University of Western Sydney

Advanced Accounting Notes

Unit 200267

2014

Chapters refer to the prescribed text: Rankin, M, Stanton, P, McGowan, S, Ferlauto, K & Tilling, M 2012, Contemporary issues in

Advanced Accounting

Topic: Introduction to advanced accounting

Chapter 1

What is theory?

Theory helps explain a phenomena, a situation etc. It helps explain an opinion.

Positive theory	Normative theory
- Describes - Explains - Predicts - Uses deductive reasoning	- Suggests - Recommends - Uses inductive reasoning (this is the type of reasoning accountants tend to use)

Why do we use theories in accounting?

In accounting we use theories for the following reasons:

1) To explain what is happening in the accounting practice
2) To describe what is happening in the accounting practice
3) To predict what may happen in the accounting practice
4) Recommend or suggest what should happen in the accounting practice

Positive theory explained

Positive research seeks to predict and explain particular phenomena. The associated theories of positive research are positive accounting theories (PAT). Positive theories are developed through some form of deductive logical reasoning. Thus, the explanation and prediction of particular phenomena is assessed based on observation – that is observing how the theory's predictions correspond with the observed facts.

Normative theory explained

Normative theories prescribe particular actions. It is based on what the researcher believes should occur in particular circumstances. As it is not based on observation it cannot be evaluated on whether they reflect actual accounting practice. They may rather suggest radical changes in the way things are done.

<u>Topic: The Conceptual Framework</u>

<u>Chapter 2</u>

<u>What is the Conceptual Framework (CF)?</u>

The CF is a set of guidelines we use as accountants to prepare financial reports. The CF is a normative theory, which is used to apply theory to practice. It consists of a coherent system of concepts, which are guidelines to the accounting standards used for financial reporting.

Under paragraph 12 of the CF, talks about "helping users make useful decisions", this is known as the *decision usefulness theory*, which explains how it helps stakeholders make decisions about organisations.

<u>The CF as normative theory</u>

The CF is a normative theory in that it seeks to guide individuals in selecting the most appropriate accounting policies for given sets of circumstances. The CF is seen as a normative theory in that it provides guidance on how assets, liabilities, expenses, income and equity should be defined recognised and measured.

<u>Difference between CF and Accounting Standards</u>

Conceptual Framework	Accounting Standards
- Designed to provide guidance and apply to a wide range of decisions - Concerned with General Purpose Financial Statements (GPFSs)	- Specific requirements for a particular area - May go beyond the CF - Are mandatory - Sometimes conflict with the framework

Note: The CF is used as guidance for setting Accounting standards.

<u>Structure and components of the CF</u>

What is the purpose of financial statements?	-Concerned with GPFS - prepare financial information useful to existing and potential investors, lenders and other creditors in making decisions. - FSs should provide information that: • Help predict the future • Provide feedback on previous decisions • Accountability and stewardship
Who are they prepared for?	- Existing and potential investors - Lenders - Other creditors

What assumptions are to be made when preparing financial statements?	- Normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future
What type of information should be included?	Fundamental qualitative characteristics: - Relevance - Faithful representation Enhancing qualitative characteristics: - Comparability - Verifiability - Timeliness - Understandability
What are the elements that make up financial statements?	- Assets - Liabilities - Equity - Income - Expenses
When should the elements of financial statements be included?	The elements should be included if they meet the two criteria below: - Probability; and - Measurability

Pros and Cons of the CF

Benefits	Problems and Criticisms
- *Technical benefits*: • Basis for setting accounting rules • Helps individuals prepare, audit or use FSs - *Political benefits*: • Prevents political interference in setting accounting standards - *Professional benefits*: • Protects the professional status of accounting and accountants	- Its ambiguous, principles can be too vague therefore leaving room for alternative interpretations - Its descriptive not prescriptive - The concept of faithful representation is inappropriate • *Realist view*: FSs are representationally faithful as long as they provide and objective picture of an entity's resources • *Social constructionist view*: although the world is as it is, we as accountants information and therefore create reality.

True and fair view in accounting

- P 1.1: AASB 101 paragraph 15; tells us that FSs shall present fairly the financial position performance and cash flow of the entity.
- The Australian Corporations Law s297, 295 paragraph 3 part c; talks about faithful representation
- The CF: Qualitative Characteristics; faithful representation

What is the decision usefulness theory and why is it such an important theory?

