Accounting Standards & Regulations

Lecture 1: The function of Accounting

What accounting is?

Accounting is simply a type of record-keeping.

- Record-keeping has been used by humans for thousands of years.

➢ Why keep records?
- Increasing social complexity
- Accountability

Functions of accounting (3)

➢ Function 1 – Decision Making

- Decision making has become increasingly more important with industrialisation.
- Decisions relate to the allocation of scarce resources, especially capital. So decision making is paramount.

- The regulators see this use as preeminent (surpassing all others, important).
  - "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 in making decisions about providing resources to the entity.

Who uses this information?

- Primary users; existing and potential investors, lenders and other creditors.
- Secondary users; employees, suppliers, customers, Government, the public.

Allocation decisions?

- Investors; do they buy or sell shares?
- Lenders; do we lend to a company, and if so, with what conditions?

How does accounting information help?

Accounting information is paramount to making informed decisions about the financial and managerial side of the firm. This information is mostly translated through the 3 financial statements (P/L, B/S and C/F).

➢ Function 2 – Contracting

What is a contract?

"A contract is a binding agreement which governs the relationship between two or more people or companies, setting out what they must and mustn't do".

What is a company?

A company is a nexus (collection) of contracts.

The relationship between;

- Management (CFO/CEO) – Company
- Lender – Company. (Lender- anyone who gives/borrows money to a company).

- Accounting numbers (i.e. profits, assets, liabilities) are used in various accounting contracts.

Why??

- Goal misalignment (not everyone has the same goals).
    - Those who provide the capital (principals) may have different goals to those who are in charge of that capital (agents).

Goal misalignment leads to the – agency problem.

Agency problem- Usually refers to a conflict of interest between a company's management and the company's stockholders. This happens when the owners have others working for them.

- Assumptions;
    - People act in their own self-interest
    - Delegation of decision making (entrusting others to make decisions)
    - Information asymmetry (A situation in which one party in a transaction has more or superior information compared to another). Companies don't always release/give all the information that they know.

There are costs to the principals (those who provide the capital) from delegating decision making;

- Poor decision making, and/or,

- These are the costs to equity investors, and to lenders, when a company delegates decision making (agency problem).

Equity Investors	**Lenders**
• Perquisite consumption; the spending of money that isn't their own. Agents spending the money of investors or outrageous things. • Different time horizons	• Dividends; if dividends are paid out before lenders receive their money back, this is a big problem. • Claim dilution; A reduction in the ownership percentage of a share of stock caused by the issuance of new stock. • Asset substitution; A problem that arises when a company exchanges its low-risk assets for high-risk investments. This substitution transfers value from a firm's bondholders to its shareholders. • Under-investment; An agency problem where a company refuses to invest in low-risk assets, in order to maximize their wealth at the cost of the debt holders.

Mechanisms to generate alignment;

- Bonding; 'carrot & stick' mechanism. Making the employee want the same thing that you want.
- Monitoring; watching what is going on.

Principals; those who invest in a company, or lend money to a company.

