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Ms Sarah Bachelard
Committee Secretary
Joint Parliamentary Committee Financial Services
Department of the Senate
Parliament House
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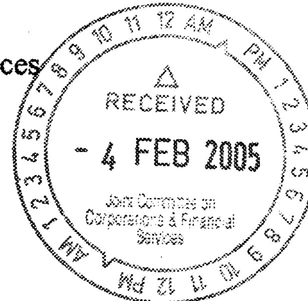

2 February 2005

Dear Ms Bachelard

1 Enclosed are a couple of articles relevant to the Committees current deliberations:

(a) "The emasculation of accounting standard setting in Australia" published Journal of the Securities Institute of Australia, Issue 3 Spring 2003

(b) "International accounting standards under pressure" published Journal of the Securities Institute of Australia, Issue 2 Winter 2004

(c) "Why the goodwill accounting changes are a farce"

(d) "Improvement yes, but well short of perfection" published Australian Financial Review 16/12/04.

2 As a matter of background, over many years I have been a member of the Australian Accounting Standards Board, International Accounting Standards Sub-committees on Financial Instruments and the International Financial Reporting Interpretations Committee.

3 Unfortunately, the Institute of Chartered Accountants has a policy of supporting the mandatory adoption of IFRS standards (not surprisingly, given the work that it generates for the profession).

4 Accordingly, you won't find anything critical of IFRS standards in the Institute's magazine.

Yours sincerely

Wayne Lonergan

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The Emasculation of Accounting Standard Setting in Australia

The decision that Australia must adopt international accounting standards from 1 January 2005 has significant ramifications for the entire economy. Wayne Lonergan discusses the impact of this decision on accounting standard setting in Australia.

The Australian accounting standard setting process has been emasculated by the policy of mandatory adoption of international accounting standards[i]. As a result, Australia's accounting standard setting capacity and position as a centre of accounting excellence has been fundamentally weakened. The inevitable result will be lower quality financial reports in Australia. The seeds of the next and more serious round of corporate collapses have therefore already been sown.

Creating corporate financial stability

The current corporate governance enhancement efforts are focused on increased disclosure, independence and best practice guidelines including the mandatory disclosure of non-compliance in company annual reports[ii]. Industry and professional groups are all busy releasing guidance for their constituents.

The laudable aim of corporate governance reform is to create a culture of integrity and trust between the relevant parties and stakeholders - company directors, management, auditors, analysts, fund managers and shareholders.

However, correcting the symptoms (which is what current reforms are focusing on) rather than fixing the underlying causes of the problem is, as always, doomed to failure.

Accounting standards are the backbone of the financial reporting regime

Overlooked in the recent furore, significant and damaging changes to the very core of our corporate governance system have occurred. The financial reporting regime, encompassing the accounting standard setting process, the relevance and quality of standards and their application, form the basic building blocks for financial reporting and disclosure.

It is only if financial statements are both 'true and fair' that other corporate governance reforms, particularly those focused on disclosure, can have any hope of success.

The financial reporting regime in Australia

Notwithstanding that it still has its serious limitations and deficiencies, Australia's, financial reporting regime was until recently among the strongest in the world and was recognised accordingly.

This was a remarkable achievement given the relatively small size of our economy and depth of our capital markets compared to the powerhouse economies of the US, UK, Europe and Asia.

Parliament has delegated the responsibility for preparing and issuing accounting standards for both the private and public sector to the Australian Accounting Standards Board (AASB)[iii].

Compliance with accounting standards is mandatory for reporting entities under the Corporations Act[iv]. Although standards are subject to disallowance by Parliament, in the history of accounting standard setting, there has only been one partial disallowance by Parliament[v].

The way we were

Prior to 2000, the accounting standard setting process operated independently, despite its (limited) financial resources being funded by the two professional accounting bodies and the Federal Government. The fundamental objective of the standard setting regime was to maintain a broad public interest perspective and improve the quality of financial reporting and auditing in Australia from both a preparer's and from an end user's perspective.

Input and technical support to the board was provided by the Australian Accounting Research Foundation (AARF) which was established jointly by CPA Australia (CPAA)[vi] and the Institute of Chartered Accountants in Australia (ICAA) in

November 1966. The AARF provided the research, technical and secretarial support to the AASB.

The AASB was a part-time board which, with the exception of the Chairman, operated on a voluntary basis.

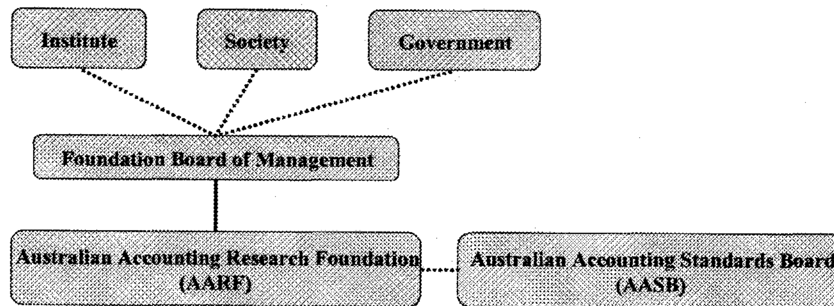

Figure 1 – The AASB structure prior to 2000

Some of the advantages of the former system included:

- relative independence (albeit inadequate funding) of the accounting standard setting process
- the development of a world recognised centre of excellence and pool of intellectual capital relating to technical accounting matters
- the development of a relatively detailed conceptual framework for the development of accounting standards
- close links and interaction with the accounting profession
- relative independence from its funding sources in board selection, agenda setting and research direction.

The features of the previous structure allowed the standard setting process to remain true to its primary objectives of undertaking research into and development of accounting standards and financial reporting issues.

One of the outstanding achievements of the previous structure was that it led to the development of a pool of intellectual capital and an internationally recognised centre

of excellence in accounting research and financial reporting. The result was internationally recognised technical pre-eminence in financial reporting with consequent flow-on benefits to Australia's capital markets and cost of capital.

Beyond 2000

In the most significant changes to accounting standard setting arrangements since 1966, the Corporate Law Economic Reform Program Act 1999 as part of the Government's Corporate Law Economic Reform Program (CLERP) fundamentally altered the structure of the accounting standard setting process.

The following changes came into effect on 1 January 2000:

- the establishment of the new Government-appointed 15 member body[vii] – the Financial Reporting Council (FRC)
- the FRC being superimposed over the AASB
- the establishment of a new AASB, with the new nine member (part-time) board being appointed by the newly formed FRC and a full-time Chairman appointed by the Treasurer
- the FRC being responsible for the oversight of the accounting standard setting process for both the private and public sectors, and the broad strategic direction of the AASB.

