ACCT2542 CORPORATE AND FINANCIAL REPORTING – DETAILED DISTINCTION NOTES

TABLE OF CONTENTS

TOPIC 2 ACCOUNTING FOR COMPANY INCOME TAX

CHAPTER 12 - INCOME TAXES

12.1 Introduction and scope

All companies that generate revenue, while incurring expenses, are normally subject to taxation.

- **Accounting profit** = revenues earned - expenses incurred
- **Taxable profit** = taxable revenues - allowable deductions
    - The tax calculated based on taxable profit reflects only the current tax effect of transactions recorded in accounting that needs to be paid to the ATO
    - This tax is payable for the current period so it is reflected into a current tax liability account

As a result of the differences between accounting and taxation rules, there might also be some future tax effects resulting from current transactions or accrual accounting adjustments.

- As long as those future tax effects are consequences of the transactions that already occured, they should be recognised for accounting purposes
- Together with current tax effects, those future tax effects are reflected in the income tax expense calculated based on the accounting profit
    - If those future tax effects are not recognised in accounting, the income tax expense for the current year will be misleading

The accounting depreciation method reflects the pattern in which the economic benefits are derived from the use of the asset.

- If the tax depreciation is calculated using a different method, the current tax liability calculated based on the taxable profit after depreciation does not reflect the total tax effects of the way the economic benefits are derived from the asset, but only the current tax effect.
- Income tax accounting should not be based only on taxable profit
    - The future tax effect also needs to be considered and those may reflect less or more tax to be paid in the future (which should be recognised as deferred tax assets/liabilities)

Prior period tax losses can be used as tax deductions in following years, resulting in a reduction in the amount of tax paid.

The tax consequences of transactions that occur during a period should be 'recognised as income or an expense in the net profit or loss for the period' irrespective of when those tax effects will occur. (AASB 112)

- A transaction may have two tax 'effects':
    1. Tax payable on profit earned for the year may be reduced or increased because the transaction is not taxable or deductible in the current year.
    2. Future tax payable may be reduced or increased when that transaction becomes deductible or taxable.

12.2 Differences between accounting profit and taxable profit

Accounting profit and taxable profit are determined under different sets of rules.

- **Accounting profit** is measured as the difference between accounting revenues and accounting expenses.
    - The accounting revenues and expenses are determined in accordance with the rules established by accounting standards, normally based on accrual accounting.
- **Taxable profit** is calculated as the difference between taxable revenues and allowable tax deductions
    - The taxable revenues and deductions are determined in accordance with the rules established by the taxation authorities

The different treatment of some revenues and expenses for taxation and accounting gives rise to two categories of differences between taxable and accounting profit:

1. **Permanent differences** that will never reverse - NO TAX EFFECT
    - Some revenues may never be taxed (e.g. government grant)
    - Some expenses may never be allowed as a deduction (e.g. entertainment expenses, fines, goodwill impairment)

2. **Temporary differences** that will reverse over time - WILL GIVE RISE TO FUTURE TAX EFFECTS (i.e. taxable/deductible temporary differences)
    - Some revenues may not be recognised for taxation in the current period when earned but in the next period when received (e.g. rent or interest receivable)
        - That will make the taxable profit lower than the accounting profit in the current period but in the next period accounting profit will be lower
    - Some revenues may not be recognised for accounting in the current period as while they are received now, they have not yet been earned, but will be earned in the next period (e.g. revenue received in advance)
        - That will make the taxable profit higher than the accounting profit in the current period, but in the next period accounting profit will be higher.
    - Some expenses may not be recognised for taxation in the current period when incurred, but in the next period when paid (e.g. accrued expenses).
        - That will make the taxable profit higher than the accounting profit in the current period, but in the next period accounting profit will be higher.
    - Some expenses may not be recognised for accounting in the current period when paid, but in the next period when incurred (e.g. prepayments).
        - That will make the taxable profit lower than the accounting profit in the current period, but in the next period accounting profit will be lower.

12.3 Current and future tax consequences of transactions and other events

Some transactions may not have any consequences for taxation.

Other transactions have only current period consequences for taxation.

Some other transactions have both current and future tax consequences.

