# ACCOUNTING STANDARDS AND REGULATIONS

## WEEK ONE – A FRAMEWORK FOR FINANCIAL REPORTING

### LECTURE NOTES

- Important to understand why we have financial reporting, and where the regulation comes from
- The issues are generally the same, and if the answers are the same, there is a lot of efficiency to be gained by focusing on the common problems and the common solutions
- Numerous accounting standards would fail on tests of plagiarism – they always use the same words that have the same meaning – *using groups of standards*
- They are part of a cohesive team of standards, rather than isolated
- When it comes to accounting, there are always choices:
  - Revenue – what is revenue, how much, and when do you recognise it?
  - Assets – what measurement model (historical cost/ FV) – recognition of costs, limits
- Everything always has choices, and you need to know the questions that you need to ask
- Conceptual frameworks → useful in establishing a comparison point – *highlight how accountants generally think about accounting issues*
  - They define the nature, subject and purpose of general-purpose financial reports
  - Identify a range of benefits that come from this conceptual framework
- Issue of measurement – how do you measure costs
- In Australia, the board is the AASB – conceptual framework is ED264- *Conceptual Framework for Financial Reporting*
- "panacea" – a solution or remedy for all difficulties → framework for an educational aid to identify what's consistent – *can easily identify when things are consistent, and when they are inconsistent*
- The framework is an educational aid rather than a normative theory
- Standards and frameworks are increasingly focused on equity investors
- It should be relevant – meeting requirements to support decision making
- Measurement uncertainty – historic cost (HC) has a lot of measurement uncertainty
- When talking about inventory, HC is a good framework to use, with less measurement uncertainty
- Measurement uncertainty – important in decision as to whether you use historic cost or fair value
- Faithful representation – complete, neutral & free from error – *no longer conservatism and reliability*
- Asymmetric prudence – sort of conservatism, but we don't have true conservatism in our framework
- Elements of financial statements – assets, liabilities and equity
  - Equity = assets – liabilities → ensures that everything is in the BS once and once only
- Income – do not distinguish between realised and unrealised income
- General features of financial reports – fair and faithful representation
  - Without going concern, historical cost is irrelevant
- In financial statements, you can't 'dress- up' another number and pretend that it's income
- AASB101 – accounting policies
  - *What better way to change your accounting result than to change your accounting policy*
  - Number one policy of manipulating accounting standards is to not get caught
- If there's no accounting standard, then use the conceptual framework to guide you
- Accounting policies do need to change – regulation changes, circumstances change (e.g. a company changes from being a mining explore to biotech firm – policies would have to change on R&D
- Whilst we value consistency, you can make changes – if you do make changes, you need to have a valid reason for changing them, and look at what the impact of the change is – disclosures
- A financial report is prepared at a point in time – need to make a decision about what goes into the financial report and what doesn't

## AASB 110 – EVENTS AFTER THE REPORTING PERIOD

- An entity should not prepare its financial statements on a going concern basis if events after the reporting period indicate that the going concern assumption is not appropriate
- Purpose of the standard – *to prescribe when an entity should adjust its financials for events after the reporting period & disclosures*
- ***Events after the reporting period –*** *events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue*
    - Those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period)
    - Those that are indicative of conditions that arose after the reporting period (non- adjusting events after the reporting period)
- In some cases, an entity is required to submit its financial statements to its shareholders for approval after the financial statements have been issued – *financial statements are authorised on the date of issue, not the date of approval by shareholders*
- Events after the reporting period include all events up to the date when financials are authorised for issue, even if the events occur after the public announcement of profit
- Adjusting events after the reporting period:
    - Settlement after the reporting period of a court case that confirms the entity had a present obligation at the end of the reporting period
    - An asset was impaired at the end of the reporting period – *bankruptcy confirms that the customer was credit- impaired at the end of the reporting period*
    - Discovery of fraud or errors that show the financials are incorrect
- Non- adjusting events after the reporting period → decline in fair value of investments between the end of the reporting period and date of authorisation of financials
- If an entity declares dividends to holders of equity instruments after the reporting period, the entity shall not recognise those dividends as a liability at the end of the reporting period – *no obligation existed at this time*
- An entity will not prepare its financial statements on a going concern basis if management determines after the reporting period that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so
- Deterioration in operating results and financial position after the reporting period may indicate a need to assess whether going concern is still appropriate
- An entity shall disclose the date when financial statements were authorised for issue and who gave the authorisation → if the owners have the power to amend financial statements after issue, the report must disclose this
    - *It is important to know when financial statements were authorised for issue, because financial statements do not reflect events after this date*
- If non- adjusting events after the reporting period are material, non- disclosure could influence the economic decisions that users make on the basis of financial statements – *they must disclose the nature of the event, and an estimate of the financial effect:*
    - Announcing a plan to discontinue an operation
    - Disposing of a major subsidiary
    - Major purchases of assets, classification of assets as held for sale
    - Destruction of a major production plant by a fire after the reporting period
    - Changes in tax rates or tax law
    - Commencing major litigation
    - Major restructure
    - Abnormally large changes in foreign exchange rates

