Accounting Standards

Building international opportunities for Australian business

Corporate Law Economic Reform Program

Proposals for Reform: Paper No. 1

ISBN 0 642 26110 5

The Government is seeking comments from interested parties on the detail of the proposals in this paper which should be forwarded to the following address:

First Assistant Secretary
Business Law Division
The Treasury
Parkes Place
PARKES ACT 2600

Telephone: 02 6263 3960
Fax: 02 6263 2882
Email: clerp@treasury.gov.au

Copies of this paper are available from the Australian Government Publishing Service and on the Treasury web site (http://www.treasury.gov.au).

Enquiries concerning the paper can be made to:

Ms Veronique Ingram
Assistant Secretary
The Treasury
Telephone: 02 6263 3970

Printed by the Australian Government Publishing Service

TABLE OF CONTENTS

ABBREVIATIONS

AARF	Australian Accounting Research Foundation
AASB	Australian Accounting Standards Board
AASC	Australian Accounting Standards Committee
ASB	UK Accounting Standards Board
ASC	Australian Securities Commission
ASCPA	Australian Society of Certified Practising Accountants
ASRB	Accounting Standards Review Board
ASX	Australian Stock Exchange
AuSB	Auditing Standards Board
FAF	US Financial Accounting Foundation
FASB	US Financial Accounting Standards Board
FRC	Financial Reporting Council
GAAP	US generally accepted accounting principles
GASB	US Government Accounting Standards Board
IASC	International Accounting Standards Committee
ICAA	The Institute of Chartered Accountants in Australia
IOSCO	International Organisation of Securities Commissions
LRB	Legislation Review Board
PAP	Project Advisory Panels
PSASB	Public Sector Accounting Standards Board
SEC	US Securities and Exchange Commission
UIG	Urgent Issues Group

PART 1: REFORM PROPOSALS

PROPOSAL NO. 1 — ROLE OF ACCOUNTING STANDARDS

- It should be specifically stated, either in the charter of the standard setter or in the legislation under which it is established that, in designing accounting standards, the standard setter should seek to ensure that the standards lead to the production of:
  - relevant;
  - reliable;
  - neutral; and
  - comparable

  financial information for the users of financial statements.
- A cost/benefit analysis should be undertaken by the standard setter in the development of each accounting standard. In undertaking the cost/benefit analysis, consideration should be given to whether the proposed standard is suitable for all entities required by legislation to prepare financial statements in accordance with accounting standards, or whether the proposed standard should only apply to a specific class of entity.
- It should be made clear in legislation that accounting standards should be interpreted from a commercial perspective to promote compliance by preparers of accounts, not only with the black letter of the standard, but also its overall purpose.

PROPOSAL NO. 2 — HARMONISATION WITH INTERNATIONAL STANDARDS

- The ultimate objective for the setting of accounting standards in Australia should be the production of high quality accounting standards that facilitate Australian business by leading to lower costs of capital and enabling Australian companies to compete on an equal footing overseas, while also maintaining investor confidence.

- In the immediate future, Australia should continue to harmonise its standards with International Accounting Standards Committee (IASC) standards so that compliance with Australian standards will automatically result in compliance with IASC Standards — this should not lead to a diminution in quality of Australian standards, but rather make Australian standards more internationally recognisable, so that Australia's capital market is not out of step with major overseas capital markets.
- The prime focus of the proposed Australian Accounting Standards Committee (AASC) should be to influence the development of high quality and relevant IASC accounting standards with the objective that these will be adopted internationally for domestic purposes, especially within the major economies where capital raising takes place.
- A key role of the proposed Financial Reporting Council (FRC) should be to ensure that the AASC is committed to, and works towards, adoption of IASC standards having regard to what is taking place in the major capital raising economies.
- The FRC should report to the Government by 30 November 1998 on progress made by the IASC towards completion of the core set of standards and the likelihood of endorsement of those standards by the International Organisation of Securities Commissions (IOSCO) by 31 December 1998.
- From 1 January 1999, the AASC should issue identical exposure drafts of standards for public comment to those issued by the IASC with the objective that final standards issued by the AASC would be consistent with Australian law and be the same as those issued by the IASC, unless the Government, upon advice from the FRC, determines that to do so would not be in Australia's best interests.
- Australia should encourage the IASC in its proposed restructuring to ensure greater representation on its constituent bodies by national standard setting bodies.

PROPOSAL NO. 3 — INSTITUTIONAL ARRANGEMENTS FOR STANDARD SETTING IN AUSTRALIA

Advisory Group

- To facilitate greater stakeholder involvement in the standard setting process, an advisory group, entitled 'the Financial Reporting Council'

(FRC), should be established with responsibility to provide broad oversight of the process and maintain the momentum towards the development and adoption of internationally accepted standards.

- Membership of the FRC should be representative of the following key interest groups who should have the authority to nominate their representatives on the FRC:
  - users / analysts of financial statements;
  - preparers of financial statements;
  - governments / public sector;
  - the professional accounting bodies; and
  - the Australian Stock Exchange (ASX) and Australian Securities Commission (ASC).
- The Treasurer should identify bodies to be represented on the FRC and appoint persons to sit on the FRC from nominated representatives.
- The Treasurer should appoint the Chairman of the FRC, with the Deputy Chairman being appointed by the FRC itself.
- Under a charter, the FRC should:
  - appoint the members (other than the Chairman) of the AASC, which will replace the Australian Accounting Standards Board (AASB);
  - approve the priorities and business plan of the AASC and monitor compliance with them;
  - oversee the provision of administrative and research / technical support for the AASC;
  - set broad strategic direction and provide feedback to the AASC on the general policies it should be pursuing, including advice in broad terms on issues of public concern or controversy;
  - make recommendations about, and oversee, the consultative arrangements of the AASC;
  - oversee the funding arrangements of the AASC and approve its budget; and
  - review the performance of the AASC and Urgent Issues Group (UIG) and provide a public report annually on the operation of the FRC, AASC and UIG.

New Standard Setting Body

- The AASC should be established under legislation and have the powers of a body corporate.
- The functions of the AASC should be to prepare, approve and issue accounting standards for private and public sector entities required to prepare financial statements in accordance with accounting standards.
- The FRC should determine the precise size and make-up of the AASC in light of moves to harmonise and eventually adopt IASC standards.
- Members of the AASC should be appointed on the basis of ability, in particular, their experience in, or knowledge of, accounting, finance, business or government. Members should not sit on the AASC as representatives of any particular constituency to ensure the AASC's independence.
- Initially, and subject to the views of the FRC, the AASC would desirably consist of six part-time members, together with a part-time Deputy Chairman and full-time Chairman (eight in total). The Chairman should be appointed by the Treasurer with the remaining members appointed by the FRC.
- The terms of appointment of the members, Deputy Chairman and Chairman of the AASC should be three years.
- Project Advisory Panels of experts on particular subjects being considered by the AASC should be used as sounding boards from the early stages and throughout the development of particular standards to facilitate stakeholder involvement in the making of accounting standards.
- The UIG should continue its present functions, but with a revised structure so that it shares a common chairman with the AASC and reports directly to the AASC in relation to its decisions. Members of the UIG should be appointed by the FRC.
- Meetings of the AASC and UIG should be held in public. Voting in the AASC should be by way of a simple majority and the existing voting procedures for the UIG should be retained.

PROPOSAL NO. 4 — SECRETARIAT AND RESEARCH SUPPORT

- A dedicated full-time secretariat, engaged by, and directly accountable to, the AASC should be established to provide core administrative and research support.
- The specific arrangements regarding secretariat and research support for the AASC should be determined and re-assessed periodically by the FRC, particularly in light of Australia's move towards adoption of IASC standards.
- The AASC should have a dedicated Secretary / Director who would be directly responsible for the provision of the administrative support to the FRC and AASC. The Secretary / Director would also oversee the provision of research / technical support to the AASC, the UIG and any other subcommittees or consultative groups established in respect of particular projects.
- The AASC should have the flexibility to augment this support by contracting with outside providers as appropriate.

PROPOSAL NO. 5 — FUNDING

- In recognition of the importance to Australia of having high quality accounting standards that are recognised internationally, the Government is committed to ensuring that the proposed AASC is adequately funded. This will enable the AASC to provide high level input to the development of IASC standards, and domestic standards where necessary, and to promote acceptance of those standards in major overseas capital markets.
- To provide ongoing certainty regarding funding of the accounting standard setting process, increased stakeholder commitment to it and a greater spreading of the cost burden amongst beneficiaries, funding totalling approximately $10 million over the next three years should be provided by government and the private sector.
- The total amount of funding that should be allocated to accounting standard setting should be periodically reviewed by the FRC.

PROPOSAL NO. 6 — LEGAL BACKING

- The AASC should not make determinations regarding which types of entities should comply with accounting standards, this being a matter for the legislation governing those bodies or industries. However, this should not preclude the AASC from prescribing different standards for different entities as considered appropriate.
- The ASC should continue to monitor compliance with accounting standards and take appropriate enforcement action when necessary.
- At a more general level, the FRC should monitor the operation of accounting standards to assess their continued relevance and to determine whether they are still achieving their objectives.

PROPOSAL NO. 7 — PUBLIC SECTOR ACCOUNTING

- Subject to the agreement of the accounting bodies and State and Territory governments, the AASC should have responsibility for making accounting standards in respect of public sector, non-corporate and non-profit entities.
- Public sector interests should be represented on the FRC.
- Whilst members of the AASC should not necessarily be drawn from the public sector, at least some of the members on the AASC should have particular expertise in relation to the public sector.
- It should be left to each government (Commonwealth, State or Territory) to determine the legal effect of accounting standards made by the AASC in respect of public sector entities falling under their responsibility.
- The FRC should consider the desirability of retaining specific consultative arrangements for the AASC in respect of public sector issues.

PROPOSAL NO. 8 — OTHER ISSUES

- The AASC should give a high priority to addressing the outstanding issues in the conceptual framework for general purpose financial reporting.
- The possibility of developing a generic Financial Reporting Act should be explored with State and Territory Governments.

- Australia should promote moves internationally to introduce market value accounting and work towards addressing fundamental issues such as measurement.
- The AASC should give priority to considering the introduction of risk accounting in the accounting framework to provide a dynamic measure of an entity's financial condition.

PART 2: INTRODUCTION

2.1 BACKGROUND

On 4 March 1997 the Treasurer announced that, as part of the Government's new Corporate Law Economic Reform Program, a paper on how the accounting standard setting process in Australia should be reformed would be released.

The issues to be addressed include:

- the development of accounting standards that enhance efficiency, expansion and international competitiveness of Australian business while at the same time maintaining investor confidence;
- the composition and funding of the AASB and the need for greater industry and user participation;
- the relevance and usefulness of existing accounting standards to contemporary conditions;
- the extent to which accounting standards should be strictly prescribed and whether there is scope for individual companies to be permitted or required to determine the level and type of disclosure which is appropriate for those companies; and
- whether Australia should continue to develop its own set of standards or whether international standards should be used as a basis and adapted to Australian conditions where necessary.

This paper proposes an accounting standard setting framework for Australia which requires the involvement and support of all stakeholders in financial reporting. The restructuring of the existing regime gives rise to a range of associated issues including consideration of the role of accounting standards (Parts 4 and 5), the institutional arrangements for standard setting in Australia (Part 6), the funding of the accounting standard setting process (Part 7), compliance with accounting standards (Part 8), the separation of the setting of accounting standards for public and private sector entities (Part 9) and future developments (Part 10).

2.2 KEY ECONOMIC PRINCIPLES

As with other key corporate law policy areas which the Government has identified in the Corporate Law Economic Reform Program, the proposed reforms are to be assessed against the following key principles:

- cost / benefit analysis of the existing law and proposed changes;
- the development of a regulatory and legislative framework that is consistent, flexible, adaptable and cost effective;
- the reduction of transaction costs for firms and other market participants;
- an appropriate balance between government regulation and industry self-regulation;
- the removal of barriers to entry for service providers; and
- improved harmonisation between Australia's regulations and laws with those applying in major world financial markets.

PART 3: THE CASE FOR REFORM

3.1 IMPETUS FOR REFORM

It is essential to investor confidence in Australia's capital markets that Australian financial reporting requirements, and the accounting standards which underpin them, are soundly based and in tune with major overseas capital markets.

Australian companies are increasingly competing in a global market for goods and services. It is therefore incumbent upon the Government to ensure that Australian companies can compete effectively and efficiently in that market. The emergence of global markets and cross-border financing have underlined the need for Australia's regulatory requirements, including accounting standards, to be in step with those of our trading partners. Australia cannot afford to be out of step with the rest of the world in this area because it is a relatively small economy.

Australian accounting standards are generally of a high quality and our standard setters are well regarded internationally. However, there have been criticisms made to the Government from time to time about the content of accounting standards, the processes involved in setting them and the funding arrangements underpinning the standard setting process. In particular, concerns have been expressed that:

- the existing arrangements for accounting standard setting are confusing, inefficient and not conducive to stakeholder participation;
- there is duplication between the AASB and PSASB;
- Australian accounting standards are not understood in, and are out of step with, the major capital markets in the United States (US), United Kingdom (UK) and Europe, thereby resulting in higher costs of capital for Australian business;
- the standard setting process is perceived to be dominated by the accounting profession and there is no real accountability to its users;
- accounting standards do not reflect modern business practices, being too prescriptive and overly technical, thereby imposing excessive costs on business; and

- the processes involved in standard setting have failed to attract broad input and the necessary level of financial support, with the result that accounting standards are not meeting the demands of constituents.

Regardless of whether any, or all, of these criticisms are valid, Australian accounting standards should be, and be perceived to be, an asset to Australian companies and investors.

