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*The International Accounting & Auditing
Institute*

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Mr Jorge del Busto
Secretary Financial Reporting Council
C/- The Commonwealth Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr del Busto,

SUBMISSION ON THE USE OF A SECTOR NEUTRAL FRAMEWORK FOR THE MAKING OF AUSTRALIAN ACCOUNTING STANDARDS

We congratulate Mr Kevin Simkins for the report 'Use of a sector neutral framework for the making of Australian accounting standards' (the report). It is a thorough coverage of the terms of reference, and a most interesting and informative paper. The report contains an excellent summary of the status of accounting standards setting frameworks and thinking internationally, and sets out the policy decisions required for Australian accounting standards setting.

In 1981 Professor Robert N Anthony of Harvard University visited Australia and presented at a seminar organised with the accounting department of the University of Melbourne for introducing accrual accounting into governments. His paper ended with a question he had posed to the various US accounting standards boards – if accounting for government requires separate accounting treatment to the 'private' sector, what are the differences? He noted that no one had provided him with any convincing arguments there were any significant differences then, and 25 years later the challenge still remains unanswered.

Australian and New Zealand governments now produce whole of government general purpose financial reports on the accrual basis under the single framework of accounting concepts and standards. This has demonstrated that it is possible to use one accounting framework applicable to all sectors, and to have financial statements that make government finances understandable by replacing the voluminous and meaningless cash balances related to the Budget that previously represented government accounting. It would be unfortunate to revert now to differentiated frameworks for setting accounting standards with all the additional complications and unnecessary institutional duplications and potential conflicts this would create.

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Are differences in accounting real or only created to serve sectoral interests?

The main issue addressed by the report is whether there should be different financial reporting rules for entities in different sectors. This is summarised in paragraph 8:28 under the two opposite points of view – those who believe that there are differences between sectors requiring separate accounting standards, and those do not. We are firmly in the latter category. We disagree with the author that holding such a perspective is ‘unhelpful’ or ‘overlooks’ the ‘...real differences in objectives and environments’ of entities depending upon which category they are classified in. We are most aware that there are differences between reporting entities depending on their economic sector classification, objectives, mission, legal structure and status, stakeholders, size, industry, operating capacity, regulation and governance arrangements. We also hold that these factors are not relevant when deciding on what general purpose financial reports should look like, and what financial information should be disclosed.

Accounting is accounting, a dollar is a dollar, and a standard should be a standard, not a multiple choice depending on the arbitrary category the entity is assigned to. Describing differences as ‘real’ does not make them so. It could equally be said that those who seek separate accounting standards for different sectors are only reflecting their own sectoral interests, and not seeing the potential for uniform accounting standards to produce financial statements that accurately and objectively reflect financial performance, financial position, investing and financing activities and compliance of the entity, regardless of the interests or objectives of those who prepare them, for the benefit of all users.

The current arrangements in Australia of having one standards setting board for all financial reporting has proved efficient and effective. By focusing on the needs of the user of general purpose financial reports instead of trying to meet the perceived differences depending on which sector an entity resides in, financial reporting in Australia has benefited, and has demonstrated that it can work.

All reporting entities as defined under Statement of Accounting Concepts No 1 (SAC 1), *Definition of the Reporting Entity*, are required to meet the objectives of financial reporting as established in SAC 2, *Objective of General Purpose Financial Reports*. Paragraph 7 of SAC 2 states “...General purpose financial reporting focuses on providing information to meet the common information needs of users who are unable to command the preparation of reports tailored to their particular information needs. These users must rely on the information communicated to them by the reporting entity”.

For each of the so called unique circumstances of the public sector or ‘other non profit’ categories referred to in the report (for example, paragraph 6:28, page 67), equal contrary arguments can be mounted that there is no difference in substance in the financial transactions undertaken. The same *accounting treatment* should be applied to revenue, expenditure, assets, liabilities and equity transactions, and the same standard *displays* of those transactions provided. Terminology of transactions and balances may need be altered to match the environment, but the presentation of financial transactions should be the same format, and use the same measurement basis.

What difference in accounting terms should there be in recording, depreciating and valuing a chair and a desk whether it is used in the private, public or social sectors? Does it not perform the same function, require the same cash resources to purchase, and deteriorate at the same rate, requiring apportionment of the cost of usage of that resource to the accounting period it occurs in?

