National Public Sector Convention, Perth WA

Implications of Harmonisation of Proposed International Standards for the Public Sector, including an Audit Perspective

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A. Harmonisation will impact all public sector entities

The actual degree of the changes will differ from entity to entity depending on the specifics of their business and their financial statements. As such, it is difficult to identify ‘global’ issues that will affect all public sector entities. Each entity will need to individually review the changes that will arise from harmonisation with International Standards and assess how they will impact upon them. I will be speaking from a Federal Government perspective.

The Australian National Audit Office (ANAO) will be presenting information at client seminars in November/December 2003 and April/May 2004 to assist our clients identify where their significant changes lie (discussed later). However, the onus will be on each entity to ensure that they are suitably informed such that they can identify which changes to standards will impact upon them. Agency management, in particular the Chief Finance Officer (CFO), will also need to ensure that the Audit Committee is kept informed of the agency’s progress towards International Financial Reporting Standards (IFRS) compliance.

Changes to be aware of are those that require:

- recognition or de-recognition of assets or liabilities;
- new recognition criteria of revenues and expenses;
- different data to be collected in calendar 2004, financial year 2004-2005 and onwards;
- changes to systems; and
- changes in the information to be disclosed.
Key issues to consider are the situations where:

- there is currently no Australian equivalent to an international standard;
- there is currently no international equivalent of an Australian standard; and
- the Australian standard is more comprehensive than its international equivalent.

1. There is currently no Australian equivalent to an international standard

The key major changes for Australia relate to areas where there is no current Australian accounting standard. Specifically, these areas are intangibles and recognition and measurement of financial instruments.

**Intangibles:**

Virtually all of the Commonwealth public sector’s intangibles are measured at cost, or deemed cost. This includes internally developed software for internal use. De-recognition may be required because IAS 38 allows valuation only in an active and liquid market.

**Recognition and Measurement of Financial Instruments:**

In the absence of an Australian standard on this topic, cost and market value are currently used. The proposed IAS 39 includes:

- all financial assets and liabilities must be recognised;
- a fair value option - otherwise record at fair value or amortised cost; and
- strict rules on what is a hedge for accounting purposes.

Other changes relate to:

- impairment test for non-current assets;
- recognition of defined benefit superannuation liabilities;
- restoration provisions;
- accounting for revaluations;
- accounting for correction of errors;
- accounting for voluntary changes of accounting policy; and
- revenue recognition, including of government grants.

2. There is currently no international equivalent of an Australian standard

Another issue for consideration is the situation where there is currently an Australian accounting standard, but there is no equivalent international standard. This situation is applicable to the following standards:

- **AAS 27 Financial Reporting by Local Government**;
- **AAS 29 Financial Reporting by Government Departments**;
• AAS 31 *Financial Reporting by Governments*;
• AASB 1022 *Accounting for Extractive Industries*;
• AASB 1023 *Financial Reporting for General Insurance Activities*;
• AASB 1025 *Application of the Reporting Entity Concept and Other Amendments*;
• AASB 1030 *Application of Accounting Standards to Financial Year Accounts and Consolidated Accounts of Disclosing Entities Other than Companies*;
• AASB 1038 *Life Insurance Business*;
• AASB 1039 *Concise Financial Reports*; and
• AASB 1043 *Changes to the Application of AASB and AAS Standards and Other Amendments*.

To address the issue of no international equivalent of an Australian Accounting Standard, the existing Australian standard will remain in force until an appropriate international equivalent is developed.

The Australian public sector standards (AAS 27, AAS 29 and AAS 31) are currently being reviewed. An exposure draft (ED 125) has been issued in relation to AAS 27, with comments due to the Australian Accounting Standards Board (AASB) by late February. This is an important exposure draft to read, and comment upon, as it covers issues relating to revenue recognition and accounting for government grants of relevance to the public sector as a whole. These concepts may also be applied to AAS 29 and AAS 31 when they are reviewed, after further work has been completed on the project to harmonise Australian generally accepted accounting principles (GAAP) with Government Financial Statistics (GFS).

The GFS reporting framework is a sophisticated statistical system, consistent with international statistical standards and guidance published by the International Monetary Fund. This framework provides comprehensive statistical information and assessments for economic analysis of the public sector, and reflects the needs of fiscal analysts and other users interested in such analysis. This approach contrasts with Australian GAAP, which aims to provide users with sufficient information to evaluate the entity’s financial performance and position, and utilisation of resources.

