



## *Applying International Financial Reporting Standards to the Public Sector*

### *Frequently Asked Questions*

December 2003

#### **Disclaimer**

This publication is a guide based on information available as at December 2003 and is not a substitute for the exposure drafts, AASB and IASB Standards. Users of this publication should be aware that the requirements of IFRS could change over time until the release of final AASB equivalent of IFRSs. For further information, please refer to the AASB website or other useful websites listed on Page 21.

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## 1. BACKGROUND TO IFRS TRANSITION

In July 2002, the Financial Reporting Council (FRC) announced that Australia will adopt international accounting standards<sup>1</sup> (now known as International Financial Reporting Standards – IFRS) by 1 January 2005. The effect of the FRC's pronouncement means all reporting entities under the *Corporations Act 2001* both listed and unlisted entities, private and public will be affected. In addition, since the Australian Accounting Standards Board (AASB) sets one set of standards for all reporting entities, the new standards will apply to all non-Corporations Act entities as well.

To this effect, before the transition deadline, existing Australian standards (AASBs) which are legally binding standards under the Corporations Act, will be converged with their international equivalents (IASB standards).

The proposed international harmonisation strategy means Australian entities applying the AASB standards from 1 January 2005 will automatically satisfy the requirements of the IASB standards. This move will not only promote consistency in international reporting but also promotes the transparency and comparability of financial reporting across international borders.

## 2. PUBLIC SECTOR PERSPECTIVE

The Australian Accounting Standards Board (AASB) is responsible for the technical agenda of 2005 convergence. The AASB develops standards that apply to all reporting entities both for-profit and not-for-profit. By contrast, IASB standards are limited to for-profit entities. Notwithstanding the for-profit nature of some public sector entities, as part of the convergence process the AASB may include additional text or requirements in some standards to address specific not-for-profit accounting issues, which will apply to public sector entities.

## 3. SOLUTIONS TO YOUR QUESTIONS

To ensure a smooth transition process for the fast approaching deadline of January 2005, public sector entities must be equipped to produce transparent corporate information under the new regime.

To promote awareness of IFRS issues, this publication addresses some of the broad key issues that may arise as public sector entities consider their strategies for conversion with the international standards and provides solutions to some of the frequently asked questions on the process of converging AASB standards with IASB standards. QAO will continue to monitor the implementation of IFRS in the public sector and provide assistance where necessary to ensure a successful transition.

## 4. SUMMARY OF SIGNIFICANT CHANGES FROM CONVERGENCE OF AASB WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS

The transition to the adoption of IFRS is fast-approaching, particularly for public sector agencies with a 31 December year end as comparative information (under the new IFRSs) will be required for annual reporting periods beginning 1 January 2004. As a result of the conversion, a number of significant changes<sup>2</sup> will be seen which impact on all reporting entities —

- A wide ranging impairment test will replace the recoverable amount test. Impairment testing will apply to ALL public sector entities and to most assets. Currently, AAS 10 does not apply to public sector entities where assets are not dependent on generating cash inflows or assets measured at fair value. The emphasis in IFRSs is on valuation – fair value is the norm rather than cost allocation.
- Amortisation of goodwill will no longer apply, and will be replaced by an asset impairment test. This same rule applies to identifiable intangible assets with indefinite lives.
- Internally generated brands and mastheads cannot be recognised in the books.
- Negative goodwill will be booked as a profit on acquisition.
- An acquiree's contingent liabilities must be recognised at their fair value in an acquisition.
- Only previously existing provisions for restructuring and terminations may be recognised in an acquisition.

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<sup>1</sup> The term International Accounting Standards (IAS) is used interchangeably with International Financial Reporting Standards (IFRS) and International Accounting Standards Board (IASB) standards throughout the document.

<sup>2</sup> Shanahan. J, 'International Financial Reporting Standards and Public Sector Reporting', 13 November 2003

- Quasi-equity, such as resetting preference shares, will be recognised as a liability rather than as equity. In-substance defeasances will be banned. This means that debt will have to be re-recognised. However, if assets have been transferred irrevocably, they cannot be re-recognised.
- Recognition and measurement rules will be imposed for financial instruments.
- Explicit hedge accounting rules – and guidance on measuring hedge effectiveness are established.
- Voluntary changes in accounting policy are taken against opening retained earnings rather than through current period profit or loss (therefore, profit or loss will no longer be an 'all inclusive' concept).
- Australian reporting standards on related party transaction disclosures will be lowered.
- Investment property may be recognised on a fair value basis and not depreciated, with value changes being recognised in profit and loss.
- Any lease other than a finance lease is an operating lease as opposed to current *AAS 17: Leases*.
- 'For-profit' entities will have to account for revaluation changes on an individual asset basis rather than a class basis.
- When depreciable assets are revalued, in most cases, accumulated depreciation is eliminated against the carrying amount of the asset and the asset is restated at its net revalued amount, with no accumulated depreciation.
- It will be mandatory to recognise significant components of complex assets with differing useful lives.
- There will be a new category of assets – assets held for disposal, where assets must meet several tests to qualify. If assets qualify as assets held for disposal, these assets will no longer be depreciated.

## 5. QUESTIONS

### WHAT ARE THE BENEFITS OF IFRS?

#### 1. Question ♦

What are the benefits for adoption of IFRS?

*Answer*

By adopting IFRS, entities are also adopting a global financial reporting language that will enable the financial results of entities to be understood by global stakeholders. In terms of for-profit entities, the change to IFRS proposes to —

- facilitate greater access to world capital markets;
- reduce the cost of capital;
- increase portability of skills across jurisdictions;
- present financial information in one language;
- provide a level playing field for multinational corporations to apply common accounting methods across their subsidiaries, which can potentially improve internal communications and the quality of managerial decision-making; and
- attract acquisitions and divestments through greater certainty and consistency of accounting information and interpretation.

For not-for-profit and government entities, the adoption of international accounting standards also promotes the application of common accounting methods and assertions across government agencies. This facilitates more meaningful comparisons and benchmarking between similar agencies (including Whole-of-Government comparisons across jurisdictions).

As part of the Financial Reporting Council's broad strategic direction, the AASB is also pursuing the harmonisation of Government Finance Statistics (GFS) and Generally Accepted Accounting Principles (GAAP).

#### 2. Question ♦

What are the benefits of harmonisation between GFS and GAAP reporting?

*Answer*

In principle, the AASB's Project has the potential to have an impact on all public sector entities. The Board has decided to implement the project in three phases, with Phases 1 and 2 progressed concurrently. The objective of converging GFS with Australian GAAP is to produce a set of high quality standards which provide a single set of Government financial reports which are auditable, comparable between jurisdictions (Australia and internationally) and in which the outcome statements are directly comparable with the budgeted statements.

The Board proposes the following benefits from the project —

- improved transparency;
- remove opportunities for Governments to choose how they present their budgets and their outcome financial statements;
- improve the quality of the key financial statements of Government by permitting them to be audited; and
- provide a strong incentive to improve the quality of the information contained in the budget statements.

#### 3. Question ♦

How does the GAAP and GFS convergence interact with IFRS harmonisation?

