

THE UNIVERSITY OF NEW SOUTH WALES

SCHOOL OF ACCOUNTING

ACCT 3563 ISSUES IN FINANCIAL REPORTING AND ANALYSIS

SESSION 2 2005

OBJECTIVES

This subject deals with issues in general purpose financial reporting by listed public companies and similar entities. It is intended for students majoring in accounting who will be involved in the preparation or use of corporate financial statements whether as accountants, financial executives, taxation officers, auditors, financial analysts, or legal advisors.

ACCT2542 Corporate Financial Reporting and Analysis, the prerequisite for this subject, dealt with corporate accounting and the preparation of financial statements by complex organizational designs controlled by a parent company. ACCT 3563 extends what you learnt in ACCT 2542 and in previous accounting subjects by covering more complex financial accounting problems and reporting issues that may be currently controversial. These reporting issues concern important questions about the identification, recognition and measurement of assets, liabilities, revenues or expenses; whether accounting information is useful to investors; and the role of accounting information in contracting between corporate stakeholders.

Some of the more complex accounting problems to which these reporting issues relate include accounting for leases, foreign currency transactions and hedging, financial derivatives, hybrid instruments, accounting in the extractive industries, expanded disclosure regimes, and accounting issues arising from recent corporate failures.

A major theme running through ACCT 3563 is that students should know not only the practical bookkeeping aspects of financial reporting topics but also the underlying conceptual (theoretical) issues and the political and economic forces that shape regulatory and corporate responses to them. The recent collapses of Enron and Worldcom in the USA, and HIH and One.Tel in Australia emphasise the importance of this theme. Different theoretical perspectives on accounting issues are presented, in particular agency theory and the conceptual framework/accounting standards perspectives. Students will be expected to understand, explain and critique both perspectives' views about accounting issues in the Course.

From 1 January 2005, Australian companies are required to prepare their financial reports in accordance with International Financial Reporting Standards [IFRSs]. This is a major change for Australian business. Australian regulators have not simply adopted IFRSs but have introduced versions of these IFRSs - aspects of which will be covered in relevant topics in this course.

LEARNING OUTCOMES

At the completion of most topics covered in ACCT 3563, students should understand the following in relation to that topic:

- a) Whether an asset, liability, revenue or expense exists for accounting purposes, as per the Conceptual Framework and the IASB-based Australian accounting

- standards;
- b) whether these elements should be recognised (disclosed in financial statements) or disclosed by way of footnote only;
 - c) what measurement method(s) are used;
 - d) practical bookkeeping and display techniques appropriate to various types of transactions referred to in a topic;
 - e) what political forces appear to have shaped relevant accounting standards and other regulations, including the role of the international harmonisation programme;
 - f) what factors appear to motivate companies in the way they actually report financial information about the topic;
 - g) whether information provided in financial statements is useful to equity stakeholders and other stakeholders.

Better students will be able to synthesize or identify interrelationships between each of these learning attributes, and will be able to integrate knowledge across topics

COURSE WEBSITE

There is a website for this subject on WebCT. The website will contain the Course Outline, Tutorial Programme, a staff listing, and hotlinks to useful support resources. During session, lecture notes and tutorial solutions, and various announcements will be posted progressively on the website, together with relevant past examination papers. The solutions to questions a week's tutorial will be placed on the website. Students must download these solutions from the website and bring them to class. Students will be expected to attempt all questions before each tutorial.

EMAIL

Each UNSW student has an email account based on his/her student number, i.e. zstudentnumber@student.unsw.edu.au. It will be used if staff should wish to directly communicate with students, for example to notify them that they have been granted a supplementary exam. Please check your email account regularly. Other email addresses such as Hotmail, Yahoo, Optusnet, or Ozemail will **not** be used. Students should observe correct protocol in sending emails to staff. Emails to staff should contain your name, student number and your tutorial number and time. Emails without this information will not be answered.

TEXT BOOKS: students are expected to have copies of the following:

- 1) Deegan, C., *Australian Financial Accounting*, 4th edition, McGraw-Hill, 2005.
- 2) Whittred, G, I Zimmer, S. Taylor and P. Wells *Financial Accounting: Incentive Effects and Economic Consequences* 6th Edition, Thomson, 2004
- 3) *ACCT 3563/3573 Supplementary Materials*, School of Accounting, 2005

The 4th edition of Deegan covers the new Australian accounting standards operative

from 1 January 2005. Do not buy second hand copies of the 3rd edition of Deegan because it does not cover the new accounting standards introduced from 1 January 2005. Second hand copies of Whittred 6th edition may be bought, if available. For the Supplementary Materials, only purchase the 2005 version, not earlier years.

RECOMMENDED REFERENCE BOOK – Many weeks' readings contain references to new AASB standards introduced on 1 January 2005. You are not expected to know all the details of these standards, only those details highlighted by your lecturers and tutors. However, you may wish to buy this reference book, which contains the new standards:

CPA Australia *Accounting Handbook 2005, Volume 1* Prentice Hall, 2005

Note about *Accounting Handbook*: The Australian Accounting Standards Board allows free downloading of the new AASB accounting standards, Conceptual Framework documents, Policy Statements and exposure drafts from the AASB's website (www.aasb.com.au – under AASB Standards 2005).

Useful websites:

School of Accounting, UNSW www.accounting.unsw.edu.au

University of NSW www.unsw.edu.au

The Australian Accounting Standards Board: www.aasb.com.au

The Institute of Chartered Accountants in Australia: www.icaa.org.au

Australian Society of CPAs: www.cpaaustralia.com.au

The International Accounting Standards Board: www.iasb.org.uk

Australian Securities and Investments Commission: www.asic.gov.au

Australian Stock Exchange: www.asx.com.au

Financial Accounting Standards Board: www.fasb.org

Australian company annual reports are available from the Connect 4, Datanalysis and Mergent Online databases on Sirius in the UNSW library website (www.library.unsw.edu.au), and also from www.EquitiesInfo.com.au

OTHER REFERENCE BOOKS: (Students should not purchase these as all are held on Open Reserve, Main Library)

- 1) Alfredson, K, K. Leo, R. Picker, P. Pacter, J. Radford *Applying International Accounting Standards* John Wiley 2005
- 2) Belkaoui, A.R. and S. Jones, *Accounting Theory 2nd Australian Edition*, Academic Press, 2000, chapter 5 on the Conceptual Framework.
- 3) Brealey, R.A. and S.C. Myers *Principles of Corporate Finance* (latest edition, McGraw Hill, chapters on leasing, options, and hedging
- 4) Godfrey, J., A. Hodgson, S. Holmes, *Accounting Theory*, 5th ed. (Wiley, 2003).
- 5) Henderson, S., and G. Peirson, *Issues in Financial Accounting*, 9th ed., Longman, 1999 and 10th ed. 2002.
- 6) Jubb, P., I. Langfield-Smith, and S. Haswell *Company Accounting*, 3rd ed Nelson

- 2000
- 7) Leo, K.J., and J.R. Hoggett, Company Accounting in Australia, 5th ed., Wiley, 2001 and 4th ed. 1998.
 - 8) Leo, K.J. and J. Radford (eds) Financial Accounting Issues, 2nd ed. Wiley 1999.
 - 9) Nobes, C., and R. Parker (eds) Comparative International Accounting, 6th ed., Prentice Hall, 2001, and 5th ed. 1998.
 - 10) Peirson, G, R. Brown, S. Easton and P. Howard, Peirson and Bird's Business Finance 7th ed., McGraw-Hill 1998 (chapters 16 [leasing], 18 [futures contracts] and 19 [options], and 21 [international financial management])
 - 11) Scott, W.R. Financial Accounting Theory Prentice Hall 3rd ed. 2003

WORKLOAD EXPECTATIONS

It is expected that you will spend at least ten hours per week studying this course. This time should be made up of attending classes, reading, research, working on exercises and problems, performing internet searches. In periods where you need to complete assignments or prepare for examinations the workload may be greater.

Over commitment has been a cause of failure for many students. You should take the required workload into account when planning how to balance study with employment and other activities.

ASSESSMENT

The weighting of your total (composite) mark will be as follows:

Mid-session test in Week 8 (multiple choice held during normal lecture period - 90 minutes)	20
Final Examination (3 hours)	40
Group assignment (to be submitted in class in week 14)	30
Group presentation mark	10

	100
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Students must have a satisfactory performance in each component of their assessment, or they may fail the subject (they will be given a UF grade) even if their composite mark is greater than 50.

MID-SESSION TEST – WEEK 8 (20 MARKS)

Scope and Objective:

The scope of the mid-session test will cover the materials in weeks 1 to 6. The purpose of the mid-session test is to test students' knowledge midway through the course and provide timely feedback of their progress at that point.

Time and Venue:

The mid-session test will be held during the normal lecture period in ***Week 8*** covering materials canvassed in ***Weeks 1 to 6***. Further details will be provided later. The actual test will be of ***90 minutes duration including 10 minutes reading time***.

FINAL EXAMINATION (40 MARKS)

Scope:

The final examination will mainly cover the materials in weeks 7 to 13 but may also include materials in lectures 1 to 3. More information on the structure of the mid-session test and the final examination will be provided later. Students should note that there is some change in the course content from Session 1 2005 so that reliance on past papers is not advisable.

Time and Venue:

The final examination will be run in the examination period after the end of the session. It is your responsibility to find out the day, time and location of the final examination from the UNSW website.

GROUP PRESENTATION 10 MARKS

Groups of 2 students will be formed in the first lecture. It is your responsibility to ensure that you are part of a group. Groups will be assigned specific questions. The group will present an answer to the assigned question. Each group has 10 minutes for the presentation and critical analysis.

GROUP ASSIGNMENT (SUBMITTED IN CLASS WEEK 14 - 30 MARKS)

This project will be completed in ***groups each of 2 students***. The assignment is aimed at the analysis of a financial report and the restructuring of elements of the financial report to conform to current accounting standards. The financial report is that of Brian McGuigan Wines Limited for the year ended June 30 2001. Issues relating to this report will be discussed during the lecture period and students are free to ask any questions relating to the financial report during class. The submissions of students will be in the form of a report with a covering letter to the lecturer as an investor and signed by the group members as investment analysts.

SUBJECT PRIZE

As the financial report being analysed is that of a wine company, Brian McGuigan Wines Limited, George Merlot of Rattling Good Reds Limited has kindly donated a prize to the student attaining the highest overall mark in the subject. The prize will be in the form of a bottle of red, white or sparkling wine (or other selected by the student), with the

appellation to be determined by the sponsor.

AVOID PLAGIARISM AND OTHER FORMS OF ACADEMIC MISCONDUCT:

The following is from the Faculty's website at www.fce.unsw.edu.au/current_students/

“Plagiarism entails taking and using as one's own, the thoughts or writings of another without acknowledgement including:

- a) where paragraphs, sentences, a single sentence or significant part of a sentence which are copied directly, are not enclosed in quotation marks and appropriately footnoted;
- b) where direct quotations are not used, but ideas or arguments are paraphrased or summarised, and the source of the material is not acknowledged either by footnoting or other reference within the text of the paper; and
- c) where an idea, which appears elsewhere in print, film or electronic medium, is used or developed without reference being made to the author or the source of the idea.”

In addition, “Plagiarism involves using the work of another person and presenting it as one's own. Acts of plagiarism include copying parts of a document or audiovisual, or computer based material without acknowledging and providing the source for each quotation or piece of borrowed material. Similarly, using or extracting another person's concepts, experimental results or conclusions, summarising another person's work or, where there is collaborative preparatory work, submitting substantially the same final version of any material as another student constitutes plagiarism. Moreover, encouraging or assisting another person to commit plagiarism is a form of improper collusion and may attract the same penalties.”

Students caught committing plagiarism in their group assignment will be severely penalised. **They will be given zero marks for that component of the subject and they may fail the subject.** Further action will be taken in serious cases, which could result in the student being excluded from the University for one or more Semesters. See following section on “Academic Misconduct”.

Relevant material about academic misconduct has been placed under the tab for “Current students” at: www.fce.unsw.edu.au/current_students/responsibilities.shtml All students should read the material on this website.

ACADEMIC MISCONDUCT

Students are reminded that the University regards academic misconduct as a very serious matter. Students found guilty of academic misconduct are severely penalised. The penalty depends on the seriousness of the misconduct but can range from a reduction in marks, failing the subject, to exclusion from the University for a semester or permanently.

The University's official policy on Academic Misconduct states: "The following are important examples of the actions which have resulted in students being found guilty of academic misconduct in recent years:

Misconduct concerning examinations has included taking unauthorised materials into an examination; impersonation in examinations; permitting another student to copy answers in an examination; exchanging notes between students in an examination; improperly obtaining prior knowledge of an examination paper and using that knowledge in the examination; and removing an examination paper from an examination room when it is specified that the paper is not to be retained by the student;

Misconduct concerning academic works has included failing to acknowledge the source of material in an assignment; quoting without the use of quotation marks even if the source is acknowledged; plagiarism; and submitting work for assessment knowing it to be the work of another person."

SUPPLEMENTARY EXAMINATIONS AND SPECIAL CONSIDERATION

Students who believe that their performance in this subject, either during session or in an examination, has been adversely affected by sickness, misadventure or other circumstances beyond their control may apply for special consideration for affected assessments.

Such applications should be submitted to the Registrar and Deputy Principal (at the student centre) as soon as practicable after the occurrence of a problem and, in any event, not later than seven days after the final examination in this subject.

