# Box A: International Financial Reporting Standards

Australian banks, and other financial institutions, have recently begun reporting their financial statements in accordance with the Australian equivalents to International Financial Reporting Standards (IFRS). The cornerstone of IFRS is an emphasis on the use of 'fair value' – broadly speaking the use of market values net of transaction costs – for measuring most assets and liabilities, particularly financial instruments.[1] It is generally acknowledged that the introduction of IFRS will help promote more transparent financial statements by better aligning accounting information with economic reality, and also enhance the consistency of financial reporting across countries. The implementation of new accounting standards is, nonetheless, raising some challenging issues for financial analysts and regulators. In particular, the one-off change in the accounting regime is complicating the task of comparing financial indicators drawn from the latest accounts with those of previous years. Moreover, looking forward, there is likely to be more volatility in the financial accounts due to the more widespread use of fair value accounting.

Two of the key indicators that are materially affected by the change to IFRS are the return on equity and the provisions held against credit losses.

The published return on equity for the banking sector has increased significantly under IFRS, reflecting a marked decline in measured shareholders' funds. For the five largest banks, the move to IFRS has seen aggregate shareholders' funds fall from $102 billion to $81 billion (Table A1). This decline is attributable to three main factors, although the relative importance of these factors varies considerably across banks.

**Table A1: Change in Shareholders' Equity**
Five largest banks, September 2005 [(a)]

| | AGAAP | IFRS [(b)] | Change |
|---|---|---|---|
| | $m | $m | $m |
| Contributed equity | 49 422 | 42 314 | -7 108 |
| Retained earnings | 38 370 | 34 107 | -4 263 |
| Reserves | 5 340 | 2 321 | -3 019 |
| Shareholders' equity attributable to members of the bank | 93 132 | 78 742 | -14 390 |
| Minority and outside equity interests | 9 241 | 1 836 | -7 405 |
| **Total shareholders' equity** | **102 373** | **80 578** | **-21 795** |

(a) CBA data are as at June 2005
(b) IFRS figures are as at 1 October 2005 for ANZ, NAB, St George and WBC and as at 1 July 2005 for CBA
Sources: Banks' annual and interim reports

1 *For a previous discussion of this issue, see the Developments in the Financial Infrastructure chapter of the September 2004* Financial Stability Review.

The first is that hybrid securities – which have characteristics of both debt and equity – that are settled at maturity for a variable number of a bank's shares are now classified as liabilities, rather than equity. This change, along with other changes in the definition of hybrid securities, reduced measured contributed equity of the five largest banks by around $6 billion.

The second is that banks with life insurance subsidiaries can no longer recognise the excess of the market value over the net assets of the entities controlled by those subsidiaries (commonly referred to as EMVONA) as shareholders' funds. This change resulted in a $4½ billion fall in aggregate equity of the five largest banks, with this spread across retained earnings and reserves, owing to differing initial treatment of EMVONA across banks.

The third is that minority interests in banks' controlled wealth management entities were reclassified as liabilities rather than equity, leading to an aggregate fall of nearly $7½ billion in shareholders' funds.

The introduction of IFRS also saw a significant change in the provisions that banks hold against credit losses. Under the previous accounting standards (AGAAP), banks held general provisions to cover losses at a portfolio level that were incurred but not yet reported, as well as to cover losses arising from expected future events. The main change under IFRS is that accounting measures of general – now termed 'collective' – provisions are more narrowly defined and may not take into account expected losses arising from future events. Based on the latest published accounts of the five largest banks, it is estimated that this change resulted in reported general/collective provisions falling by around 20 per cent (Table A2). Going forward, this decline may be partly offset by a new regulatory requirement for a 'General Reserve for Credit Losses' (see below).

**Table A2: Change in Provisions**
Five largest banks, September 2005 [(a)]

| | AGAAP | IFRS [(b)] | Change |
|---|---|---|---|
| | $m | $m | $m |
| General/Collective provisions | 7 370 | 5 863 | -1 507 |
| Specific/Individual provisions | 1 056 | 977 | -79 |

(a) CBA data are as at June 2005
(b) IFRS estimates are as at 1 October 2005 for ANZ, NAB, St George and WBC and as at 1 July 2005 for CBA
Sources: Banks' annual and interim reports

From a regulatory perspective, the Australian Prudential Regulation Authority (APRA) has generally sought to align its prudential standards with the new accounting regime. APRA has, however, recognised that accounting rules may not always be consistent with prudential considerations and has chosen to de-couple prudential standards from IFRS in several areas.[2] One of these is the calculation of regulatory capital, where APRA will generally continue to

2 *See Australian Prudential Regulation Authority (2005), 'Response to Submissions: Adoption of International Financial Reporting Standards, Prudential Approach, 1. Fair Value and Other Issues' and Australian Prudential Regulation Authority (2006), 'Response to Submissions: Adoption of International Financial Reporting Standards, Prudential Approach, 2. Tier 1 Capital and Securitisation'.*

allow hybrid securities to qualify as regulatory capital. Notwithstanding this, regulatory capital at some institutions may be materially affected by the accounting changes and, in these cases, institutions are able to obtain approval for transitional arrangements from APRA until the end of 2007. APRA has also been mindful of the change in provisioning methodology noted above and has required all banks, and other authorised deposit-taking institutions, to report a new General Reserve for Credit Losses as part of their Tier 2 capital. This may include some portion of their IFRS collective provision as well as any additional amount necessary to reflect losses expected over the life of the portfolio.