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FINAL EXAMINATION

JANUARY 2016 SEMESTER

SUBJECT CODE	:	**EAB30903**
SUBJECT TITLE	:	**ACCOUNTING THEORY AND PRACTICES**
LEVEL	:	**BACHELOR**
TIME / DURATION	:	9.00 AM - 12.00 P.M / 3 HOURS
DATE	:	22nd MAY 2016

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INSTRUCTIONS TO CANDIDATES

1. Please read the instructions given in the question paper CAREFULLY.
2. This question paper is printed on both sides of the paper.
3. This question paper consists of TWO (2) sections; Section A and section B. Answer ALL questions.
4. Please write your answers on the answer booklet provided.
5. All questions must be answered in English (any other language is not allowed).
6. This question paper must not be removed from the examination hall.

THERE ARE EIGHT (8) PAGES OF QUESTIONS EXCLUDING THIS PAGE.

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(Total: 50 marks)

SECTION A

INSTRUCTION: Answer ALL questions in this section

1. The decision to expense or capitalise expenditures is important in historical cost system. Briefly explain the statement.

   (6 marks)

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2. Explain **TWO (2)** attributes that something possess in order to be defined as an asset.

   (4 marks)

3. Define the meaning of 'Off-balance sheet' liabilities and provide **ONE (1)** example.

   (6 marks)

4. Discuss **TWO (2)** incentives for managers to manage earnings.

   (6 marks)

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5. Standard setters have been criticised for being 'balance sheet biased'.
   Based on above statement:
   a. Explain the meaning of balance sheet biased.

      (7 marks)

   b. Briefly explain evidence to support this criticism.

      (3 marks)

6. From a shareholder's perspective:
   a. Explain the costs of high leverage.

      (4 marks)

   b. Suggest **TWO (2)** ways to mitigate the costs of high leverage.

      (4 marks)

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7. Discuss, **FOUR (4)** reasons for companies issue sustainability report.

   (10 marks)

(Total: 50 marks)

SECTION B

INSTRUCTION: Answer ALL questions in this section

Question 1

Case Study 1: Companies should come clean on the value of leases on their books

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Investors should very wary of the results reported by companies that rely heavily on leases. Silly accounting rules mean can mean that the majority of many companies' assets and liabilities don't show up on their balance sheets. As a result, even terrific companies like Woolworths report grossly inflated returns on investment and provide financial risk measures that bear no relation to reality.

Following a spate of corporate crises such as Enron's collapse, the US Securities and Exchange Commission investigated off-balance-sheet arrangement. Its mid-2005 report made sobering reading. It estimated that US-listed companies had committed themselves to lease payments totalling USD1.25 trillion that did not appear on balance sheets. About 90 percent of Australian lease are off balance sheet and most companies have some.

This smoke and mirrors trick is particularly rife in the retailing and airline sectors. David Tweedle, chairman of the International Accounting Standard Board, recently told a US congressional hearing of his ambition to "actually fly in aircraft that's on an airline's balance sheet before I die".

He should fly Qantas - to its credit, some (though not all) of its aircraft leases are on balance sheet. Last year, Business Week valued the off-balance-sheet lease liabilities of two large US retailers, CVS and Walgreen, at USD11.1 billion and USD15.2 billion respectively.

If there were on the balance sheet, the companies' respective total liabilities would be 260 per cent and 366 per cent of their reported levels. In reality, companies committing themselves to leases effectively buy assets (right to use things) funded by debt. Obligations to make regular lease payments are just like obligations to regular interest repayments. Good analysts, bankers and equity investors adjust reported financial statements to reflect this fact.

Accountants distinguish between "capital" and "operating" leases. Capital leases must go on balance sheet but operating leases don't. While the Australian standard says that lease classification should be based on a lease's "substance", its guidance criteria on capital leases (such as the lease term covering the "major part" of an asset's economic life) leave much wriggle room.

The US standard provides hard criteria, such as the present value of minimum least payment exceeding 90 percent of asset value. But such criteria have created a huge financial engineering industry and provided a "how to" guide for structuring lease deals to keep them off balance sheet.

Retailers can commit themselves to multi-decade leases involving huge lease payments, yet keep them off balance sheet. Fund manager JF Capital Partners estimates the capitalized values of 'Woolworths' and 'Coles' off-balance-sheet leases to be USD11.8 billion and USD10.8 billion respectively. Adjusting for this off balance sheeting makes a huge difference to their recently reported 2006 – 2007 results.