Dates of Supplementary Examinations:

Students may be required to sit for an oral or written supplementary examination. Dates of supplementary Final Examination will be advised and, in general, will be offered only to a student who has been prevented by some major catastrophe (such as kidnapped by aliens) from taking the Mid-Session Test or Final Examination (as the case may be) or who has been placed at a serious disadvantage during the examination, and whose circumstances have improved considerably in the period since the relevant examination was held. Failure to attend a supplementary examination, if you have been granted one, will result in forfeiture of any additional assessment granted to you.

Note: If granted a supplementary exam, you will be notified **by email** using your zstudentnumber@student.unsw.edu.au email address, so please consult that email address. Any other email addresses you may have, such as Hotmail, Ozemail, Optusnet, or Yahoo, will **not** be used for these notifications. Notification by letter in the post will not occur. Students will not be granted another supplementary exam because they did not access their university email.

CLASS ARRANGEMENTS

Students are expected to attend the lecture/tutorial each week.

STAFF AND CONSULTATION

Brian Booth (part-time), Room Quad 3113, Phone 9385 5907, Email b.booth@unsw.edu.au. Consultation times will be posted on WebCT.

ADVICE TO STUDENTS

How to study this subject

ACCT 3563 covers many topics and there is a lot of set reading, including technical material from accounting standards. To assist your studies, the following advice is offered. Do the following in the order shown:

- a) ***Attend all lecture/tutorials and take notes.*** Lecture notes and handouts will be posted on the Course website, but they will **not** contain everything the lecturer says. In preparing for exams, note which aspects of each topic the lectures cover and/or the lecturer has emphasised. It is surprising how many students do not follow this simple advice, and thus put themselves at a disadvantage.
- b) Make sure you ***attempt and understand*** the answers to **all** the questions set. Answers to questions will be posted on the course website before the relevant tutorial, and students must download these and bring them to their tutorial. It is not enough to simply read the answers.
- c) ***Read the textbook readings.*** The textbooks by Deegan and by Whittred, Zimmer, Taylor & Wells cover the factual material on accounting topics quite well. Students sometimes complain that with two textbooks there is too much reading. However, the advantage of two books is that two different perspectives are brought to bear on many topics, which should assist students' learning. Your two textbooks adopt quite different theoretical positions on accounting issues covered in the Course.
- d) ***Read the remainder of the set reading.*** Do not neglect the items in the Supplementary Materials as exam questions are often based on them.
- e) Closer to the exam date(s), work through specimen mid-session test and final examination questions, which will be posted on the Course website. The format and content of these specimen papers, however, are only a guide.
- f) Study the subject consistently throughout session and do not leave it until the last minute to study for the exams. Many topics in the course are very intellectually demanding and cannot be successfully crammed in the last few days before the exams.
- g) You must be able to explain the differences between theoretical positions when they arise in various topics.
- h) Students will benefit if they read articles in the financial press pertaining to company earnings, company failures and related announcements (which may refer

- to accounting techniques used by companies).
- i) As ACCT 2542 is a prerequisite for this subject, it is assumed that students have a practical grasp of basic company accounting (including consolidation accounting) and an understanding of the assumptions underlying the characteristics and recognition of the elements in financial statements. Students who do not feel confident that they do should re-study the relevant parts of their ACCT 2542 textbooks.

WZT

The Whittred book focuses on the economic consequences of accounting policy choices. It is based on an agency theory/costly-contracting perspective (see Preface page xii), which strongly influences the book's attitude to accounting policy choices, accounting standards and regulation. In a nutshell, its theoretical stance is that private contracting between stakeholders in a firm will produce the optimum accounting solution for that firm, in terms of reducing agency costs and providing decision useful information to stakeholders. Accounting standards can in some cases upset that equilibrium and thus be suboptimal. The formulation of new accounting standards aimed at improving financial reporting or covering emerging financial reporting issues is outside the scope of the book (see page 52). That is, in Whittred, regulators exogenously determine new accounting standards, and the book sometimes offers little guidance on the *a priori* theoretical correctness of accounting standards. Whittred does have a good summary of empirical research on accounting choices, and its end of chapter exercises are excellent. References to Australian accounting standards in Whittred are out of date after 1 January 2005 and should be ignored

Deegan

In contrast, the Deegan book adopts a more eclectic approach. Although it covers agency theory, it also examines accounting issues from the perspective of their consistency with accounting standards and the conceptual framework and it suggests ways in which the standards and practice can be improved. The economic consequences of accounting choices are just one of many factors that standard setters must allow for in standard setting. Deegan's approach assumes that private contracting will not always result in the best solution to an accounting issue. Sometimes there will be "market failures" which can only be remedied by new regulations such as accounting standards. Deegan also covers the new accounting standards regime introduced 1 January 2005

STUDENT SUPPORT:

The University provides a number of student support services to assist students who have difficulties. These services include:

Education Development Unit

Additional learning support, tailored to the needs of FCE students, is available from the

Education Development Unit (EDU) in the Faculty. The EDU offers a range of services for FCE students including academic skills workshops run throughout the session; printed and on-line study skills resources e.g. referencing guide, report writing and exam preparation; a drop-in resource centre containing books and audio visual material that can be borrowed; and a limited consultation service for students with individual or small group learning needs. More information about the EDU services including on-line resources, workshop details and consultation request forms are available from the EDU website. EDU services are free and confidential and are available to students of the Faculty of Commerce and Economics. Contacts and location:

EDU Web: <http://education.fce.unsw.edu.au> EDU Location: Room 2039, Level 2 Quadrangle Building

Other UNSW support

In addition to the EDU services, the UNSW Learning Centre provides academic skills support services for students. The Learning Centre is located on Level 2 of the Library and can be contacted by Phone: 9385 3890 or through their website: <http://www.lc.unsw.edu.au/>. Students experiencing problems of an academic or personal nature are encouraged to contact the Counselling Service at UNSW. This service is free and confidential and run by professional counsellors. The Counselling Service is located on Level 2, Quadrangle East Wing, and can be contact on 9385 5418. **The Student Support Officer** for the Faculty of Commerce and Economics provides assistance to students on probation or referral, AusAID scholarship holders and other students experiencing difficulties. The Faculty's Student Support Officer is Julie Vivas, in John Goodsell G17 (phone 9385 3754; fax 9385 2947; email J.Vivas@unsw.edu.au). Students with disabilities or other equity issues should contact the University's Equity and Diversity Unit located in the Applied Sciences Building on lower campus (www.equity.unsw.edu.au).

ACCOUNTING STUDENT SOCIETIES.

You are encouraged to join one of the student societies run by the Institute of Chartered Accountants in Australia (www.icaa.org.au) and by CPA Australia (www.cpaaustralia.com.au). Their websites contain useful information for students such as technical material on accounting standards and study resources.

SUMMARY OF TOPICS

WEEK 1

Nature and objectives of external financial reporting

- a) Economic activities and stakeholder relationships
- b) Responsibilities and ethics of directors and auditors
- c) Constraints on financial reporting
- d) Constraints on management policy choice
- e) Scope and objectives of financial reporting

Reading

- a) Deegan: Ch 1, Ch 2 pages 96-98
- b) Henderson & Peirson *Issues in Financial Accounting* 10th ed. Ch. 31 “Ethics in Accounting” extracts
- c) Peter Vardy and Paul Grosch *The Puzzle of Ethics* pp 36-50.
- d) Aristotle *Nichomachean Ethics* Extracts on Moral Virtues and Justice.

Assignments

Question 1 - Whittred et al E1-2 (Policy Choice):

Assume that the acquisition costs incurred directly relate to and are necessarily incurred in the acquisition of the property. Assume also that an independent value of the property in its intended use is land \$8,000,000 and buildings \$12,000,000. Which of the proposed alternatives are available to management? Set out the journal entries for the available alternatives.

Question 2 - Deegan Ch 1 Question 23:

Some facts relating to the “Minsec” Case are of interest. On January 25 1971, for the half-year ended December 1970, the directors of Mineral Securities Australia Limited announced a profit of some \$3.35 million. On February 4 1971, the directors withdrew the statement of January 25 and announced that the result for the half-year was actually a loss of \$3.28 million. No financial statements had been prepared by the group. The results were announced on the basis of preliminary calculations. In the period to the date of the trial, no financial statements were prepared for the half-year. Under cross examination, the auditor of the group conceded that a profit for the period of some \$10 million was possible.

In relation to PacDun, any prosecution would have to prove that the asset, goodwill on acquisition, would have to be consumed in operations in a particular pattern. How is such a proof likely?

What have the two cases got to do with each other?

Question 3 - Deegan Question 9:

Question 4 - (Policy Choice):

“Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial reports.” AASB 108 para 5

Required:

- a) Distinguish between mandatory and discretionary policies.
- b) Outline some of the policies in which directors are able to exercise discretion in accounting for property, plant and equipment and those that are mandatory.

Question 5 - (Points from Published Financial Statements – Asset Stripping)

In May 1980, a company (A) acquired the assets and assumed the liabilities of Pauls Home Centre Pty Limited (PHC) for a consideration of \$917,136. For the period July 1 1979 to May 12 1980, the following financial statements were prepared for PHC:

Income Statement for the Period July 1 1979 to May 12 1980

Net profit after tax	\$403,445
Less income tax expense	-

Net profit after tax	403,445
Add retained profits July 1 1979	413,689

Profits available for appropriation	817,134
Less dividends proposed	-

Retained profits May12 1980	\$817,134
	=====

Balance Sheet as at May 12 1980

Assets	
Accounts Receivable – A	\$917,136
	=====
Capital and reserves	
Share capital	\$100,002
Retained profits	817,134

Total capital and reserves	\$917,136
	=====

Attached to these statements was an audit certificate in which it was stated that as the profit and loss statement “is for a period other than year end, no provision for income tax has been raised”.

On the basis of these statements, on May 12 1980, the following steps were taken:

- a) The shareholders of PHC borrowed \$881,018 from a finance company (F) and paid the money to A together with an additional amount of \$36,118 as a loan to the company.
- b) A then drew a cheque for \$917,136 and paid the amount owing to PHC.
- c) PHC then drew a cheque for \$917,136 in favour of Lockwing Pty Ltd (L) as an advance to that company.
- d) L then drew a cheque for \$917,136 in favour of Shareholder Pty Ltd (S) as an advance to that company.
- e) S then drew a cheque for \$885,068 (\$881,018 + \$4,050 in “facilitation” charges to acquire the shares in PHC from the shareholders of A, with the cheque payable to the finance company.
- f) S then drew cheques for the balance of \$32,068 in favour of the promoters of the “scheme”.

All cheques were drawn at the same time.

Assume a tax rate of 46%, and that the reported profit of PHC was fully taxable. Assume also that L and S had no other substantial assets.

Required:

- a) Prepare journal entries to account for the cheques payable under the scheme.
- b) What are the benefits of the scheme to the various participants? What assets do the various companies end up with?
- c) Do you agree the opinion expressed by the auditor that no provision for income tax was required since the financial report was prepared for “a period other than year-end”? Set out clearly the reasons for your opinion, referring to accounting standards in your answer. Is the provision a matter of managerial choice?
- d) Assume that the auditor and directors stated that no provision for income tax was necessary in the case of PHC since a scheme existed to “annihilate” any possible income tax liability before June 30 1980. If such a scheme existed, would this cause you to change your answer to Question (c)? Why?
- e) Assume that the suggestion was made that the financial report prepared for PHC was a specific purpose report, since it was prepared solely for the use of the director-shareholders. Would you agree with this suggestion, with the implication that the financial report did not have to be prepared in accordance with applicable accounting standards?*
- f) Some have suggested that the real promoters of schemes such as this are the professionals who prepare the financial reports, deleting the income tax provision,

and who give advice on the income tax implications. Do you agree? Why?

Question 6 - (Money Laundering Transactions)

The following data is based on an actual case. In 20X0, a client approached a senior partner of a “Big 4” accounting firm in Hong Kong seeking a satisfactory resolution to the following problem:

- a) The client wished to transmit the equivalent of AUD 4,000,000 to a company in Australia.
- b) The transmission had to be in a form in which it was not apparent that the money was being transmitted.
- c) Any transactions were also to be carried out in such a manner that the identity of the client could not be easily ascertained.

As a solution to this problem, the partner put in place the following mechanisms:

- a) The cash was deposited in a Trust, which was set up for the specific purpose.
- b) The Trustee of the Trust was an entity, which acted under the direction of the accounting firm.
- c) The cash settled in the trust was placed in a “blocked deposit” in a Hong Kong bank at an interest rate of 7.2%.
- d) The partner of the accounting firm drafted the necessary forms, which were to be used by the Australian company of the client to apply for a loan of AUD 4,000,000 from the Singapore branch of the Hong Kong bank.
- e) The loan was approved by the Singapore bank at an interest rate of 8%, with the loan and interest secured by a guarantee against the “blocked deposit” and interest payable by the Hong Kong bank.
- f) Any interest paid by the Australian company was subject to a withholding tax rate of 10%.

No interest was actually paid by the Australian company, although the company’s accounts record such payments. No withholding tax was actually remitted by the Australian company. The Singapore bank “collapsed” the interest receivable on the loan against the interest payable on the blocked deposit and, eventually, the loan itself against the blocked deposit.

Required:

- a) Do the mechanisms, which were set in place by the partner, “satisfactorily” resolve the dilemma of the client?
- b) What are the effects of these transactions on the Australian company?
- c) What is the effective risk of the bank in these transactions?
- d) The cash placed on blocked deposit in Hong Kong came from the proceeds of drug dealing. Could it be inferred that the partner was a willing and active participant and beneficiary in drug dealing activities?

