Post-Implementation Review

Reducing the Financial Reporting Burden: A Second Tier of Requirements for General Purpose Financial Statements

Introduction

<u>The problem originally being addressed – a second tier of GPFS requirements</u>

1 This post-implementation review considers the effectiveness of the optional second tier of requirements for general purpose financial statements (GPFS) introduced in June 2010. Tier 2 requirements comprise the recognition and measurement requirements of Tier 1 but substantially reduced disclosure requirements in comparison with Tier 1. The Tier 2 reduced disclosure requirements were introduced into Australian Accounting Standards through AASB 1053 *Application of Tiers of Australian Accounting Standards*, as a way of permitting most types of entities to reduce the cost of preparing GPFS in accordance with Accounting Standards yet still provide adequate information for the users of the financial statements. An entity preparing GPFS is required to comply with the full Tier 1 requirements if it does not elect to adopt Tier 2. Some types of entities are required to comply with the full Tier 1 requirements in preparing GPFS and do not have the option to adopt Tier 2 instead.

<u>Why carry out a post-implementation review?</u>

2 The AASB normally undertakes a post-implementation review of significant Standards after at least several years of experience with them. However, the AASB was anecdotally advised that the take-up of Tier 2 was low and also noted the current system of implementing Tier 2 was administratively difficult. The adoption of Tier 2 is also a key component of another important AASB project, to clarify and simplify the financial reporting framework in Australia. Accordingly, the AASB determined to carry out the PIR in conjunction with developing proposals for revising the approach to determining Tier 2 requirements. These proposals were published in January 2017 as Exposure Draft ED 277 *Reduced Disclosure Requirements for Tier 2 Entities*. This post-implementation review extracts key matters noted in that Exposure Draft, in particular in the Preface and the Basis for Conclusions.

3 Additionally, the AASB developed a Regulation Impact Statement when it introduced the Tier 2 reduced disclosure requirements (RDR). However, the RIS was finalised shortly after the AASB made its decision to issue AASB 1053, which meant the RIS did not meet best practice. As a result, the AASB is required by the Government's regulatory requirements to carry out this post-implementation review.

General purpose financial statements

<u>What are they and why are they required?</u>

4 Australian Accounting Standards define general purpose financial statements (GPFS) as financial statements that are intended to meet the needs of users who are not in a position to require an entity to prepare financial reports tailored to their particular information needs. GPFS provide those users with information which will be useful to them for making and evaluating decisions about the allocation of scarce resources.

Which entities are required to prepare GPFS?

5 Entities that are ‘reporting entities’ are required to prepare GPFS that comply with the AASB Accounting Standards. The Appendix to this post-implementation review explains the concept of a reporting entity, which is defined in AASB 1053. Whether an entity is or is not considered to be a reporting entity is determined by each entity.

6 However, AASB 1053 effectively deems certain types of entities to be reporting entities, such as for-profit private sector entities that have ‘public accountability’ (as defined in the Standard) and the Australian, State, Territory and Local Governments. Appendix B of AASB 1053 deems the following types of for-profit private sector entities to have public accountability: disclosing entities, co-operatives that issue debentures, registered managed investment schemes, superannuation plans regulated by the Australian Prudential Regulation Authority that are not small APRA funds, and authorised deposit-taking institutions. All of these types of entities are therefore required by AASB 1053 to prepare GPFS that comply with Tier 1 requirements. These types of entities are not eligible to adopt Tier 2.

7 The *Corporations Act 2001* requires disclosing entities, public companies, large proprietary companies and registered schemes to prepare and lodge on the public record financial statements that comply with the Accounting Standards. It is expected that all disclosing entities and registered schemes are reporting entities, and so AASB 1053 requires such entities to prepare GPFS. However, public companies and large proprietary companies that conclude that they are not reporting entities are permitted to prepare special purpose financial statements (SPFS) instead of GPFS. SPFS are not required to comply with all of the Accounting Standards.

8 Entities not incorporated under the Corporations Act – such as many not-for-profit entities (charities, associations, co-operatives, etc.) and most public sector entities (other than governments) – might be required by a regulator to prepare financial statements in accordance with the Accounting Standards. However, such entities that conclude that they are not reporting entities could therefore prepare SPFS instead of GPFS.

How many entities prepare GPFS?

9 It is unclear how many entities in Australia prepare GPFS rather than SPFS to satisfy legislative or regulatory requirements to lodge financial statements on the public record, since reporting entity status is self-assessed by entities. Although an entity’s financial statements should identify whether they are GPFS or SPFS, typically no summary information regarding the type of financial statements lodged on the public record is available. For example, the Australian Securities and Investments Commission (ASIC) does not summarise information included in company financial statements lodged with it under the Corporations Act. This means that individual financial statements would have to be reviewed to determine whether they were GPFS or SPFS, which would be an expensive and time-consuming process. However, some empirical evidence was collected as part of the PIR (see paragraph 22).

