Advanced Financial Accounting ACC3AFA

Name

Institution

# Question (1)

According to Watts & Zimmerman (1990), Positive Accounting Theory (PAT) is designed to explain and predict why managers use particular accounting choices/methods. This theory recognizes that changing business environments needs managers to have flexibility in selecting accounting policies. The theory is organised around three main hypotheses: bonus plan, debt covenant, and the political cost. Bonus plan hypothesis suggests that managers of an entity that has bonus plans tend to select accounting policies that bring future period earnings to the current period (p.139). This happens because they want to rocket their bonuses for the current period. Debt covenant hypothesis states that an entity that is likely to violate the debt terms, the more likely the entity management to choose accounting policies that bring future period earnings to the current period to reduce the cost of technical default and debt constraints (p.139). While the political cost hypothesis suggests that managers of entities faced by higher political costs tend to shift reported earnings to future from current periods, especially for large firms (p.139). This because large firms attract high political attention (p.139).

In applying this theory, Youtus Enterprise will need to change its ownership status from sole proprietorship to a limited company under the equity financing option. The reason for this is the fact that sole proprietorship is not allowed to issue shares to the general public since they are not listed in security exchange markets unlike a company limited by shares (Dorathy, 2015). Thus, changing the status to a company limited by shares will enable Youtus Enterprise to float its Initial Public Offering (IPO). In this case, Youtus Enterprise management might prefer to shift the current earnings to the future due to the higher ratio of equity to debts, assuming no bonus plan.

Moreover, Youtus Enterprise will also need effective corporate governance under the equity financial option in order to guarantee investors that the enterprise will be working in their best interest. According to Core et al. (1999), as quoted by Sajid et al. (2012), weak corporate governance leads to higher problems of agency costs as managers tend to overindulge in personal interests rather than working towards maximising firm’s value. Research by Sajid et al. (2012) shows that lower agency cost is achieved when the post of Chief Executive Officer (CEO) is separated from the post of chairperson and higher remuneration. Rashid (2015) confirms that independent directors play a crucial role in controlling executive directors and prevents them from dysfunctional decisions, hence lowering agency cost and boosting the value of the firm. Youtus Enterprise may attract investors if it has strong corporate governance.

Lastly yet important, Youtus Enterprise requires a better accounting information system under the equity financing option in order to entice investors by reducing information asymmetry, which is currently not the case in the business. Information asymmetry is a situation in which the management of the enterprise has more information than the investors, which the management can use for their own interest (Malkiel, 1989). Equity holders need to see and evaluate operating income and financial position of the business in order to make decisions about the future, compare it with other entities in the same industry and find reasons as to why they should invest in it. This is possible if Youtus Enterprise uses better accounting information system that is in line with accepted accounting guidelines such as the Generally Accepted Accounting Principles (GAAPs) and compliance with International Financial Reporting Standards (IFRS) as well as Australian Accounting Standards Board (AASB) requirements for financial statement preparation and reporting. This enhances corporate reporting and encourages investors to invest their money in the company.

# Question (2)

Generally, it is agreed that the cost of debt is usually lower than the cost of equity. The reasons for this have been, on one side, the debt tends to have regularly paid interest expense that is tax deductible, and debt holders are usually paid first before equity holders in case of liquidation (Barclay et al., 2013). Furthermore, debts may be backed with assets, and as such, have a lower risk of default. On the other side, the equity is paid after debt during liquidation and is not a must to pay dividends to the equity holders. Thereby, the equity holders always demand more return in order to compensate for the higher risks they take when compared to debts holders. Thus, the reasons why the cost of debts tends to be lower than that of the equity can be viewed in terms of the risks that equity assumes in comparison (Ahmadimousaabad, et al., 2013).

