

20 January 2005

Sarah Bachelard
The Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Suite SG.64
Parliament House
Canberra
ACT 2600

Dear Sarah

Inquiry into Australian Accounting Standards

Ernst & Young is pleased to comment on the Australian Accounting Standards tabled in compliance with the Corporations Act 2001 in the Senate on 30 August 2004 and 16 November 2004.

Ernst & Young supports the endorsement of the Australian Accounting Standards that are equivalent to International Financial Reporting Standards as this will facilitate cross border comparison and reduce the cost of capital in Australia.

However, the proposed Australian Accounting Standards have a number of interpretation issues that require resolution in order to achieve the objective of comparability. The key difficulties of interpretation lie in the following areas, which are explained in more detail below:

- Scope differences between the Australian equivalents to International Financial Reporting Standards ('AIFRS') and the International Financial Reporting Standards ('IFRS');
- Interpretation issues with the International Financial Reporting Standards ('IFRS');
- Instances where the International Financial Reporting Standards ('IFRS') may lead to an undesirable outcome.

To address the interpretation issues, Ernst & Young considers that there is a need for an interpretative body in Australia, to address the interpretations issues that arise, and to have strong links with the International Accounting Standards Board (IASB).

Ernst & Young Global has developed a number of interpretative groups to address issues that arise globally for our clients. These groups are based around subject matter and include participants from member firms in Europe, Australia, New Zealand, Asia and the US. The groups address interpretation issues that arise to reach a global consensus on the treatment of particular issues. The groups are overseen by a Global IFRS Policy Committee that approves all global IFRS interpretations. These interpretations are then housed in a global interpretations database. We consider that this ensures consistency of interpretation on a global basis. However, while this

process works well for large accounting firms, smaller firms do not have the resources to commit to ensuring globally consistent interpretations. In addition, there are cases where achieving the answer to an interpretative query is not easy, as the Accounting Standard may be ambiguous, or, as is more often the case, there may be more than one possible interpretation. It is in these cases that we believe that the standard-setters have a role to play in ensuring consistency of interpretation. We understand that the Australian Securities and Investments Commission will be unlikely to accept more than one interpretation of an Accounting Standard and thus it is essential to have an arbiter in place to ensure market certainty. Importantly, that arbiter cannot act in isolation from the IASB – it must have the authority of the IASB to issue Interpretations.

Examples of the scope differences and difficulties of interpretation are as follows.

Scope differences between the Australian equivalents to International Financial Reporting Standards ('AIFRS') and the International Financial Reporting Standards ('IFRS')

One of the most significant scope differences between AIFRS and IFRS is in relation to business combinations. In developing AASB 3 *Business Combinations*, the Australian equivalent to IFRS 3 *Business Combinations*, the AASB decided to remove from AASB 3 the scope exclusion relating to business combinations involving entities under common control. According to the AASB Action Alert (November 2003), the decision to remove the scope exclusion was on the basis that such combinations are currently subject to a prescriptive treatment within existing AASB Standards (i.e. AASB 1015 / AAS 21 *Acquisitions of Assets*). Further, abandoning a prescriptive treatment for such transactions would represent a serious 'backwards' step for Australian financial reporting. Therefore, amending the scope of AASB 3 would ensure that such transactions would continue to be subject to regulation, consistent with the existing AASB requirement.

As a result, all internal reconstructions meeting the definition of a business combination must be accounted for in accordance with AASB 3 - that is, in accordance with the purchase method.¹ Note, however, that the application of the purchase method under AASB 3 is likely to give a completely different accounting result compared to application of the purchase method under AASB 1015 and AAS 21. This is due to the requirements relating to the identification of an acquirer in the respective accounting standards. Under AASB 1015 and AAS 21 the 'legal acquirer' is identified as the acquirer. Under AASB 3 the combining entity that obtains control of the other entity (or entities) is the acquirer (AASB 3 adopts a substance over form approach).

Example 1: Consider the situation where a new [holding] company is inserted at the top of an existing group structure. Under AASB 1015, the new holding company (the legal acquirer), would be identified as the acquirer. The new holding company would then fair value the group it has acquired. Under AASB 3, the existing group structure would be identified as the acquirer (since it is actually obtaining control of the new holding company). This is analogous to what AASB 3 refers to as a reverse acquisition (i.e. where the legal acquiree and not the legal acquirer is identified as the acquirer). Under AASB 3 therefore, the existing group would not be remeasured

¹ Note, however, that AASB 3 provides an alternative accounting treatment for certain internal reconstructions undertaken by an entity that is not required to prepare financial reports in accordance with the Corporations Act and is either a reporting entity or is not a reporting entity but prepares reports that are held out to be general purpose financial reports.

to fair value (i.e. the net assets of the existing group structure would continue to be measured at their pre-combination carrying amounts).

