Introduction to Accounting Policy Choice

**Financial accounting** – the regular report of the financial position and performance of an entity through financial statements issued to external users

Dictionary definitions of what a ‘theory’ is:
- A belief or principle that guides actions or behaviour
- An idea or set of ideas that is intended to explain something
- The set of principles on which a subject is based or of ideas that suggested to explain a fact or event
- More generally, a conjecture of an opinion

**Accounting theory** is:
- A description, explanation or a prediction based on observations and/or logical reasoning
- Logical reasoning in the form of a broad set of principles that (1) provide a general framework or reference by which accounting practice can be evaluated and (2) guide the development of new practice and procedures

Theories are useful in:
- Providing an explanation of what is happening; or
- Helping us predict what will happen

**Types of Theories:**

**Positive theories** are used to represent theories that are about the world as it is, for example:
- Describing what is actually happening
- Explain what is happening
- Make predictions about what will happen

A prediction is often framed as a hypothesis to help make sense of what is happening. These theories include:
- Theories about how contagious diseases are spread
- Theories that explain why managers prefer or choose particular accounting methods or policies over others

**Induction** – the process of moving from specific observations to a theory or conclusion

**Deduction** – process of developing predictions from theories

**Scientific method** – the process of beginning with limited observations, analysing them to derive a theory and then making predictions that are tested by further observations

**Normative theories** do not describe, explain or predict what is happening, but rather make suggestions or recommendations as to what should happen or what ought to be. For example:
- There are theories about what should be done to reduce greenhouse gas emissions with the aim of reducing the rate of global warming and the environmental damage it results in
- There are theories in accounting that propose that fair values should be used to measure assets in the financial statements with the aim to ensure that more relevant information is provided to users of financial statements

**Evaluating & Testing Theories**
- **Falsification** – a rational way to use observation to test a theory is not to try to find observations that confirm the theory but search for instances that do not with the theory and disprove it
The Role of a Conceptual Framework

- A conceptual framework is a group of ideas or principles used to plan or decide something
- It can be seen as a set of guiding principles – the ideas or concepts that influence and direct decisions being made in a particular area
- It is a normative theory – prescribes the basic principles that are to be followed in preparing financial statements

An example of how a set of guiding principles can be used to help influence and direct decisions:

- Governments and judges need to set rules and make decisions about punishments or penalties to be applied when people are found guilty of a crime – guiding principles may be:
  - All people should be treated fairly
  - Community’s safety must be ensured
  - Punishments and penalties should reflect community values and expectations
- Actual decisions about punishment should be consistent as they should follow guiding principles. Guiding principles should be broad, however specific decisions may vary due to different interpretations – e.g.:
  - Treat fairly – could be all people receive same punishment, or could be taking into account particular circumstances (i.e. hungry child = less severe penalty)

How a CF differs from an Accounting Standard:

- CF defines what an asset is and when it should be included in the financial statements
  - Broader, general focus
- The accounting standard on inventory (AASB 102) outlines the definition of what is considered inventory and what costs are included and also requires these assets to be measures at the lower of cost and net realisable value
  - Narrow focus
- Interpretations (AASB 132) generally clarify application of principles in standards – such as how website costs are treated
- The CF does not prescribe which measurement base to use for each element of the financial statements

Basic Accounting Policy Decision Model:

- (i) Identify the relevant facts including key stakeholders
  - Distinguish the known facts from assumptions, identify the factors that are unknown
- (ii) Define the accounting policy issues
- (iii) Identify relevant accounting standards, rules and principles
- (iv) Identify alternative accounting policies
- (v) For each alternative, decided to what extent the particular alternative satisfies the rules/principles in 2 above and identify the short and long term consequences
- (vi) On the basis of the analysis in 5 above, choose the policy that best satisfies the relevant accounting principles and rules and maximises positive or minimises negative consequences

Accounting policy choices must:

- Be made systematically
- Reflect appropriate rules and concepts
- Reflect available facts
- Reflect professional values and ethics

Evaluating theory:

- What form of financial accounting is the best has been debated for long time
- Many key debates (e.g. measurement) are not resolved
• Help us make informed decisions

4 Key Questions in FR:
• **Definition** – what was the transaction about?
• **Recognition** – when should it be recognised?
• **Measurement** – how much?
• **Disclosure** – what else do we need to know?