*Answer*

If the AASB issues a new standard converging GAAP and GFS, these requirements will supersede the IFRS requirements that commence on 1 January 2004 or 1 July 2004. Consequently, a new reporting framework will be established and will have to be adopted. It is presently unclear what the proposed commencement date will be and whether the GFS converged framework will apply to all public sector entities or only at a whole-of-government reporting level.

#### 4. Question

As a result of international convergence, what is the future for Statement of Accounting Concepts (SACs)?

*Answer*

The IASB has no equivalent to SAC 1 *Definition of the Reporting Entity*, and the reporting entity concept is embedded in Australian GAAP. The concept of general purpose financial reports in SAC 2 *Objective of General Purpose Financial Reporting*, is also essential to the application of AASB Standards. The AASB plans to retain the substantive content of SACs 1 and 2 in some form. In relation to SAC 3 *Qualitative Characteristics of Financial Information* and SAC 4 *Definition and Recognition of the Elements of Financial Statements*, the IASB has a relatively brief conceptual framework document compared with the current Australian conceptual framework in SACs 3 and 4. The IASB's Framework and SACs 3 and 4 are highly similar, except for the material relating to prudence (IASB's Framework includes prudence as a qualitative characteristic whereas SAC 3 does not) and revenues (IASB's Framework has revenues plus gains equals income - SAC 4 does not make this split).

The AASB notes that it is necessary to adopt the IASB framework when adopting the IASB standards because the standards are based on the Framework. The Framework is also part of the hierarchy of rules and guidance that entities need to apply under IAS 1 *Presentation of Financial Statements*.

#### WHICH ENTITIES WILL BE AFFECTED AND WHEN?

#### 5. Question

Which Australian entities will be required to comply with IFRS?

*Answer*

The requirement to report under IFRSs will affect all reporting entities under the Corporations Act, both listed and unlisted entities, private and public. Therefore, public sector and not-for-profit entities that are reporting entities will need to adopt IFRS by 2005. All non-reporting corporate entities must apply the recognition and measurement criteria of IFRS, but not all disclosure requirements will apply. In addition, since the AASB provides one set of standards for all reporting entities, the new standards will also apply to all reporting entities not captured within the Corporations Act. The requirement is therefore extremely wide-ranging.

This situation is in contrast to Europe, where the requirement to report under IFRS applies only to entities that have publicly listed debt or equity securities.

#### 6. Question

What is the situation with non-corporate entities that are non-reporting entities?

*Answer*

Non-corporate entities that are non-reporting entities will only be required to apply the accounting standards deemed necessary by the members of their governing body or other legislation. However, where the trust deed or other governing constitution requires a 'true and fair' view, all the material recognition and measurement criteria of IFRSs will apply.

#### 7. Question

What is a 'not-for-profit' entity?

*Answer*

The AASB's definition of a not-for-profit entity means an entity whose financial objectives do not include the generation of profit<sup>3</sup>.

#### 8. Question

When do financial reports have to start complying with IFRS?

*Answer*

Australian entities will be required to apply IFRSs in general purpose financial reports for reporting periods beginning on or after 1 January 2005.

<sup>3</sup> AASB Glossary of Defined Terms.

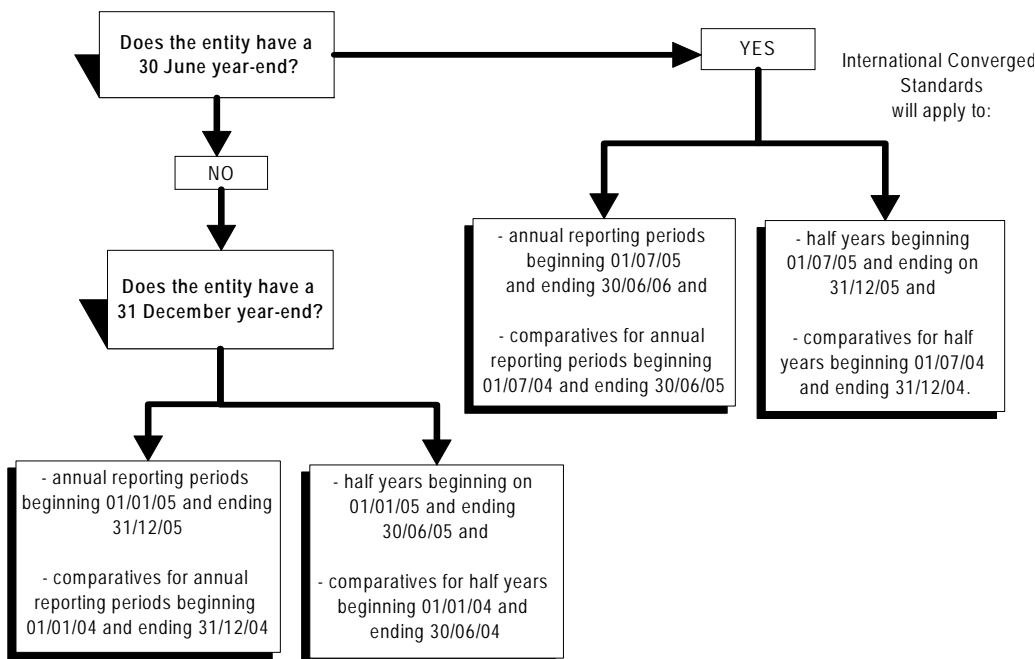
In the case of entities with a 30 June year-end, this will mean the application of converged standards to —

- annual reporting periods beginning on 1 July 2005 and ending on 30 June 2006 and comparative information presented for annual reporting periods beginning on 1 July 2004 and ending on 30 June 2005; and
- half years beginning on 1 July 2005 and ending on 31 December 2005 and comparative information presented for half-years beginning on 1 July 2004 and ending on 31 December 2004.

For entities with a 31 December year-end, application of converged standards would apply to —

- annual reporting periods beginning on 1 January 2005 and ending on 31 December 2005 and comparative information on 1 January 2004 and ending on 31 December 2004; and
- half years beginning on 1 January 2005 and ending on 30 June 2005 and comparative information presented for half-years beginning on 1 January 2004 and ending 30 June 2004.

The following diagram shows the transitional dates for adoption of IFRSs for entities with 30 June and 31 December annual reporting dates.



**Comparative Information**

The Board discussed recent comments that, on first-time adoption of AASB equivalents to IASB Standards, some relief in respect of the provision of comparative information for the preceding year might be considered if the timetable for issuing standards is delayed. Members were of the view that providing relief is inconsistent with the objectives of the Year 2005 strategy because it would mean that an entity’s first “Year 2005” financial reports would not comply fully with the requirements of IASB Standards and, as such, would be inconsistent with the FRC directive regarding 2005. Furthermore, there would be serious technical consequences if IFRS 1 were not to be applied in its entirety.

**9. Question**

Will entities have the option to adopt IFRS financial statements before 2005, and if so what issues need to be considered?

*Answer*

The AASB decided to prohibit early adoption of the AASB equivalents of IASB standards either in full or in part. The key reason for this review is the potential adverse impact on users of financial reports if different entities were to prepare reports using different sets of Standards in the same reporting period. The Board considered it to be important to maintain comparability between the financial reports of Australian reporting entities.

## 10. Question

Are the International Financial Reporting Standards effective as of now?

