Special purpose on life-support?

Reporting Update

23 May 2018, 18RU-001

Highlights

- Applying the IASB's *Conceptual Framework* in Australia
- Reporting entity issue
- Special purpose financial statements issue
- AASB preferred approach

Have your say on ITC 39 – it proposes the end of special purpose financial statements for a large number of entities

The Australian Accounting Standards Board (AASB) issued ITC 39 *Applying the IASB's revised conceptual framework and solving the reporting entity and special purpose financial statement problems* (ITC 39) in May 2018.

Applying the IASB's Conceptual Framework in Australia

What is happening?

The International Accounting Standards Board (IASB) issued a revised *Conceptual Framework for Financial Reporting* (RCF) in March 2018. In response, to be consistent with the AASB's strategy and the Financial Reporting Council's directive, the RCF needs to be applied in Australia. In the course of considering applying the RCF in Australia, the AASB has identified an inconsistency in the definition of 'reporting entity' in the RCF and the widely used and understood Australian 'reporting entity concept' set out in Statement of Accounting Concepts SAC 1 *Definition of the Reporting Entity* (SAC 1*)*.

This has drawn attention to the more emotionally-charged issue of special purpose financial statements (SPFS). ITC 39 sets out the reasons behind the AASB's decision to 'make a move' on SPFS at this particular time.

For more detail on the RCF refer to the Appendix.

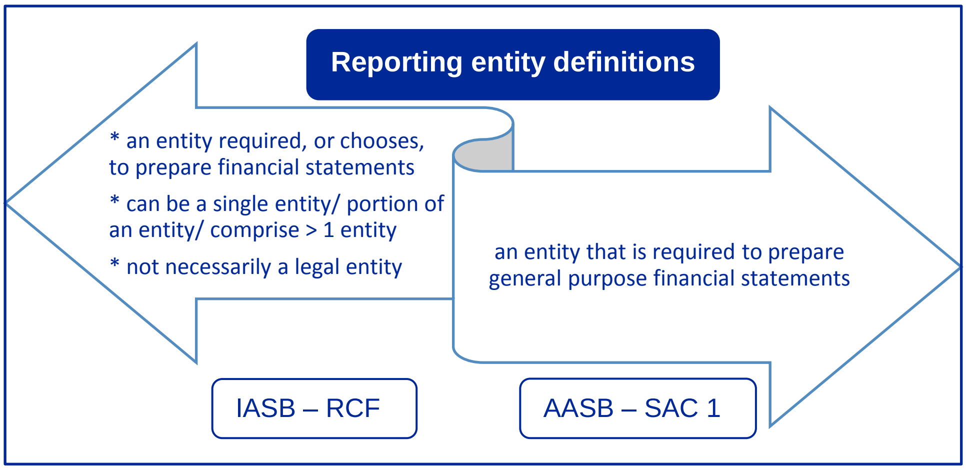
What the proposals do not impact

The AASB's proposals would not impact reporting requirements of trusts and other entities (for example, self-managed superannuation funds) that are not currently required by legislation, deeds of constitution or otherwise to prepare financial statements in accordance with Australian Accounting Standards (AAS). They would also not impact the 'grandfathered proprietary companies' having lodgement relief under s1408 of the Corporations Act.

The proposals also do not impact the 'large proprietary test' in the *Corporations Act* 2001 or any other objective thresholds set out in any legislation.

A clash in the definitions of 'reporting entity'

Reporting entity issue



The RCF entity definition of reporting determines a boundary for what economic activities need to be included in general purpose financial statements (GPFS). The SAC 1 definition of reporting entity determines who should prepare GPFS – all other entities can choose to prepare SPFS.

The concern is that the inconsistency between the two definitions could result in misinterpretation, the wrong application of AASs or non-compliance with IFRS.

'It's time' says the AASB

Special purpose financial statements issue

The dissatisfaction with SPFS has been building for some time as the proposition from which it was developed has diminished over the past 30 odd years. AASB data notes that greater than 60% of companies required to publicly lodge with ASIC lodge SPFS. The AASB would question if this is what was intended when the Australian 'reporting entity concept' was developed.

The AASB has also noted its legislative requirements under the ASIC Act require it to facilitate consistency, comparability and transparent financial statements. Arguably this is not best achieved with SPFS.

