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

Dear Ms Bachelard

INQUIRY INTO AUSTRALIAN ACCOUNTING STANDARDS

Thank you for your letter of 10 December 2004 inviting the FRC to make a submission to the Committee in respect of its inquiry into the Australian accounting standards that were recently tabled in the Australian Parliament.

The FRC is the peak body responsible for the broad oversight of the accounting and auditing standard setting processes for the private and public sectors, as well as monitoring the effectiveness of auditor independence requirements in Australia. It comprises key stakeholders from the business and investing communities, the professional accounting bodies, governments and regulatory agencies.

While the FRC's functions include approving and monitoring the Australian Accounting Standards Board's (AASB's) priorities and business plans, and determining its broad strategic direction, it is important to note that the FRC does not have power to direct the AASB in relation to the development, or the making, or a particular accounting standard.

On behalf of the FRC, I would like to comment on two matters concerning Australia's move to adopt international accounting standards:

(a) the FRC's strategic direction to the Australian Accounting Standards Board (AASB) concerning the move to such standards; and

(b) the FRC's consideration of issues associated with the implementation of international financial reporting standards (IFRS) in Australia.

Strategic direction to AASB

Under paragraph 225(2)(c) (paragraph 225(2)(d) prior to 1 July 2004) of the *Australian Securities and Investments Commission Act 2001* (the ASIC Act), one of the functions of the FRC is to determine the AASB's broad strategic direction. Paragraph 232(a) of the ASIC Act provides that,

in performing its functions, the AASB must follow a broad strategic direction determined by the FRC.

At its meeting on 28 June 2002, the FRC agreed to formalise its support for the adoption by Australia of accounting standards issued by the International Accounting Standards Board (IASB) from 1 January 2005. The meeting also agreed that a draft broad strategic direction for the AASB should be prepared for the FRC's consideration. This draft direction for the AASB in relation to the private sector was approved by the FRC at its meeting on 5 September 2002 (see Attachment A for the text of the direction).

The FRC subsequently monitored developments, both internationally and in Australia, impacting, or likely to impact, on the adoption by Australia of standards issued by the IASB from 1 January 2005.

On 31 March 2004, the FRC came to a unanimous in-principle decision to proceed with the adoption of international accounting standards from 1 January 2005. Confirmation of the March 2004 decision was subject to the FRC receiving assurance from the AASB that the 'stable platform' of 2005 international accounting standards, which were to be completed by the IASB by 31 March 2004 to facilitate adoption of international standards in the European Union from 2005, was complete and met the requirements of the Australian market place and that the AASB would be able to make available on its website the corresponding versions of Australian standards by 30 June 2004. The in-principle decision was ratified by the FRC on 23 April 2004. The FRC then wrote to the AASB to clarify the FRC's strategic direction of 2002 to the Australian Accounting Standards Board in the light of decisions made by the FRC at its March 2004 and April 2004 meetings.

The FRC directed that the AASB should continue its work in order to ensure that all international accounting standards are adopted in respect of all for-profit reporting entities for accounting periods beginning on or after 1 January 2005, to the extent that these standards do not conflict with Australian law (including the Corporations Act), after assessing that such adoption is in the best interests of the Australian economy. The FRC indicated that, subject to the Government's support for any necessary amendments of the *Corporations Act 2001*, that the AASB is directed to make standards by issuing the text of the set of standards and interpretations issued by IASB at 31 March 2004 in the manner outlined in subsection 227(4) of the ASIC Act.

After the adoption of the existing body of IASB standards and interpretations existing at 31 March 2004, the decision to adopt further changes to any IASB standards, and the decision on timing for implementation of such changes in Australia, will be taken by the AASB in due course bearing in mind the FRC's broad direction. It is the understanding of the FRC that the AASB will provide an appropriate period between the completion of a new standard or amendment to an existing standard and its implementation date. In assessing any changes, consideration will be given to the effects on Australian companies and the practical issues involved with the preparation of financial reports.

Implementation of international standards

Prior to coming to its in-principle decision to proceed with the adoption of international accounting standards from 1 January 2005, the FRC consulted widely with its stakeholders. Since its decision to confirm the adoption of IFRS in Australia for reporting periods beginning on or after 1 January 2005, the FRC has continued to monitor emerging issues in consultation with stakeholders.