Is an 'infrastructure' asset any different, whether a dam is owned by a public sector water authority or a private company? Is a statue of the founder/president a 'heritage' asset, and, if so, are there different valuation problems whether it is erected by the government or a private company? Is a museum acquisitions valuation dependent on whether it is a public or private museum? Is depreciation a notion only relevant to 'for profit' entities, or is it related to the useful life of an asset?

What is different about a liability, whether money is owed by a public listed company, a charitable trust or a government? Does it not have to be repaid in the same currency or rolled over if that entity is to be sustainable? Is a pension measured differently for a public servant than for a private company employee, irregardless of how that pension is to be funded?

Is revenue to be recorded and displayed differently because it is 'non exchange' or 'exchange' based? Is revenue received from a donation any different in substance from cash received for a sale or a tax paid, other than in the motives and incentives of the provider? Should grants be treated differently as they currently are under Australian accounting standards depending on whether an entity is in the 'business' sector or the 'not-for-profit' sector?

Is expenditure for 'non profit' purposes intrinsically different from expenditure undertaken 'for profit' purposes? Is there difference in amounts of cash involved in purchasing depending upon motive of that expenditure?

Is the equity in not for profit entities measured differently to for profit entities? i.e., assets minus liabilities?

Difficulties in defining sectors and institutional iron cages

We understand that the current international accounting standards setting arrangements are divided between "for profit" and "public sector" institutions with different governance, funding and professional accountability responsibilities, and that most countries retain separate bodies for developing government accounting standards. These divisions owe more to the iron cages of organisational history, structural encasement and institutional protection rather than accounting logic.

The categories assumed for purposes of the report discussion, i.e., profit-oriented entities, public sector not-for-profit entities and other not-for-profit entities, rely on non exclusive criteria – whether entities are 'for profit' or 'not for profit' categories, and then whether they are in the 'public sector' or not. The report does not define these categories, but rather relies on the assumption that they commonly accepted and reflected in the organisation of accounting standards internationally, therefore they are taken as the

appropriate categories for discussing the issues. If these categories are not considered relevant in accounting standards setting, then all the consequential matters raised in the report are not relevant.

To take an example from international accounting standards arrangements, Government Business Enterprises (GBEs) are required to apply the International Financial Reporting Standards/International Accounting Standards (IFRSs/IASs) as distinct from all other public sector bodies who are not GBEs which should apply the International Public Sector Accounting Standards (IPSASs). One of the required criteria for classifying an entity as a GBE under the *Framework for Presentation of Financial Statements* issued in the Handbook of Public Sector Accounting Pronouncements is that it must have been ‘...assigned the financial and operational authority to carry on a business’. However, what constitutes a ‘business’ is not defined in the Handbook.

Conducting a business can be regarded as an entity undertaking operations in an efficient, effective and ‘business like’ manner, i.e., controlling its own finances, adopting modern management principles, conducting good governance practices, etc. Running a ‘business’ should not be confused with having an objective of making a profit, although it often is. Government itself can be regarded as being one of the biggest businesses in town. Not-for-profit organisations can be very business like.

Under modern public sector management principles, most departments and agencies of governments in Australia and New Zealand now operate with reasonable autonomy, conduct commercial activities such as sale of publications, etc., distinguish between operating grants and capital, manage their own operations including contracting out internal services, etc., and can retain appropriations. This and the other criteria could be construed to mean all government agencies in Australia and New Zealand are GBEs, and therefore should be applying the IFRSs instead of the IPSASs. They effectively do so now, but this is not in accordance with the international accounting standards directions.

The United States accounting framework (‘US GAAP’) under the Financial Accounting Standards Board (FASB) covers both ‘for profit’ and ‘not for profit’ entities. (Paragraph 5.89, page 45) “Most accounting standards issued by the FASB apply to both business entities and non-governmental not-for-profit organisations” (paragraph 5.94, page 47). The US also has two government standards setting boards, the Government Accounting Standards Board (GASB) and the Federal Accounting Standards Advisory Board (FASAB), issuing different standards according to their jurisdictions. The reasons for this being “.....the GASB believes that all governmental entities are fundamentally different to for-profit entities in the private sector. Those differences result in different information needs of stakeholders, including information needed by those users to assess public accountability and make political, social and economic decisions.” (Paragraph 5.98, page 47).