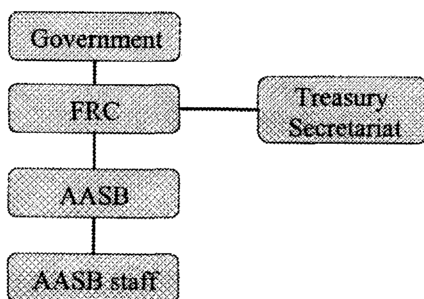

Figure 2 –The current AASB structure

The effect of the changes included:

- the AASB becoming answerable to the FRC
- the control of the selection of the board of the FRC and, in turn, that of the AASB being reasserted by the Government
- the control of the direction of Australian accounting standard setting coming under the influence of the FRC and bodies such as the ASX who have partly funded the AASB
- loss of key staff of the AASB and a watering down of the pool of intellectual capital
- the imposition on the AASB of a policy of mandatory adoption of international accounting standards[viii].

The implications were succinctly captured by the former Acting Executive Director of AARF who stated that *"It will only be to the detriment of the quality of financial reporting in Australia, and in the corporate sector, the reputation of Australia's capital market and the impact on the cost of capital, if vested interest groups and politics overtake the process under the guise of a broader and more effective constituency involvement and the need for "commercial" standards."*[ix]

Emasculation of the standard setting process

Issues such as the change in structure, the imposition of a new "boss" over the top of the AASB, the complete change of AASB board membership, and the redirection of AASB priorities, although important in their own right, have been overshadowed by the policy of mandatorily adopting international accounting standards (IFRS). The commencement date for mandatory adoption is 1 January 2005.

There are a number of reasons why mandatory adoption is a fundamentally flawed policy:

- we don't yet know what it is we have mandatorily agreed to adopt, as the IFRSs are still being developed
- it undermines Australia's ability to influence the IASB by undermining our negotiating power

- it discourages Australia's corporates, accounting profession and users from making submissions to the AASB or the IASB (i.e. "why bother, we're going to follow it anyway")

- it effectively abdicates our legislative setting role to an overseas-based board on which we have only one member (whose place is not guaranteed) and whose already limited say (one voice in 14) is further undermined by Australia's policy of mandatory adoption

- it forces Australia to adopt standards some of which contain flaws (or may contain flaws, because the standards Australia has committed to adopting have not yet been finalised) or fail to take into account considerations that may be immaterial in (say) the European context but which are very important to the Australian economy

- it makes Australia become a "me too" borrower and place of investment in the world's capital markets thus eliminating Australia's ability to distinguish its financial reports from those of other adopters of IFRS including such well known capital markets as Honduras, Trinidad and Tobago, and Barbados

- it forces on all Australian reporting entities additional costs and changes whereas IFRSs in virtually all other countries only apply (assuming they are adopted) to listed public companies.

Convergence or adoption?

The AASB's commitment to the international harmonisation of Australian accounting standards commenced in April 1996 with the release of Policy Statement 6 "International Harmonisation Policy". The harmonisation process was referred to as *"a process which leads to those standards being made compatible, in all significant respects, with the standards of other national and international standard-setters"*.[x]

This was superseded by the revised Policy Statement 4 "International Convergence and Harmonisation Policy" in April 2002. This set out the AASB strategy for the fulfilment of its function of contributing to the development of a single set of accounting standards for world wide use, and harmonisation of Australian accounting standards with those issued by the IASB, the International Federation of Accountants' Public Sector Committee and other IASB liaison members standard setting bodies[xi]. At this stage, the process the AASB was committed to was a gradual convergence and harmonisation of accounting standards.

Only three months after the release of the revised Policy Statement 4 outlining AASB's commitment to international harmonisation, the FRC announced the mandatory adoption of IFRS by all Australian companies.

The FRC Bulletin 2002/4 dated 3 July 2002 stated "*from 1 January 2005, the accounting standards applicable to reporting entities under the [Corporations] Act will be the standards issued by the International Accounting Standards Board (IASB)*", thereby eliminating the need for Australian accounting standards, and making the AASB largely irrelevant for the private sector. Furthermore, in the broad strategic direction to the AASB for 2002-03, the FRC advised that the AASB should "*work towards adoption in Australia of accounting standards that are the same as those issued by the IASB*".

In only a matter of months, the FRC directives had altered the AASB's committed process of "convergence" and harmonisation to one of "adoption". This change occurred notwithstanding that the FRC Bulletin[xii] and the FRC broad strategic direction[xiii] both contain a "best interests" proviso. Interestingly, the AASB was still referring to its strategies for bringing standards into line with international standards as "convergence" until as late as May 2003, but has since reflected the term "adoption" in its official documentation[xiv].

"Globalisation" of the standard setting agenda

There is a clear need for convergence in accounting standards internationally, in particular across the major capital markets in the world. However, there is a very large gap between mandatory adoption and sensible convergence. Australia's best position would be to maximise its benefits from being part of an international convergence of standards while at the same time preserving the best bits of its own financial reporting regime.

The implementation of a new financial reporting regime will not be easy. This is evident from the experience of the AASB in dealing with harmonisation issues since 1996. The timeframe for the full adoption of standards for Australian companies, including comparative figures for 2004 is, at best, very ambitious.

Furthermore, the IASB is planning to re-issue 32 of the existing 34 IFRSs. Fourteen standards are subject to improvement[xv] and consequential editorial change will need to be made to most other IFRSs. In addition new standards were planned to be issued prior to 1 January 2005, but these new standards will now be delayed.

Among the numerous issues required to be resolved before mandatory adoption, the AASB will at the minimum need to address the following:

- reconciliation of differences between the Australian and the different (in parts) and less detailed international conceptual framework
- the amendment of virtually every existing accounting standard in Australia
- the introduction of several new standards where no previous standard existed (that these gaps should be filled is unarguable)
- how to deal with situations where there are no current international equivalent standards for specific industries for which a dedicated Australian standard currently exists (for example, the extractive and life insurance industries).

The harmonisation dream

Proponents of the mandatory adoption of international accounting standards claim that Australia needs to adopt IFRS because:

- the European Union (EU) is also adopting international accounting standards and Australia cannot afford to be out of step with the major capital market the EU represents[xvi]
- Australian investors will benefit from of the superior quality of IFRS, giving rise to high-quality financial reports[xvii]
- Australian industries will save the cost of having to reconcile financial accounts between the different reporting regimes
- Australia's small capital market means that we need to conform to IFRS in order to attract international capital.

