

ACC3100

notes

Based on
Issues in Financial Accounting
16th edition

What's included?

- **Comprehensive notes on all subject chapters**
- **Diagrams to summarise key information**
- **Sample journal entries at the end of chapters**

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Chapter 4: Measurements and fair value

Measurement

The Framework defines measurement in accounting to mean the process of determining monetary amounts at which the elements of the financial statements are to be recognised and carried. Measurement may involve calculation, estimation, and sometimes apportionment.

Measurement makes accounting information useful as it gives meaning to the elements. It allows accounting users to assess an entity's position and performance currently and over time, as well as compare between entities.

The Framework does not give guidance on which measurement option to use. Currently, historical cost is the dominant model, but there has been a recent shift toward fair value.

Mixed measurement approach

Different measurement models are used for different financial elements, for example:

- Inventories use the lower of cost and net realisable value
- Plant uses historical cost less accumulated depreciation and impairment
- Intangible assets uses historical cost less accumulated amortisation and impairment
- Long term employee benefits use present value of cash flows
- Derivative financial instruments use fair value

Limitations of measurement

Because there are many options for measurement, this can reduce overall comparability if entities use different models. Additionally, measurements can sometimes be subjective, especially when opportunistic managers use the flexibility of choice to manipulate the numbers in their favour.

Other measurement models

Fair value

As defined in AASB 13, fair value is the price that would be received in order to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

	Advantages	Disadvantages
Relevance	Focuses on future potential	Hypothetical, not relevant to entity
Faithful representation	Uses objective market rates	Subjective if no market prices
Understandability	Simple market value	Based on complex assumptions
Comparability	Focuses on market not individual entity	Different models to use

Influences on measurement model choice

Influences on choosing which model to use can come from various areas, such as:

- The accounting standards
- Potential users of the information
- Practical considerations, such as what is possible, and not too costly
- Management motivations

Active markets for fair value

The measurement of fair value assumes that the transaction to sell the asset or transfer the liability takes place in the **principal market**, if one exists, or failing that, the **most advantageous market**.

The entity must have access to the principal market at measurement date for it to be used in the valuation. The burden of proof is on the accountants to show that a market is inactive. Some factors which could show that a market is inactive are:

- Few recent transactions
- Price quotes don't use current information
- Quotes vary substantially
- Market has gone toxic
- Wide bid-ask spread

Chapter 10: Intangible assets

Introduction to intangibles

There is increasing business expenditure on intangible assets, however of themselves they have no value. They need support systems to be of any use, and without these they can lose value dramatically, having a large impact on balance sheets.

Definition of intangible assets

AASB 138 defines intangible assets as identifiable, non-monetary assets without physical substance. Examples of this include patents, brands, and licences.

- Identifiable: the asset must be separable, i.e., capable of being separated and exchanged
- Non-monetary: the asset is not financial
- Without physical substance: it is not tangible, able to be touched, it's existence is only due to transactions

The Framework makes no distinction between tangible and intangible assets, so identifiability and tangibility are not required criteria.

Recognition and initial measurement

Internally generated intangibles

AASB 138 specifically excludes **internally generated** brands, mastheads, customer lists, publishing titles and other similar items from being recognised. Rather, the costs to build these should be expensed. Development costs will be an exception to this, as we will see.

Purchased intangibles

Purchased intangible assets, whether bought separately or through a business combination, can generally be capitalised as they meet recognition criteria of assets.

- Intangibles purchased separately are measured at purchase price plus other directly attributable costs

Chapter 19: Extractive industries

Stages of production in extractive industries

AASB 6 deals with the **exploration and evaluation** stages where a company is doing initial research to find mineral resources. Once deposits have been found, there will be **development** to gain access to the deposits and land, **construction** of assets to extract the resources, and **production** where the extraction takes place.

Four methods of accounting for exploration and evaluation

1. Expense method: everything is written off as an expense
 - Low probability of successful exploration
 - Expenses can be matched with current sales revenue
2. Expense-and-reinstate method: expense everything, but reinstate as assets when resulting in successful exploration
 - Defers asset recognition until probable
 - Matches pre-production costs with associated revenues
 - Supported by the Framework
3. Full cost method: capitalise all expenditure
 - All exploration is part of an effort to discover reserves
 - Balance sheet shows amounts close to true worth of reserves
4. Successful efforts method: capitalise when likely to result in success

Successful efforts method

This is the method used in Australia. Each area of interest is treated differently, depending on certain criteria. Costs can be capitalised if:

- Current rights to access and extract from the land, and
- The exploration costs are expected to be recouped through discovery of economically viable reserve, or it is too early to tell

Measurement

Exploration and evaluation assets are measured at cost. Subsequently, they can be measured using the cost or revaluation model. There should be separate classification for tangible (PPE) and intangible assets. Development and construction assets should be

treated according to their individual standards (AASB 116 — PPE and AASB 138 — Intangible Assets)

These assets should be impaired whenever there is an indication that the recoverable amount is less than the carrying value. Amortisation is typically calculated on a units-of-production method.

