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Abstract

Within the raft of new international accounting standards, there is at least one, namely AASB138 (IAS38) 'Intangible Assets', which not only changes the way that Australian companies account for and report their intangible assets, but advocates a treatment that is conceptually flawed and which fails to provide relevant information to the users of financial statements. Despite resistance to the new standard by Australian constituents, it became effective from 1 st January, 2005, and will have a significant impact on the financial statements of Australian reporting entities. These assertions are supported by reference to submissions offered to the AASB and IASB, as well as International Financial Reporting Standards (IFRS) disclosures made by selected Australian media companies in their 2004 annual reports. At this early stage of adoption, many of the arguments are based on suppositions and the actual effects of AASB 138 will not be known until the release of 2005 and 2006 financial statements. Although to date the IASB has been unwavering in its denial of alternative treatments for intangible assets, the AASB continues to pursue its case with the IASB, devoting resources to an intangible assets research project. The AASB mission will need to be more than convincing to change the views espoused by the IASB, given that the treatment advocated in AASB138 is consistent with that of US and UK, the IASB heavyweights. Success by the AASB would strengthen its influence at the international level of standard setting and would also allow Australian reporting entities to recognise the fair value of their underlying assets, thus strengthening the conceptual consistency and relevance of financial reporting.

Keywords

AASB138, Intangible, Assets, Bad, Apple, IFRS, Barrel

Disciplines

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AASB138 INTANGIBLE ASSETS – THE BAD APPLE IN THE IFRS BARREL

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ABSTRACT

Within the raft of new international accounting standards, there is at least one, namely AASB138 (IAS38) 'Intangible Assets', which not only changes the way that Australian companies account for and report their intangible assets, but advocates a treatment that is conceptually flawed and which fails to provide relevant information to the users of financial statements. Despite resistance to the new standard by Australian constituents, it became effective from 1st January, 2005, and will have a significant impact on the financial statements of Australian reporting entities. These assertions are supported by reference to submissions offered to the AASB and IASB, as well as International Financial Reporting Standards (IFRS) disclosures made by selected Australian media companies in their 2004 annual reports. At this early stage of adoption, many of the arguments are based on suppositions and the actual effects of AASB138 will not be known until the release of 2005 and 2006 financial statements. Although to date the IASB has been unwavering in its denial of alternative treatments for intangible assets, the AASB continues to pursue its case with the IASB, devoting resources to an intangible assets research project. The AASB mission will need to be more than convincing to change the views espoused by the IASB, given that the treatment advocated in AASB138 is consistent with that of US and UK, the IASB heavyweights. Success by the AASB would strengthen its influence at the international level of standard setting and would also allow Australian reporting entities to recognise the fair value of their underlying assets, thus strengthening the conceptual consistency and relevance of financial reporting.

INTRODUCTION

The corporate collapses and associated accounting scandals that rocked not only the Australian but global economies in recent years provided added urgency to the movement towards the internationalisation of accounting standards. Soon after the decision of the European Commission to adopt the standards of the International Accounting Standards Board (IASB) in full as from 1st January 2005, the Australian Financial Reporting Council (FRC) also made the commitment to adoption, despite lobbying by Australian constituents and little prospect of acceptance of these standards by the US and other trading partners within the near future.

It is suggested that whilst the decision to adopt IASB standards necessarily required the adoption of the complete package, there is at least one 'bad apple' within this 'barrel', namely IAS138, and the Australian equivalent AASB138 'Intangible Assets'. This standard was preceded by the related exposure draft ED109, which generated considerable lobbying by Australian companies, professional accounting bodies and firms, and the Australian Accounting Standards Board (AASB). Despite the inevitability of reporting under the new framework, the lobbying continues to a lesser extent. Not only does AASB138 impose considerable change on Australian reporting entities in accounting for and reporting their intangibles, but it is also argued that it contains several conceptual inconsistencies and does not allow for the presentation of financial information relevant to users of financial reports. Furthermore, there is the possibility that any changes made under the new regime will be reversed in future years depending on the outcome of the current work program of the AASB regarding the treatment of intangibles.

This paper will first provide background to the FRC's decision to adopt International Financial Reporting Standards (IFRS) and the arguments presented in support of the move. A discussion of

the changes that are being imposed on companies as a result of AASB138 will follow, focussing on intangibles such as brand names and mastheads. Arguments against the advocated treatment, including conceptual flaws, will be outlined, and the impact on the financial statements of Australian companies along with the anticipated economic consequences will be assessed by reference to selected Australian company accounts. This will be followed by a brief overview of the broader implications of AASB138 on the Australian regulatory framework. The paper concludes with an overview of the current and ongoing attempts to redress the perceived shortcomings of the standard and highlights the need for an ongoing debate and the tracking of the application of AASB138.