At the time the FRC confirmed its decision, there were a number of implementation issues that had been raised with the Government and / or the FRC that were of concern to stakeholders, most notably the impact on companies of the treatment of intangible assets. New issues have also

emerged such as the impact on small companies and on the managed investments industry. The FRC considered these issues at its meetings on 20 September and 6 December 2004.

To assist the FRC in its consideration of these issues, I, in my capacity as FRC Chairman, extended a standing invitation to representatives from the Australian Prudential Regulation Authority (APRA) to attend FRC meetings while IFRS implementation issues were discussed. Having senior representatives from the Australian Treasury, the AASB, ASIC and APRA present at FRC meetings, in addition to the professional accounting bodies and other user and preparer stakeholder representatives have assisted our deliberations and consideration of appropriate responses.

Intangible assets

The FRC was aware of, and supported, a AASB submission to the IASB seeking relief from the requirements of IAS 38 on the first time adoption of the standard by Australian reporting entities. Similarly, when the IASB concluded that IAS 38 should not contain transitional provisions for first time adoption of the standard, the FRC was aware of and supported the AASB's view that we should accept the IASB's decision.

Indeed, it might be argued that AASB 138 (the Australian version of IAS 38) improves the quality of Australian financial reporting. Australia has been the only significant country, in terms of accounting standards, that has allowed an accounting treatment for the recognition and valuation of internally generated intangible assets. This aspect of Australia's former accounting standards was not highly regarded internationally.

In our view, the only remaining issue in respect of intangible assets is one of taxation – thin capitalisation, which we consider is more appropriately dealt with through tax regulation. We understand that because the thin capitalisation rules refer to debt/equity ratios calculated in accordance with accounting standards, a number of accounting standards could have thin capitalisation consequences. Therefore it would be difficult to address this issue through changes to any one accounting standard and the FRC would not support this course of action.

The view of the FRC is that accounting standards have the objective of facilitating the production of high quality financial reports and relevant reliable financial information for accountability purposes and decision making by investors and others. Accordingly, standards should not be influenced by taxation issues, especially where the objectives of the two are different.

Small companies

Because of the breadth of the definition of 'reporting entity' contained in accounting standards, Australia is the only country that is mandating adoption of IFRSs beyond the listed sector in 2005. The extent to which the standards will affect smaller non-listed companies will depend on a number of factors, including whether a company is a reporting entity (if it is not, only a small number of 'core' standards will apply) and the complexity of company's operations and financial transactions.

The FRC has examined concerns raised by the Australian Institute of Company Directors (AICD) with respect to the impact of IFRS on small companies. In the case of listed companies, the FRC is of the view that uniform rules should apply to all companies participating in the market, irrespective of the size of the company. With respect to non-listed companies, the FRC raised the concerns with the AASB, which indicated that:

(a) the burden imposed on smaller companies by IFRS will be far less than their impact on larger companies; and

(b) while most smaller companies will be entirely dependant on external advisers when making their preparations for the implementation of IFRS, the changes for these companies are generally not that dramatic and they effectively have until June 2006 to prepare for the change.

At the meeting on 20 September the FRC noted that many companies are well advanced in terms of their transition to IFRS and also that there is still adequate time for other companies to prepare for the transition. The FRC subsequently noted a review by ASIC of the published financial reports of more than 1,100 listed entities with a 30 June balance date which indicates that, overall, most companies, including those at the smaller end of the market, are making good progress in their preparations for the adoption of international accounting standards.

Nevertheless, we acknowledged the difficulties that the small end of the market is confronting in obtaining expert advice and conveyed our support for any initiatives that ASIC may provide to ensure a smooth transition in 2005.

Managed investment industry

The managed investments industry raised concerns about the transition to international accounting standards because of the need to amend references to accounting standards in the constituent documents of unlisted managed investment schemes. Following consultation between ASIC, AASB and the industry, ASIC issued a Class Order to facilitate changes to references to accounting standards and concepts in scheme constitutions to mean accounting standards in force at 31 December 2004. As a result, those schemes will be able to prepare their general purpose financial reports in accordance with IFRSs to ensure consistency and comparability with other entities, but avoid the need to change systems for the purpose of providing information for other purposes (for example, unit pricing, which can continue on the current basis). This solution is similar to the one adopted by APRA, whereby entities subject to its supervision will continue to report, for prudential purposes, under the current accounting standards for a transitional period.

