

Financial Reporting Policy in a Dynamic Environment

Jeffrey Faux* and Victoria Wise**

To cope with the increasing globalisation of capital markets, financial regulators in Australia have embarked on an ambitious program to converge national accounting standards with International Financial Reporting Standards. The convergence program means a significant departure from present financial reporting policy and will necessitate substantial change by reporting entities. The effectiveness of the existing differential reporting policy is drawn into question in the light of the changes taking place. An evaluation of the perceptions of the effectiveness of the extant differential reporting model is undertaken and alternative policy approaches considered. The findings indicate that certain aspects of the differential reporting model have inherent problems not necessarily related to the recent policy change and that corrective action needs to be undertaken to maintain its relevance.

Key words: Convergence; International Financial Reporting Standards;
Differential reporting policy.

1 Introduction

In 2001 when Australia agreed to adopt the International Financial Reporting Standards (IFRS) effective from 1 January 2005, it appeared that it would be only one of many countries formally abandoning their national accounting standards in favour of a separately agreed, common, set of standards (Townsend 2004). However, Canada, Japan and the USA have all since decided to retain their independence. New Zealand and the countries of the EU have remained committed to convergence with IFRS, although at a later date than that adopted for Australian convergence.

The International Accounting Standards Board (IASB) makes it clear that the prime users of IFRS are participants in the capital markets (Jarvis 2003). That is, IFRS are primarily designed for companies that have securities traded on capital markets (*listed* companies). Companies that do not have securities traded on capital markets (*unlisted* companies) do not use the capital markets to raise finance. Therefore, both the users of the financial reports of listed and unlisted companies, and the needs of those users, will differ. Evidence from research suggests that while listed companies are large, unlisted companies tend to be small businesses.

* Jeffrey Faux, Research Associate, Centre for Strategic Economic Studies, Victoria University, Melbourne

** Victoria Wise, Research Associate, Centre for Strategic Economic Studies, Victoria University, Melbourne
The authors would like to acknowledge the support of CPA Australia in providing the funding for this project.

This suggests a case for differentiating financial reporting requirements between large and small businesses on the basis of their different users and needs.

Differential reporting is a notion that some organisations should be permitted to depart from either all, or some, of the requirements of particular accounting standards when preparing their financial reports (HKSA 2002). Nair and Rittenberg (1983) described differential reporting as a notion that certain reporting entities may be exempted from the application of specific accounting standards because of their size, legal structure, ownership, sector (public/private/industry), or the absence of a dependent user. The implication arising from these views is that distinct accounting and reporting rules should govern conceptually different organisations. There are a number of complex issues that need to be addressed when considering differential reporting. Brailsford and Ramsey (1993:54-5) raised some of these issues including:

- how is the decision to determine an entity's reporting status made;
- what accounting standards are to be used;
- what information is to be disclosed; and,
- whether the reporting entity concept contained in the Australian Conceptual Framework for financial reporting adequately services the needs of users.

It is the primary objective in this paper to consider the impact of this policy change to adopt IFRS on the differential reporting model currently in operation in Australia. Practitioner perceptions of the appropriateness of the differential reporting models were explored in this regard. The paper proceeds as follows. Some impacts of convergence with IFRS are discussed in section 2. The research method is outlined in section 3. In section 4 the research findings are presented and discussed. Section 5 contains the summary and conclusions of the study.

2. Some impacts of convergence

While harmonisation of national accounting standards involves issuing and revising accounting standards that are consistent with IFRS, convergence is 'akin to the outright adoption' (Knapp & Kemp 2004:xviii) of IFRS. Concern about the need for convergence of financial reporting philosophies across national borders has been evident in the literature from the early 1960s (Watson 1962). More recently Yong (2003) identified the underlying drive towards international convergence of accounting standards as resulting from the globalisation of financial markets and the need to meet securities regulators concerns. The implication is that under a harmonised regime, companies could avoid the costs of complying with national generally accepted accounting practice (GAAP) that exist in different jurisdictions (*preparer perspective*) and security analysts would not need to acquire costly specialised expertise in GAAP (*user perspective*). Yet research exists to suggest that financial markets are capable of adjusting financial reports prepared using national GAAP to reflect numbers that would be determined under another jurisdiction's GAAP or under IAS/IFRS (Lev & Sougiannis 1996).