The reality is that the international harmonisation of accounting standards has yet to happen.

The European Union has announced that listed companies of member states will adopt IFRS for the purpose of consolidated accounts from 1 January 2005. However, new and/or modified standards will be subject to endorsement by the European Commission. Thus claims that the EU have adopted IFRS overstates the position. What they have agreed to do, and this is a long way short of mandatory adoption, is to adopt IFRS **if** and **when** approved by the EU.

Many nations currently permit the use of IFRS domestically, but Australia stands out by having committed themselves to a process whereby the domestic accounting regime will **fully** convert to IFRS for both listed and unlisted companies.

Will the USA come to the party?

Convergence between the USA and IFRS is already underway[xviii], and is a highly desirable outcome. However, full-adoption of IFRS is a very different proposition.

The USA is the largest single market in the world, representing over 50% of the world's market capitalisation. Pragmatically, it is highly unlikely that the largest market in the world will ever surrender control and sovereignty over financial reporting to an international body which it does not control.

There are practical reasons why many in the USA will resist the adoption of IFRS in the USA. For instance, adopting IFRS will:

- create a much more level playing field between US and European companies (thus reducing the competitive advantage presently enjoyed by US companies)
- allow emerging companies better access to the US capital market thereby increasing the demand for, and hence cost of, capital whilst simultaneously diluting the quality in the pool
- make substantially obsolete the existing technical knowledge base of the US accounting profession.

The reality is that to be a truly international set of accounting standards, the IFRS need to get the USA on board. For the USA, the full adoption of IFRS would result in incurring significant costs, risk jeopardising the confidence in the USA capital market, and largely destroy the existing educational base, skills and accounting and legal precedent in the USA. While convergence between the two will continue to

occur over time, from a USA perspective full compliance with IFRS will be strongly opposed.

The reality of IFRS

Australia's accounting conceptual framework is more detailed than that of the IASB. Comments by leading academics including Professor Peter Wolnizer of the University of Sydney and Professor Bob Walker of the University of NSW confirm that Australia's accounting standards are being weakened by moves to bring them into line with IFRS. According to Professor Walker, *"there have been a number of initiatives which have been removed in the process of harmonising with international accounting standards that process* [sic] *has actually weakened some of our reporting rules'*[xix].

The superiority of Australia's financial reporting regime represents an important competitive advantage relative to the rest of the world[xx].

Given that the Australian equity market represents only just over 1% of the global capital markets, mandatory adoption of IFRS is likely to result in the loss of Australia's competitive advantage in attracting international capital. Accordingly, the likely result is a higher cost of capital for Australian companies.

Furthermore, the IASB is more likely to be swayed by the interests of other more important and larger nations than Australia. This is particularly the case as the adoption of new and/or modified IFRS in the EU is conditional upon the endorsement of the European Commission.

Is Australia barking up the wrong tree?

If access to capital is what Australia wants, there appears little rationale for the mandatory adoption of IFRS. Even in the event of the full adoption of IFRS in Australia, companies seeking to raise capital internationally are still likely to want access to the largest provider of equity funds (the USA).

IFRS advocates argue that adoption of international standards will lead to capital inflows, higher trade volumes and growth in Australia's capital markets. Past

experience in attracting international companies to list in Australia does not support this view. For example, the ASX's 'China Concept' initiative in the 1990s resulted in an increase of less than 1% in the number of listed companies, the large majority of which were spectacularly less than successful.

The case for domestic standards

The ability of Australia's representation at the IASB to influence the development and tailoring of IFRSs will inevitably be outweighed by the views of larger countries. Furthermore, submissions directly to the IASB by Australian companies are largely not forthcoming, while submissions by the large Australian accounting firms are influenced by their larger international "sister" (or more accurately "parent") firms.

In short, despite Australia's present official representation on the IASB, there is no guarantee that Australia will be actively engaged in the process of future accounting standard development. The possibility of a lack of future involvement will inevitably be exacerbated by the diminution in Australia's role as a centre of excellence.

It is also necessary to maintain a dynamic domestic standard setting capacity to create a competitive advantage. A superior set of domestic standards represents a significant advantage for a capital needy economy like Australia, that will otherwise have to compete in the global capital market as a "me too" borrower and as a price taker.

However, the strongest argument yet for domestic standards is for reasons of sovereignty. As delegated legislation (accounting standards have the force of law), control over Australian accounting standards should remain in Australia. The fact the Australian financial reporting regime is required to fully adopt IFRS (as and when released and amended) effectively means that the Australian Parliament has abrogated its legislative power[xxi] over Australian companies to the IASB, which resides outside of Australia and on which Australia has only one vote (which is not guaranteed).

The demise of the UIG?

The Urgent Issues Group (UIG) plays an important role in the context of Australian standard setting. The primary responsibility of the UIG is to review, on a timely basis, accounting issues that are likely to receive divergent or unacceptable treatment

in the absence of authoritative guidance, with a view to reaching a consensus as to the appropriate accounting treatment in the context of Australian accounting standards.

Like accounting standards, the UIG consensus views have to be followed. The success of the UIG has been its ability to provide interpretations for topical accounting issues on a timely basis.

The decision to adopt IFRS seriously undermines the UIG. The UIG's international "equivalent", the International Financial Reporting Interpretations Committee (IFRIC) will have the primary responsibility to provide interpretations on accounting issues[xxii] which the UIG will have to follow. However, unlike it's Australian counterpart, the process of obtaining international consensus typically takes IFRIC a period of almost a year, by which time the contemporaneous issue at question has long been replaced by another.

The long term viability of an international consensus group that cannot release timely guidance is questionable. It follows that the UIG has been made largely irrelevant by its subordination to its relatively slow moving international counterpart.

Implications for corporate financial soundness

The process of international harmonisation of accounting standards does not in itself jeopardise Australia's financial reporting regime.

However, the mandatory adoption by Australia of IFRS has caused an upheaval in the financial reporting regime in Australia.

The policy of mandatory adoption has seriously damaged Australia's position as a world leader in accounting standard setting.