WEEK 2

Behavioural and Stakeholder Perspectives

- a) Agency relationships
- b) Positive and normative theories
- c) Evidence of the association between agency costs and external financial reporting
- d) Dependence of financial contracting on accounting information
- e) Choice of accounting methods by companies
- f) Critique of positive accounting theory
- g) Stakeholder perspectives

Reading

- a) Reading: Deegan: 4th ed. Ch 2, sections 2.1 – 2.5 (pages 76-101, 118) pages 108-117
- b) Whittred et al., Ch 1.

Assignments

Basic Concepts

- a) Deegan Ch 2: Questions 18, 19 and 27
- b) What are the main types of agency costs and what mechanisms can be put in place to completely eliminate such costs? How can accounting information reduce agency costs?
- c) What are some of the often conflicting general and situational ethical and operational interests of management? How are these conflicts resolved?
- d) Distinguish between opportunistic and efficiency perspectives in Positive Accounting Theory and give an example of each.

Application of Concepts

Question 1: (adapted from Revsine et al 2002)

Suppose you and two friends each invested \$1,000,000 in an oil and gas exploration limited partnership. The general partner, Hugh Gamble Ltd, made no equity investment but was responsible for management of the partnership with sole authority as to when and where to drill for oil. The general partner charged a management fee and commission on the raising of the equity capital. If the exploration were successful, each limited partner would receive 15% of the income of the partnership with the balance of 55% going to the general partner. If the exploration were unsuccessful, any remaining cash is divided amongst the limited partners.

Required:

- a) What are the liabilities of the partners for debts incurred by the partnership?
- b) What agency costs might arise in this business arrangement?
- c) What mechanisms can be put in place to help minimize these costs?

Question 2: (adapted from a past examination paper)

Casca Ltd has a management bonus plan which allows a bonus equal to 1% of the profit for the year (after tax) provided that profit exceeds \$30,000,000, with the maximum bonus payable being \$500,000. An initial income statement prepared for the year ended June 30 2005 indicates that the profit for the year will be \$60,000,000. Positive accounting theory would seem to indicate that management will choose accounting policies that will maximize their own welfare. The budget for the following year ended June 30 2006 indicates that operations will be difficult with an expected profit of \$40,000,000.

Required:

- a) What is the expected PAT management response to this situation?
- b) Given the restrictions placed on management on changing accounting policies, what are some of the actions that could be taken by management to “manage” profits in the year ended June 30 2005?
- c) What would be the profit after tax that would result in a bonus of exactly \$50,000?

Question 3: [earnings management and ethics]

On July 1 20X6, Briggs Ltd acquired 2,500,000 ordinary shares in Collins Ltd as a long-term investment at a cost of \$5.20 per share, giving it a 25% interest in that company. Because the other shareholdings in Collins Ltd were widely held, Briggs Ltd succeeded in having four of its nominees appointed to the Board of Collins Ltd (total number of directors 6).

The year ended June 30 20X7 was a particularly difficult one for Collins Ltd, resulting in that company posting a loss of 48c per share, incurred evenly throughout the year. On June 1 20X7, Briggs Ltd sold 250,000 of its shares in Collins Ltd to an independent company, Denman Ltd, for \$5.20 per share. During June 20X7, two of the directors of Collins Ltd, who were nominees of Briggs Ltd, resigned and their places were taken by a director from a legal firm which provided services to Briggs Ltd, and a director from a large insurance firm which also provided services to Briggs Ltd.

Because of a reorganisation and rationalisation of the operations of Collins Ltd during the year ended June 30 20X7, the future of the company looked bright at the end of the year; despite the loss suffered during the year. At June 30 20X7, the market price of the company's shares had risen to \$5.30 per share.

At a meeting of the Board of Briggs Ltd on June 30 20X7, a resolution was carried (and minute recorded) to the effect that the remaining 22.5% equity interest in Collins Ltd was being held as a temporary, speculative investment; to be sold at an opportune time. In a letter to the company's auditors dated June 30 20X7, the managing director of Briggs Ltd, advising of the position, stated that the remaining two (2) nominee directors continued to serve on the Board of Collins Ltd solely for the purpose of providing their individual, professional expertise. The letter also stated that Briggs Ltd did not have the capacity to exert significant influence over the operating and financial policies of Collins Ltd, and that the operations and financing of Briggs Ltd and Collins Ltd were independent,

Required:

Consider yourself to be in the following position as Financial Controller of Briggs Ltd:

From discussions between yourself and other members of the Board, and from certain actions you have observed, you are in no doubt that the investment is to be held as a long-term investment. You are also in no doubt that the resolution of June 30 and the letter to the company's auditors on the same date are "window dressing" to avoid reporting a loss.

- a) What difference would the re-classification of the investment in Collins Ltd as a speculative investment have on the consolidated accounts of Briggs Ltd and its controlled entities for the year ended June 30 20X7?
- b) How do you believe the effects of the investment should be reported in the consolidated accounts of Briggs Ltd and its controlled entities?
- c) What actions would you take if the managing director instructed you to accept, at face value, the minute and letter of June 30; having pointed out to you the bright future you have with the company, and the need to be flexible in dealing with short-term problems? [Assume that you are being paid a salary of \$120,000 per year, are supplied with a Peugeot 406, have two (2) small children, a mortgage commitment of \$1,800 per month to meet on the family home, and an unemployed spouse.]

WEEK 3

Identification, Recognition and Measurements of Assets

- a) Rights (resources) and assets
- b) Criteria for the recognition of rights as assets
- c) Finite life and indefinite life assets; identifiable and unidentifiable assets
- d) Fair value, net market entry value, net market exit value, present value, value in use and opportunity costs
- e) Recoverable amount constraints
- f) Capital maintenance perspectives – current net market entry and net market exit value accounting

Reading

- a) Deegan Ch 3: pages 142-149

Assignments

Basic Concepts

- a) Deegan Ch 2: Question 16
- b) Outline the criteria for the recognition of rights as assets. What major rights cannot be recognised as assets?
- c) Distinguish between identifiable and unidentifiable assets.
- d) Under what conditions, if any, can human beings or land be considered to depreciable assets?

Application of Concepts

Question 1:

A right which, at a particular point in time, is not recognised as an asset because it fails the test of probable future economic benefits may nevertheless qualify for recognition as an asset at a later date as a result of subsequent events. What rights that fail the test of recognition at one date cannot be subsequently recognised at a later date?

During the year ended June 30 20X2, Manfred Ltd installed an item of plant to produce a specific product. The plant had an estimated useful life of 10 years with no salvage value. The plant had no usefulness apart from the specific product. The plant was installed ready for use on July 1 20X2 at a cost of \$1,000,000. Following a severe slump in demand, production was closed down in June 20X5. At that date, the directors of the company did not envisage any further production of the product. After laying idle for most of the following year, production was re-commenced on May 31 20X6. At that date, the directors anticipated that the economic life of the product was a further five years. On May 31, it was estimated that the fair value of equivalent plant services was \$400,000.

Required:

- a) On the assumption that management will act to disclose the affairs of the company as faithfully as possible, what is the effect on the accounts for the year ended June 30 20X5 of the decision to close down the plant?
- b) What is the effect on the accounts for the year ended June 30 20X6 of the decision to re-open the plant on May 31 20X6?
- c) On the assumption that management will tend to manage earnings and there are bonus schemes and debt covenants to be considered, what alternatives are available?

Question 2: (valuation concepts)

- a) On July 1 20X5, Cassius Ltd acquired an item of plant from an overseas supplier at a cost of \$1,000,000. Other necessarily incurred costs of acquisition (marine insurance and freight) amounted to \$50,000. Installation costs amounted to a further \$100,000. As the company is not a dealer in plant, at the date of acquisition, the net disposal value of the plant is estimated to be \$800,000. On completion of installation, the company expected that the benefits to be derived from the plant had been overestimated and that the PV of the recoverable amount is only \$1,000,000.
- b) In July 20X5, the company received a valuation for its Leichhardt property. The unimproved value was \$4,500,000, whilst the improved value was Land \$2,500,000, Buildings \$1,500,000. The carrying amount of the property was – land \$1,000,000 and buildings \$1,500,000 (net of accumulated depreciation \$800,000).

Required:

- a) In relation to (a), identify the various valuations. Under current accounting standards, set out the various journal entries to recognise the plant.
- b) In relation to (b), what is the relevance of different valuations? What effect will the valuations have on the recognition of the property?

Question 3: (capital maintenance concepts)

On July 1 2005, Hadrian Ltd was formed with an initial capital of \$1,000,000. The entire capital was then invested in marketable securities, which were held throughout the year. At June 30 2006, the marketable securities had a fair value of \$1,400,000. Ignore the costs of acquisition or disposal. During the year the CPI rose by 5%.

Required:

What would be the profit reported by the company for the year ended June 30 2006 assuming current accounting standards, current cost capital maintenance (CCA) and CoCoA?

WEEK 4

Acquisition of Assets

- a) General principles applying to finite and indefinite life assets
- b) Rules preventing rights from being recognised as assets
- c) Application of specific rules to the self-development of patent rights, rights arising from research activities, self-developed brand name and trade name rights
- d) Use of organizational designs to circumvent rules
- e) Donated assets
- f) Manufactured assets
- g) Generated assets – agricultural assets and produce
- h) Discovery of assets – exploration and evaluation

Reading

- a) Deegan Ch 3: pages 160-167; Ch 7 pages 253-256, 264-266, 274-276; Ch 8 305-315, 319-311

Assignments

Application of Concepts

Question 1: (asset recognition)

In June 20X6, the Lawgi Shire Council offered a parcel of land to Encounter Ltd to locate its new product production facilities in the district. The offer was contingent on the company constructing the plant and operating for a period of ten years. At the end of the ten-year period, the land would pass to the company free of charge. At the date of the negotiations, the fair value of the land was estimated to be \$500,000. The company accepted the offer in June 20X6, and commenced operations in August 20X6. The company intended to operate on the site for an indefinite period, but in excess of ten years.

Required:

- a) Should Encounter Ltd recognise the land as an asset in its accounts for the year ended June 30 20X6?
- b) Describe the nature of the company's control over the assets at the date of accepting the offer.
- c) Assuming that the land is recognised as an asset, set out the journal entry to record the asset in the accounts of the company.

Question 2: (asset recognition)

The following selected transactions were made by Tacitus Ltd during the year ended June 30 20X5:

- a) During the quarter ended June 30 20X5, the company spent \$2,000,000 on a program designed to improve relationships with its dealers. The project improved relationships with the dealers, and the company's management believed that significant future economic benefits would be derived as a result of the program.
- b) A pilot plant was constructed during the year at a cost of \$4,000,000 to test a new production process. The plant will be operated for approximately two years. At the end of the test period, the company's management will decide whether a full-scale production plant will be built. The pilot plant is too small for commercial production, and will be dismantled at the end of the test. The pilot plant has an expected nil salvage value.
- c) During the six months period ended June 30 20X5, the company spent \$500,000 in connection with a successful patent application arising from a research project conducted by the company. The patent became effective on June 30 20X5. The legal life of the patent is 17 years, but its economic life is expected to be about five to ten years.
- d) On June 1 20X5, the company received notification that the government of a foreign country intended to expropriate its wholly owned controlled entity in that country. The investment had been acquired at a cost of \$10,000,000, when the fair value of the net assets of the controlled entity was \$10,000,000. At June 30 20X5, the carrying amount of the investment in the balance sheet of the company was \$10,000,000, and in the consolidated balance sheet \$14,000,000. The fair value of the net assets of the foreign entity was estimated to be \$16,000,000. The company expected to recover approximately 60% of the fair value of the net assets of the controlled entity.
- e) A new product will be introduced early in the following year. In the period to June 30 20X5, the company spent \$3,000,000 for the design of jigs, tools and dies for the production of this product; which management believes will be commercially successful. In June 20X5, the company acquired the assets and assumed the liabilities of Nerva Ltd for a cash outlay of \$5,000,000. The assets and liabilities acquired were (amounts in thousands):

	Book Value	Fair Value
Sundry tangible assets	\$3,000	\$4,000
Patent rights		1,000
Sundry liabilities	1,500	1,500
	-----	-----
Total	\$1,500	\$3,500
	=====	=====

Required:

How would the effects of these transactions be accounted for in the preparation of the accounts for Tacitus Ltd in the year ended June 30 20X5?

Question 3: (exchange of similar assets)

Following a very poor year of operations, in June 20X5, Ajax Ltd and Spear Chief Ltd exchanged large parcels of similar real estate. The original acquisition costs of the swapped land were \$500,000 and \$700,000 respectively. At the date of the exchange, the directors of the companies valued each of the blocks of land at \$1,500,000.

Required:

- a) What are the general principles followed in accounting for exchanges of similar assets?
- b) At what amounts would the swapped land be recorded in the accounts of the companies at June 30 20X5?
- c) Would your answer to (b) be different if the asset swapped by Ajax Ltd was an operational segment with a carrying amount of \$500,000?

Question 4:

The major portion of the Electro-Optical Systems business, controlled by IMO Industries Inc (IMO), was sold by IMO to Litton Industries Inc (Litton) in a transaction, which closed on June 2 1995. The sales contract between IMO and Litton provided certain representations and warranties as to the status of the business at the time of the sale. By letters dated November 19 1996 and November 26 1996, Litton notified IMO of claims under the representations and warranties provisions for environmental losses of unspecified amounts; and anticipated losses in excess of \$9 million under a US Government contract.