In making the move on SPFS, the AASB has acknowledged that this is an opportune time to deal with this issue. Australia is the only country permitting entities to self-assess what type of financial statements are required where financial statements are required by a regulator. The AASB sees this as a way to contribute to the current environment of building trust and comparability through transparency.

"The AASB has stated in the past that the ideal solution to the special purpose issue is for regulators to amend legislation to ensure that for those entities that are required to publicly lodge financial statements they should prepare general purpose financial statements. Making this happen is not easy in the current environment. It has been over ten years since the size thresholds around proprietary companies were last revised.

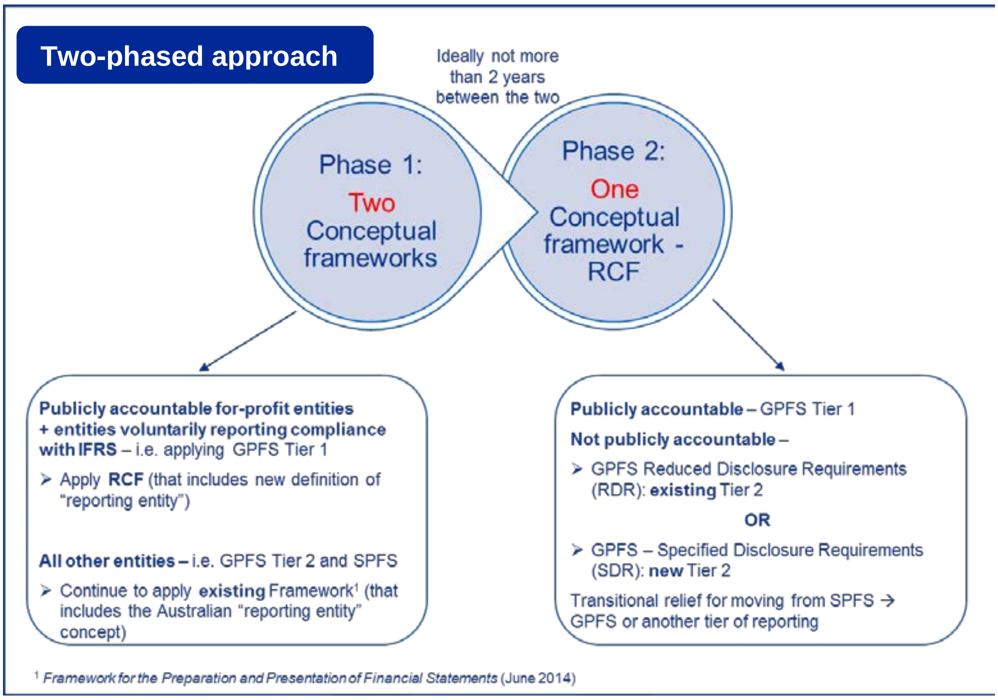
As such, the AASB has decided that with the revision to the Conceptual Framework that now is the time to address the special purpose issue."

Michael Voogt
Director, Department of Professional Practice

Two-phased approach to maintain IFRS compliance and achieve a better long-term outcome

AASB preferred approach

The AASB has a preferred option for adopting the RCF in Australia: Two-phased approach



Phase 1

Phase 1 would ensure Tier 1 entities are able to maintain IFRS compliance and its adoption will be consistent with the IASB timelines.

During Phase 1 entities preparing GPFS using Tier 2 or those preparing SPFS will continue to do so under the existing Framework.

Either RDR or SDR, not both

What is RDR?

GPFS RDR is the existing GPFS Tier 2 set out in AASB 1053 *Application of Tiers of Australian Accounting Standards* which applies full recognition and measurement of Australian Accounting Standards with **reduced disclosures** from each Accounting Standard. This includes consolidation and equity accounting where applicable.

What is SDR?

GPFS SDR is a new GPFS Tier 2 which applies full recognition and measurement of Australian Accounting Standards with **specified disclosures** from **some** Accounting Standards. This includes consolidation and equity accounting where applicable. The AASB is proposing the **full** disclosures of the following specified Australian Accounting Standards be applied:

- AASB 101 *Presentation of Financial Statements*
- AASB 107 *Statement of Cash Flows*
- AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*
- AASB 1048 *Interpretation of Standards*
- AASB 1054 *Australian Additional Disclosures*

- Related party disclosures[1]
- Revenue [1]
- Impairment of assets[1]
- Income taxes[1]

[1] For a for-profit entity this would be AASB 124, AASB 15, AASB 136 and AASB 112 respectively.