## ED262 – CHAPTER ONE – THE OBJECTIVE OF GENERAL-PURPOSE FINANCIAL REPORTING

- The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors – *for buying, selling or holding equity and debt instruments, and providing or settling loans with other forms of credit*
    - These decisions are largely dependent on returns that they can expect from an investment *e.g. dividends, principal and interest payments or price increases* → these people need information to help them
    - They need information about the resources of the entity, claims against the entity, how effectively and efficiently the entity's management have discharged their responsibility
- General purpose financial reports do not, and cannot provide all of the information that existing and potential investors, lenders and other creditors need – *also require information on general economic conditions and expectations, political events and political climate*
- Individual users have different and conflicting information needs and desires
- Whilst management is interested in financial information about the entity, they don't need to rely on these reports because they are able to obtain the information they need internally
- To a large extent, financial reports are based on estimates, judgements and models rather than exact depictions
- Information about a reporting entity's financial performance during a period can help users to assess management's stewardship of the reporting entity's economic resources – *can also indicate the extent to which events such as changes in market prices or interest rates have increased or decreased the entity's economic resources and claims, thereby affecting the entity's ability to generate net cash inflows*
- Examples of management's responsibilities to use the entity's resources include protecting these resources from unfavourable effects of economic factors e.g. price and technological changes, and ensuring the entity complies with applicable laws, regulations and contracts

## ED262 – CHAPTER TWO – QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

- Financial reports provide information about the reporting entity's economic resources
    - They may also include explanatory material about management's expectations and strategies
- If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent → usefulness is enhanced if it is comparable, verifiable, timely and understandable
- Financial information has the capacity to make a difference in decisions if it has predictive value
- ***Materiality –*** *information is material if omitting or misstating it could influence decisions that the primary users of financial reports make* – no uniform threshold on materiality
- Qualitative characteristics – *comparability, verifiability, timeliness and understandability*
    - For information to be comparable, like things must look alike
- ***Timeliness –*** *having information available to decision- makers in time to be capable of influencing their decisions* → the older the information is, the less useful it is

## AASB 108 – ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

- ***Accounting policies –*** *specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements*
- ***Change in accounting estimate –*** *adjustment of the carrying amount of an asset or a liability, resulting from the present status of, and expected future benefits – new information, not corrections*

- ***Material –*** *omissions or misstatements of items are material if they could influence the economic decisions that users make on the basis of financials – depends on the size and nature*
- ***Prior period errors –*** *omissions in the financials for one or more prior periods, arising from a failure to use, or misuse of reliable information that was available, or could reasonably expected to have been obtained e.g. fraud, mathematical errors, mistakes in applying accounting policies*
- ***Retrospective application –*** *applying a new accounting policy to transactions, as if that policy had always been applied*
- ***Retrospective restatement –*** *correcting the recognition, measurement and disclosure*
- Users are assumed to have a reasonable knowledge of business and economic activities, and a willingness to study the information with reasonable diligence
- Entities should select and apply accounting policies consistently for similar transactions, unless a standard specifically requires or permits categorisation of items
- An entity should only change an accounting policy if the change:
  - Is required by a standard
  - Results in the financials providing reliable and more information
- Many items in financial statements cannot be measured with precision, but can only be estimated – *judgement based on the latest available, reliable information*
- Estimates may be required of- *bad debts, inventory obsolescence, fair value of assets of financial liabilities, useful lives of depreciable assets, warranty obligations*
- Accounting estimates are approximations that may need revision as additional information becomes known

## TUTORIAL NOTES – WEEK ONE

- In every single line item of financial statements, decisions have to be made about what goes into the numbers – *there will always be multiple perfectly legitimate solutions*
  - You need to consider if the valuation of assets is realistic, or have they been orchestrated – *you cannot overstate your assets, you can only understate them*
- Impairment is the reducing of assets – *has an effect on probability, equity and retained earnings*
  - Companies don't like to impair assets, because of the effect it has on financials
- Directors should be asking the right kinds of questions to their accountants – they sign off on the report, so they should be held accountable for their decisions
- You can buy something as an asset, or have it as an expense – companies prefer to capitalise on it as an asset, and then expense it later on through depreciation
- *Who might be interested in the financial state of a company? → suppliers, shareholders, customers (depend on quality), leaseholders, employees, banks, unions, government*
- Issue with remuneration for incentives → bonuses largely result in a short- term focus, rather than a long- term one
- If you incentivise people, it can have terrible side effects e.g. selling insurance products, mortgages to people who can't afford it

## TUTORIAL NOTES – WEEK TWO

- ***Conceptual framework –*** *developed to provide guidance on key issues e.g. objectives, qualitative characteristics, cost constraints, elements, recognition and measurement*
- ***Objective*** of general-purpose financial reporting is to provide financial information in making decisions about providing resources to the entity