The claims arose as a result of IMO's alleged failure to notify Litton of a reasonably anticipated loss under a bid that was pending at the time of the transfer of the business. The contract was subsequently awarded to IMO's Varo subsidiary, and thereafter transferred to Litton. IMO made a preliminary analysis of the supporting documentation provided by Litton, and notified Litton that it disputed the nature, validity, and amount of the claims of losses; and objected to the timeliness of submission of notice to IMO with respect to the claims. IMO believed that the claims were without merit, and intended to vigorously defend against the claims.

Required:

- a) What are the general principles applied in accounting for contingency claims?
- b) Assuming that it believed the claim to be valid, how should Litton recognise the contingent assets under the claims, if at all, in the accounts of the company at

December 31 1996?

Question 5: (acquisition of agricultural produce)

During the year ended June 30 20X6, the costs of production for the 40 hectare Shiraz vineyard of Trajan Ltd amounted to \$160,000. Up to June 30 20X5, costs of \$16,000 had been incurred in respect of the 20X6 vintage. The normal production from the vineyard was 400 tonnes but due to the damage from a hailstorm, only 200 tonnes were produced. All costs were incurred prior to December 31 2006. In February 20X6, the grapes were harvested at an additional cost of \$4,000 and the market exit value at the date of the harvest was \$800 per tonne. As company policy, 60% of any estimated profit from the harvest was recognised in the period to December 31.

Required:

- a) Set out the journal entries to account for the grape crop during the year ended June 30 20X6.
- b) How would the costs of \$16,000 incurred on the 20X6 vintage be reported in the financial statements of Trajan Ltd at June 30 20X5?

Question 6: (acquisition of agricultural assets)

On July 1 20X2, Trajan Ltd acquired a 40 hectare block of land for the establishment of a Shiraz vineyard at a cost of \$1,000,000. In the year ended June 30 20X3, costs of \$200,000 were incurred in preparing the land for the vineyard. Additional costs of \$200,000 were also incurred in establishing a vineyard support infrastructure for the vineyard. This infrastructure was depreciated over 10 years. Over the 3 year period required to establish the cuttings and bring the vineyard to the point of production additional costs of \$400,000 were incurred. During the establishment period to June 30 20X5, no reliable measure of the fair value of the vineyard could be estimated. At June 30 20X5, it was estimated that the market exit value of the vineyard was \$3,000,000 with the market exit value of the land estimated to be \$1,200,000.

Required:

Set out the journal entries to account for the acquisition and establishment of the vineyard to June 30 20X5. Assume that the infrastructure was established at December 31 20X2.

Question 7: (acquisition of natural resources)

- a) What is meant by an area of interest?
- b) What are included in exploration and evaluation costs?
- c) Under what circumstances are area of interest exploration and evaluation costs recognised as an asset as incurred?

Question 8: (acquisition of research rights)

Over the three year period ended December 31 20X4, Paxton Ltd was involved in the research and development of the Giant Genetic Spud – the (GGS) project. During this period, the GGS research and development expenditure was:

Year ended June 30 20X3	\$ 500,000
Year ended June 30 20X4	2,000,000
Six months period ended December 31 20X4 – research costs	1,000,000
Six months period ended June 30 20X5 – development costs	1,000,000

At June 30 20X3, the company was uncertain as to the product outcome. At June 30 20X5, the company believed that the product would probably be successful, but still held some doubts as to the final outcome. The product went into development on January 1 20X4. At June 30 20X5, it was expected that the project would be successful and, with the approval of regulatory authorities, it was expected that commercial production would commence during the year ended June 30 20X8.

Required:

- a) Set out the journal entries to account for the research and development costs in each of the 3 years.
- b) If, on the basis of current accounting standards, you decide to expense the research costs, do current accounting standards allow these costs to be capitalized under certain circumstances?
- c) Under paragraph 87 of the AASB Framework, “an item that fails to meet the recognition criteria may qualify for recognition at a later date as a result of subsequent circumstances or events”. Can any research costs written off be subsequently written back at a later date? Explain.
- d) Under what conditions may development costs be capitalized as an asset?

Question 9: (costs included in the acquisition costs of assets)

According to AASB 1009, costs, which do not directly relate to a contract, include general administration and selling costs; finance costs; research and development costs; and depreciation of idle plant and equipment. They are excluded in determining the cost of acquisition, since they do not relate to reaching the present stage of completion of a particular contract. In circumstances where such costs are attributable to a particular contract, they may be included in the contract cost.

Required:

Under what circumstances are such costs treated as an acquisition cost of an asset?

WEEK 5

Post-acquisition Asset Accounting

- a) Revenue and capital expenditures
- b) Allocation to recognise the cost of asset service – depreciation or amortization of carrying amounts of finite life assets
- c) Use of net market exit values and entry values in measuring the carrying amounts of assets
- d) Recoverable amount tests and impairment
- e) Impairment testing of indefinite life assets
- f) Restatement of the carrying amounts of assets to net market values
- g) De-recognition and re-recognition of assets

Reading

- a) Deegan Ch 4 (straight line only); Ch 5; Ch 7 pages 256-262, 267-271, 288; Ch7 pages 312-319, 328-331

Assignments

Basic Concepts

- a) Distinguish between an asset and a cash generating unit.
- b) Outline the accounting treatment of finite life assets subsequent to acquisition.
- c) Outline the accounting treatment of indefinite life assets subsequent to acquisition.
- d) How is the impairment test applied to finite life and indefinite life assets?
- e) “The depreciation recognised in a period may be recognised as depreciation expense, an expense but not depreciation expense, as a non-depreciable asset or as a non-depreciable asset, or need never be recognised as an expense.” Explain.

Application of Concepts

Question 1: (revenue and capital expenditures)

During the period July to September 20X4, Timber Millers Ltd installed log handling and saw-milling plant costing \$600,000. In October 20X4, additional plant was installed at a cost of \$20,000 to improve the safety of the log handling plant. In March 20X5, the company found that certain items of plant had been incorrectly positioned in the original installation, re-positioning at an additional cost of \$80,000. The cost of routine maintenance of the plant during the year ended June 30 20X5 amounted to \$30,000.

Required:

- a) Set out the journal entries to record the effects of these transactions
- b) Are there any alternatives open to management in recording the effects of these transactions?

Question 2: (revision of probabilities)

During the year ended June 30 20X4, Brown & Broad Ltd acquired a Cremona lathe to veneer logs. The cost of the lathe was \$250,000, and a further \$100,000 was spent in installation and modification costs. By the time the lathe was installed ready for production in May 20X4, the Board of Brown & Broad Ltd decided not to veneer the logs but to process them through their sawmill. The lathe had no other use, and there was no prospect of selling the lathe. In the year 20X6, the company decided to veneer its logs, and placed the lathe in operation. It was felt that the installed cost of the lathe of \$350,000 was a fair value at the time of commencing production.

Required:

- a) Set out the journal entries to recognise the effects of these transactions.
- b) Are there any alternatives available to management in recording these transactions?
- c) Under what circumstances could we expect these alternatives to be used?

Question 3: (revaluation of asset services)

At June 30 20X5, the following property, plant and equipment were reported by Ulyanov Ltd (amounts in thousands):

Property, plant and equipment	
Land	\$ 2,000
Buildings (net of accumulated depreciation \$1,000)	5,000
Plant and equipment (net of accumulated depreciation \$6,000)	9,000

Total property, plant and equipment	\$16,000
	=====

At June 30 20X5, an independent valuer valued the land at \$4,000,000 and the buildings at \$7,000,000. On July 1 20X5, the company purchased a property for \$4,000,000 for its administration and marketing activities. Because of certain factors not noticed by the buyer at acquisition, an independent valuation put a value of only \$3,000,000 on the property (land \$1,000,000, buildings \$2,000,000); which indicated that the company had overpaid for the property.

The company's plant consisted of 2,000 individual items; some of which were specialised equipment with no economic usefulness outside the company. During the year ended

June 30 2006, the company discovered that it had understated depreciation on the plant and equipment in the previous year by \$200,000.

Required:

- a) Record the acquisition of the property on July 1 20X6.
- b) In the year ended June 30 20X6, will the company recognise a loss on the property acquired on July 1? What alternatives are available to management in respect of accounting for the properties?
- c) What valuation model would you expect management to apply to the property, plant and equipment? What would be the effect of the application of the valuation models?
- d) Set out the journal entry to adjust for the error in the estimate of depreciation in the previous year.

Question 4: (effect of revaluation of assets)

Octavius Ltd and Augustus Ltd held blocks of land of similar value which they had acquired for \$1,000,000 and \$1,400,000 respectively. At June 30 20X5, the value of each of these blocks was \$3,000,000. On June 30 20X5, Octavius Ltd revalued its land to \$3,000,000 whilst Augustus Ltd continued to use the cost model. The potential capital gains tax on the revaluation was \$600,000. In the year ended June 30 20X6, each company sold its land for \$2,900,000. The income tax payable on sale of the land was \$570,000 and \$450,000 respectively.

Required:

- a) Set out the journal entry to record the revaluation of the land at June 30 20X5.
- b) Set out the journal entries to record the sale of the blocks of land in the year ended June 30 20X6.
- c) How would the effects of the revaluation and sale of the land be disclosed in the financial statements of the companies in the year ended June 30 20X5 and 20X6?
- d) Why would management wish to revalue its land?

Question 5: (based on Deegan Ch 18 Question 15)

Wildcat Mining Ltd incurred the following exploration and evaluation costs on each of two areas of interest KP 57 and KP 58 (dollar amounts in millions).

	KP 57	KP 58
Year ended June 30 20X3	\$1,500	\$2,000
Year ended June 30 20X4	2,000	3,000
Year ended June 30 20X5	3,000	4,000

At the end of June 30 20X5, expected recoverable reserves of oil were discovered on KP 57 whilst KP 58 was abandoned. It was expected that the oil would be extracted over a

period of 10 years.

Following the evaluation of KP 57, production infrastructure was put in place at a cost of \$2,500 million. The economic life of these facilities was expected to be 10 years. Production began on completion of these facilities on December 31 20X5. The incremental production costs were \$5 per barrel. During the year ended June 30 20X6, 500 million barrels were extracted of which 480 million barrels were sold.

Sire restoration costs on KP 57 were estimated to be \$10 million.

Required:

- a) How many litres are there in a barrel of oil?
- b) At the current world demand, how many days supply have been discovered on KJP 57?
- c) Set out the journal entries to record the transactions from the year ended June 30 20X3 to the year ended June 30 20X6 (area of interest only).
- d) Are any alternatives available to management in accounting for the exploration and evaluation costs?
- e) How are the reserves disclosed in the financial report of the company?

Question 6: (valuation of agricultural assets)

Based on the present value of expected net cash flows, at the point of going into commercial production, the 40-hectare vineyard developed by Rattling Good Reds Ltd had an assessed net market value of \$2,000,000. Based on the net market values of similar land, the market value of the land was estimated to be \$300,000. For the land developments, irrigation facilities, trellises and other structures, there were no market values, which could be gleaned from an “active and liquid” market. It was decided that the best indicator of the “market value of these non-vine developments was their current cost. The current cost was estimated to be \$920,000. The market value of the vines is then assessed as follows (amounts in thousands):

Market value of vineyard (based on present values or assessed market values)	\$2,000
Less market value of the land (based on values in an active market)	- 300
Less market value of non-vine developments (based on current costs)	- 920

Market value of vines	\$ 780
	=====

Required:

- a) Of the assets in a vineyard, which are the most reliably measurable?
- b) If management were to revalue the land at balance date, how would the valuation increments on the land and vines be recognised in the financial statements?
- c) “The residual market value of the vines comprises the cost plus the revaluation increment. At the end of the useful life of the vines, the residual market value of

- the vines is zero. Thus the revaluation increment, which is recognised as a profit at the date of valuation, is “amortised” over the useful life of the vines in proportion to variations in the market value of the vines.” Do you agree? Explain
- d) “With the accounting principles applied to agricultural assets, under current accounting standards, the non-current assets of an entity may be reported in a mixture of the residuals of historical net market entry values, residuals of current net market entry values, net market exit values or present values of future cash flows. “Depreciation” may be used in the particular accounting sense of a cost allocation process, or in the general English sense of a valuation process. The depreciation of a plant production facility is an element of the cost of the merchandise produced by that facility. The “depreciation” of an agricultural asset production facility is an item of revenue or expense.” Do you agree? Explain.

Question 7: (reliable measurement and probabilities)

“In the mid-1850’s, Eugene Mercier commissioned the top barrel-maker of the day – a certain Jolibois – to make the “Foudre Mercier”, which was to be a barrel comprising 72 staves and measuring 5.5m high and 6.5m long, with a weight of 23 tonnes. The 250 thousand-year old oaks used to make this barrel came from Hungary. It took five autumns to fell the trees – this was the only season during which perfect wood could be had. The wood took three years to dry out on site, in the forest, and this process was checked daily. After the sawing and transport of the trees, the herculean task of bending the staves took a further seven years.

In 1874, eleven enormous carts, each drawn by six bullocks, carried the frame of the “Foudre Mercier” to Strasburg. From here, the frame went by train to Epernay, where assembly began. The “building site”, where this vast barrel was assembled, was finally closed on July 7 1881. This was also the day on which Jolibois died. Maybe due to exhaustion, or perhaps sheer emotion?

