

L1 - CORPORATE FINANCIAL REPORTING & REVISION (T1)

Companies:

- **Definition:** A type of organisation established under the Corporations Act (2001) which is the law that governs how companies operate in Australia. A company has the same legal capacity and power as an individual.
 - Can own property, borrow money, enter contracts, sue and be sued in its own name.
 - Ability to raise capital.
 - Ownership is by shares.
 - Limited liability of owners.
- **Types:**
 - **Public:**
 - Usually larger companies with widespread ownership (many owners).
 - May issue shares to the public and apply to have the shares listed on the stock exchange.
 - **Proprietary:**
 - Usually smaller businesses.
 - Cannot issue shares to the public and limited to 50 shareholders.
 - Classified as small if at least two of the following are met:
 - Revenue < \$25m
 - Assets < \$12.5m
 - Employees 50
- **Directors:** They are elected by shareholders to run a company.
 - **Executive:** Full-time employee involved in day-to-day operations (e.g. Managing director/CEO)
 - **Non-Executive:** Not involved in day-to-day operations but involved in policy making and planning.
 - Expected to monitor the performance of the executive directors on behalf of the shareholders.
- **Sources of Corporate Reporting Requirements:**
 - **Corporations Act (2001):** All companies must comply with the requirements of the Corporations Act.
 - **Australian Accounting Standards Board (AASB):** All companies must comply with the accounting standards guidelines.
 - **Australian Securities Exchange (ASX):** A listed company must comply with the listing rules of the exchange or the company will be delisted.
- **Financial Statements to be Presented:**
 - **AASB 101 Requires the Following Financial Statements:**
 - Statement of Financial Position (Balance Sheet).
 - Statement of Comprehensive Income.
 - Can separate into an income statement and a separate statement of comprehensive income commencing with disclosed profit and loss.
 - Statement of Changes in Equity.
 - Cash Flow Statement.

- Notes to the Accounts.
- **Who Enforces Accounting Standards:**
 - **Australian Securities and Investments Commission (ASIC):**
 - Enforce compliance with Corporations Act (AASBs).
 - **Profession (e.g. CPA, CA):**
 - Miscellaneous Professional Statement APS1 requires compliance by all CPA Australia and CA Australia and New Zealand members.
- **Australian Securities Exchange:**
 - Listed companies must comply with listing rules.
 - Rules aim to ensure that information is disseminated in an efficient and timely manner.
 - **Continuous Disclosure Requirement:**
 - **Listing Rule 3.1:** Once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately inform ASX of that information.

Accounting For:

Type of Account	Normal Balance	Increase With A	Decrease With A
Dividend	Debit	Debit	Credit
Expense	Debit	Debit	Credit
Asset	Debit	Debit	Credit
Liability	Credit	Credit	Debit
Equity	Credit	Credit	Debit
Revenue	Credit	Credit	Debit

NOTE: Accounting is done from the perspective of the company.

- **Share Issues:** When shares are issued for cash.
Dr Cash
Cr Share Capital
- **Cash Dividends:** Standard practice is for company to declare (i.e. announce) a dividend which is then paid at a subsequent date (two transactions). It may be necessary for shareholders to approve any dividend declared but we assume that directors can declare a dividend without the need for shareholder approval.

When Declared:

Dr Dividends Declared

Cr Dividends Payable

NOTE: The account "Dr Dividends Declared" decreases retained earnings and therefore Equity, it is not an Expense.

When Paid:

Dr Dividends Payable

Cr Cash

Dr Dividends Paid

Cr Dividends Declared

NOTE: The account "Dr Dividends Paid" is used to rename the account "Dividends Declared", once the dividend has been paid.

- **Share Dividends / Bonus Issues:** A bonus issue is an issue of shares to existing shareholders out of retained earnings or reserves (no cash payment). It involves a transfer from one equity account to another, leaving total shareholders' equity unchanged.

Dr Retained Earnings / General Reserve

Cr Share Capital

NOTE: The "Dr" account depends on the question, e.g. Issuing bonus shares from retained earnings, therefore "Dr Retained Earnings".