Woolies reported that net debt fell USD1.3 billion, to USD2.4 billion, in 2006-07. But adjusted for off-balance-sheet leases (which rose USD1.3 billion in value), it really remained unchanged at USD14.1 billion. Coles' adjusted net debt is really USD11.8 billion, versus the USD900 million reported. That is, 83 percent and 92 per cent of these companies' real net debt, respectively, is off balance sheet. Likewise, reported invested capital (debt plus equity) numbers grossly understate reality. Woolies' 71.9 per cent adjusted debt/capital ratio is more than double the 30.7 per cent reported, while Coles' is almost quadruple (75.1 per cent versus 19.4 per cent). While off balance sheeting doesn't distort returns on equity, its impact on debt ratio falsely downplays risk – which may cause shareholders to make poor risk / return trade – offs.

In fairness, off balance sheeting also reduces reported earnings before interest and tax (EBIT), because it causes the entire lease charge to be expensed. If lease assets and liabilities were on balance sheet, the expense would be split between depreciation and interest; the former affects EBIT, the latter doesn't. Nevertheless, off balance sheeting inflates reported returns on invested capital (ROI), as it reduces the invested capital denominator by much more than the EBIT numerator. Using JFCP's lease value and depreciation/interest splits, Woolies' lease-adjusted ROI is 15.2% per cent – while very healthy, it is little more than half the 27.1 per cent reported. Coles' 13 per cent adjusted ROI is less than half the 27.3 per cent reported.

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Off balance sheeting can also make ROI trends misleading. For example, Coles often claim that its ROI has more than doubled since 2001 – 02. It has – from 12.7 per cent to 27.3 per cent – because reported EBIT has doubled while reported invested capital has grown only 21 per cent, kept in check mainly through sorely needed working capital reductions. But as working capital is small relative to off-balance-sheet lease value, which grew 24 per cent, the adjusted ROI has only risen from 9.7 per cent to 13 per cent.

Given the market's view on Woolies (great) and Coles (poor), you may wonder why Woolies' reported ROI looks slightly worse that Coles'. The main driver is Woolies' USD5 billion of intangible assets (such as goodwill from acquisitions) versus Coles' USD1.7 billion. If intangibles are excluded to provide a better measure of real operating performance, Woolies' ROI before lease adjustments becomes 95 per cent – more than double Coles' 43.1 per cent. After lease adjustments, it is 21 per cent, much higher than Coles' 14.5 per cent.

The Woolies/Coles comparison shows that off balance sheeting can make inter-company comparisons of reported returns very misleading. As companies differ in the mix of assets under direct ownership, capital leases and operating leases, the only way to make like-for-like comparisons is to put all leases on balance sheet. Off balance sheeting can also distort comparisons across business units. Reported ROIs of Target (65 per cent) and Food & Liquor (24 per cent) do partly reflect genuine performance differences. But they also reflect the fact that off balance sheeting boosts ROI relatively less for units with higher earnings per square metre (as meterage drives lease charges, hence off-balance sheet lease values). Despite its current underperformance, Food & Liquor's USD413 million EBIT is 24 per cent above Target's. On balance sheeting would narrow its apparent ROI gap.

Following the SEC's call, the International Accounting Standards Board plans to review lease accounting (with Australian participation). Unfortunately, a new standard won't emerge until at least 2009 – and it won't necessarily require full on balance sheeting. As current standards have fostered a huge industry and allowed companies to financially engineer rosy financial reports, big changes will meet heavy resistance. Rather than wait for new standards to force on balance sheeting, companies that really care about shareholders should take the initiative to do it now.

Source: Paul Kerin, The Australian, 2 October 2007.

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Required:

A. Describe current accounting practices for leases as explained in this case study.

(5 marks)

B. Elaborate the reason for the author called leasing standards 'silly accounting rules'.

(6 marks)

C. Standard setters propose revising leasing standards to capitalize all leases. Explain the financial impact for Coles and Woolworths in 2007 – 2008 of having 'off-balance sheet' leases.

(6 marks)

D. State **FOUR (4)** advantages of capitalizing leases.

(4 marks)

E. Most companies prefer classifying leases as operating leases. Discuss **TWO (2)** arguments these company might have against capitalizing leases.