The CF defines the objective of decision usefulness theory that financial information about the reporting entity is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

This is an important theory in that it helps provide information useful to users in making decisions. The decision usefulness theory helps us to predict what may happen in the future although financial statements do not necessarily provide information in relation to the future; they help users make predictions upon these. This theory also helps provide feedback on previous decisions. Information in financial statements can help decide whether past decisions were correct and the information used to make those decisions where appropriate. Thus this helps users to assess whether better decisions can be made in the future.

Topic: Measurement issues and the theory of decision usefulness

Chapter 4

Supporting evidence: Whittington Article

Why do we measure things?

To provide information for users to make decisions.

What theories link to measurement?

- Decision usefulness theory
- CF as a normative theory

What is measurement issues facing accountants?

There are a number of measurement challenges that accountants face especially when accounting for social and environmental aspects of accounting. The three key issues surrounding measurement in a social and environmental perspective:

- What needs to be measured and accounted for?

- How can discretion and subjectivity associated with the estimation of values be managed?
- What are the consequences associated with accounting for social and environmental aspects of the entity.

One of the most significant challenges is coping with measurement in the context of accounting for green assets and other environmental and sustainability issues. Challenges lie in the measurement issues and controversy surrounding how intangible assets are accounted for. Challenge is how to measure and account for water as a limited natural resource with a view to sustainability.

How can theories help us resolve these dilemmas?

Should our CF and standards allow choices of measurement methods?

How does this choice of measurement methods connect to ideas of decision usefulness?

The measurement methods used to produce accounting information impact on the quality and thus usefulness of accounting information The decision usefulness theory is of significance as financial statements produced containing good quality information will enable users to make appropriate decisions in order to fulfil the decision useful objective. However, poor quality information could potentially mislead users and lead them to make inappropriate decisions. This in effect will give the impression that management has not performed to the best of their abilities and have not managed the resources of the entity effectively and efficiently. Therefore, it is crucial to provide information using measurement methods that is both beneficial to users and accurately depicts the performance of management.

How do we measure patents (i.e. intangible assets)?

Cost approach is the best valuation technique for patents. Intangible assets use estimation valuations to measure them.

Topic: Measurement: The Fair Value debate

Chapter 10

Supporting evidence: L & L article 2009

Fair value vs historical cost

Main two types of measurement:

Fair value	Historical cost
Advantage - Relevant (as it based on present value)	Advantage - Comparable - Reliable (since asset price cannot be changed)
Disadvantage - Problems with reliability: as the market changes - Involves subjectivity in tier 2 and 3 - Tier 1 does not always work because of inefficient markets	Disadvantage - Problems with relevance

3 tiers of Fair value

Tier 1	Active market: use active market price
Tier 2	Adjust: if no active market then look at a similar assets to set price
Tier 3	Estimate: use calculator to put a value to that asset e.g. intangibles, biological assets etc.

Why is the fair value debate so important?

The fair value debate has become important as a result of the GFC. Standard setting has moved increasingly towards the use of fair value. Current accounting standards allow a range of measures – mixed measurement system and this is likely to change. It is important to be aware of the strengths and weaknesses of fair value accounting (FVA) as the increased adoption of FVA is likely to affect the future careers of accountants.

Arguments for and against fair value

FOR	AGAINST
- Faithful representation – quoted market price set by forces outside the entity for tier 1 - Relevant – useful, how much we pay or receive for an item now is relevant	- Ignores the going concern assumption – measures values as though the entity was intending to sell off all assets and liquidate - value depends on circumstances e.g.

to decision to buy or sell…timely - Understandable – easy concept to grasp, amount to be received if item was sold. What the item is worth from a market perspective. However, not so easy for tier 2 and 3 - Comparable between entities, determined at the same point in time	current market conditions - specialised assets – not bought and sold on an active market, unique with no value other to entities - measured at current date – influenced by short term - subjective – for items with no active market, we form an estimate of fair value - market prices – represent expectations, expectations based on predictions, predictions may not be correct = volatility in market prices caused by market corrections

Fair value valuation techniques

Market approach: based on the ability to identify a market for an identical or comparable asset or liability.

Income approach: based on converting future cash flows or income and expense into a single present value.

Cost approach: based on an estimate of the cost of replacing the 'service capacity' of the asset under consideration. Known as the current replacement cost in accounting theory.

What is information asymmetry?

This is where managers possess more information about current and future prospects of an entity than people external to the entity for example investors. Therefore, since managers can choose when and how to communicate this information, this creates volatility in the market.

PAT theory suggests that managers who have possession of this information, are given the incentive to disclose this information in the form of good or bad news to the market, which further supports the volatility of the market and impacts upon the decisions of external stakeholders to entity in that it directly affects market speculations.