This reverts to Professor Anthony’s original question – what are those differences? Why do FASB accounting standards deal adequately with ‘not for profits’ outside government, but not within? What are the intrinsic factors that make government financial accountability so different? Until this question is answered, the existence of separate accounting standards bodies can only be seen as political expediency.

Historical accounting standards settings observations

Australia with New Zealand achieved World leadership in applying sector neutral standards because of the close cooperation between the part time members of the Australian Accounting Standards Board (AASB) and its antecedents, the Accounting Standards Review Board and the Accounting Standards Board of the Australian Accounting Research Foundation (AARF), with the Public Sector Accounting Standards Board (PSASB) established in 1983. The PSASB was responsible for issuing the first conceptual framework under the guidance of the AARF. The AASB and the PSASB were merged in 1999 after meeting jointly for two years on the basis that their functions were unnecessarily duplicated, and scarce resources were better utilised by having the one set of accounting standards and dealing with “differences” under urgent issues guidance, addendums to standards and in some cases separate standards¹.

Having proved in Australia and New Zealand that having a single accounting standard board works, and one set of accounting standards can be implemented by all entities with some interpretations, then why should we revert to a differential standards setting model based around non specific classification assumptions that rely more on institutional and sectoral interests and political expediency than rationality?

Response to specific questions

We respond to the questions asked in the preface to the report as follows -

1. In your view, how well are the needs of all users of general purpose financial reports, including users of public sector and other not-for-profit entities in Australia, being met?

We believe the needs of users of all general purpose financial purpose reports, as prepared under the Australian accounting standards (AASs), including those prepared by entities in the public sector and the not-for-profit or social sector, are being well served by the largely sector neutral accounting standards in Australia.

However, we recognise there are perceived significant issues between sectors, and that additional guidance and explanation on the application of accounting standards may be required. These should be regarded as implementational matters for the AASB to respond to rather than justifying the need for separate accounting standards setting boards or committees.

To the extent that entities are exempted from applying the AASs, the needs of users of general purpose financial reports are not being met. For example, the *Corporations Law* provides relief to corporations from applying the accounting standards based on their size. Entities that are not corporations may not have any legal requirement to follow the AASs, however they could be required to do so under the pronouncements of the professional accounting bodies.

¹ AASB Public Sector Policy Paper (as at 24 October 2006) sets out the current status of public sector standards in Australia

It would be preferable if there were uniformity between the professional pronouncements and the legal requirements in Australia for producing general purpose financial reports and the standard application of the AASs, notwithstanding the legislation under which the entities are governed by.

A related issue is the often expressed view that the current AASs are too technical and complicated, or ‘standards overload’, and therefore the financial reports produced under those standards are not generally understood. This type of complaint has increased as Australia has transitioned to the AIFRSs, but has always been present as an argument against achieving better standardisation of financial reporting. Developing separate and different standards for different sectors is definitely not a solution to this issue, and would only add to the complexity.

We recommend that further resources be invested in explaining the AIFRSs and their impact on accounting policies of entities for the benefit of general users. Whether this is a matter for the accounting profession to address or the government is a matter for FRC consideration.

2. Will the current approach of the AASB enable the standard-setter to respond to the more challenging environment of the future and ensure the needs of public sector and other not-for-profit users are appropriately met?

We believe the current approach of the AASB can accommodate the ‘needs’ of the public sector and other not-for-profit users, whether in the public sector or ‘other’, because it has met this challenge successfully over the past seven years. The needs of users of general purpose financial reports are basically the same, whatever sector the entity producing the financial reports is placed in.

3. Do you consider that having a conceptual framework that is applicable and appropriate to all entities is a necessary element in Australian standard-setting for all sectors? What approach to establishing a conceptual framework(s) do you consider appropriate?

We consider having a single conceptual framework in Australian accounting standard-setting is essential. The approach could follow the process adopted previously under the AARF by issuing exposure drafts and issuing the conceptual statements on a progressive basis. Unfortunately the introduction of the AIFRSs has meant that three existing conceptual statements have been withdrawn, however the opportunity exists for Australia to lead international thinking by combining the proposed IASB conceptual framework and any framework emanating from the IPSASB.