In addition to conceptual inconsistencies, there are a number of technical differences between GFS and Australian GAAP relating to timing and permanent differences, which lead to dissimilar net results and/or balance sheets. The Federal budget includes information on both bases. This has caused some confusion in the Federal Parliament, and lack of clarity in relation to comparisons with financial reporting.

### 3. The Australian standard is more comprehensive than its international equivalent

There are also instances where the current Australian accounting standards have more comprehensive requirements than their international equivalents. For example, the IAS 7 *Cash Flow Statements* requires significantly less disclosure of credit stand-by
arrangements than required by the Australian standard AASB 1026 *Statement of Cash Flows*.

To preserve the high quality of Australian standards, the AASB will add additional text to the international standards. The letters ‘Aus’ will prefix this additional text. Text applicable only by not-for-profit entities will also be added and prefixed by the letters ‘NFP’. The AASB has also resolved to include options from the international standards in the Australian equivalent standards. This decision was made on the basis of the Board’s understanding of the International Accounting Standards Board’s intention to not include options in IFRSs. The AASB will review the options in currently issued international standards on a case-by-case basis and include all options where there is a compelling reason to do so.

Examples of requirements for a not-for-profit entity only have been included in exposure drafts of Australian versions of international standards. For example, Exposure Draft 120 Request for Comment on IAS 16 and IPSAS 17 Property, Plant and Equipment included the following paragraph:

\[
\text{NFP4 In respect of not-for-profit entities, revaluation increases and decreases relating to individual assets within a class of property, plant and equipment must be offset against one another with that class but shall not be offset in respect of assets in different classes.}
\]

The AASB’s decision to include additional text for not-for-profit entities may bring about an unexpected issue for public sector adoption of international standards, whereby compliance with the AASB’s additional requirements may prevent, or inhibit, the public sector from fully adopting IFRSs. IFRS 1 *First-time adoption of International Financial Reporting Standards* includes a requirement for entities to make, in their first IFRS-compliant financial statements, an “…explicit and unreserved statement in those financial statements of compliance with IFRSs.” If, for example, the public sector accounts for asset revaluations on a class basis, this approach contradicts the international standard’s requirement for asset revaluations to be accounted for on an asset-by-asset basis. This begs the question – could the public sector realistically make explicit and unreserved statements about compliance with IFRSs while applying additional Australian requirements that are contradictory to those standards?

**B. Timing of Harmonisation**

An issue that will impact all Commonwealth public sector entities is the timing of harmonisation with International Standards. First-time application of international standards will be an issue, as it may well coincide with further compression of the financial reporting timetable and potential preparations for harmonisation of Australian GAAP with GFS.

The *Charter of Budget Honesty Act 1998* requires Commonwealth entities to provide financial information to the Department of Finance and Administration (Finance) to

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1 IFRS 1 paragraph 3
facilitate the preparation of the Consolidated Financial Statements and Final Budget Outcome (FBO) each year.

In late 2002, these deadlines were tightened following the publication of Estimates Memorandum 2002/13 “Budget Estimates and Framework Review – Recommendations”. Finance’s reporting goals are summarised in the following table:

<table>
<thead>
<tr>
<th>Financial year ending</th>
<th>Audit clearance required from ANAO</th>
<th>Calendar days from 30 June</th>
<th>Finance provides FBO</th>
<th>Calendar days from 30 June</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 30, 2003</td>
<td>August 15, 2003</td>
<td>46</td>
<td>August 30, 2003</td>
<td>61</td>
</tr>
<tr>
<td>June 30, 2004</td>
<td>July 30, 2004</td>
<td>30</td>
<td>August 20, 2004</td>
<td>51</td>
</tr>
<tr>
<td>June 30, 2005</td>
<td>July 20, 2005</td>
<td>20</td>
<td>August 14, 2005</td>
<td>45</td>
</tr>
</tbody>
</table>

To achieve these goals, Finance is proposing to incrementally tighten the reporting timetable for Commonwealth entities. The challenges with this tightening timetable lie with both agencies and the Australian National Audit Office to ensure that the required information is made available to Finance when required.

The Budget Estimates and Framework Review also recommended further work to harmonise Australian GAAP with GFS. The review proposed harmonisation would be achieved by developing an accounting standard to harmonise the two approaches by Treasury and Finance departments around Australia within the AASB framework.

The Australian Accounting Standards Board is scheduled to issue an exposure draft in May 2004 for application of the new standard in 2005-2006. The Board has recently finalised its preliminary views on a range of issues relating to harmonisation of Australia GAAP and GFS. This includes adoption of GAAP definitions, recognition and measurement principles “…with note disclosure where necessary to satisfy GFS requirements where they differ from GAAP requirements.”