Brown and Clinch (1998) suggested that a direct outcome of a shift to a standardised set of accounting standards would be that global databases would be more easily constructed by data-providers, and further, that there would be no accounting policy choice grounds for choosing where to list financial securities. Saudagaran and Biddle (1995) considered the effects of stringency of accounting disclosure requirements on foreign exchange listing decisions and concluded that exchanges with less stringent requirements gain more listings. Conversely, it has been suggested that low-disclosure exchanges might trap liquidity and that rational liquidity traders would choose exchanges with high disclosure standards. Brown and Clinch (1998) noted that this issue has yet to be confirmed and suggested that the Australian Stock

Exchanges (ASX) need to be able to attract enough custom to survive in an increasingly global financial marketplace.

Collett *et al.* (1998) suggested that the ASX has emerged as a politically powerful player in promoting the convergence of accounting standards with IFRS. Collett *et al.* noted the argument that adoption of IFRS in Australia may reduce the costs of Australian companies seeking offshore listing and facilitate capital flows into Australia. Thus it may be that the ASX is acting opportunistically to ensure its own competitiveness and ultimately its survival. Brown and Clinch (1998) highlighted the large degree of uncertainty that exists as to the consequences of convergence with IFRS due to the general dearth of debate and evidence and the fact that these issues have only recently begun to attract the attention of the research community. In the face of mixed predictions and uncertainty as to the benefits or otherwise of convergence there is room for a fuller consideration of the impact of this policy change on small to medium-sized enterprises (SME). Small companies have fewer resources available to deal with financial reporting compliance than do large companies thus concerns regarding the financial reporting burden on SME are justified given the disproportionately higher compliance costs that SME face relative to larger companies.

The differential reporting debate was an issue of considerable importance in Australia in the early 1980s when the accounting regulators were developing a conceptual framework for financial reporting. The regulators formed the view that the focus of financial reporting should be to provide general purpose information that is common to the needs of the broad range of users who are unable to command the preparation of reports tailored to their own particular needs. The regulators labelled the organisations that are required to prepare general purpose financial reports *reporting entities*. Under this conceptual approach to financial reporting no exceptions were deemed appropriate on the basis of defining characteristics such as size, ownership, (McCahey & Ramsey 1989:83) structure, sector, users or nature of operations although it has been acknowledged that size may act as a surrogate for the existence of dependent users (CAPA 2003; Mersereau 2003). Thus small and large organisations in Australia are, in principle, subject to the same financial reporting regime.

Differential reporting conditions have been introduced for proprietary (unlisted) companies in Australia. Whether the accounting and financial reporting requirements of the Corporations Act are imposed on an unlisted company depends on whether it is classified as small or large. An unlisted company is classified as small if it satisfies at least two of the following tests:

- gross operating revenue of less than \$10 million for the year;
- gross assets of less than \$5 million at the end of the year;
- fewer than 50 employees at the end of the year.

An unlisted company that does not satisfy at least two of these tests is classified as large (Corporations Act 2001: S10.1). The majority of unlisted companies in Australia are small under these tests and thus are obliged to prepare an annual financial report if shareholders controlling at least five per cent of the votes give the company the direction to do so, or, if it is controlled by a foreign company (Corporations Act 2001: S.10.3). If obliged to report, the small company annual financial report must include a profit and loss statement, a balance sheet, a statement of cash flows and a directors' report (about the company's operations, dividends paid or recommended, options issued etc.) and be in accordance with applicable accounting standards. A large unlisted company must prepare annual financial reports and a directors' report, have the financial report audited and send both reports to shareholders (Corporations Act 2001: S10.3).

Recent comments by Dixon (2003:5) suggest that this situation may not continue after the adoption of IFRS in 2005.

In the immediate future, Australia will be retaining the Reporting Entity concept. However, the form of differential reporting in the future may move to a European proposal which differentiates between listed companies and other entities. A concept of differential reporting favoured by Sir David Tweedie, Chairman of the IASB.

