Unit 3

Role of financial institutions and the management of business finance

- **Role of financial institutions**
- Financial institutions offer business advice, financial planning, investment management, arrange leases for non-current assets, insurance products, trade in shares and exchange currencies.

- **short term: cash management trusts, money market and term deposits**
- Cash management trusts; where small amounts from a range of investors are grouped and the money invested in short-term money market securities. This product is usually offered through merchant banks, banks and broking firms
- Money market; deposit on the short-term money market - such as commercial bills, bank bills and promissory notes.
- Term deposits; deposits with a bank or financial institution.

- **long term: debentures, shares, unsecured notes, trusts and term deposits**
- Shares; units of ownership interest in a corporation or financial asset that provide for an equal distribution in any profits, if any are declared, in the form of dividends.
- Debentures; a type of debt instrument that is not secured by physical assets or collateral. Debentures are backed only by the general creditworthiness and reputation of the issuer.
- Unsecured notes; a loan that is not secured by the issuer's assets. Unsecured notes are similar to debentures but offer a higher rate of return with less security than a debenture
- Trusts; a fiduciary relationship in which one party, known as a trustor, gives another party, the trustee, the right to hold title to property or assets for the benefit of a third party, the beneficiary.
- Term deposits; a fixed-term deposit held at a financial institution.

- **the management of business finance with short term and long term perspectives**
- Short term sources of finance available to Public Companies:
- Bank overdraft; firms can withdraw money from the firm’s bank account in excess of the funds deposited in there. Interest rates on the outstanding money is quite high.
- Short term loans; borrowings from the bank or other financial institutions usually with a fixed interest rate.
- Supplier credit; manufacturing or merchandising firms may delay payment for their purchases. Often, up to a month after no interest is charged.
- Factoring of accounts receivable; selling of business accounts receivable at a discount to a factoring company.

- Long term sources of finance available to Public Companies:
- Equity; capital contributions by the owner as well as the issuing of shares
- Long-term loans; loans of five years or more from banks or other financial institutions, such as merchant banks
- Leasing; when the user has all rights to the property however the ownership of the assets remains legally with the funds provider.
- Hire-purchase; similar to a lease however the ownership of the property is passed to the user at the end of the hire-purchase period.
- Debentures; loan securities issued by public companies to the general public in exchange for cash
- Unsecured notes; same as debentures however they offer no security
- Convertible notes; a loan security with a fixed interest rate, where the loan can be swapped for shares at maturity.

Financial systems and fundamental principles

- **distinguish between management accounting and financial accounting**
- Financial accounting is the process of producing general purpose financial reports used by parties external to the entity, such as shareholders, investors, lenders, suppliers, customers, employees and government. Board of directors, stockholders, financial institutions and other investors are the audience for financial accounting reports. Financial accounting presents a specific period of time in the past and enables the audience to see how the company has performed. Whereas Management accounting is the process of producing reports and providing financial information useful for decision-making purposes used by the managers of

an enterprise in the day-to-day management of its trading operations. Reports will often be detailed and frequent and compare actual performance with budget predictions.

- Distinguish between internal and external uses of accounting information and the sorts of information they require
- Internal users of accounting information are the managers of the firm who need information that will assist them to plan, coordinate and control the business on a day-to-day basis and make decisions that will maximise the profitability of the firm and ensure the security and integrity of its assets. The information they need is some sort of profit statement and cash flow statement at least monthly. They would also need information regarding the future such as capital budgeting, CVP analysis and performance results.

- **the nature of cost concepts for materials, labour and overheads**

- A cost is an economic sacrifice of resources for a particular purpose, such as making a product or providing a service. A cost can be something other than an expense.
- Costs can be classified in four ways listed below.
- A cost object is any object for which we require a value or any object for which costs are measured and assigned.
- Direct material and labour costs are directly allocated to the cost of the product. Whereas indirect material and labour costs are allocated indirectly through the use of a predetermined overhead allocation base with the other overhead costs.

- **classification of cost**
  - **behaviours: fixed, variable and mixed costs**

- Fixed costs are those that do not change in total when the level of activity changes.
- Variable costs are those that change as the level of activity changes.
- Mixed costs contain both fixed and variable elements such as a telephone bill (line rental cost + phone calls made)

  - **relationships to cost objects: direct and indirect costs**

- A direct cost is able to be traced to a product or service with a high degree of accuracy.
- Indirect costs are not so easily traced to a product or service.

  - **treatment of costs: product and period**

- A product cost includes all those costs that are attributable to a product. For example direct materials used in the making of a surfboard. (Treated as an asset).
- Costs that are not product costs are period costs such as advertising. (Treated as an expense).

  - **time orientation of costs: past and future**

- Will the cost occur in the future or has it already occurred

- **the concept of mark up and the calculation of the unit price of a product**

- (Practical)

- **the nature and importance of the master budget**

- The master budget consists of an entity's inter-related financial plans, making up of a forecast profit statement and statement of financial plan.

- **the components of a master budget**
  - **operating**
    - sales budget
    - production budget
    - cost of sales and inventory purchases
    - expense budget

  - **financial**
    - budgeted balance sheet
    - budgeted income statement
    - cash budget
    - capital expenditure budget

- **the important financial principles of asset management**
  - **appropriate levels of investment in non-current assets**
- Non-current assets; non-current assets are at the heart of a business' operations and lead to further growth, therefore requiring appropriate levels of investment in them. Businesses must decide whether to invest in real assets, financial assets or intangible assets. The purchase of NCA should be financed by long term debt or equity finance and therefore sufficient cash flow must be generated to ensure these debts are repaid and an adequate profitability earned so that the owners receive their anticipated rate of return. An underinvestment in NCA can lead to stifling business growth and the inability of a business to operate effectively and satisfy customers needs. An over-investment can result in a lack of productivity, inability to repay debt and a poor rate of return for the owner.