- **Transfers To And From Reserves:** Reserves can be created by transfers from retained earnings. It attempts to indicate some portion of retained earnings is not available for dividends (does not represent a cash reserve). Management can remove the general reserve by simply reversing the above entry.

Transfer From Retained Earnings To General Reserve:

Dr Transfer to General Reserve

Cr General Reserve

NOTE: When any amount is kept separate by a company out of its profit for future purpose then that is called as general reserves. In other words, the general reserves are the retained earnings of a company which are kept aside out of company's profits to meet future (known or unknown) obligations.

- **Closing Entries:**
 - Closing entries are required at the end of each financial year to:
 - Transfer profit/loss to retained earnings.
 - Deduct dividends declared/paid from retained earnings.
 - Bring balance of **revenues/expenses**/dividend paid/dividend declared/transfer to reserve accounts to zero.
 - This is because revenues and expenses are recorded once, during the year in which they were received/paid.
- **Retained Earnings:** The balance of retained earnings is the net income not paid as dividends or transferred to other reserves.
 - Opening Retained Earnings** (all the profits and losses made so far minus dividends).
 - + Net Profit** (profit made for this financial year).
 - Dividends Paid/Declared** (reduce retained earnings, "Dr").
 - Transfer to Other Reserves** (reduce retained earnings, "Dr").
 - = Closing Retained Earnings** (this is what you see in the statement of financial position in the equity section and becomes the "Opening Retained Earnings" for the next year).
- **Property, Plant and Equipment (PPE):**
 - AASB 116 requires that asset acquisitions are recorded at **cost** (para 15).
 - **Cost:** The purchase price (including taxes) and any costs attributable to bringing the asset to its present location and condition.
 - **Depreciable Amount:** The cost less residual value. The depreciable amount of an asset is depreciated over the asset's useful life.
 - **Residual Value:** The estimated amount to be recovered on disposal of the asset at the end of its life.

Depreciation:

- **Example:** Willis Ltd purchases a machine for \$200,000 on 1 July 2013 and depreciates the asset over 15 years with a \$20,000 residual value.

1 July 2013 - Recording Machine at Initial Purchase Price

Dr Machine 200,000

Cr Cash 200,000

30 June 2014 - Yearly Depreciation Expense

Dr Depreciation Expense 12,000

Cr Accumulated Depreciation 12,000

$(200,000 - 20,000) / 15 \text{ years}$

NOTE: We don't credit the asset directly because the standard says record assets at the price you pay for it. We credit a contra asset account which is a negative asset account to decrease the asset.

Statement of Financial Position Presentation on 30 June:

	<u>2014</u>	<u>2015</u>	<u>2016</u>
Machine (at COST)	\$200,000	\$200,000	\$200,000
– Accumulated depreciation	(\$12,000)	(\$24,000)	(\$36,000)
= Carrying amount/ Book Value	\$188,000	\$176,000	\$164,000

Measurement After Acquisition:

- After acquisition, an entity is required to choose either the **COST MODEL** or the **REVALUATION MODEL** for an entire class of PPE (AASB 116 para 29).
- **Cost Model:**
 - Assets are carried at **Cost Less Accumulated Depreciation Less Accumulated Impairment Losses** (AASB 116, para 30).
 - AASB 136 requires **At Each Reporting Date** that assets be assessed for impairment (para 9).
 - An impairment loss is recognised if the **Recoverable Amount of an Asset is Less than its Carrying Amount** (AASB 136, para 59).
 - The carrying amount of the asset is reduced to its recoverable amount.
- **Recoverable Amount:**
 - The **Higher** of an asset's:
 - Fair value less costs to sell
 - Value in use
 - Fair value is the amount obtainable from the sale of an asset in an arm's length transaction.
 - Value in use is the present value of future cash flows expected to be derived from an asset.
 - Cash inflows and outflows from use and subsequent disposal.
- **Impairment Example:** Continuing with the Willis example and assume **recoverable amount** on 30 June 2016 is **\$120,000**. Carrying amount on 30 June 2016 **BEFORE** impairment.

