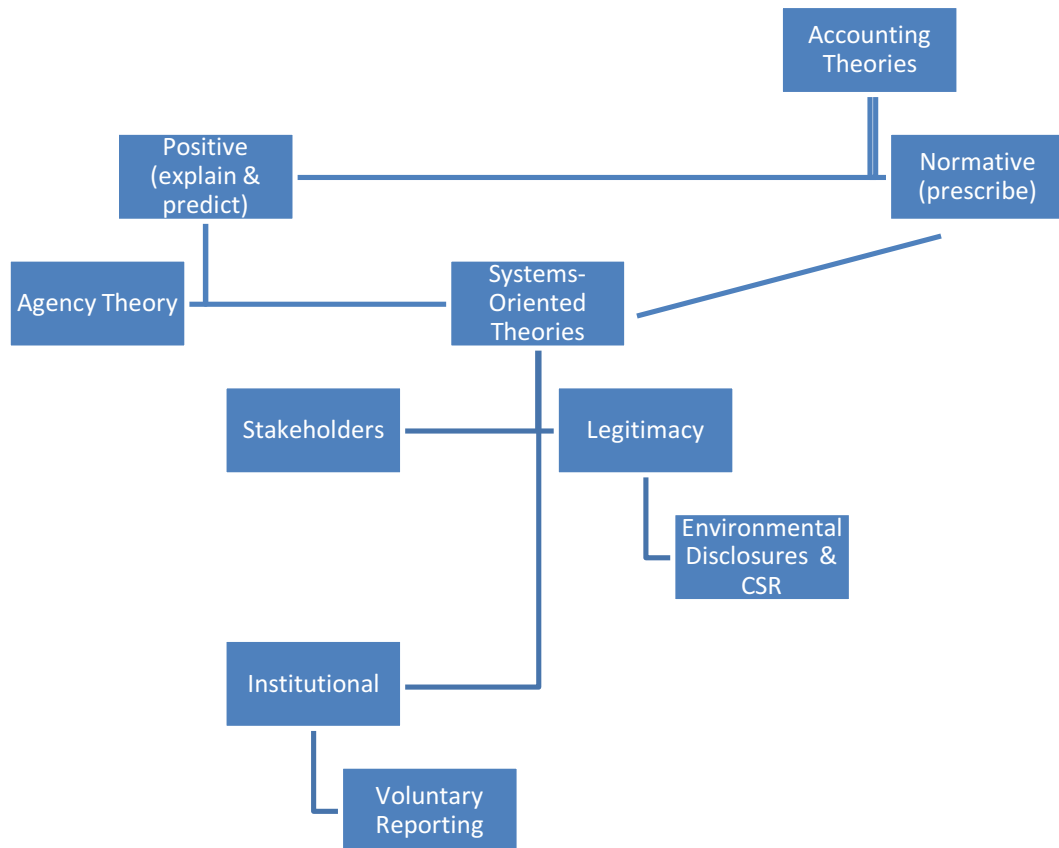


ACCT3563 Issues in Financial Reporting and Analysis

Introduction & Theories of Accounting

- Accounting theories explain or predict, given certain conditions, the likely outcomes.



- Why do we study PAT? Because accounting standards are based on the findings of PAT. Although the standards and the Conceptual Framework themselves are normative theories.
- PAT assumes individuals are self-interested and everything they do is to be understood from the perspective that this individual is trying to maximise their own interests.
- Through PAT, markets are semi-efficient in that markets are responsive to accounting choices, and these choices can affect market price including stock prices.
- Agency costs (of equity) to shareholders arise initially from the agent's self-interest behaviour which may not align with the shareholders' interests. To reduce the costs, the principal uses monitoring and bonding mechanisms.

- Agency costs (of debt) occur when debt-holders predict that the agent will not always act in their interest and therefore would demand contractual conditions before lending the money. There are costs that exist in monitoring the agent, not violating these conditions and bonding to incentivise the agent to adhere to these conditions.
- Semi-efficient markets act as a monitoring device for the agency costs of equity. Underperforming firms are targets for corporate takeovers, and managers of the firm are usually first to be dismissed following the takeover.
- Markets are imperfect and the lack of perfect foresight means that no contract can specify the accounting methods employed under all circumstances.
- PAT sums up the relationship between accounting and economic consequences in three simple hypotheses:
 1. Bonus plan.
 2. Debt covenant.
 3. Political cost.
- From the opportunistic perspective, managerial discretions form part of the residual loss. The motivation is to choose accounting methods that maximise the manager's self-interest.
- From the efficient perspective, managerial discretions are not part of the residual loss. The motivation is to maximise firm value.