  - **appropriate management of accounts receivable, inventory and cash**
- Cash; cash is vital to the liquidity of the business, and sufficient cash must be held to meet normal operational demands so that debts can be repaid, expenses paid, assets acquired and advantage taken of discounts. Too much cash is costly due to fees and low interest rates, so therefore surplus cash should be invested where possible. However if too little cash is held this can lead to liquidity issues, and is important to therefore arrange overdraft facilities in advance.
- Accounts receivable; large accounts receivable can lead to bad debts and opportunity cost due to the loss of investment potential, as well as affecting the liquidity of a business. However the lack of credit facilities to customers can result in potential loss of sales. Credit control is costly and time consuming, but necessary. Identification of poor credit risks and encouragement of prompt payment by all debtors is vital.
- Inventory; maintaining inventory is costly. If the type or quantity of inventory is incorrect this can result in out of date stock, and slow-moving items. To ensure good inventory turnover, it is necessary to have appropriate reorder points and reorder quantities and to take advantage of bulk purchase and discounts. Over-investment in inventory can lead to opportunity cost whereas underinvestment can lead to a loss in sales or disruption in production.

  - **appropriate management of short and long term debt**
- Short term finance should only be used when a temporary shortage of cash happens during normal day-to-day activities and should not be used to pay for NCA as the cash they generate will not be quickly enough to repay the short-term loan.
- Long term finance is used to pay for assets that will help make income over a long period of time.

  - **appropriate level of equity capital**
- It is important for a business to have sufficient equity as a business that is leveraged too highly has a much higher financial risk. An inadequacy of equity may be described as undercapitalisation. The consequences of this include:
  - lack of working capital to effectively carry out day-to-day trading operations
  - insufficient non current assets, preventing the business from maximising profit
  - inadequate returns to equity holders in times when the overall return on assets may fall below the cost of borrowing
  - liquidity problems caused by the need to maintain interest payments and repay loans
  - a higher rate of interest required by the lender because of the increased risk
- Overcapitalisation can also cause problems. Including;
  - ineffective utilisation of funds employed, leading to overall fall in returns
  - lower returns to equity holders who are unable to benefit fully from a situation - most commonly when the overall return on assets exceeds the cost of borrowing.

- **nature and importance of capital investment decisions**
- Capital investment decisions have four main characteristics:
  - involve large sums of money relative to the size of the business
  - expenditures are usually long-term
  - the decision is difficult to reverse
  - they are high risk
- Examples of capital investment decisions are establishing a new store, purchasing new machinery, taking over of an existing business.

- They are important to a business due to the monetary significance and risk they present, as well as the potential return they could generate.

- **concept of the time value of money**
- The time value of money means money today is worth more today that the same amount in the future.
- This is due to inflation and the interest that is able to be earned on that amount.

- **factors affecting capital investment decisions, including:**
  - **consumer preferences**
- Will the expansion match up with the changing trends and consumerism of customers?

  - **competition**
- Will the expansion enable them to keep up with competitors or increase market share?

  - **government regulation**
- The extent to which these may effect the expansion now and in the future in relation to import restrictions, health and safety regulations.

  - **employees**
- What impact the expansion will have on employee morale and motivation

- **explain the relationship between volume of activity, costs and profit**
- As the volume of activity of a business increases, so do its variable and mixed costs, however at higher levels of activity economies of scale comes into play, and overall costs become less significant. Profit is directly proportional to the volume of activity.

Recording, processing and communicating financial information

- **(practical)**

Evaluating financial information for planning, coordinating, controlling and investing

- **differences between internal and external reporting, including:**
  - **users: internal and external**
- External reporting enables users to asses the performance, position and liquidity of an entity. Users of external reports are the government, shareholders, the general public, employees and anyone with interest in the company.
- Internal reports are prepared by the management accountant and submitted to the different levels of management.

  - **regulation: accounting standards**
- Regulation of reports and reasons why; the only factor controlling the preparation of internal reports is cost. Whereas external reporting is very much controlled by legal, statutory and external obligations to such organisations such as ASIC and ASX. This is done because people in our society should be protected to some degree from exploitation by others who may be better informed or more export than they are. External reports are controlled by legislation, external audits and the accounting conceptual framework.

  - **types of financial statements**
- Examples of external reports are income and tax statements submitted to the government, or the balance sheet and income statement given to shareholders.

  - **types of reports**
- Nature of reports produced; external reporting enables users to assess the performance, position and liquidity of an entity. Whereas internal reports are prepared by the management accountant and submitted to the different levels of management for purpose of planning and control. Such reports include make or buy reports, production reports and sales reports.

- Frequency with which reports are produced; external reports such as those given to shareholders are annual or biannual. However other reports can be submitted to other parties at any time. Whereas internal reports are produced at any interval of time, as often as daily.
- The purpose of external reports is to allow the custodians of the business management to be accountable for the decisions they have made and to show how they have invested the resources at their disposal. They are able to show how they have fulfilled their legal obligations and compliance with other statutory requirements. Internal reporting supports the managerial decision-making process. It assists in the management of business assets, liabilities, income and expenses and is important in enabling the business to reach its goals and improve performance.

- **internal audit and control, including:**
  - **purpose of internal audit**
- Internal audit is the continual review of the procedures, systems and policies of the business to ensure that these are being adhered to and working efficiently and effectively.

  - **review of business procedures and policies**
  - the monitoring, examining and testing of the effectivity of established internal control systems.
  - Assessing the management of risk within the business.
  - Assisting management in the improvement of internal controls.

  - **detection and correction of errors and deficiencies**
  - An internal auditor is employed to give independent, objective assurance and consulting designed to add value and improve the business' operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes. (IAA definition). Internal auditors report to the management of the entity. They identify any errors or deficiencies, and develop solutions to correcting these and minimising them.

  - **internal control**
- Reasons for having an internal control system
  - assets, current and non-current, need to be protected against loss or damage
  - assets must be employed as efficiently as possible
  - management must be provided with the necessary information to ensure the protection and efficient utilisation of assets
- Main principles adopted in controlling any asset
  - segregation of duties
  - established lines of responsibility
  - appropriate security of assets and records
  - installation of mechanical and electronic devices
  - adequate recording and documentation systems
  - installation of verification and checking processes
  - the existence of authorisation processes
  - employment of competent and reliable staff
- Internal control processes for cash
  - Cash is the most vulnerable and desirable asset
  - To minimise the likelihood of fraud and theft, cash control measures must be taken such as;
    - Systematic and separate authorisation of payments
    - Proper documentation of receipts and payments
    - Regular reconciliation with the bank's records and an audit trail that will enable transactions to be traced, which enables the cause of any losses to be identified
  - Regular cash budgeting is vital so future deficits or surpluses can be dealt with efficiently

- **the role and function of the accountant in managing business operations**
- The accountants role in the business is to;
  - design and keep financial systems
  - record transactions
  - prepare reports
  - analyse and interpret reports

- manage internal control
- perform CVP analysis
- offer financial planning and advice

- **purpose and function of cash budgets:**
  - **importance of cash to business viability**
- Cash is vital to the liquidity of the business, and sufficient cash must be held to meet normal operational demands so that debts can be repaid, expenses paid, assets acquired and advantage taken of discounts.
  - **interpretation of cash budgets**
- A cash budget can assist the owner/ management to manage the cash flows of the business. It can alert the business to a potential cash shortage which allows them to organise measures to account for this. It can also show a cash excess, allowing the owner to invest some of this cash without stress to gain extra income.