Adopting IFRS

Disadvantages	Advantages
• Loss of independent accounting standard setting capability	• Distant prospect of internationally accepted standards
• Loss of accounting intellectual capital	
• Diluted financial reporting regime	
• Control of standard setting handed to IASB	
• Loss of sovereignty over part of Australia's delegated legislation	
• Loss of Australia's competitive advantage in	

attracting global capital

- Adoption of standards that have no guaranteed international acceptability
- Enforceability of IFRS is problematic
- Australia has limited influence over IASB
- Weakened role of UIG

Figure 3 The disadvantages outweigh the potential upside

The unfortunate reality is that by weakening Australia's position as a centre of excellence and undermining Australia's standard setting role, the seeds of destruction for the next round of corporate collapses have already been sown.

Can Australia rescue its position?

Australia's position can only be rescued by treading a delicate path of supporting the IASB given its laudable long term objectives, whilst adopting the best features of the international standards and the global convergence program. Effectively, this represents a reversal of the policy of mandatory adoption of international standards.

Though it may seem counter intuitive to some, stepping back from the policy of mandatory adoption will actually strengthen the IASB's negotiating position with the reactionary and recalcitrant members of its constituency. Simply put, Australia should pursue a policy whereby international standards will not be adopted unless they are of the highest quality.

Australians should also be actively (not just nominally) involved in international projects in which we have significant experience and intellectual capital, for instance in the valuation of intangibles, extractive industries and accounting for joint ventures.

Unless there is a real, rather than nominal, participation in these projects and unless the AASB, the accounting profession and users generally are prepared to reject any IFRSs that compromise quality for the sake of international (and, in particular EU) acceptance, then Australia's position as a centre of excellence is doomed, our intellectual capital will be dissipated, and our accounting standards and our capital markets will be further weakened.

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ENDNOTES:

[i] International Accounting Standards are now known as International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB).

[ii] Under ASX Listing Rule 4.10, companies are required to provide a statement in their annual report disclosing the extent to which they have followed the best practice recommendations set out in the ASX Corporate Governance Council "Principles of Good Corporate Governance and Best Practice Recommendations" in reporting periods commencing after 1 January 2003.

[iii] The statutory power of the AASB to make accounting standards is by virtue of s334 of the Corporations Act 2001 (Cth).

[iv] The Corporations Act requires all disclosing entities, public companies, large proprietary companies and registered schemes to prepare financial reports in accordance with accounting standards s292 and s296.

[v] The Senate passed a resolution on 17 February 2000 disallowing paragraphs 6.3 and 6.4 of Accounting Standard AASB 1015 "Acquisitions of Assets".

[vi] Previously known as the Australian Society of Certified Practicing Accountants (ASCPA).

[vii] FRC Bulletin 2003/1 – 11 April 2003.

[viii] Under the strategy adopted by the Financial Reporting Council (FRC) at its meeting on 28 June 2002 and publicly announced on 3 July 2002 (refer FRC Bulletin 2002/4 – 3 July 2002 available on the FRC's web site www.frc.gov.au) , the Australian Accounting Standards Board (AASB) is obligated to work towards the full implementation of International Accounting Standards (now known as International Financial Reporting Standards (IFRS)) in Australia in respect of financial years commencing on or after 1 January 2005: Alfredson (2002).

[ix] Pound (2002).

[x] Policy Statement 6 (1996); paragraph 1.2.

[xi] Policy Statement 4 (2002); page 4.

[xii] FRC Bulletin 2002/4 – 3 July 2002.

[xiii] FRC Bulletin 2002/5 – 15 December 2002, Broad Strategic Direction provided by the Financial Reporting Council to the Australian Accounting Standards Board for 2002-03; paragraph c.

[xiv] AASB plans for adopting IASB standards by 2005 (last updated 22 July 2003).

[xv] According to the AASB plans for adopting IASB standards by 2005 (last updated 22 July 2003) there are 14 IASB standards denoted as List B - proposed "improved" IASB standards scheduled to be reissued.

[xvi] The EU has recently endorsed all but two of the existing IFRS (the exceptions being IAS 32 and 39 on Financial Instruments). Given that 14 of these standards are subject to improvement, and are likely to be significantly amended, it should be a matter of concern that:

(a) existing IFRS identified for improvement have nevertheless been approved in their existing form, and

(b) opposition to market valuing derivatives and other financial instruments is so entrenched in Europe that not even the limited requirements of, and the wide range of choices permitted by, the existing IAS 39 is acceptable to the EU.

[xvii] Proponents of mandatory adoption conveniently overlook factors such as that the IASB does not even have a standard on materiality, the massive internal inconsistencies in IAS 39, and numerous other technical issues.

[xviii] In a memorandum of understanding known as "The Norwalk Agreement" (18 September 2002) the Financial Accounting Standards Board (FASB) and IASB "pledged to use their best efforts to:

(a) make existing financial reporting standards fully compatible as soon as practicable; and

(b) to co-ordinate their future work programs to ensure that once achieved, compatibility is maintained".

[xix] Synnott and Dagge (2002)

[xx] This is not just a matter of observation of capital flows over the past 20 years; it has also been noted by other commentators, for example, Addison and Leo (1998) *"The certainty and transparency of the information contained in Australian financial reports has facilitated investment, opened doors to foreign governments, and generally improved the image of Australian business"*.

[xxi] "In rare and exceptional circumstances, the AASB may decide that adoption of an IASB standard is not consistent with main objects of Part 12 of the Australian Securities and Investments Commission Act 2001" (AASB plans for adopting IASB standards by 2005; Last updated 22 July 2003). Clearly the AASB has adopted a policy of mandatory adoption and the

FRC reference to best interests is no more than maintaining ultimately the right of Parliament to form a different view.

[xxii] Although the IASB has stated that "its intention is to minimise the number of interpretations and to amend standards rather than issue interpretations"; AASB Action Alert No. 64 – August 2003.

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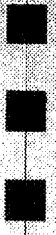
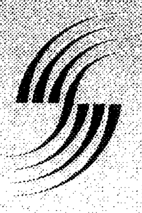




SECURITIES INSTITUTE

Understanding strategic decisions and investments

International accounting standards under pressure

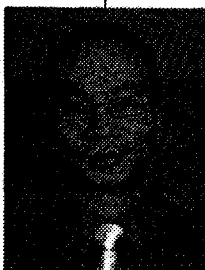
[illegible] and accountability

Buy-write strategy vs index portfolio

International accounting standards under pressure

Australia was quick to champion the cause of international accounting standards, but now there is growing concern that we jumped on board without thinking the issues through. **WAYNE LONERGAN** and **HUNG CHU** explain.

WAYNE LONERGAN FSIA
DR HUNG CHU
Lonergan Edwards & Associates Limited



The FRC/AASB policy of mandatory adopting of IFRS from 1 January 2001 has a number of serious and adverse consequences.