*Answer*

The adoption of IFRS presents several difficulties. The first issue deals with copyright, where the AASB cannot, for the time being, issue an Australian equivalent to IFRS 1 due to the status of the copyright for IASB Standards. In respect of copyright, Accounting Standards made under the *Corporations Act 2001* by the AASB are delegated legislation and under Government policy legislation is to be made freely available. The AASB is currently negotiating with IASB in this regard. In the interim, the IASB will release the standards free of charge. However, the associated guidance material which is essential to interpreting the Standards, will have to be purchased.

The second technical issue relates to the cross-referencing of standards in the converged AASB standards. In making standards, which are disallowable instruments, the AASB must comply with the Acts Interpretation Act. The Board has been advised that under this Act a disallowable instrument can only make references to other instruments already in existence when it is made.

Currently, the AASB is pursuing two alternatives to the copyright issue including —

- all documents must be issued at the same date otherwise the board would be breaking the law; or
- the board can issue documents progressively and make them as standards, but the effective dates must be the same in order for the guidance to be workable.

The AASB intends to make all Australian Standards that are equivalent to IASB Standards on the same day in 2004, however, the Board has decided to approve the contents of pending standards on a progressive basis and to make Pending Accounting Standards available on its web site, to assist entities to identify changes that may be needed in their financial reporting systems.

The Pending Accounting Standards will be presented in the style and format expected to be used when the Standards are formally made. The contents of an ultimate AASB Standard will be the same as in its pending version, except where necessary to incorporate amendments made in another Standard subsequent to the release of the Pending Accounting Standard.

Pending Accounting Standards will be listed in numeric sequence, beginning with the IFRS-equivalent standards (AASB 1 - 99) followed by the IAS-equivalent standards (AASB 101 – 1000). They can also be downloaded in Adobe Acrobat PDF format via the AASB website [www.aasb.com.au](http://www.aasb.com.au)

The pending standards approved the Board in November 2003 include —

- AASB 110 Events After the Balance Sheet Date;
- AASB 121 The Effects of Changes in Foreign Exchange Rates;
- AASB 107 Cash Flow Statements

## 11. Question

Will reporting entities have to maintain and produce two sets of financial statements for 2005 under the AASB and IFRS frameworks?

*Answer*

The simple answer is "yes". For entities with 30 June balance dates, the AASB equivalents to IASB standards will be mandatory for reporting periods ending 30 June 2006. Accordingly, for 30 June 2005, an entity will need to apply the existing AASB standards for the 1st year's report and, in order to have comparatives for the 30 June 2006 report, will also need to apply AASB equivalents to IASB standards for financial periods ending 30 June 2005. Similarly, entities with a 31 December year end will also be required to prepare two sets of financial statements for the 2004 reporting year to enable comparatives to be produced under the IFRS framework.

Therefore, for entities with a 30 June year end, they will maintain two sets of financial statements for the 2004-05 financial year – one set in accordance with the existing AAS/AASB standards for the 30 June 2005 financial year end, the other an IFRS set of statements to obtain opening comparative figures as at 30 June 2005 for the first IFRS financial statements as at 30 June 2006.

## HOW WILL IFRS CONVERSION TAKE PLACE?

### 12. Question ♦

Are any entities exempt from disclosing comparative information given the delays on release of IFRS?

*Answer*

The existing requirements for first time adoption of IFRS, require entities to apply IFRS retrospectively, as if IFRS has always been applied. All transactions and balances in the prior year financial statements have to be reclassified and restated as if the IFRSs existed at that time. Currently, the Board has not granted exemptions for entities disclosing comparative information under IFRS. This means for entities with a 31 December year-end, (Universities and Grammar Schools), the reporting date for its first IFRS financial statements will be 31 December 2005, with comparatives to be prepared under IFRS for periods 1 January 2004 – 31 December 2004. Given the reporting timeframes, these entities will be required to prepare financial statements under international standards that will not be released till mid 2004.

To date, the AASB has not proposed any solutions to address this problem. For further information, refer to Question 8.

For additional information, refer to the AASB website on [www.aasb.com.au](http://www.aasb.com.au)

### 13. Question ♦

If not-for-profit exemption applies to a parent entity, does this also apply to a for-profit subsidiary of the not-for-profit parent entity?

*Answer*

Where this situation occurs, the for-profit subsidiary will be required to prepare two sets of financial statements – one set of statements under the IFRS framework and the other statements in accordance with the framework to which its not-for-profit parent entity is subject to, which may include the exemptions which apply to the parent entity.

### 14. Question ♦

Will there be any exemptions or additional guidance information for the public sector entities?

*Answer*

The AASB has decided that except for standards specific to the not-for-profit or public sectors or that are purely of a domestic nature, IASB Standards should be used as the 'foundation' standards. AASB proposes to add material detailing the scope and applicability of the standard in the Australian context and any other statements dealing with local reporting requirements. Additions, where necessary are proposed to broaden the content to cover the not-for-profit sector and domestic regulatory or other issues.

### 15. Question ♦

How will the new standards be issued and what is the new convention for the numbering of standards under IFRS?

*Answer*

The AASB will continue to issue Australian standards, however, in future, they will have embedded international standards. The AASB standards will contain a foreword, including a reference retaining Australia's approach to differential reporting by stating that the standard is for application by reporting entities. The main body of the standard will be followed by paragraphs addressing special requirements, if any, for public sector entities, not-for-profit entities and other relevant regulatory requirements. The IASB equivalent AASB Standards will be applicable to all entities by an application clause similar to the clause contained in IFRS 1. Each AASB standard will be put before parliament for the requisite period for possible disallowance.

Under the new IFRS framework, the current AASB standards will also require new naming conventions, for example, any new Australian standard based on an IFRS will be numbered in simple, two digit format commencing with AASB 1 i.e. the Australian version of IFRS 1 will be equivalent to AASB 1. Where the IASB rolls forward a revised version of an existing IAS standard, the new Australian standard will be numbered as AASB 1XX, where XX represents the existing number of the IAS standard. The examples below illustrate examples of the revised AASB numbering —

- IFRS 1 - AASB 1;
- IAS 1 - AASB 101;
- IAS 23 - AASB 123;
- AASB 1031 - AASB 1031; and
- AAS 27 - AASB 1101.

The existing numbering system, AASB 10XX, will be retained for any existing AASB standard that is not superseded in the international harmonisation process and which continues to apply in Australia. While all the new standards will have public sector and not-for-profit application clauses, specific public sector standards i.e. the revised versions of AAS 27, AAS 29 and AAS 31, will appear as AASB 11XX.

For additional information, refer to the AASB website on [www.aasb.com.au](http://www.aasb.com.au)

## 16. Question

Under IFRS 1, what does the initial transition to IFRS involve?

*Answer*

IFRS 1 – *First-Time Adoption of International Financial Reporting Standards* requires an entity to comply with each IFRS effective at the reporting date for its first IFRS financial statements. In general, IFRS applies when an entity adopts IFRS for the first-time as its basis of accounting by an explicit and unreserved statement of compliance with IFRS. The IFRS requires disclosures that explain how the transition from previous Generally Accepted Accounting Principles (GAAP) to IFRSs affected the entity's reported financial position, financial performance and cash flows.