Machinery	\$200,000
- Accumulated Depreciation	<u>(36,000)</u>
= Carrying amount	164,000

As the carrying amount of \$164,000 exceeds the recoverable amount of **\$120,000** an impairment loss is recorded:

Dr Impairment Loss 44,000

Cr Accumulated Impairment 44,000

(164,000 – 120,000)

Carrying amount on 30 June 2016 **after** impairment:

Machinery	\$200,000
Less: Accumulated Depreciation	(36,000)
Less: Accumulated Impairment	<u>(44,000)</u>
Carrying amount	120,000

Depreciable amount is now **\$120,000** less residual value of \$20,000, **remaining useful life is 12 years** life. Depreciation expense is \$8,333 per year (120,000 – 20,000) / 12.

Revaluation Model:

- **Characteristics:**

- Assets are recorded at **Fair Value**.
- Fair value is the amount obtainable from the sale of an asset in an arm's length transaction.
- If an item is revalued, the entire class of assets must be revalued (AASB 116 para 36).
 - Cannot net increases/decreases within or across asset classes.
- When revaluing a depreciable asset, any balance of accumulated depreciation is credited to the asset account prior to the revaluation.

Dr Accumulated Depreciation

Cr Asset

NOTE: This entry reduces accumulated depreciation to zero and restates the asset balance to the carrying amount.

- **Increments:**

- Where the carrying amount is increased, the increase is credited to a revaluation surplus which is part of owner's equity (AASB 116, para 39)

Dr Asset

Cr Revaluation Surplus

- Subsequent depreciation is based upon the revalued amount.

- **Example:**

- The Balance Sheet of Weekend Ltd on 30 June 2018 showed the following asset:

Plant	\$100,000
Accumulated Depreciation	<u>(30,000)</u>
Carrying amount	\$70,000

- On 1 July 2018, the firm revalued the plant to its fair value of **\$95,000**.
- The plant at the date of revaluation had a **remaining useful life** of 10 years and expected residual value of \$5,000.

- **1 July 2018**

First, write-back accumulated depreciation:

Dr Accumulated Depreciation 30,000

Cr Plant 30,000

NOTE: The plant is now recorded at \$70,000.

Then, revalue the plant:

Dr Plant 25,000 (95,000 – 70,000)

Cr Revaluation Surplus 25,000

- **Disposal of a Revalued Asset:**

- The gain or loss is measured as the ***Difference Between the Carrying Amount*** of the revalued asset at the time of disposal **& Net Proceeds** (if any) from disposal.

- **Journal Entry:**

Dr Cash at Bank

Dr Accumulated Depreciation

Cr Asset (Revalued Amount)

Dr Loss on Sale

OR

Cr Gain on Sale

NOTE: The amount is calculated by (Selling Price – Carrying Amount).

NOTE: If selling price > carrying amount = profit, therefore Cr Gain on Sale.

This is a revenue account.

NOTE: If selling price < carrying amount = loss, therefore Dr Loss on Sale.

This is an expense account.

L2 - INTRODUCTION TO CONSOLIDATION (T2)

Accounting For Investments In Other Entities:

- Companies often invest in other entities (e.g. companies, partnerships).
- The type of accounting for the investing company is dependent on the ***Level of Influence*** that the investing company (investor) has over the other entity (investee).