One of the most serious is the reduced disclosure of price sensitive information about the value of identifiable intangible assets, in particular those identifiable assets that would be – but for the IFRS prohibition – recognised or revalued.

The practice of recognising and revaluing non-current assets, including identifiable intangible assets, is a long-established generally accepted accounting practice in Australia.

This practice has been permitted by the AASB and its predecessor equivalents for many years.

However, the proposed adoption of the most recent version of IFRS 1 and IFRS 38 has these effects:

(a) Internally generated identifiable intangible assets will not be recognised except in the rare circumstances that there is an active market for them;
(b) Existing revaluations of identifiable intangible assets will have to be reversed (except where it is impractical to do so);
(c) Future revaluations of internally generated or acquired identifiable intangible assets will be prohibited (except in the rare circumstances that there is an active market for them, for example, taxi licences).

Goodwill concessions won't compensate

The revised IFRS standard on goodwill differs from the long- established present AASB standard (which is basically similar to other accounting standards throughout the world in terms of limited life/ amortisation requirements). From 2005, goodwill will no longer be subject to annual amortisation. Instead a recoverable amount test (called an impairment test under IFRS) will be applied each year.

This change has a number of important consequences:

(a) Companies may have to make impairment write-downs when interest rates rise or industry economic conditions deteriorate. Such impairment write-downs will exacerbate profit reductions caused by the same factors;
(b) The long-established Australian practice of accounting arbitrage from goodwill in favour of identifiable intangible assets will, in future, be reversed;
(c) Companies who have attributed substantial values to internally-generated identifiable intangibles, or who have revalued purchased identifiable intangibles, will have to write these values off.

The end result will be:

(a) Some companies will have significantly reduced or even negative shareholders funds;
(b) Unnecessary problems will be created in maintaining (and sometimes in even paying) dividends;
(c) Some companies will be in breach of borrowing covenants or thin capitalisation tax rules;
(d) Valuable information about intangible asset values will no longer be available to investors.

Information about intangible assets is value-relevant

Findings from a number of academic studies conducted in Australia and overseas consistently suggest that capitalisation and revaluation of intangible assets including identifiable intangible assets are relevant to firm valuations.

For example, examining the 100 largest companies listed on the Australian Stock Exchange (ASX), as measured by market value of equity as of 30 June 1996, and a random sample of 250 firms selected from the remaining Australian firms traded on the ASX with market value of equity greater than A$10 million from the period between 1991 and 1995, Barth and Clinch (1998) show that revalued intangible assets are consistently significantly positively associated with share prices.

Godfrey and Koh (2001) tested whether capitalisation of intangible assets, either in aggregate or by specific category of intangible assets, affects firm valuations. Using a sample of 172 Australian firms with reported intangible assets in 1999, the study found capitalised intangible assets, as a whole, provide information that is relevant for investors in valuing firms.

A more significant finding of the study is that when capitalised intangible assets are disaggregated into goodwill, R&D and other identifiable intangible assets, both goodwill and other identifiable intangible assets provide relevant valuation information incremental to other balance sheet items.

These findings are hardly surprising, given that intangible assets have become increasingly important components of firm value. Studying the relative growth of intangible assets (calculated as the excess of market value over book value) and the All-Ordinaries index between June 1984 and June 1999, Lonergan, Stokes and Wells (2000a) found that:

(a) On average, intangible assets now outweigh tangible assets;
(b) There is a high correlation (with a 99% confidence level) between the growth in intangible assets and the All-Ordinaries index.

This is also consistent with evidence in Lonergan, Stokes and Wells (2000b) which shows a persistent decline in the ratio of book value of net tangible assets over firm market values, so that this ratio is now significantly below one.

De-recognition of intangible assets will cause serious adverse consequences

Given that capitalised and re-valued intangible assets are value-relevant and they form important (for many companies, the most important) components of firm value, the de-recognition of many existing intangible assets, particularly revalued identifiable intangible assets caused by the compulsory adoption of IAS 38 in Australia will decrease the usefulness of financial reports.

The loss of price-sensitive information from financial statements will force investors to seek the omitted information from other sources. Using analysts' ratings of firms' disclosures, Gelb (2002) found that firms with higher levels of intangible assets (which are not allowed to be recognised in their financial reports) are more likely to receive significantly higher ratings for their investor relations programs or voluntary publications than for their annual reports.

These findings suggest that firms with higher levels of intangible assets emphasise supplemental disclosures because mandated accounting disclosures inadequately present their financial position and performance.

Notwithstanding the voluntary supplemental disclosure of information about intangible assets, the non-recognition of these assets still cause investors to incur costs in understanding the implication of the disclosed information for the value of the non-recognised assets.

Such an understanding would need to be sought from information processing intermediaries such as analysts at a cost. Consistent with this, Barth, Kasznik and McNichols and Kasznik (2000) found that analyst coverage is greater for firms with more intangible assets.

Because the search for and acquisition of information about the derecognised intangible assets, which would otherwise be readily available from financial statements, can be time-consuming and costly, the derecognition of these assets could contribute to a greater level of information asymmetry between insiders and outside investors in intangible asset intensive firms. This in turn leads to:

(a) A higher level of uncertainty about firm value and higher cost of capital particularly for new productive investments;
(b) An "un-level playing field" for investors, particularly those who are less informed and trade for liquidity reasons. For example, Aboody and Lev (2000) found that trades by insiders in R&D intensive firms were three to four times as profitable as were trades by insiders in non-R&D intensive firms.

It naturally follows that one of the outcomes of automatically adopting IAS 1 and IAS 38 in Australia would be inconsistent with the regulators' general goals of reducing cost of capital for new productive investments and maintaining a level playing field for all investors.

Are the IASB's grounds valid?

Notwithstanding consistent market evidence on the value relevance of capitalisation and revaluation of identifiable intangible assets, the IASB does not allow internally generated identifiable intangible assets to be recognised or revalued (except in the rare circumstance where there is an active market) in financial statements. IASB adopted this stringent approach to accounting for intangible assets mainly on the ground that the value of these assets cannot be reliably measured.

That is, lack of reliability has actually overwhelmed relevance justifying, in the IASB's view, the non-recognition of these assets.

While the value of internally generated intangible assets is sometimes subject to a degree of measurement uncertainty, reliability in its own right is not a valid reason for not according these assets financial

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statement recognition. There are several reasons why.

Firstly, accounting often involves making estimates, and therefore it is insufficient to reject the recognition of an estimated fair value because that amount represents an estimate rather than a precise estimate.