The above requirements are the minimum requirements. For example, an entity principally holding investment properties would also need to consider the disclosure requirements in AASB 140 *Investment Property*. So there is still an element of the preparer determine what to disclose.

Genuine consultation process

The AASB has been explicit in its communication that it is genuinely interested in feedback and views on all aspects of the consultation. For example, in relation to specified disclosures – are these the 'right' disclosures to meet users' needs. The AASB is open to other suggestions. ITC 39 is the first step in the consultation process in relation to Phase 2, which will include significantly more gathering of data and research, targeted consultation and only then the issue of an Exposure Draft.

The consultation process may identify the need for an additional tier of financial reporting – for example, the ACNC's legislative review. The AASB has not ruled out additional tier(s) and is seeking comment by all as part of the consultation process. The key for the AASB will be the development of an objective criteria to determine who falls in each tier.

Transitional relief

One of the most significant impact of an entity currently preparing SPFS moving to preparing GPFS is the application of consolidation and equity accounting – where these have not previously been applied. The AASB is aware of the practical difficulties that such a requirement brings and is committed to providing practical transitional relief to alleviate the challenges of sourcing historical data that may either not be able to be obtained, or not reliable if obtained, in order to apply consolidation or equity accounting, as applicable.

The other options considered

The AASB did consider four other options for addressing the perceived issues:

- Option 2: Operate with two conceptual frameworks indefinitely
- Option 3: All entities apply the RCF when it first becomes applicable
- Option 4: Do nothing and lose IFRS compliance
- Option 5: All entities to apply the RCF, change the name of the Australian reporting entity concept and prescribe minimum requirements for SPFS.

ITC 39 details each of these options together with benefits and barriers to each – and why the AASB has rejected the respective option and prefers Option 1.

The AASB also reconsidered IFRS for SMEs but dismissed it for all the same reasons as when AASB 1053 has initially adopted.

Next steps

Read the ITC for further information and full details. Submissions relating to Phase 1 are due by **9 August**. Submissions relating to Phase 2 are due by **9 November**.

Appendix - IASB Conceptual Framework

What is the *Conceptual Framework*?

A practical tool that assists

Board	Preparers	All
to develop Standards	to develop consistent accounting policies	to understand and interpret Standards

Addresses fundamental issues

What is the objective of financial reporting?	What makes financial information useful?	What are assets, liabilities, equity, income and expenses, when should they be recognised and how should they be measured, presented and disclosed?

The *Conceptual Framework* sets out the fundamental concepts of financial reporting that guide the IASB in developing IFRS Standards. It helps to ensure that the Standards are conceptually consistent and that similar transactions are treated the same way, providing useful information for investors and others.

The *Conceptual Framework* also assists companies in developing accounting policies when no IFRS Standard applies to a particular transaction; and it helps stakeholders more broadly to understand the Standards better. We expect it to be rare for companies to use the *Conceptual Framework* to select their accounting policies in the absence of specific requirements in the Standards. Companies will need to apply any changes in accounting policies retrospectively.

Examples were a company may use the *Conceptual Framework* may include:

- determining whether a transaction with an owner is in their capacity as an owner or a trading partner
- prepayments for future services that do not meet the definition of property, plant and equipment, intangibles or leases.

The *Conceptual Framework* underpins the Standards but does not override any Standard or any requirements in a Standard.

The IASB released a revised *Conceptual Framework* in March 2018. The IASB will start using the revised *Conceptual Framework* immediately, whereas companies will use it from 2020.

The *Conceptual Framework* sets out:

- the objective of general purpose financial reporting
- the qualitative characteristics of useful financial information
- a description of the reporting entity and its boundary
- definitions of an asset, a liability, equity, income and expenses and guidance supporting these definitions
- criteria for including assets and liabilities in financial statements (recognition) and guidance on when to remove them (derecognition)
- measurement bases and guidance on when to use them
- concepts and guidance on presentation and disclosure
- concepts relating to capital and capital maintenance.

