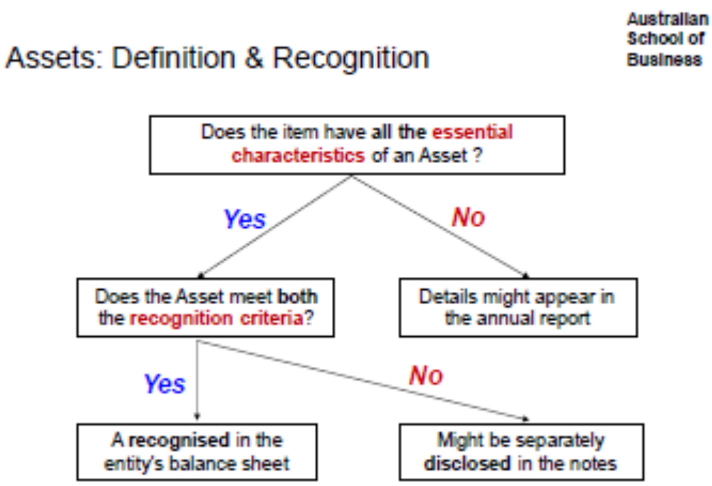
ACCT1511 Notes

1. Financial Reporting Principles and Accounting Standards

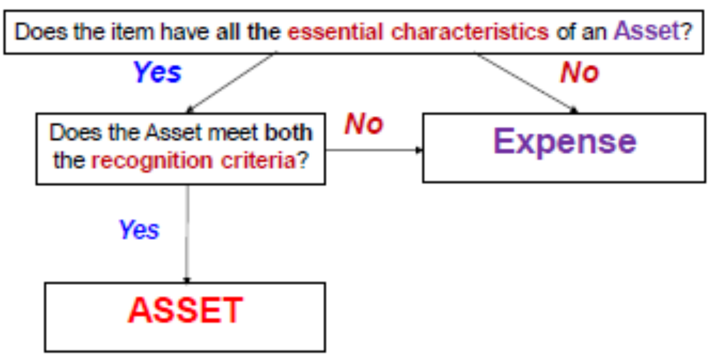
- **Rules-based accounting** relies on following a detailed set of rules while **principles-based accounting** relies on the ethical use of professional judgement to follow certain standards and principles
  - Although rules promote consistency in accounting methods as principles are more open to interpretation, having rules creates opportunities for financial engineering as managers may attempt to work around the rules
- The conceptual framework states the:
  - Objective of general purpose financial reporting
  - The qualitative characteristics that determine the usefulness of information in financial statements
  - The definition, recognition and measurement of the elements of financial statements
- The objective of financial reports is to provide financial information that is useful to investors, lenders and other creditors in making decisions about providing resources to the entity
- Financial information should be:
  - **Relevant**: capable of making a difference in the decisions made by users if it has:
    - Predictive value - helps users to predict the future
    - Confirmatory value - confirms something in the past
    - Or is material - omission or misstatement of information could influence the decision making of users
  - **Faithfully represented**: Information must be:
    - Complete: includes all necessary information
    - Neutral: free of bias
    - Free from error: no errors in the description of economic phenomena or processes used to produce the information
  - **Comparable**: information should be able to be compared across entities
  - **Verifiable**: ensures that information is faithfully represented
  - **Timely**: information must be provided early enough to allow for decisions to be made
  - **Understandable**: Reports should be prepared having regard to the ability of users to interpret the information
- There are tradeoffs between characteristics such as timeliness and verifiability, completeness and understandability
- Apply cost benefit test to determine if reporting financial information is justified
- **Key assumptions**:
  - **Going concern**: company will continue to exist in the foreseeable future
  - **Accruals concept**: incomes and expenses are recognised in the accounting periods to which they relate rather than on cash basis
  - **Matching principle**: expenses incurred must be charged in the accounting period in which revenue related to those expenses are earned
  - Conservatism/Prudence: requires caution in estimation to avoid overstatement of assets and income, or understatement of liability and expenses <u>no longer part of framework</u>

2. Assets: Application of Financial Reporting Principles (1)

- **Assets** are resources controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity - they must satisfy both the definition and recognition criteria to appear on the balance sheet
- Definition criteria:
  - Future economic benefit: **potential** to contribute to the flow of cash
  - Controlled by the entity: if benefits are controlled by entity, do not need legal control
  - Result of past events
- Recognition criteria:
  - **Probable** that future economic benefit will flow to the entity; do not confuse probability of future economic benefits with the potential for future economic benefits
  - Item has a cost or value that can be measured reliably; must be estimated in most cases



- Costs, assets and expenses are not the same thing:
  - Costs/expenditure refers to amounts paid for something
  - Assets and expenses are how we account for those costs
    - Not capitalise and record as expense: Cost > expense
    - Capitalise and record as asset: Cost > asset > expense



- **Intangible assets** are identifiable non monetary assets without physical substance
    - It must meet the definition criteria of assets
    - It must be identifiable - can be separated from the entity and sold, transferred, exchanged, etc.
    - Examples include patents, licences, copyrights, franchises and trademarks - financial instruments are not intangible assets
- If intangible assets are acquired: capitalise the cost and record an asset
- If intangible assets are internally generated: asset is classified into the
    - research phase: costs are expensed since entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits
    - development phase: costs can be capitalised
    - Brands, publishing titles, customers lists, etc cannot be distinguished from costs of developing the business as a whole and are never recognised as assets