McCahey and Ramsey (1989) considered a number of other differential reporting proposals which included: the simplification of accounting standards; and, differential disclosure within accounting standards. While they regarded simplification as an appealing concept, they argued that this approach would not satisfy the need for guidance on emerging issues. They also asserted that reporting costs are generally associated with measurement requirements rather than disclosure requirements and so differential disclosure would be unlikely to solve the cost/benefit problem of financial reporting. Two other differential reporting models, the *integral* and the *distinct* models, were discussed in CAPA (2003). The *integral* model provides for exemptions to components within accounting standards specifically to suit the circumstances of SME and the needs of their financial report users. The *distinct* model requires the preparation of a separate accounting standard comprising all the issues that are addressed in the IFRS that are relevant to SME.

3. Research Method

Prior studies have largely been limited to normative pronouncements and therefore a survey of the perceptions of accountants was considered the most appropriate research method. An internet survey of accountants involved in financial reporting was conducted to determine attitudes to the introduction of IFRS; the perceived effects of this policy initiative; and the effectiveness of the Australian differential reporting model. Participation was invited from members of CPA Australia, who were involved in financial reporting matters. The invitation to participate was extended through 'CPA Online', a weekly electronic newsletter. A web address was provided and an incentive was offered by the research sponsor to members who responded promptly. The use of CPA Australia's database of members is restricted in order to protect members' privacy and confidentiality, and as a consequence the approach taken to elicit responses is the only one available given the context. 52 CPA members provided usable responses to the survey. In addition to the above-mentioned areas surveyed, certain profiling demographics of respondents such as age and current employment position were also collected.

4. Findings and results

The information contained in Tables 1 and 2 provide a significant insight into the profile of respondents. An indication of the number of participants in each age category is presented in Table 1. The majority of participants range in age from 25-55 with a pre-dominance towards the 46-55 age category.

Table 1 Age categories of respondents

Age Categories	Frequency	Percentage
18-24	3	5.8
25-35	14	26.9
36-45	12	23.1
46-55	17	32.7
56+	6	11.5
Total	52	100.0

In Table 2 the age of respondents is cross tabulated with their employment category to ascertain the level of *experience* that they may have accumulated and, consequently, the validity of their observation regarding the issue of the policy change to IFRS and differential reporting.

Table 2 Cross tabulation of age and employment category

Age/employment Categories	Sole practitioner		Partner in small practice		Partner in large practice		Professionally qualified employee		Total	
18-24					1	2.2%	1	2.2%	2	4.3%
25-35			1	2.2%			10	21.7%	11	23.9%
36-45	3	6.5%			1	2.2%	8	17.4%	12	26.1%
46-55	3	6.5%					12	26.1%	15	32.6%
56+	4	8.7%	2	4.3%					6	13.0%
Total	10	21.7%	3	6.5%	2	4.3%	31	67.4%	46	100.0%

The expectation is that the older age categories would reflect greater levels of financial reporting experience and this is reflected in Table 2 particularly in those employment categories as sole practitioner and partner in practice. With a high degree of experience it is expected that responses to the substantive questions contained in the survey and discussed in the findings and results section below would be reliable.

An aim in this research was to explore practitioners' perceptions of the appropriateness of the two differential financial reporting models as specified in the Australian conceptual framework and the Corporations Act. The key points and measures of the differential reporting models addressed in the survey were:

- User dependency (conceptual framework)
- Gross operating revenue < \$10m for the year (Corporations Act)
- Gross assets < less than \$5m at year end (Corporations Act)
- < 50 employees at year end (Corporations Act)

The existence of users who are dependent on general purpose financial reports was deemed by more than 55.8% of respondents (Table 3) to be an effective criterion for classifying businesses as small or large for the purposes of differential financial reporting. This was not a surprising outcome given that Australian accounting practitioners have, since 1991, operated within a conceptual framework for financial reporting that determines the need for financial reporting on the basis of the existence of users reliant on general purpose financial reports.

There appears to be a significant lack of support amongst respondents for the differentiating criteria of *Revenue*, *Assets*, and *Employees* specified in the Corporations Act. Importantly, the *Small* versus *Large* test contained in the Corporations Act is not conceptually based, it is arbitrary. An implication is that there may be other measures that determine the difference between small and large entities more effectively.