Example 2: Consider the situation where a parent interposes a holding company above three subsidiary companies. Under AASB 1015, the intermediate holding company (the legal acquirer) would be identified as being the acquirer. The intermediate holding company would then fair value the each of the three subsidiary companies that it has acquired. Under AASB 3, the intermediate holding company could not be identified as the acquirer. Assuming the three subsidiaries represent disparate entities with their own management structures, one of the subsidiary companies being acquired would need to be identified as the acquirer.² Given the combination was initiated by the ultimate parent entity, this may result in one of the three subsidiary companies being arbitrarily identified as the acquirer. Having identified one the subsidiaries as the acquirer for the purpose of AASB 3, only the net assets of the other subsidiary companies would be remeasured to fair value (i.e. the net assets of the subsidiary identified as the acquirer would continue to be measured at their pre-combination carrying amounts). The fact that an internal reconstruction has resulted in “some” of the net assets being remeasured to fair value is an odd accounting outcome.

We are concerned by the accounting outcomes generated by the application of AASB 3 to business combinations involving entities under common control, particularly in situations such as Example 2 above. Whereas the application of AASB 1015 resulted in the remeasurement to fair value of all net assets acquired, the application of AASB 3 can result in none or only some of the net assets acquired being remeasured to fair value.

Unlike AASB 3, business combinations involving entities under common control are excluded from the scope of IFRS 3. As IFRS 3 is silent on the treatment, our concern is that divergent practices will result as there is no interpretative guidance. Whilst some entities may adopt the principles of IFRS 3 (as in Australia), other entities applying IFRSs (in Europe for example) may ultimately adopt a “pooling” approach for business combinations involving entities under common control (particularly considering that this is the approach adopted in the US). In other words, the net assets of the combining entities will be measured at their pre-existing carrying amounts (that is, no fair value uplift). Proponents of this approach argue that ultimately nothing has occurred (that is, there has been no transaction to account for). Therefore, our concern is that the lack of guidance will result in reduced comparability as divergent practices are adopted.

The IASB is expected to consider the accounting for business combinations involving entities under common control as part of its Business Combinations Phase II project. Until such time that due consideration is given to the accounting for these combinations and a particular treatment prescribed, there will be divergent accounting practices between countries and, outside Australia, possibly within countries because the accounting method is not prescribed.

² Alternatively it may be appropriate to treat the three subsidiary companies as one entity for the purpose of identifying an acquirer. For example, it may be that the three companies share the same management team and operate together in pursuit of the same goals/objectives. If this is the case, the three subsidiary companies together may be identified as the acquirer, in which case none of the net assets of the subsidiary companies would be remeasured to fair value.

Interpretation issues with the International Financial Reporting Standards ('IFRS')

Financial Instruments

There are a number of interpretation issues that arise with application of AASB 132 *Financial Instruments: Disclosure and Presentation* and AASB 139 *Financial Instruments: Recognition and Measurement*.

One area of specific concern is the classification of debt/equity instruments. Where the previous version of IAS 32 (and AASB 1033 *Presentation and Disclosure of Financial Instruments*, which was equivalent), took a substance approach to the application of the definition of financial liabilities, AASB 132 is more concerned with the form of the instrument and requires a contractual obligation to deliver cash or another financial asset to exist in order for an instrument to be classified as debt. Therefore in some instances, instruments that would have been classified as debt under AASB 1033 may now be classified as equity.

Example: Consider a redeemable 5 year reset preference share. At the end of 5 years, the holder has the option to request the issuer to convert the preference shares to ordinary shares or redeem for cash. If the issuer rejects this request, the issuer is unable to pay an ordinary dividend for 2 years (a 'dividend stopper'). Under AASB 1033, the substance of this arrangement would have been considered debt as the existence of the dividend stopper would make the issuer economically compelled to convert or redeem the preference shares. In considering the economic compulsion, consideration would have been given to factors such as the detrimental impact on the share price of not paying a dividend, the reputation of the entity and other factors.

However, under AASB 132, the application guidance to the standard states that an option to redeem the shares for cash does not meet the definition of a financial liability, as the issuer does not have a present obligation to transfer financial assets to the holder. Therefore, although there may be an economic compulsion to redeem the shares, this does not constitute a liability. Hence, under AASB 132 the preference shares would be classified as equity.

