

# IFRS complex issues and the way forward

Regina Fickers and Sasha Kitto review the differential reporting issues affecting our clients.

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## The proposed IFRS for SMEs in Australia

On 31 May 2007 the Australian Accounting Standards Board (AASB) released its proposed differential reporting regime for Australia, following the International Accounting Standards Board (IASB) exposure draft on IFRS for small and medium-sized entities (IFRS for SMEs). If introduced, these proposals would involve significant changes to Australia's current differential reporting framework.

In this document we summarise the proposals and share our insights in considering how the financial reporting requirements could change.

### 1. The proposed differential reporting regime in Australia

#### The issue

The AASB has released its proposed differential reporting regime for Australia. It outlines which entities need to prepare general purpose financial reports and incorporates plans to implement the IASB's exposure draft on IFRS for SMEs. The proposals suggest sweeping changes to Australia's current differential reporting framework.

#### The impact

The debate on the merits of a simpler set of financial reporting requirements for small and medium-sized entities has recently heated up in Australia in response to the AASB's proposals. However, many companies remain unclear on what the proposals entail.

Over the page are two tables summarising the proposals. The first table considers the overarching changes proposed; the second table outlines how the proposed two tier approach would apply to entities that currently prepare general purpose financial reports.

## The overarching changes proposed by the AASB

Proposed change	Effect	Insight
The definition of reporting entity would no longer determine the level of disclosure required.	Many entities that currently prepare special purpose financial reports will have more onerous disclosure requirements. These entities will no longer have the option to choose which disclosure requirements they apply to their accounts.	Removing the reporting entity concept has been criticised as impractical by some members of the business community. For instance, although the proposals allow subsidiaries of listed or foreign companies to report under IFRS for SMEs, many will continue to report under IFRS to ensure their accounting treatments are consistent with the rest of their group. The proposals will thus increase their number of disclosures. In our view, the AASB should retain the reporting entity concept (refer to section 3).
The level of reporting would largely be determined by the concept of public accountability.	Typically, IFRS would be mandated for entities that are publicly accountable. The proposed IFRS for SMEs could be adopted (instead of IFRS) by entities that are not publicly accountable, but that prepare general purpose financial reports.	According to the IASB, publicly accountable entities are those that: <ul style="list-style-type: none"> <li>file, or are in the process of filing, financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market.</li> <li>hold assets in a fiduciary capacity for a broad group of outsiders, such as a bank, unit trust with external investors, insurance entity, securities broker/dealer, pension fund, mutual fund or investment banking entity.</li> </ul>
Reports filed on a public register or otherwise made publicly available would no longer be special purpose financial reports.	All reports currently filed on a public register (i.e. ASIC) and those that are otherwise made publicly available would be defined as general purpose financial reports.	This proposal has caused some confusion, as the AASB's interpretation of 'public register or otherwise made publicly available' is unclear. For instance, it could include all financial reports lodged with ASIC, the Department of Fair Trading and published on an external website. If this aspect of the proposals is implemented, we encourage the AASB to restrict it to apply only to those entities that lodge financial reports with ASIC.
Private entities that currently prepare general purpose financial reports would have the option to apply IFRS or the proposed IFRS for SMEs.	The proposed IFRS for SMEs contains simpler measurement and recognition requirements, with fewer disclosure requirements than IFRS.	Affected private entities would benefit from simpler measurement rules and fewer disclosure requirements than IFRS (refer to section 2). For instance, under the proposed IFRS for SMEs, testing of goodwill and indefinite life intangibles is only required when there is an indicator of impairment (such as a significant decline in an asset's market value) rather than annually.

## The proposed two tier approach for general purpose financial reports

(including all entities that currently lodge accounts with ASIC)

IFRS would apply to:	IFRS for SMEs (or IFRS if they so choose) would apply to:
For profit entities that are publicly accountable, including all listed entities.	
For profit entities that are not publicly accountable but have consolidated revenue of \$500m or consolidated assets of \$250m.	For profit entities that are not publicly accountable that meet two of the following three criteria: <ol style="list-style-type: none"> <li>consolidated revenue of \$25m;</li> <li>consolidated assets of \$12.5m;</li> <li>50 (consolidated) employees.</li> </ol>
Not-for-profit and public sector entities with consolidated revenue of over \$25m or consolidated assets of over \$12.5m.	Not-for-profit entities and public sector entities with consolidated revenue below \$25m and consolidated assets below \$12.5m.
Neither IFRS or the proposed IFRS for SMEs would apply:	
Small proprietary companies that meet at least two of the three criteria do not have to lodge accounts with ASIC: <ol style="list-style-type: none"> <li>fewer than 50 employees;</li> <li>consolidated revenue below \$25m;</li> <li>consolidated group assets below \$12.5m.</li> </ol>	
Under certain circumstances, small foreign controlled companies which are not part of a large group and registered foreign companies can obtain relief from lodging financial statements.	