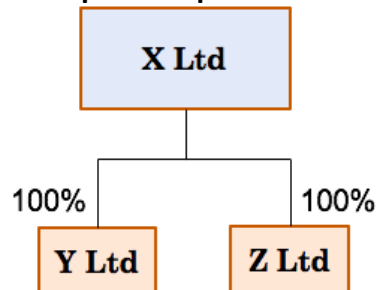
Level of Influence	Accounting Requirement	Accounting Standard	Covered

Control	Consolidated Financial Statements	AASB 10	Topics 2 - 7
Significant Influence	Equity Accounting	AASB 128	Topics 8 - 9
Joint Control	Equity Accounting or Proportional Consolidation	AASB 11	Topic 10
Investments Without Influence	Fair Value with Fair Value Changes	AASB 139	Not Covered

Group:

- **Structure:**

- Common for groups of companies to combine in pursuit of common goals.
- **Example Group Structure:**

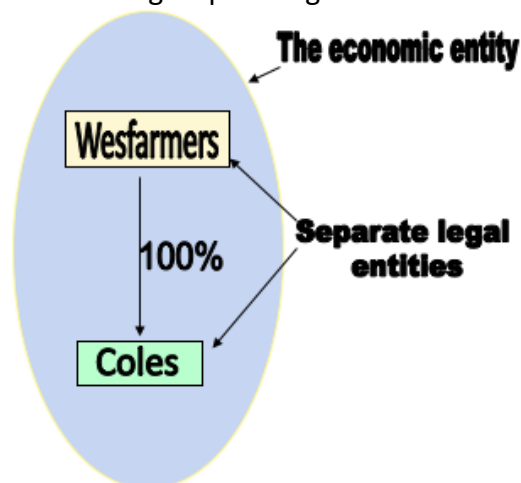


- This group consists of three companies.
- X Ltd is known as the “Parent Company”.
- Y Ltd and Z Ltd are known as “Subsidiaries” of X Ltd.

- **Definitions:**

- **Parent:** An entity that has one or more subsidiaries (X Ltd).
- **Subsidiary:** An entity, including a partnership, that is **Controlled** by another entity (Y and Z Ltd).
- **Group:** A parent and all its subsidiaries (X, Y and Z Ltd).

NOTE: Group is NOT a legal entity, it is an **Economic Entity**. The companies within the group are legal entities.



- **Consolidated Financial Statements:** The set of financial statements presented to show the results and financial position of a group as if it were operating as a **Single Economic Entity**.

Consolidated Financial Statements:

- **Advantages:**
 - The group is viewed as a single operating unit.
 - Relevant information: The investors have interest in the group as a whole, not just in the parent entity.
 - Accountability: Provides information on the group to **Stakeholders in the Parent Entity** to allow assessment of the performance of management in operating **All** resources under their control.
 - Only practical means of reporting for large complex groups.
- **Importance of Consolidation Accounting:**
 - Prior to the amendments some companies avoided full consolidation, e.g. selectively choose who are the subsidiaries and who are not the subsidiaries of the company depending on if the subsidiary made profits.
 - Why?
 - Boost profit and asset values.
 - Hide under performing subsidiaries.
 - Hide risks/high leverage.
- **Who Needs to Prepare These Statements?**
 - S295 of the Corporations act states that the content of a financial report:
 - For a company, it is the financial statements **Required by Accounting Standards**;
 - However, if the accounting standards require the company to prepare consolidated financial statements, the required financial statements are the consolidated financial statements.
 - This means that a parent entity only needs to prepare consolidated financial statements and does not need separate financial statements for the parent or subsidiaries.
 - S297 requires the consolidated statements present a true and fair view.
 - AASB 10 requires parent entities to prepare consolidated financial statements for the group.
 - The parent does not disclose separate financial statements for itself. It must disclose:
 - Current and total assets and liabilities
 - Shareholders' equity
 - Profit or loss
 - Guarantees of debts of subsidiaries
 - Contingent liabilities
- **Consolidation Procedures:**
 - In preparing consolidated financial statements, an entity combines the financial statements of the parent and subsidiaries **Line by Line** by adding like items of assets, liabilities, equity, income and expenses.

- **Procedures:**
 - Eliminating the investment account against the equity of the subsidiary at the date of acquisition (topic 3).
 - Complete fair value adjustments at date of acquisition (topics 4 and 5).
 - Eliminating intra-group transactions and balances (topic 6).
 - Disclosure of non-controlling interest's share of profit and equity (topic 7).