Why change?

The previous *Conceptual Framework* was issued in 1989 and partly revised in 2010. It was incomplete and needed improvement – in particular:

- it was identified as a priority by stakeholders as part of the 2011 Agenda Consultation
- there were gaps that needed to be filled – for example, guidance on measurement, presentation and disclosure, including guidance on the use of profit/loss and other comprehensive income
- there was a need to update some guidance – for example, the definitions of assets and liabilities
- there was a need to clarify some guidance – for example, the role of measurement uncertainty and the roles of stewardship and prudence in financial reporting.

In revising the *Conceptual Framework* the IASB has sought a balance between providing high-level concepts and providing enough detail for the *Conceptual Framework* to be useful to the IASB and others.

What's changed?

<table>
<tr><th colspan="4">New</th></tr>
<tr><td>Measurement</td><td colspan="3">Concepts on measurement, including factors to be considered when selecting a measurement basis</td></tr>
<tr><td>Presentation and disclosure</td><td colspan="3">Concepts on presentation and disclosure, including when to classify income and expenses in other comprehensive income</td></tr>
<tr><td>Derecognition</td><td colspan="3">Guidance on when assets and liabilities are removed from financial statements</td></tr>
<tr><td colspan="4"></td></tr>
<tr><th colspan="4">Updated</th></tr>
<tr><td>Definitions</td><td colspan="3">Definitions of an asset and a liability</td></tr>
<tr><td>Recognition</td><td colspan="3">Criteria for including assets and liabilities in financial statements</td></tr>
<tr><td colspan="4"></td></tr>
<tr><th colspan="4">Clarified</th></tr>
<tr><td>Prudence</td><td>Stewardship</td><td>Measurement uncertainty</td><td>Substance over form</td></tr>
</table>

The revised *Conceptual Framework* is more comprehensive than the old one. However, most of the concepts are not new – it codifies the IASB's thinking adopted in recent standards (for example, IFRS 16 *Leases*).

The granularity of guidance differs. Some chapters only highlight a list of choices for the IASB to apply when setting Standards – for example, measurement, and presentation and disclosures. Conversely other chapters provide more direction on how the IASB should make those choices – for example, assets and liabilities. The distinction between liabilities and equity has been removed from the revised *Conceptual Framework*. It will be dealt with as a separate project.

The main changes to the revised *Conceptual Framework's* principles have implications for how and when assets and liabilities are recognised and derecognised in the financial statements.

Some concepts are entirely new – for example, the practical ability approach to liabilities. It is unclear what challenges the IASB (and preparers) will encounter as new standards are developed.

Change	Impact and challenges
New 'bundles of rights' approach to assets	A physical object can be 'sliced and diced' from an accounting perspective. For example, in some circumstances a company would book as an asset a *right to use* an aircraft, rather than an aircraft itself. The challenge will be determining to what extent an asset can be split into different rights and the impact on recognition and derecognition.
New 'practical ability' approach for recognising liabilities	The old recognition thresholds are gone – a liability will be recognised if a company has no practical ability to avoid it. This may bring some liabilities on the balance sheet earlier than at present. However, if there is uncertainty over existence and measurement or a low probability of outflows, then this may result in no or delayed recognition in some cases. The challenge will be determining which future actions/costs a company has no 'practical ability' to avoid.
New control-based approach to derecognition	A company will take an asset off balance sheet when it loses control over all or part of it – i.e. the focus is no longer on the transfer of risks and rewards. The challenge will be determining what to do if the company retains some rights after the transfer.

Further details of changes to the *Conceptual Framework* may be found in the IASB Project Summary.

Exemptions

IFRS 3 *Business Combinations*

To avoid unintended consequences, acquirers are required to apply the definitions of an asset and a liability and supporting concepts in the previous, rather than the revised, *Conceptual Framework*. The IASB plans to assess how IFRS 3 can be updated without unintended consequences.

Regulatory account balances

When developing accounting policies for regulatory account balances applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, entities are required to refer to the previous, rather that the revised, *Conceptual Framework*. This avoids entities revising those accounting policies twice within a short period: once for the revised *Conceptual Framework* and again when a revised Standard on rate-regulated activities is issued.