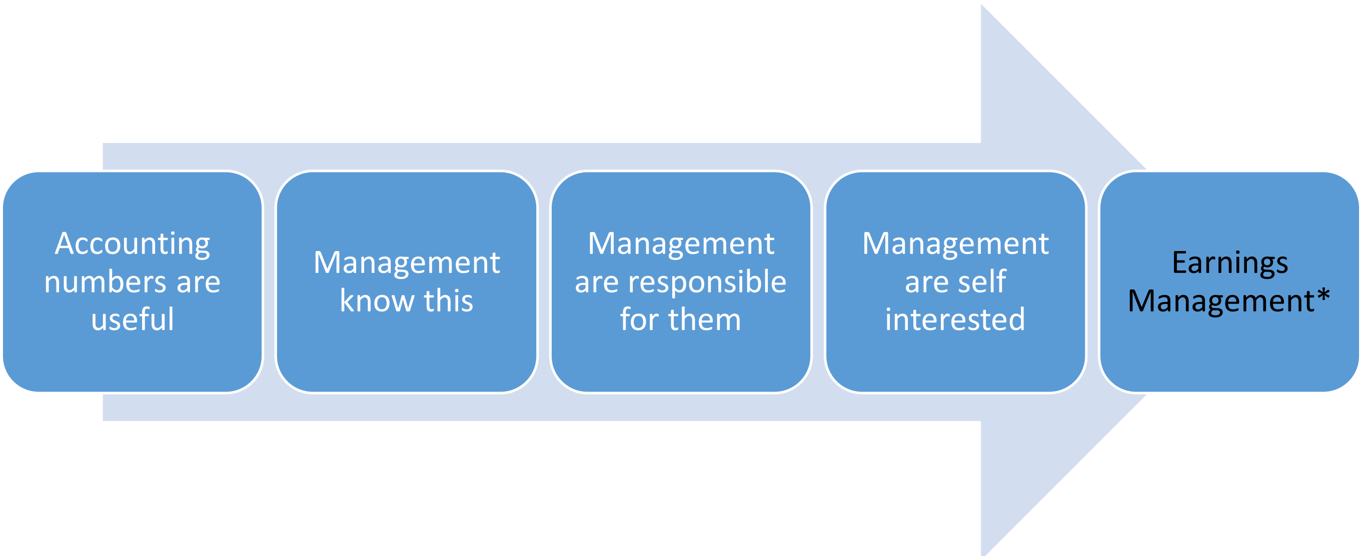
Equity investors	Lenders
➢ Principals expect to see a return through a dividend stream and/or capital growth. ➢ Therefore, profitability and share prices are important. ➢ Accounting numbers; o Directly; e.g. profit targets and bonuses. o Indirectly; e.g. options/shares as part of pay package.	➢ Principals expect to see a return through interest payments and also the repayment on the loan. ➢ Accounting numbers; o Included in clauses of contract to ensure management do (or do not do) certain things. E.g. leverage ratios, dividend payout ratios.

- Function 3 – Stewardship

Stewardship; Stewardship is an ethic that embodies the responsible planning and management of resources.

- Primary concern is for the agent to demonstrate compliance with the delegated authority.
  - i.e. Stewards reporting to Lords in medieval times
  - i.e. Banks demonstrating capital requirements to the Government.

Accounting Regulation



Earnings management can arise when companies report their accounting numbers. Accounting regulation aims to stop this.

Why we have regulation

- Earnings management is a problem.
  - Its not just earnings that get managed.
- Users are making decisions based on this information.

Therefore, if the information is poor = poor decisions.

Efficient	Opportunistic
• Financials are an accurate representation	• Financials represent what management want them to

← Having an opportunistic approach, leads to Earnings Management.

How do we deal with earnings management?

- DO NOTHING.
  - Accounting information is as good as any other.
  - Management are best placed to decide what to report
  - Companies will volunteer to tell you both good and bad information.

- Regulation
  - Accounting information is a public good
  - Whilst markets may be efficient on average, exceptions occur.

What does accounting regulation do?

- Limits accounting policy choices available to management
  - i.e. inventory cost methods – LIFO is by law, illegal to use in Australia.
- Provides more certainty as to how the accounting numbers are generated
- Still allows management some discretion (some option/choice).

Who the regulators are

- Generate accounting standards

  - International Accounting Standards Board (IASB) – covers 130 countries.
  - Australian Accounting Standards Board (AASB) – Aus. Adopted the international standards in 2005.

- Enforce accounting standards

  - Australian Securities & Investment Commission (ASIC)

- Enforce accounting standards & own rules

  - Australian Stock Exchange (ASX)

The conceptual framework

The conceptual framework is a ‘set of interrelated concepts that define the nature, purpose, and broad content of general purpose financial reporting’.