In 1883, 1,600 hectolitres of the best Champagne growths were mixed in the vat, producing the largest vintage ever. It was transported to Paris for the World Fair in 1889, and was to prove, along with the Eiffel Tower, one of the main attractions at this magnificent event. To take the Barrel through the narrow streets of Paris, drawn by twenty-four bullocks and assisted by eighteen horses, four houses were acquired and demolished.”

Required:

Assuming that the current accounting standards were applicable to the entire period under review, as the accountant of Mercier, how would you have accounted for the costs involved in the construction of the barrel, and the costs involved in its subsequent transport to the Paris World Fair?

WEEK 6

Liabilities

- a) Identification and recognition of obligations as liabilities
- b) Contingencies and provisions
- c) Extinguishment of obligations
- d) Restructuring of debt and deferred maintenance
- e) Employee entitlements, superannuation and post-retirement benefits
- f) Debentures and commercial bills
- g) Disclosure of finance facilities

Reading

- a) Deegan Ch 9 pages 344-349, 350-352, 354-364; Ch 11 pages 429-435; Ch 12 447-461

Assignments

Basic Concepts

- a) Distinguish between payables, accruals and provisions.
- b) Outline the accounting treatment of gain and loss contingencies.
- c) Outline the accounting treatment of restructuring costs and deferred maintenance costs.
- d) Outline the accounting treatment of short-term and long-term (other than superannuation) employee benefits.
- e) Outline the accounting treatment of costs incurred under defined contribution superannuation plans.
- f) Outline the accounting treatment of costs incurred under a defined benefit superannuation plan.

Application of Concepts

Question 1 - Deegan Ch 9: Questions 4 and 10

Question 2 - Deegan Question 20 – assume that the debenture issue gives the holders the right to convert the debentures into ordinary shares on maturity and that the debentures are issued for the face amount \$5,000,000. Assume also that all debenture holders converted the debentures into ordinary shares on maturity.

Question 3: (restructuring and deferred maintenance costs)

The financial year of the manufacturing company, Ulyanov Ltd, ends on December 31. In its initial year ended December 31 20X5, before considering deferred maintenance, the profit for the year was \$500,000. The company shut down for a 4 week period beginning

December 23, during which extensive maintenance was to be carried out at an estimated costs of \$1,000,000. At December 31 20X5, because of errors in original estimates and changes in the market, the company had a constructive obligation of \$1,000,000 for restructuring in terms of paragraph 72 of AASB 137.

Required:

- a) Set out the journal entries to record the effects of these events in the year ended December 31 20X5.
- b) What would be the effects of the transactions on the profits of the company in the year ended December 31 20X5?
- c) What was the profit for the year ended December 31 20X5?

Question 4: Deegan Ch 11 Question 16

Question 5: (defined benefit plan)

In the defined pension benefit plan covering the employees of Archer Ltd, the company's contributions have been determined by the projected benefit obligation estimates of an actuary. During the year ended June 30 20X6, an actuarial assessment of the status of the plan disclosed that the fair value of the net assets of the plan was \$54 million, whilst the projected benefit obligation was \$50,000,000.

Required:

- a) What are some of the assumptions made by an actuary in determining projected benefit obligations? Why are such assumptions necessary?
- b) What is the probable cause of a surplus arising in a pension plan?
- c) What is meant by the term "unfunded" in relation to a pension plan?
- d) What are some of the options available to Archer Ltd in respect of the pension fund surplus of \$4,000,000?
- e) What is the role of the accountant in respect of the actuarial assumptions?

Question 6: (commitments at balance date)

The following information is contained in Note 23 to the financial statements of LVMH for the year ended December 31 1997:

"Certain subsidiaries of the Champagne and Cognac segments have contractual arrangements with various growers to supply portion of their future requirements for grapes and distilled alcohol. Based upon either contractual prices or latest current market prices and anticipated yields, these commitments amounted to FRF 2,504 million at December 31 1997 (FRF 2,811 million in 1996, FRF 2,187 million in 1995) and principally concern the supplies for 1998 and 1999.

The Group has committed the amount of FRF 332 million at December 31 1997 (FRF

125 million in 1996, FRF 142 million in 1995) to purchase property, plant and equipment, of which FRF 200 million are related to the purchase of casks over a seven-year period.”

Required:

Assuming that an Australian company had these same commitments at the reporting date, what disclosures would be required in the accounts?

Question 7: (contingencies, liabilities, accruals and provisions)

During the year ended June 30 20X6, the following events affected the operations of Ajax Ltd:

- a) A US company, Citation Inc, had taken legal action against the company for alleged patent infringement, claiming \$1,000,000 in damages. The legal advisers of Ajax Ltd have indicated that they consider Citation Inc to have a strong case, and advise negotiating a settlement around \$1,000,000. Legal fees are expected to be around \$200,000. The matter is not expected to be resolved within twelve months of the reporting date.
- b) A customer of Ajax Ltd suffered extensive injuries during the year as a result of using one of the products of the company. At June 30 20X8, it was not clear whether the failure was due to a fault in manufacture, for which the company carried adequate insurance; or to a fault in product design, for which the company was not insured. Damages and legal fees could run as high as \$2,000,000, and the matter is not expected to be resolved for three to four years.
- c) The company has a top-flight staff of key executives. These executives have signed agreements to remain with the company for the following year ended June 30 20X9 for a total salary cost of \$2,900,000 plus participation in the company’s share option scheme.

Before considering the impact of the preceding events, the company earned a profit from ordinary activities after tax of \$20,000,000 in respect of the year ended June 30 20X6.

Required:

- a) In each of the preceding cases, establish whether or not the company has a present obligation at June 30 20X8, which must be recorded as a liability.
- b) Which case would require information or additional information to be disclosed in a note?
- c) At what amount would the present obligation, if any, be reported in the statement of financial position of the company at June 30 20X8?

Question 8: (implicit interest)

On July 1 20X1, Repshot Ltd sold a recently constructed plant complex for a total

consideration of \$20,000,000; on a cash deposit of \$2,000,000, and three equal annual payments of \$6,000,000 commencing June 30 20X2. The contract of sale stipulated that no interest was payable on the outstanding amounts. With the plant complex as collateral, the company could borrow equivalent finance at 10% interest. At the date of disposal, the plant complex was carried in the books of the company at \$18,000,000.

Required:

- a) Calculate the profit or loss on the sale of the complex.
- b) Set out the journal entry to record the sale in the accounts of Repshot Ltd.
- c) Set out the journal entries to record the effects of the transaction in the year ended June 30 20X2.

Question 9: (multiple-choice)

On September 30 20X4, Josie Brown Ltd borrowed \$500,000 for a period of five (5) years at 15% interest, repayable in five (5) equal annual instalments of \$149,158, commencing September 30 20X5. A loan schedule was prepared disclosing the following details:

	Interest	Payment	Balance
September 30 20X4			\$500,000
Interest for year ended September 30 20X5	\$75,000		575,000
Payment September 30 20X5		\$149,158	425,842
Interest for year ended September 30 20X6	63,876		489,718
Payment September 30 20X6		149,158	340,560
Interest for year ended September 30 20X7	51,084		391,644
Payment September 30 20X7		149,158	242,486
Interest for year ended September 30 20X8	36,373		278,859
Payment September 30 20X8		149,158	129,701
Interest for year ended September 30 20X9	19,457		149,158
Payment September 30 20X9		149,158	-

During the year ended June 30 20X5, the company commenced manufacture of a product, which it sold for \$400 per unit. The product was sold under a three-year warranty. The repairs under warranty were estimated to cost \$15 per unit; of which 40% were expected to be incurred in the first year of warranty, 20% in the second year, and 40% in the third year. The company manufactured 5,000 units and sold 4,000 units during the year ended June 30 20X5, and made repairs under warranty in the amount of \$12,000. During the year ended June 30 20X6, the company manufactured 8,000 units and sold 7,500 units. Warranty repairs amounted to \$60,000.

On July 31 20X6, prior to completion of the accounts for the year ended June 30 20X6, the directors of the company resolved to pay one of its managers a bonus of \$200,000 in respect of the year ended June 30 20X6. The bonus was payable on January 1 20X7, contingent on the manager remaining with the company.

Question A:

In the year ended *June 30 20X6*, the interest expense incurred by Josie Brown Ltd on the loan was:

- a) \$63,876
- b) \$57,480
- c) \$66,657
- d) None of the above

Question B:

In its balance sheet as at *June 30 20X6*, the amount reported by Josie Brown Ltd under non-current liabilities as Loans Payable was:

- a) \$425,842
- b) \$361,966
- c) \$340,560
- d) None of the above

Question C:

In its balance sheet as at *June 30 20X6*, the amount reported by Josie Brown Ltd under current liabilities as Loans Payable (excluding any interest payable) was:

- a) \$ 74,158
- b) \$ 85,282
- c) \$149,158
- d) None of the above

Question D:

In its balance sheet as at *June 30 20X6*, the total amount reported by Josie Brown Ltd as interest payable (current and non-current) was:

- a) \$ 63,876
- b) \$ 47,907
- c) \$170,790
- d) None of the above

Question E:

At June 30 20X7, the lender agreed to accept 100,000 ordinary shares in Josie Brown Ltd in full settlement of the loan and any accrued interest. The increase in the ordinary share capital recorded by Josie Brown Ltd as a result of the debt conversion would have been:

- a) \$340,560
- b) \$378,873
- c) \$391,644
- d) None of the above

Question F:

The warranty expense recognised by Josie Brown Ltd in the year ended June 30 20X5 was:

- a) \$60,000
- b) \$75,000
- c) \$24,000
- d) None of the above

Question G:

At June 30 20X6, the balance in the Accrued Warranty Payable account of Josie Brown Ltd was:

- a) \$100,500
- b) \$123,000
- c) \$ 66,750
- d) None of the above

Question H:

Assume that production and sales were made evenly over each year of the years under review, and that warranty repairs are being incurred as expected. At June 30 20X6, the expected balance in the Accrued Warranty Payable account of Josie Brown Ltd would be:

- a) \$102,000
- b) \$117,750
- c) \$148,500
- d) None of the above

Question I:

In its balance sheet as at June 30 20X6, in respect of the bonus of \$200,000 contingently payable to its manager:

- a) The bonus payable would not be recognised as a liability, but a note would be included in the accounts providing details of the company's contingent liability.
- b) The bonus payable would not be recognised as a liability, since the liability relates to an event occurring subsequent to June 30 20X6.
- c) The bonus payable of \$200,000 would be recognised as a liability.

- d) The bonus payable, in an amount equivalent to the present value of \$200,000, would be recognised as a liability.

Question J:

An accrued warranty liability is recognised by a reporting entity at the reporting date if it is determined that:

- a) It is probable that future economic benefits will be sacrificed in respect of goods sold under warranty to the reporting date, and the amount of those benefits can be measured reliably.
- b) It is probable that future economic benefits will be sacrificed in respect of the goods sold under warranty to the reporting date, even if the amount of those benefits cannot be measured reliably.
- c) There is a possibility that a sacrifice of future economic benefits will be made in respect of goods sold under warranty to the reporting date.
- d) It is probable that future economic benefits will be sacrificed in respect of goods produced to the reporting date, even if those goods have not been sold; and the amount of those benefits can be measured reliably.

Question K:

Which of the following statements indicates that a liability for a term loan of \$5,000,000, due for settlement on June 30 20X8, had not been defeased, in substance or in fact, by a company at June 30 20X8:

- a) On June 30 20X8, the company forwarded a cheque for \$5,000,000 to the lender, but the cheque was not presented to the bank until July 3 20X8.
- b) On June 30 20X8, the company rolled over the loan by re-negotiating a further three-year loan of \$5,000,000 with the lender.
- c) On June 30 20X8, the lender converted the debt into equity by accepting 1,000,000 ordinary shares in the company in full settlement.
- d) On June 30 20X8, the company gained an extension of time of twelve months in which to settle the loan. At that date, the company placed 1,000,000 ordinary shares in Amoeba Ltd valued at \$5,000,000 in a trust under the trusteeship of an independent trustee, to be administered solely for the settlement of the loan. The company considered the shares to be a risk-free investment.

WEEK 7

Lease Accounting

- a) Economic importance of leasing
- b) Types of lease contracts
- c) Substance of a lease transaction
- d) Basis of accounting for leases under current accounting standards
- e) Accounting for simple lease transactions
- f) Sale-leaseback transactions
- g) Constructive capitalization of operating leases from financial statement notes
- h) Review of the empirical evidence, including the economic consequences of lease capitalisation

Reading

- a) Deegan: 4th ed. Ch. 10
- b) Whittred et al., Ch 8 (ignore pp 202-203 on leveraged leases)
- c) Supplementary Materials: Readings 3-6 (by McGregor, Monson, AAA)
- d) Financial Accounting Standards Committee, and ASIC) Handbook: AASB 1

Basic Concepts

- a) During the lease term what rights are controlled by the lessee and lessor?
- b) Distinguish between finance leases and operating leases.
- c) Distinguish between minimum lease payments (from the viewpoints of the lessee and lessor) and lease commitments.
- d) Distinguish between a guarantee lease residual and an unguaranteed lease residual.
- e) What are direct lease costs and how are these costs accounted for in a finance lease by the lessee and lessor?
- f) How are direct lease costs recognised by the lessee and lessor in an operating lease?
- g) In a sale and leaseback transaction, over what period is any profit on the transaction recognised by the lessee?
- h) What is involved in the constructive capitalization of leases?
- i) What are the incentives for management in “structuring” a lease as an operating lease rather than as a finance lease.

Application of Concepts

Question 1: (recognition of leased assets)

"Under certain circumstances, a leased asset may be reported in the statements of financial position of the lessee and lessor or may not be reported in the statements of financial position of either the lessee or the lessor". Do you agree with this statement? Explain.