THE IFRS 'BARREL': FRC'S ADOPTION DECISION

On 28th June 2002 the FRC announced that Australian reporting entities would be required to comply with all of the standards issued by the IASB as from 1st January 2005 [1]. This was an about turn to its previous ratification, 3 months earlier, of Australian Accounting Standards Board (AASB) ED102 'International Convergence and Harmonisation Policy' [2] (issued as policy in April 2002), which advocated a longer term process of harmonisation. This abrupt change of plans was attributed to the decision of the European Union (EU) to adopt IASB Standards from 1st January 2005. However, it should also be seen in the context of the economic crisis of the late 1990's and more significantly the phenomenon of corporate collapses experienced in the Western world in the early 2000s. Blame for these collapses was attributed partially to the inability of contemporary accounting and financial reporting to prevent or warn of the impending collapses. These accounting scandals acted as a catalyst for urgent regulatory reform in Australia, with politicians and regulators forced to address issues of corporate governance and increased disclosures in financial reports. Recommendation 4 of the HIH Royal Commission stated that "Australia should participate fully in the development of international accounting standards and pursue the adoption of high-quality, consistent and readily understood accounting standards" [3, p lxv]. It might also be argued that the political responsibility for the inevitable round of future corporate collapses would be diverted away from the Australian government to the IASB [4, p11].

IFRS provided a convenient and timely option for regulators, with the much cited benefits of increased comparability of financial statements in different countries, removing barriers to international capital flows, reducing financial reporting costs for Australian multinational companies and foreign companies operating in Australia and reporting elsewhere, and finally improving the quality of financial reporting in Australia to best international practice [5, p1436]. In spite of these grand claims, however, there was little or no opportunity given for critique of the proposed benefits [6, p20].

The FRC also made the decision that the IASB standards would be adopted as a complete package and that all reporting entities would be required to comply with these standards from the same date, namely 1st January 2005. Inevitably, not all of these standards would sit well with Australian constituents and some IASB standards would prescribe treatments that were perhaps inferior to or inconsistent with previous Australian pronouncements. It is suggested that this is indeed the case with one of the standards, AASB138 'Intangible Assets', which heralds much change to existing practices.

'THE BAD APPLE' : CHANGES IN ACCOUNTING FOR INTANGIBLE ASSETS

Accounting for intangible assets has generated controversy in Australia for many years, from debate over methods of amortisation to the recognition of various intangibles. The adoption of AASB138 has fuelled that debate, bringing significant changes to existing Australian GAAP, compounded by the retrospective nature of the new requirements, and the potential quantitative effects on the balance sheets of many Australian companies. The major changes focus on issues of identifiability, prohibition, reversals of previous revaluations and future revaluations.

IDENTIFIABILITY CRITERION

A comprehensive standard on intangible assets did not exist within the previous Australian suite of accounting standards, although AASB1011 'Accounting for Research and Development Costs' and AASB1013 'Accounting for Goodwill' provided coverage in respect of limited categories of intangibles. Guidance on the definition of intangible assets was provided via the general criteria in the non-mandatory Statement of Accounting Concepts 4 (SAC4), namely that "assets are future economic benefits controlled by the entity as a result of past transactions or past events" (paragraph 14). The new AASB138 narrows the criteria somewhat, defining an intangible asset as "an identifiable non-monetary asset without physical substance" (paragraph 8). Further refinement in paragraph 11 requires the intangible to be "identifiable to distinguish it from goodwill", and paragraph 12 introduces the notion of 'separability', that is the asset is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability.

PROHIBITION OF THE RECOGNITION OF CERTAIN INTERNALLY GENERATED INTANGIBLES

The recognition of internally generated brands, mastheads, publishing titles, customer lists and similar items is now prohibited (AASB138 paragraph 63). The argument presented in the new AASB138 against recognition is that expenditure on such items cannot be distinguished from the cost of developing the business as a whole (paragraph 64). This narrows the scope previously available to entities to recognise those assets if they met the recognition criteria of SAC4, namely the probability that future economic benefits embodied in the asset would eventuate and that the asset possessed a value that could be reliably measured (paragraph 38).

REVERSAL OF PREVIOUS REVALUATIONS.

AASB138 stipulates that intangible assets must initially be valued at cost (paragraph 24). AASB1 'First Time Adoption of Australian Equivalents to International Financial Reporting Standards' at first glance provides an opportunity for entities to use fair value or a revalued amount as an asset's 'deemed cost' at the date of transition to IFRS, however this is effectively negated by the condition that the AASB138 criteria, including the existence of an 'active market', must be met. Paragraph 8 of AASB138 provides the definition for 'active market', and specifies that in such a market, items traded are homogeneous, there are willing buyers and sellers at any time and prices are available to the public. This requirement is more stringent than the requirements of the previous AASB1041 'Revaluation of Non Current Assets', which allowed companies to 'deem' the carrying amount of a previously revalued asset to be its cost, in the situation where those companies were reverting to the cost basis of valuation and did not wish to be locked into the constraints of the fair value basis of accounting for non current assets. In most cases therefore, AASB138 requires a retrospective writeback of any previous revaluations to original cost and not deemed cost.