Conclusion

In my view the benefits of adopting IFRS are clear in terms of facilitating comparisons by investors and cross-border investment flows between Australia and the rest of the world. Acceptance of Australian financial statements in overseas capital markets will give Australia greater ability to compete offshore and attract international capital to support the continued growth and dynamism of our markets. Adoption of global accounting standards also increases the scope for companies to minimise the costs of complying with different regulations across jurisdictions. In this regard I note indications from the US Securities and Exchange Commission that as part of the convergence program between the International Accounting Standards Board and the US Financial Accounting Standards Board it may not require reconciliations to US GAAP for foreign companies registered in the US that comply with IFRS. To obtain this concession, it is likely that companies would need to make an unreserved statement of compliance with IFRS.

Australia's adoption of IFRS will also benefit Australian companies that do not operate in other jurisdictions or have to lodge financial reports with regulatory bodies in other countries. Through the adoption of IFRS, Australia now has a comprehensive set of high quality accounting standards that address a number of significant areas of financial reporting for which Australia did not previously have standards. As a consequence, the overall quality of financial reporting in Australia can be expected to be enhanced with consequent benefits to participants in the Australian capital market.

I would also like to take this opportunity to convey to you the main impression that I gathered from a recent visit to North America and Europe. While discussions continue on possible amendments to IAS 39 and other accounting issues, such as share-based payments, the general mood is shifting towards an increased emphasis in the objective of achieving convergence between IASB and US GAAP. I was encouraged by these developments, both in the US and Europe, which only reinforce the appropriateness of Australia's decision to adopt IFRS.

I would be pleased to appear before the Committee to elaborate upon the matters dealt with in this submission. I should, however, mention that, to the extent the Committee is interested in technical issues concerning specific standards, questions on those matters should be directed to the Chairman or other representatives of the AASB.

Yours sincerely

Charles Macek
FRC Chairman

Attachment A

Broad strategic direction provided by the Financial Reporting Council to the Australian Accounting Standards Board for 2002-03 in respect of the private sector

In accordance with paragraph 225(2)(d) of *the Australian Securities and Investments Commission Act 2001*, the FRC sets the following broad strategic direction for the AASB for 2002-03 in respect of the private sector:

(a) The Board's strategy and activities should be consistent with the objectives of accounting standard setting set out in section 224 of the Act, in relation to the characteristics of the financial information to be required by accounting standards, facilitation of the Australian economy and maintenance of investor confidence.

(b) The AASB should strike an appropriate balance in allocating resources to the development of accounting standards for the private, public and not-for-profit sectors.

: The AASB should advise the FRC promptly of any resource constraints on the Board's ability to fulfil its responsibilities.

(c) The AASB should follow its stated objective of pursuing, through participation in the activities of the IASB, the development of an internationally accepted single set of accounting standards. In working towards this objective, the AASB should:

: work towards the adoption in Australia of accounting standards that are the same as those issued by the IASB - and interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) - to ensure their applicability to Corporations Act entities for accounting periods beginning on or after 1 January 2005;

: continue to work closely with the IASB and align its work program with that of the IASB;

: continue its present harmonisation program, working towards the adoption of accounting standards in Australia that harmonise with standards issued by the IASB, unless such standards are considered not to be in the best interests of the Australian public and private sectors;

: promptly issue IASB exposure drafts in Australia for comment by constituents, and limit the need for subsequent issue of an AASB exposure draft to cases justified by the newness and complexity of a standard;

: continue to remove non-conformities between existing Australian and IASB standards on a planned basis;

: address, on a transparent basis, any transitional issues falling within the Board's mandate that may arise for Australian reporting entities, having regard to the cost of capital objective of the Act;

: ensure, as far as possible, that the work of the Urgent Issues Group has close regard to IFRIC pronouncements;

: in consultation with the FRC, communicate to constituents an overall strategy for adoption of IASB standards from 1 January 2005 to facilitate constituents' knowledge of and preparedness for the change