- **purpose and function of budgeted income statement**
- Budgeted income statements use accrual accounting to give an estimated profit or loss for a future period. It shows budgeted income less budgeted expenses.

- **difference between cash and accrual performance**
- Cash accounting is where the income or expense is recognised when the cash is transferred. Whereas accrual accounting recognises income when it is earned, when control of the goods is passed onto the customer. Expenses are recognised when the loss or consumption occurs, not when the cash is paid for them.

- **interpretation of performance reports for cash budgets and budgeted income statements**
- After a budget period is over, all budgets should be checked with actual performance. If there are large differences between budgeted figures and actual figures, these variance need to be investigated. The identification of these variances allow management to revise and create more accurate budgets for the next period, as well as determine the reason for the variances and if possible minimise or account for them.

- **interpretation of capital investment/ budgeting techniques to evaluate capital expenditure**
- Payback period method is the period of time it takes for the cash flows from an investment to exceed the initial cost of the investment. The larger the payback period, the worse, as it represents a larger amount of time for there to still be risk and cost the business. Contrary, the smaller the payback period as it shows that the business will make a return on the expenditure sooner with less risk.
- The Net Present Value method considers the time value of money, taking into account the importance of cash flows rather than profit. A positive NPV result indicates that the investment is acceptable, while a negative result indicated that it is not acceptable and should be rejected as it creates a net loss to the business.

- **importance of business planning, including a consideration of:**
  - **goals, objectives and generic business strategies: cost leadership versus differentiation, strategic initiatives and performance management**
- Strategic decisions are those that determine the long-term policies of the business, which require the formation of specific objectives.
- Operating decisions are those that focus on the efficient use of the resources available to the firm in the short-term.
- Cost leadership is when the business places itself in a position to price its products more cheaply than competitors to maintain or improve market share.
- Differentiation is when the business positions itself so that it is recognised as providing a good or service that is different from competing products.

  - **reducing costs and risks**
- Through the use of effective budgeting, setting of goals and objectives and performance management a business can reduce their costs by identifying and eliminating deficiencies as well as identify and account for risks.

- **CVP analysis for decision making purposes (practical)**
  - **cost behaviour**
  - **contribution margin**
  - **break-even point**
  - **margin of safety**

- **interpretation of CVP results and testing of sensitivity to changing decisions about:**
  - **volumes, product mixes, pricing and costs and the impact of capacity constraints**
  - **make or buy decisions**
  - **close down product/business unit decisions**
  - **accept or reject special order decisions**
  - **(practical)**
  - CVP analysis is a technique used to determine the effects of changes in an organisations sales volume on its costs, revenue and profit.
  - Five ways CVP analysis can assist management in decision making:
    - what the selling price of a product should be
    - how profit changes if any of the variable for fixed costs change
    - at what volume of production will the business break even
    - how profit changes if the selling price changes
    - what volume of production a business needs to achieve in order to make a profit of a set amount

The role and influence of governments and other bodies

- **the concept of insolvency as defined by the Corporations Act 2001**
- "Solvency is defined as the ability to pay all debts as and when they become due and payable" - Corporations Act 2001
- A person or business is said to be insolvent when they do not have sufficient cash flow to pay debts when they are due; and if their liabilities are greater than assets.
- If a sole trader or partnership becomes insolvent they will go into bankruptcy, whereas companies have to announce they're in voluntary administration or receivership.

- **actions for insolvent companies, including:**
  - **voluntary administration**
  - A voluntary administrator takes over to investigate the company's affairs
  - The object is to increase the possibility of continuing the company's business in a successful way.
  - If this is not possible they either enter into a deed of company arrangement or proceed to winding up the company.

  - **liquidation**
- Company is wound up, and then deregistered
- Company ceases to carry on business
- Can be voluntary or compulsory
- A liquidator is appointed to control the affairs of the company and sells assets to distribute the proceeds to all stakeholders

  - **receivership**
- The secured creditors of a company can appoint a receiver to realise the assets and repay them their debt owed.
- Takes control of all or part of the company, with the intention of taking control of the secured assets to see that the secured creditors are repaid.

- **order of priority of the distribution of funds when insolvent**
  - Liquidator
  - Secured creditors
  - Employee entitlements
  - Unsecured creditors

- Shareholders

The influence of social, environmental and ethical factors

- **identification of the costs and potential income associated with engaging in socially and environmentally responsible practices**

• Costs of CSR include direct costs, such as new processes, additional staff and equipment and the production of CSR reports. Indirect costs include loss of competitiveness.
• Benefits of CSR include:
  - favourable perceptions of the company amongst employees, customers and the general community
  - compliance with government regulations
  - possible future business opportunities through improved products or processes
• An example is Woolworths switch to no single-use plastic bags. This is following CSR as it's helping the environment, however it costs the business in that it creates a hassle for customers - potentially losing business. The potential income associated with this is that it is viewed better by the general public as an environmentally responsible business, and may cause an increase in customers who want to support these types of businesses.

- **the ethical issues encountered in financial dealings between business owners/managers and their employees, clients and investors**

• Ethical behaviour is behaviour that is fair, objective and consistent and considers the interests of all those likely to be affected, directly or indirectly, by the behaviour. It is doing what is right, not just what is strictly legally required.
• 6 ethical dilemmas commonly faced by responsible officers within a company:
  - Conflict of interest; when a business owner or employee has competing interests in a decision that must be made
  - Confidentiality; information should not be released to others to the disadvantage of the company that employs them. Confidentiality can only be breached when there is a legal of professional duty to do so,
  - Making use of financial information for personal gain; information should be handled as dictated and not made use of for personal gain,
  - Using company assets for personal gain; employees are often given responsibility for the control of assets that belong to the business, these should not be used for outside the business for personal gain.
  - Schemes to evade or reduce taxation; the concealing or falsifying of details to avoid tax is called tax evasion and is illegal,
  - Manipulation of financial information; business owners are directors may be tempted to withhold or manipulate records given to shareholders and employees etc if faced with recent poor business performance.