REVALUATION OF INTANGIBLES

The standard now allows subsequent revaluations of intangible assets to fair value, determined by reference to an active market (AASB138 paragraph 74). Given the relatively small size of the Australian market and the unique nature of many intangible assets, this requirement more or less precludes this avenue. Paragraph 78 goes as far as to say that "it is uncommon for an active market ... to exist for an intangible asset", and that "an active market cannot exist for brands, newspaper mastheads, music and film publishing rights, patents or trademarks, because each such asset is unique." Contrasted with this was the relative freedom previously granted to reporting entities to revalue their intangibles subject to the requirements of the previous AASB1041, where the only stipulation was that if an entity chose to value its assets to fair value, then the fair value needed to be regularly reassessed.

WHY IS IT BAD?: CONCEPTUAL FLAWS AND LOBBYISTS' ARGUMENTS

Lobbying against these changes has been robust as evidenced by extensive press coverage and the submission to the AASB of numerous comment letters (ED109 comment letters) on the relevant exposure draft, ED109 'Request for comment on IASB ED3 Business Combinations, IASB ED of Proposed Amendments to IAS36 Impairment of Assets, and IAS38 Intangible Assets and AASB added material' [7]. Reference to this lobbying will be made to support the two lines of argument against the advocated treatment in AASB138, firstly the failure of the standard to provide a consistent and conceptually strong treatment for intangibles, and secondly the inability of the standard to allow for the presentation of relevant financial information.

AASB138 – BAD ACCOUNTING?

The desire to have a theoretically pure system of accounting has been the quest of countless theorists, boards and committees during the last century. Theoretical soundness though has been compromised by accepted practice and the inability to reach consensus about the most appropriate methods. The IASB has strived to develop a principles based system of fair value accounting and reporting, and whilst imperfect it goes some way to overcoming the inadequacies of the modified historical cost system. Property, plant and equipment, investment properties and financial instruments may all be valued at fair value under IFRS, whilst the results of entities must now take into account such fair value adjustments as impairment losses. The fair value approach however, has not been reflected in the intangibles standard, and the result is a standard full of anomalies and inconsistencies with the Framework for the Preparation and Presentation of Financial Statements (the Framework) and other IFRSs.

The most glaring anomaly is that of the definitional requirements of intangible assets, which include the concepts of identifiability and separability. For tangible assets, it is enough to be able to demonstrate a flow of future economic benefits from the asset and the ability by the entity to control the asset (the Framework, paragraph 49a). Identifiability, however, adds a further dimension and limits the ability of companies to include some assets on their balance sheets. The concept of 'separability' has generated a substantial amount of debate within corporate Australia, particularly in respect of the practicalities of such a requirement and the conceptual inconsistency between intangibles and tangible assets [8, p15] [9, p18].

The differentiation between the recognition criteria for internally generated and purchased intangibles has generated significant controversy. Australian reporting entities have to date been allowed the flexibility to recognise such assets provided that they could demonstrate that the assets met the definition and recognition criteria of SAC4. This scope acknowledged the increasing importance of intangibles to the balance sheet of corporates, the move by Australian

regulatory bodies towards fair value accounting and the acceptance of recognised methods of valuation for such intangibles. As identified by many interested parties in their ED 109 comment letters [10] [11] [12], the prohibition of the recognition of some internally generated assets, such as brand names, trademarks and the like, is inappropriate, as it is inconsistent with the definition and recognition criteria of the Framework, and there are no grounds for making such a distinction. The financial statements of companies which have developed their intangibles in-house should reflect these assets regardless of source, just as those companies with externally purchased intangibles are able to. Furthermore, "unlike goodwill, the internally generated intangible assets referred to can be identified and are separable from the entity" and "while these assets may not, in a number of circumstances, be separately distinguished from the cost of developing a business, the point to be emphasised is that an acceptable methodology exists to support their separate measurement and recognition" [12, p7]. Rural Press Ltd, an Australian listed company which will potentially lose \$169 million or 18% of total assets from the face of its balance sheet as a result of the new standard, argued that "prohibiting recognition of such items is arbitrary and overly restrictive...Whilst we acknowledge the difficulty inherent in distinguishing between the creation of these types of intangible assets and the development of internally generated goodwill, we believe that such items should be capable of recognition if the recognition criteria and guidance applicable to internally generated intangible assets is satisfied" [13, p3].

As noted, the transition to IFRS will mean that in most cases previous revaluations of intangibles will be required to be reversed, such that the assets are stated at cost. Contrasted to this is the AASB1 treatment of tangible assets whereby entities may elect to measure these assets at fair value or revalued amount and use that value as deemed cost (AASB1 paragraphs 16 and 17). The Group of 100 has noted that for those companies where such derecognition takes place, there would be a serious impact on the net assets of these entities [8, p19]. The AASB has highlighted the punitive nature of such a retrospective adjustment and requested that the IASB "should permit the use of a previously deemed cost determined under national GAAP as a deemed cost for the purposes of IAS38 (AASB138)" [14, p2]. As suggested by the AASB, it is expected that the derecognition of certain intangible assets and previous revaluations will in some cases give rise to a net deficiency which, but for the derecognition requirement, would not be the case [15]. The use of the economic consequences argument with respect to standard setting is certainly not a recent phenomenon, with Zeff [16] noting the use of the argument as early as 1941 in the US. It appears that in the case of IAS38, however, the IASB has neglected this argument. The AASB's claim that "the transitional arrangements for intangible assets in IFRS1 would compromise the comparability of financial statements" [17, p8] is refuted by the IASB on the grounds that the Australian treatment for internally generated intangibles and revaluations, whilst allowed, was optional only [17, p8].

