

ACCG224 – Financial Accounting and Reporting Summary Notes

Table of Contents

LECTURE 1: INTRO TO THE REGULATORY ENVIRONMENT AND THE CONCEPTUAL FRAMEWORK	2
LECTURE 2: ACCOUNTING FOR INCOME TAX – PART 1	13
LECTURE 3: ACCOUNTING FOR INCOME TAX – PART II	15
LECTURE 4: ACCOUNTING FOR PROPERTY, PLANT AND EQUIPMENT.....	17
LECTURE 5: ACCOUNTING FOR IMPAIRMENT	23
LECTURE 6: ACCOUNTING FOR LEASES	27
LECTURE 7: REVENUE RECOGNITION AND STATEMENT OF COMPREHENSIVE INCOME	34
LECTURE 8: STATEMENT OF FINANCIAL POSITION, STATEMENT OF CHANGES IN EQUITY AND DISCLOSURES	41
LECTURE 9: STATEMENT OF CASH FLOWS – OVERVIEW AND DIRECT METHOD.....	46
LECTURE 10: STATEMENT OF CASH FLOWS – INDIRECT METHOD, NOTES AND LIMITATIONS.....	52
LECTURE 11: FINANCING COMPANY OPERATIONS – EQUITY FINANCING	61
LECTURE 12: FINANCIING COMPANY OPERATIONS – DEBT FINANCING - DEBENTURES	65

LECTURE 1: INTRO TO THE REGULATORY ENVIRONMENT AND THE CONCEPTUAL FRAMEWORK

Key sources of regulation of financial reporting in Australia

- Major sources of financial reporting regulation in Aus.:
 1. The Corporations Act 2001
 2. Australian Accounting Standards
 3. The Conceptual Framework
 4. ASX Listing Rules
- 1. The Corporations Act 2001
 - Aus. Companies must comply with requirements of the Corporations Act 2001
 - S296 of the *Corporations Act 2001* requires compliance with Aus. Accounting standards
 - Corporations Act requires prep of financial reports for:
 - **Disclosing entities**
 - **Large proprietary companies**
 - **Public companies**
 - **Registered schemes**
 - **Proprietary company**
 - Limited by shares - shareholders afforded more protection when it comes to the level of liability
 - Unlimited company with share capital - shareholders' liability is not limited
 - < 50 non-employee shareholders
 - Doesn't offer securities for which disclosure required
 - Can be either small or large
 - **All non-proprietary companies are public companies**
 - **Small proprietary company**
 - Satisfies *at these two of*:
 - Consolidated revenue for financial year of company and entities it controls is < *\$25 million*
 - Value of consolidated gross assets at end of financial year < *\$12.5 million*
 - < *50 employees* at the end of the financial year
 - **Large proprietary company**
 - Company that doesn't fulfil the definition of a small proprietary company (above)
- The Reporting Entity
 - In Australia, the Statement of Accounting Concepts (SAC) 1 defines '**reporting entities**' - Entities in which it is reasonable to expect existence of users who depend on:
 - **General-purpose financial reports**
 - **Indicators of users' existence**
 - **Separation of management from economic interest**
 - **Economic or political importance/influence**
 - **Financial characteristics**
 - Reporting entity concept used to determine whether entities are required to present GPFRs
 - Critical factor → existence of users who depend on GPFRs to make decisions
 - Following AASB adopted International Financial Reporting Standards (IFRSs) in 2005 → AASB issues accounting standards with requirements that are the same as those of IFRSs

2. Australian Accounting Standards

- AASB 1053 *Application of Tiers of Australian Accounting Standards* requires a two-tiers reporting system
 - Tier 1 and 2 differential reporting requirements define what accounting standards reporting entities have to follow
 - **Tier 1:** full International Financial Reporting Standards (IFRS) as adopted in Australia (AASB) or
 - **Tier 2:** reduced disclosure requirements (RDR):
 - Full compliance with identification and measurement requirements reduced disclosure requirements
 - Main distinction criterion is **public accountability**:
 - Each Australian accounting standard sets out disclosure requirements in which Tier 2 entities are excused

3. The Conceptual Framework

- Issued by AASB
- Main purpose to provide a coherent set of principles to follow - Assists:
 - With standard consistency
 - Preparers deal with issues not addressed by a standard
 - Auditors in forming an opinion on compliance
 - Users to interpret statements

