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Our ref PIC Australian Accounting Standards

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21 January 2005

Dear Ms Bachelard

### **Submission to the inquiry into Australian Accounting Standards**

Thank you for the opportunity to make a submission to the inquiry into Australian Accounting Standards. We wish to offer the following comments in relation to the overall standard setting arrangements in Australia. We have also provided responses to the matters for consideration outlined in your covering letter.

#### **General comments**

KPMG supports the adoption of the Australian equivalents to the international financial reporting standards (AIFRS) with minimal change because it is in Australia's national interest to do so. It is important to understand that the adoption of the international standards with minimal change will help enhance the Australian capital market and its meet the needs of shareholders by achieving greater efficiency and effective reporting. Notwithstanding this it is essential that no standards be disallowed at this stage of implementation given the importance of immediate adoption. We do encourage the committee to provide the necessary feedback to the AASB to improve the process in the future.

It is imperative for the Joint Parliamentary Committee in making its inquiries about the Australian Accounting Standards to consider its findings within the context of international developments and the need for one set of high quality globally accepted standards.

We believe that many of the issues facing Australia will be addressed at an international level. Furthermore, it is our view that working in collaboration with the international standard setters will help Australia achieve its legislative objectives and convergence with international standards. This is preferable to the AASB trying to second-guess the International Accounting Standards Board's (IASB) next step and prematurely introduce unnecessary requirements or remove options that may remain in the international financial reporting standards.

## Matters for consideration

We provide the following comments in relation to the areas of consideration:

### *Consistency of accounting standards with Corporations Act (2001)*

When accounting and reporting requirements exist in more than one legislative instrument there is risk that they will overlap and at times contradict. This risk exists in relation to disclosure of remuneration which is addressed in s300A of the Corporations Act and in the accounting standards. It is KPMG's opinion that all financial reporting requirements should be addressed in the accounting standards and all governance reporting requirements be included in the Corporations Act to avoid duplication, conflicts and confusion in the future. As delegated instruments of the Corporations Act the accounting standards are subject to due process, public scrutiny and parliamentary scrutiny and subject to disallowance by Parliament. Moreover, the process should ensure that standard setters and legislators clearly understand where the boundaries of responsibility lie and encourage effective communication to achieve the desired outcome ensuring no omissions in requirements and avoiding contradictory requirements.

#### *Examples of inconsistency in standards*

The main area of inconsistency between the Corporations Act and accounting standards relates to the requirements for disclosures about director's and executive's remuneration.

The Corporations Act (S300A) requires listed companies to disclose information about the remuneration of directors and executives. AASB 1046 *Director and executive disclosures by disclosing entities* requires disclosure of similar information in the financial reports of disclosing entities. The S300A disclosures are linked to AASB 1046 by virtue of Regulation 2M.3.03. However, there are many inconsistencies between the two sets of requirements. These include:

- The entities that must apply the requirements - S300A applies to listed companies, while AASB 1046 applies to all disclosing entities
- The people whose remuneration must be disclosed - S300A requires disclosure about each director of the company and each of the five group executives who receive the highest remuneration. AASB 1046 also requires disclosures about the directors of the entity. However in relation to executives, it requires disclosures about the five or more executives who have the greatest authority for managing the economic entity. These may not be the same as those receiving the highest remuneration,
- The detail of the disclosures differs, eg AASB 1046 requires qualitative and quantitative information about service contracts that are not required by S300A
- The credibility of the information - S300A information is not subject to audit, the AASB 1046 information is subject to audit.

The fact that two different remuneration reports may be presented in the annual report is itself a source of confusion to the reader.

AASB 1046 was developed by the AASB in the expectation that the S300A requirements would be removed from the directors' report requirements and that information about director's and executive's remuneration would be included in the financial report with the sole source of the requirements being AASB 1046.

