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The Effect of IFRS Adoption on the Financial Reports of Local Government Entities

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Cover Page Footnote

Comments from seminar participants at La Trobe University and financial support from La Trobe and Murdoch Universities are acknowledged



The Effect of IFRS Adoption on the Financial Reports of Local Government Entities

Kamran Ahmed*¹, Manzurul Alam²

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This paper aims to analyse the changes in accounting surplus (loss), equity and assets, and liabilities as a result of accounting policy changes from the Australian Accounting Standards (AAS) to the International Financial Reporting Standards (IFRS) in Australian local government entities. Using the reconciliation notes disclosed by 117 local government entities, evidence is provided on the effects of IFRS adoption by identifying the key items that of difference between IFRS and AASB. The results show some differences between two sets of accounts prepared under these different accounting standards. While the average surplus (loss) of local councils has decreased, their equities, assets and liabilities have increased, with no major significant changes in their overall financial position, except for liabilities. These results indicate the possible consequences of the adoption of IFRS by local government entities in other countries on performance indicators who have or are yet to implement these standards.

Keywords: AASB, IFRS, Accounting policies, Local government entities.

JEL Classification: M40, M41

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Introduction

In this study we examine how the adoption of the International Financial Reporting Standards (IFRS) impacted on equities, surpluses, assets and liabilities of local government entities in Australia. This research is particularly important for many reasons, not least of which that there is a paucity of research using annual reports of local government entities. For example, Pilcher & Dean (2009a) pointed out that accounting for infrastructure assets, such as roads, bridges, parks and heritage buildings, and the preparation of accounts under accrual accounting are currently a source of debate confronting public sector practitioners and regulators in many countries. Hoque (2004) showed the controversies of including land under roads as assets in financial reports in his study of local councils. The adoption of IFRS has brought this debate into the limelight as many western developed countries are yet to adopt IFRS for local government entities. PricewaterhouseCoopers (PwC) (2008) suggests that the implementation of IFRS is a complex process involving understanding differences between country-specific accounting standards and IFRS for local government entities. For example, in the context of the U.K., PwC has identified several differences that need to be considered before evaluating the annual report performance of local government entities which will move to accounting on an IFRS basis by 2010/11. This includes: controversies remaining on the valuation of fixed assets on fair value as opposed to current value; accounting leases of land and buildings; pension plans; and joint venture and associates. Pilcher & Dean (2009) pointed out that infrastructure can comprise up to 90% of a council's total assets and a changeover to IFRS from AASB-based reporting can have a major impact on the performance of Australian local government entities.

In 2004, Australia became one of the first countries to adopt IFRS for local government entities with full compliance taking place for the 2005/06 financial year. The decision to implement IFRS by the Financial Reporting Council (FRC) in Australia generated much public debate. There seemed to be general agreement among the various interest groups and the wider community that its introduction would materially affect Australian entities' financial performance and accounts quality (Buffini 2005; Clarke & Dean 2005). One of the reasons for such concern was that the adoption of IFRS would lead to significant changes in several existing Australian standards and minor changes in others (Deegan 2005, p.32-35) reporting requirements.

In the context of local government entities, changes to accounting standards were expected to impose significant and major modifications to the way these entities previously reported financial performance to their stakeholders. Like profit-seeking entities, local government entities were uncertain of the impacts prior to the implementation of changes in financial reporting in line with the adoption of IFRS (Pilcher & Dean 2009a). These changes required a rethink of many underlying concepts and methods, changes in accounting processes and systems and new presentation formats. Further, local government entities were expected to prepare for the changes, explain them to respective councillors, staff and the public, meet audit office expectations, review and revise policies, effectively prepare two sets of financial statements for the year to 30 June 2005 and still do all their normal work. Indeed, a study based on a survey of Director of Corporate Services (or similar) in all councils of NSW in 2006 by Pilcher & Dean (2009b) found that the implementation of IFRS by local councils was a costly and time-consuming exercise. It is questionable whether there are significant benefits as claimed by AASB in the adoption of IFRS standards by all sectors, especially the local government entities.