Extra theory not clearly specified in the syllabus:

Advantages of budgeting:

- encouragement of planning
- promotes coordination of functions within a business
- a form of communication
- a basis for responsibility accounting
- a basis for a control mechanism
- authorisation of expenditure
- motivation of employees

Differential analysis:

- a process that uses relevant information to evaluate alternative options

Relevant information:

- information such as costs or income that differs between alternative courses of action

- for example, relevant costs, differential costs, avoidable costs, opportunity costs, relevant income, differential income
- Relevant costs and income are those that differ between the options.
- Opportunity costs are always relevant. Opportunity cost is the potential benefit that is given up when one course of action is taken over another.
- Sunk costs - those that have already been paid and cannot be recovered - are not relevant
- Unavoidable costs - those that will occur regardless of which course of action is taken - are also not relevant.
- Relevant information may be quantitative or qualitative. Quantitative being those expressed in numerical terms such as dollar estimates, or qualitative factors, those that cannot be expressed in numerical terms such as preference of customers or environmental impact.
- Examples of qualitative factors:
  - customers
  - effects on other parts of the business
  - employees
  - competitors
  - legal constraints
  - suppliers

Standard Costing:
- Standard costing is a predetermined cost based on a benchmark or standard that is considered appropriate for the making of a product.
- A system that calculates the cost of a product or service using a standard or benchmark based on certain efficiencies that management is wanting to achieve.

Variance Analysis:
- The main advantage of standard costing is that it enables performance evaluation through the use of variance analysis.
- Variance analysis when using standard costs is the comparison of the actual results compared to these standard amount or value.

Unit 4

Financial systems and fundamental principles

- **characteristics of public and large proprietary companies liability of owners**
- **number of members and directors**
  - Minimum of 1 owner, with no maximum limit.
  - Minimum of 3 directors required by the Corporations Act

- **continuity of existence**
  - A company will continue to exist until it is brought to an end (wound up) by a formal legal process and deregistered by ASIC
  - Shareholders may die, or sell their shares but the company continues to exist

- **legal entity**
  - The company is a separate legal entity from its owners (shareholders) formed by going through a process called incorporation
  - A company can own property and can enter into contracts under its own name
  - Can sue and be sued in its own name

- **transferability of ownership**
  - Simply done through a transfer of the shares in the company, does not need any reallocation of ownership of assets like unincorporated businesses.

- **separation of ownership and management**
  - the ownership and management of a company is separated

  - the owners of a company are called shareholders who pass control or power to make decisions to directors who supervise the management of a company
  - Directors are appointed by shareholders at an AGM

- **the purpose of accounting standards in:**
- protecting external users; assisting creditors and investors and other parties to analyse and make informed judgements about entities, facilitating the provision of financial information, providing for comparable reports.

- assisting directors in discharging their obligations; assisting prepares of financial reports by giving them a framework and benchmarks, facilitating accountability, promoting accurate reporting.

- providing confidence to investors in Australian capital markets; promoting market efficiency, thus reducing the cost of capital and enabling effective international competition
- ensuring that the capital markets operate effectively through engendering confidence of creditors and investors in financial reports.

- **the role of The Framework and its key elements**
- The Framework is a "broad theory of accounting that is used as a basis from which Accounting Standards are developed."
- the nature of the reporting entity
  - those entities reasonably expected to have users who depend on the entity's general purpose financial reports for information that will be useful to them for making and evaluation decisions about the allocation of scarce resources.

- the objective of general purpose financial reports
  - to communicate information about the financial position of an entity at a particular point in time or for a period of time, provide information about the cash receipts and cash payments for an entity during an accounting period, and to observe the overall change in equity during a period.

- evaluation and application of the qualitative characteristics of financial information
- The Fundamental Characteristics
  - Relevance

    Information is considered relevant if it is capable of making a difference in the decisions made by users. Information that has predictive value and/or confirmatory value is considered to be relevant. Information is considered to have predictive value if it can be used to develop expectations for the future. Information is considered to have confirmatory value if it confirms or contests users' past or present expectations. Information can often be both predictive and confirmatory. The relevance of the information is affected by its materiality. Information is material if its omission or misstatement could affect users' decisions. Small expenditures for non- current assets (e.g. tools) are often expensed immediately rather than depreciated over their useful lives to save the clerical costs of recording depreciation, and because the effects on performance and financial position measures over their useful lives are not large enough to affect decisions. Another example of the application of materiality is the common practice by large companies of rounding amounts to the nearest thousand dollars in their financial statements. Materiality is a relative matter — what is material for one entity may be immaterial for another.

    eg. A bank manager looking at the balance sheet of a business for the last two years who has to decide whether or not to approve a loan to that business will need all the information that will assist him to confirm the financial stability of the business in the past and to help him predict the stability of the business in the future.

  - Faithful Representation

    According to the Conceptual Framework, for relevant information to be useful, it must be a faithful representation of the real-world economic phenomenon that it is supposed to represent. Information is a faithful representation if it is complete, neutral and free from material error.

A complete, faithful representation of an item or event includes all necessary descriptions and explanations. For example, a complete picture of a company's assets would include, a description of the nature of the assets, a numerical amount for all of the assets, and a description of what the numerical amount represents. The information contained in accounting reports must be neutral, that is, free from bias. A neutral representation is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that the information will be received favourably or unfavourably by users.
eg. Vecchio Ltd has revalued land from $1,000,000 up to $3,000,000 in its balance sheet. The person who valued the land is Mr Vecchio, himself who claims he used to be a real estate agent. Mr Vecchio has put a very favourable valuation on the land as he is about to sell his company. This could be considered bias and as a result not a faithful representation. However, had the valuation been conducted by four or five independent valuers who come up with a valuation of $2,500,000, then this could be considered neutral, free from bias and therefore a faithful representation.
To be reliable, the information must also be complete and without material omissions.