S300A was not removed; rather, it was expanded through the CLERP 9 requirements. We understand that the AASB is now considering whether to withdraw AASB 1046. This is not an appropriate solution. Without AASB 1046 there will not be any consistent guidance on both the measurement of remuneration and its disclosure. Also the disclosure could lose credibility as it will not be subject to audit.

We recommend the following:

- Recognition, measurement and financial report disclosure requirements in relation to director's and executive's should be included in the accounting standards
- S300A could be amended to include requirements relating to disclosure of corporate governance aspects of director's and executive's remuneration in the director's report under the heading remuneration report. Such disclosures would include for example the remuneration policy and strategy requirements.
- AASB 1039 *Concise financial reports* could be amended to require the AASB 1046 disclosures to be included in any concise financial reports.

This would prevent entities from having to duplicate information and the potential from conflicting information being provided. The AASB 1039 requirement would ensure that the information would be available to shareholders receiving concise reports.

As an alternative, could be retained within the directors' report requirements, and withdrawn from AASB 1046, while the quantitative disclosures could be withdrawn from the Corporations Act and retained in the accounting standard.

#### *Other areas of inconsistency*

Other areas of inconsistency between the Corporations Act and accounting standards include:

- S 258F – reductions because of lost capital

This section could be construed as permitting losses to be written off against share capital rather than against current year profits as required by accounting standards

- Regulation 2M.6.03 and Schedule 5A provide relief from some aspects of Chapter 2M for Australian banks and life companies.

Schedule 5A is now out of date and has been overtaken by the issue of accounting standards for financial institutions and life insurers

- Redemption of preference shares

The S 254K requirement that preference shares can only be redeemed out of profits or a fresh issue of shares conflicts with the accounting standards on classification of debt and equity.

- Payment of dividends out of profits

The S 254T requirement that dividends may only be paid out of profits needs reconsidering given developments overseas in this area.

- Small/large proprietary companies versus the reporting entity concept

The existence of two systems of classifying companies in order to determine their accounting requirements continues to confuse.

The Corporations Amendment Bill should incorporate the necessary amendments in order to remove these inconsistencies between the Corporations Act and the accounting standards.

### ***AIFRS acting in the furtherance of the objectives of the Act***

In KPMG's opinion, the objective of international convergence has not been achieved in Australia. To achieve the objective of efficient and effective reporting for the enhancement of the Australian capital market, to facilitate overseas investment in the Australian market, and to meet the needs of the shareholders in Australia and the global capital markets, Australia should adopt international standards with minimal change.

To illustrate the extent to which the objective has not been realised, , KPMG International Financial Reporting Group in London produced a 600 page publication to demonstrate the application of IFRS. It has been necessary for KPMG Australia to issue a 76 page addendum to be used with the book for entities applying AIFRS and the additional Australian guidance.

### ***Inconsistencies between AIFRS and IFRS***

The IFRS developed by the IASB have been modified by the AASB. The modifications to IFRS:

- eliminate application of choices permitted between alternative accounting treatments. Where choices exist in IFRS, the AASB has generally retained only the existing Australian treatment where that treatment is consistent with one of the international options;
- amend the application of specific standards by modifying their scope;
- provide additional guidance on the application of specific paragraphs in Australia, including the use of non mandatory examples in appendices;
- provide exemptions or modified application to particular accounting requirements for not-for-profit entities;
- provide exemptions to the parent entity from particular disclosure requirements;
- increase the number of required disclosures.

In addition to the above, some references required modification to accommodate the Australian legislative environment.

AASB 101 *Presentation of financial statements* will require reporting entities to state that the financial report is in accordance with AASBs. In addition, if they comply with IFRS they will be required to state that that is the case.

Entities that comply with AIFRS will not automatically comply with IFRS, particularly where the Australian specific exemptions above are utilised. Similarly, use of additional guidance issued by the AASB may not enable dual AIFRS/IFRS compliance.

Entities will need to perform an additional assessment to determine whether they can claim compliance with IFRS.