There have been numerous studies on the costs and benefits of IFRS adoption on profit-seeking corporations. For example, in Australia, Goodwin, Ahmed & Heaney (2008) examined the effect of adopting IFRS on the accounts and accounting quality in listed firms,

relying on retrospective reconciliations between numbers prepared under Australian Accounting Standards and IFRS. They found that the adoption of IFRS increased total liabilities, decreased equity and more firms experienced decreased surpluses. Becis, Ng & Roca (2006) using a much smaller dataset of listed companies found that for medium and small firms a positive relationship exists between the impact of IFRS on net profit after tax (NPAT) and market value. For large firms, this relationship was negative. However, there has been very little evidence available on this issue for local government entities in Australia. Pilcher & Dean (2009a) examined the effects of IFRS in the decision-making process of local government entities. Their study concluded that large councils could adopt IFRS standards and develop organisational processes to introduce such changes. The smaller councils with limited resources were not ready for such changes, and as a result their normal activities were affected and this shift was found to be time-consuming and expensive.

This study will contribute significantly to our understanding of the effect of IFRS adoption on significant accounting measures in Australian local government entities. This study provides insights into the effects of IFRS adoption which would be a valuable source of information for other countries which are either adopting or yet to adopt IFRS for reporting entities. For example, local government bodies in the United Kingdom are expected to adopt IFRS-based reporting by 2010/2011. Similarly, in Canada, the IFRS will be fully adopted by reporting entities in 2011. In the U.S. the Securities and Exchange Commission (SEC) has proposed allowing and eventually requiring public U.S. issuers to report financial results in accordance with IFRS.

This paper analyses the changes in accounting surplus, equity, assets and liabilities as a result of accounting policy changes from Australian Accounting Standards (AAS) to IFRS in local government entities. The selection of surplus (loss), earnings, assets and liabilities as a focus of study is justified on the grounds that the calculation of these indicators has a cumulative effect on the financial position and financial performance of local government entities. The adoption of IFRS affects the treatment of many issues such as: property plant and equipment (PPE); intangible assets; depreciation; proceeds of disposal of assets; written value of assets sold; recognition of previously unrecognised assets; share of net profit/losses of associates and joint ventures; accumulated surplus; retained surplus (loss); error correction prior year; both short-term and long-term liabilities; interest; and other expenses. Earnings and surpluses are used interchangeably in this study. Thus, the IFRS numbers focussing on surplus (loss) and the balance sheet are compared with those under AASB for the period immediately prior to IFRS adoption, to get an understanding of the consequences of the adoption of IFRS by local government entities. Specifically, this study aims to gain insights into whether local government surpluses are affected by the adoption of IFRS standards. Secondly, to examine significant items that can influence earnings/surpluses and equity as a result of accounting policy changes. Finally, this study aims to examine, whether there are significant variations among local government entities on these changes in surplus (loss), equity, and assets and liabilities.

The remaining sections are organised as follows. The following section provides background information about the adoption of IFRS by local government entities. The next section reports on the data collection. The following section presents the results of the effect of IFRS on surplus (loss), equity, assets and liabilities of local government entities. Finally, conclusions are drawn.

IFRS and Local Government

The introduction of IFRS accounting standards is applicable to all sectors of the Australian economy, which means that such standards are sector neutral. The same standards are applicable to all entities including public and not-for-profit entities. Public sector entities are different compared to their private sector counterparts, not least, in terms of ownership and organisational objectives. Such differences raise questions as to whether the same accounting standards are suitable for public sector organisations.

The Australian public sector is composed of three tiers of government: local government, state government, and the commonwealth government. Prior to the introduction of accrual accounting, all public sector entities maintained their accounts on a cash basis. As with all other tiers of the public sector the local government entities adopted accrual accounting with the introduction of AAS 27. Public sector financial reporting was mainly guided by three accounting standards in Australia and these were: *AAS 27 (Financial Reporting by Local Government)*; *AAS 29 (Financial Reporting by Government Department)*; and *AAS 31 (Financial Reporting by Governments)*³. As IFRS has no separate accounting standards for public and not-for-profit entities, the AASB needed to consider specific guidelines and additional notes as part of the adoption process. Such initiatives were aimed at eliminating duplications in accounting standards, integrating Government Financial Statistics (GFS), comparing existing standards with IFRS standards, and issuing specific guidance. The introduction of IFRS standards in local government entities can be seen as complicated when compared to the private sector since these entities have social objectives and complex arrangements, such as private/public partnership programs and the dominance of infrastructural assets.

Data Collection

As discussed earlier, local government entities were required to prepare financial statements in accordance with IFRS and existing accounting standards, such as *AAS 27 (Financial Reporting by Local Governments)*. The AASB 1047 “*Disclosing the Impacts of Adopting Australian Equivalents of the International Financial Reporting Standards (AEIFRS)*” required certain disclosures to be made in the Notes to the Financial Statements for the initial adoption periods. The Australian equivalents to IFRS were applicable for reporting periods beginning after 31 December 2004 and local government entities were required to restate comparatives and provide reconciliations to AASB in the first year of adoption (AASB 1). This requirement permits comparison between accounting earnings/surpluses, equity, assets and liabilities dollar amounts prepared under AASB and those under IFRS for the same set of entities. Such presentation of accounts under two different standards for the same periods provided a significant opportunity to see the effects of IFRS on local government financial reporting.