- The Enhancing Characteristics
  - Comparability

    Making a decision involves choosing between alternatives. Consequently, the conceptual framework argues that information about a company is more useful if it can be compared with similar information about other companies and with similar information about the same company for another period or another date. Comparability enables users to identify and understand similarities in, and differences among items. Comparability is more effective when different companies use the same accounting practices. Information that is comparable facilitates users identifying similarities and differences between different economic phenomena. Consistency refers to the use of the same accounting policies between entities, at the same point in time, or the same entity over time. Consistency supports the achievement of comparability.
    In accounting, comparability is achieved when an entity uses the same or consistent accounting principles each year and different entities use the same accounting principles. Comparability between enterprises and consistency in the application of methods over time increases the informational value of comparisons.

  - Verifiability

    Verifiability means that independent observers could reach a consensus – but not necessarily 100% agreement – that a particular depiction is a faithful representation. Verification can be direct or indirect. Direct verification means verifying an amount or other representation through direct observation. For example, counting cash to verify cash reported in the balance sheet, or counting inventory to determine the quantities in stock. Indirect verification is where techniques and calculations are used to check the amount or representation.

  - Timeliness

    Timeliness means having information available to decision makers in time to be capable of influencing their decisions. Having relevant information available sooner rather than later can enhance its capacity to influence decisions, and a lack of timeliness can rob information of its potential usefulness. Generally, the older the information is the less useful it is. However, some information may continue to be timely long after the end of the accounting period because decision makers may need to establish trends in the data.

  - Understandability

    This relates to the quality of information that assists users to understand the meaning of the information provided. Understandability refers to the extent to which information can be understood by proficient users; that is, users who have reasonable knowledge of accounting and business activities. It is not practicable to require financial reports to be understandable to novices.

- evaluation and application of asset, liability, income and expense recognition and measurement criteria

  - An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. An asset is included in the balance sheet if it is probable that the future economic benefits contained in the asset will be received and if the value of the asset can be measured reliably.
  - A liability is a present obligation of the entity resulting from past events, the settlement of which is expected to result in an outflow from the entity or resources embedding economic benefits. A liability is included in the balance sheet if it is probable that the future sacrifice of economic benefits will be required and if the amount of the liability can be measured reliably.
  - Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants. Income is recognised if the entity has passed control of the goods or other assets to the buyer, or has completed a service, and if it is probably that the future economic benefits that make up the selling price of the goods or other assets will be received by the seller, and if the amount of the revenue can be measured reliably.
  - Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. An expense is recognised if it is probable that the consumption or loss of future economic benefits has occurred, and if the consumption or loss of future economic benefits can be measured reliably.
  - Equity is the residual interest in the assets of the entity after deduction of its liability. EQ=A-L

- **Statement of Cash Flows as per AASB 107, including:**

- benefits of the cash flow statement information
  - Assists to analyse a company and evaluate how the purchase of non-currents have been financed, how the company paid a dividend when it made a loss, if the company paid back its debts etc, allowing a better understanding of the company's position.
- concepts of cash and cash equivalents
  - Cash or assets that can quickly be turned into cash, eg. cash at bank, deposits on call, bank overdraft.

Recording, processing and communicating financial information

- **(Practical)**

Evaluating financial information for planning, coordinating, controlling and investing

- **examination and interpretation of annual reports, financial statements and stock exchange data to assess the position and performance of a public company**

- An annual report should contain the company's financial statements, notes to the financial statements, the directors report and declaration, as well as a corporate governance statement and an audit report of the financial statements.
- To assess the position and performance of a public company, various ratios need to be calculated. Such as liquidity ratios, leverage ratios, profitability ratios, efficiency ratios and market ratios. These can be used to assess the ability of a business to pay its debts, its financial security in the long term, how profitable the company is, the managements efficiency in managing the assets of a company, as well as assessing the return investing in the company will give.

- **purpose of annual reporting and the use of key performance indicators by directors for accountability and decision-making purposes**

- The purpose of annual reporting is to:
  - Report primarily on the company's financial performance and position and to show how it has achieved its main financial function and purpose. The annual report should be an effective accountability document and allow the directors to report on their stewardship responsibilities.
  - Contain details about the company's social and environmental obligations.
  - Include all matters that are important to shareholders in making decisions regarding their continued investment in the company.

Unit 3 and 4 Accounting Theory

- Key Performance Indicators (KPI's) are financial or non-financial quantifiable measures that assist the company to evaluate how successful it has been in achieving its goals, usually its long-term goals.
- Each business will have different KPI's depending on their nature and strategy, however the underlying philosophy behind them is:
  - reducing costs
  - motivating employees by the way they are measured
  - ensuring success through measurement
- Examples of financial KPI's:
  - share prices
  - price - earnings ratio
  - earnings per share
  - sales growth
  - sales figures
  - operating cash flows
- Non financial KPI's:
  - market share
  - turnover of employees
  - sick days taken
  - customer satisfaction ratings
- Directors use these to measure employees, enabling them to hold them accountable, as well as providing key data for decision making such as sales growth and cash flows.

- **interpretation of the following ratios:**

- Liquidity ratios
  - Working capital/current; this ratio shows the ability of a business to pay its short-term debts over the next 12 months using its current assets. A ratio of between 1:1 and 2:1 shows a business can pay its short-term debts comfortably. Higher than this means they may have too much current assets that could be more profitably invested elsewhere, and less than this means it'll have issues paying debts.   Formula = Current Assets/Current Liabilities

  - Quick asset; this ratio shows the ability of a business to pay its immediate or urgent debts, usually in the next month or two. Quick assets are those that are cash or can be converted to cash quickly. Urgent debts are those that'll need to be paid in next month or two. A business should aim to keep the ratio around 1:1, higher than this means money could be invested elsewhere, and less than this means it'll have liquidity issues. Formula = Current Assets (excluding inventory and prepayments)/ Current Liabilities (excluding bank overdraft).

- Efficiency ratios
  - Debtor's collection; this ratio measures how quickly a business collects the money from its credit sales. It is a measure of how efficient management is in collecting accounts receivable. The lower the better. Formula = Average debtors/ Net Credit Sales x 365 - expressing the answer in days. Most businesses have a credit period of around 30 days.