Secondly, because both relevance and reliability are important characteristics of financial information, basing recognition decision on reliability alone is too simplistic. Barth, Clinch and Shibano (2001) show that reliability relative to relevance, rather than reliability per se, is a key attribute in determining whether recognition of an accounting item results in greater or lower price information.

Thirdly, the value of intangible assets estimated by either independent valuers or company directors can be sufficiently reliable to be reflected in share prices and returns.

Barth, Clement, Foster and Kasznik (1998) examined the association between brand values estimates and share prices of firms owning the brands for a sample of over 330 brands owned by firms in a variety of industries. The brand value estimates used in this study were derived by FinancialWorld (FW) using a methodology adopted by the brand valuation consulting firm, Interbrand Ltd. The study shows that:

(a) Share prices are positively related to brand value estimates;
(b) Annual share returns are positively related to year-to-year changes in brand value estimates.

These findings support the view that the value of intangible assets can be estimated by independent valuers, and such value estimates are sufficiently reliable to be impounded into share prices and returns. In discussing the implications of their findings for accounting standard setting, the authors observe: "... these findings call into question concerns of those who believe that brand value estimates are too unreliable to be the basis for recognition as an intangible accounting asset".

Regarding source of value estimates, Barth and Clinch (1998) found little evidence indicating independent appraiser-based revaluation amounts for intangible assets are value relevant more often than director-based amounts.

Finally, even when directors' discretionary valuations of intangible assets are subject to biases, there is evidence which suggests that investors are not misled by the lack of their reliability in their value estimates (although this does not excuse them from doing the valuation correctly).

For example, Kallapur and Kwan (2002) examined whether the market capitalisation rates of brand assets differ for a sample of UK firms that have high and low incentives to bias the recognised brand amounts.

Firms with high incentives to bias their discretionary valuations of brand assets are those characterised by managers' desire to discourage shareholder approval for acquisitions/disposals or reduce apparent financial leverage. If firms with high contracting incentives overvalue brands or introduce greater measurement uncertainty then their brand capitalisation rates should be lower.

Consistent with this proposition, empirical results in their study suggest that the brand capitalisation rates for firms with high contracting incentives are significantly lower than those for firms with low contracting incentives.

These findings suggest that while managers' discretionary valuations of intangible assets recognised in financial statements might not always be reliable, particularly for firms with high contracting incentives, the markets do seem capable of seeing through the differences in reliability.

Additional disclosure won't be a solution

Unfortunately, the adverse consequences caused by the IASB insisting on de-recognition of existing identifiable intangible assets cannot be simply fixed by additional disclosure.

This is because not only does disclosure about identifiable intangible asset values, affect share price values but that it is only when such asset values are reflected in company accounts, as opposed to additional note disclosure, that share values properly reflect such information. That is, additional note disclosure is not an adequate substitution for balance sheet recognition. This proposition has been confirmed in several studies.

For example, Harper, Mister and Strawser (1987) found that a significantly greater number of commercial bankers surveyed included the pension obligation in the numerator of a debt / equity ratio when the pension information was presented in a balance sheet than when the same information was presented as a supplemental note to the balance sheet.

Consistent with their prior study, Harper, Mister and Strawser (1991) also found that lenders were more likely to perceive an unfunded post-retirement benefit as a component of debt when it was recognised in the balance sheet as a liability than when the same item was accorded supplemental footnote disclosure.

The findings from these experimental studies support the view that the method of reporting a liability within the balance sheet can affect the way in which users of financial statement perceive and measure a company's debt .

Not only does the method of reporting an accounting item influence financial statement users' perceptions, it can result in differential pricing in the market.

Aboody (1996) found that oil and gas firms recognising a write-down in connection with a decrease in oil prices experience a negative stock market reaction, whereas there was no significant stock market reaction for firms disclosing in its footnotes, but not recognising a write-down.

Barth, Clinch and Shibano (2001) provide a theoretical explanation for the differing impacts of recognition and disclosure on the informativeness of share prices. Their explanation is based on the proposition that understanding disclosures requires accounting expertise beyond that needed to understand recognised amounts, and that expertise acquisition is costly.

The cost and benefit trade-off facing investors in their expertise acquisition choice differ between recognition and

disclosure regimes. The implication of this is that whether an asset is recognised or disclosed can affect the proportion of investors acquiring expertise to understand the accounting disclosure and, consequently, the extent to which fundamental information about a firm's value is impounded into its share price, ie the informativeness of share prices.

Where to from here?

High level representations were, being made to the IASB to at least grandfather the existing revaluations. Given other IASB concessions to corporate pressure in other areas (eg grandfathering of pooling, existing derivative values, and de-recognition) this was hardly a big ask. However, the Australian request was rejected.

Most of the IASB constituents come from a deeply entrenched historic cost focus. As a result they are both unfamiliar with revaluation issues and profoundly sceptical of many of the values attributed to revalued intangibles. (That the IASB happily accept the very same valuation methodologies applied to acquisition accounting and impairment testing does not seem to strike them as inconsistent).

The IASB approach to identifiable intangible assets is inconsistent with both the approach taken with acquisition accounting (which mandates that all underlying assets be fair valued in a process which requires them to be valued) and with their push to fair value accounting in other standards including derivatives, SGARA's impairment testing, financial instruments, employee options, etc.

In essence, while the IASB is moving gradually to fair value measurement, they have taken the opposite stance on identifiable intangible assets (ie no or very few can be recognised or revalued plus reverse existing recognition/ revaluations). Given that:

(a) The aim of financial reporting is to produce information that is useful to users;
(b) Identifiable intangible assets clearly meet the conceptual framework definition of an asset (ie control over future economic resources);
(c) Intangible asset values represent the majority of asset values in most listed company balance sheets;
(d) Information about identifiable intangible asset values is clearly price sensitive; and
(e) The value of identifiable intangible assets estimated by independent appraisers is sufficiently reliable to be impounded into share prices.

It is clear that the present IASB view on identifiable intangible assets values is not sustainable. It would be a serious indictment on the IASB, and indeed the whole concept of mandatory adoption of IFRS, if the IASB did not rethink its approach to this important issue.

That the IASB workload may not permit it to review this matter for some years is hardly an acceptable excuse. It will be to the detriment of financial reporting, however, unless the IASB gives ground on these important issues.

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Why the goodwill accounting changes are a farce

Business combinations standard

1 The new business combinations standard replaces the mandatory 20 year (maximum) amortisation period for goodwill with an annual impairment test under AASB 136 (IAS 36) *Impairment of Assets*. In the absence of impairment, no amortisation is required.