In essence, the accounting must:

- Prescribe the accounting treatment of the ***current*** tax consequences of transactions.
    - This will give rise to current tax liabilities or current tax assets. The task is to determine an entity's liability for taxation in the current period based on an assessment of the entity's current taxable profit or tax loss determined in accordance with the tax legislation.
    - Dr Income tax expense (current)
      Cr Current tax liability
      (Recognition of the current tax liability)
- Prescribe the accounting treatment of the ***future*** tax consequences of transactions
    - This involves an analysis of whether more tax (deferred tax liabilities) or less tax (deferred tax assets) will need to be paid in the future as a result of those transactions.
    - Dr Income tax expense (deferred)
      Dr Deferred tax asset
      Cr Deferred tax liability
      (Recognition of movement in deferred tax accounts)

12.4 Calculation of current tax

The current tax liability is the recognition of the tax payable to the taxation authorities in relation to the current year. The calculation of this liability involves measuring the taxable profit and multiplying it by the current tax rate (30%).

Convert accounting profit → taxable profit (via **current tax worksheet**)

<table>
<tr><td colspan="3">Start with accounting profit before tax</td></tr>
<tr><td>ADD</td><td>SUBTRACT</td><td rowspan="3">- Assessable income → look for cash received
- Deductions → look for cash paid
- For non-cash expenses (deduction based on)
→ Depreciation: rate determined by the ATO
→ Bad debt: amount of bad debt written off</td></tr>
<tr><td>Expenses</td><td>Revenues</td></tr>
<tr><td>Assessable income</td><td>Deductions</td></tr>
<tr><td colspan="3">Taxable profit</td></tr>
<tr><td colspan="3">* Tax Rate</td></tr>
<tr><td>Current Tax Liability
(for the year)</td><td colspan="2">Dr Income Tax Expense
Cr Current Tax Liability
(Recognition of the current tax liability)</td></tr>
</table>

Tax losses occur when allowable deductions exceed taxable revenues.

- In Australia, tax losses can be carried forward and deducted against future taxable profits.
- This means that an entity that incurs a tax loss has a future tax benefit: provided it earns taxable profit in the future, it will be able to use the carried forward balances of tax losses to reduce the tax it needs to pay on that taxable profit.
    - This tax benefit will be recognised as an asset referred to as 'a deferred tax asset'.

In dealing with tax losses it is necessary to distinguish between two events occurring at two different points of time.

1. *The creation of carry-forward tax losses*.
    - In the year in which a tax loss occurs, there is no liability to pay tax as there is no taxable profit.
    - Instead a deferred tax asset is recorded to recognise the future deductibility of the tax loss.
    - Dr Deferred tax asset
      Cr Income tax revenue
      (Recognition of current period tax loss)
2. *Recoupment of carry-forward tax loss*.
    - In a period subsequent to that in which the tax loss was incurred, an entity may earn taxable profit.
    - The amount of tax to be paid on that period's taxable profit may then be reduced by claiming a deduction for past tax losses.
    - Dr Income tax expense (current)
      Cr Deferred tax asset
      Cr Current tax liability
      (Recognition of current tax)
    - A tax loss must first be set off against the entity's exempt income before any reduction can be made in relation to the current period's liability for tax.

12.5 Calculation of deferred tax

Future tax consequences arise as a result of transactions and any other adjustments that affect the future amounts to be paid for tax.

TOPIC 5 – CONSOLIDATION: CONTROLLED ENTITIES & WHOLLY OWNED SUBSIDIARIES

CHAPTER 26 – CONSOLIDATION: CONTROLLED ENTITIES

26.1 Consolidated financial statements

The majority of entities listed on public stock exchanges such as the Australian Securities Exchange (ASX) are groups of entities that have combined their activities in pursuit of common objectives.

Each of those entities that together form a group prepares its own financial statements, showing its financial position, financial performance and cash flows. However, an additional set of financial statements—**consolidated financial statements**—is required to be prepared for the group to show its financial position, financial performance and cash flows as those of a single economic entity.

The purpose of preparing consolidated financial statements is to show the combined financial position, financial performance and cash flows of the group of entities as if they were a single economic entity. As such, they consist of a consolidated statement of financial position, a consolidated statement of profit or loss and other comprehensive income, a consolidated statement of changes in equity and a consolidated statement of cash flows. These consolidated statements reflect only the effects of transactions with external parties to the group.

Group – A parent and its subsidiaries.
Parent – An entity that controls one or more entities.
Subsidiary – An entity that is controlled by another entity.

The parent will prepare the consolidated financial statements by combining the financial statements of all entities in the group, subject to some adjustments.