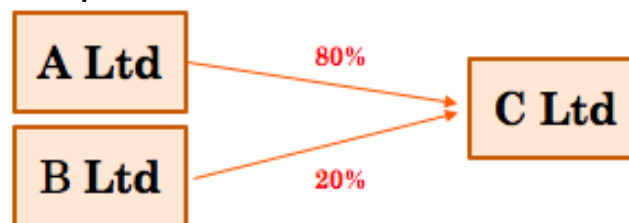
Control:

- **Re-Cap:**
 - Control is the criterion that determines whether consolidation accounting takes place.
 - A subsidiary is an entity **Controlled** by another entity.
 - The control definition is principles-based and must be interpreted in the basis of *professional judgement*. Different decision makers may reach opposing conclusions.
 - It is not rules-based, this would not require professional judgement.
- **Definition:** **COULD BE IN EXAM.**
 - An investor controls an investee when it is (1) **Exposed, or has Rights, to Variable Returns** from its involvement with the investee and has the (2) **Ability to Affect Those Returns** through its (3) **Power Over the Investee** (AASB 10 para 6).
 - **NOTE:** To have control and to be required to create consolidated financial statements, all three components of this definition must be satisfied.
 - Focus is on the economic substance of the investor-investee relationship. Having more than 50% of the voting shares is not sufficient to determine the existence of control.
 - There can only be one parent.
- **(3) Power Over the Investee:**
 - Power arises from **Rights** that give it the current ability to direct the *relevant activities* (direct both financing and operating activities of the company) of the investee.
 - Control is presumed to exist where the parent owns (directly or indirectly) more than half the voting rights of an entity unless the entity can clearly demonstrate that such ownership does not constitute control.
 - Control can be **Passive** (not actively involved in the company).
 - The rights must be **Substantive** rights (must be currently exercisable).
 - If a right is purely **Protective**, then the holder does not have power. (e.g. They have control over your assets but they cannot direct your financing or operating activities).
 - **Voting Rights:**
 - Control also exists if an entity owns 50% or less of the voting power of an entity if:

- The entity has power over more than half the voting rights by virtue of an agreement with other investors.
- The remaining shares are widely dispersed amongst numerous shareholders so that the other shareholders are unlikely to vote as a block.
- Due to **Apathy** (lack of interest), the majority of other shareholders do not vote at general meetings.

○ **Passive:**

- Control depends on the ‘power’ over the investee, so control can be **Active** or **Passive**.
- Controlling entity may play a **Passive** role by appointing a management company to run the day-to-day operations of the subsidiary.
- **Example:** At 30 June 2016



At 30 June 2016, B Ltd is actively involved in the operations of C Ltd where A Ltd is not involved in the operations of C Ltd.

In the absence of any other information, does B Ltd control C Ltd?

○ **Substantive:**

- Substantive right is a right that the investor has the practical ability to exercise (e.g. options to buy shares).
- The rights must be **Substantive**.
 - No barriers such as financial penalties, terms and conditions that make it unlikely for the holder to exercise the rights, etc.
 - The right must be “in the money” (e.g. if the share price on the ASX is \$25 but you have an option to buy the shares at \$20).
 - **NOTE:** Therefore, being substantive means it needs to be “in the money” so that you benefit from it, you have the financial ability and there is no barriers preventing you from exercising the option.

○ **Protective:**

- Rights “*designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate*” (AASB 10A).
- **Example:** Right to seize assets from borrower if the borrower breaches provisions of the loan contract.

○ **Summary:**

- Control is **Not** determined by ownership.
 - By not basing control on ownership prevents firms from reducing ownership below 50% to avoid consolidation.
- Determining whether control exists requires the exercise of professional judgement.