#### *Eliminate the application of choices and modification of scope*

The AASB has modified the application of IFRS by eliminating permitted alternatives, expanding the scope of standards and modifying definitions. Specifically:

- Transactions between entities that are part of the same commonly controlled group (i.e. internal reconstructions) are subject to application of AASB 3 *Business combinations*. This modification ensures that common control transactions are recognised at fair value, as “mandated” by the Senate in February 2000 by disallowing the cost method in then revised accounting standard AASB 1015 *Acquisitions of assets*.

To achieve this outcome, AASB 3 introduces the concept of *contributions by owners* which requires common control transactions to be accounted for at fair value with the difference between fair value and consideration paid recognised in equity when it satisfies the

definition of *contributions by owners* and profit and loss in any other event.

We understand that it is common practice in Europe to account for the transfer of assets and liabilities in business combinations of entities under common control at book value. Accordingly, under IFRS, the above difference would not be recognised or accounted for.

IFRS takes the view that any transaction with owners on a non-arms length basis will be equity in nature, and no gains or losses are recognised in the income statement. The extension of the scope of AASB 3 to cover commonly controlled entities and the introduction of the concept of *contributions by owners* may not result in compliance with IFRS.

- Entities with investments in *joint venture entities* must account for such investments by using the equity method rather than having the choice of the equity method or the proportional consolidation method.
- Cash flows from operating activities must be presented using the “direct” method. The “indirect” method must be presented in the notes to the financial statements.
- Government grants must be recognised at fair value and initially recognised as deferred revenue. The alternative treatment which allowed such grants to be recognised at a nominal amount and as a reduction against the carrying amount of an asset has been removed.
- The term *reporting entity* in Australia has a wider meaning than that under IFRS.

While we understand that the policy of the AASB was to not allow alternative treatments in AIFRS, this policy was not consistently applied in all standards. For example, under AASB 123 *Borrowing costs* there is a choice between expensing or capitalising borrowing costs for qualifying assets.

We support the additional requirements applicable to “not-for-profit” entities. However, we consider that changes to IFRS applicable to “for-profit” entities should be limited to those required by the local regulatory environment. That is, we would prefer that the AASB permitted the use of all options available under IFRS in AIFRS.

The IASB has indicated that it will eventually remove the options from its standards. There is a significant risk that the IASB will not eliminate the same options as those eliminated by the AASB. The reversal of the AASB’s stance on the removal of the corridor option in AASB 119 *Employee benefits* highlights the risks associated with the AASB’s approach of not permitting the use of all options in IFRS in Australia. Initially, use of the “corridor” method in the recognition of gains/losses on defined benefit superannuation plans was not permitted by the AASB in AASB 119 *Employee benefits*. This prohibition was subsequently removed when the IASB approved a third alternative. In allowing the third alternative, the AASB reinstated use of the corridor method as a permitted alternative.

### *Disclosure exemptions*

Entities required to prepare consolidated financial reports under the Corporations Act must also prepare parent entity financial reports.

If a parent entity takes advantage of a disclosure exemption available under the AASB standards, and that exemption is not available under IASB standards, the parent entity will not be able to claim compliance with both AASB standards and IFRS.

### *Additional non-mandatory guidance*

The AASB based standards contain additional commentary and guidance which does not form part of the relevant accounting standard. In a number of cases, the additional guidance contradicts IFRS and its application would result in non-compliance with IFRS.

In contrast additional implementation guidance for revenue recognition set out in the Implementation Guidance to IFRS 1 *First-time adoption of international financial reporting standards* has been omitted from guidance to the Australian equivalent, AASB 1.

### *Related matters*

#### *Due process*

While the AASB's approach in adopting IFRS has been to adopt the basic IFRS wording and paragraph numbering, changes introduced by the AASB could have benefited by greater transparency.