## What's happening now and what needs to happen next?

Overall the Australian business community's initial response to the IFRS for SMEs proposals has been positive. Many support the concept of a separate, stand-alone standard for small and medium-sized entities that is written in plain English, with fewer accounting options and complexities than in IFRS. The challenge for Australia is in agreeing the right entities to which it should apply.

However, some members of the community still consider the proposals overly complex, with too many disclosure requirements and an unnecessary reliance on fair value accounting rather than the simpler use of historical costs. The main debate at the global level will focus on these issues.

Although the AASB is proactively engaging with various members of the business community, we encourage all interested parties to share their views on the proposals by 1 September 2007.

## 2. Have the IFRS for SMEs proposals gone far enough?

### The issue

Some members of the business community expected much simpler accounting and disclosures in the IFRS for SMEs proposals. Some also question whether removing the reporting entity concept, which allowed non-reporting entities to select the disclosures most relevant to their users, could result in cluttered financial statements that are less meaningful to users.

### The impact

Under the proposals, non-publicly accountable entities (subject to certain size thresholds) that currently prepare general purpose financial reports can apply the less onerous disclosure requirements in IFRS for SMEs rather than IFRS. Although this reduces the time and cost involved in financial statement preparation for these entities, there are still many disclosures.

#### Example:

In the proposed IFRS for SMEs there are over 370 disclosure requirements to comply with. The disclosure checklist for the most simplified set of general purpose financial statements is 54 pages long.

Currently certain non-publicly accountable entities can choose which disclosure requirements to include in their financial statements based on the needs of their users. Removing the reporting entity concept would mean these entities lose the ability to tailor the information that is disclosed in their financial statements to the needs of their users.

In some instances, the benefits of meeting these additional disclosure requirements aren't clear, particularly for small or medium-sized non-publicly accountable entities. Financial statement users of some entities might only include shareholders, the entity's bank and the Australian Taxation Office, who may not need all of the proposed disclosures.



#### Example:

Financial statement users of non-publicly accountable entities may not benefit from some of the disclosures required under the proposed IFRS for SMEs. For instance, the following disclosures could be considered too detailed and burdensome for the users of SME accounts:

- The requirement to restate income and expenses of discontinued operations for years prior to the decision to sell
- Detailed disclosures of assumptions used in the valuation of financial assets and liabilities
- A description of the forecast transaction and the periods when cash flows are expected to occur when applying hedge accounting to certain transactions
- Numerous reconciliations of balance sheet items

The wider community has also questioned whether the measurement and recognition provisions of the proposed IFRS for SMEs achieves the right level of simplicity required. It could be considered unnecessary to retain a number of different revaluation models and an emphasis on fair value accounting. A simpler measurement criteria based on amortised cost, with less choice and complexity, might be considered more appropriate by some preparers and users of financial reports.

#### Example:

Under the proposed IFRS for SMEs, an entity would need to meet strict criteria in order for it to account for financial instruments using cost or amortised cost. For instance, its financial instruments would need to have a maturity date or due on demand date; a fixed amount return, a fixed rate or a variable rate that is observable on the market; and no prepayment option.

### PwC's suggestions for moving forward

In Australia a broad spectrum of entities would report under the proposed IFRS for SMEs. This makes it difficult to judge the most appropriate level of disclosure. The disclosure needs of an entity with \$26 million in revenue could be quite different from an entity with \$499 million in revenue.

We would encourage the AASB to consider additional research into the needs of users of financial reports at both ends of this spectrum. This would allow the AASB to more accurately determine whether the proposed IFRS for SMEs should be applied to small or medium-sized entities in Australia. We may need another tier of financial reporting if the needs are disparate. We encourage entities to assist the AASB by giving their comments on the proposals with additional contextual information about their size.

## 3. Financial reporting by unlisted companies

### The issue

Some unlisted companies, including subsidiaries of listed entities and foreign owned subsidiaries, that currently prepare special purpose financial reports are concerned that under the proposed IFRS for SMEs they would have to prepare general purpose financial reports.

### The impact

The AASB's proposals have an awkward reporting impact for some subsidiaries of listed companies and foreign owned subsidiaries. Many of these entities, particularly in the financial services industry, cannot obtain "ASIC Class Order" style relief from preparing financial reports.