The reason parents are required to create consolidated financial statements are:
- To supply ***relevant information*** to investors in the parent entity – more efficient
- To allow ***comparison*** of the group with similar entities
- To assist in holding the management of the group ***accountable***
- To report the ***risks and benefits*** of the group as a single economic entity
- To ensure ***consistency*** of information provided to users

26.2 Control

Control is the criterion for the existence of a parent–subsidiary relationship between an investor and an investee (AASB 10).

Three elements that must be held by an investor in order for it to have control:

a) ***power*** over the investee...
   - Existing rights that give the current ability to direct the relevant activities
     - **Substantive rights -** practical ability to exercise its rights
     - **Protective rights -** 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.

b) exposure, or rights, to ***variable returns*** from its involvement with the investee...
   - Where an investor holds ordinary shares in an investee, it is entitled to receive returns in the form of dividends, changes in the value of the investment, or residual interests on liquidation

c) the ability to ***use its power*** over the investee to affect the amount of the investor's returns.

An **agent** does not have control over an entity when it exercises its decision-making rights on behalf of the **principal**.

TOPIC 7 – CONSOLIDATION: NON-CONTROLLING INTEREST

CHAPTER 29 – CONSOLIDATION: NON-CONTROLLING INTEREST

29.1 The nature of a non-controlling interest

Non-controlling interest (NCI) is defined as equity in a subsidiary not attributable, directly or indirectly, to a parent.

- The non-controlling interest is still regarded as equity of the group.
- Hence, there are effectively two equity parties in the group: the owners of the parent and the NCI.

There are four potential reasons for entities preferring to have less than 100% ownership interest in some subsidiaries including: limited financial resources, executive and shareholders' interest alignment, regulatory requirements or risk protection.

29.2 Measurement and disclosure of the NCI share of equity

The NCI is entitled to a share of the equity of the subsidiary adjusted for the effects of profits or losses made on intragroup transactions.

The presentation of the total equity of the group in the consolidated financial statements requires the equity attributable to the owners of the parent to be shown separately from the equity attributable to the NCI.

- However, the various line items in the statement, such as revenues and expenses, are not required to be separated between parent and NCI

The information that needs to be disclosed for NCI is:

- the NCI share of profit after tax
- the NCI share of total comprehensive income
- the NCI share of consolidated equity.

29.3 The consolidation worksheet in the presence of NCI

There is no NCI share extracted from the assets or liabilities section of the worksheet as NCI receives a share of equity only.

However, because it is necessary to distinguish between the parent share and the NCI share of equity in the consolidated financial statements, extra columns and lines are added in the consolidation worksheet to divide the consolidated equity into the NCI and parent share.

29.4 The effects of the NCI on the goodwill recognised in the consolidation process

Full goodwill: goodwill on consolidation is split between the parents and NCI

- Total goodwill = CT + FV_{NCI} – FVINA
  - Goodwill to the parent = partial goodwill = **CT – (OS% * FVINA)**
  - Goodwill to the NCI = total goodwill – partial goodwill (recorded in BCVR)
- Control premium is recognised in the pre-acquisition entries

Partial goodwill: only the parents share of goodwill is recognised (via pre-acquisition entry)

- Goodwill to the parent = partial goodwill = **CT – (OS% * FVINA)**
- NCI does not get a share of goodwill

29.5 Calculating the NCI share of recorded equity

The **NCI share of consolidated equity** is calculated in two stages:

1. the **NCI share of 'recorded equity'**, which is the equity contained in the records of the subsidiary itself plus any BCVR recognised at acquisition date
    - To calculate the NCI share of equity, the equity of the subsidiary at the end of the reporting period is divided into three parts:

Step 1	OS_{NCI}% x Equity $_{\text{acquisition date}}$
Step 2	OS_{NCI}% x [Equity $_{\text{beginning of current period}}$ – Equity $_{\text{acquisition date}}$]
Step 3	OS_{NCI}% x change in current period P/L

2. the adjustments to the NCI share of recorded equity due to the effects of intragroup transactions.

29.6 Adjusting NCI for the effect of intragroup transactions

The adjustments for intragroup transactions are the same regardless of whether the subsidiary is wholly owned or partially owned by the parent.

- However, that in the case of dividends declared/paid by the subsidiary, only the dividends to the parent are intragroup dividends and will be eliminated on consolidation

Adjustments to NCI are only recorded for **upstream transactio**ns (sub → parent)

29.7 Gain on bargain purchase

In the rare case that a gain on bargain purchase arises as a result of a business combination, such a gain has no effect on the calculation of the NCI share of equity.