4. ASX Listing Rules

- Companies listing on ASX need to comply with ASX listing Rules
 - The Listing Rules include requirements for continuous disclosure and periodic reporting
 - **Primary focus on disclosure**

The role of key players in financial reporting regulation

1. Financial Reporting Council (FRC)
2. Australian Accounting Standards Board (AASB)
3. Australian Securities and Investments Commission (ASIC)
4. Australian prudential Regulation Authority (APRA)
5. Australian Securities Exchange Group (ASX)
6. International Accounting Standards Board (IASB)
7. IFRS Interpretations Committee (IFRIC)

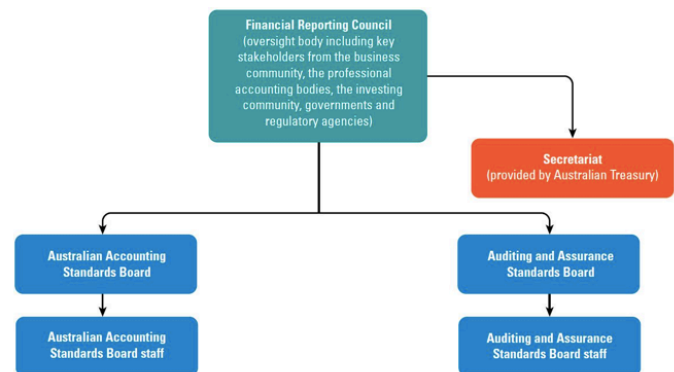


Figure 1.3 Australian accounting standard-setting institutional arrangements
Source: FRC (2008).

1. Financial Reporting Council (FRC)
 - FRC is responsible for overseeing effectiveness of financial reporting framework
 - Is also responsible for the broad oversight of processes for setting accounting standards

2. Australian Accounting Standards Board (AASB)

- Gov. agency under the ASIC Act 2001
- Sanctuary functions of AASB are:
 - Transforms International Accounting Standards (IAS) and IFRS into Australian standards
 - 'Australianises' the IASB's Framework
 - Develop a conceptual framework
 - Make accounting standards under s. 334 of Corp. Act

3. Australian Securities and Investments Commission (ASIC)
 - Controls compliance with financial reporting and auditing requirements
 - Investigates companies suspected of non-compliance with Corporations Act or accounting standards
 - Issues its own understandings of financial reporting requirements from the Corporations Act
 - AKA 'corporate watchdog'
 - Is Australia's corporate, markets and financial services regulator
4. Australian Prudential Regulation Authority (APRA)
 - Prudential regulator of the Australian financial services industry:
 - Banks
 - Credit unions
 - Building societies
 - General insurance and reinsurance companies
 - Life insurance
 - Most members of the superannuation industry
 - Additional reporting requirements for these entities
 - Is the prudential regulator of the Australian financial services industry
5. Australian Securities Exchange Group (ASX)
 - Oversees compliance with its operating rules, promotes standards of corporate governance among Aus's listed corporations and endeavours to inform retail investors
 - Central to the ASX is enabling business owners to increase capital from general public by issuing various tradable securities, and to facilitate a secondary market for those securities
6. International Accounting Standards Board (IASB)
 - Formation of International Accounting Standards Committee (IASC) - 1973
 - Designed to develop accounting standards for worldwide use
 - Criticism that IASC was not independent → restructured in 2001 into the International Accounting Standards Board (IASB)
 - From January 2005 Australia adopted International Accounting Standards (IAS; published until 2001) and International Financial Reporting Standards (IFRS; published from 2001 on)
 - Australia adopted standards issued by IASB on or after 1 January 2005
 - Independent standard-setting board
 - Develops & approves International Financial Reporting Standards (IFRSs)
7. IFRS Interpretations Committee (IFRIC)
 - Reviews on a timely basis widespread accounting issues that have arisen within the context of current International Financial Reporting Standards (IFRSs)
 - Reaches consensus on the appropriate accounting treatment (IFRIC Interpretations) and provides authoritative guidance on those issues
 - Principles based international accounting standards require global interpretation
 - Consistency of interpretation is the key challenge for the accounting profession

Rules-based vs. Principles-based standards

- **Rules-based standards**
 - Sets of **detailed rules** - these must be followed when preparing financial statements
- **Principles-based standards**
 - E.g. generally accepted accounting principles (GAAP) is used as a conceptual basis for accountants
 - Based on a conceptual framework that provides a **broad basis** for accountants to follow
 - The focus is on the economic substance of a transaction, engaging the professional judgement and expertise of those preparing financial statements