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2 AASB Action Alert number 22 October 2003.
C. **Managing relationships with clients including providing assistance, whilst maintaining independence**

The previous slide listed a number of issues for public sector entities to be aware of and ultimately work through. As noted earlier, this is a particular challenge for Chief Finance Officers and senior management. As our client’s independent auditors, we will be seen as a source of advice during this time of change. Whilst this is an excellent opportunity to add value to our clients, we also need to be aware of the boundaries of this role and ensure we do not compromise our independence.

In addition to the publication of our annual *AMODEL Illustrative Accounts* and quarterly newsletter *Opinions*, the ANAO are presenting two series of client seminars. The first series will be run in November/December 2003 and will cover:

- fundamental differences between the international and current Australian frameworks;
- the process of transition from current to international-equivalent standards;
- client’s responsibilities for managing the change; and
- major changes in selected subject areas, such as accounting for intangible assets.

The second series of seminars will be held after the new Australian standards to apply from 2005 are all ready for issue in April/May 2004. These seminars will deal more comprehensively with the detail of the changes made.

D. **Identification of accounting issues that will impact on each of our clients**

Our clients are not the only ones who need to get across the changes arising from the adoption of international standards. Auditors also need to be aware of these changes to be able to:

- identify which changes will be significant for each of their clients;
• assess the process/es their clients have put in place to address these changes (including system changes as required);
• provide their clients with value-adding advice; and
• effectively complete their audits.

The ANAO has planned extensive training for our own staff to ensure they have the skills and knowledge required to continue to complete financial statement audits to a high standard. This includes both an initial awareness program to be followed by more detailed training closer to the time of implementation.

E. Understanding changes to harmonised auditing standards

The ANAO is also planning an extensive training for our own staff to ensure they are aware of any changes arising from harmonisation of Australian Auditing Standards with International Standards on Auditing.

The Auditing and Assurance Standards Board (AuASB) has a long-standing policy of convergence and harmonisation with International Standards on Auditing (ISA). The AuASB uses ISAs as the basis for its corresponding Australian Auditing and Assurance Standards (AUSs). It is the policy of the AuASB, to aim to ensure that moving forward, compliance with AUSs will also constitute compliance with ISA. It is anticipated that, through ongoing revisions of ISA and AUSs and their further convergence over the next two years, the project’s goal of attaining harmonisation by the commencement of 2005 will be achieved.

The AuASB has recently undertaken a comparison of the ‘black-letter’ requirements of ISA and AUSs to determine the extent and nature of any differences. This review identified 35 differences between the current ISA and AUSs.

The AuASB and International Auditing and Assurance Standards Board generally issue an exposure draft of a proposed auditing and assurance standard concurrently for consideration by interested parties. It is expected that an exposure draft will be issued to address each difference noted.

On the basis of exposure drafts issued to date, it is expected that the harmonised standards will take on a principles-based approach to auditing, as opposed to the prescriptive-based approach used in the United States after the introduction of Sarbanes-Oxley. The principles-based approach allows for greater use of auditor’s judgment and contrasts with the current approach in the United States, which includes the creation of the Public Company Accounting Oversight Board (PCAOB) as regulator and upholder of Sarbanes-Oxley Act requirements and American auditing standards.

F. When to audit comparatives for calendar 2005 or financial year 2005-2006?

When the ANAO and other auditors will audit the internationally compliant data prepared as comparatives for the first published IFRS-compliant financial statements
is a significant operational matter to be considered. There are a number of alternative approaches could be taken, including auditing this information:

- concurrently with the calendar 2005/2004-2005 financial statements;
- immediately after the completion of the audit of the calendar 2004 or financial year 2004-2005 financial statements; or
- as part of the audit of the calendar 2005 or financial year 2005-2006 financial statements.

There are of course pros and cons with each approach. Auditing the re-cast financial information immediately after the completion of the audit might be preferred, as this approach takes best advantage of the currency of transactional information in both the minds of the financial statement preparers and auditors.

A significant part of the decision-making process will need to be consultation with the client to determine which of the approaches is most practical, and taking into consideration any guidance given to agencies by Finance.

G. Concluding Remarks

The essential messages for all organisations involved in the preparation of financial reports is to ensure they have the appropriate systems and procedures in place to effectively manage the transition to the adoption of the international and other harmonised standards. We all need to take a pro-active approach. Nevertheless, you can expect the assistance of your external auditors while recognising that changes to your systems, including the generation of comparative information, are management’s responsibility.