised by, *inter alios*, David Boymal (Chair of AASB) as being not quite as far along the continuum as the US - but, contrary to the admonitions of some other less-informed commentators, not far removed.

We are yet to see any explanation of to what *principles* the AASB, IFRS or FASB Standards conform. Ultimately, each amount to rules that are to be observed, it seems, even if they do not result in the financial showing of a “true and fair view”, or its equivalent. The only dominant theme underpinning the Standards is compulsory compliance! The “principles v. rules” dichotomy has been substituted for the “substance over form” mantra preceding it. Just as in the final wash-up the “form” was the “substance”, the “rules” have become the “principles” for all practical purposes. Consider the latest IAS 39 which has many, especially European bankers, incensed and the local brouhaha surrounding the IASB Standard IAS 38 on intangibles. We should ask “why” all such jockeying with terms? The answer is that *principles, rules, substance, form, standards and the like*, are used rather than stating what the underlying singular and *workable quality criterion* ought to be for financial statements.

We suggest that “true and fair” is the singular quality criterion to be applied in respect of companies’ financials. ..., [and] ...

6. *Compliance with the IFRSs.* Were the serviceability criterion to be invoked, the source of the Accounting Standards would not be an issue. Indeed, it is questionable whether anything more need to be prescribed other than the criterion itself. Were it prescribed, no doubt tried and tested means of achieving the quality required would emerge as common, standard, practices. That is how accepted high quality procedures develop in other professions – through the dissemination of knowledge of and experience with successful methods of achieving critical

outcomes, and the accumulated wisdom of those engaging in them. Compliance with the IFRSs is a red herring. The primary defect in Australian accounting at the moment is not the source of the Standards, by whom or how they are established. The primary problem is that they are not underpinned by a general quality criterion such as “serviceability”.

In respect of the current ‘Inquiry’, the crux is whether the application of the new IFRSs will produce reported financial information any more serviceable than their predecessor national standards. It has been suggested by many that they will because, it is posited that, in contrast with their national predecessors, IFRSs are ‘principles- (not rules-) based’. We (as it would appear do Keith Alfredson and many others) contest that proposition. No general principle or principles have been specified, no explanation of how the data to emerge from the IFRSs will contribute to a true and fair view of an entity’s financial position and performance has been made. Indeed no explanation of the dimensions of what *a true and fair view* entails has been forthcoming. For a successful transition such a specification is a prius.

As well as our observations on this aspect in point 3 of our 11 March 2004 Submission above, more recently we have noted the contestability of such a claim in an Editorial (vol. 41:1, pp. i-iii) in an international accounting journal, *Abacus*. An extract from that Editorial is reproduced:

“PRINCIPLES V. RULES: TRUE AND FAIR VIEW AND IFRSs

A characteristic of human nature appears to be that if something is said often enough it becomes accepted as if it were true. A case in point, arguably, is the mantra that the universal adoption of international financial reporting standards (IFRSs) by 2005 will purge accounting of its ills. This editorial considers that proposition, especially in the light of the interplay of the quality criteria of ‘true and fair’ or ‘presents fairly’ with compliance with IFRSs.

Following the unexpected corporate collapses of Enron, WorldCom, Vivendi, Parmalat and HIH, numerous legislative initiatives have emerged worldwide, including the Sarbanes-Oxley Act of 2002 in the U.S.A. and Australia’s CLERP 9 Bill. The Australian Bill proposes a new co-regulatory regime premised on a ‘vision of promoting transparency, accountability and shareholder activism’. It advocates that the regulatory regime generally, and financial reporting system specifically, should be principles-based. Much of the discussion of the corporate

governance reforms proposed in the Bill has examined whether the new regulatory regime would achieve a balance between ensuring that confidence in the market is regained through new continuous disclosure mechanisms to inform the securities market more effectively, and a desire not to impose excessive regulations that would stifle the economy's growth.

At the professional practitioner level there is a relentless push for accounting setting convergence. The IASB is seeking to have IFRSs in place worldwide by 2005. How this will mesh with the drive for a so-called principles-based approach to accounting is problematic.

Debating financial reporting and corporate law reform has a long history. Discussion of this appeared recently in an *Abacus* editorial (Dean, 2002, pp. i–vi). The issue of balancing 're-regulation initiatives' after a bout of deregulation is not new, and nor are the suggestions of commentators that we do not need to straitjacket the many because of the actions of a few (bad apples). There is a sense of 'presentism' in the current debates — a failure to be aware of similar historical patterns — which raises the likelihood that those who do not learn from history are doomed to repeat the mistakes of the past.

Every U.K. corporate law reform committee of enquiry since around the 1890s has noted that directors are in the main honest, that the regulatory system is working effectively most of the time, and that there is no need for substantial reform ... that only tinkering is required. This point is made well in Edwards (1981). In contrast, one should note Chambers' 1991 lament that: 'Piece-meal patching will not make a worm-eaten craft seaworthy; neither will piece-meal tinkerings of individuals, boards and committees make cost-based valuations trustworthy' (p. 18).

There is an implied premise in many of the submissions to the CLERP 9 Bill of the need to move towards the ideal of a principles-based system of regulation generally, especially in respect of matters like auditor independence and the setting and monitoring of accounting and auditing standards. The IASB's IFRSs are perceived to represent the closest thing to a principles-based regime, with reference to true and fair state of affairs and the need for current value information to inform investors — reliable, relevant, understandable and comparable data — proxied by fair value reporting (e.g., CLERP 9, 2002, p. 112). U.S. standards in contrast are categorized as the archetypical rules-based (black letter) system of reporting, while Australia's regime is categorized as being not quite as far along the continuum as the U.S.