Inconsistent treatment between tangible and intangible assets arises not only on first time application of IFRS, but also in respect of future revaluations. Paragraphs 31 to 33 of AASB116 'Property, Plant and Equipment' state that these assets may be revalued to fair value, usually market value determined by appraisal, but if no market exists then an estimate may be made using an income or depreciated replacement cost approach. This option is not permissible for intangibles, where revaluations are restricted to the existence of an 'active market'. As highlighted by CPA Australia, whilst the active market criteria may be suitable for the larger and more diverse markets in the USA or Europe, in those cases not specifically excluded because of their unique nature, it may be problematic for a small country like Australia [12, p7]. Financial statements of American or EU companies may include some revalued intangibles but those in Australia will be confined to reporting at cost. Thus, one of the advocated advantages of international accounting standards, comparability, might be lost.

It seems incongruous that the value of intangible can be established in the event of a business combination (AASB3) or for the purposes of impairment testing (AASB136) even in the absence of an active market, yet this is unacceptable for the purposes of revaluation of the same assets. As CPA Australia notes, "within Australia, methods of valuing these assets have general support, even by the Australian Taxation Office!" [12, p7]. Lonergan [18, p59] highlights the inconsistencies between this treatment of intangibles and that of other assets, noting that

"the IFRS even require the marking to market of self-generating and regenerating assets when in many cases the valuations of such assets are much more problematic than those of identifiable intangibles. The IFRS also require market values of other assets, including derivatives, financial instruments, etc. In essence, if assessing the present value of future cash flows, or applying some earnings multiple as a surrogate thereof, is good enough for other asset classes, for acquisition accounting and for impairment testing then it cannot be fairly said that such methodologies are too unreliable for revaluation purposes."

Given the unique nature of many intangibles and the limited size of the Australian market, it is perhaps short sighted of the IASB to fail to consider alternatives to the active market criteria. Absence of an active market does not necessarily equate with no value, and alternatives such as 'value in use' are worth considering. The IASB is no stranger to this concept which it has introduced as a means of determining the recoverable amount of an asset in accordance with AASB136 'Impairment of Assets'. As suggested by Upton [19, p90], "much of the value of an intangible comes from the ability of a particular enterprise to develop that intangible and use it as part of its unique business operation." Active trading in the shares of intangible rich companies, such as those in the media sector, certainly suggests that investors recognise the value of these assets. Thus the active market criteria may not be a valid criterion for the revaluation of intangibles.

AASB138 reflects a somewhat conservative approach to the recognition and measurement of intangibles, precluding the recognition of some internally generated intangibles and the capitalisation of research expenditure, requiring retrospective write downs of past revaluations of intangibles and severely hampering the ability to revalue intangibles above cost. It appears that the new AASB138 is influenced more so than other standards by the concept of prudence, a concept which did not feature in the Australian Conceptual Framework, but which has made its appearance in the Framework (paragraph 37) and specifically requires that an element of caution be introduced in the preparation of financial statements. As suggested by Carnegie [20, p58] "in the post-Enron, WorldCom and HIH climate, it is not altogether unsurprising that corporate regulators would be more circumspect in prescribing and enforcing accounting practices."

The foregoing would suggest that in the case of AASB138 it is not at all about 'good accounting', but rather playing the game. FRC Chairman, Jeff Lucy, was cited as saying that "Australian accounting standards have always been regarded as highest quality. The problem we suffer is (that) no-one else understands them. If you want to play an international game, you have to use a language everyone understands" [21, p52]. It is also about consistency of accounting standards; standards that have been influenced by those of the IASB member nations. This consistency however may mean consistent application of poor accounting principles and the presentation of incomparable financial statements. The financial statements of companies which take the initiative to internally develop such intangibles as brand names or mastheads will be incomparable with those who have purchased theirs from external sources. Companies whose asset base is weighted to intangibles will find their balance sheets incomparable to those companies weighted toward revalued tangibles. Comparison will also be impaired between Australian companies and foreign companies, each group being subject to different market

contexts. It may also be argued that these inconsistencies and omissions will inevitably result in the failure of financial reporting to provide relevant information.

AASB138 - BAD INFORMATION?