The Government considers that in light of the criticisms mentioned above, together with recent moves towards internationalisation of accounting standards, the Australian accounting standard setting framework should be reviewed, and reformed where necessary, to remove perceived impediments in the process of standard setting, make it more accountable to stakeholders and better equip it to meet the challenges of the future. It is notable in this context that some six years have passed since the current arrangements were put in place.

The ultimate objectives to be achieved from reforming the accounting standards framework in Australia are to inspire investor confidence in Australian enterprises, improve the regulatory environment within which Australian enterprises operate domestically, reduce any inhibitors to the expansion of our enterprises overseas and increase international investment in Australia.

3.2 What the Government is Seeking to Achieve

The specific outcomes the Government is seeking to achieve as a result of the reforms proposed in this paper are:

- a clear and relevant policy framework for the development of accounting standards to ensure they are responsive to changes in commercial practices, meet the needs of users without being overly burdensome, and improve Australia's international competitiveness;
- improved institutional arrangements for the standard setting process that will ensure that the process operates in a responsive, efficient and effective manner, thereby enabling all relevant stakeholders to participate while maintaining the independence of the process; and
- a more equitable spreading of the cost burden in respect of the funding of the standard setting process so that those who benefit from accounting standards contribute to their development.

PART 4: ROLE OF ACCOUNTING STANDARDS

4.1 OBJECTIVES AND IMPACT OF ACCOUNTING STANDARDS

The basic purpose of accounting standards is to facilitate the provision of financial information about entities to enable investors, analysts, creditors and the entities themselves to make informed decisions about the allocation of resources. Accounting standards are essentially about disclosure and, in many respects, are at the heart of market efficiency.

Clearly, while accounting standards assist preparers of financial statements by providing a framework within which to construct the statements, their prime importance is to assist users of the statements to make meaningful assessments about the financial position of an entity. Users of financial statements range from directors to investors, through to credit rating agencies.

Effective financial reporting, which is essential to investor confidence, can only be achieved if it is underpinned by relevant and well designed accounting standards. As the detail of financial reporting requirements is increasingly being left by legislation to be filled in by accounting standards, the importance of accounting standards is becoming accentuated.

Accounting standards facilitate both the efficient day-to-day operations of individual business entities and contribute to the efficient operation of capital markets.

At the firm level, accounting standards improve the accountability of individual business enterprises and their managements to investors and creditors. By promoting accurate reporting, accounting standards assist the management of a business entity to maximise the wealth of the entity and to put in place effective and efficient corporate governance arrangements. At a broader level, accounting standards are central to the provision of accurate, transparent and reliable information to the market as a whole. In this regard, a well informed market will generally be an efficient one.

Accounting standards that result in the provision of accurate and comparable information about the true financial performance and position of business entities promote investor confidence and market integrity, thereby ultimately reducing the costs of capital throughout the economy. Public confidence in the integrity of the financial reporting framework is central to maintaining and expanding a sophisticated domestic capital market.

4.2 CONTENT OF ACCOUNTING STANDARDS

Whilst Australian accounting standards have sometimes been criticised as being too detailed and complex, this does not necessarily mean that they are fundamentally flawed. Feedback to the Government from business and international standard setters suggests that the form and content of Australian accounting standards are broadly consistent with those existing in other countries with sophisticated capital markets. Accordingly, it would be inappropriate to consider a wholesale or fundamental change in the way standards are written. However, there may be scope for better targeting and design of particular standards.

Just as financial reporting must be dynamic and responsive to the needs of users, so must be the accounting standards upon which the financial reporting framework is based. The question, therefore, arises as to how to ensure that accounting standards are meeting the needs of users who are increasingly demanding a higher level of sophistication and reliability of financial reports.

The legislation that establishes the AASB, the *Australian Securities Commission Act 1989*, does not provide any indication to the AASB as to the purposes of, or the objectives to be achieved by, the accounting standards it is required to prepare. In this regard, it is desirable that the standard setter be given greater guidance as to what accounting standards should be designed to achieve. Whilst clarification of the objectives of accounting standards would not guarantee the production of high quality and relevant standards, it could go a fair way down that track.

In light of the above, and to ensure that the standard setter has regard to the objectives of accounting standards, it should be specifically stated, either in the charter of the standard setter or in the legislation under which it is established, that in designing accounting standards, the standard setter should seek to ensure that compliance with accounting standards leads to the production of relevant, reliable, neutral and comparable financial information for users of financial statements.

- <u>‘Relevant’</u> information is used in the sense of enabling users of financial statements to assess the actual financial performance and position of, and risks attaching to, an entity.

- ‘Reliable’ information is used in the sense of leading to the production of a picture of the financial performance and position of an entity that is representationally faithful / accurate.
- ‘Neutral’ information is used in the sense that the standard should not be biased by leading to the production of a more or less favourable picture of the financial position of an entity than is the position in reality.
- ‘Comparable’ information is used in the sense that the standard facilitates comparisons being made about the relative financial performance and position of entities so that similarities and differences between entities can be accurately assessed.

The increasing complexity of financial reporting does, at times, make it more difficult to achieve these objectives and it has been suggested that it would be more appropriate to frame accounting standards as general principles rather than black-letter prescriptive requirements. While the adoption of a general principles approach has its attractions, in most cases it would not be feasible without significantly compromising the objectives of comparability and reliability. That is not to say that endeavours should not always be made to frame accounting standards in simple and clear terms with the minimum amount of detail required to achieve the objectives.

Accounting standards are becoming more prescriptive, partly because of the tendency for them to be interpreted from a strictly legal perspective rather than a commercial one. It seems that a vicious circle is being created in this regard because preparers of financial statements are increasingly relying on adherence to the black letter of the standards to protect themselves legally, rather than following the spirit of the standards.

A way of addressing this issue could be to explicitly provide in legislation that accounting standards should be interpreted from a commercial perspective and not just a purely literal or legal one. By a commercial perspective, it is intended that more weight should be given to the objectives of the standards and what is generally considered in the relevant market to be good commercial practice. This may give comfort to the preparers of financial statements who might then more willingly follow more principled-based standards. The standard setter may also be more inclined to set less prescriptive standards if it does not feel the pressure of having to foresee every eventuality or address every possible evil when developing a standard. However, this is not to say that accounting standards should not be binding on preparers of accounts, but simply that both the black-letter and spirit of the standard should be complied with.

4.3 NEED FOR COST/BENEFIT ANALYSIS OF STANDARDS

In addition to specifying the objectives of accounting standards in legislation or in the charter of the standard setter, it would be desirable to require the standard setter to undertake some form of cost/benefit analysis to determine the need for a standard and also during a standard's development to assist in the standard's optimal effectiveness in the marketplace.

The costs of compliance with accounting standards are increasingly becoming an issue. To some extent this is understandable given the growing sophistication of financial transactions which accounting standards seek to address. In particular, accounting standards are complex in many cases because the underlying financial transactions they are dealing with are complex.

Although rigorous and detailed accounting standards assist in establishing greater transparency in the market, thereby ultimately reducing the costs of capital for business as a whole, it is important that the costs of compliance with accounting standards, not only to corporates and the business community, but also to the economy as a whole, do not exceed the benefits. In this regard, it should be noted that while the owners of an enterprise bear the direct costs of compliance, they are also the ultimate beneficiaries of a well informed market.

The costs of compliance with accounting standards are difficult to quantify, but some of the direct costs to an entity include:

- collection and storage of raw information;
- retrieval of information;
- presentation of data;
- analysis and interpretation of standards and their translation to an entity's particular financial statements; and
- reviews of compliance with accounting standards.

The indirect costs to the economy are much harder to specify. Similarly, the benefits of accounting standards are by their nature relatively intangible. There is therefore a tendency to focus more on the direct costs of complying with an accounting standard rather than on the benefits that may be derived from applying it.

Because some of the beneficiaries of accounting standards, for example creditors, potential investors and shareholders, do not always directly bear the costs of compliance with them (and vice versa), cost/benefit analysis of accounting standards is by no means a simple task. However, such analysis in the course of developing a standard will assist in avoiding the adoption of conceptually pure standards which, although possibly leading to world's best practice, do not result in benefits which justify the costs incurred.

Having regard to the above, there is merit in introducing a legislative requirement that each standard undergo some degree of cost/benefit analysis during its development. This could involve the production of a form of economic impact statement by the standard setter which canvassed the merits of a proposed standard and assessed its impact on business and the economy as a whole. It is noted that the Legislative Instruments Bill 1996, currently before the Federal Parliament, will require cost/benefit analysis to be undertaken for all legislative instruments (see Part 8).

Such cost/benefit analysis and adherence to the objectives mentioned above would be relevant even if Australia were to ultimately move to the adoption of IASC exposure drafts and standards for domestic use as outlined in Part 5 of this paper. In particular, it would be important for the Australian standard setting body, in assisting the development of IASC standards, to give significant weight to these objectives and to seek to influence the IASC to use cost/benefit principles when determining the need for, and content of, particular standards. Certainly, in the developmental stages of IASC drafts and when providing feedback on IASC exposure drafts, the Australian standard setter should have these principles at the forefront.

4.4 Appropriateness of Particular Accounting Standards

An important consideration when assessing the costs and benefits of a proposed standard is the impact it would have on each of the types of entities required to prepare financial statements. For example, it may be that a particular standard is appropriate for disclosing entities under the Corporations Law, but needs to be modified in respect of its application to other entities such as large proprietary companies. That is, the 'one size fits all' approach of accounting standards may not be appropriate in all cases and should be tested in relation to every standard.

The issue of having different accounting standards for different types of entities will increasingly become an issue if Australian accounting standards are comprehensively harmonised with international accounting standards. While it may be important for listed companies and Australian companies seeking to raise capital from overseas to be in compliance with international accounting standards, this may not be the case for companies or entities with an entirely domestic focus. Accordingly, greater attention will need to be paid in the harmonisation process to the impact of revised or new harmonised standards on each of the types of entities required to comply with accounting standards.

Proposal No. 1 — Role of Accounting Standards

- It should be specifically stated, either in the charter of the standard setter or in the legislation under which it is established that, in designing accounting standards, the standard setter should seek to ensure that the standards lead to the production of:
  - relevant;
  - reliable;
  - neutral; and
  - comparable

  financial information for the users of financial statements.
- A cost/benefit analysis should be undertaken by the standard setter in the development of each accounting standard. In undertaking the cost/benefit analysis, consideration should be given to whether the proposed standard is suitable for all entities required by legislation to prepare financial statements in accordance with accounting standards, or whether the proposed standard should only apply to a specific class of entity.
- It should be made clear in legislation that accounting standards should be interpreted from a commercial perspective to promote compliance by preparers of accounts, not only with the black letter of the standard, but also its overall purpose.

PART 5: ROLE OF INTERNATIONAL ACCOUNTING STANDARDS

5.1 GLOBAL ENVIRONMENT

The globalisation of business and investment markets has led to demands from both corporations and investors for the development of financial reporting requirements that facilitate business and investment activities across national boundaries. International direct investment brings substantial benefits to home and host countries by contributing to the efficient utilisation of capital, technology and human resources and promotes economic and social welfare.

The emergence of global markets and cross-border financing has highlighted a need for internationally harmonised financial reporting and accounting standard regimes. In recognition of this, key players, both domestically and internationally, have expressed a commitment to improving international comparability of financial reporting.

In Australia, the AASB, PSASB, Australian Society of Certified Practising Accountants (ASCPA), Institute of Chartered Accountants in Australia (ICAA) and Group of 100 have supported the internationalisation of financial reporting requirements. Internationally, the IASC and IOSCO have recently agreed to a program designed to deliver a body of accounting standards which can be used by foreign companies for the purposes of cross-border capital raisings.

5.2 AUSTRALIA'S PLACE IN THE WORLD OF STANDARD SETTING

Australia has influenced international accounting standards well in excess of its comparative economic position. This has occurred because of the expertise in standard setting which has been developed in Australia and the high profile which the Australian accounting bodies have taken in international forums.

Australia, Canada, the US and UK are widely considered to have the pre-eminent national standard setting bodies in the world. Australian representatives meet with other members of this group and the IASC on a regular basis. This grouping, referred to as G4+1, has an established work program.

The objective of the AASB, ICAA and ASCPA on the world scene has, more recently, been to pursue the development of an internationally accepted set of accounting standards which can ultimately be adopted by Australia. Australia is a founding member of the IASC and has been one of the most active and influential members of its committees since its inception. An Australian, Michael Sharpe, is the current Chairman of the IASC Board.

5.3 DEVELOPMENTS OVERSEAS

Globally, a range of national strategies have developed to address the need for accounting standards both domestically and internationally. Certain countries have well established accounting standard regimes while others, particularly developing countries, have elected to adopt the standards of other jurisdictions. The potential benefits for greater harmonisation are, however, recognised even by countries with well established standard setting regimes.

Summaries of the accounting standard setting regimes of the US, UK, Canada and the IASC are provided in Appendix A.

The profile of IASC standards has been steadily increasing for a number of years. Countries to have moved to substantially adopt IASC accounting standards include some of Australia’s closer and emerging trading partners in Asia, such as, Malaysia, China, and Hong Kong. Moves are also being made in Europe to adopt IASC accounting standards. Germany, for example, has been considering whether to provide in legislation for the use of IASC standards and the French Parliament was considering a new law which would recognise the use of IASC standards by companies which have stock market quotation outside France. In Australia, the ASX has allowed foreign listed companies to use IASC standards.

Significantly, however, leading capital markets have yet to adopt IASC accounting standards for domestic reporting purposes. Neither the US nor UK, whose markets together total over 50 per cent of world capitalisation, have adopted IASC standards and indications are that moves by these nations to adopt IASC standards will be somewhat cautious.