1. Business combination valuation entry
Record any valuation adjustments.

2. Pre-acquisition entry
Dr Share capital [OS_{PARENT}% x SC]
Dr Retained earnings [OS_{PARENT}% x RE]
Cr Gain on bargain purchase
Cr Shares in subsidiary [given]

3. NCI (step 1)
Dr Share capital [OS_{NCI}% x SC]
Dr Retained earnings [OS_{NCI}% x RE]
Cr NCI [balancing entry]

29.8 Disclosure

The disclosure related to NCI is prepared in accordance with the requirements included in AASB 10, AASB 101 and AASB 12.

TOPIC 9 – ASSOCIATES AND JOINT VENTURES & JOINT ARRANGEMENTS

CHAPTER 31 – ASSOCIATES AND JOINT VENTURES

31.1 Introduction and scope

An equity investment refers to an entity's investment in shares of another entity.

- An equity investment may result in the investee being deemed an associate or a joint venture
- AASB 128 requires the equity method to be applied to both associates and joint ventures.

31.2 Identifying associates and joint ventures

- An **associate** is an entity over which the investor has *significant influence* (power to participate in the policy decisions of the investee i.e. 20%-50% acquisition)
- Account for investment using the equity method

A **joint arrangement** is an arrangement of which two or more parties have *joint control*.

- **Joint control** is defined as the *contractually agreed* sharing of control of an arrangement, which exists only when decisions about the relevant activities *require the unanimous consent* of the parties sharing control
- There are two types of joint arrangements
  - Joint operation
  - Joint venture

31.3 The equity method of accounting: rationale and application

The **equity method** is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.

Standard setters consider the equity method a better measure of the investor's success in influencing the returns and performance of an associate or joint venture.

- Where an entity prepares consolidated financial statements, the equity method is applied to associates of the parent and its subsidiaries in the consolidated financial statements, and not in the separate accounts of the parent.
- Where an entity does not prepare consolidated financial statements, the equity method is applied to investments in associates in the accounts of the investor.

31.4 Applying the equity method: basic principles

The application of the equity method differs depending on whether or not the investor prepares consolidated financial statements:

A: Investor does not prepare consolidated financial statements
There are 4 key steps in its application.

1. Recognise the *initial investment* in the investee at cost.
   - If the investment has already been recorded at fair value, an adjustment must be made to restate the investment back to its original cost.
   - Dr Investments in associates and joint ventures
     Cr Cash
     (OS% investment in associate/joint venture)
2. Recognition of the share of profits or loss of associate/joint venture (i.e. post-acquisition profit or loss)

- Dr Investment in associates and joint ventures

  Cr Share of profit or loss of associates and joint ventures

  (Share of profit or loss of associate/joint venture: OS% x P/L)

3. Recognition of share of OCI: increase in asset revaluation surplus
   - Dr Investment in associates and joint ventures

     Cr Share of OCI of associates and joint ventures

     (Share of revaluation increase: OS% x Increase in ARS)
   - Dr Share of OCI of associates and joint ventures

     Cr Asset revaluation surplus

     (Accumulation of revaluation increase in equity)
4. Adjustment for dividend paid by associate/joint venture
   - Such changes include those arising from the revaluation of assets where the movements are recognised in the reserves of the investee's equity rather than in profit or loss.
   - Dr Cash

     Cr Investments in associates and joint ventures

     (Adjustment for dividend paid by associate/joint venture: OS% x Dividend paid)

Part B: Investor prepares consolidated financial statements

Steps 1-3 are the same.

Step 4 is recorded as:

Dr Dividend revenue

Cr Investments in associates and joint ventures

(Adjustment for dividend paid by associate/joint venture: OS% x Dividend paid)

31.5 Applying the equity method: goodwill and fair value adjustments

Goodwill arising from the acquisition of an associate or joint venture is not separately recognised. Accordingly, goodwill is not tested separately for impairment.

Excess on acquisition is recognised along with share of profit of the investee at the first reporting date after acquisition.

Calculation of adjustments for differences between carrying amounts and fair values is always on an after-tax basis.

Where differences between fair values and carrying amounts exist at acquisition date for the investee's identifiable assets and liabilities, subsequent equity recognised by the associate may include pre-acquisition adjustments relating to these differences.

Prior to calculating the investor's share, reported profit of an associate or joint venture must first be adjusted to account for fair value differences at acquisition.