These inconsistencies and omissions would not matter if intangibles were of little importance to contemporary companies, however this is not the case. Intangible assets are seen to be the main value drivers of companies in the new economy, an economy transformed by new information technologies and the rapid pace of innovation necessitated by globalisation. Intangibles such as intellectual capital, customer relationships, brand names, employee skills and research are what set contemporary organisations apart. One only has to look at the 2004 financial statements of leading Australian companies to realise the importance of intangibles to the market value of companies, with companies such as Lion Nathan Limited [22] and Burns Philp Limited [23] showing in 2004 accounts negative net tangible assets of \$156 million and \$1.4 billion respectively, yet whose shares are still trading strongly. Now, more than at any time in the past, there is a need for information on the nature and value of corporate intangibles, yet the current disclosures in financial reporting do not capture this relevant information, with AASB138 threatening to exclude even more information.

The task of identifying relevant information is indeed an onerous one, and obviously within the scope of financial reporting relevance must be weighed up against other considerations such as reliability and the costs of providing the information. Guidance may be sought from the Framework, which in paragraph 12 outlines the objective of financial reports, namely “to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions”, that is, a decision usefulness approach. Of particular concern here is the information on the financial position of an entity, specifically the economic resources controlled by the entity and its ability to generate cash and cash equivalents in the future (paragraph 16). Relevant information will be that which allows users to evaluate past events and predict the ability of the entity to take advantage of opportunities or deal with adverse situations in the future (The Framework, paragraphs 26 to 28). The Framework (paragraph 38) also acknowledges the importance of completeness of information within the bounds of materiality and cost. The economic resources of many contemporary companies will be comprised at least partially of intangibles and information regarding these assets is thus required to meet the objectives of relevance and completeness. AASB138’s failure to recognise a large portion of these assets is a failure of financial reporting to provide relevant financial information to users. Rather than limiting the intangibles that are being recognised on financial statements, the IASB should be looking to capture more information.

This failure to provide relevant financial information may indeed be “causing serious private and social harms” as identified by Lev [24, p3]. For early stage, knowledge intensive companies, insufficient financial disclosures may result in excessive cost of capital and may also result in systematic undervaluation by investors in the shares of these enterprises. Investment and growth may consequently be hindered and undervalued companies may find themselves the target of takeovers. Insider gains may be made by officers of R&D intensive companies from trading in the stocks of their employers, and the continued deterioration of financial information may contribute to excessive riskiness of securities as users have inadequate information upon which to base decisions [24, pp3-4].

Furthermore, whilst it is not the objective of financial reporting to provide an explanation for the gap between the net book value of a company, and the recognised value of a company usually reflected in its market capitalisation, the failure to provide some explication of the gap represents

a failure of financial reporting to provide complete and relevant financial information useful for decision making by users. A Brand Finance analysis of the 2003 balance sheets of Australian listed companies found that of their total market value, capitalised intangibles accounted for 9% and tangible assets 28%, leaving 63% unexplained by conventional financial reporting (as cited by Burbury, [25, p68]). Upton [19, p2] attributes such a gap to differences between accounting and market assessments of the measurement of recognised net assets, the market assessment of the value of unrecognised intangibles, market assessments of future plans and other factors such as market psychology. The recognition of intangibles at appropriate values may go some way to bridging the gap between accounting book value and market capitalisation, and allow financial reporting to gain more relevance to users.

The recognition and measurement of intangibles, especially those that are internally generated, have been fraught with the difficulties of uncertainties surrounding the fruition of future economic benefits, control, lack of markets in which to trade these intangibles and the inability to separate the benefits from other related assets. However, the need for relevant and complete information should prevail over difficulties in accounting, and the current sensitivity in the wake of corporate collapses should not take accounting to the extremes of conservatism.

Post mortems on recent corporate collapses have exposed the inclusion of rather dubious and fictional assets on the balance sheets of the companies in question, and it is understandable that regulators are sensitive to the inclusion of anything but the most certain and verifiable of assets on corporate balance sheets. In the case of HIH Insurance Limited, a leading Australian insurance company which plummeted to collapse in 2001, the increased reliance on intangibles to prop up the shareholders equity was staggering. In the December 1997 accounts, intangibles, comprising goodwill, future income tax benefits and deferred technology costs, represented 23% of total shareholders equity but by June 2000 this ratio had reached 75% [3, p xiii]. The HIH Royal Commission [3, p xiii] acknowledged that "this is not to say reliance on intangibles is illegitimate. But the trend is disturbing...in the accounting practices of HIH goodwill became something of a repository for the unpleasant and unwanted consequences of poor business judgement". Dubious accounting practices by the few have overshadowed the legitimate practices of many other corporations and generated a sensitivity to the reporting of intangibles, and it could be said that this sensitivity has given us a standard that due to its conservative nature is not in keeping with fair value accounting and which may be more in line with liquidation accounting. The "new accounting regime", seems to be mainly "intent on valuing businesses for when they fail" [26, p69]. As James [26, p69] quite aptly suggests "the IFRS regulations are a heavy-handed reaction to the dot-com excesses of the late 1990s, when many companies concealed the fact they did not have a business by saying they were fostering their intangible assets. The response from the regulators is a bit like a man who, discovering he should be using a screwdriver rather than a hammer to open a lock, starts hitting harder with the hammer." The move to fair value reporting embraced by the IASB for most of the IFRS's should be extended to intangibles and if the value of intangibles falls below reported values, then AASB136 'Impairment of Assets' should operate to recognise the loss in value.