Benefits

- Makes regulation more consistent and logical
- Increased comparability, accountability, and understandability
- Makes standard setting more economical

Consists of;

- SAC 1; Definition of the reporting entity
  - The concept of the ‘reporting entity’ is currently used to help identify those entities that must apply Australian Accounting Standards.

- AASB Framework; Framework of the preparation and presentation of financial statements.

  - Sets out the concepts that underlie the preparation and presentation of financial statements to external users (framework paragraph 1).

Deals with;

- Objective of financial statements;
- Qualitative characteristics of useful financial information
- Definition, recognition and measurement of financial reporting elements; and,
- Concepts of capital and capital maintenance.

However;

- Even with a conceptual framework, a consistent and logical outcome is not guaranteed.
  - i.e. AASB 6 *Exploration for and Evaluation of Mineral Resources* v AASB 141 *Agriculture*

- Conservatism is not yet mentioned once, yet;
  - “.. conservatism has survived in accounting for many centuries and appears to have increased in the last 30 years.
  - Conservatism causes bias in a negative sense.

Legal requirement

- Corporations Act 2001

  - s292 discusses who has to prepare
  - s296(1): The financial report for a financial year must comply with the accounting standards.
  - s334(1): The AASB may, by legislative instrument, make accounting standards for the purposes of this Act.

Political aspects

- Regulation is a highly political process.

- Farber et al. (2007),
  - Examined the lobbying effects by industry to block the FASB standard requiring expensing of stock options at fair value – the effect of this standard is that it lower's a company's profit as stock/shares can be valued and therefore expensed when given out.

  Found;

  - Those congressional members who supported the Act (i.e. to block the FASB standard), were more likely to be;
      - Republican, conservative and received PAC contributions.
  - Those companies who donated more through their PAC;
      - Had larger stock option expenses.

International Standards

- International harmonisation;
  - The move to have all countries in the world using the same reporting standards.
  - Eg; all pilots and traffic control centres must speak English.

- Why?
  - Lower cost for investors to compare
  - Lower cost for companies to list in another country.

- Why not?
  - Economic differences
  - Political differences
  - Cultural differences
  - Implementation and enforcement

- Currently;
  - Over 120 countries require or permit IFRS reporting.
      - Includes; Aus. EU, Singapore, South Africa.
  - Over 85 require IFRS for all domestically listed companies.

- Future;
  - US; does not allow, but the Boards (FASB and IASB) are working together on convergence.
  - China; does not allow, but convergence is occurring
  - Japan; voluntary adoption, but moving towards adoption,
  - India; does not allow, but convergence is occurring
  - Indonesia; does not use.

Definitions (Textbook chapter 1,2,3)

- Special purpose financial statement- a financial statement designed to meet the needs of a specific group or to satisfy a specific purpose. Can be contrasted with a general purpose financial statement, which is intended to meet the information needs common to users who are unable to command the preparation of reports.
- General purpose financial statement- financial statements that comply with conceptual framework requirements and accounting standards and meet the information needs common to users who are unable to command the preparation of financial statements tailored specifically to satisfy all their information needs.
- Australian Securities & Investment Commission (ASIC)- the body responsible for administering corporation legislation in Australia. It is independent of state ministers or state parliaments and reports directly to the Commonwealth Parliament, the Treasurer and the Parliamentary Secretary to the treasurer.
- Australian Accounting Standards Board (AASB)- Body in charge with developing a conceptual framework for accounting practices, making and formulating accounting standards, and participating in and contributing to the development of a single set of accounting standards for worldwide use.
- Financial reporting council (FRC)- the body that oversees the activities of the AASB and the AUASB.
- Australian Securities Exchange (ASX)- A company incorporated on 1 April 1987. The ASX sets uniform trading rules, ethical standards and listing requirements.
- Conservative accounting policies- Policies that tend to understate the value of an entity's net assets. A bias towards understating the carrying value of assets and overstating the carrying value of liabilities.