Where the investor prepares consolidated financial statements, the equity method is applied in the consolidation worksheet. As consolidation entries are never posted, the effects of all prior periods' equity method adjustments must be accounted for along with the current period's adjustments.

31.6 Applying the equity method: inter-entity transactions

Under the equity method of accounting, the investor recognises its share of realised equity of an associate; hence, adjustments are made for unrealised profits.

- Adjustments to the investor's share of the equity of the associate are made for the effects of both upstream and downstream transactions even though a downstream transaction does not affect the equity of the associate.

TOPIC 10 – TRANSLATION OF FINANCIAL STATEMENTS INTO A PRESENTATION CURRENCY

CHAPTER 24 – TRANSLATION OF FOREIGN CURRENCY FINANCIAL STATEMENTS

24.1 Introduction and scope

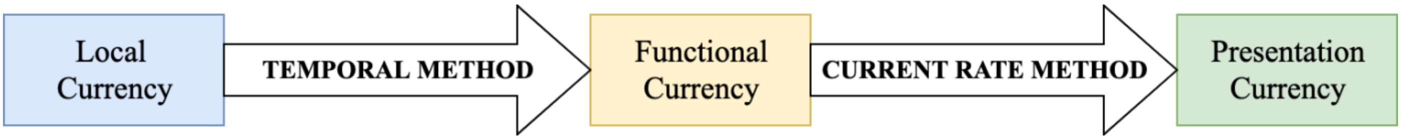
- The financial statements of an overseas subsidiary may be recorded in a foreign currency and translated into Australian dollars for the purpose of combining those statements with the financial statements of the parent Australian company. (AASB 121)
- The financial statements of an Australian company may be prepared in Australian dollars and translated into a foreign currency for presentation purposes.

24.2 Functional and presentation currencies

There are three different types of currencies:

- **Local currency** – the currency the subsidiary records transactions
- **Functional currency** – where the primary economic environment is]
    - Currency that determines the selling price/sales market (where revenue is generated)
    - Currency that determines production cost
    - Currency where the company raises financing
- **Presentation currency** – the currency the parent uses to prepare financial reports

24.3 The translation process



24.4/5 Translation into the functional currency – the temporal method and the current rate method

<table>
<tr><th>Items</th><th colspan="2">Applicable Rate</th></tr>
<tr><th></th><th>TEMPORAL METHOD</th><th>CURRENT RATE METHOD</th></tr>
<tr><td colspan="3">Income statement items</td></tr>
<tr><td>Sales</td><td colspan="2">Average rate (if evenly distributed through year)</td></tr>
<tr><td>Cost of sales
Opening stock
Purchases
Closing stock</td><td colspan="2">
Historical rate (@ date opening stock is purchased)
Average rate (if evenly distributed through year)
Historical rate (@ date closing stock is purchased)</td></tr>
<tr><td>Depreciation Exp</td><td>Historical rate (@ date asset acquired)</td><td>Average rate (if evenly distributed)</td></tr>
<tr><td>Other operating exp</td><td colspan="2">Average rate (if evenly distributed through year)</td></tr>
<tr><td colspan="3">Equity</td></tr>
<tr><td>o/b retained earnings</td><td colspan="2">Historical rate (@ acq date for pre-acq R/E carried forward for post-acq movements)</td></tr>
<tr><td>Dividends paid (declared)</td><td colspan="2">Historical rate (@ date when dividends paid (declared))</td></tr>
<tr><td>Share capital</td><td colspan="2">Historical rate (@ acquisition date)</td></tr>
<tr><td colspan="3">Assets & Liabilities</td></tr>
<tr><td>Monetary items (e.g. cash, A/R, pensions, provisions)</td><td>Closing rate</td><td rowspan="2">Closing rate</td></tr>
<tr><td>Non-monetary items (e.g. inventory, PPE, provision)</td><td>Historical rate (@ date item acquired)</td></tr>
<tr><td>VERIFICATION</td><td>Opening net monetary assets
+ Sales
– Purchases/div./exp (excl. COGS/depn)
= FOREX Gain/Loss</td><td>Opening net assets (@CR– historical rate)
+ P/L @ closing rate
– P/L translated
= FOREX Gain/Loss</td></tr>
<tr><td>Recording gain or loss</td><td>P/L for the period in which they arise</td><td>OCI (accumulated in FCTR on B/S)</td></tr>
</table>