As this paper aims to locate the changes in earnings/surpluses, equity, assets and liabilities as a result of accounting policy changes, the annual reports produced by local government entities in 2005 provided the required data to assess these changes as these reports showed accounting information in comparative figures. We obtained a list of all local government entities in New South Wales (NSW), Queensland (QLD), South Australia (SA) and Victoria (VIC) from their respective Offices of Local Government, who as state bodies are responsible for the administration and regulation of local government. From this list,

³ AAS 27, AAS 29 and AAS 31 were withdrawn in 2008.

only annual reports for the year ended 30 June 2005 containing reconciliation notes in accordance with AASB 1 were identified. Table 1 shows the data for 117 local councils comprising City, Shire and Regional councils. There are 39, 10, 20 and 48 councils from NSW, QLD, SA and VIC respectively. The City, Shire and District councils represent 52%, 43% and 5% respectively. The reconciliations from AASB to IFRS form the basis for this study.

Table 1
Description of Sample

	N	Percentage	NSW	QLD	SA	VIC
City Council	61	52%	18	6	12	25
Shire Council	50	43%	15	4	8	23
District Council	6	5%	6	0	0	0
Total	117	100%	39	10	20	48

Empirical Results

Reconciliations of Surplus and Equity

Table 2 (Panels A and B) shows the aggregated reconciliations for the last year surplus (loss) and for equity at the most recent balance date under AASB. For example, for a 31 December annual balance date council surplus (loss) is for the year to 31 December 2004 and equity, liabilities and assets as are 31 December 2004. We selected the most frequent reasons for differences and ranked from greatest to least changes in average surplus (loss) and equity. Some items were found to be income-increasing and others as income-decreasing. Using the AASB surplus (loss), the most common income-increasing items were: depreciation and amortisation, employee benefits, other revenue, borrowing cost, net gain/loss on PPE, and materials; and income-decreasing items were: written value of assets sold, other expenses, and share of net profit/losses of associates and joint ventures.

Using the AASB equity, the most common items that increased the equity were: accumulated surplus, retained surplus (loss), error correction prior year, and council interest. The most common items that reduced the equity were: recognition of previously unrecognised assets, reserves, and PPE/capital (Panel B). The table also shows that the highest positive mean change from AASB surplus (loss) to IFRS surplus (loss) in dollar terms is due to materials previously expensed followed by recognition of other revenue items. The highest negative average change is associated with written assets sold followed by other expenses. For equity, the highest positive change is due to the transfer of balance to retained surplus (loss), followed by interest capitalisation.

Table 2
Effect of Most Significant Items on Surplus (loss) and Equity

	Mean	Median	Std Dev	N=117
Panel A: Surplus (loss)				
AASB	36,561.32	4,454.56	204,516.4	
Materials	556.33	890.80	31,525.29	24
Depreciation and amortisation	1,231.21	2.22	9,199.32	64
Net gain/loss on PPE	999.80	36.80	5,219.73	22
Other revenue	697.35	4.71	2,330.09	35
Employee benefits	449.85	12.20	3,124.11	36
Borrowing cost	138.28	36.56	345.22	29
Share of net profit/losses of associates and joint ventures	-15.09	33.53	295.89	10
Other expenses	-211.51	2.00	744.82	10
Recognition of previously unrecognised assets	2,234.76	700.06	5,656.89	20
Proceeds on disposals of assets	24,981.70	597.01	14,519.70	36
Written value of assets sold	-31,405.90	664.20	157,576.20	25
IFRS	33,748.71	3,241.00	201,765.30	
Panel B: Equity				
AASB	1,973,419.0	412,592.90	12,153,621.00	
Retained surplus (loss)	22,765.37	54.32	67,955.90	17
Council interest	12,200.0	-5.04	30,236.79	7
Accumulated surplus	4,011.49	41.50	35,176.29	74
Error correction prior year	3,257.37	60.25	14,497.18	15
PPE/capital	-1,844.20	120.05	4,824.79	5
Recognition of previously unrecognised assets	-1,0114.0	-6.13	54,883.31	27
Reserves	-14,232.90	-1,187.35	58,398.21	18
IFRS	1,989,462.0	427,626.88	12,321,798.26	

Table 3 shows the overall effect of IFRS adoption on local government surplus (loss) and equity. The mean effect on surplus (loss) is negative amounting to \$1.89 million while the mean effect on equity is positive to the extent of \$6.6 million. Overall, the stakeholder wealth was better off following the adoption of IFRS in 2005. The mean changes in surplus (loss) and equity are divided by population and total rate income. The mean per capita loss is \$25 and \$0.042 per dollar of rate received by the councils during the year 2005. This loss has been more than compensated by the increase in equity to the extent of \$47 per capita and \$0.88 per dollar of rate revenue.