Question 2:

- a) Outline the accounting recording process for a lessee in respect of an operating lease.
- b) Where is the operating lease rental recognised if the leased property is a motor vehicle used by the CEO, an item of plant used in the production of merchandise for resale, an item of plant used in the development of land, on which a warehouse is to be constructed, a harvester used to harvest an agricultural crop, such as a grape crop, or a tractor used exclusively in the maintenance of a vineyard?

Question 3:

- a) A lease may involve a depreciable asset used in the manufacture of merchandise for resale. Under what circumstances can merchandise for resale or work in process be classified as a qualifying asset?
- b) If the merchandise is not a qualifying asset, is there any difference in the accounting treatment of the interest incurred on the lease finance if the lease is classified as an operating lease or as a finance lease? Explain.

Question 4: (multiple choice)

On July 1 20X4, a merchandising company, Mavin Ltd, leased an item of plant which was supplied by Lyons Ltd with the lease finance being provided by DEF Finance Ltd. Data relating to the lease are:

- a) The lease was non-cancellable with a term of four (4) years, and the useful life of the plant was estimated to be five (5) years with no salvage value. The lessee did not intend to retain the plant at the end of the 4-year lease term.
- b) The cash purchase price was \$378,314 (equivalent to the PV of the lease rentals and lease residual).
- c) Immediately prior to the lease, the plant was carried in the books of Lyons Ltd at cost \$400,000, less accumulated depreciation of \$100,000.
- d) The lease rental was \$100,000 per year payable in advance commencing July 1 20X4, while the lease residual of \$60,000 was guaranteed by Lyons Ltd.
- e) The lease interest rate was 12%.
- f) The PV of \$100,000 received annually in advance for four (4) years at 12% interest is \$340,183, while the PV of \$60,000 received at the end of four (4) years at 12% interest is \$38,131.
- g) Lease schedule data that may be useful in determining answers to the questions are as follows:

Based on a PV of \$340,183

	Rental	Interest	Balance
July 1 20X4			\$340,183
Rental July 1 20X4	\$100,000		240,183
Interest to June 30 20X5		\$28,822	269,005
Rental July 1 20X5	100,000		169,005
Interest to June 30 20X6		20,281	189,286
Rental July 1 20X6	100,000		89,286
Interest to June 30 20X7		10,714	100,000
Rental July 1 20X7	100,000		-

Based on a PV of \$378,314

	Rental	Interest	Balance
July 1 20X4			\$378,314
Rental July 1 20X4	\$100,000		278,314
Interest to June 30 20X5		\$33,398	311,712
Rental July 1 20X5	100,000		211,712
Interest to June 30 20X6		25,405	237,117
Rental July 1 20X6	100,000		137,117
Interest to June 30 20X7		16,454	153,571
Rental July 1 20X7	100,000		53,571
Interest to June 30 20X8		6,429	60,000
Residual July 1 20X8	60,000		-

Question A:

The lease is:

- a) A finance lease from the viewpoints of both Mavin Ltd and DEF Finance Ltd.
- b) A finance lease from the viewpoint of Mavin Ltd, and an operating lease from the viewpoint of DEF Finance Ltd.
- c) An operating lease from the viewpoint of Mavin Ltd, and a finance lease from the viewpoint of DEF Finance Ltd.
- d) An operating lease from the viewpoint of both Mavin Ltd and DEF Finance Ltd.

Question B:

In the years ended ***June 30 20X5*** and ***June 30 20X6***, the total expense arising from the lease recognised by Mavin Ltd is:

- a) \$100,000 in each year
- b) \$ 97,186 and \$ 88,647 respectively
- c) \$115,740 and \$101,068 respectively

d) None of the above

Question C:

At **June 30 20X6**, assuming that the lease is accounted for as a finance lease by Mavin Ltd, the lease rentals payable and interest payable would be reported in the company's balance sheet as:

- a) Current liabilities - accrued interest payable \$28,822, and lease rentals payable \$71,178; non-current liabilities - lease rentals payable \$169,005.
- b) Current liabilities - accrued interest payable \$20,281 and lease rentals payable \$79,719; non-current liabilities - lease rentals payable \$89,286.
- c) Current liabilities - Accrued interest payable \$10,714 and lease rentals payable \$89,286.
- d) None of the above

Question D:

At **June 30 20X6**, assuming that the lease is a finance lease from the viewpoint of DEF Finance Ltd, the lease rentals receivable and accrued interest receivable arising from the lease would be reported in the balance sheet of DEF Finance Ltd as:

- a) At the same dollar amounts as the corresponding lease rentals payable and accrued interest payable reported by Mavin Ltd.
- b) At greater dollar amounts than the corresponding lease rentals payable and accrued interest payable reported by Mavin Ltd.
- c) At lesser dollar amounts than the corresponding lease rentals payable and accrued interest payable reported by Mavin Ltd.
- d) The current lease rentals receivable would be reported at a lower amount and the accrued interest receivable would be reported at a greater dollar amounts than the corresponding lease rentals payable and accrued interest payable reported by Mavin Ltd.

Question E:

Assuming that Mavin Ltd accounts for the lease as a finance lease, in comparison to accounting for the lease as an operating lease, the retained profit to **June 30 20X6** (ignoring any tax effects) is:

- a) the same
- b) lesser by \$19,194
- c) greater by \$15,276
- d) None of the above

Question F:

Suppose that at the end of the lease term Lyons Ltd paid out the guaranteed residual, and then sold the plant to Mavin Ltd for \$105,000 cash. If the original estimate of the economic life of the plant did not change, in the year ended *June 30 20X9*, the depreciation expense recognised by Mavin Ltd is:

- a) \$105,000
- b) \$100,000
- c) \$ 85,045
- d) None of the above

Question G:

Suppose that at the end of the lease term Lyons Ltd paid out the guaranteed residual, and then sold the plant to Mavin Ltd for \$105,000 cash. In comparison to accounting for the lease as an operating lease, accounting for the lease as a finance lease would result in Mavin Ltd:

- a) Reporting less profit over the lease term, but the same profit over the useful life of the plant.
- b) Reporting more profit over the lease term, but the same profit over the useful life of the plant.
- c) Reporting the same profit over the lease term, but more profit over the useful life of the plant.
- d) Reporting the same profit over both the lease term and the useful life of the plant.

Question 5:

On September 25 20X5, Bronson Ltd leased an item of plant on a four-year non-cancellable lease, at an annual lease rental of \$400,000 commencing at the inception of the lease. Bronson Ltd guaranteed the lease residual of \$688,507. Bronson Ltd had constructed the plant at a cost of \$1,200,000 and, on the date of completion, had sold it to the lessor, ABC Finance Ltd, for \$1,850,000. The initial direct costs amounted to \$15,000. ABC Finance Ltd provided the lease finance at 10% interest.

The estimated useful life of the plant was ten (10) years, with no residual value. At the inception of the lease, Bronson Ltd intended to utilise the plant over its estimated economic life. The lessor provided the following lease schedule:

	Rental	Interest	Balance
September 30 20X5			\$1,865,000
Rental payment September 30 20X5	\$400,000		1,465,000
Interest to September 30 20X6		\$146,500	1,611,500
Rental payment September 30 20X6	400,000		1,211,500
Interest to September 30 20X7		121,150	1,332,650
Rental payment September 30 20X7	400,000		932,650
Interest to September 30 20X8		93,265	1,025,915
Rental payment September 30 20X8	400,000		625,915
Interest to September 30 20X9		62,592	688,507

Question A:

Arising from the sale and leaseback transaction, the lease is:

- a) An operating lease from the viewpoint of both the lessee and the lessor
- b) An operating lease from the viewpoint of the lessee and a finance lease from the viewpoint of the lessor
- c) A finance lease from the viewpoint of the lessee, and an operating lease from the viewpoint of the lessor
- d) A finance lease from the viewpoint of both the lessee and the lessor

Question B:

In the income statement of Bronson Ltd for the year ended *June 30 20X6*, on the sale of the plant to ABC Finance Ltd will be recognised (amounts to the nearest dollar):

- a) Profit on Sale of Plant \$665,000
- b) Profit on Sale of Plant \$124,688
- c) Profit on Sale of Plant \$ 49,875
- d) No item "Profit on sale of Plant" will be recognised

Question C:

Assume that the lease is a finance lease from the viewpoint of the lessee. For the year ended *June 30 20X6*, the total lease related expense (amortisation expense, interest expense, less any profit recognised on the disposal of the plant) recognised in the income statement of the lessee is (amounts to the nearest dollar):

- a) \$125,062
- b) \$166,750
- c) \$266,500
- d) None of the above

Question D:

Assume that the lease is a finance lease from the viewpoint of the lessee. For the year ended **June 30 19X7**, the total lease related expense (amortisation expense, interest expense, less any profit on disposal of the plant) recognised in the income statement of the lessee is (amounts to the nearest dollar):

- a) \$147,736
- b) \$152,736
- c) \$147,738
- d) None of the above

Question E:

Assume that the lease is a finance lease from the viewpoint of the lessee. In the balance sheet of the lessee as at **June 30 20X7**, the *current liabilities* of accrued interest payable on the lease finance and lease rentals payable are reported as (amounts to the nearest dollar):

- a) \$121,150 and \$400,000 respectively
- b) \$ 90,863 and \$278,850 respectively
- c) \$ 90,863 and \$309,137 respectively
- d) None of the above

Question F:

Assume that the lease is a finance lease from the viewpoint of the lessee. In the balance sheet of the lessee as at **June 30 20X7**, the *non-current liability* of lease rentals payable is reported as (amounts to the nearest dollar):

- a) \$ 627,275
- b) \$1,211,500
- c) \$1,332,650
- d) None of the above

Question G:

Assume that at **September 30 20X5** the PV of the lease residual is \$470,528. The PV of the minimum lease rentals at that date, therefore, is:

- a) \$1,394,472
- b) \$ 994,472
- c) \$1,865,000
- d) None of the above

Question H:

Assume that the lease is a finance lease from the viewpoint of the lessee. At **June 30 19X6**, the leased plant is reported in the balance sheet of Bronson Ltd at (amounts to the nearest dollar):

- a) Plant \$1,200,000 less accumulated amortisation of \$90,000
- b) Plant \$1,200,000 less accumulated amortisation of \$15,187
- c) Plant \$1,200,000 less accumulated amortisation of \$186,500
- d) None of the above

Question I:

Assume that on October 1 20X8, immediately subsequent to the payment of the lease rental on September 30 20X8, Wilson Ltd acquired all leased rights and assumed all obligations under the lease from Bronson Ltd for \$500,000 cash. Arising from the transaction, for the year ended **June 30 20X9**, the income statement of Bronson Ltd would disclose:

- a) A profit of \$805,500
- b) A loss of \$12,975
- c) A Loss of \$805,500
- d) None of the above

Question H:

Assume that the plant had not been sold and leased back by Bronson Ltd, but that the company had borrowed \$1,850,000 on the same terms. The costs of borrowing amounted to \$15,000. Over the four-year period of the loan, the total of the depreciation on the plant and the interest on the loan would have been:

- a) The same as the total of the lease related expenses over the same period.
- b) Less than the total of the lease related expenses over the same period
- c) More than the of the total lease related expenses over the same period
- d) The same as the total of the lease related expenses over the same period, only if the lease residual is equal to the carrying amount of the depreciated plant

Question 6:

The Directors' Report in the Annual Report of Rothbury Wines Limited for the year ended June 30 1994 contained the note that the company had entered into an agreement with Durst Mineral Securities Pty Limited for the four (4) year lease of the Augustine vineyards from Durst Mineral Securities Ltd.

The leased property comprised approximately 44 hectares of irrigated vineyard in the Mudgee district, together with the associated Augustine Wines' cellar door and

hospitality activities. The annual lease rental was \$209,720 payable quarterly.

The company had a call option to acquire the operations at the end of the four (4) year term in exchange for a consideration of \$1,972,992; and Durst Mineral Securities Ltd had a put option to sell the vineyards to the company for the same amount.

Assume the following data:

- a) the normal output of the vineyard is 440 tonnes, and the operating cycle is 2.5 years;
- b) the market price of 44 hectares of vineyards is \$1,800,000, with a useful life of 30 years;
- c) the balance of the assets comprising the cellar door and hospitality facilities has a useful life of 20 years; and
- d) the interest rate implicit in the lease is 10%.

Required:

- a) Would the lease be classified - as an operating lease, or a finance lease? Explain.
- b) Assume that no part of the lease rental is allocated to the cellar door and hospitality facilities, and the lease is accounted for as an operating lease. During the lease term, and prior to any exercise of the option, how would you account for the lease rental payments?
- c) Following on from (b), how would you account for the lease rental in the year ended June 30 1995 if production was 330 tonnes?
- d) Assuming the same approach as in (b), what would be the difference in reported profits in the years ended June 30 1994 and June 30 1995, if the lease were accounted for as a finance lease?
- e) At June 30 1995, the assets of the economic entity controlled by Rothbury Wines Limited totalled approximately \$66 million. What factors would appear to have motivated the decision of directors, and the compliance of auditors, in the classification of the lease?

Question 7:

Adams Ltd constructed an item of plant, with an expected useful economic life of ten (10) years, at a cost of \$420,000. Immediately on completion, September 1 20X1, the company sold the plant to DEF Finance Ltd for \$600,000; immediately leasing it back at a rental of \$121,554 per year for a lease term of five (5) years, commencing September 1 20X1. Adams Ltd guaranteed the lease residual of \$150,000. The interest rate was 10%. Adams Ltd was responsible for the maintenance and insurance of the plant.