4. Different approaches could be used to set standards in Australia. Which approach do you consider the most appropriate?

- *to continue to develop a single set of standards;*
- *To develop two separate sets of standards: one for profit-oriented entities and the other for not-for-profit entities; or*
- *another approach e.g. three sets of standards (profit-oriented, public sector not-for-profit and other not-for-profit sets) or two sets of standards with other not-for-profit*

entities being addressed together with profit-oriented entities? (If you prefer this option please describe the approach you prefer)

The most appropriate approach is to have a single set of accounting standards.

5. If, in response to Consultation Issue 4, you considered standards different from those applying to the for-profit sector should be developed for one or more sectors please indicate, for each such sector, what the primary base should be for those standards:

- Government Finance Statistics (GFS);***
- International Public Sector Accounting Standards (IPSAS); or***
- A range of sources, including International Financial Reporting Standards, IPSAS and GFS, depending on the particular issue being considered?***

We do not believe there should be any different accounting standards between the 'sectors' or depending on whether entities are 'for profit' or 'not for profit'.

We regard the *GFS* as having a separate role particular to government financing, and therefore should not be confused with general purpose financial reporting.

We consider the recent General Government Sector (GGS) standard issued in Australia inappropriate as the general government sector is not a reporting entity.

6. If a single set of standards continues to be developed in Australia, do you prefer:

- the current approach of the AASB;***
- a matrix approach, retaining specific standards for types of public sector and possibly also other not-for-profit entities while maintaining a general set of topic based standards applicable to all entities; or***
- an approach involving a single set of standards but with non-standard level guidance (such as the Statements of Recommended Practice in the United Kingdom) applicable to particular sectors or groups of entities in sectors?***

We prefer an approach involving a single set of standards with any additional guidance for entities who consider the standards do not meet their particular reporting needs provided through the AASB.

7. Would developing a Statement of User Needs for the public sector and other not-for-profit sectors, based on research, and including an analysis of how any different needs impact financial reporting be useful? If so, please suggest how that Statement of User Needs could be developed and maintained. Do you have any other views on how user input could be enhanced?

We do not see any value in maintaining a Statement of User Needs for the public sector and other social sector entities if there is a common conceptual framework, and that framework adequately expresses the requirements of the general user for financial information from general purpose financial reports.

There may be a need for sub groups to develop guidance for Special Purpose Financial Reports relevant to the users of financial statements within those categories, but this is dependent on structuring the accounting standards setting around a single set of accounting standards. We would suggest the AASB as the appropriate body to determine any structure of sub groups of expertise required.

8. Do you consider that there is enough clarity on the direction that the AASB is taking in establishing requirements for the public sector and other not-for-profit sector, including identifying the base set or sets of standards which will be adopted?

Yes, except for the aberration of the GGS accounting standard, which should not be an accounting standard but a guidance note on reconciling the GFS and financial reporting information of government as a special purpose financial report.

9. A number of options to enhance the recognition of different environments and issues in sectors have been identified in the Report. Do you consider any of the options, including those relating to board membership, sub-boards or committees, expectations of board members, staffing or explicit board sign-offs would enhance the ability of the standard-setting process to meet user needs?

The question of structuring boards and committees to best serve the standards setting processes is not regarded as a key strategic issue in our response, as we consider the AASB should be the sole body responsible for accounting standards, and any matters of membership, sub groups, expectations or staffing should be the responsibility of that body, and be accountable to the FRC and the government.

We consider the realities of resource constraints should be kept in mind when deciding structures and processes. There are very few competent and experienced accounting standard setting technicians in Australia and internationally. We have been extremely fortunate in Australia that the core of standard setters from AARF have been retained and continue to play significant roles in accounting standards setting in Australia and overseas. The availability of these technicians would suggest retaining the single accounting standards board and a single set of accounting standards as by far the most sensible approach for Australia.

10. Are there any other matters that you would like to suggest for consideration by the FRC?

1. The FRC responsibility includes over sighting auditing and assurance standards in Australia, and the approach between the accounting standards and auditing standards needs to be aligned. We recommend therefore that there should be one set of accounting standards and one set of auditing standards in Australia for all sectors. This would assist in maximising usage of scarce accounting resources, improve the quality and understanding of financial reporting and provide better accountability and transparency for all entities.