Table 3
Effect of Most Significant Items on Assets and Liabilities

	Mean	Median	Std Dev	N=117
Panel A: Assets				
AASB	1,894,675.87	419,073.05	12,503,366.03	
Receivables	18,976.56	-17.00	74,646.10	16
Investment property recognition	13,474.93	2,777.00	55,031.76	29
Other items	9,639.33	531.00	48,368.48	43
PPE non-current	6,486.56	523.00	46,023.42	43
Other assets	2,819.94	3,845.00	9,122.65	17
Inventory	2,479.43	5,245.50	10,122.68	14
Investment property current	2,347.24	3,493.00	8,225.88	21
Land valuation adjustments	1,401.31	676.00	10,375.70	13
Employee entitlements	1,330.17	-17.00	3,365.05	6
Non-current assets held for resale	748.36	527.00	9,840.62	14
Intangible assets	-230.57	221.50	9,252.93	14
Cash or cash equivalent	-679.34	531.00	10,350.92	35
Adjustments for infrastructural assets	-859.46	-80.00	9,314.13	13
Investment non-current	-1,949.00	-1,632.50	14,300.64	6
IFRS	1,950,019.52	433,502.50	125,15,430.00	
Panel B: Liabilities				
AASB	41,412.37	20,922.01	122,530.2	
Trade payables	2,734.82	528.50	9,941.28	23
Provisions short-term	2,253.22	832.20	4548.37	31
Others	649.83	82.5	1255.58	6
Employee benefits	56.38	6.23	1,777.30	39
Provisions long-term	26.778	-3.30	8,827.87	67
Payables short-term	25.17	113.09	3,746.91	18
Payables long-term	-2,672.55	-905.30	6,843.60	20
IFRS	44,486.83	20,947.30	123,019.30	

Reconciliation of Assets and Liabilities

Table 4 (Panels A and B) shows the most frequent assets and liabilities items extracted from reconciliation statements prepared by the first-time local government adopters. The difference between the average total assets under IFRS and AASB is \$55.34 million. The most frequent items that increased assets are: other items; PPE non-current; investment property recognition; other assets; receivables; inventory; non-current asset held for resale; land valuation adjustments; and employee entitlements. The most frequent items that decreased assets are: cash or cash equivalent; intangible assets; adjustments for infrastructural assets; and investment non-current.

Panel B shows that the average liabilities under IFRS are higher than those under AASB and the difference is about \$3.07 million. The most frequently items that increased liabilities are: provisions long-term; employee benefits; provisions short-term; trade

payables; payables short-term; and other items. The only item that reduced liabilities is the reduction in long-term payables. We tested for the difference in the aggregate effect of the adoption of the IFRS on assets and liabilities and found that the difference in total liabilities prepared under AASB and IFRS is significant at the 5% level while the difference in total assets is not significant. These results suggest that the implementation of the IFRS caused some change in the capital structure of local bodies within local government bodies in Australia.

Table 4
Effect of IFRS Surplus (loss) and Equity on Population and Rates

	Average (\$'000)	Median (\$'000)	Standard Deviation
Change in Surplus (loss) (IFRS-AASB)	-1,894.209	0.000	15,639.281
Change in Equity (IFRS-AASB)	6,572.564	0.000	42,506.909
Population	79,721.255	58,050.000	104,070.660
Rates	48,435.941	30,943.000	99,849.906
Surplus (loss) effect			
Population	-0.025	0.000	0.167
Rates	-0.042	0.000	0.284
Equity effect			
Population	0.047	0.000	0.303
Rates	0.088	0.000	0.403