HOW BAD IS THAT APPLE?: EVIDENCE FROM AUSTRALIAN COMPANIES

The foregoing arguments take on significance when viewed in light of the published financial information of Australian listed companies. As previously suggested, around 63% of the market value of Australian companies cannot be explained by conventional financial reporting, yet AASB138 is set to remove even more intangibles from the balance sheets of these companies.

In 2004, of the 1700 companies listed on the Australian Stock Exchange, 430 recognised around \$167 billion of intangibles, comprising almost 8 % of the total assets of these companies. As the

AASB138 requirements do not commence until 2005, the financial effects of the application of the new standard are difficult to gauge, however estimates of the potential writedowns extend from \$10 billion [27, p1] to \$44 billion [28, p26]. Some indication of the effects may be gauged by AASB1047 'Disclosing the Impacts of Adoption of Australian Equivalents to International Financial Reporting Standards' disclosures in the 2004 financial statements of Australian entities.

AASB1047 (paragraph 4.1) requires reporting entities to disclose in respect of reporting periods ending on or after 30th June 2004 an explanation of how the transition to IFRSs is being managed, and also a narrative explanation of the key differences in accounting policies that are expected to arise from adoption of IFRSs. In a review of AASB1047 disclosures made by 808 Australian listed companies, conducted by Jubb [29] on behalf of the Institute of Chartered Accountants in Australia (ICAA), the new treatment of intangibles was identified as the sixth most important policy change as a result of IFRS.

Whilst AASB1047 did not require disclosure in 2004 accounts of the quantitative effects of the new regime, in some cases companies have chosen to make preliminary quantitative disclosures. For the purposes of this paper, an analysis of these quantitative disclosures for a selection of companies on the Australian Stock Exchange (ASX) will be made to estimate the impact of AASB138. Due to the high proportion of intangibles to total assets of companies in the ASX sub-industry groups of 'publishing and printing' and 'broadcasting and cable TV', these companies have been selected for analysis. It is acknowledged that this selection represents only a small proportion of listed companies and it is intended as indicative research only.

It might be expected that the 'publishing and printing' group would be hard hit by the new standard with much of its asset base weighted towards intangibles in the form of mastheads. With News Corporation Limited making the decision to redomicile in the US, the major remaining listed company in this category, Fairfax Ltd, carries most of its mastheads of \$2.3 billion at cost. This is the result of the company being placed into administration in 1991 with the refloated company purchasing the mastheads from the liquidator. Had it not had the problems of 1991, the company would have recognised a significant level of internally generated mastheads [25, p68], and would now be facing material writedowns. Rural Press Ltd [13, p60], on the other hand faces the reversal of \$169 million of previous revaluations, reducing the total assets of the consolidated entity by 18%. The AASB1047 disclosure of APN News and Media Limited (2004) (APN) notes that its Board "does not agree that an active market does not exist in respect of newspaper mastheads, however, will comply with the requirement of the new standard to reverse all past revaluation of such assets" [30, p7]. Whilst the accounts of APN do not quantify the extent of previous revaluations in respect of mastheads, the Asset Revaluation Reserve contains an amount of \$149 million, so the potential is there for a writeoff of 5% of the total assets of the entity. Taken as a whole, this sub industry group carries \$5 billion in intangibles or 66% of the total assets (Table 1), with at least \$300 million set to disappear with the application of AASB138.

The 'broadcasting and cable TV' sub group includes the major Australian television networks, whose combined total assets amount to over \$15 billion, with intangibles, primarily TV licences, accounting for 53% of these assets (Table 1). Several of these companies elected to carry their TV licences at 'deemed cost' in accordance with the previous AASB1041 requirements. However, as previously discussed, AASB138 requires intangibles to be initially recognised at cost with any previous revaluations reversed. Publishing and Broadcasting Ltd (PBL) (2004)