Historically, the debate over IASC standards has centred around qualitative issues. IASC standards have been perceived at times to be:

- inferior in terms of underlying accounting policies;
- incomplete and incapable of adoption without substantial support from national standards and national regulatory bodies;
- incapable of achieving the same level of investor protection that currently exists in Australia;
- relaxed in terms of allowing alternative accounting methods to be used thereby reducing the comparability of financial information; and
- incapable of responding quickly to changing market conditions (that is, the adoption of standards by the IASC takes, on average, about three years).

The main areas of concern are that the standards:

- have allowed the use of too many options in the preparation of financial reports;
- contain insufficient explanatory material and guidance on use; and
- are incomplete — there are gaps in the standards.

In light of the above, the IASC agreed with IOSCO in 1995 to a new work program designed to address the criticisms of international standards, particularly regarding gaps in their coverage. The work program aims to produce a complete core set of IASC standards by March 1998, and to re-examine a substantial number of existing IASC standards. The core set of IASC standards being developed are primarily for cross-border offerings and listings.

IOSCO has indicated that its endorsement of IASC standards will be withheld until such time as a core set of acceptable standards are in place. IOSCO has given the IASC a deadline of the end of 1998 in this regard.

In the US context, it is interesting to note that the US Congress recently passed the *National Capital Efficiency Act 1996*, which draws attention specifically to the accounting problems facing issuers seeking to raise capital across international borders. The US Securities and Exchange Commission (SEC) is to report back to Congress later this year on the progress of the development of IASC accounting standards.

5.4 IN WHICH DIRECTION SHOULD AUSTRALIA BE HEADING?

As mentioned above, the internationalisation of the Australian economy is dependent on the competitiveness of Australian companies and the Australian financial services market. Accounting standards play a key role in enhancing competitiveness. Accordingly, Australia needs to have in place an accounting standard setting regime that clearly facilitates access by companies to capital, both domestically and overseas.

Three approaches to the setting of Australian accounting standards are generally suggested. They are to:

- maintain quality Australian accounting standards and continue to develop distinctly Australian standards;
- adopt IASC standards or generally accepted accounting principles (GAAP) applying in the US capital markets; or
- harmonise Australian standards with IASC standards.

5.4.1 Adopt Distinctly Australian Accounting Standards

The great majority of Australian companies do not seek to directly raise foreign capital and would conceivably be content with a standard setting regime focussed purely on domestic needs. However, a policy of developing domestic standards without regard to international developments could act as a barrier to timely improvements in the quality of financial reporting and adversely impact on the efficiency of the Australian capital market by comparison with foreign capital markets. This could potentially disadvantage all Australian companies seeking to raise capital, whether at home or abroad.

There is no benefit in Australia having unique domestic accounting standards which, because of their unfamiliarity, would not be understood by the rest of the world. Even if these standards were considered to represent best practice, Australia would not necessarily be able to attract capital because foreign corporations and investors would not be able to make sensible assessments, especially on a comparative basis, of the value of Australian enterprises.

The need for a common accounting language to facilitate investor evaluation of domestic and foreign corporations and to avoid potentially costly accounting conversions by foreign listed companies are powerful arguments against the retention of purely domestic financial reporting regimes.

In addition, the production of distinctly Australian standards from scratch would be a relatively costly exercise which would not take advantage of work already undertaken internationally.

5.5 Adopt US GAAP or International Standards

The adoption of US GAAP or the outright adoption of IASC standards have been suggested as alternatives to harmonising Australian accounting standards with IASC standards. While each approach may have merit, they need to be critically examined having regard to the domestic and international requirements of Australian business and investors.

5.5.1 Adopt US GAAP

The US capital market is the single largest and most liquid capital market in the world. The adoption of US accounting standards could offer significant savings to Australian companies already listed, or seeking to list, on US stock exchanges and could facilitate comparisons made by Australian investors of Australian and US companies. It may also attract US listed companies to seek listings in Australia.

Currently, foreign companies seeking to raise capital in the US are required to provide accounting information and financial statements that have been prepared in accordance with, based on or reconciled with US GAAP. It is, however, noted that the SEC has approved the use of a limited number of IASC standards, without reconciling to US GAAP, for foreign issuers.

While the number of Australian and other foreign companies reconciling their accounts with US GAAP seem to make it the prime candidate with which to reconcile Australian accounting standards, it is important to understand that the extensive body of financial reporting requirements comprising US GAAP has been developed in the context of the US legal environment. As such, they can be difficult to interpret for someone unfamiliar with that environment, and, moreover, they may be incompatible with other legal environments. They also rely heavily on a strong enforcement regime provided by the SEC. In addition, and perhaps more importantly, the adoption of US GAAP would subject Australian companies to accounting rules over which they effectively had no influence.

It is notable that no other country is specifically adopting US GAAP in relation to its financial reporting requirements. This is not to say that US GAAP should necessarily be ignored in the development of Australian accounting standards. Rather, as noted under Part 5.4.1, it is essential that Australian accounting standards reflect the latest international developments in financial reporting. It is likely that many such developments will emanate from the US.

5.5.2 Adopt IASC Standards

If a single set of internationally accepted accounting standards was to be adopted by major capital markets, there would be no reason for Australia not to similarly adopt the international standards for cross-border capital raising and domestic reporting purposes. There are, however, considerable differences in accounting practices throughout the world and no single set of internationally accepted accounting standards currently exists. The development and acceptance of internationally accepted accounting standards is therefore an outcome which Australia should be actively pursuing and supporting. In this regard, Australian support for the work of the IASC and IOSCO and its involvement with the G4 + 1, together with the support of US authorities in the development of international standards to facilitate cross-border capital raising and company listings, will accelerate the possibility of adopting an internationally acceptable set of accounting standards in the future.

The development of a high quality set of IASC standards, and their adoption by major capital markets, offers the best prospect for the establishment of globally accepted accounting standards. However, at this point in time IASC standards are not of a quality and level of international acceptance whereby Australia can simply adopt them. Whilst IASC standards are moving in the right direction and will no doubt in time reach a level of acceptance in key capital markets, Australia needs to ensure that it does not commit itself irrevocably to IASC standards until there is some certainty that they will become internationally acceptable.

5.5.3 Harmonisation with IASC standards

The AASB and the PSASB have embarked on a significant project of harmonisation of Australian standards with IASC standards and have issued a formal statement on their international harmonisation policy objectives and strategies (Policy Statement 6 — ‘International Harmonisation Policy’). This policy confirms as the ultimate goal the establishment of a single set of internationally accepted accounting standards and the more immediate objective of ensuring that compliance with Australian accounting standards results in compliance with IASC standards.

The recent Financial System Inquiry Report to the Government (March 1997) reaffirmed the need for the AASB to, where practicable, harmonise Australia's accounting standards with international standards (Recommendation 12 of Financial System Inquiry Report).

In addition, the ASX has indicated its support for international harmonisation by contributing financially to the development of international accounting standards in the form of donations to the IASC, and has secured the agreement of companies listed on the Exchange to contribute $1 million over two years to the harmonisation of Australian standards with IASC standards by Australian standard setters. That contribution is being met by a 3 per cent levy on listing fees for two years.

It is in Australia's best interests to harmonise Australian standards with IASC standards with a view to adopting them when they have been accepted for reporting purposes in the major capital markets. This approach clearly has the best prospects for enhancing the competitiveness of Australian companies without leading to a diminution in the standard of financial reporting that currently exists in Australia.

Accordingly, in the immediate future, Australia's accounting standards should continue to be harmonised with those of the IASC so that Australian bodies required to produce financial statements will also be complying with IASC standards. Where there are significant differences between an Australian standard and the corresponding IASC standard, overseas standard setters should be entreated to work towards the development of an acceptable standard which maintains the integrity of financial disclosure and the corresponding benefits to users of financial statements.

It is hoped that by 31 December 1998, the IASC will have completed the review of its standards to be used for the purposes of cross-border listings and capital raisings and that the standards will have gained the endorsement of IOSCO. With this in mind, it would be desirable for the Australian standard setting body to begin issuing IASC exposure drafts and standards as its own from 1 January 1999. While Australia would maintain its existing set of harmonised standards as the basis for financial reporting, it is envisaged that any exposure drafts of proposed new IASC standards issued after 1 January 1999, would be released in Australia for public comment largely unchanged. Similarly, any new standards issued by the IASC after 1 January 1999 would be released as Australian standards with only modifications to ensure that they did not conflict with our law and to ensure that any definitions and cross-references relied upon were consistent with the existing body of Australian standards.

After 1 January 1999, the Australian standard setting body would clearly still need to issue domestic exposure drafts and standards on topics not being covered by the IASC. Such standards could be expected to deal with public sector specific issues (which are not dealt with by the IASC) and specialised sectors (for example, extractive industries and public utilities). It would be desirable for the Australian standard setting body, when seeking to develop a standard not already being covered by the IASC, to offer to develop the standard on behalf of the IASC.

To assist in determining the feasibility and desirability of Australia's move to adoption of IASC standards after 1 January 1999, the proposed FRC (see Part 6) should report to the Government by 30 November 1998 on progress made by the IASC towards completion of its core set of standards and the likelihood of approval of those standards by IOSCO by 31 December 1998.

The Australian standard setting body should adopt IASC standards from 1 January 1999, as mentioned above, unless the Government, following advice from the FRC, determines that this would not be in Australia's best interests.

On an ongoing basis, it would be desirable for the FRC to oversee Australia's move to international standards and ensure that Australia's standard setting body is committed to, and works towards, adoption of IASC standards having regard to what is taking place in the major capital raising economies.

5.5.4 Australian Involvement on the IASC

Australia should employ its expertise in standard setting to actively participate in IASC standard setting and influence the development of international accounting standards. In doing this, Australia can enhance the quality and comparability of financial information in a competitive international market which should lead to reduced costs and enhanced efficiencies for Australian companies operating internationally.

The IASC is an independent private sector body, with the objective of formulating and publishing private sector accounting standards which have worldwide acceptance and observance. The business of the IASC is conducted by a board comprising representatives of accountancy bodies in 13 countries and other organisations with an interest in financial reporting.

Much of the detailed work of the IASC is delegated to project steering committees set up by the IASC Board. Steering committees are responsible for preparing draft statements of principles, exposure drafts and proposed international accounting standards, which are reviewed by the IASC Board for approval to issue.

Australia is one of 16 members of the IASC and is represented by two members of the accounting profession (one of whom is also currently a member of the AASB). Each country may nominate up to two representatives and a technical adviser, who invariably are drawn from the private sector accounting profession, to attend IASC Board meetings.

The IASC is currently considering a restructuring of its operations and committees. This provides an ideal opportunity for Australia to pursue reform of IASC processes by encouraging the IASC to require nominees for appointment to the IASC Board to be drawn from members of national accounting standard setting bodies, rather than private sector professional accounting bodies. As well as facilitating the more rapid acceptance of IASC standards internationally, this should also assist in enhancing the credibility of international standards.

Proposal No. 2 — Harmonisation with International Standards

- The ultimate objective for the setting of accounting standards in Australia should be the production of high quality accounting standards that facilitate Australian business by leading to lower costs of capital and enabling Australian companies to compete on an equal footing overseas, while also maintaining investor confidence.

- In the immediate future, Australia should continue to harmonise its standards with IASC standards so that compliance with Australian standards will automatically result in compliance with IASC Standards — this should not lead to a diminution in quality of Australian standards, but rather make Australian standards more internationally recognisable, so that Australia’s capital market is not out of step with major overseas capital markets.

- The prime focus of the proposed AASC should be to influence the development of high quality and relevant IASC accounting standards with the objective that these will be adopted internationally for domestic purposes, especially within the major economies where capital raising takes place.

Continued

- A key role of the proposed FRC should be to ensure that the AASC is committed to, and works towards, adoption of IASC standards having regard to what is taking place in the major capital raising economies.
- The FRC should report to the Government by 30 November 1998 on progress made by the IASC towards completion of the core set of standards and the likelihood of endorsement of those standards by IOSCO by 31 December 1998.
- From 1 January 1999, the AASC should issue identical exposure drafts of standards for public comment to those issued by the IASC with the objective that final standards issued by the AASC would be consistent with Australian law and be the same as those issued by the IASC, unless the Government, upon advice from the FRC, determines that to do so would not be in Australia's best interests.
- Australia should encourage the IASC in its proposed restructuring to ensure greater representation on its constituent bodies by national standard setting bodies.

PART 6: INSTITUTIONAL ARRANGEMENTS FOR STANDARD SETTING IN AUSTRALIA

The revised institutional arrangements that are established for the making of accounting standards in Australia must be capable of ensuring that the objectives of accounting standards as outlined in Parts 4 and 5 of this paper are met. The arrangements must also ensure the independence and transparency of the standard setting process, while enabling stakeholder involvement to facilitate ownership of outcomes.

6.1 EXISTING ARRANGEMENTS

An outline of the current arrangements for the making of accounting standards in Australia is at Appendix B.

In summary, the AASB is a statutory body with the power to make accounting standards for the purposes of Parts 3.6 and 3.7 of the Corporations Law ('the Law') which establish the financial reporting and auditing obligations of entities that are required to lodge financial statements under the Law.

The AASB also assists with the development of accounting standards for non-corporate bodies and works closely with the PSASB on the development of standards for use by public sector non-Corporations Law bodies.