Specifically:

- By developing a Preface to each standard that incorporates some of the Introduction to the IASB's standards, the AASB created its own material with the potential for unintended differences from the IASB's documents. The preliminary paragraphs to each standard identify the context in which they are to be read. In some standards the AASB has excluded a majority of the content from the IASB's preliminary paragraphs. As a result, it is possible that the AASB's standards may be read and interpreted differently.
- the AASB provided little justification for its decision to remove the "proportionate consolidation" method from AASB 131, despite its inclusion in Australian Exposure Draft ED 121 and that 9 of the 13 respondents to the exposure draft agreed that the option should not be retained.
- Most differences between AIFRS and IFRS are identified as "AASB Deleted" in the case of paragraphs that have been deleted by the AASB and "AusX.x" in the case of modifications and additional requirements. In the case of modifications to AASB 120 *Accounting for government grants and disclosure of government assistance*, the modifications were not

readily apparent as the modified paragraphs were not identified with the prefix "Aus". On the face, it would appear that no modification exists.

- The timeframe between approval of the final IASB standards and Australian equivalents was short. The limited time period resulted in drafting errors or the inclusion of additional guidance that was not subject to the usual levels of scrutiny by inclusion in an Exposure Draft. Due to the legislative mechanism of accounting standards as disallowable instruments standards were created as "pending standards" until such time as they could be "made" simultaneously. In the process of making Pending Standards into Final Standards, the AASB made a number of changes, partly as a result of the consequences from the above process, but also as a result of interpretation, again without communication and due process.

For example, the AASB incorrectly interpreted changes to the Corporations Act 2001 under CLERP 9 to require half - year reporting for the parent entity of a consolidated group. The AASB then made last minute amendments to AASB 134 *Interim financial reporting* which incorrectly made half - year reporting for the parent a requirement of the standard. This circumstance highlights the consequences of the regulatory bodies making interpretations without appropriate consultation. The standard has since been amended.

### ***Implementation issues***

We agree that the elimination of choice in accounting standards assists in the comparability of financial statements in Australia. However, it does not achieve the objective of facilitating Australian companies operating in the global market or international companies with investments in the Australian capital market. Further, separate financial statements/records may need to be maintained if an entity is:

- a subsidiary of a foreign parent, and that parent has applied a different permitted alternative under IFRS; or
- dual listed in a foreign market, when compliance with AIFRS does not result in compliance with IFRS.

Further, when the IASB eventually removes the options from its standards, there is a risk that the option removed will not be the same as the option removed by the AASB giving rise to additional changes in accounting standards in Australia in the short term.

In most cases, interpretation of IFRS is a global, not just local, issue. We agree that certain matters of interpretation remain outstanding and that shortfalls exist in the IASB based standards. However, the interpretive guidance provided by AASB, ASIC or any other regulatory body should:

- result in compliance with IFRS;



- not be mandatory; and
- not be considered the only outcome that would result in compliance with accounting standards, otherwise, a rules - based system like that in the US, which has been highly criticised, may evolve.

Such authorities should accept, that until matters of interpretation have been addressed by the IASB or its interpretative body IFRIC, an acceptable range of accounting policies may exist under IFRS.

### ***Regulatory Impact Statement***

We acknowledge the difficulty in determining the costs and benefits associated with adopting international accounting standards. However, we believe that the AASB has not fully assessed the costs and benefits of changes made to the international standards as well as the impact of adopting the international standard. The cost of these amendments to Australian companies and overseas companies investing in Australia should be determined and assessed against the benefits that the AASB has determined arise from those Australian specific requirements. AASB should provide this assessment as part of the legislative process of issuing new and revised standards.

### **Conclusion**

KPMG's overall position is that to achieve the objective of efficient and effective reporting for the enhancement of the Australian capital market and to meet the needs of the shareholders in Australia and within the global capital market Australia should adopt international standards with minimal change. Notwithstanding this it is essential that no standards be disallowed at this stage of implementation given the importance of immediate adoption. We do encourage the committee to provide the necessary feedback to the AASB to improve the process in the future.

Should you wish to discuss our comments, please contact me on (02) 9335 7676 or Cath Mulcare on (03) 9288 5214.

Yours sincerely



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