This is contestable, as one cannot find any explanation of principles to which the AASB, IFRS or FASB standards conform. Ultimately, each standards-based regime contains rules that are to be observed, even it would seem if they do not result in the financial reports showing a 'true and fair view' or its equivalent. The only dominant theme underpinning the standards is compulsory compliance! The 'principles v. rules' dichotomy has been substituted for the 'substance over form'

dictum preceding it. Just as in the final wash-up the form was the substance, for all practical purposes the rules have become the principles. We should ask ‘Why?’ of such jockeying with terms. The answer is that principles, rules, substance, form, standards and the like are invoked rather than a statement of the underlying singular and workable quality criterion to apply to the preparation and audit of financial statements. Arguably, ‘true and fair’ — serviceability — is that singular quality criterion.

The ‘true and fair’ criterion has long been a cornerstone of British-based corporations law regimes (see Chambers and Wolnizer, 1991, pp. 197–213). As it currently stands, there is considerable confusion as to the primacy of ‘true and fair’. The professional accountancy bodies and most accountants and auditors appear to proceed on the assumption that ‘true and fair’ is a second order imperative, and that primacy lies in compliance with the accounting standards. We have noted elsewhere that even as the Australian Corporations Act is currently worded, that is contestable (Clarke *et al.*, 2003, esp. Chs 1, 2, and pp. 319–21).

....

Consider the situation were ‘true and fair’ is the sole criterion dictating directors’ and auditors’ reporting and attestation obligations. Explanation of how the statements of financial position and financial performance disclose the matters they are held out to show would fall, and quite properly so, on those who prepared the statements and those who audited them. One might expect that regular, common, profession-wide, tried and proven methods of reporting on the wealth and financial progress of companies would emerge as a matter of professional acumen. That happens in other professional pursuits entailing greater complexity than financial affairs. Indeed, that is how ‘professional expertise’ develops. Why not in accounting?” [References are available from authors if needed].

2. Whether the proposed standards will act in furtherance of the objectives of the Act;

The objectives of the Corporations, 2001 as emphasised in the recent CLRRP 9

deliberations, include to

- (i) ‘make a significant contribution to restoring investor confidence in Australia’.
- (ii) ‘improve the content and reliability of financial reporting, among other things, through its CEO/CFO sign-off requirements and Operating and Financial Review’.
- (iii) ‘ensure transparency, accountability and shareholder activism’; and
- (iv) ‘balance these goals (i-iii) with a desire not to impose excessive regulations to stifle the economy’s growth’.

We have explained elsewhere (most recently F. Clarke and G. Dean, ‘An Evolving Conceptual Framework Evolution?’, *Abacus*, September, 2003, pp. 297; and previously

in Clarke, Dean and Oliver, *Corporate Collapse: Accounting, regulatory and ethical failure*, CUP, 2003) as well as above (response to Issue 1) that *reliable* financial information, reliable statements of financial performance and statements of financial position turn upon the *serviceability* of the data in, their *fitness* for, the uses ordinarily and habitually made of them – determining periodic profit and loss; disclosing the nature, composition and money's worth of assets; the nature composition and amount of legally enforceable liabilities against the company; deriving the salient financial characteristics of companies from such data – rate of return, solvency, the proportion of debt to equity, asset backing, rate of stock turnover, the mathematical relationship between various classes of assets to one another, a similar of the relationship of various classes of liabilities to various classes of assets, and the like. Each of those derived data relate to actual amounts of money or its equivalent variously related to one another with a view to obtaining indications of the financial structure of a company, in order to assess its past and make reasoned predictions about its future. That is what we have described as *serviceability*. There is no place in such calculations for data other than actual amounts of money in the company's possession, or to which it has access – money equivalents; to which it can lay legal claim; and amounts that it is legally enforced to pay others. Arguably, for the most part, the products of tax effect accounting, consolidated financial statements, depreciation and impairment accounting to derive the value of physical assets, as specified in the IFRSs fail to meet the serviceability test. In our opinion the data likely to emerge from the employment of the IFRSs are unlikely to be serviceable for making necessary financial assessments like solvency assessments by corporate officers, in the manner which we take the Corporations Act to imply.

Consistent with this submission to the current PJCCFS Committee Inquiry Issue 1 (above) those objectives will not be satisfied unless there is recognition that the true and a fair view override is truly an override and that the directors and auditors will need to apply professional judgement always in preparing the accounts, and not simply adopt a tick-a-box approach in respect of applying IFRS. Compliance *per se* is not a desideratum. As some standards setters, like David Boymal and Keith Alfredson have consistently stated, this has always been the case, legally. But for many years in the 1990s it appears

many preparers and auditors may have lost sight of this fact in practice (for evidence on this see submissions of many underpinning the 2002 JCPAA *Report 391*). Consideration under this sub-head should recall the Australian Parliament's 2004 re-emphasis of the significance of the 'true and fair view override' – as evidenced by the comments of Senator Chapman (Chairman of PJCCFS) in his Media Release of 26 June, 2004, related to the PJCCFS '*Report on CLERP , Part 2*' as it especially related to the 'True and fair view requirement':

"The Committee believes that financial statements should, but do not necessarily, provide users with information that will help them to assess a company's financial position and performance. The Committee has consequently recommended the insertion of a definition to clarify the purpose of the true and fair view requirements. In addition, the Committee has endorsed the JCPAA's recommendations for the inclusion of additional explanatory material in the notes to the financial statements if they do not otherwise give a true and fair view."

3. *Any related matter.*

We feel our submission re points and 2 cover the substantive issues.

Sincerely,

Professors Graeme Dean and Frank Clarke.