Example – Company A has a transaction with Company B:
• Definitions/Components – e.g. sell building to associate for $1m and agree to buy back 1 year later for $1.2m
• What A, L etc. are affected – is this a sale or financing transaction?
• Recognition – we should receive it when we receive the cash
• Measurement – initially $1m, and then recognise the extra $200k as interest
• Disclosure -

The answer to these questions are found in an entity’s accounting policies (defined in AASB 108)
• Prescribes the criteria for selecting and changing accounting policies
• Where an Aus acc standard applies, use it
• Where no standard applies, must use judgment that results in accounting info that is relevant and reliable

What drives our judgment?
• Provision of true and fair view – Corp Act
• Satisfying obligations of accountability – to shareholders
• Professional ethics and values
• Self-interested needs

If judgment is wrong:
• Accounting signals result in movements in wealth
• Loss of public confidence in the accounting profession
• Damages to reputation, fines, gaol

### Regulation & Accounting Principles

**Reporting requirements under the Corporations Act**

*Section 292*
• All disclosing entities – listed companies
• All public companies
• All large pty ltd companies; and
• All registered schemes e.g. managed investment scheme

And small pty companies, but only if they are directed to by:
• Shareholders s293
• Members of companies limited by guarantee s 294A
• ASIC s 294, s194B

**Compliance:**
• S 298(1) – the financial report for the financial year must comply with the accounting standards
• S 297 – must give a true and fair view
• Company’s must comply with both provisions – i.e. disclose additional information in notes to financial statements if compliance with accounting standards does not give a true and fair view, so that a true and fair is presented
• Auditor’s must also form an opinion on whether the statements give a true and fair view or presents fairly in all material aspects

AASB 101 paragraph 15
• Present fairly in accordance with definitions and recognition criteria in the framework
• Application of IFRS with additional disclosures where necessary is presume to result in fair presentation
• Paragraph 17: in virtually all circumstances an entity achieves a fair presentation by compliance with AASB

AASB 101/IAS 1
• In extremely rare circumstance where management believes compliance would be so misleading as to conflict with the objectives of the framework the entity shall:
  o Depart from the requirement (if the relevant regulatory framework permits )so called override
  o Provide disclosure in accordance with para 20
• The reg framework (i.e. corp act) does not permit departure from acc standards

Framework’s Fundamental Qualitative Characteristics
• Relevant – ensures that only financial information that could make a difference in decision making is included
• Faithful representation – ensure users have confidence in and can trust the financial information provided in financial reports
  o Neutral- free from bias
  o Free from error – estimates are used in accounting, but errors would indicate that the information is not a faithful representation
  o Complete – all relevant information is required for decision making
• Enhancing characteristics
  o Comparability – users need to be able to compare reports from one period to another, and understand why there are differences in numbers
  o Verifiability – information can be supported and confirmed, thus users are confident in relying on information
  o Understandability – must be able to be understood, otherwise it cannot be used
  o Timeliness – must be delivered on a timely basis, otherwise the information is not relevant to decision making

What does a ‘true and fair view’ mean?
• Economic reality
• Substance over form
• Representational faithfulness
• Accurate – a lot of estimates
It is a legal term and can have differing interpretations
• Compliance with acc principles is only prima facie evidence of true and fair view

Implications of Definition
• No definition
  o Raises uncertainty
Provides courts with flexibility in interpretation
- Increases opportunities for earnings management
- Increases litigation risk for auditors and preparers

- Defined as compliance with standards
  - Provides more certainty about what is required
  - Still allows some flexibility in the choice of accounting policies (if standards allow choice)

The courts do not define the phrase and prefer to treat each case on its merits
- E.g. Re Grierson, Oldham and Adams Ltd (1967)
- Reluctant to define what constitutes a true and fair view because
  - It is necessarily ambiguous – to cover any unforeseen eventuality
  - It must apply to an infinite variety of situations
  - A definition could be too restrictive and lead to inequities
  - Social policy may need to be considered
- Courts do not always understand accounting rules e.g. below

*Lloyd Cheyham & Co Ltd v Littlejohn & Co* (1986)
- Trec Rentals Ltd leased out trailers, which it depreciated over 10 years
- Tyres have a life of 3-4 years but cost between 12.5-20% of cost of trailers
- Trec’s accounting policy was to expense the cost of tyres at the time of purchase
- P acquired Trec on basis of financial statements
- At time of purchase, most of the tyres were very close to the end of their useful life but no provision had been made in the accounts for their replacement
- “Revenue and profits dealt with in the P&L accounts are matched with the associated costs and expenses by including in the same account the costs incurred in earning them so far as these are material and identifiable – SSAP 2 Disclosure of Acc Policies
- Woolf J: supported the use of accounting standards as the presumed basis for reporting but then misunderstood the rules in the standards – essentially took the view that if a cost had to be estimated then it should not be recognised
  - Counter to conventional accounting practice where estimates are recognised provided they are reliable

Accounting Standards can be rules based or principles based:
- Rules based:
  - Attempts to cover all circumstance – very detailed standards
- Principles based
  - Based on set of principles – the conceptual framework
  - Essential characteristics of elements of fin statements derived from their definitions
  - Recognition criteria

Part III

What is an Accounting Policy