  - Inventory/stock turnover; Measures how many times each year a business replaces its average stock. Formula = Cost of Sales / Average inventory - answer is the number of times per year. It is a measure of how efficiently management manages its inventory/ stock. The higher the better. This ratio is best when compared against industry average.

- Profitability ratios - how effectively the business has generated sales/revenue, controlled expenses and used its assets.
  - Profit; Profit (after tax)/ Total Revenue - presented as either a % or ratio to 1. This ratio shows the profit made by the business for every dollar of sales/revenue. How a business has controlled all costs compared to net sales. The higher the better.

  - Rate of return on assets; measures the profitability of the business in relation to the amount of assets used by a business. It shows how efficiently a business has used its assets to generate profits. Needs to be compared to other businesses in the industry to be meaningful. However, an increase is favourable since it means the business is using its assets more efficiently. Formula = Profit (before tax) + interest expense / Average assets x 100

- Times interest earned; This ratio shows the number of times that the interest of a company is covered by the profit before tax. The more times interest is covered by profit earned the greater the ability of the company today its finance costs and the more financially safer the business will be. Higher is better, and generally 3-4 times offers a good safety margin. Formula = Profit (before tax) + Interest expense / Interest Costs (expensed and capitalised)

- Leverage ratio
  - Debt to equity; this ratio shows the extent to which assets are financed by external liabilities compared to internal capital provided by the owners. Usually expressed as a %, formula = Total Liabilities/ Equity x 100. If this ratio is higher than 100%, it means the business is highly geared and relies more on external borrowings than on funds provided by the owners. A highly geared business has less chance of obtaining future loans and pays lots of interest expense, meaning it is less financially secure in the long term. If the ratio is less than 100%, it is low geared and relies on equity more than external borrowings. More financially secure in the long term.

- Market ratios
  - Earnings per share; Measures the profit available to ordinary share holders as a dollar or cent amount per share. Investors always look for highest EPS available, therefore the higher the better. Formula = Profit (after tax) / Weighted average number of shares issued

  - Price/ earnings; measures the amount investors on the stock market are prepared to pay for each dollar of profit. Formula = Market Price per ordinary Share / Earnings per ordinary share - expressed as amount of times.

  - Dividend yield; measures the current return to an investor on buying a share on the stock market. Expressed as a %, investors will compare this to alternatives such as term deposits, in search for the best returns on their money. Therefore, the higher the better. Formula = Annual dividend per ordinary share / Market price per ordinary share.

- **interpretation of the movements in cash flow items**
- Introduction should comment on what has happened to the cash balance over the year, if it has decreased or increased and by how much.
- Next, comment on net cash from operating activities:
- • A positive net cash from operating activities is a healthy indicator for a business. It means the cash inflows from customers is enough to cover its payments to suppliers and employees.
- • A negative net cash from operating activities is a concern for s business, it means the cash inflows from customers is not enough to cover its payments to suppliers and employees and the money to cover this shortfall must come from other areas.
- • A business can not survive, in the medium to long term, unless it generates positive cash flows from operating activities.
- • Is any dividend paid to the shareholders larger than the net cash from operating activities? This may indicate excessive dividend paid out.
- • Is any dividend paid to the shareholders less than the net cash from operating activities? This may indicate the business has retained some profits rather than pay dividends. This is positive if it is reinvested.
-
- Comment on the net cash from investing activities by addressing the following:
- • Has the business purchased non-current assets that can be used to generate income in the future? This is a positive indicator for a business.
- • Has the business sold non-current assets to finance a negative cash flow from operating activities? This is a negative indicator for a business.
-
- Comment on the net cash from financing activities by addressing the following:
- • Did the business have to borrow money or raise additional share capital to pay for a negative net cash from operating activities? This is a negative indicator for a business.
- • Has the business used short term sources of finance, such as a bank overdraft or short term loan to purchase non-current assets?
- • Non current assets should be purchased using either long term sources of finance or equity.

- **limitations in assessing performance from financial statement analysis and from traditional financial accounting**
- historical cost accounting; historical cost accounting is widely used, easily understood and is reliable. However, using historical cost accounting in financial statements is somewhat a limitation since it is not a good basis for assessing the performance of an entity. It does not give the real value or profit of the business, one reason being that it is not the current value of the asset.

- lack of comparability between entities; ratios are best when compared to an industry-wide standard. However this is not always available since different businesses use different accounting practices for example, straight-line or reducing balance methods of depreciation, meaning it is less accurate to compare entities. The preparation of financial statements involves, in some cases, non-comparable accounting methods and estimates.

- lack of disclosure; companies are not legally required to disclose all information such as individual expenses and which accounting methods and estimates have been used. This can make calculating some ratios impossible.

The role and influence of governments and other bodies

- **the purpose and nature of the Corporations Act 2001, and its impact on company formation and operations**
  - A Commonwealth Act which:
    - regulates corporate activity in Australia
    - defines and gives legal existence to our companies
    - provides shareholder protection
  - It does this by having written rules and requirements covering:
    - formation, naming, operation and administration of companies
    - duties of directors and other office holders
    - raising finance
    - trading in shares
    - reporting
    - registration and appointment of company auditors
    - registration of receivers and liquidators, and the process of winding up a company

- **powers and duties of directors**
  - Directors of a company are vested with certain powers by corporate legislation. These generally include power to act as the firms agents, have full access to the firms accounts, enter the firm into contracts, pledge the firms assets, borrow and give security and determine the T&C's of the company.
  - Directors must; act in good faith, act in the best interests of the company, avoid conflicts of interest, act honestly, exercise care and diligence, ensure the company does not trade insolvent, report to and help the liquidator in the event of winding up.

- **a written constitution**
  - A constitution binds the company, shareholders and directors, in following the rules of the company.

- **replaceable rules**
  - Basic rules set by the Corporations Act which govern the internal management of a company - may be adopted by a company as its own rules. The table of replaceable rules includes; officers and employees, inspection of books by members, directors meetings, meetings of members, shares, transfer of shares, capitalising profits.

- **prospectus**
  - An invitation to the public to purchase shares or debentures. ASIC compels public companies to include in this document sufficient information to ensure potential applicants can make informed decisions about investing. Details in the prospectus must include; evidence of the company's current financial stability and profitability, evidence of past

performance and predictions for the future, details of the offer eg. share details if raising equity, and an application form.