What was the problem?

10 Prior to the issuance of AASB 1053, reporting requirements less than compliance with full Australian Accounting Standards were only available to non-reporting entities in preparing SPFS. This was because the Accounting Standards included only one tier of

reporting requirements for all entities preparing GPFS. One concern expressed to the AASB by entities that prepare GPFS was that the disclosure requirements of the Accounting Standards were onerous for some entities, particularly those that are not listed or disclosing entities. It was argued that the costs of preparing GPFS for some entities were greater than the benefits for the users of those GPFS, because the Accounting Standards specified disclosure requirements for GPFS that were overly burdensome for many entities.

11 Full details of the issues raised regarding compliance with the full requirements of Australian Accounting Standards and the options considered by the AASB in response are set out in the AASB's Regulation Impact Statement *Reducing the Financial Reporting Burden: A Second Tier of Requirements for General Purpose Financial Statements*, which was finalised by the AASB in June 2010. The AASB considered three options:

- introducing a second tier of GPFS reporting requirements involving compliance with the Standards except for significantly reduced disclosure requirements;
- adopting the *International Financial Reporting Standard for Small and Medium-sized Entities* (*IFRS for SMEs* Standard) issued by the International Accounting Standards Board (IASB), modified to cover matters affecting not-for-profit entities; and
- doing nothing – maintaining the position that all GPFS would have to comply with the full requirements of the Standards.

Two tiers of general purpose financial statements – the 2010 changes

<u>What did the AASB do?</u>

12 To respond to this issue, the AASB established a differential reporting framework consisting of two tiers of GPFS, with the same recognition and measurement requirements but different levels of disclosures (option 1). Tier 2 disclosure requirements are substantially reduced in comparison with the disclosure requirements of Tier 1. Although there is a need for GPFS to cater for the information needs of a wide range of users, the objective is to find a balance between the benefits of financial information to the users and the costs to the preparers of providing that information. There is also a need to ensure that the users are not overburdened with unnecessary information that would make financial statements less understandable to them.

13 The Tier 2 requirements are optional, but when adopted reduce the reporting obligations on an entity in comparison with Tier 1. An entity preparing GPFS is required to comply with the full Tier 1 requirements if it does not elect to adopt Tier 2.

<u>When were the Tier 2 requirements introduced?</u>

14 Reduced disclosure requirements (Tier 2) were introduced through the issuance of Accounting Standard AASB 1053 and the accompanying AASB 2010-2 *Amendments to Australian Accounting Standards arising from Reduced Disclosure Requirements* in June 2010. The Tier 2 reduced disclosure requirements had an application date of annual reporting periods beginning on or after 1 July 2013. However, early application was permitted from 1 July 2009, so that eligible entities could elect to comply with Tier 2 from the time the reduced disclosure requirements were issued.

What do the Tier 2 requirements cover?

15 The Basis for Conclusions to AASB 1053 articulates the then Board's approach to determining disclosure requirements under RDR (the Reduced Disclosure Requirements of Tier 2), specifically, "… that satisfying the objective of general purpose financial statements should be the overriding basis for determining the disclosures under the RDR …" (paragraph BC76). Paragraph BC78 states:

> … the AASB concluded that users of general purpose financial statements of non-publicly accountable for-profit entities are particularly interested in information about:
>
> (a) short-term cash flows and about obligations, commitments or contingencies, whether or not recognised as liabilities;
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> (b) liquidity and solvency;
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> (c) measurement uncertainties;
>
> (d) the entity's accounting policy choices;
>
> (e) disaggregation of amounts presented in the financial statements; and
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> (f) transactions and other events and conditions encountered by such entities.

16 The approach to determining Tier 2 disclosures starts with the disclosures applying to Tier 1 entities and reduces them for Tier 2 entities by applying the 'user need' and 'cost-benefit' principles that underlie the disclosure requirements in the IASB's *IFRS for SMEs* Standard. Operational guidance was developed to facilitate the application of those principles. Therefore, the disclosures under the current RDR are determined by:

(a) drawing directly on the *IFRS for SMEs* Standard when the recognition and measurement accounting policy requirements under RDR are the same as those under the *IFRS for SMEs* Standard; and

(b) using the 'user need' and 'cost-benefit' principles applied by the IASB in developing its *IFRS for SMEs* Standard when the RDR recognition and measurement requirements are not the same as those under the *IFRS for SMEs* Standard.

What impact was expected?