In Youtus, if the cost of funding under the debt option is higher than that of the equity financing method, then this means that the debt option is riskier in comparison. The reason why this might be the case is the fact that the debt is paid on a regular basis irrespective of the profit made by a business (Kajirwa, 2015). It is expected that Youtus will adversely be affected by changes in subcontracting policy in Australian as the government tries to protect their local industries. This may mean lower operating income, which threatens the ability of the business to pay its regular interest expense (Abdulsaleh, and Worthington, 2013). Failure to pay debt obligation could lead to bankruptcy and Youtus may have no enough assets to pay for such a debt in this scenario. Hence there is higher bankruptcy cost. The worst thing in this is that the personal assets of Mr. Laba can be used to pay the debt Youtus if the assets cannot pay the debt under bankruptcy. In other words, a sole proprietor is legally responsible for all aspects of the business, including business losses and debts (Business.gov.au, 2018).

# Question (3) (a)

The decision by Youtus to influence the outcome of the proposed regulation is consistent with the Capture theory. Capture theory is embraced by organisations that want to ensure that the rules subsequently released are advantages to them, even though they are initially introduced to serve the ‘public interest’ (Cohen, and Sundararajan, 2015). In other words, the government designed regulations for the interest of the company and not the public as it was originally expected (ibid). In this case of Youtus, the government of Australia is planning to put in place stringent regulations to discourage foreign subcontracting for the sake of protecting the local industries. By successfully persuading the government to ensure that the foreign subcontracting policy is designed in their favour, then they will have captured the government (Semple, et al., 2013).

# Question (3) (b)

One of the common practice examples of corporate intervention in public policy formulation is through lobbying. This is a multibillion-dollar industry in Australia, which uses complex strategies to get favours for their clients or members by influencing political and public opinion (Rennie, 2016). The aim is usually to realign or co-opt policy by targeting the public or the regulators/government. Corporate embrace lobbying through use of ex-legislators in case the target is the regulators or the use of Trade unions in case the target is the general public (ibid). For example, according to Knaus, and Evershed (2018), more than half of the lobbyists in Australia have previously worked inside the government, with 1 out of 4 having worked as parliamentary secretaries or in the office of ministers. Lobbying the public includes use of press releases, protests, commissioned research, op-ed pieces, and advertisements. Rennie (2016) confirms that by successfully convincing either of these targets, the business can get the policy aligned in their own interest.

# Question (4) (a)

If the lease liability increases the debt-to-equity ratio, then equity shareholders of Youtus Enterprise will likely be better off. The reason for this is the fact that an increase in debt reduces agency costs (such as bonding costs and monitoring costs) that equity shareholders normally incurs (Nguyen, 2018). According to agency theory, management often acts to maximise their own interest rather (Bosse, and Phillips, 2016). Chen (2018) argues that the terms and conditions of debt keeps the management in check in such a way that they cannot embrace their own interests since they must meet the debt obligations. As such, these make the management re-focus on generating resources to cover the debt obligations, and in the process, this will guarantee better performance of the equity-shareholders. However, the increase in the debt-to-equity ratio will also create another conflict of interest. This is because, the equity holders, debt holders, and the management have different interests, which are often conflicting.

# Question (4) (b)

Capitalisation is the process by which expense is recorded in a permanent account and subsequently amortised over multiple financial periods instead of recording it against the income for the current period (Athabasca University, 2015). Capitalised expense, therefore, means that it is recorded in the Statement of Financial Position as an asset since it generates benefits for the company for several financial periods. According to the Australian Accounting Standards Board (AASB) 16, lessees are expected to capitalise in their books of accounts the leases they have. They are required to measure the right-of-use of the leases and record it as an asset in the Statement of Financial Position, upon which it will be amortised over the lease term. AASB 16 states that right-of-use of the lease includes the initial measurement of the lease liability, payments due to lease done before the commencement date, and indirect costs incurred by the lessee. However, there are 2 main exceptions under which the lease agreement cannot be capitalised. First, if the lease period is less than or equal to 12 months, right from the commencement of the lease agreement. Secondly, if the asset is of low value, the lessee also is not required to capitalize the lease agreement. For example, a personal computer or small items of office furniture can be considered a low-value asset and need not to be capitalised.

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