Cultural and Ethical Influences on Accounting

- Teleological ethical theories:
 1. Ethical egoism.
 2. Utilitarianism.
- Kant's categorical imperative first formulation: would I be happy if everyone else did what I was doing?
- Kant's categorical imperative second formulation: would I be happy if someone else did this to me? Am I okay using someone for my own interests regardless of how it affects them?
- Aristotle divided virtues into moral virtues and intellectual virtues. Each type is necessary for the other and they all interact with each other.
- Intellectual virtues are not means between extremes, but they are about perfections of the intellect.

Accounting for Assets

- Under PAT, agents are motivated to misclassify the direct costs attributed to bringing the asset to operating condition and location.
- Revaluation increments:
Dr PPE
Cr Revaluation Reserve

- Why do revaluation increments go to equity rather than income? The bonus hypothesis of PAT allows incremental revaluation to effect the accounting profit, which will open the scope for opportunistic behaviour. For bonus sake, if normal profit does not reach the threshold, managers will have a very high incentive to use discretionary upward revaluation to boost profit, hence their personal bonus.
- Under the net method, the first step is to reverse the accumulated depreciation and credit the PPE asset. This step will bring the value of the asset down to its carrying amount because it is the carrying amount that we use to compare with the fair value to determine whether there is an increment or decrement. The second step is to account for an incremental valuation.

Dr Accumulated Depreciation

Cr PPE

Dr PPE

Cr Revaluation Reserve

- What if the first revaluation results in a decrement? The standard requires that a first time decremental revaluation must be charged to the P&L as a loss on revaluation i.e. it is an expense.
- Reversals of revaluation de/increments:
 1. Dr PPE
 - Cr Gain on Revaluation (the reversal in the P&L)
 - Cr Revaluation Reserve (any excess Cr to equity)
 2. Dr Revaluation Reserve (the reversal Dr to equity)
 - Dr Loss on Revaluation (any excess in the P&L)
 - Cr PPE
- The asset revaluation reserve is a non-recyclable item meaning at the time of disposing the asset, any balance in the associated revaluation reserve account must not be transferred to the P&L. it can be transferred to other equity accounts i.e. retained profits or capital reserve. This is to ensure that upward revaluation has no positive effect on income at all.
- Upward asset revaluation has long term decreasing effects on income.
 - The depreciation expense is calculated on the higher carrying amount resulting from the upward revaluation.
 - There is a lower disposal gain because the carrying amount is higher now after the upward revaluation.
- In reality, the application of the revaluation model is quite costly as managers are required to provide evidence of the fair value, and the cost of compliance is quite considerable.
- Frequent changes of accounting policies signal to the auditor and outsiders that there may be some accounting irregularities within the company, which may cause investors to discredit the managers' reputation.
- Under the cost model, if the carrying amount is less than the recoverable amount, then the asset is not impaired and no action is required.
- When intangibles acquired externally at arm's length, they normally pass the measurement test. Therefore, they can be recognised as assets at cost. The next consideration is what model is applicable for subsequent measurements.
- The use of the fair value model is highly restricted as the firm must prove that there exists an active market for the underlying item, so the market value must be easily attainable.

- Only cost model applies to goodwill as it is unique and has no active market.
- Most intangibles under the cost model must undergo amortisation which is similar to depreciation for tangible assets.
- All intangibles, regardless of whether they are measured by the cost model or the fair value model, must undergo regular impairment testing.
- Internally generated goodwill does not pass the identifiability test (para 48). Although purchased goodwill through business combinations is a recognised asset under AASB 3.
- R&D activities, which may body future economic benefits, are internally generated but this condition alone does not qualify it as an asset.
- The definition of research clearly shows that the probability of such undertakings to generate future economic benefit is very remote. It is only a prospect so suggesting that research is unlikely an asset.
- It is only after research has generated findings or viable paths, that development activities will follow.
- Suggesting that activities move on to the development phase, the probability increases which will lead to eventual production.
- All expenditure incurred during the research phase must be expensed.
- Expenditure during the development stage may be capitalised if, and only if, they pass all six conditions for asset recognition (AASB 138, para 57). The amount recognised cannot be greater than the probable future economic benefits it generates (if the asset is valued higher, then the difference should be expensed).

Accounting for Revenue

- Definition of revenue (AASB 15) – revenue is income arising during an entity's ordinary activities.
- The primary issue in accounting for revenue is determining when to recognise revenue.
- F.O.B. (free on board) is a term used for when the legal title is passed onto the buyer.