While the standard contains a general requirement that an entity must comply with each IFRS effective at the reporting date when it first adopts IFRSs, there are limited exemptions in specified areas where the cost of compliance would exceed benefits to users.

As outlined in IFRS 1, the initial transition to IFRS involves —

- selection of the accounting policies that comply with IFRSs;
- preparation of an *opening IFRS balance sheet at the date of transition to IFRSs* as the starting point for subsequent accounting under IFRSs (refer question below). The date of transition to the international standards is the beginning of the earliest comparative period presented in the entity's first IFRS financial statements;
- determination of estimates under IFRSs for both the opening IFRS balance sheet and other periods presented in an entity's first IFRS financial statements; and
- presentation and disclosure in an entity's first IFRS financial statements and interim financial reports.

In addition, an entity shall use the same accounting policies throughout all periods presented in its first IFRS financial statements, and also in its opening IFRS balance sheet. Those accounting policies shall comply with each IFRS effective at the *reporting date* for its first IFRS financial statements.

For additional information, refer to the AASB website on [www.aasb.com.au](http://www.aasb.com.au)

## 17. Question

Under IFRS 1, what does the opening IFRS balance sheet require?

*Answer*

An entity shall prepare an opening IFRS balance sheet at the date of transition to IFRSs. The opening balance sheet needs to comply with all recognition and measurement requirements of IFRS. In summary, in its opening balance sheet, an entity should —

- recognise all assets and liabilities whose recognition is required by IFRS;
- de-recognise assets or liabilities if IFRSs do not permit such recognition;
- reclassify items that the entity recognised under previous GAAP as one type of assets, liability or equity that are different types of assets, liability or equity under IFRS; and
- apply IFRS principles in measuring all recognised assets and liabilities.

In preparing its opening IFRS balance sheet, entities will need to adjust the amounts that were previously reported under GAAP. All adjustments will be made against equity rather than the income.

**18. Question** ◆

What are the materiality considerations in recasting the opening balance sheet under IFRS (how far do entities have to go?)

*Answer*

The AASB definition of materiality refers to information which, if omitted, misstated or not disclosed has the potential to adversely affect decisions about the allocation of scarce resources made by users of the *financial report* or the discharge of accountability by the management or governing body of the entity.

The AASB has agreed that it should retain AASB 1031-*Materiality* in its current form and to continue to make cross references to AASB 1031 in AASB standards. AASB 1031 and the IASB Framework (paragraphs 29 and 30) are consistent, however, AASB 1031 is far more comprehensive. The AASB plans to retain AASB 1031 in its existing form to ensure that the meaning of materiality remains clear. The AASB also agreed to recommend to the IASB that it deal with materiality in its review of its *Framework for the Preparation and Presentation of Financial Statements*.

**HOW BIG IS THE GAP BETWEEN IFRS AND THE AUSTRALIAN GAAP?**

**19. Question** ◆

How different will IFRSs be to the Australian Generally Accepted Accounting Principles?

*Answer*

In Australia, the harmonising of IFRS and GAAP has been on-going since 1996. While a number of standards are already aligned to the IASB standards, the introduction of IFRS represents a fundamental change for the Australian financial reporting framework, with 29 out of 42 Australian standards affected and three new standards introduced. There are, however, five topics covered by international standards that are not covered by Australian standards, including intangibles, recognition and measurement of financial instruments, investment property, accounting for post-employment benefits and obligations associated with the disposal or retirement of long-lived assets.

**WHAT ARE THE MAJOR IFRS IMPLICATIONS ON PUBLIC SECTOR ENTITIES?**

**20. Question** ◆

Do all the international accounting standards apply to public sector entities?

*Answer*

In some cases, existing AASB standards contain helpful commentary that is not included in the equivalent IASB standards. The AASB will retain this commentary as guidance that is not part of the international standards where it is considered to be of benefit to users of AASB standards and provided it does not contradict the content of AASB equivalents of the IASB standards. Such guidance may, for example, deal with situations that are commonly encountered in the Australian environment or in the public sector but which are not catered for in the IASB standards.

The body of the standard will be followed by paragraphs addressing special requirements, if any, for public sector entities, not-for-profit entities and other relevant regulatory requirements. Each AASB standard will be subject to the full due process, as currently applies, including being put before parliament for the requisite period for possible disallowance.

**21. Question** ◆

How will 'Machinery of Government' (MOG) changes be affected by IFRSs?

*Answer*

There should be little or no change to current treatment. Under proposed amendments to AAS 29, any revenues and expenses resulting from a transfer of assets and liabilities are disclosed on the face of the income statement on a net basis (currently, this is optional under AAS 29 but is not required under the Financial Reporting Requirements for Government Departments). In addition, MOG changes are not considered to be assets held for sale and will not be impacted by those IFRS requirements, as is currently the case under AASB 1042 'Discontinuing Operations'.

**22. Question** ◆

How will 'administered items' be affected IFRSs?

*Answer*

The major changes proposed will be the requirement to disclose administered cash flows. Also, where responsibility for the management of administered assets and liabilities is transferred from one department to another, each department must disclose details of the transfer, separately from the disclosure of administered items.

**NON-CURRENT ASSETS****23. Question** ◆

What are the key changes to non-current asset measurement and disclosures which impact on financial reporting by public sector entities?

*Answer*

The revised standards which cover non-current asset issues include International Accounting Standard (IAS) 36 'Impairment of Assets' and IAS 16 'Property, Plant and Equipment' which combine standards on the acquisition, depreciation and valuation of assets.

For additional information, refer to the AASB website on [www.aasb.com.au](http://www.aasb.com.au)

**24. Question** ◆

What is 'recoverable amount'?

*Answer*

*Recoverable amount* is the higher of an asset's net selling price and its value in use. *Net selling price* is an estimate of the asset's market price, adjusted for incremental costs directly attributable to the disposal of the asset.

If there is no binding sale agreement but an asset is traded in an active market, then net selling price equals an asset's market price *less* cost of disposal. If there is no binding sale agreement or active market for an asset, net selling price is based on the best information available to reflect the amount that an entity could obtain, at reporting date, for the disposal of the asset in an arm's length transaction *less* cost of disposal.

If it is not possible to determine net selling price because there is no basis for a reliable estimate, recoverable amount is based on reference to its *value in use*.

**25. Question** ◆

What is 'value in use'?

*Answer*

Value in use is determined by the discounted net cash flows from the asset. Under the IASB standards, the new proposal for estimating value in use involves the following steps —

- estimate the future cash flows and outflows derived from continuing use of the asset and from its ultimate disposal; and
- application of the discount rate to future cash flows to derive present value.

When measuring value in use, the following should be considered —

- cash flow projections based on reasonable and supporting assumptions;
- cash flow projections based on most recent financial budgets/forecasts approved by management or the governing body; and
- cash flow projections beyond the period covered by the most recent budget must be estimated by extrapolating projections based on budgets using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified.