There are currently 10 part-time members of the AASB, including a part-time Director, who have been appointed for three year terms. Appointments to the AASB are made by the Treasurer who may appoint who ever they choose provided they are satisfied that the person is qualified for appointment by virtue of their knowledge of, or experience in, accounting, law or business. However, prior to making appointments to the AASB, it has been the practice of the Government to invite a range of interest groups to submit names of suitable individuals. Appointments have usually, but not always, been made from nominations received. The groups which have provided nominations have included the ASCPA, ICAA, Accounting Association of Australia and New Zealand, ASX, Business Council of Australia and Group of 100.

The arrangements regarding public sector standard setting are discussed in Part 9.

The AASB and PSASB are serviced in terms of administrative and research support by the Australian Accounting Research Foundation (AARF), which is a body established and funded primarily by the ASCPA and ICAA.

Apart from the question of unclear and narrowly based funding, criticisms of the existing institutional arrangements for accounting standard setting have centred around the lack of broad stakeholder involvement and the need for an independent research capability.

6.2 WHO SHOULD SET ACCOUNTING STANDARDS?

There is strong support from users and preparers of financial statements for Australia to continue to have a domestic standard setting body whose primary functions are to improve the quality of financial reporting in Australia and influence the development of international accounting standards.

Having a domestic standard setting body assists in maintaining an awareness in the business and investment community of the importance of accounting standards to stability and growth of the financial system. It also assists in promoting a culture of compliance with accounting standards. There are, however, a range of options on how accounting standard setting could be undertaken in Australia. The principal options are for:

(i) standard setting to be returned to the accounting profession to be undertaken on a self-regulatory basis;

(ii) the Government to take greater control of the process and make accounting standards by way of regulation; or

(iii) greater stakeholder involvement in standard setting and the adoption of a structure for accounting standard setting similar to the US and UK systems.

Option (i) would be considered to be backward-looking. The devolution of responsibility for accounting standard setting solely to the accounting profession does not sit well with accounting standards having legal recognition and therefore being seen to be made by an independent body. On the other hand, providing complete government control over the making of accounting standards under option (ii) would not address calls for greater stakeholder involvement.

In relation to option (iii), Appendix A outlines the standard setting regimes in the US and UK. The common features of these regimes which could provide a useful model for the restructuring of Australian accounting standard setting arrangements include:

- a peak body or council consisting of groups with an interest in financial reporting. The peak body has oversight of the administrative arrangements for the standard setting body and provides guidance and strategic direction to the body in terms of its work plans, priorities and general policies that it should be pursuing; and
- a small, independent standard setting body (seven members in the US and nine members in the UK) consisting of persons appointed by the peak body on the basis of merit. The members of the body do not represent particular constituencies once they have been appointed and the accounting standards that the body makes are not subject to review or veto by the peak body.

6.2.1 Advisory Group

The formation of an advisory group to oversee the accounting standard setting process in Australia has considerable merit. It has the advantage of actively involving in the standard setting process the principal parties with an interest in financial reporting without leading to a capture of the process or outcomes by particular stakeholders.

Ideally, the advisory group, which should be entitled the Financial Reporting Council (FRC), should consist of organisations from the following key interest groups:

- users / analysts of financial statements;
- preparers of financial statements;
- governments / the public sector (see Part 9);
- the professional accounting bodies; and
- the ASX and ASC.

By having a broad representation of stakeholders on the FRC, which would have oversight but not day-to-day control of the standard setting body, actual or perceived capture of the accounting standard setting process by particular interest groups can be avoided. In addition, outcomes of the standard setting process should be more acceptable even if not all interests agree with the outcomes all of the time.

The FRC should be established under a charter setting out its role and functions in the oversight of an Australian accounting standard setting regime.

It is envisaged that, in addition to overseeing the move towards international standards (see Part 5) by the standard setter, the specific role or functions of the FRC with respect to the standard setting body would be to:

- appoint members of the standard setting body (the AASC), except the Chairman (see Part 6.2.2);
- approve the priorities and business plan of the AASC and monitor compliance with them;
- oversee the provision of administrative and research support for the AASC;
- set broad strategic directions and provide feedback to the AASC on the general policies it should be pursuing, including advice in broad terms on issues of public concern or controversy;
- make recommendations about, and oversee, the consultative arrangements of the AASC;
- oversee the funding arrangements of the AASC (see Part 7) and approve its budget; and
- review the performance of the AASC and UIG and provide a public report annually on the operation of the FRC, AASC and UIG.

The FRC would not, however, have any power or authority to determine, change or veto particular standards made by the AASC, although it could offer views or feedback regarding the appropriateness of any proposed standard. The FRC could also establish broad policy directions in relation to standards, such as in relation to the timing of adoption of IASC standards, but could not determine policy in relation to a particular standard.

The Treasurer should determine which groups with an interest in financial reporting should be members of the FRC. It would then be a matter for each group on the FRC to nominate their representative to sit on the Council, with the Treasurer making the formal appointment of the representative to the FRC. Desirably, representatives would be appointed at a very senior level. The Treasurer would appoint the Chairman of the FRC and the FRC itself would appoint a Deputy Chairman.

The FRC should determine how often it should meet and how it should conduct its business.

6.2.2 The Standard Setting Body

The AASC should be established to replace the existing AASB.

The function of the AASC should be to prepare, approve and issue accounting standards for both private and public sector entities required to prepare financial statements in accordance with accounting standards. The legal effect of the accounting standards made by the AASC is discussed in Part 8. The desirability of the AASC having responsibility for developing public sector specific standards is discussed in Part 9.

The new body should not only be set up under legislation, but should have the powers of a body corporate to enable it to more efficiently exploit publication revenues, to engage staff on a contractual basis and to otherwise conduct its business in an efficient and flexible manner.

As with the existing AASB, the new AASC should be completely independent in terms of determining the specific content of the standards it issues. This is essential to maintain the credibility of accounting standards and to avoid the development of standards becoming akin to an auction process where the lowest common denominator of what is acceptable to particular affected interests prevails.

Recognising that one of the key roles of the AASC should be to involve itself in, and influence the development of, international accounting standards acceptable for adoption in Australia, the size of the AASC should be kept to a minimum. As the need to develop ‘home grown’ standards from scratch should diminish in light of moves to IASC standards, the AASC should be able to operate effectively with a small membership. However, it is envisaged that, at least initially until IASC standards are capable of outright adoption in Australia, the AASC would need a maximum of six part-time members, a part-time Deputy Chairman and a full-time Chairman. This approximates the number of members on the US Financial Accounting Standards Board (FASB), although it is noted that the members of the FASB are all full-time.

An initial membership of eight would ensure that the AASC could operate effectively, responsively and flexibly while at the same time enabling a sufficiently broad range of backgrounds and experience to be brought to the process. Members should be appointed for three year terms by the FRC, with the Chairman appointed by the Treasurer. While it would be expected that the members would be broadly representative of the various stakeholders’ interests in financial reporting, to avoid capture by any one interest, they should be appointed on the basis of merit, in particular, their experience in, or knowledge of, accounting, finance, business or government. To reinforce the link between the AASC and the IASC, one of the Australian members of the IASC Board should be a member of the AASC.

To attract the best quality of person to sit on the AASC, it would be preferable for them to be remunerated as far as possible in accordance with market rates.

The question of the amount of remuneration and other issues regarding the exact size and make-up of the AASC should be left for determination by the FRC, having regard to the overall budget of the AASC.

6.2.3 Consultative Processes

The AASB and the PSASB currently have dedicated consultative groups with which they meet twice each year to discuss work programs of the boards and issues of particular concern to group members. The consultative groups have very broad interests in financial reporting.

Although the consultative group mechanism has proved useful in updating members on progress regarding the boards' work programs, it has not always proved as useful in the sense of addressing concerns of group members with the content of particular standards.

Accordingly, with the establishment of the new FRC, which would largely mirror the consultative groups in terms of membership, it would seem desirable to disband the two consultative groups and establish a more efficient mechanism to promote the exchange of information between the AASC and affected stakeholders. This could be done by the AASC making greater use of existing Project Advisory Panels (PAP) of experts on particular subjects upon which a standard is being developed. Desirably, at least two members of the AASC should work closely with PAP during the early stages of development of a standard, before detailed consideration of the standard by the AASC.

Other consultative processes adopted by the existing AASB, such as the publication of discussion papers and extensive exposure of draft standards for public comment, should be continued by the proposed AASC. Consultation with PAP should be continuous throughout the development of a standard.

Ultimately, it should be a matter for the FRC to determine whether particular consultation arrangements put in place by the AASC are working satisfactorily or should be revised.

6.2.4 Urgent Issues Group

The UIG was established in 1995 to address the need for urgent financial reporting issues to be resolved quickly. The UIG effectively complements the work of the standard setting body and can act in a timely fashion to resolve questions of interpretation of standards and provide some certainty where controversy arises in relation to a particular financial reporting issue.

As the UIG has been working very effectively to date, it would be desirable to continue its operations. This could be done by integrating it into the proposed new structure for accounting standard setting. In this regard, it is proposed that the UIG share a common chairman with the AASC and that its other members, who would not need to be members of the AASC, be appointed by the FRC. However, the pronouncements of the UIG should be formally approved by the AASC before they have any effect. In all other respects, the existing charter of the UIG should remain in effect.

6.2.5 Meeting Procedures

As in the US, meetings of the AASC and the UIG should be in public. Whilst this may impose some constraints on members, it has the advantage of assisting the perception of independence and helps affected persons who are not directly involved in the standard setting process to understand the rationale for particular standards.

Voting procedures for the AASC should be by way of simple majority which has worked effectively in the past. The Chairman should desirably have a casting vote.

A diagram of the structure for the proposed new Australian standard setting regime is at Appendix C.

Proposal No. 3 — Institutional Arrangements

Advisory Group

- To facilitate greater stakeholder involvement in the standard setting process, an advisory group, entitled 'the Financial Reporting Council' (FRC), should be established with responsibility to provide broad oversight of the process and maintain the momentum towards the development and adoption of internationally accepted standards.
- Membership of the FRC should be representative of the following key interest groups who should have the authority to nominate their representatives on the FRC:
  - users / analysts of financial statements;
  - preparers of financial statements;

Continued

- governments / public sector;
- the professional accounting bodies; and
- the ASX and ASC.

- The Treasurer should identify bodies to be represented on the FRC and appoint persons to sit on the FRC from nominated representatives.
- The Treasurer should appoint the Chairman of the FRC, with the Deputy Chairman being appointed by the FRC itself.
- Under a charter, the FRC should:
  - appoint the members (other than the Chairman) of the AASC, which will replace the AASB;
  - approve the priorities and business plan of the AASC and monitor compliance with them;
  - oversee the provision of administrative and research / technical support for the AASC;
  - set broad strategic direction and provide feedback to the AASC on the general policies it should be pursuing, including advice in broad terms on issues of public concern or controversy;
  - make recommendations about, and oversee, the consultative arrangements of the AASC;
  - oversee the funding arrangements of the AASC and approve its budget; and
  - review the performance of the AASC and UIG and provide a public report annually on the operation of the FRC, AASC and UIG.

New Standard Setting Body

- The AASC should be established under legislation and have the powers of a body corporate.
- The functions of the AASC should be to prepare, approve and issue accounting standards for private and public sector entities required to prepare financial statements in accordance with accounting standards.

Continued

- The FRC should determine the precise size and make-up of the AASC in light of moves to harmonise and eventually adopt IASC standards.
- Members of the AASC should be appointed on the basis of ability, in particular, their experience in, or knowledge of, accounting, finance, business or government. Members should not sit on the AASC as representatives of any particular constituency to ensure the AASC's independence.
- Initially, and subject to the views of the FRC, the AASC would desirably consist of six part-time members, together with a part-time Deputy Chairman and full-time Chairman (eight in total). The Chairman should be appointed by the Treasurer with the remaining members appointed by the FRC.
- The terms of appointment of the members, Deputy Chairman and Chairman of the AASC should be three years.
- Project Advisory Panels of experts on particular subjects being considered by the AASC should be used as sounding boards from the early stages and throughout the development of particular standards to facilitate stakeholder involvement in the making of accounting standards.
- The UIG should continue its present functions, but with a revised structure so that it shares a common chairman with the AASC and reports directly to the AASC in relation to its decisions. Members of the UIG should be appointed by the FRC.
- Meetings of the AASC and UIG should be held in public. Voting in the AASC should be by way of a simple majority and the existing voting procedures for the UIG should be retained.

6.3 SECRETARIAT AND RESEARCH SUPPORT

The AASB and PSASB currently receive their secretariat and research / technical support from the AARF.

The AARF was formed in 1966 as a joint venture between the ASCPA and ICAA.

The AARF comprises an Executive Director and about 30 other staff members, roughly two thirds of whom are devoted to the work of the AASB and the

PSASB. The remaining staff service the ICAA and ASCPA's private sector Auditing Standards Board (AuSB) and Legislation Review Board (LRB).

The service support provided by the AARF includes:

- investigating and researching into relevant accounting topics;
- providing advice on matters relating to local and overseas financial reporting developments;
- conducting seminars and other presentations on current and emerging issues;
- collating and analysing comments from interested parties on financial reporting;
- liaising with professional bodies, the ASC, the Commonwealth Treasury and overseas standards setters;
- providing support for the international harmonisation initiatives;
- preparing draft papers for consideration by AASB and PSASB members;
- providing administrative and organisational support to the AASB and PSASB; and
- providing subscription services to enable interested parties to keep up-to-date with accounting issues.

Over the years, the AARF has evolved into a highly regarded technical and research organisation which is on a par with those existing in leading overseas accounting standard setting jurisdictions (for example, in the US, UK and Canada).