- ***Elements** directly related to measurement of financial position are assets, liabilities and equity, and income statement are income and expenses*
  - Cash flow statement reflects income statement elements and changes in balance sheet elements → no unique elements to this statement as per the Framework
- ***Recognition –** process of incorporating in the balance sheet or income statement an item that meets the definition of an asset and satisfies the criteria for recognition*
  - Definition is set out as *it is probable that any future economic benefit associated with the item will flow to or from the entity; and the item has a cost or value that can be measured with reliability*
- ***Measurement –** process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried out in the balance sheet & income statement*
  - Numerous measurement bases – historical cost, current cost, realisable (settlement) value, present value
- ***Other –** the central framework came into play after a number of standards were introduced; hence we have a number of different recognition & measurement criteria*
  - The central framework evolves, but it still follows the IASB
- The Central Framework is not a standard in itself, but it must be referred to under AASB 108
  - If there is a conflict between the CF and an AASB, the standard prevails
- Benefits of the central framework – *accounting standards should be more consistent and logical because they are developed from an orderly set of concepts:*
  - Increased international compatibility should occur
  - AASB and IASB should be more accountable for their decisions as the thinking behind specific requirements should be explicit
  - Development of standards should be more economic
  - May be less need to develop additional standards as the concept may be captured under the central framework
- Contracts don't define every detail, so management discretion exists, and companies are willing to pay extra to maintain this flexibility
- Every item on the balance sheet apart from cash has had some kind of management input – *has a greater sense of what the company is about*
- Annual reports are financial statements, but they are also a marketing tool
- ***Statutory loss –** bottom line loss in accordance with accounting standards – companies will generally talk about their underlying profit because it sounds better than statutory loss*
- You can't overstate the value of assets → has to be realistically what you would get to sell it
- ***Sensitivity analysis –** "if we were to do this or that, what would happen" e.g. hedging*
- Decision makers need to know the performance of the company to decide whether to extend credit – *there has to be numbers that we know what we are agreeing to*
- We need to have flexibility, and try to portray the business as it accurately is
- Concept of international harmonisation with standards → *the international standards are principle-based, whereas the US' standards are rule- based → it is very easy to get around rules*
- Once you appoint management to operate on your behalf, you have management costs
- Annual reports are there to try and reduce agency costs – *the costs of directors and that claiming what they shouldn't be able to* e.g. $5000 parchment waste can (garbage bin
- Accounting standards are an expensive and slow process to change
- Shareholders have a much more long- term approach → shareholders want you to take some risk so that you get a return, from a manager's POV, cash- rich is good – *leads to bonuses*

## WEEK TWO – REVENUE

### LECTURE NOTES

- Earning = income – expenses
- ***Earnings –*** *measure of performance of the firm*
    - Economic perspective – increase in someone's well-offness
    - Net increases in net assets
- For firms that had profit increases, their stock prices went up
    - Profit decreases, stock prices went down
- Timeliness of earnings will be one of the few things that is questioned → not just the earnings change, but the earnings level
- *Are earnings better than cash flow?* – yes, from an accounting perspective
- What's better than cash flow? – accruals
    - On average, as we transform cash flow into income, we are providing more and better information to investors
- Accruals is a value- adding process in capturing the value of the firm → accruals are a part of accounting standards
- Expenses are decreases in net assets – comprise expenses and losses
- Most things for accounting standards are focused on revenues, not expenses
    - *Dr Cash, Cr Revenue* - simple when there is only one item
- When there is more than one good or service being sold, it can be more complicated – *e.g. mobile phone package – some revenue earned now, some more in the future*
    - Dr Cash, Cr Revenue & Dr Cash, Cr Unearned Revenue
- Sometimes you have receivables, when you buy something now, and recognise it later – what about when payment is deferred for a period of time → is a dollar today the same value as a dollar in a year's time – *Dr Acc. Receivable, Cr Revenue & Dr Cash, Cr Acc. Rec*
- Should it be recognised on the basis that the service is provided – a subscription, do you recognise unearned revenue, or recognise the revenue progressively over the next 12 months
- If the service is provided sporadically, maybe you recognise it differently – *Dr Unearned Revenue, Cr Revenue (in the proportion as you earn it)*
- These are all challenges when it comes to recognising revenue → what is revenue? How much is revenue? And when do we recognise it?
- *What, how much and when? When do you apply it and why?*

### AASB 15

- *Paragraph 9 – identify the contract*
    - An agreement between two or more parties that creates enforceable rights and obligations
    - A contract and commitment → written, oral or custom
    - Identify rights regarding goods of services
    - Identify payment terms
    - Commercial substance
- Collectability → if you can't collect the money, you can't recognise the revenue
- If cash cannot be collected – you cannot recognise the revenue
    - *Example – selling a scrum machine for rugby, can't recognise the revenue at the start of the period, because you can't guarantee collectability*

• Re-evaluated regularly and recognize revenue when considered collectable or terminated (i.e., when they start winning games – i.e., 31 July).

| Date | Account | Dr | Cr |
|---|---|---|---|
| 31 July | Unearned Revenue | 50,000 | |
| | A/C Receivable | 450,000 | |
| | Revenue | | 500,000 |
| 31 Aug | Cash | 450,000 | |
| | A/C Receivable | | 450,000 |