(9 marks)

[30 marks]

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Question 2

Case Study 2: Islamic Social Responsibility

From the Islamic perspective, the concept of accountability would be defined as a perceived relationship between individuals and firms, with God. This was an extension of the basic Islamic concept of tawhid which meant „unity with God" (Maali et al., (2006). In Islam, all people and businesses were accountable to God and to umma (Islamic society) by recognizing the rights of others.

Additionally, every Muslim must strive for an optimal balance between worldly gains and spiritual rewards, which was dependent on their performance in this world (Baydoun and Wilet, 1997). This added another dimension to the valuation of things and deeds compared to those already embodied in western financial statements (Siddiqi, 1981).

In corporations, the management and the shareholders were accountable for their actions to all the stakeholders of the firm or in other words to society or the public at large. Baydoun and Willet (2000) suggested that from the perspective of corporate reporting, two essential principles underlie the concept of accountability in Islam, viz., the principle of full disclosure and the concept of social accountability.

The concept of social accountability under Islam was related to the principle of full disclosure, where the preparer of accounts had to disclose everything that was believed to be of importance to the Islamic users for purposes of serving God. The concept of full disclosure was thus related to the concept of accountability. Hence the key objectives of the Islamic Social Reporting (ISR) were; to show whether the organization was compliant with Islamic principles; to show how the operations of the organization had affected the well-being of the Islamic community; and to help Muslims perform their religious duties (Maali et. al., 2006).

With the rapid development in Islamic Capital Market, the shariah-approved companies were expected to present a religious dimension to their financial statement disclosures for the benefit of Muslim stakeholders. Haniffa and Hudaib (2001) further emphasized that the conceptual framework for Islamic accounting should be based on the shariah as it was supported by the objectives of Islamic accounting as follows: 'To assist in achieving socio-economic justice (al-falah) and recognize the fulfillment of obligation to Allah, society and

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individuals concerned, by parties involved in the economic activities viz. accountants, auditors, managers, owner, government, etc as a form of worship.'

They also stressed that organizations should disclose how it was fulfilling its duties and obligations according to the shariah, for example their lawful dealings, zakat to the beneficiaries, sadaqa (charities/gifts), wages, the objective of any business ventures and initiatives to protect the environment, among others. To achieve this purpose, an Islamic corporation was expected to disclose any prohibited transactions they made, zakat obligations they ought to pay and have already paid as well as their social responsibility role, among others. This meant that financial reporting in Islamic corporations was more detailed than the prevalent conventional disclosure requirements.

There were two ISR items that were frequently disclosed by all the corporations over the three year period, viz., riba activities and BOD structure between Muslims and non-Muslims. The riba activities were reported as „interest income" or „interest expense", while the information on BOD structure disclosure was required by law. It was hoped that these two items would be disclosed directly and clearly in all future annual reports of companies under ISR.

This article also found six Islamic information that were not disclosed, namely; gharar, policy on late repayments and insolvent clients, Current Value Balance Sheet (CVBS), higher echelons in the company performed the congregational prayers with lower and middle level managers, Muslim employees were allowed to perform their obligatory prayers during specific times and fasting during Ramadhan on their working day and finally the number of Muslim shareholders and its shareholdings.

Examples of key findings included; Value Added Statement (VAS) was disclosed in the annual report of some corporations such as IJM Corporation Bhd and Petroleum Gas Bhd in all the three years. However, this did not comply with the proposed VAS as suggested by Baydoun and Willet (2000). Another example of disclosure in a shariah-approved company was the Lion Industries Corporation Bhd, which disclosed that they were involved in the brewery business in all the three years. These were forbidden activities according to shariah.

Another key finding was that Society was the highest theme of disclosure for all the three years. This showed that corporations were well aware of their corporate social responsibility and the involvement of companies with society was a key part of ISR. The Finance and Investment theme displayed the lowest theme of disclosure for 2005 and 2006. This was

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indicative of a lack of transparency in terms of disclosure with respect to Islamic values especially for two important ISR items, namely CVBS and VAS. The CVBS was important for the accurate computation of zakat while the VAS would show how the benefits of the company were shared among the employees, shareholders, government, the company itself and also whether the companies dealt with insolvent clients ethically.

Source: International Business & Economics Research Journal – April 2010 Volume

Required:

A. Discuss the concept of social accountability that relate to the principle of full disclosure from Islamic perspectives as explain in this case study.

(10 marks)

B. Do you agree that Islamic Social Reporting can helps in contributing to the corporate performance? Provide **FOUR (4)** reasons to support your answer.

(10 marks)

[20 marks]

END OF QUESTION PAPER

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