Perspective

This is one of a series of articles where experts in assurance, reporting and regulatory matters discuss recent technical and policy developments in these areas.

Reform of the Australian Financial Reporting Framework

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What's the problem?

You've just established a new business and you are hard at work focusing on making it a success. Surprisingly quickly the end of the financial year comes around and you remember you need to attend to some administrative tasks, in particular, financial reporting. But what exactly are your financial reporting requirements? Where do you look? What factors do you need to consider? You soon realise these questions are not straightforward and are likely to take some time to answer. You begin to wonder if this really is the best use of your time. Maybe you could get back to focusing on your business sooner if we had a simpler, more objective financial reporting framework.

How many business go through the same issue? The Australian Bureau of Statistics estimates around 2.1 million for-profit businesses are in operation. In the not-for-profit sector, estimates put the number of entities around 600,000. What proportion of these 2.7 million entities should be required to make their financial statements available to the public and what should they report?

It gets more complicated when you start to consider that different legal structures have different reporting obligations, so phoning a friend probably won't help. Entities incorporated under the *Corporations Act 2001* look primarily to that Act to identify their specific reporting requirements. Cooperatives and Incorporated Associations, among others, need to consider legislation in their State or Territory of formation. The outcome is that different reporting obligations are imposed on different types of entities using different criteria. Some types of entity, such as partnerships, do not have formal public reporting requirements imposed on them at all. Understandably, both preparers and users of financial statements are puzzled when entities of similar size have different financial reporting obligations due only to their different legal entity type.

At this point you might have figured out whether you need to prepare some sort of financial report. But the next question you need to ask is: what must I report? You soon realise this is a very loaded question, but why? You must determine whether your business is a *reporting entity*. A *reporting entity* is one that is expected to have users dependent on the general purpose financial statements of those entities because they cannot demand what they want. General purpose financial statements comply with all relevant accounting standards (Tier 1) or comply with reduced disclosure requirements (Tier 2). If not a *reporting entity* you may prepare special purpose financial statements instead, with only minimal requirements to fulfil the entity's public reporting obligations. The *reporting entity* assessment is highly subjective, and often requires significant effort, ordinarily on an annual basis.

The problem, therefore, is the complexity and disparity of the Australian financial reporting framework.

What is the AASB intending to do?

One of the Australian Accounting Standards Board's strategies is to take a leadership role in shaping the Australian Reporting Framework. The financial reporting framework project intends to assist regulators achieve reforms in financial reporting that appropriately balance the costs and benefits of reporting, and result in 'fit for purpose' public information. The aim of the project is to establish objective criteria that determine which entities would be required to prepare general purpose financial statements and the level of the reporting requirements. Effectively, individual entities would no longer need to apply the *reporting entity* concept.

The AASB intends to cover the three major sectors:

- For-profit private sector
- Not-for-profit private sector
- Not-for-profit and for-profit public sector.

The project will progress broadly through four phases:

Phase 1 Benchmark reporting criteria

Phase 2 Research the for-profit financial reporting framework

Phase 3 Identify potential improvements to the reduced disclosure framework

Phase 4 Research the not-for-profit financial reporting framework.

What has the AASB discovered so far?

Phase 1 – Benchmarking

The Phase 1 benchmarking research for for-profit private sector entities compares Australian requirements with those in ten jurisdictions.[1] In October 2015 the AASB noted that unlisted company reporting requirements differed significantly across the jurisdictions. Some jurisdictions, like Australia, require companies to lodge financial statements based on meeting a number of criteria. Other jurisdictions, such as the United Kingdom, require all companies to lodge financial statements regardless of the characteristics of the entity in question. However, most jurisdictions established requirements that attempted to strike a cost / benefit balance. For example, all jurisdictions required listed entities to publicly lodge financial statements while some jurisdictions provided smaller unlisted entities less onerous reporting obligations.

[1] Canada, Hong Kong, Japan, Korea, Malaysia, New Zealand, Singapore, South Africa, the United Kingdom and the United States of America.

Subsequent AASB staff research has revealed varying implementation of financial reporting tiers in other jurisdictions. Some jurisdictions operate a model similar to Australia where general purpose financial reporting offers two tiers: Tier 1, incorporating full International Financial Reporting Standards (IFRS) requirements; and Tier 2, reduced disclosure burden for non-publicly accountable entities. Other jurisdictions operate different accounting frameworks for their different tiers, such as full IFRS for Tier 1 and *IFRS for SMEs* for Tier 2 entities. However, some jurisdictions operate more than two reporting tiers.