Because there are no external users of their financial reports, some of these entities may currently prepare special purpose financial reports, including only limited disclosures. Under the AASB's proposals they may wish to adopt IFRS for SMEs to avoid the detailed disclosures required by IFRS. However, this may result in them adopting accounting treatments different from those adopted in their group's consolidated financial reports. This would mean their financial information would need to be adjusted before being included in the group's results.

**Example:**

The proposed IFRS for SMEs requires all costs relating to defined benefit obligations to be recognised in an entity's profit and loss account. This differs from what is currently required under IFRS.

AASB 119 *Employee Benefits* allows actuarial gains and losses to be recognised in the profit and loss account, in equity or using the more complicated corridor approach. The corridor approach allows entities to 'smooth' the impact of actuarial gains and losses over the working lives of employees. If the parent has a policy of using the corridor approach under IFRS, it would need to adjust the numbers reported by the subsidiary when that entity is consolidated into the group. Many companies are unlikely to want to do this because it undermines the advantages intended to flow from IFRS - a single set of standards.

In the example above, the subsidiary could align its accounting with the group treatment and adopt the corridor approach set out in AASB 119. However, this would mean that the entity would need to adopt the whole of that standard, including its more detailed disclosure requirements.

The existing proposals don't seem to cater well for this situation. The only way to avoid the additional costs associated with adjusting financial information is to incur the costs of preparing additional disclosures.

#### PwC's suggestions for moving forward

Entities might wish to consider whether the AASB should amend its proposals to provide more disclosure relief for some subsidiaries of listed companies or foreign owned companies. In our view, the simplest way to achieve this would be to retain the existing "reporting entity" approach.

## 4. Financial reporting by charities

### The issue

There is a concern that neither IFRS nor the proposed IFRS for SMEs addresses the needs of users of charities' financial statements.

### The impact

**Background:**

On 7 June 2007, the Treasury published a discussion paper titled 'Financial Reporting by Unlisted Public Companies' to stimulate public debate on financial reporting by unlisted public companies. The paper considered the financial reporting requirements for unlisted public companies (those companies limited by guarantee or by shares). A large number of these companies are not-for-profit entities such as charities.

This discussion paper followed the amendments to the Corporations Law to increase the size thresholds for proprietary companies that are required to prepare financial reports. Based on the new size thresholds and the proposed IFRS for SMEs, unlisted public companies which have consolidated revenue over \$25 million or consolidated assets over \$12.5 million would have to prepare general purpose financial reports under IFRS.

Some members of the community have questioned the practicality of IFRS and the application of the proposed IFRS for SMEs to not-for-profit entities. Neither the Treasury's discussion paper nor the IFRS for SMEs proposals have addressed the reporting requirements for charities from the perspective of the primary users of their financial report and the information they need.

**Example:**

The public is interested in understanding whether the funds raised at charity events are utilised in accordance with the charities' stated objectives. Some contributors like to understand the percentage of funds allocated to administration costs.

Charities are incorporated in a variety of entity types with different reporting obligations. The Treasury's discussion paper and the IFRS for SMEs proposals will impact some charities due to the way they are incorporated. Other charities will not be affected. This appears incongruent - it is the charities' activities which drives the community's expectations of reporting, not the type of entity.

#### PwC's suggestions for moving forward

This is an opportunity for the community to make a difference in the efficiency and relevance of reporting for charities. We encourage further consultation and development of specific accounting guidance for charities by a body such as the AASB. This has been done in the UK with their "Accounting and Reporting by Charities: Statement of Recommended Practice". It may also be an appropriate time to reconsider the governance requirements of charities. This has also been done in the UK with the Charities Commission.

## Conclusion

Most seem to agree that regardless of the specifics of the accounting rules, easier financial reporting for small entities is a welcome change. However, many in the community are concerned about the differential reporting proposals of the AASB and its impact on entities such as subsidiaries of listed or foreign owned companies.

The AASB has requested comments on the SME and differential reporting proposals by 1 September 2007. Entities are encouraged to engage in the debate and share their views with the AASB so that it can consider them in its comment letter to the IASB by 1 October 2007. It will take some time for the IASB and the AASB to consider all the issues these proposals raise, therefore we expect a conclusion to take some time to develop.

## For more information or further help...

For more information on how we can help you understand the proposed IFRS for SMEs, please contact your regular PricewaterhouseCoopers representative.

To access the latest information and thought leadership on IFRS issues, please visit our Australian IFRS website [www.pwc.com/au/ifrs](http://www.pwc.com/au/ifrs).