17 The AASB expected that by providing the reduced Tier 2 disclosure requirements for GPFS there would be a substantial reduction in the reporting burden of many Australian entities that are required to prepare GPFS. For example, eligible entities that prepare GPFS, including large proprietary companies that consider themselves to be reporting entities, would be able to comply with the Tier 2 disclosures and not continue providing the larger set of Tier 1 disclosures in their GPFS. However, as application of the Tier 2 requirements is optional, and reporting entities could still elect to continue to comply with some or all of the Tier 1 requirements, there was no clear expectation as to how many for-profit and not-for-profit entities would adopt the reduced disclosure requirements of Tier 2 in their GPFS.

18 The Regulation Impact Statement prepared by the AASB in relation to the issuance of AASB 1053 identified positive, neutral and negative impacts on three groups from introducing Tier 2 reduced disclosure requirements: preparers of financial statements, users, and the accounting profession. Overall, the AASB concluded that introducing Tier 2 would offer a greater level of benefits than either continuing to require all GPFS

to fully comply with all disclosure requirements in the Accounting Standards or adopting alternative proposals, such as adopting the IASB's *IFRS for SMEs* Standard.

Post-implementation review

<u>How was the PIR conducted?</u>

19 The AASB has undertaken a post-implementation review of the Tier 2 reduced disclosure requirements for GPFS. Information was obtained from users of Tier 2 entities' financial statements about their information needs. Users consulted included bankers, specialist practitioners who help businesses to avoid liquidation, business valuers, private equity investors, and funders of not-for-profit entities.

20 Further information was obtained from an analysis of the financial reporting practices of large proprietary companies in Australia lodging annual financial statements with the ASIC, a review of some financial statements lodged with the ACNC, and feedback received through general stakeholder engagement, including feedback from the public sector.

<u>What did the PIR find?</u>

21 In summary, the feedback identified the common information needs of users as relating to:

(a) financial performance;

(b) liquidity and solvency;

(c) cash balances and cash flows;

(d) related party transactions and balances;

(e) accounting policies applied; and

(f) transactions and events that are significant for the entity.

These information needs of users are not the same as the information needs of users previously identified by the AASB, as listed in paragraph 15.

22 Consultation indicates that for entities that prepare GPFS and are eligible to apply the Tier 2 disclosure requirements:

(a) the level of adoption of Tier 2 GPFS requirements among companies limited by guarantee (not-for-profit entities) and subsidiaries of Tier 1 entities is reasonably widespread. Anecdotal evidence in the form of a non-random sample of 15 charities lodging GPFS with the ACNC identified that 80 percent were applying the Tier 2 disclosure requirements. There is also some anecdotal evidence that the increasing reporting requirements established under various State and Territory associations incorporation Acts may increase the adoption of RDR by other not-for-profit private sector entities;

(b) the level of adoption among other types of companies, including large proprietary companies, is very low – with the likely reason being that the general level of disclosure under Tier 2 is still viewed as burdensome and not sufficiently different to Tier 1 to warrant change. In relation to this, a recent analysis of the financial reporting practices by a sample of large proprietary companies in Australia lodging annual financial statements with the ASIC[1] identifies that:

(i) less than 10 percent of the total sample use Tier 2 disclosures; and

(ii) of those large proprietary companies sampled that prepare GPFS, around 20 percent use Tier 2 disclosures; and

(c) within the public sector, one factor seen as preventing greater use of Tier 2 disclosures is the need to consolidate public sector entities into the jurisdiction's whole-of-government general purpose financial statements and the perception that the differences between Tier 1 and Tier 2 do not warrant change from complying with the full disclosure requirements under Tier 1.

23 The post-implementation review identified:

(a) that the existing Tier 2 disclosure requirements determined using the disclosure principles based on those used by the IASB in determining the disclosures under the *IFRS for SMEs* Standard had not delivered the outcome expected; and

(b) a need to refine the principles used in determining the reductions in the disclosure requirements for Tier 2, in order to achieve an appropriate balance between the benefits of financial information to the users and the costs to the preparers of providing that information.

24 The apparent variable rate of adoption of Tier 2 requirements by different types of entities as noted in paragraph 22 most likely reflects varying assessments of the benefits to financial statement preparers in complying with Tier 2 rather than Tier 1 in their GPFS, as well as the opportunity to prepare SPFS when an entity can conclude that it is not a reporting entity. There does not appear to be any reason to link the uptake of Tier 2 with the enforcement activities of other regulators, such as the ASIC and the ACNC.

