The Impact of IFRS Adoption on New Zealand Public Sector Entities' Financial Statements -Research Proposal-

Introduction

New Zealand public sector entities have been required to prepare financial reports in compliance with International Financial Reporting Standards (IFRS) since 2007 with the option for adoption from 2005 (Bradbury & Baskerville, 2008). Compliance with IFRS in New Zealand applies to both the public and private sectors following New Zealand's commitment to sector-neutral standards in the early 1990's. The relevance of continuing sector neutral standards is now being questioned as IFRS were developed for private sector financial reporting interests, not the public sector (Brady, 2009). There have been increasing calls for New Zealand to abandon sector neutral standards in favour of standards designed specifically for each sector (Bradbury & Baskerville, 2008). Prior research in New Zealand and overseas has focused on the impact of IFRS on profit-oriented organisations (Daske, Hail, Leuz & Verdi, 2007; Goodwin & Ahmed 2006; Kabir, Laswad & Islam, 2010.) There has been little research undertaken on the impact adoption of IFRS has had on the New Zealand public sector. This research aims to investigate the impact of the adoption of IFRS on public sector entities' financial statements.

Motivation

This study is motivated by the adoption of IFRS by New Zealand public sector entities. The position taken by New Zealand and Australia regarding sector-neutral accounting standards is unique. They are the only countries which require IFRS to be used in the public sector in line with their sector neutral policies (Ryan, Guthrie & Day, 2007). The use of IFRS by public sector entities is now being questioned as IFRS were developed primarily for the profit-oriented sector (Brady, 2009).

Since 2007 when the use of IFRS in New Zealand became mandatory there have been increasing concerns about the relevance of these accounting standards for the public sector. In two reports Kevin Brady (the New Zealand Auditor General between 2002 and 2009) expressed concern about the continuing relevance of sector neutral accounting standards in New Zealand. In particular he is concerned that the poor relevance of IFRS to the public sector is resulting in financial statements that are not meeting the requirements of their users, for example accountability (Brady, 2009). The future of public sector financial reporting in New Zealand is now uncertain as the Accounting Standards Review Board (ASRB) is considering changes including the introduction of International Public Sector Accounting Standards (IPSASs) (Scott, 2010).
There has been some literature investigating the impact the adoption of IFRS has had on profit-oriented firms. Prior research has focused on the capital market effects and changes in quality of accounting information in the private sector (Daske et al. 2007; Li 2010; Goodwin, Ahmed and Heaney 2007). Kabir et al. (2010) studied the effect of IFRS adoption on the accounts and earnings quality in the New Zealand private sector. They found IFRS caused an increase to total assets, total liabilities and the net profit of listed New Zealand companies. Botica-Redmayne & Laswad (2010) investigated the effect of IFRS adoption on New Zealand public sector entities’ audit fees and effort; however there has been little investigation into the effect of IFRS adoption on public sector entities financial statements.

Due to the increasing concerns about the suitability of IFRS for the public sector (Scott, 2010) this research aims to assess the impact of IFRS on public sector entities’ financial statements.

**Aim**

The aim of this research is to investigate:

- What is the impact of IFRS adoption on New Zealand public sector entities’ financial statements; and
- Which accounting standards had the biggest impact on New Zealand public sector entities’ financial statements

**Background**

*History of Public Sector Financial Accounting Standard Setting in New Zealand*

In August 1981 a public sector working group was created by the New Zealand Society of Accountants (NZSA) (Bradbury & Baskerville, 2007). This group became the Public Sector Accounting Standards Board in 1986 and had the responsibility of researching and preparing exposure drafts for the public sector. In 1984 the newly elected Labour Government began a comprehensive reform of the public sector (Bradbury & Baskerville, 2007). New legislation was introduced such as the Public Sector Finance Act 1989 and accrual accounting was introduced to the public sector (Bradbury & Baskerville, 2007). In 1990 the New Zealand Financial Reporting Standards Board (FRSB) decided there should be a single set of standards applicable to all New Zealand entities as they share common transaction features (Bradbury & van Zijl, 2007). The Financial Reporting Act 1993 created the ASRB with the role to review and approve accounting standards developed by the FRSB (Bradbury & Baskerville, 2007). The standards produced were known as Financial Reporting Standards (FRS) and all sectors were considered in their development. FRS’s were widely accepted as being sector neutral (Brady, 2009).
The Adoption of International Financial Reporting Standards

Since the late 1980’s New Zealand was working towards harmonisation of accounting standards both with Australia and internationally (Bradbury & van Zijl, 2007). In 1997 the FRSB announced all future New Zealand Standards would be based on standards issued by either the Australian Accounting Standards Board (AASB) or the International Accounting Standards Committee (IASC) (Bradbury & van Zijl, 2007). In June 2002 the Australian Financial Reporting Council (FRC) instructed the AASB that Australian entities would be required to prepare their financial reports according to IFRS for accounting periods beginning on or after 1 January 2005 (Brady, 2009). As a result of the Australian decision, in October 2002 the ASRB decided listed issuers would be required to comply with IFRS from 2007 with the option to comply earlier from 2005.