Table 3 Effectiveness of Australian differential reporting model

Differential points	Effective		Not effective	
Dependency	29	55.8%	23	44.2%
Revenue	-	-	52	100.0%
Assets	11	21.2%	41	78.8%
Employees	8	15.4%	43	82.7%

In support of Table 3 further differential points were added to explore whether (1) respondents perceived the arbitrary threshold of \$10 million for revenue to be too low, and/or (2) whether other balance sheet indicators - *Liabilities*; *Equity*, *Other* - were perceived as relevant to the classification of entities for the purposes of differential reporting. Perceptions as to the appropriateness of these differential points in categorising entities as small or large were determined by having respondents indicate the applicability of the measure for identifying a reporting entity. The four additional differential points were: Annual turnover (quantum requested); Equity at reporting date (comments requested); Financial liabilities at reporting date (comments requested); and Other (as separately identified by respondents).

Table 4 Comments regarding additional/alternative differential points

Indicator	Number of comments received	Comments received regarding classification of small and large entities
Turnover	6	Suggested range of turnover for small entities \$5M -\$50M
Revenue	0	No comments received
Assets	1	For large entities assets greater than \$2M
Employees	7	Range for small entities 25 -75 and for large entities, greater than 50
Equity	15	Range for small entities \$10,000 - \$20M and for large entities, greater than \$2M
Liabilities	18	Range for small entities \$0 -\$10M and for large entities, greater than \$100,000
Other	9	Comments reflected extant differential points: additional comments included; larger size of entities; use of the income tax return; number of shareholders; customers; interest coverage ratio; societal impact

Additional comments as to appropriate differential points for classification of entities as small or large for the purposes of differential financial reporting provided by respondents are summarised in Table 4. The respondents provided a diverse set of comments that reflected dissatisfaction with the arbitrary nature of the small versus large test provided in the Corporations Act. The number and scope of comments regarding Liabilities and *Equity* and the relatively low ranges suggests that the internal and external funding positions of entities is perceived, by respondents, to provide important measures. The *Other* indicator yielded nine comments and of particular interest was reference to the number of shareholders, interest coverage ratio and societal impact as potential differential indicators.

Respondents were asked whether the policy change to adopt IFRS would have a significant effect on entities. The results presented in Table 5 show that 55.8% of respondents expect the policy change to have a significant effect on entities. While this represents a majority position a recent commentary suggested that effect on entities would be greater than indicated in Table 5 (Fenton-Jones 2004).

Table 5 Expected effect of policy change

Change effect	Significant		Not significant	
Response	29	55.8%	23	44.2%

A consideration of the relationship between the significance of the policy change to adopt IFRS and the effectiveness of the differential reporting model currently in operation in Australia is reported in Table 6. There is a relationship between the policy change and the four aspects of the differential reporting model but the relationship is not statistically significant (*Dependency* $X^2 (1) = 0.006, p 0.937$; *Revenue* Nil; *Assets* $X^2 (1) = 0.492, p 0.483$; and, *Employees* $X^2 (2) = 3.886, p 0.143$).

Table 6 Pearson chi-square of the relationship between policy change significance and differential reporting model

Differential points	Value	df	Asymp. sig. (2-sided)
Dependency	0.006	1	0.937
Revenue		No statistics	
Assets	0.492	1	0.483
Employees	3.886	2	0.143

Whilst problems are identified with current differential reporting policy and the change to IFRS is perceived as significant the relationship between the two is not statistically significant. This is a curious outcome as significant policy change could be anticipated as having a very real effect on the entities that are required to report under the present differential reporting arrangements. This situation may represent a deep-seated problem with the small versus large test not necessarily reflected in the current policy change.

5 Summary and Conclusion

The globalisation of capital markets is the primary catalyst for the Australian policy move to converge with IFRS. This represents a substantial policy change that is likely to affect the differential reporting model that currently operates in Australia and consequently, reporting entities. The effectiveness of the existing differential reporting policy is drawn into question in the light of the changes taking place and an evaluation of the perceptions of the effectiveness of the model that was undertaken in this study.