In contrast with the position in most overseas jurisdictions with standard setters, the AARF itself is not directly accountable to the boards it services, but to the professional accounting bodies. This has led to the perception in some quarters that the accounting profession may be in a somewhat privileged position in terms of potentially influencing the outcome of standard setting. Whether this influence is actual or perceived, it is important for the credibility of the standard setting process that it is seen to be in fact independent and not subject to undue influence by any one group of interests.

Accordingly, it is proposed that the AASC engage its own staff for research, drafting of standards, liaison and administration. This may involve the transfer of part of the AARF from the accounting bodies' infrastructure, or the engagement of AARF on contract, and would need the cooperation of the accounting bodies who clearly, and to their credit, have contributed generously and somewhat disproportionately to the support framework for accounting standard setting to date.

While there is a clear need for there to be a full-time dedicated research and secretariat facility (including a full-time Secretary / Director to head it) for the standard setting process to ensure consistency and high quality of output, the question arises whether in some areas of the AASC's activities, research and technical support could be tendered out / out sourced.

It would be important in setting up the arrangements for the provision of support services to the AASC that Australia's potential to influence international accounting standards was not diminished in any way, particularly through any lack of continuity. However, the support infrastructure for the standard setting process should be flexible and enable outside providers to be contracted directly by the AASC to undertake specific research / technical projects. This could be done alongside existing arrangements for the secondment of particular experts to the Secretariat for discrete periods of time.

To ensure the ongoing appropriateness and efficiency of the arrangements for secretariat and research support for the AASC, these arrangements should be approved and reviewed by the FRC.

Secretariat support for the FRC should be provided by the Commonwealth Treasury. This would involve the preparation of agenda, minutes and background papers for meetings of the FRC. The administrative support for the FRC in terms of handling the arrangements for meetings of the FRC should be undertaken by the AASC's Secretariat.

Proposal No. 4 — Secretariat and Research Support

- A dedicated full-time secretariat, engaged by, and directly accountable to, the AASC should be established to provide core administrative and research support.
- The specific arrangements regarding secretariat and research support for the AASC should be determined and re-assessed periodically by the FRC, particularly in light of Australia's move towards adoption of IASC standards.

Continued

- The AASC should have a dedicated Secretary / Director who would be directly responsible for the provision of the administrative support to the FRC and AASC. The Secretary / Director would also oversee the provision of research / technical support to the AASC, the UIG and any other subcommittees or consultative groups established in respect of particular projects.
- The AASC should have the flexibility to augment this support by contracting with outside providers as appropriate.

PART 7: FUNDING OF THE ACCOUNTING STANDARD SETTING ARRANGEMENTS

The proposed new accounting standard setting framework will provide for the making of accounting standards that apply to companies incorporated under the Corporations Law and other bodies regulated under State and Territory laws. For the purpose of estimating current costs and revenue needs, it is therefore necessary to take into account the revenues and costs of the AASB, PSASB, UIG and AARF.

Concerns in relation to the existing arrangements for the funding of the accounting standard setting process are that they are uncertain and are not conducive to a sharing of the costs by all beneficiaries of accounting standards. Accordingly, it is important that any revised arrangements for standard setting provide security and equity in relation to the ongoing funding of the process.

7.1 CURRENT AASB FUNDING ARRANGEMENTS

The activities of the AASB are funded primarily by Commonwealth Government appropriations administered by the ASC.

AASB operating costs for the year ended 30 June 1997 totalled $1,312,000. Those costs comprised the Chairman's remuneration, members' sitting fees, accommodation, travel and meeting costs, costs involved with international liaison and the cost of AARF services. The ASC pays the Chairman's remuneration and members' sitting fees directly to them. The AASB's other costs are administered by AARF.

Parliamentary appropriations for the year ended 30 June 1997 totalled $885,000. During that year, AARF contributed $177,000 to supplement the Parliamentary appropriations, while the ASX (as part of the international harmonisation program) contributed $250,000.

7.2 CURRENT AARF FUNDING ARRANGEMENTS

Funding for the AARF comes primarily from the following sources:

- the ASCPA and ICAA;
- the Commonwealth Treasury;
- the Commonwealth Department of Finance and State and Territory equivalents; and
- the sale of publications.

Those revenues are applied to undertaking work in relation to the AASB, PSASB, AuSB, LRB, Financial Board of Management (FBM), and UIG.

For the 1996 calendar year, contributions to the funding of accounting research and standard setting activities (that is, AASB, PSASB, AUSB, LRB, FBM and UIG), as a percentage of the total funding for these activities were approximately:

- ASCPA and ICAA: 52 per cent;
- publications: 15 per cent;
- government: 26 per cent; and
- ASX and other: 7 per cent.

In the 1996 calendar year, the total funding for accounting research and standard setting activities was $3.7 million, of which approximately $2.6 million was expended on functional activities that are components of the proposed new standard setting framework:

- AASB: $1.4 million;
- PSASB: $0.8 million;
- UIG: $0.3 million; and
- AARF management: $0.1 million.

7.3 FUNDING OF COMPARABLE OVERSEAS REGIMES (US AND UK)

The US and UK standard setting regimes offer possible models for the funding of standard setting arrangements. Each is based on the principle that the process of standard setting should be funded by parties with an interest in financial reporting.

7.3.1 Funding of the US Financial Accounting Standards Board (FASB)

The US Financial Accounting Foundation (FAF) manages the funding for the FASB and the US Government Accounting Standards Board (GASB). The main sources of funding are donations and publications sales. In the 1995 calendar year, donations were approximately US$8.5 million while publications raised US$13 million. More than half of the funds contributed were from the public accounting profession, with the remainder coming from industry and the financial community. The donations source profile (approximate percentages based on the 1994 and 1995 FAF annual reports) is:

- accounting profession: 50 per cent;
- industry: 30 per cent;
- government and government-related organisations: 15 per cent: and
- banks and investment firms: 5 per cent.

7.3.2 Funding of the UK Accounting Standards Board (ASB) and Financial Reporting Review Panel

The UK Financial Reporting Council manages the funding of the ASB and the Financial Reporting Review Panel. For the year to March 1996, the UK Financial Reporting Council's funding was approximately £2.2 million, which included £300,000 of revenue from the sale of publications. The first three years of funding came equally from the accounting profession, government, and business and industry.

7.4 Proposed Funding Arrangements For Australian Accounting Standard Setting

To maintain investor confidence in Australia's financial reporting framework, it is important that Australia continues to support a domestic standard setter that is sufficiently resourced to not only develop high quality domestic standards where necessary, but in particular, to provide high level input into the development of international standards and to positively influence the adoption of those standards in major overseas capital markets.

In its move towards international standards, it is important that Australia devote significant resources to standard setting so that we can maintain our influence on the world scene and our contribution to the quality of standards being adopted.

To facilitate achievement of the objectives of standard setting outlined earlier in this paper, it is envisaged that funding of approximately $10 million over the next three years would be needed.

Under the new arrangements, the AuSB and LRB would be separately funded and run by the ASCPA and ICAA as they considered appropriate.

Ideally, funding for accounting standard setting should be broadly based and emanate largely from stakeholder organisations, namely:

- the business sector, as preparers and users of financial reports;
- the accounting profession and analysts — the professional accounting bodies, particularly because of their direct and continuing interest in accounting standards in relation to their members' obligations as a profession; and
- the public sector and regulators — both on public interest grounds and as preparers and users of financial reports.

Broadly based funding requires the financial commitment of stakeholders in the standard setting regime and provides incentives for greater efficiencies. Additionally, it tests stakeholder commitment to an Australian accounting standard setting regime.

The FRC, like the UK Financial Reporting Council, is to be a representative body the membership of which will include bodies concerned with accounting standards — professional accounting bodies, government, market providers, preparers and users / analysts.

A function of the FRC should therefore be to oversee funding arrangements for the operation of the accounting standard setting regime, and approve the budget of the AASC.

To provide ongoing certainty regarding funding of standard setting, the FRC should secure funding agreements with the various stakeholder organisations, including government, for three year periods. This approach would not preclude additional specific purpose funding such as that currently provided by the ASX.

Additional funding for standard setting could be generated through sales of publications for which the AASC would hold the Australian copyright or have distribution rights. The expenditure of funds generated by sales of publications should also be subject to the approval of the FRC.

Proposal No. 5 — Funding

- In recognition of the importance to Australia of having high quality accounting standards that are recognised internationally, the Government is committed to ensuring that the proposed AASC is adequately funded. This will enable the AASC to provide high level input to the development of IASC standards, and domestic standards where necessary, and to promote acceptance of those standards in major overseas capital markets.
- To provide ongoing certainty regarding funding of the accounting standard setting process, increased stakeholder commitment to it and a greater spreading of the cost burden amongst beneficiaries, funding totalling approximately $10 million over the next three years should be provided by government and the private sector.
- The total amount of funding that should be allocated to accounting standard setting should be periodically reviewed by the FRC.

PART 8: COMPLIANCE WITH ACCOUNTING STANDARDS

8.1 LEGAL BACKING

Entities regulated under the Corporations Law must comply with AASB standards where they are required to prepare and lodge financial statements under Parts 3.6 and 3.7 of the Law with the ASC. Accounting standards have legal backing in respect of their application to Corporations Law entities and are disallowable instruments for the purposes of section 46A of the *Acts Interpretation Act 1901*.[1]

Prior to 1991, an option existed for entities regulated under the former co-operative companies and securities scheme not to apply an accounting standard in the preparation of financial statements if, in the opinion of the directors, its use would not give a true and fair view of the results and position of the entity.

This option effectively made compliance with accounting standards optional and was removed by legislation in 1991.[2] Following this change, a company's directors were required to ensure that the company's financial statements were made out in accordance with applicable accounting standards.[3] The Corporations Law was also amended to provide that where the company's financial statement would not provide a true and fair view, the directors must add such information and explanations as would give a true and fair view.[4]

These amendments to the Corporations Law were necessary as a result of extensive non-compliance with accounting standards. The true and fair override made it very difficult for the regulator to supervise compliance. Additionally, the true and fair override allowed the possibility for directors to apply pressure on auditors to use their discretion to depart from accounting standards where this would lead to the presentation of an enhanced picture of

---

1 *Corporations Act 1989*, subsection 32(2).
2 *Corporations Legislation Amendment Act 1991*, Schedule 3 (effective 1 August 1991).
3 Corporations Law, section 298.
4 Corporations Law, section 299.

the financial position of the entity. The flexibility which the true and fair override allowed also potentially compromised the comparability of financial statements.

It is noted that the IASC has very recently decided to adopt a true and fair override in its standard on the presentation of financial statements. This would be contrary to our Law and would therefore have no legal effect if the standard were adopted in Australia.

Given that the operation of the true and fair override is central to the issue of mandatory compliance with accounting standards, and goes beyond issues of content and presentation of financial reports, it is not considered appropriate for the override to be dealt with in accounting standards.

In light of the above, it is not proposed to amend the Law to reintroduce the true and fair override in Australia.

While not all comparative overseas jurisdictions have the same legislative underpinning as Australian accounting standards, other commercial, legal and cultural imperatives operate in those jurisdictions which mitigate the need to prescribe strict compliance with accounting standards. In this regard, it is noted that in the UK, the Financial Reporting Review Panel has a strong and effective mandate to supervise compliance, and in the US, accounting standards effectively have legal backing through the SEC.

One of the clear advantages of the legal backing of accounting standards in the Corporations Law is that enforcement can occur, not only through strict supervision by the ASC, but also by the companies' shareholders. That is, by requiring directors to strictly adhere to accounting standards in the Corporations Law, shareholders/companies have clear and more certain avenues of private enforcement.

It is considered that the requirement under the Corporations Law to comply with accounting standards should therefore be retained in its current form.

As a consequence of this legal requirement, accounting standards would be legislative instruments for the purposes of the Legislative Instruments Bill 1996, which is currently before the Federal Parliament. This Bill will require a standard to be tabled before both Houses of Parliament after it is made. In addition, if the scheme in the Bill is implemented, each standard would need to go through a rigorous consultation process and cost/benefit analysis. Such process and analysis would reinforce proposals in this paper, outlined in Part 4 — they would also not be inconsistent with the proposal to move towards adoption of IASC standards given that IASC exposure drafts would need to be subject to detailed consultation arrangements within Australia prior to their final adoption.

8.2 APPLICATION OF ACCOUNTING STANDARDS

As mentioned above, the Corporations Law specifies which bodies governed by it are required to prepare financial statements in accordance with accounting standards.

Similarly, other Commonwealth, State and Territory legislation governing the formation and/or regulation of incorporated and unincorporated bodies, public sector and non-profit entities determines the application of accounting standards to those entities. It is therefore not within the legal purview of the accounting standard setter to determine which bodies should comply with accounting standards, but rather what standards should apply to entities required by law to prepare financial statements.[5]

In the absence of a generic Financial Reporting Act as proposed in Part 10 of this paper, it is considered desirable that the determination of the specific types of entities that should be required to prepare financial statements in accordance with accounting standards should remain the responsibility of the respective Commonwealth, State and Territory legislatures.

By clarifying the mandate of the AASC in this fashion, constitutional issues regarding the power of the AASC to impose regulatory requirements on bodies not required by law to comply with them should be avoided. In particular, the AASC should be able to make standards in respect of corporate, non-corporate and public sector entities and non-profit organisations even though they are regulated at different levels of government.

The issue whether particular entities should be legally required to comply with accounting standards is a matter for the legislation governing those entities.

Should the accounting profession desire the application of accounting standards to go beyond those bodies required by legislation to comply with them, that is a matter for the ethical rulings of those bodies and nothing in the proposed new arrangements for accounting standard setting would affect this.