**NOTE:** For public sector entities, value in use is the deprival value also known as the written down replacement cost. The deprival value of an asset equates to fair value for market price and to depreciated reproduction cost BUT NOT replication cost under the deprival value methodology adopted by the Queensland public sector. In assessing the deprival value of an asset, the circumstances will determine the most appropriate valuation method – where the remaining future economic benefits embodied in the asset *would be replaced* if the entity was deprived of the asset, the asset should be measured at one of the following —

- current market buying price of a similar asset – where a similar asset can and would be purchased; or the lower of;
- *current replacement cost of the same future economic benefits of the existing asset* - where a different asset having a similar purpose can and would be purchased; or
- current reproduction cost of the same future economic benefits of the existing asset - where the above techniques are not applicable.

## 26. Question ♦

What is 'impairment testing' of assets?

*Answer*

The purpose of impairment testing is to assess whether the carrying amount of an asset will be recovered through use or sale of the asset. The IASB observed that requiring assets to be remeasured when they are impaired is a valuation concept rather than one of cost allocation. This reflects 'the recoverable cost concept' which focuses on the benefits to be derived from the asset in the future, rather than on the process by which the cost or other carrying amount of the asset should be allocated to particular accounting periods. Impairment loss results when the asset's carrying amount exceeds its recoverable amount.

## 27. Question ♦

How often do entities have to test for impairment of assets?

*Answer*

Under the IASB Standards, an entity shall assess at each balance date, whether there is an indication that an asset may be impaired. If such indication exists, the entity shall estimate the recoverable amount of the asset. Regardless of whether there is any indication of impairment, an entity shall also —

- estimate at the end of the each annual reporting period the recoverable amount of an intangible asset with an indefinite useful life or an intangible asset not yet available for use; and
- test goodwill acquired in a business combination for impairment annually.

## 28. Question ♦

What are the external and internal indicators of impairment?

*Answer*

In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following external and internal factors —

### *External Indicators*

- During the period, the asset's market value has declined significantly more than what it would be expected to as a result of the passage of time or normal use.
- Significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.
- Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.
- The carrying amount of the net assets of the entity is more than its market capitalisation.

**Internal Indicators**

- Evidence is available of obsolescence or physical damage of an asset.
- Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.
- Significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, the extent to which, or manner in which, an asset is used or expected to be used. These changes include the asset becoming —
  - idle;
  - plans to discontinue the asset;
  - restructure the operation to which an asset belongs;
  - plans to dispose of an asset before the previously expected date; and
  - reassessing the useful life of an asset as a finite rather than indefinite.

**29. Question** ◆

What are cash-generating units?

*Answer*

A cash-generating unit is the smallest identifiable group of assets that generate cash inflows independent of the cash inflows from other assets. Where indication of impairment of asset or cash-generating unit exists, its recoverable amount must be determined but where it is not possible to identify an individual asset's recoverable amount, then its value must be determined for the asset's cash-generating unit (CGU).

**30. Question** ◆

Under the IFRS framework, how is a cash-generating unit identified for a particular asset?

*Answer*

IAS 36 provides guidance on the identification of the cash-generating unit to which an asset belongs. The standard provides that an asset's cash-generating unit is the smallest group of assets that includes the asset and that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets. Identification of an asset's cash-generating unit involves judgement. If recoverable amount cannot be determined for an individual asset, an enterprise identifies the lowest aggregation of assets that generate largely independent cash inflows from continuing use.

In testing a cash-generating unit for impairment, an enterprise should identify whether goodwill that relates to this cash generating unit is recognised in the financial statements. IAS 36 provides specific guidance as to how entities should test a cash-generating unit for impairment and how the impairment loss is allocated on a reasonable and consistent basis.

For additional information, refer to the AASB website on [www.aasb.com.au](http://www.aasb.com.au)

**31. Question** ◆

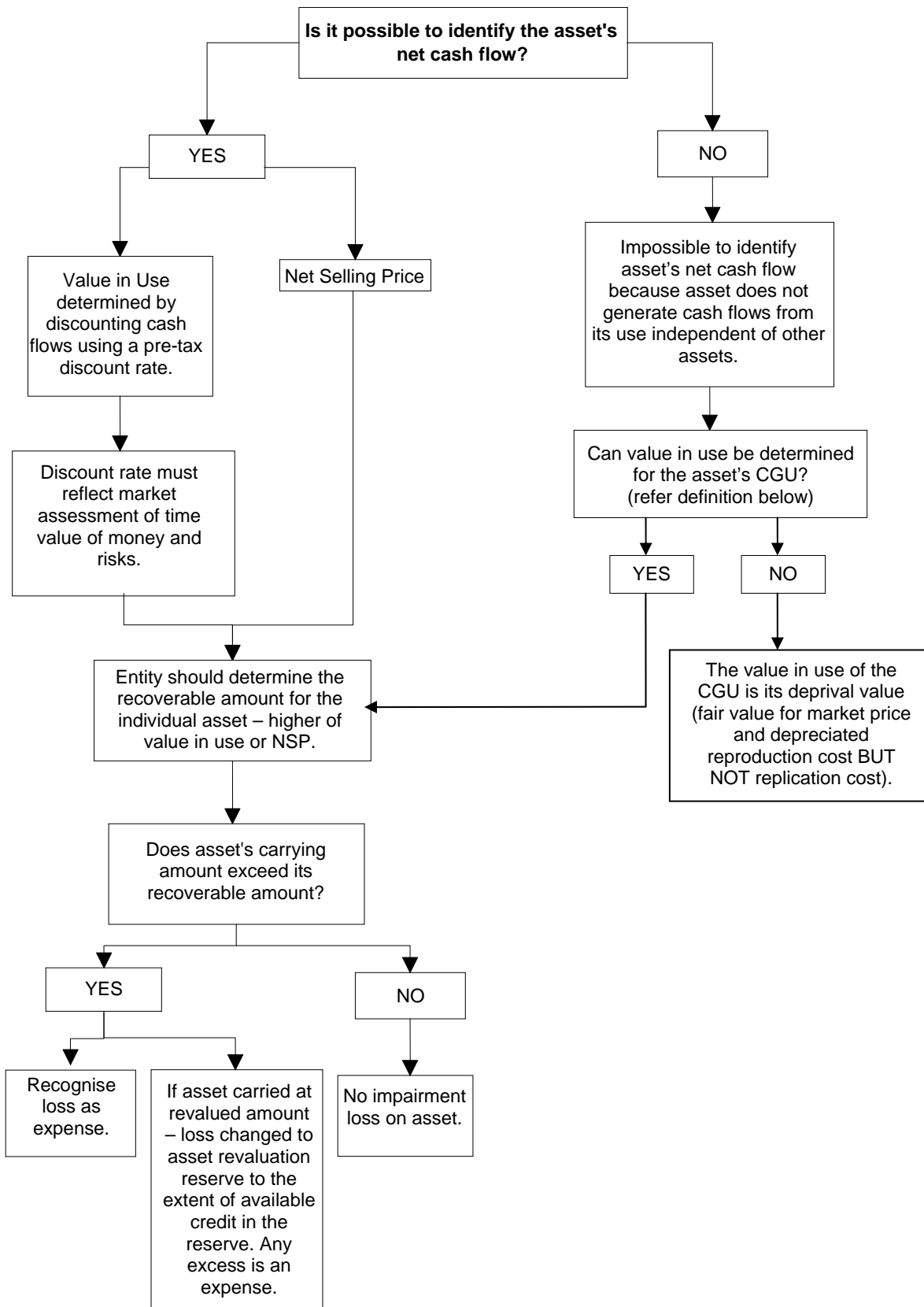
Do the "not-for-profit" entities have to revalue assets on an asset-by-asset basis like the "for-profit" sector?