- **rights of shareholders**
  - Ordinary shareholders have a right to:
    - A dividend if and when one is declared by the directors
    - The return of their investment in the vent of liquidation after preference shareholders
    - Attend Annual General and Special Meetings
    - A right to vote on resolutions put to the meetings
    - A right to receive a copy of the annual financial reports
  - Preference shareholders have a right to:
    - A fixed annual dividend
    - Preference over other holders on return of investment if stipulated in the constitution
    - An additional dividend where participating preference shareholders' dividends exceed the preference rate
    - Return of investment on an agreed date where preference shares are redeemable

- **the nature and importance of the following groups which regulate and influence the general purpose financial reporting of companies in Australia:**
- the Financial Reporting Council (FRC)
  - Made up of members who have business, legal, government, academic & other interests eg representatives from:
    - Business Council of Australia G100
    - Australian Shareholders Association Institute of Chartered Accountants
    - ASX
    - Aust Institute of Company Directors
    - State & Federal Governments
  - Appoints board members to AASB
  - Broad oversight of standard setting process. Gives AASB broad strategic direction
  - Responsible for relevant and effective Accounting Standards for Australia
  - Directs AASB to adopt international best practice in standard setting
  - Maintains the budget for AASB
- Australian Securities and Investments Commission (ASIC)
  - The overall role of the ASIC is to administer the Corporations Law.
  - It is assigned by the Federal Government with the primary regulatory role for both listed and unlisted companies:
    - In other words, the AASB sets the standards and the ASIC enforces them.
  - It also interprets Accounting Standards where this is necessary and issues these interpretations through the medium of Accounting Practice Notes.
- International Accounting Standards Board (IASB)
  - An independent board
  - Cooperates with national accounting standard setters to achieve convergence in accounting standards around the world.
  - Goal to provide the world's integrated capital markets with a common language for financial reporting.
- Australian Accounting Standards Board (AASB)
  - The main role of the AASB is to develop and amend Accounting Standards that are internationally compatible
  - To develop a conceptual framework for the purpose of evaluating proposed Accounting Standards and international standards.
  - To make Accounting Standards for the purpose of the Corporations Act
  - To formulate Accounting Standards for other purposes
  - To participate in and contribute to the development of a single set of Accounting Standards for world wide use.
- Australian Securities Exchange (ASX)
  - Basically the role of the ASX extends only to those public companies which are listed on the stock exchange.
  - Its main concern in relation to the preparation and presentation of accounting reports is with the presentation and disclosure of financial information by public listed companies.

  - In addition the ASX aims to ensure that all companies listed on the Stock Exchange act in a manner which is at all times in the best interests of shareholders and the general public good.
  - The ASX has Listing Rules
  - Specify the form, content and frequency of published financial statements for public companies.
- Lobby groups
  - Groups that attempt to influence the standing setting process by making submissions to the standard setters with reference to standards that are relevant to their industry or interest.
    - Group of 100
    - Small Business Association
    - Business Council of Australia
    - Environmental groups etc

- the function of the external audit, including:

- protecting external users; the function of the external audit is to determine whether the financial statements of a business show a true and fair view of all material aspects of the company's position. By doing this it protects external users from being mislead or lied to, protecting their investment.
- providing confidence to stakeholders in Australian capital markets; through the testing and confirming of a company's disclosed financial information, it enables stakeholders to be confident that their investment will not be abused.

- the role of the external auditor appointed by the shareholders and reappointed at the annual general meeting (AGM)

- perform an independent audit of the financial statements
  - Test the Accounting Systems make sure everything has been properly recorded.
  - Satisfy themselves that the company has kept the accounting records following the rules set down in the Corporations Act and the Accounting Standards.
  - The reports based on the records give a "true and fair view" of the company's financial performance for the period and its financial position at the end of the period.
  - Prepare an audit report in which they express their opinion on the above items

The influence of social, environmental and ethical factors

- the extent and nature of corporate social disclosure

  - Corporate social disclosure is about reporting on the success or otherwise of the business' efforts to contribute to economic development while improving the quality of life for its workforce, its employees' families and society at large. It reflects the relationship between the company, the community and environment.
    (Corporate social disclosure refers to the publication of economic, environmental and social information in an integrated report. It is about how a company reports on its performance in its relationship between itself and the community and environment.)
  - CSD is mostly voluntary and there is a great deal of variety in how companies report in this area. An urgent issues group in 1995, indicated that those companies in the extractive industry must report on the amount of their restoration responsibilities shown as a liability and by what accounting method they arrived at this figure. The Corporations Act also requires companies that are subject to the requirements of a Commonwealth, state or territorial law relating to environmental regulation to report through the company's annual report on the details of the company's performance in relation to this. There is no particular set or rules on how CSD should occur, and can take many forms.
  - 5 approaches used by Australian companies to report or CSD are:
    - Cost approach; the company details the cost of each of its achievements. There is seldom, however, any attempt to quantify the benefits or effectiveness of such activities.
    - Cost benefit approach; under the cost benefit approach both the cost and benefit of each activity is given. Ideally under this method the reported profit is adjusted to take account of these costs and benefits.
    - Achievement against social indicators; another approach to CSD is for companies to show how they measure against a social indicator, such as its health and safety record, number of work-related injuries, the gender balance of people in executive positions or net employment creation.

  - Inventory approach; the company will provide a list of its achievements during the past year. The list may include what it has done to reduce pollution and protect the environment. May detail donations made to community or sustainability groups or may detail activities such as how its reduced its energy or water consumption.
  - The target-based or program management approach.
- Can include:
  - Economic component; traditional financial data (quantitative)
  - Social component; disclosures about social issues (ie. diversity of employees, health and safety record, employment conditions, etc)
  - Environmental component; disclosures about environmental issues (ie. how is the entity impacting the environment and contributions to sustainability)

- **the difficulties faced by accountants in producing social and environmental information**
  - The costs of CSD are more easily absorbed by a large company than by small-medium sized ones which will be a challenge to legislators in the future to provide an equitably applicable framework to all.
  - The move towards mandatory CSD seems inevitable, whether through accounting standards or legislation and reporting frameworks.
  - Companies need to establish credibility through reporting on social and environment issues via audit processes for accountability (currently there is little or no independent checking of CSR reports)
  - Changes are constantly occurring in the economic environment shaped by movements in technology and socio-political culture.
  - Companies feel increasing pressure from such issues as atmospheric and water pollution, depletion of resources and the effects of climate change.
  - Technological developments in communication will affect the ways that companies report to their stakeholders and the demands that those stakeholders will place upon companies for up-to-date information.