Principles-based standards

- **Advantages**
 - Principle-based standards are simpler
 - Supplies broad guidelines that are applicable to many situations
 - Improves representational faithfulness of financial statements
 - Allows accountants to utilise their own professional judgement
 - Evidence suggests that managers are less likely to attempt earnings management
- **Disadvantages**
 - Managers may select treatments that do not reflect underlying economic substance
 - Judgement involved in the majority of assessments mean that comparability among financial statements can be reduced
- **Professional judgement in accounting**
 - Accounting is not merely following a set of accounting rules or procedures → accountants are often called upon to exercise professional judgement
 - Theories help us to:
 - Predict accounting policy choice
 - Understand implications of alternative accounting policies
 - Provide a source of direction in accounting policy decisions

Regulation

- **Advantages**
 - More efficiency in allocating capital
 - Cheaper production
 - Check on perquisites
 - Public confidence
 - Standardisation
 - Public good
- **Disadvantages**
 - It is argued that free-market mechanisms would generate enough info to reach a socially acceptable level at which the costs of providing that info are equalled by the benefits
 - Disadvantages include:
 - Difficult to achieve efficiency and equity
 - Determining the optimal quantity of information is problematic
 - Regulation is difficult to reverse
 - Communication is restricted
 - Reporting entities are different
 - There is lobbying
 - Monopolisation of accounting standards

What is an accounting policy?

- Whether accg for a one-off transaction or developing a policy for routine transactions, accg policy decision needs to address the following components:
 - Definition
 - Recognition
 - Measurement
 - Disclosure

What is accounting theory?

- Theory:
 - ‘the coherent set of hypothetical, conceptual and pragmatic principles forming a general framework of reference for a field of enquiry’
- Types of accounting theory:
 - **Normative** theories - prescribe what should happen
 - **Positive** theories - explain or predict activities
- Development of theories
Inductive reasoning



Deductive reasoning



- **Positive accounting theory**
 - It is ‘designed to explain and predict which firms will and which firms will not use a particular method’ (Watts & Zimmerman, 1986)

Agency theory

- **Agency relationship:**
 - Principal (shareholders) delegates decision-making authority to an agent (managers)
 - Agent has legal and fiduciary duty to act in best interests of principal
 - However, managers are likely to act in their own interests
- Hence, following types of agency costs arise:
 - Monitoring costs
 - Bonding costs
 - Residual loss
- **Owner-manager agency relationships**
 - Smith & Watts (1982) identify three major problems in owner-manager agency relationships:
 - **Horizon problem:** differing time horizons are important to each party
 - **Risk aversion:** managers generally prefer less risk
 - **Dividend retention:** managers’ preference to hold onto funds
 - Remuneration contracts align interests of managers with owners
- **Manager-lender agency relationships**
 - When lender agrees to provide funds to an entity, the risk is that the borrower may not honour its obligation to repay all of the borrowed funds with interest

- Smith & Warner (1979) identify difficulties that increase the lenders risk: excessive dividend payments to owners
 - **Asset substitution**
 - **Claim dilution**
 - **Underinvestment.**
- Debt contracts with covenants based on accounting numbers, such as maximum leverage ratio, can reduce agency problems of debt and enable the lender to take action, such as demand repayment, if debt covenants are breached.

The Conceptual Framework

- **Nature and definition**
 - Definition of framework?
 - 'A set of ideas or principles used to plan'
 - Normative theory
 - What is the Conceptual Framework of Financial Reporting?
 - 'A coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards'
 - Attempts to deliver a structured theory of accounting that prescribes practice
- **Purpose**
 - Forms concepts that underlie prep and presentation of GPFR
 - Answers the questions of:
 - Objective, users, assumptions, qualitative characteristics, elements, recog. criteria, measurements
- **Components**
 - The IASB's conceptual framework for financial reporting comprises 4 chapters:
 - C1: the objective of general purpose financial reporting
 - C2: the reporting entity
 - C3: the qualitative characteristics of useful financial reporting
 - C4: the framework
- How does it differ from an accounting standard?
 - **Conceptual Framework**
 - **Not an accounting standard** → When preparing and presenting financial statements, it is a set of principles to be followed
 - General concepts or principles - designed to **provide guidance**
 - **Accounting standards**
 - Specific requirements for a particular area of financial reporting, goes beyond framework
 - Conceptual framework - more broadly defines