TABLE 1 EXTRACTED FINANCIAL INFORMATION

| Company | Balance date | Total Assets \$000 | Intangibles \$000 | Intangibles as a % of total assets | Estimated effect of AASB138 |
|---|--------------|--------------------|-------------------|------------------------------------|--|
| <u>Publishing and printing</u> | | | | | |
| APN News and Media Limited | 31/12/04 | 2,801,289 | 1,970,569 | 70% | Possible writeback of previous revaluation of \$149m |
| John Fairfax Holdings Limited | 30/6/04 | 3,531,190 | 2,314,919 | 66% | |
| Rural Press Limited | 30/6/04 | 921,805 | 624,617 | 68% | Previous revaluation of \$169m written back |
| West Australian Newspapers Holdings Limited | 30/6/04 | 398,863 | 104,956 | 26% | |
| | | 7,653,147 | 5,015,061 | 66% | |
| <u>Broadcasting and cable TV</u> | | | | | |
| Austereo Group Limited | 30/6/04 | 1,039,035 | 928,800 | 89% | |
| Austar United Communications Limited | 31/12/04 | 328,094 | 78,661 | 24% | |
| AAV Ltd | 31/12/04 | 134,719 | 33,782 | 25% | |
| Entertainment World Limited | 30/6/04 | 6,114 | 4,652 | 76% | |
| Macquarie Communications Infrastructure Ltd | 30/6/04 | 996,518 | 281,358 | 28% | |
| Publishing and Broadcasting Limited | 30/6/04 | 7,541,542 | 3,200,064 | 42% | Previous revaluation of \$423m written back. Possible writedown of internally generated mastheads. |
| Prime Television Limited | 30/6/04 | 337,396 | 269,436 | 80% | |
| Southern Cross Broadcasting | 30/6/04 | 1,033,817 | 661,680 | 64% | Previous revaluation of \$33m written back |
| Seven Network Limited | 30/6/04 | 2,067,887 | 1,318,982 | 64% | Previous revaluation of \$480m written back |
| Sunrasia Television Limited | 30/6/04 | 134,418 | 57,640 | 43% | |
| Ten Network Holdings Limited | 31/8/04 | 1,548,302 | 1,154,674 | 75% | Deferred tax balance debited by \$225m |
| | | 15,167,842 | 7,989,729 | 53% | |

[31] has acknowledged in its 2004 annual report that it will reverse previous revaluations to the extent of \$423 million, or approximately 6% of the total asset value. Added to this is the potential writeback of some component of internally generated mastheads (book value \$1.3billion), the effect of which was still being assessed at the time of release of the 2004 accounts, and the financial effect of AASB138 on PBL is significant. Southern Cross Broadcasting Limited (2004) [32] acknowledges a reversal of a previous revaluation to the extent of \$33 million, or 3% of total assets. Seven Network Limited (2004) [33] also faces a significant reversal of previous revaluations, amounting to \$480 million, or 23% of total assets. The consolidated entity of Ten Network Holdings Limited (2004) [34], carries its TV licences at cost, although a deferred tax balance of \$225m relating to previous revaluations by a controlled entity, Ten Group Pty Ltd, will be reversed to retained profits. Overall the reversals of previous revaluations made by Broadcasting and Cable TV companies' amount to almost \$1 billion, or 6% of the total asset value. Interestingly, in respect of the three large free-to-air television groups, "the value of their television licences - identifiable intangibles - will change by very different amounts, despite being all worth approximately the same under Australian accounting standards" [Lonergan as cited in 35, p72].

Thus it can be seen that even in a small sample of Australian listed companies, the introduction of AASB138 will result in the writedown of intangibles, in many cases as a result of revaluation reversals and in some cases the derecognition of internally generated assets. Combined with the effective prohibition of future revaluations, the balance sheets of many Australian companies will be transformed.

Significant changes to the numbers on financial statements will impact on financial statement indicators in the short term at least, and in the absence of supplementary disclosure of intangibles and their respective fair values, AASB138 will remove information necessary to fully appreciate the effect of intangibles on these indicators. The Framework objective (paragraph 12) of providing information that is useful to users in making economic decisions will not be fulfilled. Initially, the net assets of many companies are likely to suffer as intangibles are written off, and the resulting undervalued balance sheets will produce exaggerated returns on assets. Restated debt to equity ratios, as a result of intangible writeoffs and possibly exacerbated by debt reclassifications under AASB132 'Financial Instruments: Disclosure and Presentation', may adversely affect debt covenant clauses which have been drafted pursuant to existing standards. Some companies also broached the prospect of the inability to pay dividends as a result of writeoffs to retained profits, and distribute excess franking credits to shareholders [36, p1], a view reinforced by the AASB [16].

Concerns have been raised [11] [36] [37] over the taxation implications of IFRSs, and in particular that of thin capitalisation rules. These rules are covered in Division 820 of the Income Tax Assessment Act, and generally place limits on the deductibility of interest where the ratio of foreign debt to equity exceeds specified limits. Companies with foreign ownership may find themselves with higher than expected tax bills as adjustments to the balance sheet accounts, such as those imposed as a result of AASB138, move them into the thin capitalisation regime. As noted by the ICAA [37], "many taxpayers which previously had no TC (thin capitalisation) exposure, will find that they have excess debt not because of any changes in the 'funding mix' of the entity nor any change to the business operation, but rather, simply because the entity is required to comply with IFRS." The Australian government has recognised this situation and has accordingly allowed a three year transition period for such companies, during which time companies will be able to make the necessary thin capitalisation calculations "using Australian GAAP as they existed pre 1 January 2005" [38]. Beyond the potential effects on individual Australian companies as noted, the acceptance and application of AASB138 has broader implications.