*Answer*

Under the converged standards there will be no specific standards on revaluation (AASB 1041) or depreciation (AASB 1021). These issues will be covered in IAS 16 *Property, Plant and Equipment*. For not-for-profit entities, IAS 16 states that revaluation increases and decreases relating to individual assets within a class of property, plant and equipment must be offset against one another within that class but shall not be offset in respect of assets in different classes. Therefore, in contrast to the revaluation of assets on an asset-by-asset basis as will occur in the "for-profit" sector, when an item of property, plant and equipment of a not-for-profit entity is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued.

A class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations, for example, land, buildings; plant and equipment, infrastructure, heritage and cultural assets.

The diagram below summarises the key concepts embedded in the IFRS standard on non-current assets.



**INTANGIBLES****32. Question** ◆

Under IFRS, which types of intangible assets cannot be recognised?

*Answer*

Under the AASB Exposure Draft 109, internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets. This standard is of the view that these items cannot be distinguished from the cost of developing the business as a whole, and therefore, such items are not recognised as intangible assets.

An asset should be treated as meeting the identifiability criterion in the definition of an intangible asset when it –

- is separable, i.e. capable of being separated from the entity and sold, transferred, rented or exchanged with a related contract, asset or liability; or
- arises from a contractual or other legal right.

Intangible assets will only be able to be revalued if their fair value can be determined with reference to an active market (currently there are no such limitations). If the intangible has an indefinite life, it need not be amortised but must be tested for impairment annually.

For additional information, refer to the AASB website on [www.aasb.com.au](http://www.aasb.com.au)

**33. Question** ◆

What are the major IFRS implications in relation to disclosure of research and development costs under IAS 38 *Intangible Assets*?

*Answer*

IAS 38 requires an intangible asset to be recognised if, and only if, it is probable that the future economic benefits attributable to the asset will flow to the entity, and its cost can be measured reliably. In assessing whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into –

- Research phase – no intangible asset arising from research shall be recognised. Expenditure on research shall be recognised as expense when it is incurred.
- Development phase – an intangible asset arising from development shall be recognised if, and only if an entity can demonstrate **all** of the following —
  - technical feasibility of completing the intangible asset so it will be available for use or sale;
  - its intention to complete the intangible asset and use or sell it;
  - its ability to use or sell the intangible asset;
  - how the intangible asset will generate probable future economic benefits;
  - the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible; and
  - its ability to reliably measure the expenditure attributable to the intangible asset during its development.

The treatment under IAS 38 of subsequent expenditure on an in-process research and development project acquired in a business combination and recognised as an asset separately from goodwill is unclear.

For additional information, refer to the AASB website on [www.aasb.com.au](http://www.aasb.com.au)

## GOVERNMENT GRANTS

### 34. Question

In relation to the reporting of government grants, what will IFRS require?

*Answer*

The AASB proposes to adopt the IASB approach in respect of for-profit entities but to maintain the existing Australian requirements (AASB 1004) in respect of not-for-profit entities. The AASB proposes to retain UIG Abstract 11 for not-for-profit entities.

From an accounting perspective, the two main issues associated with government grants are whether such government funding is in the nature of capital or revenue; and if the transaction is classified as revenue, how it should be recognised. Under the IFRS, the definition of revenue will be narrower. The IAS revenue recognition criteria focuses more on transfer of significant risks and rewards of ownership and the probability that compensation will flow to the entity and less on passing of control and whether the entity controls the right to be compensated. Government grants will be recognised as income over the periods necessary to *match* them with the related costs (consistent with the matching principle) which they are intended to compensate (currently, government grants must be recognised as revenue in full when received if they are non-reciprocal).

IAS 20 'Government Grants' specifically requires disclosure of —

- the nature and extent of government grants recognised in the financial report and an indication of other forms of government assistance from which the entity has directly benefited; and
- any unfulfilled conditions and other contingencies attaching to the government assistance that has been recognised.

The AASB is concerned about the following choices that are available to entities under IAS 20 —

- a non-monetary government grant may be recorded at fair value *or* nominal amount; and
- the amount of the grant carried forward may be presented as either deferred income *or* as a reduction in the carrying amount of the asset.

For additional information, refer to the AASB website on [www.aasb.com.au](http://www.aasb.com.au)

## RELATED PARTY DISCLOSURES

### 35. Question

What are the additional disclosure requirements under IAS 24 'Related Party Disclosures'?

*Answer*

The AASB plans to consider adopting IAS 24, depending on the final "improvements" made by the IASB. ED 106 Director, Executive and Related Party Disclosures Part 1 is likely to become a separate "domestic" AASB Standard. There is a separate project on related party disclosures in the public sector, and the AASB would probably exclude public sector entities from applying the AASB equivalent to IAS 24.

For additional information, refer to the AASB website on [www.aasb.com.au](http://www.aasb.com.au)

### 36. Question

Is there any impact on recognition of dividend payments for Government Owned Corporations (GOCs) under IFRS?

*Answer*

The short answer is no. Under IAS 10 - *Events After the Balance Sheet Date* (paragraph 11) states that "If dividends to holders of equity instruments (as defined in IAS 32: *Financial Instruments: Disclosure and Presentation*) are proposed or declared after the balance sheet date, an enterprise should not recognise those dividends as a liability at the balance sheet date."

IAS 10, paragraph 11 does not deal with cases in which dividends are proposed before the balance sheet date and declared after the balance sheet date. Also, it does not deal with cases in which dividends are proposed or declared before the balance sheet date but need to be approved by shareholders after the balance sheet date.

This is consistent with AASB 1044 which prohibits the recognition of dividends as liabilities where they were not declared, determined or publicly recommended on or before reporting date (i.e. balance date).

In the case of GOCs, there is a present obligation at 30 June, based on the agreement in the approved Statement of Corporate Intent (SCI), for a dividend to be made to Shareholding Ministers. The SCI as agreed between the GOC and the Shareholding Ministers provides sufficient information to ascertain —

- whether or not a dividend is to be paid; and
- the estimated quantum of the payment.

Therefore, at 30 June, there exists sufficient information to include a provision for dividends in the financial statements of the corporation. The GOC should record the provision for dividend based on the amount in the SCI, if there is no official Board resolution or Ministerial correspondence approving a final dividend prior to 30 June.

If a decision were to be made on the final amount of the dividend between the reporting date and the date the audit report is issued, the decision would meet the criteria of an event occurring after balance date as defined in AASB 1002 *Events Occurring after Balance Date*. This Standard distinguishes between two types of events occurring after the reporting date ?

- the first type of event provides evidence of, or additional evidence of, conditions which existed at reporting date; and
- the second type of event creates new conditions after reporting date.

The decision as to the final amount of a dividend payment would satisfy the criteria for the first type of event in AASB 1002, and the Standard requires, where applicable, that the effect of the first type of event is to be reflected in the financial report that is being completed. If materially different from the original amount in the SCI, then the revised final amount of the dividend payment should be recorded in the provision in the financial statements.