2 The prohibition on the recognition of internally generated goodwill, in theory, remains (see AASB 138 *Intangible Assets*). In reality however, some of it will be subsumed into the carrying value of acquired goodwill.

3 Where goodwill is subject to an impairment write down, that write down can never be reversed even if the conditions resulting in that write down cease to exist.

4 Corporate Australia has been obsessed for many decades with avoiding the annual goodwill amortisation charge. Historically, this obsession has manifested itself in a number of ways including, but not limited to, the undervaluation of offer consideration and the over-valuation of identifiable intangible assets such as brands, licences and mastheads.

Maintenance of capital charge is out

5 It should be noted that Corporate Australia's obsession with goodwill amortisation is based on a fundamental misunderstanding of how equities are valued. Goodwill amortisation does not affect cash flow. It naturally follows that it does not affect share values. This fundamental valuation principle has been confirmed by a number of Securities Institute of Australia surveys of investment institutions which have consistently confirmed that 93% of investment institutions add back goodwill amortisation when assessing share values.

6 It is, however, fair to concede that the other 7% are a bit of a worry.

7 For the non-accountant readers who wonder why you amortise something that almost everyone adds back, the real reasons for amortising acquired goodwill are that:

(a) acquired goodwill does decline in value, and

(b) it is a maintenance of capital concept.

8 This is best explained by way of simple example. Assume that a company is acquired for $200 million whose sole asset is goodwill. Under the present goodwill standard this goodwill would be amortised on a straight line basis over 20 years as set out in Table 1.

Table 1

Amortisation and Maintenance of capital – P&L simplified

	Year 1	Year 2	Year 3		Year 20
	$m	$m	$m		$m
Profit	10	10	10	...	10
Less amortisation of goodwill	(10)	(10)	(10)	...	(10)
Net effect on profit[1]	-	-	-	...	-

Note:

1 Ignores tax, PV and growth complications.

9 The object of the amortisation of goodwill was to try and ensure that companies did not dissipate their capital by buying wasting assets and declaring profits, when in substance the so-called profit was really, in part or in whole, no more than a return of capital.

10 In balance sheet terms the principle underlying how capital was maintained is shown in Table 2:

Table 2

How capital was maintained – old rules

		$m
Initial Capital / cash	(Y_0)	200
Acquire goodwill asset		(200)
Net cash		-
Add back:		
- 20 years cash flow from amortisation of goodwill		200 +
Year 20 Capital / cash	(Y_{20})	200

Under IFRS Rules capital will be depleted

11 Under the new accounting rules the value of acquired goodwill will no longer have to be amortised, but it will be subject to an annual impairment test. This is demonstrated in Table 3:

Table 3

What will happen under the new IFRS Rules

	Year 1	Year 2	Year X	...	Year 20
	$m	$m	$m		$m
Profit	10	10	-	...	10
Goodwill impairment write-down			(30)		
Net effect on profit[1]	10	10	(30)	...	10

Note:

1 No profits in year x due to recession year.

12 In balance sheet terms capital will not be maintained as demonstrated in Table 4:

Table 4

Capital won't be maintained post 2005

		$m
Initial Capital / cash	(Y_0)	200
Acquire goodwill asset		(200)
Net cash		-
Blur internally generated goodwill, acquired goodwill and synergy benefits[1]		30
Year 20 Capital / cash	(Y_{20})	30

Note:

1 The result is that the only capital maintained is that arising out of impairment write-downs (in this example, $30 million in whatever year the write down occurs).

Unfortunate timing of impairment write-downs

13 Corporate Australia is delighted at the elimination of the annual goodwill amortisation charge.

14 However, they will be a lot less delighted in the next economic downturn when the inevitable profit declines will be exacerbated by impairment write downs on acquired goodwill.

Future accounting arbitrage will favour goodwill

15 The elimination of annual goodwill amortisation has important implications for future financial reporting. In essence, instead of avoiding goodwill recognitions and favouring the recognition of identifiable intangible assets as occurred in the past, in future years the reverse will occur. This is demonstrated in Tables 5 and 6:

Table 5

The economic reality of acquisitions	**$m**
Purchase cost of acquisition	100
Less net tangible assets	40
Total intangible assets	60

Comprising:	
- identifiable intangibles (brands, licences, etc)	45
- unidentifiable intangibles (goodwill)	15
	60

Table 6

The reversal of the accounting arbitrage of goodwill

	Pre 2005	**Under IFRS**
	$m	**$m**
Purchase cost of acquisition	100	100
Less net tangible assets	40	40
Total intangible assets	60	60
Valued allocated:		
- identifiable intangibles	60	-
- goodwill	-	60
	60	60

Note:
Neither arbitrage position is promoted in the respective standards. However, it is what has happened in the past, and undoubtedly what will happen in the future.

16 The over valuation of acquired goodwill and the carrying forward of this over-valuation will occur, notwithstanding the more definitive approach contained in AASB 3 with respect to the recognition of identifiable intangible assets acquired. Indeed we have already seen examples of this. For example, one gold miner, whose product is clearly homogenous with that of other gold mines has recognised billions of dollars of acquired goodwill!

Behavioural consequences

17 The over-valuation of acquired goodwill is not just a matter of accounting and reporting arbitrage. The new goodwill accounting rules will actually change corporate behaviour.

18 Post the new standards companies seeking profit growth and EPS growth will actually have an incentive to acquire companies with substantial intangible asset values. Whereas the previous goodwill amortisation rules kept a cap on, or even reduced, post takeover profits, in future this constraint will no longer apply.

19 Simply put, the new goodwill standard will actually encourage takeovers.

20 Furthermore, such takeovers will, for a time at least, also be EPS positive. This is because the carrying value of acquired goodwill will not have to be amortised and will only be tested for impairment (refer below).

21 Those who bother to read the accounting standards might think that the intent of, and the effect of, the Business Combination standard will be to properly reflect the market value of acquired identifiable intangibles, reduce or eliminate acquisition provisioning and generally reduce post acquisition results due to, inter alia, faster amortisation of identifiable intangibles values and other acquired asset.

22 If corporate Australia's long established history of arbitraging goodwill to generate the desired accounting result is taken as a guide, then we can confidently look forward to some very large values being (wrongly) attributed to acquired goodwill. Furthermore, these overstated values will be carried forward until a catastrophic event occurs.

Blurring of acquired and internally generated goodwill

23 Measurement of impairment at a CGU level will inevitably result in the blurring of acquired goodwill, internally generated goodwill and synergistic benefits.