Depreciation

If the useful life of any PPE exceeds the life of the reserves and the assets cannot be economically removed from the site, depreciation should be calculated over the life of the reserve.

If the asset can be economically moved or its useful life is less than that of the reserve, depreciation should be allocated over the asset's life.

Removal and restoration costs

Firms may have an obligation to restore sites back to their original state after production is complete, and to remove their equipment. If these obligations (legal or constructive) meet the definition of a liability, which they often do, they should be recognised as such. Typically, PV calculations will be used in the measurement for provisions for restoration, and they should be charged against the particular phase of the extraction (e.g., exploration and evaluation or production).

Journal entries

Typical extraction process (excluding impairment of unsuccessful site)

30/06/2018	Exploration and evaluation assets	50 000	
	Cash / payables, etc.		50 000
30/06/2019	Assets under construction - PPE	35 000	
	Assets under construction - intangibles	15 000	
	Exploration and evaluation assets		50 000
	Assets under construction - PPE	12 000	

Chapter 17: Earnings per share

Introduction to earnings per share

AASB 133 — Earnings Per Share requires disclosure of basic and diluted earnings per share of the statement of comprehensive income. This applies to listed companies or those in the process of listing. Earnings per share is reported as a dollar figure, e.g., \$1.70 per share.

Basic earnings per share

The general formula for basic earnings per share is earnings from continuing operations attributable to ordinary shareholders divided by the weighted average number of ordinary shares outstanding in the period. The earnings portion therefore excludes preferences dividends and earnings attributable to non-controlling interests.

Earnings

Preference shares only need to be deducted from earnings if they are actually declared, or if they are not declared but are cumulative (i.e., they will need to be paid in another period).

Weighted average ordinary shares

The weighting takes into account share issues, bonus issues, buybacks or splits that occur during the period. This is typically calculated by weighting according to the number of days that the shares were outstanding as part of the whole period.

Share issues of 100 000 occurring halfway through the period will increase the weighted average number of ordinary shares by 50 000. Share buybacks of 24 000 occurring a quarter of the way into the period will decrease the weighted average by 18 000. Bonus share issues are counted as if they had occurred at the beginning of the period.

Partly paid shares count as part of ordinary shares if they have pro-rata rights to dividends.

Chapters 13 and 24: Financial instruments part 1

Types of financial instruments

A financial instrument is a contract that gives rise to a financial asset for one entity and a financial liability or equity instrument for another entity.

Debt vs equity

Some issued financial instruments can contain a debt and equity component. Otherwise, the issuer must determine whether the instrument is debt or equity. Typically, managers prefer to recognise instruments as equity, since this will reduce their debt to equity ratio, and contractual payments will be dividends rather than interest expense. Holding equity also falls in line with APRA capital adequacy requirements.

However, managers are not free to decide. They must take into account whether there is contractual obligation, and with which party the residual risk applies, in order to determine whether the contract is a liability or an equity.

Primary vs derivative

The value of **primary** financial instruments is determined directly by the market, e.g., the value of a share. A **derivative** instrument has value based on other underlying assets, e.g., a share option whose value is derived from the value of the underlying shares.

Single vs compound

Single financial instruments contain only a single financial asset, liability or equity instrument, such as a loan receivable or an ordinary share. A **compound** financial instrument consists of a combination of financial assets, liabilities, and equity instruments, such as convertible notes.

From the issuer's perspective, a compound financial instrument contains a liability component and an equity component.

Disclosure

AASB 7 requires disclosure of hedging relationships. For cash flow hedges, this includes the periods when cash flows are expected to occur and when they will affect profit and loss. The purpose of these disclosure is to allow users to:

- Evaluate how significant financial instruments are in the grand scheme of a company's position or performance
- Calculate the risk undertaken by the company, and see how the company manages that risk

Risk typically refers to credit risk, liquidity risk, and market risk.

Journal entries

Cash flow hedge with forward contract

01/04/2020	Forward contract (asset)	350 141	
	Cash flow hedge reserve (OCI)		350 141
	Inventory	4 615 385	
	Accounts payable		4 615 385
	Cash flow hedge reserve (OCI)	350 141	
	Inventory		350 141
30/06/2020	Foreign exchange loss (P&L)	384 615	
	Accounts payable		385 615
	Forward contract (asset)	410 509	
	Gain on forward contract (P&L)		410 509
15/07/2020	Foreign exchange loss (P&L)	454 545	
	Accounts payable		454 545
	Forward contract (asset)	282 131	
	Gain on forward contract (P&L)		282 131