- **Goodwill** is an accounting concept meaning the value of an entity over and above the value of its separate identifiable assets less liabilities because of reputation, customer loyalty, staff knowledge, etc
    - can only recognise acquired goodwill (amount paid for business - estimated market value of net assets)
    - internally generated goodwill is not recognised as its value cannot be measured reliably
- **Depreciation** is a process of systematically allocating cost over the useful life of the asset but it is not a method of valuation

3. Assets - Applications of Financial Reporting Principles (2)

- Methods of valuing assets:
    - **Historical cost** - amount paid for the asset or cost to develop it
    - **Market value** (fair value) - how much the asset is worth in the present if we sold or it bought it
    - **Value in use** (present value) - what the asset is worth to the company
    - Liquidation sale - what you could for the asset if you have to sell it really fast (less common and generally not used unless company is not expected to continue operations)
    - Price-adjusted historical cost - historical cost adjusted for inflation (generally only used when economy is experiencing hyper inflation)
- PPE: measurement at recognition is the value put on the asset when first recorded - measured at its cost, including:
    - **Purchase price** including import duties and taxes, etc
    - **Costs directly attributable** to bringing the asset to the location and condition necessary incl. employee benefits, site preparation, delivery and handling, installation, etc
    - Estimate of the cost of dismantling and removing the item and restoring the site on which it is located if and only if the company is required to do so
- PPE: measurement after recognition involves either using the cost model or the revaluation model
    - **Cost model** - PPE will be carried at its cost less accumulated depreciation and accumulated impairment (record asset at historical cost and then depreciate)
    - **Revaluation model** - if its fair value can be measured reliably, PPE shall be

carried at a revalued amount of its fair value at date of revaluation less accumulated depreciation and accumulated impairment (estimate fair value and depreciate asset based on fair value)
        - Must be done regularly (3-5 years)
        - May lead to an increment or decrement relative to carrying amount (cost less accumulated depreciation)
            - First time revaluing asset:
                - Increment - DR Asset, CR Revaluation Reserve (Equity on B/S)
                - Decrement - DR Loss on revaluation expense, CR Asset
            - Subsequent revaluations:
                - Increment reversing decrements: DR Asset, CR Gain on revaluation (until all losses are reversed), CR Revaluation Reserve
                - Decrement reversing increments: DR Revaluation Reserve (until zero), DR Loss on revaluation, CR Asset
        - Must be done as part of a whole class of assets (company cannot cherry pick assets to revalue)
        - Revaluation when depreciation is needed:
            - Update depreciation
            - Write down asset to its carrying amount: DR acc depr, CR asset
            - Record the increment or decrement
            - Recalculate the depreciable amount
        - Disposal of assets: amounts left in revaluation reserve is taken to retained earnings since net increments belong to previous periods but net decrements have already been included in retained earnings - record disposals as usual and then DR revaluation reserve, CR retained earning
- Intangible assets: measurement at recognition involves measuring at cost, including:
    - Purchase price
    - Directly attributable costs
    - For internally generated intangibles, the cost is the sum of expenditure incurred from the date when the intangible asset first met the recognition criteria (from development phase)
- Intangible assets: measurement after recognition involves either the cost or revaluation model
    - **Revaluation model** - active market must exist in order to determine fair value but intangible assets tend to be unique in nature
    - **Cost model** - intangibles are usually recorded using the cost model
- **Impairment** - entities need to check if there is any indication that asset values are overstated at each reporting date and if so, they must test for impairment
    - Indicators of impairment include declining market values, technological change, economic changes, damages, declining economic performance of assets
    - Test for impairment by comparing the carrying value of the asset with the highest value that we can get from selling or using the asset
        - Know carrying value of asset
        - Find recoverable amount of asset, which is the higher of: fair value less cost to sell, or value in use
            - Carrying < recoverable = not impaired

            - Carrying > recoverable = impaired
        - If impaired, write down asset's value:
            - Cost method: DR Loss in impairment, CR accumulated impairment
                - To reverse impairment loss: DR accumulated impairment, CR gain on reversal of impairment
            - Revaluation method: DR loss on revaluation, CR asset
                - To reverse impairment loss: DR asset, CR revaluation reserve or gain on revaluation
        - Impairment on goodwill can never be reversed
- **Inventory** should be measured at the lower of cost or net realisable value (market value)
    - Loss is recorded as an expense in the accounting period in which the write down occurs
    - DR inventory loss, CR inventory
- Relation to qualitative characteristics:
    - Historical cost - more reliable and harder to manipulate (faithful representation) but not as relevant
    - Revaluation - more relevant information than historical costs (relevance) but easier to manipulate and more open to judgement and distortions of management
    - Prudence/Conservatism - revaluation increments are not in income statement (does not overstate profit), test for impairment to ensure asset is not overstated, lower of cost or market value ensure that inventory is not overstated

<u>4. Liabilities - Application of the financial reporting principles</u>

- A **liability** is 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
    - Essential characteristics:
        - existence of a present obligation arising from a past event
            - obligation can be **legally enforceable** (binding contract/statutory requirement) or **constructive** (normal business practice, custom, to act in an equitable manner)
            - obligation must exist today
        - <u>potential</u> to result in an outflow of economic benefits; where the entity gives up resources
    - Recognition criteria:
        - **probable** that any future economic benefit associated with the item will flow from the entity (more than 50% chance)
        - item has a cost or value that can be **measured reliably**; estimates are allowed