Lease Schedule

	Rental	Interest	Balance
Total purchase price September 1 20X1			\$600,000
Initial rental September 1 20X1	\$121,554		478,446
Interest to August 31 20X2		\$ 47,845	526,291
Rental payment September 1 20X2	121,554		404,737
Interest to August 31 20X3		40,474	445,211
Rental payment September 1 19X3	121,554		323,657
Interest to August 31 20X4		32,366	356,023
Rental payment September 1 20X4	121,554		234,469
Interest to August 31 20X5		23,447	257,916
Rental payment September 1 20X5	121,554		136,362
Interest to August 31 20X6		13,638	150,000
Residual payment September 1 20X6	150,000		-
	-----	-----	
Total rental payment and interest commitments	\$757,770	\$157,770	
	=====	=====	

Required:

- a) How is the lease to be classified?
- b) Set out the journal entries to account for the sale of the plant and the lease in the accounts of the lessee in the year ended June 30 20X2.
- c) Show how the plant would be disclosed in the balance sheet of the less at June 30 20X2.

WEEK 8

Revenue, Expense and Income Recognition and Measurement

- a) Income, revenue and expense
- b) Recognition and measurement of income
- c) Income recognition on long-term construction contracts and franchising
- d) The value relevance of earnings

Reading

- a) Whittred, et al.: Cha 4 (pages 82-87 only)
- b) Deegan: Ch 15 sections 15.1, 15.2, 15.6
- c) Handbook: Standards AASB 118, AASB 111, AASB 101, AASB 108, AASB 133

Basic Concepts

- a) Deegan Ch 15: Question 11
- b) In relation to a construction contract, distinguish between incentive payments, penalty clauses, contract variations, contract claims, contract overruns and backlog
- c) Where the profit is recognised on a contract on the basis of proportionate performance measured as the costs incurred to date as a percentage of expected total costs, the costs of contract overruns are spread over the current and remaining contract periods. Do you agree? Explain.
- d) What conditions are required for profit on a contract to be measured on the basis of proportionate performance?

Application of Concepts

Question 1: (accounting processes on a construction contract)

On September 1 20X4, Pardon Ltd entered into a contract to construct a complex for Carbine Ltd at a contract price of \$20,000,000. The estimated total contract cost was \$16,000,000, giving an expected contract profit of \$4,000,000. Contract proportionate performance was measured on the basis of actual costs to date as a proportion of total expected costs, with any cost overruns thus being apportioned over the whole of the contract. Data relating to the three-year duration of the contract were (amounts in thousands):

	Year ended June 30		
	20X5	20X6	20X7
Actual costs incurred in the year	\$ 2,000	\$ 8,000	\$7,000
Expected costs to complete the contract at balance date	14,000	6,500	-
Contract billings in the year	2,300	10,500	7,200
Cash collected in the year	2,000	9,800	7,700

Other data:

- a) At June 30 20X7, an amount of \$500,000 was withheld by Carbine Ltd for a retention period of six months ending on September 14 20X7.
- b) During the preparation of the accounts for the year ended June 30 20X7, Pardon Ltd was made aware of deficiencies in the plant construction, which were required to be rectified at an expected cost of \$200,000.
- c) The plant construction was completed on March 14 20X7 and, in spite of the rectification required, was ready for use at that date; although it was not used by Carbine Ltd for production until July 14 20X7.

Required:

- a) Set out the journal entries to recognise the effects of the contract transactions in the accounts of Pardon Ltd and Carbine Ltd over the contract period to June 30 20X7.
- b) Show how the effects of the contract would be disclosed in the financial statements of pardon Ltd and Carbine Ltd over the contract period to June 30 20X7.

Question 2: (construction accounting – multiple choice)

During the year ended June 30 20X4, Janson Ltd entered into a long-term contract to construct a plant complex for DEF Manufacturing Ltd at a contract price of \$120,000,000. The expected contract cost was \$80,000,000. The following data relate to the contract from the viewpoint of Janson Ltd (amounts in thousands):

	Year ended June 30		
	20X4	20X5	20X6
Costs incurred in the year	\$16,000	\$59,000	\$20,000
Estimated cost to complete the contract at the end of the year	64,000	15,000	-
Billings during the year	20,000	70,000	30,000
Cash collected during the year	18,000	65,000	31,000

An amount equal to 5% of the contract price (\$6,000,000) had been withheld by DEF Manufacturing Ltd at June 30 20X6 until the end of the retention period October 31 20X6. During July 20X6, prior to completion of the accounts of Janson Ltd for the year ended June 30 20X6, DEF Manufacturing Ltd advised the contractor of structural faults, the rectification of which was expected to cost \$2,000,000.

Janson Ltd recognised profit on the contract on the basis of proportionate performance, with the percentage completed being measured as the percentage of costs incurred to the reporting date to the total estimated contract cost at that date.

Question A:

In the year ended *June 30 20X4*, the profit recognised by Janson Ltd on the contract is:

- a) \$ 8,000,000
- b) \$10,000,000
- c) \$ 5,333,333
- d) None of the above

Question B:

In the year ended *June 30 20X5*, the profit recognised by Janson Ltd on the contract is:

- a) \$19,736,842
- b) \$17,000,000
- c) \$25,333,333
- d) None of the above

Question C:

In the year ended *June 30 20X6*, the profit or loss recognised by Janson Ltd on the contract is:

- a) Nil
- b) A profit of \$5,263,158
- c) A loss of \$2,000,000
- d) None of the above

Question D:

At *June 30 20X5*, the account receivable from DEF Manufacturing Ltd by Janson Ltd is:

- a) \$ 7,000,000
- b) \$ 5,000,000
- c) \$70,000,000
- d) None of the above

Question E:

At *June 30 20X6*, the Account Receivable from DEF Manufacturing Ltd by Janson Ltd is:

- a) \$ 1,000,000
- b) \$ 4,000,000
- c) \$30,000,000
- d) None of the above

Question F:

At *June 30 20X4*, the contract work in progress, reported by Janson Ltd, is:

- a) A current asset of \$16,000,000
- b) A current liability of \$ 4,000,000
- c) A current asset of \$ 4,000,000
- d) None of the above

Question G:

At *June 30 20X5*, the contract work in progress, reported by Janson Ltd, is:

- a) A current liability of \$15,000,000
- b) A current asset of \$10,000,000
- c) A current asset of \$15,000,000
- d) None of the above

Question H:

At *June 30 20X5*, the contract work in progress would be reported by DEF Manufacturing Ltd as:

- a) A non-current asset of \$75,000,000
- b) A current asset of \$10,000,000
- c) A non-current asset of \$83,000,000
- d) None of the above

Question 3: (construction contract accounting – recognition of losses)

Jones Ltd entered into a contract to construct a complex for Bain Ltd for \$15,000,000. The anticipated contract cost was \$12,000,000. The data relating to the first year of the contract was as follows:

Costs incurred during the year	\$5,000,000
Billings during the year	4,000,000
Cash collected during the year	3,000,000

By the end of the first year it had become apparent that the costs had been underestimated, and the company felt that additional costs of \$12,000,000 would be required to complete the complex.

Required:

- a) What profit (loss) would the company recognise in the first year of the contract?

- b) Set out the journal entries to recognise the effects of the contract in the accounts of Jones Ltd and Bain Ltd in the first year of the contract.
- c) How is the work in progress disclosed in the balance sheet of the company at the end of the first year?
- d) All of the cost overrun has occurred in the first year because of teething problems. The management of Jones Ltd wishes to recognise all these cost overruns in the first year. Set out the journal entries to recognise the effects of the contract transactions in the first year on this basis. Why would management wish to account for the contract in this manner?

Question 4: (insurance recoveries)

On July 1 20X7, a factory plant owned by Colonus Ltd was destroyed by fire. Immediately prior to the fire, the carrying amount of the plant was \$1,000,000 (cost \$2,000,000 less accumulated depreciation \$1,000,000) and the tax base was \$600,000. Prior to completing the financial report for the year ended June 30 20X8, it was learned that the recovery from the insurance company would be only \$800,000.

Before considering the effects of the fire loss, for the year ended June 30 20X8, the company's income statement disclosed the following (amounts in thousands):

Sales revenue	\$10,000
Cost of sales	5,000
Operating expenses	2,000
Income tax expense	1,200

Required:

- a) Set out the journal entries to record the effects of the fire loss in the accounts of Colonus Ltd in the year ended June 30 20X8.
- b) Prepare an income statement for Colonus Ltd for the year ended June 30 20X8.

Question 5: (franchise accounting)

On July 1 20X6, as part of a reconstruction plan, Skipton Ltd sold a segment of its operations comprising six (6) Barbecued Bambis franchise outlets to Cook Ltd. The following data relate to this sale:

- a) At the date of the sale, the carrying amount of the assets of the franchise segments was \$1,240,000.
- b) In acquiring the franchises, Skipton Ltd paid an initial franchise fee. At June 30 20X6, the unamortised balance of this initial fee was \$450,000. The franchise segments had a remaining term of ten (10) years.
- c) In addition to the initial franchise fee, a franchise fee was payable at the rate of 10% of sales revenue. At June 30 20X6, the amount accrued but unpaid in respect of the sales for the year ended June 30 20X6 was \$120,000.

Under the contract terms of sale, Cook Ltd acquired from Skipton Ltd the franchise rights, the assets of the franchise, and assumed the liability for the accrued franchise fees. The amount paid comprised a cash deposit of \$400,000 on July 1 20X6, followed by payments of \$500,000 and \$600,000 on July 1 20X7 and July 1 20X8, respectively. In the contract, both deferred payments were stated to be interest free. The market rate for finance of similar risk was 10%.

At the date of sale, the book values of the franchise assets approximated fair value. The sales from the outlets for the year ended June 30 20X7 amounted to \$5,000,000.

Required:

- a) Set out the journal entries to record the effects of the disposal of the franchises in the books of Skipton Ltd and Cook Ltd.
- b) For the year ended June 30 20X7, set out the journal entry to record the franchise related expense in the accounts of Cook Ltd.

WEEK 9

Entity Performance Reporting

- a) Structure of income statements and statements of changes in equity
- b) Retrospective and prospective adjustments
- c) What do you understand by earnings quality
- d) What is the link between (a) earnings management, (b) earnings quality and (c) opportunistic choices in Positive Accounting Theory
- e) Basic and dilutive earnings per share
- f) Related party disclosures

Reading

- a) Deegan Ch 16, Ch 24 and Ch 25
- b) Whittred et al: Ch 4 (pages 87-93 only)
- c) Supplementary materials; Readings 1 and 2
- d) Handbook: AASB 101, 108, 118 and 120

Basic Concepts

- a) Distinguish between retrospective and prospective adjustments and give examples of each type of adjustment.
- b) In an income statement, expenses may be reported on the basis of their nature or their function. What is the difference between the two bases? What additional information, if any, must be provided if expenses are reported according to function?
- c) Deegan Ch 25: Questions 1, 2 and 4
- d) Deegan Ch 24 Questions 1, 5, 6 and 9

Application of Concepts

Question 1: (income statement and statement of changes in equity)

(Deegan Ch 16 Question 14) -What additional information (if any) would be required to be disclosed as the expenses are shown by function?

Question 2: (construction of income statement and statement of changes in equity)

At June 30 2004, the reported shareholders' equity of the wine producer, Rattling Good Reds Limited, was:

Shareholders' equity	
Ordinary share capital	\$30,000,000
Asset revaluation reserve	2,000,000
General reserve	5,000,000
Retained profits	4,000,000

Total shareholders' equity	\$41,000,000
	=====

The following data was reported for the year ended June 30 2005:

Sales revenue	\$65,000,000
Cost of sales	36,000,000
Income derived from vineyard construction contract services	5,000,000
Income derived from contract processing	500,000
Interest revenue	100,000
Borrowing costs	600,000
Distribution expenses	1,500,000
Marketing expenses	12,000,000
Administration expenses	9,500,000
Profit on disposal of property, plant and equipment	100,000
Increment from revaluation of grape vines	1,000,000
Increment from revaluation of land (net of tax \$600,000)	2,000,000
Profit from the sale of discontinued operations	
Profit from operations to date of sale (net of Tax \$60,000)	200,000
Profit from the disposal of the operation (net of tax \$600,000)	2,000,000
Income tax expense on profit derived from continuing operations	4,000,000

Other information:

- a) In respect of land sold during the year, the directors resolved to transfer a revaluation increment on this land of \$400,000 to retained profits.
- b) During the year ended June 30 2005, a material error was discovered in the closing inventory at June 30 2004. This inventory had been undervalued by \$1,000,000 (income tax \$300,000). No adjustment has been made for this error in the above data.
- c) As a result of a change in accounting standards, an amount of \$1,000,000 in intangibles carried forward at June 30 2004 has to be written off.
- d) During the year ended June 30 2005, the dividend declared at June 30 2004 of \$1,000,000 was paid on October 14 2004, an interim dividend of \$500,000 was paid on January 15 2005, and a final dividend of \$1,000,000 was declared on June 30 2005.
- e) The directors resolved to transfer \$1,000,000 from retained profits to a general reserve.
- f) At June 30 2004, there were 50,000,000 shares on issue. An additional 2,000,000 shares were issued on January 1 2005 at \$6 per share.

- g) Throughout the year ended June 30 2005, the CEO of the company held 2,000,000 stock options which could be exercised as bonus shares.