- Conceptual framework- A framework that seeks to identify the objective of general purpose financial reporting and the qualitative characteristics that financial information should possess.
- Reporting entity- When users are said to exist who do not have access to information relevant to decision making and who are judged to be dependent on general purpose financial statements, the entity is deemed to be a reporting entity.
- Asset- defined in the AASB Conceptual Framework, as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- Future economic benefits- the scarce capacity to provide benefits to the entities that use them – common to all assets irrespective of their physical or other form.
- Control (assets)- if an asset is to be recognised, control rather than legal ownership must be established. Control is the 'capacity of the entity to benefit from the asset in pursuit of the entity's objectives and to deny or regulate the access of others to that benefit'.
- Liability- a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- Notes to the financial statements- further explanation or information relating to particular items appearing in financial statements.
- Expenses- decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases of equity, other than those relating to distributions of equity participants.
- Income- increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions of equity.

- Equity- residual interest in the assets of the entity after deduction of its liabilities. The residual interest is a claim or right to the net assets of the reporting firm.
- Conventional financial reporting practices- represented by the set of GAAP in place at a point in time. They rely heavily on historical-cost accounting and associated doctrines, such as the doctrine of conservatism.
- Full-cost method- in relation to the extractive industries, this method of accounting requires all exploration and evaluation costs incurred by an entity to be matched against revenue from the total economically recoverable reserves discovered by the entity across all sites.
- Successful efforts method- method of accounting used in the extractive industries, under which only costs resulting directly in the discovery of economically recoverable reserves are carried forward, all others are being written off as incurred.

- Theory- coherent set of hypothetical, conceptual and pragmatic principles forming a frame of reference for a field of inquiry.
- Positive accounting theory (PAT)- seeks to explain and predict accounting practice.
- Agency relationship- involving the delegation of decision making from the principal to an agent.
- Monitoring cost- cost incurred monitoring the performance of others.
- Perquisite consumption- consumption by employees of non-salary benefits.
- Rational economic person assumption- that all actions by individuals are driven by self-interest, the prime interest being to maximise personal wealth.
- Information asymmetry- where some individuals have access to certain information that is not available to others.
- Bonus scheme- where the manager receives a bonus that is tied to the performance of the organisation.
- Generally accepted accounting principles (GAAP)- body of conventions, rules and procedures that are generally applied by accountants.
- Accounting-based bonus scheme- employee remuneration scheme where employees receive a bonus tied to accounting numbers.
- Net present value- the difference between the present value of all future cash inflows and the present value of the future cash outflows relating to a particular project or object.
- Leverage (gearing)- measure of the amount of debt issued by an entity. The greater the use of debt, the greater the gearing.
- Debt covenant- restriction within the trust deed on the operations of a borrowing entity.
- Debt holder- external party with a claim against an organisation for the repayment of funds previously advanced.
- Political costs- costs that groups external to the firm might be able to impose on the firm as a result of political actions.
- Accounting policy notes- notes showing accounting principles, bases of recognition and measurement rules adopted in preparing and presenting financial statements.
- Creative accounting- where those responsible for preparing accounts select accounting methods not objectively but according to the result desired by the preparers.
- Normative accounting theories- accounting theories that seek to guide individuals in selecting the most appropriate accounting policies.
- Current-cost accounting- a system of accounting that measures that value of goods and services in terms of their current costs.
- Continuously contemporary accounting (CoCoA)- a normative theory that proposes an approach to accounting that relies on measuring the exit prices of the entity’s assets and liabilities.

- Exit-price theory- normative theory of accounting that prescribes that assets should be valued on the basis of exit prices and that financial statements should function to inform users about an organisation's capacity to adapt.
- Capacity to adapt- a measure, promoted by Chambers, tied to the cash that could be obtained if an entity sold its assets.
- Current cash equivalents- represented by the amount that would be expected to be generated by selling an asset.
- Net selling price- the selling price of an item less the costs that are incidental to making the sale.
- Present value- the value of an item to be received or paid for in the future expressed it terms of its value today.
- Current replacement cost- a valuation method based on the current replacement cost of an item rather that its historical cost.