The findings of the effectiveness of the extant differential reporting model are interesting in that whilst the dependency test incorporated in the Conceptual Framework receives majority support this is not the case with regard to the measures contained in the small versus large test in the Companies Act. The lack of support for the measures employed to differentiate between small and large entities is not necessarily because of the introduction of IFRS but more likely because the measures have little correlation with other measures of small and large entities used by the Australian Bureau of Statistics, the Australian Taxation Office and various other business councils. The multiplicity of measures serves only to confuse the matter and may be one of the reasons for the low effectiveness rating of the small versus large test. Other considerations are that the economy has grown considerable since the implementation of these measures and they may no longer adequately reflect the distinction that was intended when the legislation was first implemented.

Any policy re-examination should consider not only the small versus large differential point but also the large versus very large situation. The stated objectives of the policy underpinning convergence with IFRS are comparability and usefulness of information, and the cost effectiveness of similar GAAP for cross-border listings. There are approximately 35 very large companies in Australia that have cross-border listings and the types of disclosures they are making are likely to be complex. With this in mind perhaps there is a need to move to a more extensive model based on a small, large and very large categorisation as operates in Canada. With the rapid growth of the Australian economy the suggested change is becoming an imperative as the costs associated with financial reporting compliance rise. It is also worth considering whether any measures of entity size should be dynamic and reflect the growth in the economy rather than be static measures such as those employed in the present model.

References

- Brailsford T. and Ramsey A. 1993, 'Issues in the Australian Differential Reporting Debate', *International Accounting, Auditing & Taxation*, 2(1), pp. 43-58.
- Brown, P. & Clinch, G. 1998, 'Global Harmonisation of Accounting Standards: What Research into Capital Markets Tells Us', *Australian Accounting Review*, Vol.8, No.1, pp.21-29.
- CAPA. 2003, *A Framework for Differential Reporting: A Response to ISAR's Accounting and Financial Reporting Guidelines for Small and Medium Sized Enterprises*, Report, Confederation of Asian and Pacific Accountants, Malaysia.
- Collett, P., Godfrey, J. and Hrasky, S. 1998, 'Standard-setting in Australia: Implications of Recent Radical Reform Proposals', *Australian Accounting Review*, Vol.8, No.2, pp.9-17.
- Corporations Act. 2001, Australian Government.
- Dixon J. 2003, *International Financial Reporting Standards (IFRS) for Australia in 2005*, CPA Australia Academic Information Session, Melbourne.
- Fenton-Jones, M. 2004, 'Changes to accounting test SMEs', *Australian Financial Review*, 29 June, p.49.
- HKSA (Hong Kong Society of Accountants). 2002, *Consultation Paper on a Proposed Framework for Differential Reporting*, issued by the Council, HKSA, August.
- Jarvis, R. 2003, 'A question of definition', *Accountancy Magazine*, p. 80.
- Knapp, J. & Kemp, S. 2004, *Accounting Handbook 2004*, Pearson Education Australia.
- Lev, B. & Sougiannis, T. 1996, 'The Capitalisation, Amortisation, and Value-Relevance of R&D', *Journal of Accounting and Economics*, Vol.21, pp.107-38.
- McCahey, J. & Ramsey, A. 1989, 'Differential Reporting: Nature of the Accounting Standards Overload Problem and a Proposal for its Resolution', *Discussion Paper No.13*, Australian Accounting Research Foundation.
- Mersereau A. 2003, 'Differential Reporting', *CA Magazine*, June/July, pp. 30-2.
- Nair, R.D. & Rittenberg, L.E. 1983, 'Professional Notes: Privately held businesses: Is there a standards overload?', *Journal of Accountancy*, 155(2), February, pp. 82-96.
- Parker, C. 2003, 'SMEs and 2005 adoption', *Australian CPA*, November, pp.65-6.
- Saudagaran, S. and Biddle, G. 1995, 'Foreign Listing Location: A Study of MNCs and Stock Exchanges in Eight Countries', *Journal of International Business Studies*, Vol.26, No.2, pp.318-41.
- Townsend, R. 2004, 'It's time to embrace accounting standards', *Australian Financial Review*, 9 March, p.63.
- Watson, A.K. 1962, address at the 8th International Congress of Accountants, New York, September, in Mahon, J.J. *Journal of Accountancy*, Vol.119, Iss.1, 1965.
- Yong, L. 2003, 'Foreword by CAPA President', in *A Framework for Differential Reporting*, Confederation of Asian and Pacific Accountants.