5 It is, however, noted that the ASCPA and ICAA have indirectly made all accounting standards enforceable by requiring their members to comply with accounting standards issued by the AASB and PSASB in respect of ‘reporting entities’.

8.3 ENFORCEMENT OF ACCOUNTING STANDARDS

Compliance with accounting standards is a key to investor confidence in the market. Having well formulated and rigorous accounting standards will not achieve investor confidence if compliance with them is not perceived, and seen, to be vigorously monitored and enforced.

More recently, concerns have been expressed to the Government that the ASC needs to continue to actively monitor compliance with accounting standards to ensure the integrity of financial reporting in Australia. The ASC and the accounting profession need to work in partnership and maintain a high profile role reviewing compliance with, and subsequent enforcement of, accounting standards where necessary. It is only in this manner that investor confidence and integrity in the Australian capital market can be maintained.

In addition to the central role needed to be undertaken by the ASC in promoting compliance with accounting standards, there is a role for the proposed FRC to monitor the application of accounting standards and ensure their continued relevance and usefulness. Standards which appear to be causing difficulties in their application, or which appear not to be meeting their objectives, should be referred back to the proposed AASC for revision or repeal, or for further consideration by the IASC where necessary.

Proposal No. 6 — Legal Backing

- The AASC should not make determinations regarding which types of entities should comply with accounting standards, this being a matter for the legislation governing those bodies or industries. However, this should not preclude the AASC from prescribing different standards for different entities as considered appropriate.
- The ASC should continue to monitor compliance with accounting standards and take appropriate enforcement action when necessary.
- At a more general level, the FRC should monitor the operation of accounting standards to assess their continued relevance and to determine whether they are still achieving their objectives.

PART 9: PUBLIC SECTOR ACCOUNTING

9.1 CURRENT ARRANGEMENTS

Accounting standards for use in the public sector are primarily the responsibility of the PSASB, which was established by the ASCPA (then known as the Australian Society of Accountants) and ICAA in October 1983 as a board of AARF.

The PSASB's main objective is to improve the quality of financial reporting by public sector entities in Australia. In pursuing this objective, the PSASB develops statements of accounting concepts and Australian accounting standards. The PSASB works closely with the AASB on the development of projects relevant to entities in the public and private sectors and seeks to ensure that the standards developed by both boards contain, as far as possible, identical requirements.

The PSASB comprises nine members — four nominated by the ASCPA, four by the ICAA and the Australian representative on the International Federation of Accountants' Public Sector Committee. The international committee representative is an *ex officio* voting member of the PSASB. The appointment of members to the PSASB is for an initial period of three years. Members are not remunerated, but costs associated with attending meetings are funded through AARF.

9.2 1992 REVIEW OF MERGER PROPOSAL

In 1990, the Board of Management of AARF released a report by Professor Graham Peirson that, among other things, advocated a merger of the predecessor to the AASB, the Accounting Standards Review Board (ASRB), and the PSASB.

Subsequently, during the second half of 1992, the then Commonwealth Attorney-General agreed to the establishment of a working party to further consider the desirability of a merger of the AASB and PSASB. The

Commonwealth, States and Northern Territory, the accounting bodies and a number of key interest groups were represented on the working party.

The draft report of the working party was released for public comment in September 1993. The report recommended that there be a merger of the AASB and the PSASB, subject to:

- the provision of adequate safeguards to protect the priorities of the public and private sectors;
- appropriate action being taken to enable the members of a merged board to cope with an increased workload; and
- the negotiation of satisfactory funding arrangements for a merged board.

In general, public submissions supported the merger of the two boards.

When working party members met to consider the submissions, it became apparent that there was a lack of agreement on a number of the issues that needed to be resolved to ensure the successful operation of a merged board. These issues included:

- the need to ensure that equitable funding arrangements were put in place for the merged board;
- the question whether standards made by a merged board should be automatically adopted by Commonwealth, State and Territory departments and authorities and other bodies incorporated under State and Territory laws; and
- the nature of the disallowance mechanism or mechanisms that should apply to new and amended standards.

In view of the lack of consensus on these issues, the merger proposal was not progressed at that time.

However, the revised institutional framework proposed in this paper for setting accounting standards may assist in resolving a number of these issues.

In particular, in relation to the need to ensure that equitable funding arrangements are in place, the proposals outlined in Part 7 of this paper for broadly based funding should address these concerns. In this regard, it is envisaged that there would be a significant public sector presence on the FRC which would settle the detail of the funding arrangements.

In relation to the issue of the application of accounting standards to public sector entities and other entities incorporated under Commonwealth, State and Territory laws, the proposals in this paper would not affect the ability of

Commonwealth, State and Territory governments to determine this. That is, the proposed AASC would only have power to determine the content, not the application, of accounting standards (although the content may vary between particular entities).

As it would continue to be up to each legislature to decide whether particular standards should have mandatory legal effect, the question of the need for a disallowance mechanism would be a matter for each legislature.

9.3 OPTIONS FOR MERGER

Four broad options have been identified for either merging the two boards or ensuring that their work is more closely coordinated:

- total merger of PSASB and AASB into the proposed AASC;
- retention of separate boards that have a joint chair;
- establishment of a subcommittee of the proposed AASC to deal with specific public sector issues; or
- leave the PSASB as it is.

The arguments in support of not merging the two boards include:

- the ability of each board to determine and pursue sector-specific priority projects without the need to balance the relative importance of each sector's projects, as would be the case with a merged board;
- the advantage of having a specialist board available to deal with the complex issues frequently associated with public sector-specific projects; and
- that harmonisation of Australia's accounting standards with IASC standards may result in Australia's public sector standards diverging from public sector standards used in other countries.

The disadvantages of continuing to have two boards include:

- the continuing inefficient use of technical and administrative resources, especially if the same body provides the support for both boards; and
- scope for equivalent private and public sector standards to ultimately diverge in terms of their requirements, especially if there is increased pressure for harmonisation of public sector standards with equivalent international public sector standards.

The principal case for a merger of the boards is that it would result in:

- facilitation and consolidation of the trend towards uniform accounting practices throughout the Australian economy; and
- a more efficient and effective use of standard-setting resources.

The potential disadvantages associated with a merger are:

- the risk that the priorities for either the private or the public sector may become overwhelmed by the priority allocated by a merged board to the needs of the other sector;
- the possibility that the additional work for members of a merged board, over and above the workload borne by members of the current separate boards, might be such that it would be difficult for part-time members to discharge their duties effectively; and
- the possibility that, except in the case of public sector-specific standards, international harmonisation of standards used in the public sector would not be able to be achieved because different international committees deal with public and private sector standards.

The 1992 working party identified a number of ways in which the disadvantages listed in the first two points above could either be overcome or their effects minimised. In particular, the working party considered that the interests of both sectors could be safeguarded through the establishment of broadly based consultative groups for each sector, by ensuring that the composition of a merged board was such that all interest groups were fairly represented and by the board undertaking other liaison activities. Problems relating to the workload of a merged board could be addressed by the appointment of a full-time chairman and the use of subcommittees to progress particular board projects.

Some of the measures considered by the working party, including the establishment of broadly based consultative groups and the use of subcommittees to progress particular board projects, have already been implemented by the existing boards. The need to further refine these initiatives, and other measures such as the need for a full-time chairman, are considered elsewhere in this paper.

It is noted that the financial reporting requirements of the public and private sectors are converging. In many jurisdictions, government business enterprises are being reorganised to operate along similar lines to equivalent private sector businesses and, as a consequence, to adopt private sector reporting requirements. New Zealand is among the leaders in this move towards common requirements, having enacted financial reporting legislation that sets out a disclosure framework to be used by both the public and private sectors.

Overall, a merger of the two boards would appear to ensure a more efficient use of the technical and administrative resources used by the boards on each project. This benefit would appear to be sufficiently great to outweigh any concerns that a merged board may favour one sector at the expense of the other.

While having separate boards with a joint chairman could be expected to ensure a high level of coordination between the work of the separate boards and to ensure that, on particular issues, the boards did not reach significantly different — and possibly irreconcilable — conclusions, there would not seem to be any real advantages in terms of efficiency in use of resources to be gained. The 1992 working party noted that a case could be made out for having a joint chair, but it was envisaged as an interim measure to facilitate the merger of the two boards rather than a permanent feature of the standard setting process.

In relation to the option of establishing a subcommittee of the proposed AASC to consider public sector-specific issues, this would not seem to be the optimal way to proceed as it implies that public sector issues are either secondary or special when in fact they are neither. Indeed, it could be argued that public sector issues are not very different from other sector specific issues such as banking, insurance and mining. The proposed new AASC should thus be well equipped to deal with public sector issues in the same way that it would be with any other sector-specific issues provided its membership is broadly based and expert in nature.

To promote greater alignment of public sector standards with private sector standards, it would be desirable for the FRC to examine ways of harmonising these standards.

9.4 Implementation Strategy

Given the particular interests of State and Territory governments in public sector accounting, any proposed merger of the PSASB with the proposed AASC would need to have their support to be effective.

Accordingly, it is proposed that, following consultation with State and Territory governments, the winding-up of the PSASB and its absorption within the proposed new accounting standard setting framework be undertaken in a staged manner. This would have the advantage of facilitating the early establishment of the proposed new arrangements.

Proposal No. 7 — Public Sector Accounting

- Subject to the agreement of the accounting bodies and State and Territory governments, the AASC should have responsibility for making accounting standards in respect of public sector, non-corporate and non-profit entities.
- Public sector interests should be represented on the FRC.
- Whilst members of the AASC should not necessarily be drawn from the public sector, at least some of the members on the AASC should have particular expertise in relation to the public sector.
- It should be left to each government (Commonwealth, State or Territory) to determine the legal effect of accounting standards made by the AASC in respect of public sector entities falling under their responsibility.
- The FRC should consider the desirability of retaining specific consultative arrangements for the AASC in respect of public sector issues.

PART 10: OTHER ISSUES

This part outlines a number of issues in relation to which the Government, the FRC and / or the AASC can be expected to become more actively involved over the next five to ten years. The principal issues are likely to be:

- further development of the conceptual framework for general purpose financial reporting;
- the desirability of a national or generic Financial Reporting Act;
- the adoption of market value accounting; and
- the introduction of risk accounting.

10.1 CONCEPTUAL FRAMEWORK

One of the existing functions of the AASB is the development of a conceptual framework, not having the force of an accounting standard, for the purpose of evaluating proposed accounting standards. This function has been undertaken by the AASB and its immediate predecessor, the ASRB, in consultation with the PSASB and AARF.

To date, four Statements of Accounting Concepts have been developed by the Boards and AARF:

- SAC 1 — *Definition of the reporting entity*;
- SAC 2 — *Objective of general purpose financial reporting*;
- SAC 3 — *Qualitative characteristics of financial information*; and
- SAC 4 — *Definition and recognition of the elements of financial statements.*

Much work remains to be done, with work on important areas such as the bases and techniques for the measurement of the elements of financial statements still awaiting completion. Other issues that require detailed consideration include the nature of the information that should be disclosed in general purpose financial reports and the policies that the standard setters should adopt in relation to the development, structure and application of accounting standards.

An outline of the work that has been undertaken, and the issues that are still awaiting attention, is set out in Policy Statement 5, *The Nature and Purpose of Statements of Accounting Concepts*, issued by the AASB and AARF in March 1995.

It would be desirable for the AASC to give some priority to addressing the outstanding issues in the conceptual framework for general purpose financial reporting. The availability of a comprehensive set of conceptual statements against which proposed accounting standards, whether they are being developed by the AASC or through the IASC, can be evaluated is essential if Australia is to have a range of accounting standards that are consistent with the conceptual framework.

10.2 GENERIC FINANCIAL REPORTING ACT

In Australia, as in many other countries, there is an ongoing move towards harmonising the financial reporting requirements for the public and private sectors. In part, this is a result of moves to require government agencies and business enterprises to adopt similar management structures and reporting requirements to those used by their private sector counterparts.

In conjunction with these moves, recommendations have from time to time been made to the Government for the development of a generic Financial Reporting Act, under which the myriad of federal and state financial reporting obligations currently applying to private sector and public sector entities would be replaced with one legislative regime.

Even where the accounting standards currently issued by the AASB or PSASB are applied to particular entities, they can be varied or modified under differing legislative mandates. Compliance with differing legislative requirements results in increased financial costs and distortions in financial information available to the market which in turn can lead to the inefficient allocation of scarce resources.

Many Australian proponents of a generic Financial Reporting Act note in support of their proposal that New Zealand already has a single financial reporting regime for both the public and private sectors. However, these proposals tend to ignore the fact that the Commonwealth Government's constitutional powers do not permit it to enact such legislation except in respect of its own agencies and business enterprises and companies incorporated in the Australian Capital Territory.

Nevertheless, there is a Commonwealth / State legislative model that could be used to put such legislation in place. This is the Corporations Law, under which the States and Northern Territory apply as their law legislation enacted by the Commonwealth for the purposes of the Australian Capital Territory.

The possibility of developing a generic Financial Reporting Act should be explored with State and Territory governments.

10.3 MARKET VALUE ACCOUNTING

A key priority of the Government is to ensure that the Australian financial system is efficient and competitive. The proposed restructuring of Australian accounting standard setting is a positive step in ensuring that broader interests are taken into consideration in the setting of accounting standards and that accounting standards provide a basis for the provision of relevant, reliable, neutral and comparable financial information for the users of financial statements.

The efficient operation of our financial system is based on the full and effective disclosure of information. In any system that is reliant on disclosure, a premium will be placed on the quality of the information disclosed. The adequacy of accounting standards in facilitating both the appropriate measurement of exposures and the effective disclosure of risk is of central importance in this regard.