The approach in the public sector to financial reporting is vastly different to the for-profit private sector, but appears relatively consistent across jurisdictions. AASB staff have made significant progress in their public sector benchmarking research, with draft findings to be reported at the June 2016 AASB meeting. The Australian public sector perceives itself to have a much higher level of public accountability than the for-profit private sector. Almost every component of the public sector makes general purpose financial statements publicly available. Those financial statements tend to be prepared to the highest standard, with only a few jurisdictions permitting public sector entities to apply Tier 2 Reduced Disclosure Requirements.

AASB staff are in the early stages of benchmarking the not-for-profit private sector financial reporting requirements. There have been significant developments in this sector with jurisdictions establishing accounting requirements for charities, and, as in Australia with the Australian Charities and Not-for-profits Commission, a regulator that is specifically responsible for charities.

Phases 2 & 4 – Research the financial reporting framework

What is emerging from the benchmarking research is that there are a number of approaches to establishing a clearer and simpler financial reporting framework. However, any reform of the framework depends on the involvement of government policymakers and regulators who have the power to identify entities that must report publicly and their reporting requirements. The AASB aims to encourage policymakers and regulators to revisit reporting criteria and thresholds to ensure that the benefits of financial reporting requirements exceed the costs. To that end, the AASB held two roundtables in January 2016 to engage representatives from the not-for-profit private and public sectors. The feedback from the roundtables supported the AASB's financial reporting framework initiative and concluded that consultation papers should be developed in conjunction with major stakeholder groups.[2]

The not-for-profit arena is challenging because not-for-profit entities tend to be formed under State or Territory legislation and are regulated by the respective State or Territory regulator. Not-for-profit organisations often hold themselves to a high level of public accountability and consider financial reporting central to discharging that accountability. However, as financial returns to stakeholders are not the principal objective of not-for-profits, additional reporting might be needed to best discharge their accountability. This area is the focus of the AASB's Service Performance Reporting and Income of Not-for-Profit Entities projects, which are both addressing aspects unique to the not-for-profit sector.

The AASB intends to consider a range of issues in the consultation papers, with the benchmarking research findings identifying some possible alternative approaches. For example, some jurisdictions have more than two tiers of financial reporting requirements or

[2] The roundtable feedback is available on the AASB website – see the Australian Financial Reporting Framework project summary.

even accounting standards made specifically for the not-for-profit sector.

Phase 3 – Reduced Disclosure Requirements

The Reduced Disclosure Requirements (RDR) framework is the second tier in general purpose financial reporting. It is intended to be simpler for non-publicly accountable entities to apply. However, constituent feedback indicates a low uptake of RDR. This prompted the AASB and the New Zealand Accounting Standards Board (NZASB) to undertake a joint research project to create a framework for the Boards to use to determine reduced disclosure requirements. Both Boards undertook outreach in 2015 to identify what disclosures preparers and users think a Tier 2 general purpose financial statement should emphasise. That outreach identified some key information needs relating to:

- financial performance;
- liquidity and solvency;
- cash balances and cash flows;
- related party transactions and balances;
- accounting policies applied; and
- transactions and events significant to the entity.

The AASB and the NZASB have further refined these key information areas into a potential new model for determining reduced disclosure requirements. The AASB expects to consider a draft Exposure Draft on RDR at its August 2016 meeting, which will propose both the new model and new reduced disclosure requirements for existing pronouncements. The ultimate aim of this work is to approach Tier 2 disclosure in a way that results in more relevant disclosures and a better cost / benefit outcome.

What will happen next?

There is clearly plenty of work to be done and the AASB is collaborating with other Australian regulators to develop consultation papers that will explore potential changes to the Australian reporting framework.

The AASB will seek public comment on the consultation papers, which will be your opportunity for formal input. However, the AASB accepts all feedback, whether sent by email, phone call, Twitter or LinkedIn. AASB staff will post a number of discussion topics on the AASB's LinkedIn group, seeking feedback every step of the way.

There is a long road ahead, but the goal of simpler and clearer financial reporting requirements is well worth the effort.