Consultation with the public sector occurred over the following two months with the result being a very strong support for the adoption of IFRS by the public sector and continuation of sector neutral accounting standards (Bradbury & van Zijl, 2007). Consequently, in December 2002 the ASRB announced all reporting entities in the public and private sectors would be required to comply with IFRS for periods beginning on or after 1 January 2007, with an option to comply with IFRS for periods beginning on or after 1 January 2005.

Literature Review

Sector neutral accounting standards in New Zealand

While public sector support for IFRS was initially strong it has since declined. The relevance of sector neutral accounting standards in New Zealand has been increasingly questioned over the past few years (Brady, 2009). The debate has increased substantially since the mandatory adoption of IFRS by all reporting entities in New Zealand in 2007.

Bradbury and van Zijl (2007) outline the adoption of IFRS by New Zealand entities and conclude sector neutrality in New Zealand may already be lost. This is because amendments made to recognition and measurement of NZ IFRS applies only to the public sector. Therefore the private and public sectors in New Zealand are effectively following separate standards. Bradbury and Baskerville (2007 and 2008) outline the development of public sector accounting standards in the public sector culminating with the adoption of IFRS. The focus of these articles is the impact of sector-neutral standards and the amendments that have been made to IFRS for the public sector. Bradbury & Baskerville (2007) conclude that sector-neutral accounting standards can lead to a wider set of robust standards and it is hoped this value will not be lost with the demise of sector neutral standards. Bradbury & Baskerville (2008) argue the amendments which have been made to NZ IFRS
mean the private sector are not following pure IFRS and progress on issues relevant to the public sector has been slowed. They conclude that sector neutral accounting standards are not leading to optimal standards for either the public or private sectors.

Kevin Brady, former New Zealand Auditor General, released two reports expressing concerns about IFRS adoption in the public sector. Brady (2007) argued that the adoption of NZ IFRS by the public sector entities entails high costs but does not provide many benefits. He further argued that the reporting issues most relevant to the public sector are not being addressed. Brady (2007) concluded changes must be made to the current sector-neutral approach or there will be demands for separate financial reporting standards. Similarly Brady (2009) is concerned about the quality of financial reporting applying to the public sector. It is a major concern that IFRS have been designed to meet the needs of large profit-oriented entities users rather than the needs of public sector accounting reports. Additionally there has been little change and guidance given in NZ IFRS for the public sector. The report concludes there needs to be a change in the development of accounting standards for the public sector in New Zealand to ensure financial reports are relevant and meet the needs of users (Brady, 2009).

Ryan et al. (2007) also question the use of sector neutral accounting standards in Australia. The development of accounting standards in the public sector is outlined in detail culminating in the mandatory adoption of IFRS in 2005. They argue that the private sector has always dominated the public sector’s reporting needs. Ryan et al. (2007) conclude that the public sector should develop their own standards to ensure the users of their financial statements’ needs are met. However before accounting standards are developed appropriate conceptual frameworks needs to be developed (Pallot, 1992).

Pallot (1992) is a study on the development of a conceptual framework for the public sector. She argues appropriate concepts, classifications and meanings must be developed prior to the creation of appropriate accounting standards. The public sector conceptual framework did not get developed in New Zealand as sector neutral standards were adopted. This has led to the debate over the sector neutral conceptual framework. Newberry (2001) argues that differences in interpretations between the private and public sectors effectively have lead to different practices between the sectors. She also argues that some developments in the public sector are incompatible with business practice.

The literature on sector neutral accounting standards demonstrates there are growing concerns about the relevance of IFRS for the public sector. It is suggested that IFRS do not meet the needs of the public sector (Brady, 2009; Bradbury & Baskerville, 2008; & Ryan et al. 2007). As a result of these
concerns the ASRB is now considering making changes to public sector financial reporting (Scott, 2010). The proposed research will investigate the magnitude and causes of impact the adoption of IFRS has had on New Zealand public sector entities’ financial statements.

**Previous studies assessing the impact of IFRS**

A number of studies have analysed the impact of IFRS on profit-oriented organisations.

Daske *et al.* (2007) and Li (2010) both analyse the effects of IFRS adoption on international capital markets. Daske *et al.* (2007) provides a comprehensive study of the effects of mandatory IFRS adoption for profit-oriented entities. They found firms adopting IFRS in the year of mandatory adoption experience large increases in market liquidity and cost of capital. These effects are only present in countries with strong legal enforcement and are likely to be heterogeneous across countries. They concluded the results from this study are likely the joint results of IFRS adoption and improved enforcement and governance regimes (Daske *et al.*, 2007). In a similar study Li (2010) examined the effects of IFRS on the cost of equity capital in the European Union. Contrary to Daske *et al.* (2007) it is found mandatory adopters of IFRS experience significant reductions in the cost of equity capital in the years of mandatory adoption. However, this is only significant in countries with strong legal enforcement (Li, 2010).