Business has traditionally used historical cost accounting (under which assets and liabilities are recorded at the monetary amount of the transaction in which they were acquired or incurred) for maintaining the accounting records of an entity and preparing its financial statements. However, in a world of often rapidly changing asset and liability values as a consequence of general movements in prices, fluctuating interest rates and other market developments, measurement based on historical cost can be largely meaningless for the purpose of assessing the financial standing or solvency of an entity.

In view of the need for informed capital markets, there is a need to move away from the current historical cost accounting framework and to introduce a disclosure regime based on market value and risk accounting. Australia should be promoting moves internationally to introduce market value accounting and working cooperatively to address fundamental issues such as measurement.

Market value accounting, or ‘mark-to-market’ as it is also known, is a form of measurement used for determining the quantum of the various items or groups of items included in the financial statements of an entity. Market value can be defined as meaning:

- in the case of an asset — the amount which could be expected to be received from the disposal of the asset in an orderly market; and
- in the case of a liability — the amount which could be expected to be paid to extinguish the liability in an orderly market.

The advantages of market value accounting are that it:

- provides greater transparency;
- better reflects risk management practices; and
- obviates the need for ledger accounting.

While market value principles have been included in a number of Australian accounting standards (for example, in accounting for the general insurance industry), the method is not favoured by the business community. Completion of the conceptual statement on measurement would provide more information about the technique and should lead to greater acceptance of the method by the business community.

Greater use of market value accounting would enable the market to operate more efficiently through a reliance on enhanced transparency from institutions and corporations in relation to their operations.

In particular, market value accounting would provide a more informative means of financial reporting for investors, market participants and regulators. Accordingly, the proposed AASC, having regard to international developments, should seek to promote the use of market value accounting when developing and revising accounting standards that require the valuation of assets and liabilities.

10.4 Risk Accounting

There has been considerable focus in recent years on the desirability of having better measurement and disclosure of the market risks being borne by entities, both on and off their balance sheets. The significant growth in the trading of debt and equity securities, including their derivatives, has exposed many entities and, in particular, financial institutions to greater risks of interest rate and other market price movements impacting on their solvency.

To date, most interest in this area has been in respect of financial institutions. For example, the Basle Committee on Banking Supervision has developed new guidelines for measuring, and capital provisioning for, the market risks borne by banks, essentially in relation to their traded portfolios and movements in exchange rates.

While industrial and other commercial entities that have a high level of borrowings or are actively involved in international trading are also exposed to significant risks from interest and exchange rate fluctuations, accounting standard setters have yet to focus on proposals for risk accounting. However, given the emphasis that many entities are now placing on risk management through measures such as hedging, accounting standards or other requirements are needed to ensure that there is disclosure of entities' risk allocations on a meaningful and uniform basis.

It is expected that the development of formal requirements for the disclosure of risk accounting would provide a dynamic measure of an entity's financial condition, as it would expose how changes to the entity's balance sheet occurs as a result of changes in the underlying financial economic environment.

Proposal No. 8 — Other Issues

- The AASC should give a high priority to addressing the outstanding issues in the conceptual framework for general purpose financial reporting.
- The possibility of developing a generic Financial Reporting Act should be explored with State and Territory Governments.
- Australia should promote moves internationally to introduce market value accounting and work towards addressing fundamental issues such as measurement.
- The AASC should give priority to considering the introduction of risk accounting in the accounting framework to provide a dynamic measure of an entity's financial condition.

APPENDIX A: OVERSEAS STANDARD SETTING ARRANGEMENTS

STANDARD SETTING IN THE UNITED STATES

The US Securities and Exchange Commission (SEC) is empowered by US law to set accounting standards. Since 1936 the SEC has delegated that function to private bodies affiliated with the accounting profession. The US Financial Accounting Standards Board (FASB), a private sector body, is the designated organisation for establishing standards for financial accounting and reporting. The FASB is independent of government and professional organisations.

Prior to the formation of the FASB, accounting standards were promulgated by the Committee on Accounting Procedure of the American Institute of Certified Practising Accountants (AICPA) (1936-59) and then by the Accounting Principles Board, also an arm of the AICPA (1959-73).

Basis of the FASB’s Authority

The FASB derives its authority largely from endorsement by governmental and non-governmental bodies. The FASB’s authority is limited to setting accounting standards. The SEC remains the regulating authority.

SEC regulations contain a uniform set of accounting rules which govern the form and content of all financial statements required to be lodged with the SEC. The requirements are contained in ‘Regulation S-X’. On occasions in the past, the SEC has adopted rules in place of FASB pronouncements. The SEC does this when the FASB is silent or when the SEC considers that other practices will provide more useful information. In such cases, companies registered with the SEC must comply with the SEC’s ruling.

At the state level, the FASB’s pronouncements are endorsed by the state-level agencies that license public accountants and enforce compliance with US generally accepted accounting principles. Figure A-1 below sets out the structure of the US accounting standard setting scheme.

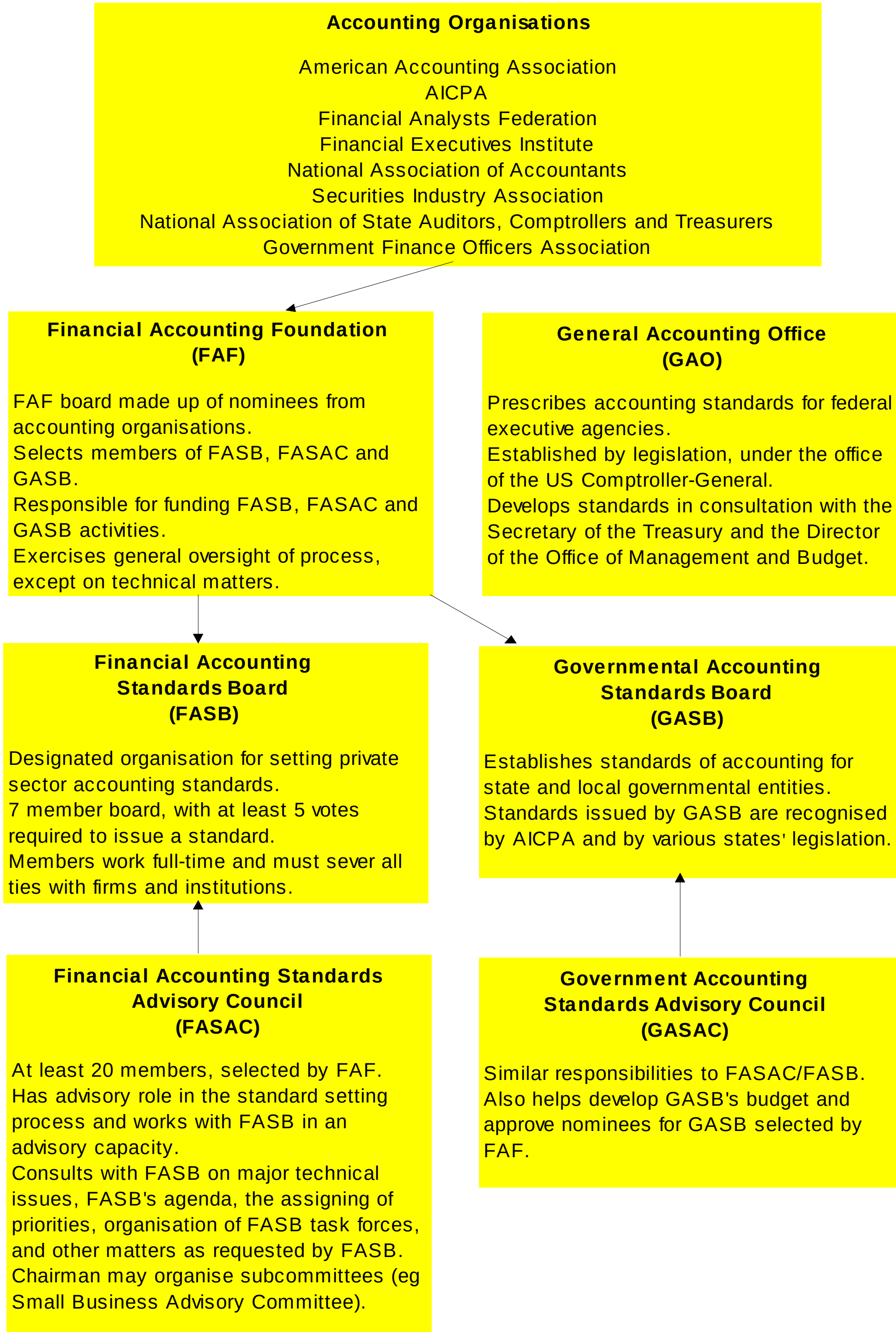
Structure of FASB

The FASB is constituted by a seven member Board. It requires a five to two majority to make an accounting standard. The Board is comprised of senior accountants from major US corporations and accounting firms, and academics. Board members may serve a maximum of two terms, each of five years duration. The FASB holds its meetings in public.

A staff of about 40 officers service the Board. The level of staff has not changed in about 12 years. The staff provide administrative and research assistance to the Board. The work of the FASB is also supplemented by an Emerging Issues Task Force.

The FASB has a parent organisation, the US Financial Accounting Foundation (FAF). The FAF is constituted by a 16 member board of trustees, comprising persons drawn from stakeholder groups with an interest in financial reporting, including corporate executives, bankers, accountants and financial officers. The FAF's major roles are to provide funding to the FASB, consider appointments to the Board and oversee its work.

FIGURE A-1: STANDARD SETTING IN THE UNITED STATES



STANDARD SETTING IN THE UNITED KINGDOM

Standard setting in the United Kingdom is overseen by the Financial Reporting Council (FRC).

The FRC has three operating companies:

- the Accounting Standards Board (ASB);
- the Financial Reporting Review Panel (FRRP); and
- the Urgent Issues Task Force (UITF).

The companies are subsidiaries of the FRC in terms of the Corporations Law, but in practical and functional terms are independent entities (see Figure A-2).

Financial Reporting Council

The FRC, which has 25 members, is responsible for securing funding for its subsidiaries and ensuring that the work of those subsidiaries is carried out efficiently and economically.

Funding is secured from a number of sources including the Consultative Committee of Accountancy Bodies, government, companies, the Stock Exchange and the Bank of England. The FRC guides the ASB on policy matters (although it has no say on the detail of particular standards) and provides a forum for public advocacy and support for accounting standards. Membership of the FRC is designed to be representative of all those concerned with accounting standards and members represent users, preparers and auditors drawn from the accountancy profession, the financial community and business and administration at large.

Accounting Standards Board

The ASB is headed by a full-time Chairman and Technical Director. Seven other members, who must have knowledge or experience in accounting and financial matters, are appointed on a part-time basis.

The *Companies Act 1989* prescribes the ASB as the UK's standard setting body. Applicable accounting standards are those issued or adopted by the ASB and the ASB issues standards on its own authority.

The ASB's aim is to establish and improve standards of financial accounting and reporting for the benefit of users, preparers and auditors of financial information.

While the ASB is independent, it remains necessary, as a matter of practical reality, for the ASB to obtain the consensus of the accounting bodies and users of accounting standards to maintain credibility.

Financial Reporting Review Panel

The FRRP examines and queries departures from accounting standards by public limited companies and companies not qualifying as small or medium-sized under the Companies Act. The Panel can apply to the court following a material departure from an accounting standard, and, if it appears that the accounts do not provide a true and fair view, the court may order the company to prepare revised accounts and circulate these to all persons likely to have relied on the previous accounts.

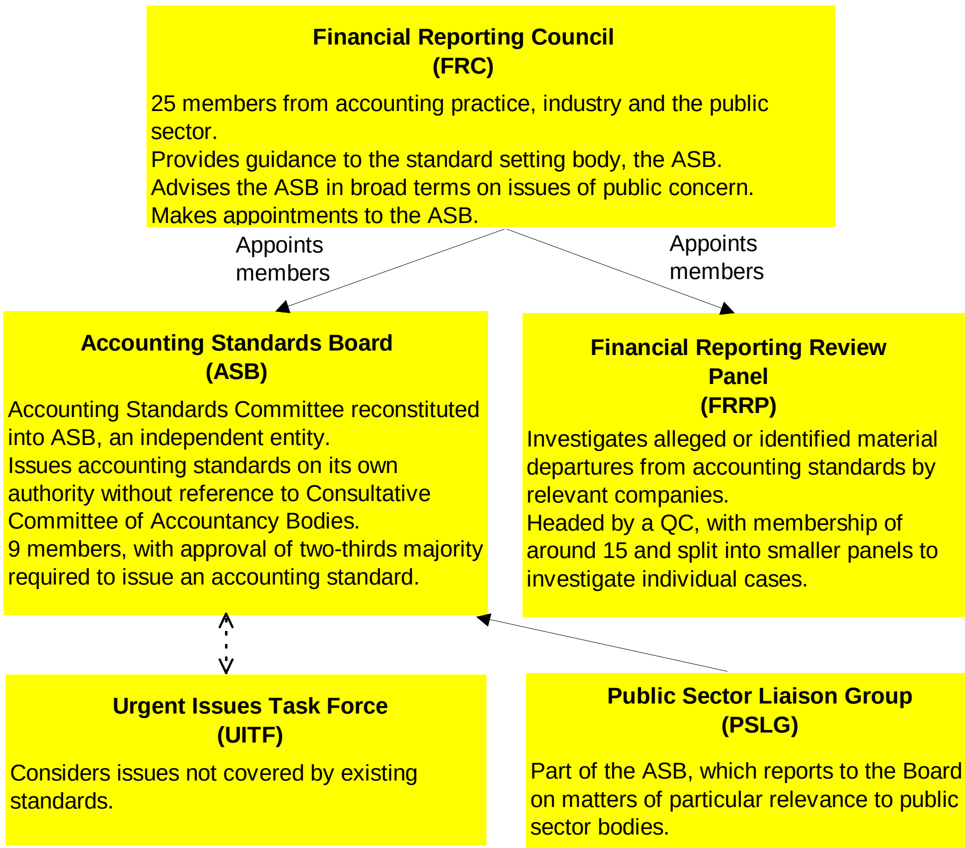
Accounting standards have the force of law via the *Companies Act 1989*. If there are material departures from accounting standards, the Panel can order a company to withdraw and reissue its financial statements, and take the company to court if the statements are not amended. Compliance with the standards is further enhanced by complementary legislation that provides that, where directors are party to approval of defective accounts, all the costs and expenses involved in action taken in respect of those accounts are to be paid by those directors.