2. The consolidated financial statements of the Commonwealth have been qualified by the Auditor General for at least five years over material accounting treatments

including non inclusion of GST revenues and the calculation of taxation revenue. The 2004/05 annual financial statement of Victoria received an ‘emphasis of matter’ report from the Victorian Auditor General for inconsistent application of accounting frameworks.

Such qualifications do not reflect well on governments who are responsible for regulation of entities across all sectors and for the Federal government that now is responsible for issuing the Australian accounting standards under the oversight of the FRC. It could be considered a direct conflict of interest if a separate public sector accounting standards board were now created – i.e., the government does not agree with the existing standards, therefore it seeks to write its own standards.

We consider that it is vitally important that the AASB, through the oversight and governance arrangements of the FRC, remains totally independent of government and public sector influence promoting sectoral interests.

3. It has come to our attention that there is a lack of consistency in applying the SAC1 criteria of determining reporting entities within general government sectors. This leads to the inability of general users to obtain information on the financial performance and financial position of government programs.

We believe the FRC should consider whether SAC1 is being applied appropriately by governments, and therefore require the preparation of general purpose financial reports to be accountable to the taxpayers and other users of government financial reports.

We also consider that the general government sector, an imprecise economic classification, is not a reporting entity. AASB 1049 *Financial Reporting by General Government Sectors by Governments* (September 2006) should therefore be withdrawn.

We note from the report that other countries regard objectives of *GFS* reporting as being separate from the requirements of general purpose financial reports. For example, the report notes in paragraphs 5.116 and 5.117 that the FASAB and the GASB both consider the needs of users of *GFS* and general purpose financial reports are separate.

4. There are confusing institutional relationships and responsibilities between financial reporting, auditing standards, regulators, professional accounting bodies and sectoral interests in Australia. While most emphasis is placed on corporations (especially public listed corporations) and their regulation under *Corporations Law* and the *ASIC Act*, the scope of the accounting and auditing standards is across all forms of reporting entities, including public sector entities. For example, large superannuation funds are regulated under the Australian Prudential Regulation Authority (APRA) legislation with separate financial reporting and auditing requirements, while self managed superannuation funds are regulated through the Australian Taxation Office (ATO) under the APRA Act, again with separate reporting and auditing requirements.²

² A ‘mud map’ of relationships between institutions, standards, legislation and professional accounting bodies pronouncements is included in the FRC *Report on Auditor Independence 2005 – 06*, page 56.

There are also professional obligations of the members of the accounting profession to comply with the ethical requirements, accounting standards and auditing standards, but these are sometimes distinct from their legal obligations under the various acts.

There are also variances between the several bodies representing accountants, with three bodies being recognised by IFAC and therefore subject to the international professional accounting obligations framework, and other accounting bodies that do not have IFAC membership.

A recommendation for consideration of the FRC is to continue the use of a sector neutral approach to setting accounting concepts and standards and auditing and assurance standards as a means to minimise the confusing mixture of institutional responsibilities, to obtain a common approach to financial reporting and to reduce red tape. This could be a recommendation to the government when formulating the *Simpler Regulatory System Bill*.

Conclusion

Australia has been well served by relatively few people involved in the development and issuing of the accounting standards over the last 40 years. We have demonstrated that a single set of accounting standards produced by the one standards board can be applied by all reporting entities thereby improving the overall level of financial reporting and serving the public interest with the most efficient and effective use of scarce resources.

Arguments have always been made as to why an entity, a sector or a country is somehow different and therefore requires different accounting standards and different types of financial reports. There are also compelling counter arguments that there is no difference in basic financial transactions, and therefore financial reporting needs to be the same.

RD Laing is reputed to have delivered an entire lecture on philosophy at Harvard University by repeating the single phrase 'what you see is where you sit'. His insight is appropriate to the single issue addressed in this report. Until it can be shown that the needs of general users of financial information are different, there is no reason for having differential accounting standards.

We urge the FRC to maintain the present arrangements for accounting standard setting in Australia through the AASB, and to continue to promote uniformity of application rather than the creation of further differences and complexity.

Yours sincerely,

Graeme Macmillan
Principal