24 The reason for this is that the goodwill impairment assessment of a CGU will be based on the assessment of future cash flows of the CGU. In the case of goodwill impairment three sources of cash flow will inevitably be combined. These are cash flows from:

(a) acquired goodwill, plus
(b) internally generated goodwill, plus
(c) synergy benefits.

25 This is a complete contradiction of the long established and universal prohibition on the recognition of internally generated goodwill. It is also in complete contradiction to the IAS 36 rationalisation that goodwill impairment write downs can't be reversed because any increase in the recoverable amount would be attributable to internally generated goodwill.

The relevance of CGU's

26 The new impairment test is based on cash generating units (CGU). In simple terms a CGU is the smallest unit that generates identifiable cash flows.

27 To minimise future impairment write downs many corporates will naturally seek to report on the basis of larger rather than smaller CGU's. In this way what would otherwise be impairment losses can be offset against the internally generated goodwill of more profitable units. Companies seeking a more conservative outcome (yes, both of them) will define smaller CGU's.

Testing for impairment

28 Testing for impairment test, assuming it is triggered, is to be based on a comparison of carrying value with the higher of fair value and value in use.

29 Testing against fair market value is correct in principle. However, the accounting standards view of "value in use" is seriously flawed. There are so many problems with value in use that this concept will be examined more fully in a separate article. In summary the key problems areas are:

(a) use of pre-tax discount rates
(b) failure to allow for the effect of tax on future cash flows
(c) ignoring the effect of debt; and
(d) ignoring the effect of capital upgrades.

Conclusion

30 The end consequences of the new accounting standard requirements for goodwill are that:

(a) more value will be attributed to acquired goodwill

(b) the carrying value of acquired goodwill will continue to be overstated due to the blurring of the values of acquired goodwill, internally generated goodwill and synergy benefits

(c) these overstated values will be carried forward until a catastrophic event occurs

(d) in the first serious economic downturn following the introduction of IFRS standards the accounting treatment of goodwill will inevitably be discredited.

31 This discrediting should occur, since the outcome of adopting IAS 38 in Australia will inevitably lead to the over-valuation of acquired goodwill and the unjustified retention of its carrying value when the reality in many, if not most situations, is that the real value of acquired goodwill has fallen.

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FINANCIAL REVIEW

Improvement yes, but well short of perfection

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The use of present value calculations is the major improvement in the reform to financial statements on impairment, says Wayne Lonergan.

In the past, financial statements have consistently failed to forewarn shareholders of impending financial collapse. Users of accounts who hope that the new financial statement on impairment (AASB 136), which is part of the switch to international standards, would remedy this deficiency, are doomed to disappointment.

AASB 136 contains a number of significant improvements over its predecessor standard. These include reference to fair value as one of the impairment reference points and significantly improved disclosure requirements. But there are other problems.

The most significant improvement is the effective mandating of the use of present value. That is, the recognition that dollars in the future are worth less than a dollar today. This is hardly rocket science but, unbelievable as it may seem, the use of present value is not mandated under the previous accounting standard.

Many shareholders, creditors and lenders rely on disclosed book values as support for share values, credit assessment and lending purposes.

The justification, or otherwise, of this reliance is a subject for another day.

Historically, readers of accounts expected falls in asset values to be recognised in financial reports.

The failure to demand recognition of the time-value of money in recording asset values therefore permitted many companies to maintain overstated asset values in their accounts. This was generally agreed to by auditors because the use of present value was not mandated by the accounting standards.

This serious, many might say fundamental, deficiency has been partly fixed in the new standard by requiring recognition of the time-value of money in assessing asset values.

However, as ever in accounting, things aren't as simple as they might seem.

Firstly, impairment testing in future will be conducted by reference to the cash generating unit (CGU) level. The result is that overstated individual asset values will be able to be shown provided they are offset by unrecognised goodwill or other unrecognised identifiable intangible asset values at the CGU level.

This "okay until you hit the pavement" approach to impairment recognition means that significant falls in asset values will not have to be recognised until other unrecognised CGU intangible asset values are first eliminated.

In simple terms, early warnings of declines in asset values can still be hidden.

The problem of delayed recognition of declining asset values by offsetting the fall against other hidden CGU asset values is exacerbated by the prohibition of the revaluation of identifiable intangible assets under the goodwill standard.

The introduction of value in use as an alternative reference point for impairment testing also creates a number of unnecessary problems. This is because under AASB 136, value in use is required to be calculated ignoring the effects of tax, financing and future restructuring costs and benefits.

For all but the simplest businesses and CGU's, these excluded items are fundamental to the assessment of value.

To further complicate matters, these excluded items are not required to be put at a fair value under other accounting standards.

Future value in use cash flows are also required to be calculated using before-tax rather than after-tax

discount rates.

Contrary to popular belief, in most cases, the before-tax discount rate is not simply the after-tax rate grossed up for tax.

More fundamentally worrying is that value in use cash flows are to be based on management's view rather than the market's view of future cash flows. In essence, "value is in the eyes of the [be] holder".

The net result is that the way value in use is required to be calculated is a conceptual dog's dinner.

Another inevitable outcome of applying AASB 136 will be increased volatility in reported results and asset values.

This volatility arises because in an economic downturn, and periods of rising interest rates, asset values will fall.

In the early stages of value decline this will be offset against the hidden values of other CGU assets.

As the downturn worsens falling asset values, and their consequent profit effects will have to be reflected in financial statements. The requirement to present value will mean that these writedowns will occur much more frequently.

As the economy recovers, or interest rates fall some of these writedowns (but not goodwill) will be reversed.

However, impairment losses are not to be reversed just because of the unwinding of the present value discount. Given that present value is fundamental to valuation assessments and that present valuing is effectively mandated for impairment testing under AASB 136, this exclusion can only be described as "curious".

Under AASB 136, some impairment losses will still not be recognised for financial reporting purposes.

Some excessive asset values will also continue to be reflected in accounts with the impairment loss offset against the value of unrecognised goodwill, or shadowed by the value of internally generated goodwill or other unrecognised identifiable intangible asset values.

The basic conceptual problem that the accounting standard setters have not yet come to grips with is that you can't sit astride the fair value fence. In particular, standard setters should not introduce flawed concepts such as (the standards version of) value in use into an accounting model that simultaneously mandates market value principles and historic cost accounting for integrally related items.

Overall, AASB 136 is a big improvement on AASB 1010, but it still mandates unlike accounting treatments for like items.