- **(2) Ability to Affect Returns:**
 - The investor needs to be able to use its power to affect the investor's returns from its involvement with the investee (para 17).
 - Determining whether the investor is a **Principal** or an **Agent** is important.
 - The agent acts on behalf of the principal and should not have a conflict of interest in carrying out the act.
 - E.g. Principal = Shareholders, Agent = CEO.
 - An investor that is an agent does **Not** control an investee when it exercises decision-making rights delegated to it (e.g. receiver or management company).
- **(1) Exposure or Rights to Variable Returns:**
 - An investor is exposed or has rights to **Variable** returns from its involvement with the investee when the investor's returns from its involvement vary as a result of the investee's performance (para 15).
 - **Examples of Variable Returns:**
 - Dividends
 - E.g. if a subsidiary is doing well it can pay dividends, if it is not doing well it can't pay dividends.
 - Obtaining scarce resources on a priority basis or lower cost
 - E.g. if a subsidiary owns a mine, sometimes there may be valuable resources.
 - Combining functions to achieve economies of scale
- **Conclusion:** To have control you must satisfy the following:
 - Have variable returns.
 - Be able to direct activities which generate those variable returns.
 - Have power in terms of the board of directors or shareholdings.
- **Acquiring Control Over Another Entity:**
 - Usually achieved by acquiring enough voting rights in another entity to obtain control.
 - **Why Acquire Control?**
 - Eliminate a competitor
 - Synergies / Economies of scale (merging to reduce costs, e.g. in operations).
 - Increasing size for political purposes or to increase remuneration of managers
 - Acquisition of technology, operational skills, rights, etc.
 - Removal of inefficient management of acquired firm.
 - Diversification of activities (e.g. Going into different industries, different geographic regions).
 - Listing rights (backdoor listing).
 - E.g. A private company buying a little public company to bypass the IPO to be a listed company.
- **Takeover Procedures:**
 - Corporate acquisitions are regulated by Chapter 6 of the Corporations Act.
 - When shareholding reaches 5%
 - This triggers the requirement for **Public Disclosure** when a substantial holding is acquired.

- The company and ASX (if investee is a listed entity) must be given notice by the holder of this shareholding within 2 working days of the acquisition.
 - Any subsequent movement of at least 1% in their holding must be reported.
 - Corporations Act s671B.
- Any increase in shareholding from 20% or below to more than 20%.
 - Section 606 of the Act **Prohibits** an acquisition of a relevant interest in the voting shares of a company if the acquisition would increase the voting power of any person (or parties acting in concert) from 20% or below to more than 20%.
 - Section 611(7) of the Act provides an **Exemption** to s606 if shareholders' approval in general meeting is obtained.
 - An independent Expert's Report is normally required to express an opinion as to whether or not such transaction is fair and reasonable to the shareholders of the entity.
- Any increase in shareholding from a starting point that is above 20% and below 90%.
 - The holding within this range must not be increased except by use of the '**Creep**' provisions (3% in 6 months as per s611(9)).
 - Can only buy 6% of shares a year if the shareholders of the investee company agree to it.
 - If they wish to increase their holding by other means, they must now make a formal **Takeover Bid**:
 - On-market bid
 - Off-market bid
- **Takeover Bids:**
 - **On-Market Bids:**
 - Offer must be to buy **All** the securities in a bid class.
 - Must be **Cash Only** and last for at least 1 month but not more than 12 (can't offer any equity).
 - Must be **Unconditional** (can't put any conditions on the investee).
 - **Off-Market Bids:**
 - Offer must be to buy **All** the securities in a bid class.
 - Consideration may take any form (cash or equity) and last for at least 1 month but not more than 12.
 - May be conditional (s626-629).
 - E.g. For the first 10% I will pay you \$30 per share, for the next 10% I will pay you \$25 per share, for the next 15% I will pay you \$20 per share.
 - This incentive encourages you to sell your shares faster.
 - Offer period may be extended.
- **The Provisions in Chapter 6 of Corporations Act (2001):**
 - Are aimed at ensuring that:
 - Any change in control of the target company takes place in an efficient, competitive and well-informed market.

- The shareholders and directors of the target company know who is making the bid.
- The shareholders and directors have appropriate information and a reasonable time to consider the proposal.
- That **All** shareholders have a reasonable and equal opportunity to take part in the proposal.