### 37. Question ♦

Will the introduction of IFRS impact on a company's/GOC's dividend payment policy?

*Answer*

A company/GOC's ability to pay dividends depends on the profitability of the company/GOC. In accordance with the *Corporations Act 2001*, dividends are required to be paid out of profit. As some of the standards may affect reported results, this may impact on the company/GOC's dividend policy. Adoption of IFRS may affect profitability in such areas as intangible assets, impairment of assets, and financial instruments. Hence, IFRS adoption may indirectly affect a company/GOC's ability to pay dividends.

Furthermore, even if a company/GOC ends up with a negative opening retained earnings due to first time adoption of IAS, for example, due to write off of intangible assets, if a profit is made a dividend can still be paid, subject to the company/GOC remaining solvent.

## FINANCIAL INSTRUMENTS

### 38. Question ♦

What is the impact of IFRS on financial instruments?

*Answer*

All financial assets and liabilities, including derivatives will have to be recognised in the statement of financial position. Most financial assets will be measured at fair value with gains and losses included in income.

### 39. Question ♦

What is the proposed treatment of share options under IFRS?

*Answer*

Share options granted as remuneration will be expensed. This rule emerges from an IFRS on Share Based Payments.

**EMPLOYEE ENTITLEMENTS****40. Question**

What is the difference in the employee entitlement standard under IFRS?

*Answer*

IAS 19 is the new standard for employee entitlement. The only substantive difference between AASB 1028 and IAS 19 is in the application of IAS 19 to post-employment benefits that are superannuation or medical benefits. Sponsors of defined benefit superannuation funds will have to recognise an asset or liability in relation to the fund, based on an actuarial valuation of the obligation owed to employees and the fair value of the plan assets (currently not addressed by Australian Standards).

All actuarial gains and losses would need to be recognised immediately as they arise.

**WHAT ARE THE MAJOR CHANGES TO THE PRESENTATION OF FINANCIAL STATEMENTS?****41. Question**

Is the term 'financial statement' used in current accounting standards consistent with IFRS ?

*Answer*

In making Australian equivalents of IFRSs, the AASB must ensure these are consistent with the *Corporations Act 2001* (and regulations), accord with the criteria in the *Australian Securities and Investments Commission Act 2001* and satisfy the requirements of the *Acts Interpretation Act 1901*.

The IASB uses the term 'financial statements' to include notes to the financial statements. This is inconsistent with s.295 of the *Corporations Act 2001* where 'financial statements' and notes are separately identified as components of the financial report. The financial reporting obligations imposed by the Corporations Act refer to 'financial reports', not financial statements. Depending on the context, 'financial statements' in an IFRS refers sometimes to the statements per se and sometimes to the statements and notes. The AASB proposes to translate the latter with the term 'financial report'.

**42. Question**

Are there additional disclosure requirements in the primary financial statements under IFRS?

*Answer*

Under the IFRS framework, reporting entities are required to prepare the following statements —

- Balance Sheet (previously Statement of Financial Position);
- Income Statement (previously Statement of Financial Performance);
- Cash Flow statement; and
- Statement of Changes in Equity (additional statement required).

IAS 1 *Presentation of Financial Statements* requires all reporting entities to prepare a Statement of Changes in Equity as a new disclosure. The standard requires entities to present, as a separate component of its financial statements, a statement showing the following —

- (a) the net profit or loss for the period;
- (b) each item of income and expense, gain or loss which, as required by other Standards, is recognised directly in equity, and the total of these items; and
- (c) the cumulative effect of changes in accounting policy and the correction of fundamental errors dealt with under the Benchmark treatments in IAS 8.

In addition, an entity should present, either with this statement or disclose in the notes —

- (d) capital transactions with owners and distributions to owners;
- (e) the balance of accumulated profit or loss at the beginning of the period and at the balance sheet date, and the movements for the period; and
- (f) a reconciliation between the carrying amount of each class of equity capital, share premium and each reserve at the beginning and the end of the period, separately disclosing each movement.

**43. Question** ◆

What is an acceptable approach to present the Statement of Changes in Equity?

*Answer*

The approach adopted in many jurisdictions follows a columnar format which reconciles between the opening and closing balances of each element within shareholders' equity, including items (a) to (f) in Question 42. Alternatively, the Statement can be presented as a separate component of the financial statements which presents only items (a) to (c). Under this approach, items (d) to (f) are shown in the notes to the financial statements. Whichever approach is adopted, the standard requires a sub-total of the items in (b) to enable users to derive the total gains and losses arising from the entity's activities during the period.

**44. Question** ◆

Will there be any changes to the presentation of the Cash Flow statement under IFRS?

*Answer*

The current AASB 1026 is stricter than IAS 7 and overall, the exposure draft proposes to retain many of the stricter requirements of AASB 1026, including —

- permitting only the use of the 'direct' method of presentation of the cash flow statement when IAS 7 permits the use of either the direct/indirect method; and
- the requirement to include a reconciliation between profit from ordinary activities after tax to cash flows from operating activities. IAS 7 does not require this disclosure.

In addition, the AASB has proposed to remove the option which is implicit in IAS 7 for entities to present dividends as either an operating or financing cash flow. Australian standards will require dividends paid to be classified as a financing activity, which is consistent with the prevailing AASB 1026. This Standard has been released as a Pending Standard (refer Question 10).

**45. Question** ◆

What is the difference between the direct and indirect method for the presentation of the cash flow statement?

*Answer*

The *direct method* is where each major class of gross cash receipts and gross cash payments are disclosed, where as the *indirect method* requires the accrual net profit or loss to be adjusted for the effects of any non-cash transactions.

For additional information, refer to the AASB website at [www.aasb.com.au](http://www.aasb.com.au)

**46. Question** ◆

Will the concept of 'extraordinary items' change under IFRS?

*Answer*

IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies* – requires extraordinary items to be disclosed on the face of the income statement (previously known as the Statement of Financial Performance) separately from profit or loss from operating activities.

The AASB exposure draft, however, proposed to eliminate the concept of extraordinary items from IAS 8 and prohibit the presentation of items of income and expenses as extraordinary items in the income statement and notes. This would be set out in IAS 1 and is expected to result in greater consistency between entities in the presentation of the income statement.

**47. Question** ◆

How will fundamental errors be treated under IFRS?

*Answer*

One of the significant changes to IAS 8 includes the elimination of the allowed alternative treatment for changes in accounting policy and correction of errors. This item will no longer be accounted for prospectively and retrospective treatment will be required under which —

- Changes in accounting policy would be treated as if each new accounting policy had always been in use (by adjusting opening balance of retained earnings for the earliest prior period presented); and

- Errors would be corrected by presenting the financial statements as if each error had never occurred (by restating comparative amounts for the prior period in which the error occurred or if the error occurred prior to the earliest period presented, by restating the opening balance of retained earnings for that period).

An entity will no longer be permitted to include adjustments related to changes in accounting policies or correction of errors in profit and loss for the current period or present comparative information as it was reported in the financial statements of the prior period.

#### *WHAT RESOURCES AND IMPLEMENTATION STRATEGIES ARE REQUIRED FOR A SUCCESSFUL CHANGE?*

#### 48. Question

What immediate actions should be undertaken by public sector entities?