WILL ONE BAD APPLE SPOIL THE BARREL?: BROADER IMPLICATIONS

AASB138 implications extend beyond the corporate level to the broader Australian regulatory framework and to the integrity of internationalisation arguments, and although it is not within the scope of this paper they are worthy of mention. Despite various protestations by the AASB to the IASB concerning the treatment of intangibles, the IASB did not make concessions, leaving us to question the influence that the Australian regulator has and will have at the international level of standard setting. The AASB is only too aware of this possibility, and is undertaking various measures to maintain its voice in the international arena. Recent cross appointments between Australian and New Zealand regulatory bodies represent "a serious commitment on the part of both bodies to the development of a regional power base" as Australia does not have "sufficient critical mass on its own right to dent the influence of the Europeans and the Americans on the setting of international accounting standards"[39].

The adoption of IFRS was seen as a means of improving the quality of financial reporting and overcoming the concerns that have surrounded it as a result of recent corporate collapses. The move by the IASB to fair value accounting needs to be applauded, but it should be consistent; one that encompasses fair value accounting for all transactions and balances. The foregoing has suggested that AASB138 fails in the provision of relevant and complete information, and it may be argued that this failure is symptomatic of the wider irrelevance of traditional financial reporting. Today's users of financial information have access to multiple sources of information, often online, and conventional financial reporting is being challenged as a timely and authoritative source of information. This situation is being compounded by the widely reported failure of traditional financial statements to forewarn of the corporate collapses suffered by the global community in recent years. Standard setters should indeed be aware of this issue and work towards ensuring the future viability of financial reporting by continual assessment of the IFRS.

CAN THE AASB REPLACE THE BAD APPLE IN THE BARREL?

The heat may have been taken out of the intangibles debate as company officers resign themselves to compliance with the IFRS regime. As the Parliamentary Joint Committee on Corporations and Financial Services [40, p22] noted, that whilst the new rules for internally generated intangibles were "a source of some contention during the development of the standards, there was little evidence on this issue before the committee." The sense of resignation was apparent in the submission made by Mr Keith Alfredson [40, p1], former chair of the AASB, who commented that "derecognition of internally developed intangibles is an inevitable outcome of Australia's strategy to achieve international comparability through the adoption of accounting standards equivalent to International Financial Reporting Standards".

Although Australian companies appear now to be focussing their energy on compliance with IFRS rather than continued lobbying, the AASB continues in its role of leader in the IASB research project on intangible assets and goodwill, and is currently seeking confirmation from the IASB on the scope of the project. The AASB [41, p4] believes that the focus should be on "major issues such as initial and subsequent accounting for internally generated intangible assets, particularly the question of reliable measurement." The AASB had flagged its March 2005 meeting for presentation of a paper on initial accounting for internally generated intangible assets, however to date the presentation has not been forthcoming. There is the possibility that intangibles written off as part of the current regime may indeed be reinstated in the future depending on the outcome of this project.

The IASB has also released a draft 'Memorandum of Understanding on the role of Accounting Standard – Setters and their relationships with the IASB', seeking comment from interested parties by 29 July 2005. If, as the memorandum claims, the IASB is supportive of the involvement of national standard setters in project teams and encourages commitment to effective contributions by such teams [42, p17], then the AASB can at least hope that its views on intangibles will be heard. The possibility for change, though, is slim given that the advocated treatment in AASB138 mirrors that of the US and UK standards on intangibles, and the fact that Australia was alone in its more liberal approach to the definition and recognition of intangibles. Furthermore the depth of disdain for this approach was apparent in the comments of Sir David Tweedie, chairman of the IASB, who stated that "Australia has got the worst record in intangibles asset accounting in the world. I've looked at some of the things in your accounts and, actually, it's deplorable" [as cited in 43, p1]. The AASB is also unlikely to garner support from the US, as the FASB removed the intangibles project from its research agenda at its January 14, 2004 meeting due to the inactivity of the project [44].

CONCLUSION

The catalyst for the Australian decision to adopt the IASB standards was the corresponding decision of the EU, however it should be seen in the context of recent corporate collapses and an air of nervousness on the part of Australian politicians and regulators. Not only was a raft of international accounting standards advocated as a means to improve the quality of financial reporting and the comparability of companies on a global scale, it was allegedly the way to minimise the opportunities for manipulation of financial statements. AASB138 'Intangible Assets' came as part of the IASB package, and despite significant lobbying by Australian constituents against this standard, with legitimate arguments of conceptual inconsistencies and the inability to provide relevant information, the IASB would not allow any changes to the standard nor concessions in its application. The impact of AASB138 on the financial statements of Australian reporting entities is difficult to gauge at this time, however early estimates based on a review of Australian media companies suggest that the financial effects could be significant, with further research aiming to extend the sample and track the AASB138 consequences. On a broader scale, the deficiencies of AASB138 reveal the rhetoric of internationalisation arguments and reflect the inability of Australian regulators to have their voice heard on the international standard setting stage. Australian regulators, however, have not given up the intangibles cause, with the AASB engaged in a current working party on intangibles, but it could be said that any future propositions made by the AASB will need to be more than convincing to change the views espoused by the IASB. This early research provides the seeds for further research into the politicisation of the standard setting process, and suggests the need to explore the issues within a theoretical framework.

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