Required:

- a) Prepare an income statement for the year ended June 30 2005
b) Prepare a statement of the changes in equity during the year ended June 30 2005

Taxation information:

- a) Increases in provisions during the year – long service leave \$200,000 and warranty \$400,000
b) Reductions in provisions during the year – doubtful debts \$200,000
c) The depreciation recognized during the year was \$600,000, whilst the depreciation allowed as a tax deduction was \$650,000
d) The income tax relating to the profit from discontinued operations was income tax payable – deferred tax was not affected
e) The intangible of \$1,000,000 written off against retained profits at July 1 2004 was an impairment of goodwill which should have been recognized in the previous year. An additional amount of \$1,833,000 for impairment of goodwill is included in administration expenses.
f) In respect of the land sold during the year on which an amount of \$400,000 was transferred to retained profits, the deferred tax liability on the revaluation of \$180,000 became payable.
g) At July 1 2004, the deferred tax liability was \$400,000 (arising from depreciation differences), whilst the deferred tax asset was \$500,000. The balance in the income tax payable account was \$1,000,000.
h) The income tax rate was 30%.

Required:

Prepare a statement of taxable income for the year and prepare the necessary journal entries to recognize the income tax expense.

Question 3: Deegan Ch 25 Question 6

Question 4: Deegan Ch 25 Question 7

WEEK 10

Accounting for Foreign Currency Transactions and Hedge Transactions

- a) Functional, reporting and domestic foreign currencies
- b) Spot rate and forward rate
- c) Exchange gains and losses from foreign transactions (exchange rate risk)
- d) Translation of foreign currency receivables and payables at balance date and accounting for translation gains and losses
- e) Qualifying assets
- f) Hedging in foreign currency transactions
- g) Hedging investments in foreign subsidiaries and associates
- h) Speculative hedges

Reading

- a) Deegan 4th ed. chapter 31 sections 31.1 – 31.6 (pages 1031-1065)
- b) Handbook: AASB 121 and 139

Basic Concepts

- a) Differentiate between the terms "functional currency", "domestic currency", and "reporting currency". Under what circumstances could these currencies be the same currencies?
- b) What is a foreign currency transaction? Give an example of a transaction denominated in a foreign currency that is a foreign currency transaction; is not a foreign currency transaction; and is a foreign currency transaction to both parties to the transaction
- c) If an Australian company purchases inventories from a Malaysian supplier and the purchase price is denominated in US dollars, will the Australian company suffer a loss if, between the date of acquisition and settlement date, the Australian dollar strengthens against the US dollar but weakens against the Malaysian dollar? Explain.
- d) In its accounts for the year ended January 31 1990 a Malaysian company, General Corporation Berhad, recognised all unrealised translation losses, but not unrealised gains; presumably on the grounds that this is consistent with accounting for contingency losses and gains. How does this differ from the recommendations of AASB 1012? What is the basis of the recommendations of AASB 1012 in relation to translation gains or losses? Refer to SAC 4 in your answer.
- e) What are the objectives of a currency forward exchange contract hedge, and a currency option hedge?
- f) What is a qualifying asset? If an entity hedges a foreign currency commitment related to the construction of a qualifying asset, how are the hedge cost and exchange differences recognised in the accounts?

Application of Concepts

Question 1: (foreign currency purchases)

Deegan Ch 31 Question 10 – assume that the contract is settled on July 5 2005 when the exchange rate is AUD 1 – STG 0.42. Set out the journal entry for the settlement.

Question 2: (foreign currency income)

Deegan Question 11

Question 3: (foreign currency transactions on a qualifying asset)

Deegan Question 13

Question 4: (hedging currency exposure through a forward exchange contract)

Deegan Question 14

Question 5: (hedging exposure through a forward exchange contract)

Deegan, Exercise 31.15 - In the example in Deegan, the fair values of the hedge contract are not given. Assume that the fair values of the hedge contract are – March 1 Nil; \$33,450 liability at June 1; \$58,750 liability at June 30; with a final settlement of \$91,463 at August 1.

Question 6: (foreign currency purchases and hedging)

Deegan Exercise 31.19 - Again, the data in Deegan give no fair values of the hedge contract. Assume that the relevant values are – March 15 Nil; May 11 \$25,250 liability; June 30 \$27,300 liability; and August 14 \$20,243 liability.

WEEK 11

Accounting for Derivative Financial Instruments

- a) Primary and derivative instruments
- b) Accounting for futures contracts
- c) Accounting for options
- d) Accounting for interest and currency swaps
- e) Evaluation of accounting for derivatives

Reading

- a) Deegan Ch 14, sections 14.1, 14.3, 14.4 (pages 504-524 only), section 14.5; Ch 31 section 31.6 (pages 1049 - 1065), 31.7 (pages 1065-1070)
- b) Handbook: AASB 139
- c) Supplementary Materials : Readings 7 and 8 on Joint Working Group's proposal to abolish hedge accounting and the Group of 100's response
- d) Handbook: AASB 139

Assignments

Basic Concepts

- a) Deegan Ch 14 Questions 4, 7 and 8
- b) What is meant by the term "financial instrument"? What is a "derivative financial instrument"?
- c) On June 30 20X6 Reddich Ltd entered into a forward rate agreement with a settlement date of September 30 20X6, to hedge against possible interest rate rises on a borrowing of \$10,000,000 for a 90 day period. Is Reddich Ltd a buyer or a seller? What is the period being hedged? If the FRA contract rate is 8% and the market rate at the date of settlement is 10%, what will be the effective interest rate paid by the entity over the period being hedged?
- d) What is the nature of a futures contract? In what way does a commodity futures contract differ from a forward contract to purchase commodities? Why are futures contracts "standardised"? What proportion of futures contracts are deliverable, and what futures contracts cannot be delivered?
- e) Distinguish between a coupon swap and a basis swap. In an interest rate swap, on what basis is the interest obligation calculated and what is the effective obligation of a contracting party?

Application of Concepts

Question 1: (convertible bonds)

Deegan Ch 14 Question 17

Question 2: (call options)

Alpha Ltd plans to purchase 10,000 shares in Westpac on June 30 20X7 but is worried that Westpac's share price will rise significantly before then. On May 1 2005, Alpha Ltd purchases 10,000 call options in Westpac for an outlay of \$30,000 - \$3 per option. The options have an exercise price of \$36 per share and mature June 30 2007. Alpha marks its derivatives to market each reporting date. Assume zero transaction costs. The relevant share prices and option prices are:

	Share Price	Option Price
June 30 2005	\$34.00	\$2.00
June 30 2006	30.00	1.00
June 30 2007	39.00	3.00

Required:

- a) What is the purpose of the call option contract?
- b) Set out the journal entries to account for the option transactions assuming that Alpha Ltd exercises its options on June 30 2007.
- c) Set out the journal entries to account for the option transactions assuming that Alpha Ltd allows the option contract to lapse on June 30 2007 and does not purchase the Westpac shares.

Question 3: (put options)

On July 1 2005, Johnson Ltd borrowed STG 10,000,000 for 5 years from a British bank at a fixed interest rate of 5%, with the interest payable each June 30 and the principle payable in STG. On the same date it entered into an agreement through its bankers to swap STG 4,000,000 at a fixed interest rate of 5% for USD for USD 7,500,000 at a fixed interest rate of 5.25%. The interest on the swap was payable annually on June 30. At relevant dates the exchange rates were:

July 1 2005	AUD 1 = STG 0.40 = USD 0.75
December 31 2005	AUD 1 = STG 0.41 = USD 0.76
June 30 2006	AUD 1 = STG 0.42 = USD 0.75

Required:

- a) Set out the journal entries to account for the loan and the swap in the year ended June 30 2006?
- b) What would be the purpose of such a swap?
- c) What additional information would be required to comply with AASB 139?

Question 4: (debt instruments and fair values)

Deegan Ch 14 Question 26

WEEK 12

Expanded Disclosure Regimes in Financial Reporting

- a) Continuous, half-yearly and annual reporting
- b) Shareholder focus of financial reporting
- c) Expanding focus to meet needs of other stakeholders
- d) Meeting the needs of stakeholders in specific entities
- e) Triple bottom line reporting – community, employee, environmental and consumer perspectives

Reading

- a) Deegan: Ch 16 and 33
- b) Supplementary Materials: Reading 9 ASX Continuous Disclosure: Listing Rule 3.1

Assignments

Basic Concepts

- a) Deegan Ch 33 Question 4
- b) Deegan Ch 33 Question 6
- c) Deegan Ch 33 Question 10
- d) Deegan Ch 33 Question 14

Application of Concepts

Question 1: (profit reporting)

Deegan Ch 16 Question 13

Question 2: (expanding performance reporting)

Deegan Ch 33 Question 11

Question 3: (responsibilities of entities to employee stakeholders)

Deegan Ch 33 Question 24

Question 4: (attitudes to expended performance reporting)

Deegan Question 28

Week 13

Accounting Issues Arising from Incompetence, Failure and Fraud

- a) Earnings management and manipulation
- b) Corporate collapse and creative accounting
- c) The nature and causes of corporate collapses
- d) Implications and costs of collapses
- e) Contributing accounting factors
- f) Regulatory responses

Reading

- a) Reading 10: Clarke and Dean “*Corporate Collapses Analysed*”
- b) Reading 11: Dellaportas et al. “*Creative Accounting*”
- c) Reading 12: Healy and Palepu “*The Fall of Enron*”

Assignments

Basic Concepts

- a) Distinguish between “earnings management” and “earnings manipulation”
- b) What is meant by company “failure”? Distinguish between a failure such as Traveland (the travel operations of Ansett) and the failure of Southcorp.
- c) “Business activity failure is an inevitable consequence of the market economy system. No only is it an inevitable consequence but an essential consequence.” Do you agree? Explain.
- d) From an equity stakeholder’s viewpoint, why are the operations of Southcorp as a “stand alone” unit less attractive that they are as part of Fosters?
- e) Do the recent corporate collapses signal a negative corporate trend?
- f) “Management cannot manipulate reported earnings without the cooperation of the chief financial officers and possibly auditors.” Do you agree? Explain.
- g) Is there a need for more regulation to assuage the public’s concern about corporate failure? What other mechanisms could be put in place?

Application of Concepts

Question 1: (manipulation and falsification of performance and position)

From Reading 12, describe at least two accounting manipulations by Enron and the purpose of these manipulations. Describe at least one manipulation in which accounting was not involved to any great extent.

Question 2: (social realities of fraud)

The following information has been taken from various articles written in the period 1990 to 1992 cited in *FRAUD, Bringing Light to the Dark Side of Business*, by W. Steve

Albrecht et al:

“The FBI and other federal agencies have estimated that total US fraud losses are between \$60 billion and \$200 billion annually.”

“With present funding, only cases involving amounts greater than \$100,000 are being investigated (by the FBI).”

“In the United States \$11.6 billion in merchandise is stolen in 200 million shoplifting incidents each year. Approximately 60% of Americans have shoplifted at some time in their lives.”

“The US Chamber of Commerce says that losses from employee embezzlement may be as high as \$20 billion to \$40 billion annually. These figures place employee theft at a larger amount than burglary, car theft, robbery and larceny combined.”

“Several retail studies, for example, have revealed that shoplifting accounts for 30 percent of retail fraud losses, while employees take 70 percent. Similar studies conducted in banks have found that employees account for 95 percent of bank losses, while customers and robbers account for only 5 percent”.

“In 1990, the IRS claimed that taxpayers paid only \$4 of every \$5 they owed the federal government in taxes. The worst offenders are individuals and sole proprietors – the two categories that account for 75% of the annual tax shortfall (of approximately \$100 billion).”

“A study by the Institute of Management Accountants (IMA) indicated that 87% of managers were willing to commit fraud in one or more of the cases presented to them, if it would make their organizations look better. Another survey of 400 managers shows that one-third of them distrust their own direct bosses and 55% don't believe top management.”

Required:

Accepting this information as reliable

- a) What type of behaviour would we expect a proportion of senior management to exhibit?
- b) Would this behaviour be prevented, to any substantial degree, by regulatory mechanisms?

Question 3: (creation of assets and financial report falsification)

The following information was taken from The Australian Financial Review Friday 27 June 2003:

“The accountant for King Bros bus company (Mr Vincent Evans) yesterday admitted that, in January 3003, he amended the draft annual financial statements for the 2002 calendar year on instruction from Mr King to include: \$14 million to \$16 million of bank savings he couldn’t verify, \$16 million trade debts hr had not previously heard of or verified, directors’ loans he knew did not exist and bus assets he suspected didn’t exist.

To make matters worse, he signed another half-yearly financial statement for the last half of 2002 on the same day, which went to one of the company’s financiers, Toyota Finance, which had different figures for savings, assets and trade debts.

In the case of loans by directors to the company, one financial statement claimed the figure was \$81 million, yet another claimed it was \$166 million. The reality was that directors had loaned none of their own money: it was loaned to the company by the banks.

Yesterday, Mr Evans admitted he had provided false information on numerous occasions.

The receiver’s hearing had previously been told by the company’s CEO, Andrew Walmsley, that the company had invented a phantom fleet of 300 buses. It then sold the non-existent buses for more than \$150 million to the National Australia Bank on a sale-and-leaseback deal.”

Required:

- a) What circumstances could you envisage which could explain the provision of false information and the drafting of false financial statements by an accountant?
- b) At the time of the provision of false information and false financial statements, what monitoring mechanisms would you consider to be less than optimal in Toyota Finance and National Australia Bank?