Share Based Payments

AASB 2 *Share-Based Payment* requires an expense to be recognised in relation to share based payment transactions, and where transactions are equity settled, for the corresponding credit entry to be recognised in equity.

AASB 2 does not prescribe where the credit entry should be recognised within equity or whether it is treated as a separate component. Therefore, a number of different interpretations exist, particularly in relation to whether the credit entry can be recognised in retained earnings, thereby eliminating the cumulative recognition through profit. As no further guidance exists within the standard, in the absence of any interpretative guidance, practices will differ in the treatment of the credit entry.

Instances where the International Financial Reporting Standards ('IFRS') may lead to an undesirable outcome

There are examples within some of the standards where, although there are no interpretation issues, we consider that the outcome of applying the standard is undesirable and does not constitute an improvement in the financial reporting of entities. We have include the following examples to illustrate.

Share-Based Payments

AASB 2 *Share-Based Payment* makes a distinction between market vesting conditions and other (non-market) vesting conditions, which results in a different accounting treatment. Market conditions (which are related to the entity's share price) are taken into account when estimating the fair value of the equity instruments granted. This results in recognition of an expense when a counterparty satisfies all other vesting conditions, even if the market conditions are not met and hence the instruments do not vest.

Conversely, vesting conditions other than market conditions are taken into account by adjusting the number of equity instruments expected to vest, rather than the fair value of the instruments. Therefore, the expense recognised is based on the number of equity instruments that actually vest. If a vesting condition is not met, then no expense is recognised.

We consider that the distinction between the two types of vesting condition is arbitrary and the use of market conditions may lead to an undesirable outcome for many entities, as an expense is recognised if the instruments do not vest, solely because the market condition is not met. The arbitrary distinction may lead entities to reconsider the vesting conditions relating to equity instruments in order to avoid this treatment.

Defined Benefit Pension Plans

AASB 119 was recently amended by the AASB to be fully compliant with IAS 19 in relation to the accounting for defined benefit pension plans. The revised standard (applicable for accounting periods beginning on or after 1 January 2006, although early adoption is permitted) allows entities a choice of three accounting treatments for the actuarial gains and losses arising on the defined benefit plans, whereas the previous version of the standard mandated one treatment. Under the previous version of AASB 119, all actuarial gains and losses must be recognised in the profit and loss account. This option is still included within the revised version of the standard, however there are also an additional two options. Entities can elect to recognise actuarial gains and losses directly in retained earnings or alternatively they can elect to adopt the 'corridor approach' which smooths the profit impact over a period of time.

Whilst the Australian standard is now compliant with IAS 19, we consider that giving entities three options does not enhance comparability of financial reporting.

There are other International Accounting Standards that permit reporting entities options in selecting an accounting treatment and we have similar concerns regarding a lack of comparability where alternative treatments are allowed. Australian Accounting Standards in the past have not permitted options.

Conclusion

While Ernst & Young supports the adoption of IFRS in Australia we believe that there are a number of interpretation issues that require resolution in order to achieve the objective of comparability in financial reporting. We have highlighted a few examples of these issues in this letter, but there are many more. We acknowledge that achieving absolute comparability in financial reporting will be impossible, because, to start with, some of the Accounting Standards themselves

permit choices in accounting treatments. In addition, globally consistent interpretations is a lofty goal but unrealistic in practice, for reasons outlined above. However, we believe that a fundamental step towards achieving globally consistent interpretations is the establishment of a network of standard-setters, acting under the authority of the IASB, that are able to address interpretative issues on a timely basis. The Australian Accounting Standards Board should be one such body. The existing global interpretative body, IFRIC, is not able to cope with its existing workload and is unlikely to be able to cope with a dramatically increased workload once the adoption of IFRS commences this year.

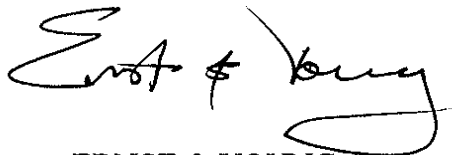
We have also highlighted areas where we believe that the adoption of IFRS will result in a lower quality of financial reporting than would be desirable or than has existed in Australia in the past. We bring these to your attention for your information only as they are a consequence of the decision to adopt IFRS, which you have stated is not open for review.

We note also that there are a number of unintended tax consequences of some IFRS. We understand that other parties will raise these with the Committee.

Further Information

Ernst & Young would be pleased to provide the Committee with further information on the points outlined above if required. We will also be please to appear before the Committee. Please contact Ruth Picker on 03-9288 8620, Charles Feeney on 02-9248 4665 or John O'Grady on 03-8650 7659 should you have any questions.

Yours sincerely



ERNST & YOUNG