There is also literature studying the effects of IFRS adoption on the quality of accounting standards in the private sector. Goodwin and Ahmed (2006) analysed the impact of IFRS in Australia in relation to the size of entities. They argue IFRS provides little change or more benefits for smaller firms. These benefits include few adjustments required upon adoption and increases in net income and equity. In contrast larger firms were found to require increasing numbers of adjustments, negligible increases to net income and a decrease in equity. Goodwin *et al.* (2007) is a similar study of the effects of IFRS on the quality of accounting for Australian firms. The ten major differences between Australian GAAP and IFRS are outlined. They found on average IFRS has caused increases in liabilities and the leverage ratio and decreases in equity and earnings. Barth, Landsman & Lang (2008) found an increase in accounting quality resulting from the adoption of IFRS in 21 countries previously using non-United States GAAP. Entities that prepared their financial accounts under IFRS were exposed to less earnings management, more timely loss recognition, and more value relevance of accounting amounts than those entities domestic GAAP.

Rixon & Faseruk (2009) is a public sector study focusing on the impact of IFRS on Canadian Workers Compensation Boards (CWCB). IFRS applies to all Canadian public sector entities classified as Government Business Enterprises (GBE’s). CWCB’s are a unique group of GBE’s (Rixon & Faseruk,
They found that the implementation of IFRS by these Canadian entities has decreased comparability rather than improved it. This is because the entities interpreted the accounting standards differently which resulted in different classifications of financial instruments. Some entities classified their financial assets as available for sale while others classified them as held for trading. This resulted in unrealised gains and losses being recognised for some entities but not for others. Rixon and Faseruk (2009) argue that this lack of comparability was caused by a lack of guidance in the accounting standard. In addition the alternative methods allowed under IFRS to calculate the CWCB’s funded position resulted in reduced comparability. They conclude that IFRS has had an unforeseen impact on the entities’ financial statements. Requiring the use of IFRS will result in unexpected challenges as the standards may be interpreted differently unless specific guidance is provided.

There have been at least three New Zealand studies on the impact of IFRS adoption on audit fees. Griffin et al. (2009) analysed the effect of regulatory changes and IFRS adoption on the audit fees of the New Zealand private sector. They found a significant increase in mean audit fees between 2002 and 2007 and a decrease in non-audit fees. The increase in audit fees was largest around introduction of IFRS so they concluded it was a result of the adoption of IFRS. In a similar study Hart, Rainsbury & Sharp (2009) analysed the change resulting from the adoption of audit fees on listed New Zealand companies. It was found the median audit fees increased by 48% upon adoption of IFRS indicating the change in accounting standards had an impact on the audits of these companies. In a similar study Botica-Redmayne & Laswad (2010) analysed the impact of IFRS on New Zealand public sector audit fees and audit effort. The results were similar to Griffin et al. (2009) and Hart et al. (2009) as they found a significant increase in audit fees and audit effort in year of adoption in the public sector.

Kabir et al. (2010) studied the impact of IFRS adoption on the accounts and earnings quality of New Zealand private sector entities. The sample is drawn from firms listed on the New Zealand stock exchange. Of particular interest in this study is the first research question which focuses on the impact of IFRS adoption on the accounts of the firms. They find that IFRS caused an increase in total assets, total liabilities and profit over previous NZ GAAP. The main adjustments which caused these increases were found to be increases in goodwill and other intangible assets, and increases in investment properties. Employee benefits and share based payments reduced profits and adjustments to tax, employee benefits, revenue and provisions were found to reduce equity (Kabir et al., 2010).
Method

The study will take a quantitative research design. It will involve analysing the financial statements of New Zealand public sector entities in their first year of adoption of IFRS.

The entities to be analysed include all New Zealand public sector entities. The main categories of New Zealand public sector entities to be included in the sample include: Public Service Departments, District Health Boards, Crown Entities, Tertiary Education Institutions, State Owned Enterprises and Local Authorities. The initial population consists of the 299 entities listed on the New Zealand Government’s Public Sector Directory Website (New Zealand Government, 2010). The annual reports of the public sector entities will be accessed via their websites and the relevant data will be extracted.

The analysis of the impact of IFRS on the financial statements of public sector entities will be conducted by analysing the comparative note required by NZ IFRS 1. NZ IFRS 1 First Time Adoption of New Zealand Equivalents to International Financial Reporting Standards requires all New Zealand entities to explain in a note to the financial statements the impact IFRS adoption has had on their financial statements for the year of transition. Similarly to Goodwin et al. (2007) and Kabir et al. (2010) this study will examine the impact the adoption of IFRS has had on total assets, total liabilities, equity and surplus or deficit. The change in monetary value, percentage change and direction of the change will be analysed. The reasons for these changes and the accounting standards responsible for the changes will be identified through note analysis. This analysis will be completed for the entire public sector. The results will also be split into the sub-sectors identified on the Public Sector Directory (New Zealand Government, 2010). This should provide further empirical analysis of the impact IFRS adoption has had on New Zealand public sector entities.

Proposed Timeline

July: Research proposal
        Start data collection
August: Data collection completed
        Data analysis
        Literature review
September: First draft
October: Second draft
November: Final report completed
          Findings presented
References