25 The AASB also noted that the IASB had decided not to update the *IFRS for SMEs* Standard for some of the limited-scope amendments and new IFRS Standards that were issued over the past few years (for example, IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases*). This means that, contrary to expectations, the *IFRS for SMEs* Standard cannot be used as the starting point for determining disclosure requirements for Tier 2 entities for these recently issued Standards. Instead, the AASB would have to make decisions about disclosure requirements for Tier 2 entities before the IASB or else delay those decisions until the IASB updates the *IFRS for SMEs* Standard.

<u>The AASB's conclusion</u>

26 After considering the findings of the PIR, the AASB decided to develop proposals to revise the Tier 2 disclosure requirements so that more entities would be expected to

1 Potter, B., Tanewski, G., and Wright, S., 2016, *Financial Reporting by Private Companies in Australia: Current Practice and Opportunities for Research*, paper presented at the AASB Research Forum, November 24, Sydney. The sample was a random sample of 394 large proprietary companies (with a 95 per cent confidence level).

elect to adopt the reduced requirements. The PIR findings and the proposals have been published in Exposure Draft ED 277 *Reduced Disclosure Requirements for Tier 2 Entities*, which was issued in January 2017. ED 277 includes a proposed revised framework for the AASB to determine Tier 2 disclosure requirements as well as proposed disclosure reductions for existing Australian Accounting Standards, which would replace the existing RDR disclosure concessions.

27 The AASB has received a range of comments from 14 Australian respondents in response to ED 277 and is addressing the issues raised in conjunction with the New Zealand Accounting Standards Board, which has the same Tier 2 requirements for for-profit entities. However, it is relevant to note here that all respondents supported redeveloping and improving the existing Tier 2 requirements (ie more disclosure concessions given). The respondents' views further support the PIR outcomes that change is needed to the existing Tier 2 concessions for GPFS for eligible entities. The optional basis of eligible entities being able to elect to apply Tier 2 rather than Tier 1 in preparing GPFS continues to be supported.

28 ED 277 respondents also noted that the Tier 2 RDR requirements are a key component of another AASB project, to improve the Australian financial reporting framework, which may resolve the issue of SPFS and result in a greater take-up of Tier 2. Consequently, the AASB is continuing to develop its approach to revising the Tier 2 requirements.

APPENDIX

Reporting entities

1 The Australian Accounting Standards Board (AASB) makes Australian Accounting Standards, including Interpretations, to be applied by:

(a) entities required by the *Corporations Act 2001* to prepare financial reports;

(b) governments in preparing financial statements for the whole of government and the General Government Sector (GGS); and

(c) entities in the private or public for-profit or not-for-profit sectors that are reporting entities or that prepare general purpose financial statements (GPFS).

2 'Reporting entities' are required to prepare GPFS that comply with the AASB Accounting Standards. A reporting entity is defined in AASB 1053 *Application of Tiers of Australian Accounting Standards* as an entity in respect of which it is reasonable to expect the existence of users who rely on the entity's GPFS for information that will be useful to them for making and evaluating decisions about the allocation of resources. A reporting entity can be a single entity or a group comprising a parent entity and all of its subsidiaries.

3 Whether an entity is or is not a reporting entity is determined by each entity. Assessing whether an entity is a reporting entity requires significant judgement in many cases. Statement of Accounting Concepts SAC 1 *Definition of the Reporting Entity* sets out guidance rather than mandatory requirements. SAC 1 identifies the following indicative, primary factors to be considered in determining whether an entity is a reporting entity: the separation of management from holders of economic interests in the entity, the economic or political importance or influence of the entity, and the entity's financial characteristics (such as the size or indebtedness of the entity).

4 It is not clear how many entities that present financial statements in Australia are reporting entities preparing GPFS, since reporting entity status is self-assessed by entities. Furthermore, although an entity's financial statements should identify whether they are GPFS or special purpose financial statements (SPFS), typically no summary information regarding the type of financial statements lodged on the public record is available. For example, the Australian Securities and Investments Commission (ASIC) does not summarise information included in company financial statements lodged with it under the Corporations Act. This means that individual financial statements would have to be reviewed to determine whether they were GPFS or SPFS, which would be a very expensive and time-consuming process.

5 Under the Corporations Act, disclosing entities, public companies, large proprietary companies and registered schemes are required to prepare and lodge financial statements that comply with the Accounting Standards. However, that requirement does not mean that such entities are reporting entities. For example, many unlisted public companies and large proprietary companies would not be reporting entities.

6 Entities not incorporated under the Corporations Act – such as many not-for-profit entities and most public sector entities – are required to apply the Accounting Standards in preparing their financial statements if they are reporting entities or

otherwise holding out their financial statements to be GPFS. Again, it is up to each entity to assess whether it is a reporting entity. However, regulators could require regulated entities that meet specified criteria to prepare GPFS, regardless of whether the entities assess themselves as reporting entities.