Size Effect

Prior to the adoption of IFRS, several commentators argued that smaller firms would be disadvantaged. For example, the Australian Institute of Company Directors (AICD 2004, p.6) stated that smaller companies are at “. . . a greater disadvantage in moving to IFRS than larger companies”, primarily due to resources constraints. The Institute of Chartered Accountants in Australia also supported some relief for small- and medium-sized entities in its submission to the Committee (ICAA 2005, p.2). Wayne Cameron, Technical Director of RSM Bird Cameron, claimed that generally small firms’ balance sheets will be weakened by Australian IFRS except for intangibles (Andrews 2005). In contrast, the chairman of the AASB, David Boymal, was of the view that small firms would be surprised to see no significant effect on their financial position due to the adoption of IFRS (Andrews 2005). Because of the conflicting views, we examined whether or not small councils were worse off. Goodwin and Ahmed (2006), using data from 135 listed firms, found that more than half of small listed firms on the Australian Stock Exchange have no change in net income or equity from IFRS, and that there is an increase in the number of adjustments to net income and equity with firm size. Their study also finds that IFRS has increased net income for small- and medium-sized firms. Equity has increased (decreased) under IFRS for small (large) firms. Small firms experience higher surplus (loss) variability than medium-sized or large firms under IFRS.

Table 5
Effect of IFRS Surplus (loss) and Equity on According to Size

	Average (\$'000)	Median (\$'000)	Standard Deviation
Small Council			
Surplus (loss) effect	-981.760	0.000	4,794.350
Equity effect	574.311	5.750	3,595.445
Medium Council			
Surplus (loss) effect	-1,309.892	0.000	5,416.144
Equity effect	5,013.795	0.000	15,843.591
Large Council			
Surplus (loss) effect	126.000	0.000	2,681.795
Equity effect	1,273.620	0.000	5,703.295
Test of difference (ANOVA): Surplus (loss)	F=1.125, Sig =0.328		
Test of difference (ANOVA): Equity	F=2.145, Sig =0.122		

As reported in Table 5, we divided the councils into three equal groups based on population. The table shows that while small and medium councils experienced loss in surplus (loss) amounting to \$981,760 and \$1,309,892, respectively, these losses have been offset by an increase of \$574,311 and \$5,013,795 in equity respectively. On average, large councils had a positive effect in surplus (loss) and equity. With respect to equity no major deviation has been noted, and ANOVA tests do not show any significant impact on both surplus (loss) and equity across the three groups of councils. With respect to assets and liabilities, we also undertake similar analysis and do not find any size effect.

Summary and Conclusions

The adoption of the IFRS in Australia has been a significant event in Australian financial reporting history and generated much debate about the implications of IFRS adoption with regard to material effect on Australian entities' financial performance and accounts quality. Changes to accounting standards in local government entities were expected to impose significant and major modifications to the way these entities reported their financial performance and position to their stakeholders. This study makes a significant contribution to our understanding of the effect of the adoption of IFRS for local government entities and examines the changes in accounting surplus (loss) and equity as a result of accounting policy changes from AASB to IFRS. Using the 2005 annual reports of 117 local government entities in Australia, evidence is provided of the effect of adoption of IFRS by such entities by identifying the key items reported in the reconciliation notes that caused differences between IFRS and AASB surplus (loss) and equity. The results show some differences between the two sets of accounts. Using the AASB surplus (loss), the most common income-increasing items are: depreciation and amortisation; employee benefits; other revenue; borrowing cost; net gain/loss on PPE; and materials. Income-decreasing items are: proceeds on disposals of assets; written value of assets sold; recognition of previously unrecognised assets; other expenses; and share of net profit/losses of associates and joint ventures.

Overall, while the surplus (loss) of local councils decreased, their equities show a significant increase, with no major significant changes in overall financial position. The results also show that while small and medium councils experienced a loss in surplus (loss), these losses have been offset by an increase in equity. On average, large councils had a positive effect in both surplus (loss) and equity. With regard to the effect on total assets and total liabilities, we find that total assets and total liabilities have increased by about \$55 million and \$3.07 million, and only the increase in total liabilities is significant at the 5% level. Our findings are consistent with other studies on the effect of IFRS adoption in private sectors entities in Australia.

The findings from this study contribute to our understanding of the effects of the implementation of the adoption of the IFRS on reported figures of surplus, equity, assets and liabilities using a large number of local government entities. The results also shed insight into the possible effect on reported numbers by local councils in countries such as Canada, Malaysia and the U.K. who are about to implement IFRS for local government entities.

Further studies need to be undertaken to investigate other areas of the IFRS adoption process. It may be useful to undertake one or two in-depth case studies to see the adoption process from a longitudinal perspective. Nevertheless, the contribution made by this study is highly significant; not least because it shows the effects on performance. It is also expected that other studies on IFRS adoption in local government entities in other countries will be undertaken and that this will provide significant opportunities for comparative understanding of different adoption strategies and their amplifications.

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