- **the use made of corporate social disclosure by the company and other users**
  - Pre-emptive strike against environmental/social interest groups, disallowing them to have an impact on the company
  - Good public relations; being seen as a good corporate citizen keeps up its image with society
  - Forestall government interference; save money by self regulation rather than having the government regulate it.
  - Financial benefit; can attract more customers, employees, investors etc

- **critical evaluation of corporate social disclosure as made by Australian companies**
  - Companies tend to report the good things they have done in relation to social, environmental and ethical issues, but they don't report the negative impacts of their operations. Recent research shows that an increasing number of companies are reporting on social and environmental issues in their annual reports. In addition, it is becoming more common for CSD to be audited and checked. While some companies prepare a seperate report for CSD, many companies choose to disclose information in the annual report and many still disclose very little.

Extra theory not clearly specified in the syllabus:

- **Company stuff:**
- A company is a business organisation setup as a separate legal entity in terms of the Corporations Act 2001
- Incorporated means that the company exists as a separate entity in law

- **Extra characteristics of a company:**
  - the capital or owners' equity is divided into shares
  - taxed as a separate entity
  - internal operations governed by formal set of regulations

- **Advantages of a company:**

- Owners' liability is limited
- Capacity to contract in the businesses name
- Easy to transfer ownership
- Continuity of existence
- Taxation of flat 30%
- Access to capital

- **Steps to form a company:**
  - Promoters are a group of people interested in forming a company and are prepared to take up some shares when the company is formed.
  - To incorporate a company the promoters must fill in a form 201 from ASIC and then send it to ASIC with the prescribed fee.
  - The form must contain the following info:
    - Name of company
    - Names of initial shareholders
    - Registered office details
    - Principal place of business details
    - Whether or not it will govern under the Corporations Act or its own Constitution
  - Once the application has been successfully processed by ASIC it gives the company an Australian Business Number, registers the company and issues a certificate of registration.

- **Types of companies:**
  - Public companies
  - Small proprietary companies
  - Large proprietary companies

According to Section 45A of the corporations act, a proprietary company is one which:

- has less than 50 non-employee shareholders
- is not able to invite subscriptions of funds from the public.

The Act defines a large proprietary company as one that exceeds two of the following conditions:

- gross revenues in the financial year of $25 million
- gross assets at the end of financial year of $12.5 million
- at least 50 full-time employees at the end of the financial year

Legislative control for companies

- All companies must:
- notify ASIC of the issue of shares and changes in registered office, principal place of business, directors or company secretary
- have at least one shareholder
- keep an up-to-date register of shareholdings and charges on the company's assets
- pay ASIC an annual fee
- keep proper, systematic and sufficient financial records

- All proprietary companies must:
- must raise funds by the issue of securities only from existing shareholders and employees
- must have at least one director
- may, but are not required to, have a company secretary

- Small proprietary companies need to produce annual audited financial statements only if requested to do so by shareholders holding at least 5% of the company's shares or by ASIC.
- Whereas all large proprietary companies must produce audited financial reports and a directors' report, which must be sent to all shareholders and lodged with ASIC.

- All public companies must:
- have at least three directors
- hold an annual general meeting (AGM) of members each year within five months of the end of the financial year
- lodge with ASIC a copy of its constitution
- maintain financial and other records as specified in the Act
- produce audited annual financial reports and a directors' report, which must be sent to all shareholders and lodged with ASIC.

in addition to these, public companies must publish audited financial reports every six months, as well as making sure their prospectus complies with the requirements of the Act. The Act also contains numerous provisions for the internal management of companies and their record-keeping.

Administering companies:
Companies are run by a board of directors. Directors are appointed by the votes of shareholders at an annual general meeting. Meetings of members (general meetings) may be held at any time when called by directors or shareholders with >5% stake. Apart from the appointment of directors, AGM's also address:

- consideration of the company's financial statements and directors report
- approval of recommendations for final dividends
- appointment and remuneration of auditors

The company secretary, who may also be a director, acts as the assistant to the board, takes the minutes of the meetings, arranges and circulates the agenda and ensures that the company meets all its obligations under the Corporations Act.

Profit:

- Profit is the excess of income over expense for an accounting period.
- In a company, the directors decide how this profit will be distributed
- After profit has been taxed, it is then transferred to an account called "retained earnings". The directors then decide how much of the balance in this account will be paid out to shareholders as their share of the profit (dividend) and how much will be retained within the business. Profits that are retained can then be used to pay future dividends to shareholders, or they may be transferred to a reserve which implies they will be used for a specific purpose such as purchase of an asset.
- Reserve is company profits retained within the business for specific or general purposes. A reserve may be created out of retained earnings or by gains in the value of assets

Dividends:

- A dividend is the amount decided by the directors to be paid to the shareholders as their share of the company's profit. The dividend is proportional to the member's shareholding.
- Dividends are allocated to individual shareholders in proportion to their holding.
- Some shareholders are called preference shareholders meaning they are entitled to receive their dividend before any payment can be made to the ordinary shareholders and receive a fixed rate of return dividend.
- For a preference dividend with an 8% return this means that someone with $2 of shares will get back a 16 cent dividend
- Ordinary share dividends are expressed in terms of x cents per share
- Traditionally, directors would recommend dividend to the AGM where members would be able to approve, reduce, reject but not increase the directors recommendation.
- Now a provision in the constitution enables directors to declare a dividend without shareholder approval.
- The dividend becomes a liability when it is declared at an AGM
- An interim dividend is one that is paid during the course of the year, generally paid halfway through the financial year.

Users of information:

	Investors	**Lenders**	**Customers/ Employees**	**Analysts**	**Auditors**	**Directors/ Managers**
Profitability	Yes	Yes	Yes	Yes		Yes
Growth Potential	Yes			Yes		Yes
Return on Investment	Yes			Yes		
Risk	Yes	Yes	Yes	Yes	Yes	Yes
Liquidity	Yes	Yes	Yes	Yes		Yes
Management Efficiency	Yes		Yes	Yes	Yes	Yes

Tom.H