*Answer*

Entities that have implemented IFRS recognise that the transition places an enormous responsibility on management to be able to communicate effectively to accountable bodies and other stakeholders in the new financial reporting framework. To ensure entities are prepared for the transition, consideration should be given by management to —

- adapt annual reports and accounting manuals;
- change or adopt management information systems;
- review systems and assess their limitations;
- review systems to obtain requisite data;
- design group reporting packages to gather information from subsidiaries; and
- integrate and embed internal and external reporting requirements.

Refer also *QAO IFRS checklist for public sector entities*, available on the QAO website at [www.qao.qld.gov.au](http://www.qao.qld.gov.au)

#### 49. Question

What can public sector entities do to raise awareness of IFRS?

*Answer*

Given the demanding timeframes to report under the IFRS framework, communicating and promoting awareness of IFRS issues is essential. For public sector entities to ensure that management, staff and interested stakeholders are kept informed in the process of conversion to IFRS, consideration should be given to —

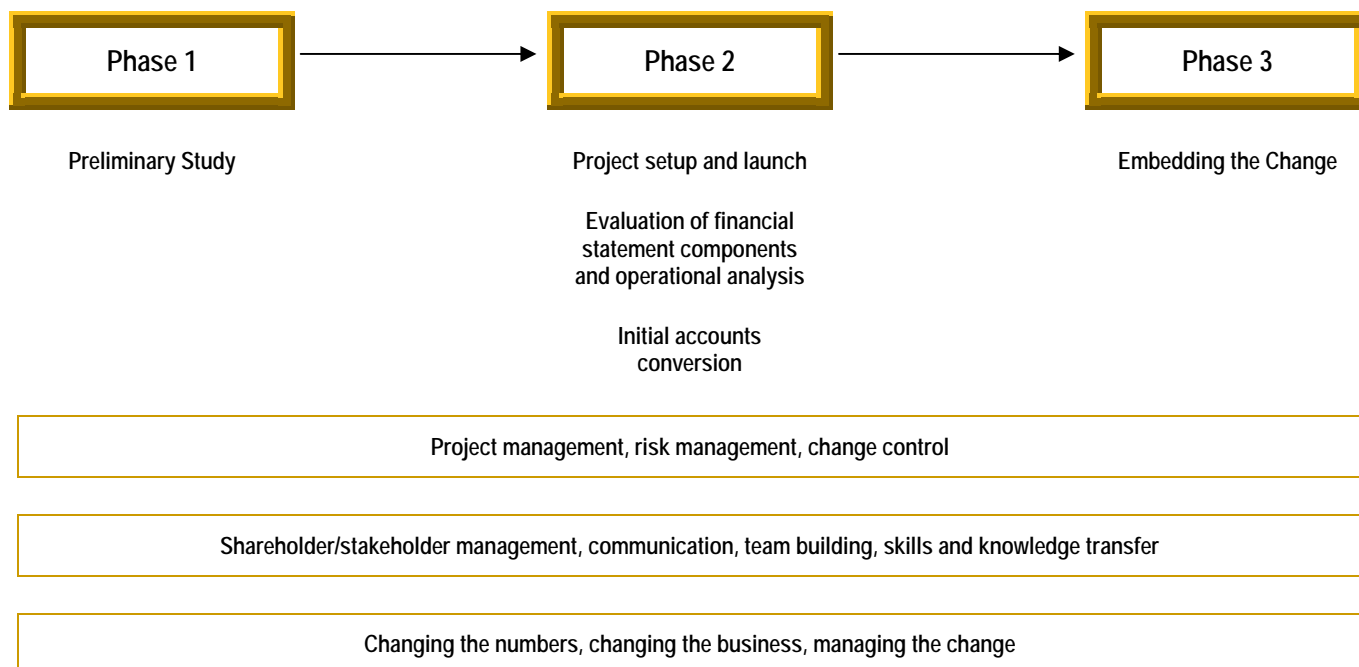
- communicate the timeframes and impact of IFRS to stakeholders, including Ministers, Director-Generals, senior management and the general public;
- reporting on movements in bottom-line due to different accounting treatments (as occurs in the private sector);
- investment in in-house training or engaging an interim project or steering team to drive or manage the conversion;
- ensure financial statement preparers, senior management and audit committees are familiar with the requirements for reporting under the IFRS framework;
- take detailed notes in meetings and workshops and distribute minutes to relevant stakeholders; and
- involve internal and external auditors in the process from an early stage to ensure a smooth transition process.

## 50. Question

What is an example of an accounts-conversion methodology?

*Answer*

The following implementation model<sup>4</sup> is a methodology for conversion to IFRS that can be tailored to address all the different issues that an entity needs to consider in making the change. The model is presented below —



Phase 1 - puts the entity in control by providing a high level of understanding about the impact of IFRS on key numbers and ratios and highlight accounting issues and recommends focusing on operational issues, resources and project management. Entities may perform gap analysis between what information is currently available and what is required under IFRS.

Phase 2 - enables the entity to operate effectively while the transition project is in progress. An evaluation of the financial statement components results in fully-informed decisions on IFRS accounting policies and conversion strategies. Phase 2 also facilitates the conversion of the initial set of financial statements under the new framework.

Phase 3 - enables the entity to implement change and to further refine and enhance systems, processes and train personnel to maintain the knowledge transfer and achieve new skills. This may include ensuring new reporting requirements are understood by the Board, Audit Committee, executives and accountants to avoid misinterpretation.

<sup>4</sup> *TransitionIFRS* is an accounts-conversion methodology developed by PricewaterhouseCoopers.

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- PriceWaterhouseCoopers (2003) *Australia and International Financial Reporting Standards 2005. Your Questions Answered – Focus on the change to IFRS*.
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- [www.aasb.com.au](http://www.aasb.com.au)
- [www.cpaaustralia.com.au](http://www.cpaaustralia.com.au)
- [www.icaa.org.au](http://www.icaa.org.au)

## OTHER QAO PUBLICATIONS ON IFRS

The following reports and publications, including this publication, on international financial reporting standards have been published by the Queensland Audit Office and can be accessed at [www.qao.qld.gov.au](http://www.qao.qld.gov.au)

Other publications include –

- Auditor-General's Report to Parliament No. 7 for 2002-03;
- Auditor-General's Report to Parliament No. 4 for 2003-04;
- INFORM 11 (April 2003);
- INFORM 12 (November 2003);
- IFRS Checklist for Public Sector Entities; and
- QAO responses to selected Exposure Drafts.

## USEFUL WEBSITES

- [www.qao.qld.gov.au](http://www.qao.qld.gov.au)
- [www.aasb.com.au](http://www.aasb.com.au) (link to International Accounting Standards Board)
- [www.icaa.org.au](http://www.icaa.org.au)
- [www.cpaaustralia.com.au](http://www.cpaaustralia.com.au)

### **Disclaimer**

This publication is a guide based on information available as at December 2003 and is not a substitute for the exposure drafts, AASB and IASB Standards. Users of this publication should be aware that the requirements of IFRS could change over time until the release of final AASB equivalent of IFRSs. For further information, please refer to the AASB website or other useful websites listed on Page 21.

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