Urgent Issues Task Force

The role of the UITF is to assist the ASB in areas where there is uncertainty or controversy in relation to the interpretation of an accounting standard or the Companies Act. The UITF also advises the ASB on areas where no standard or legislation exists.

UITF Information Sheets are circulated to directors of all listed companies. The ASB expects pronouncements of the UITF ('abstracts') to be regarded as accepted practice where they do not conflict with current law, standards or policies of the ASB.

FIGURE A-2: STANDARD SETTING IN THE UNITED KINGDOM



STANDARD SETTING IN CANADA

The setting of accounting standards in Canada has effectively been delegated to the Canadian Institute of Chartered Accountants (CICA) (see Figure A-3). Regulations under the *Canadian Business Corporations Act* require financial statements to be prepared in accordance with the standards set out in the CICA Handbook. The CICA Handbook serves as the primary source of generally accepted accounting principles in Canada and it is referred to by most of Canada's provincial corporations and securities legislation.

In December 1972, Canadian Securities Administrators issued a National Policy Statement indicating that where the term 'generally accepted accounting principles' is used in companies and securities legislation they regard pronouncements by the Accounting Standards Committee of CICA, to the extent set out in research recommendations in the CICA Handbook, as generally accepted accounting principles.

Accounting Standards Board (AcSB)

The Accounting Standards Board (AcSB) was established to issue standards for reporting by public and private profit-oriented enterprises, and non-profit private organisations.

The AcSB issues Accounting Recommendations in the CICA Handbook as well as Accounting Guidelines to provide interpretation of Recommendations. The AcSB is also able to establish Task Forces to undertake special studies of particular subjects, either for the AcSB's internal use or for publication.

The AcSB normally comprises 13 voting members. A chairman is appointed for two years, and other members for three years. Approximately one-third of the membership of the AcSB changes annually. Board members are appointed by the CICA. The AcSB balances occupational representation and geographic representation. Members donate their time and are supported by a full-time research staff.

Standards Advisory Board (SAB)

The SAB provides a forum for users to discuss the impact of Accounting and Auditing Recommendations set out in the CICA Handbook. The SAB participates in setting priorities for the ASB, as well as providing advice on professional matters.

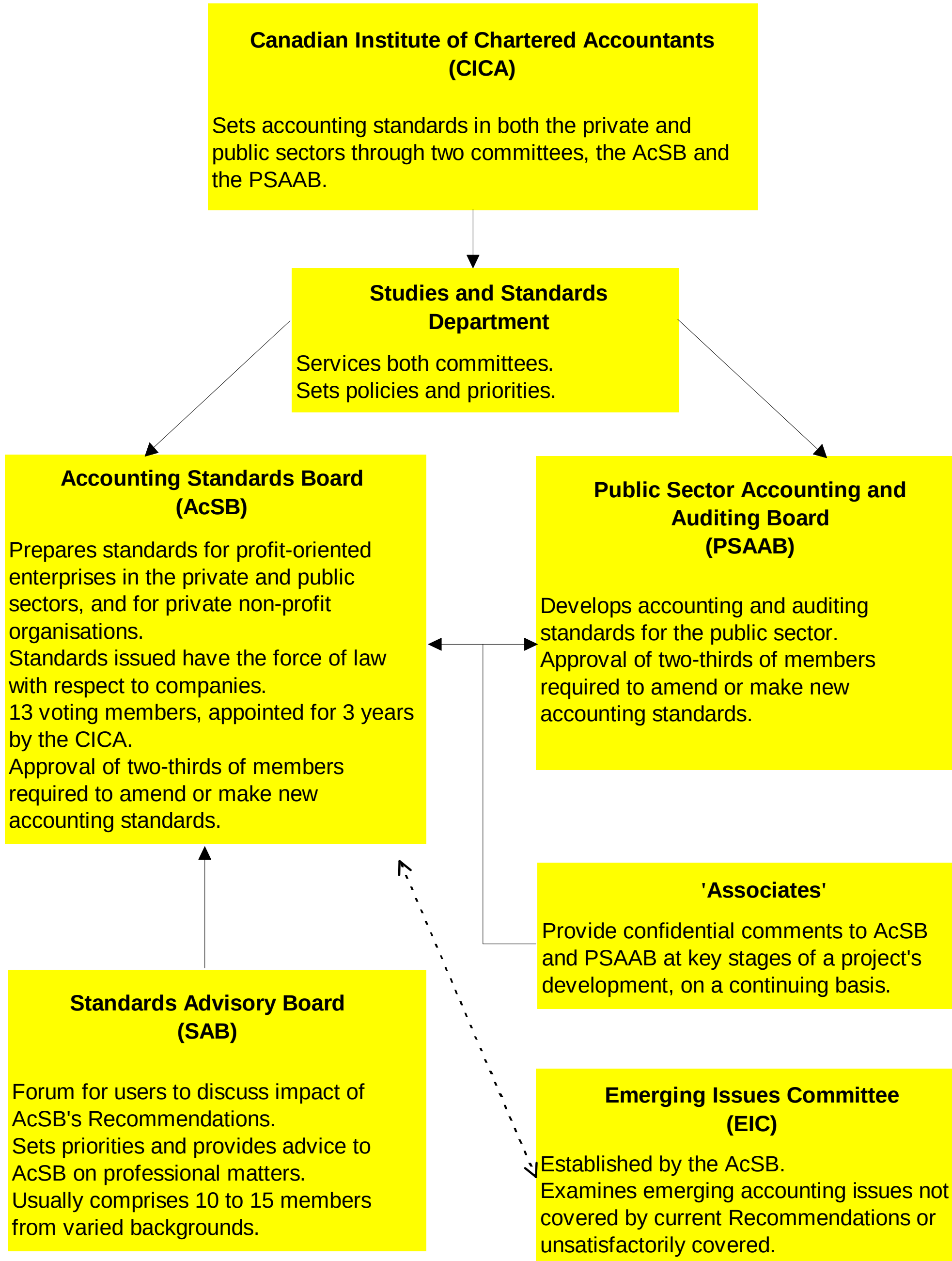
The SAB normally consists of 10 to 15 members from varied backgrounds, including law, business and industry, the media and academia.

Emerging Issues Committee (EIC)

In 1989 the CICA perceived a need for a new committee to deal with emerging accounting issues. The role of the EIC is to reach consensus as to the appropriate accounting approach to be adopted. The EIC's deliberations are published in order to be available to users.

The EIC's Terms of Reference state that '[t]he Emerging Issues Committee is established by the Accounting Standards Board to provide a forum for the timely review of emerging accounting issues that are likely to receive divergent or unsatisfactory treatment in practice in the absence of some guidance'.

FIGURE A-3: STANDARD SETTING IN CANADA



INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE

The International Accounting Standards Committee (IASC) was founded in June 1973 by the accounting bodies of Australia, Canada, the United Kingdom, the United States, France, Germany, Japan, the Netherlands, Ireland and Mexico. IASC membership comprises 116 professional accounting bodies from 86 countries.

The objectives of the IASC are to:

- formulate and publish in the public interest accounting standards to be observed in the presentation of financial statements;
- promote worldwide acceptance and observance of accounting standards it develops; and
- work generally for the improvement and harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements.

The IASC's policy is to work with other standard setting bodies to achieve common improvements in accounting standards and greater comparability between accounting standards in different countries.

Standard Setting Procedure — IASC Board

The structure of the IASC is set out in Figure A-4.

IASC standards are made by the IASC Board, which comprises a total of 17 seats:

- up to 13 country members, representing professional accounting bodies; and
- up to four co-opted members from non-accounting organisations approved by the Board.

Board members can nominate up to two representatives and one technical adviser. Each member has one vote on the Board. The Board usually meets three times each year.

An exposure draft must be supported by two-thirds of Board members. Final standards must be approved by 75 per cent of all members.

Oversight — IASC Advisory Council

The Advisory Council's role is to promote the acceptance of IASC standards. It also performs the general oversight functions of the IASC, including budgeting and fundraising for the IASC's activities, reviewing the Board's plans and strategies and promoting participation in the work of the IASC. The Advisory Council does not participate in the Board's technical deliberations.

Council members are unpaid and are appointed by the Board. The Council holds closed meetings at least once a year.

General and Project-specific Bodies

The Board establishes steering committees to develop proposals in respect of specific technical matters. Steering committees are usually chaired by a Board representative and a project manager from the IASC is assigned to each project to settle research requirements and prepare draft documents. The steering committee publishes a draft statement of principles on each project. The draft statement is released for public comment and forms the basis of a Statement of Principles which is settled and subsequently published by the IASC. The IASC then releases an exposure draft of the standard for public comment.

The Board also meets regularly with a consultative group of users and preparers of financial information, standard setting bodies and international organisations. The consultative group includes among its members IOSCO, the International Chamber of Commerce, the Organisation for Economic Cooperation and Development, the United Nations Centre on Transnational Corporations and the World Bank.

Figure A-4: International Accounting Standards Committee

IASC Sponsoring Organisations

The IASC comprises members from 116 accountancy bodies from 86 countries.

Advisory Council

Role is to promote acceptability of IASC standards and to enhance the credibility of the IASC's work.
Its duties include:
- reviewing the Board's plans and strategies;
- assuring the independence of the IASC in making technical decisions;
- promoting worldwide participation in and acceptance of the IASC's work;
- raising funds for the IASC and approving its budget.

Does not participate in or influence technical decisions made by the Board.
10 unpaid members, appointed by the Board for 2½ years.
Holds closed meetings at least once a year.

Appoints all members

IASC Board

Formulates standards and works towards their worldwide acceptance.
Also:
- approves project proposals;
- appoints steering committees;
- approves standard setting procedures.

Up to 17 voting seats:
- 13 nominated and appointed by the Council of the International Federation of Accountants;
- 4 additional organisations having an interest in reporting, as approved by the Board.

Board members serve up to 5 years (normally 2½ years) and are part-time and unpaid.
Meets 3 times a year.

Consultative Group

Represents bodies not represented on the Board, mostly 'international' organisations (eg World Bank).
Make-up determined by the Board.
No standard making ability, but rather advises the Board on projects and priorities affecting the acceptability of IASC standards.
Members are unpaid and the group holds closed meetings twice a year.

Steering Committees

Board appoints a Steering Committee for each project, which carries out research and detailed deliberations for that project.
Members are selected from the Board, Consultative Group or other expert organisations.
Responsible for identifying issues and proposing solutions to the Board, often in the form of draft IASC Standards.
6 to 8 members: 4 from Board member countries, 1 from the Consultative Group, the remaining from standard setting bodies or other organisations.
Responsible for seeking public comment on proposals.

APPENDIX B: CURRENT AUSTRALIAN ACCOUNTING STANDARD SETTING ARRANGEMENTS

Treasurer
Makes appointments to the AASB in consultation with interest groups.

Accounting Bodies
ICAA
ASCPA

Australian Accounting Standards Board (AASB)
Established under the ASC Act.
Responsible for issuing accounting standards for entities subject to the Corporations Law.
Currently the AASB comprises 10 part-time members.

Joint Standing Committee
Comprises the executive committee of each of the ICAA and ASCPA.

Support

Australian Accounting Research Foundation (AARF)
Responsible to the Joint Standing Committee.
Comprises 5 Boards:
- Foundation Board of Management (FBM);
- Auditing Standards Board (AuSB);
- Public Sector Accounting Standards Board (PSASB);
- Legislation Review Board (LRB);
- Urgent Issues Group (UIG).

Provides research, technical and secretarial support to the AASB and the PSASB.
Members of AARF are appointed by the Joint Standing Committee.

Foundation Board of Management (FBM)
Responsible for the management of AARF and co-ordinates activities and funding of Boards.
Comprises members of the National Executive of ICAA and ASCPA, Executive Directors of ICAA and ASCPA, and chairmen of AASB, PSASB, AuSB and LRB.

Auditing Standards Board (AuSB)
Develops auditing standards to ensure that auditors play a vital role adding credibility to financial statements.
Contributes to the development and implementation of International Standards on Auditing.
Comprises 11 members: 5 nominated by each of the accounting bodies, and the Australian representative on the International Auditing Practices Committee.

Public Sector Accounting Standards Board (PSASB)
Develops Statements of Accounting Standards for the public sector and non-companies jointly with the AASB.
Comprises 9 members: 4 nominated by each of the accounting bodies, and the Australian representative on the International Public Sector Committee.
Members are appointed for 3 years.

Legislation Review Board (LRB)
Prepares submissions to regulators on financial reporting, auditing and corporate governance.
Comprises 8 members: 4 nominated by each of the accounting bodies.

Urgent Issues Group (UIG)
Addresses urgent and narrowly focussed issues.
All members appointed by the FBM, except one appointed jointly by the AASB and PSASB.

Appendix C: Proposed New Structure for Australian Standard Setting Arrangements