**Accounting and Finance**

**Unit 3**

**Accounting and Finance For WA**

**Chapter 1 – Introduction to Financial Management**

**Test Your Knowledge**

**Question 6**

**Outline the role of an accountant working for a small business.**

The essential role of an accountant working for a business is to provide the managers of the business with the information they need to maximise the entity’s financial performance. This role may include the following functions:

* the selection or design and maintenance of appropriate financial systems;
* recording financial transactions;
* producing financial reports for the information of managers and external users where necessary. This would include income statements, statements of financial position, statement of cash flows, budgets, and performance reports;
* analysing the reports, interpreting the data they contain and advising management on appropriate courses of action arising from them. This might include cost-volume-profit analysis and capital budgeting;
* implementing strategies for the control of the firm’s assets and for the internal review and control of the firm’s financial systems – this is part of the role and function of internal auditing; and
* cost accounting – the determination and analysis of the cost of a product or service.

**Question 12**

**Define and explain the purpose of management accounting.**

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.

**Question 13**

**Define and explain the purpose of 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.

**Question 14**

**List the main external users of financial accounts.**

Shareholders, investors, lenders, suppliers, customers, employees, and government.

**Question 15**

**What types of enterprise need to have their accounting systems and reports regulated?**

Public companies and some large proprietary companies. This is to protect shareholders as they rely on these reports as their sole or main source of information to assist them in making economic decisions about that organisation (eg. whether to buy, maintain or sell a shareholding in it).

**Question 16**

**What is a ‘reporting entity’ as defined by SAC 1? Give two examples.**

A ‘reporting entity’ is an organisation that must comply with standards in the production of its financial reports. A reporting entity, according to SAC 1, is an organisation that has users of its reports who rely upon those reports as their sole or main source of information to assist them in making economic decisions about that organisation (eg. whether to buy, maintain or sell a shareholding in it). Two examples are public companies and some large proprietary companies.

**Question 17**

**What is a ‘general purpose financial report’ as defined by SAC 2? What is the purpose of financial reporting?**

This is a report whose users rely on it as their sole or main source of information to assist their economic decision-making. GPFRs must comply with Accounting Standards. Clearly any financial report produced by a reporting entity is a GPFR but there will be many instances of reports produced by organisations that would not normally be regarded as reporting entities, which are nonetheless GPFRs. The purpose of GPFRs as outlined by SAC 2 and the Framework is to enable:

* users to assess the financial performance, position, and liquidity of the business;
* users to assess the financing and investing decisions made by the entity; and
* those charged with the responsibility of managing the entity to show compliance with statutory requirements.

**Question 18**

**What is the ‘Framework’ and what is its purpose?**

The ‘Framework’ is the Framework for the Preparation and Presentation of Financial Reports set out by the International Accounting Standards Board (IASB). It constitutes the conceptual outline within which Australian businesses must operate. The Australian Accounting Standards Board (AASB) has issued several Accounting Standards that deal with specific items of preparation or presentation. Generally, Standards comply with the principles contained in the Framework; though, if there is a conflict, the Standard prevails.

**Question 19**

**What is the role of an external auditor? How is such an officer appointed?**

To check the accounts of, generally, public companies by a qualified expert accountant who is independent of the company. The auditor is required to check the company’s systems and records to make sure that they have been properly maintained and that the reports at the end of the financial period accurately represent the company’s performance and position for that period. The auditor is essentially acting on behalf of the shareholders and is appointed by them at the company’s annual general meeting.

**Question 20**

**Outline the principles and purpose of internal control.**

All businesses need to have systems within them that ensure that assets are safeguarded and used as effectively as possible. There are three main purposes governing internal control:

1. assets, current and non-current, need to be protected against loss or damage;
2. assets must be employed as efficiently as possible; and
3. information must be available to management that is accurate to enable compliance with the requirements of the first two purposes and to ensure adherence to the policies they have established. This information must meet statutory requirements where necessary.

The principles of internal control are:

* 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; and
* employment of competent and reliable staff.

**Question 21**

**State the main categories of assets over which a business must exercise control. Outline the reasons for and methods of control in each case.**

1. Cash Control – is the most vulnerable asset, being both desirable to all and easily disposed of. Cash control measures must be such as to minimise the likelihood of fraud and theft by requiring 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, enabling the cause of any losses to be identified.
2. Stock or Inventory – the stock control system should ensure that the firm has the stock it needs, but not an excessive amount and that this stock is safeguarded against loss or damage. With the use of computers, firms can control their stock effectively; most firms can afford to use the perpetual inventory system, which allows easier identification of losses due to theft and reports can easily be produced to identify slow and fast-moving lines of stock.
3. Debtors or Accounts Receivable – for firms that do a significant amount of their business on credit, their debtors may represent a large investment of resources. Offering customers credit facilities may be necessary for commercial reasons, but the firm needs to ensure that the minimum amount of funds are tied up in this way and that bad debts (credit sales that eventually must be written off as irrecoverable) are minimised.

**Test Your Understanding**

**Question 1.1**

**Suggest appropriate classifications for the expenses listed below. The proposed classifications are Cost of Sales, Selling and Distribution, Financial Expenses, General Expenses and Office Expenses.**

|  |  |
| --- | --- |
| **Expenses** | **Classification** |
| **Advertising** | Selling and Distribution |
| **Bad Debts** | Financial Expenses |
| **Cartage Inwards** | Cost of Sales |
| **Cartage Outwards** | Selling and Distribution |
| **Cost of Sales** | Cost of Sales |
| **Customs Duty** | Cost of Sales |
| **Delivery Vehicle Expenses** | Selling and Distribution |
| **Depreciation of Delivery Vehicles** | Selling and Distribution |
| **Discount Allowed** | Selling and Distribution |
| **Insurance** | General Expense |
| **Interest Expense** | Financial Expenses |
| **Office Wages and Salaries** | Office Expenses |
| **Postage and Stationery** | General Expenses |
| **Rent** | General Expenses |
| **Sales Commissions** | Selling and Distribution |
| **Sales Salaries** | Selling and Distribution |
| **Telephone and Internet Connections** | General Expenses |

**Question 1.2**

|  |  |  |  |
| --- | --- | --- | --- |
| **Bean and Counter** | | | |
| **Income Statement** | | | |
| **for the year ended 30 June 2010** | | | |
|  | **$** | **$** | **$** |
| **Income** |  |  |  |
| Fees |  | 967 000 |  |
| Interest Revenue |  | 2 500 |  |
|  |  |  | 969 500 |
| **Less Expenses** |  |  |  |
| **Direct Accounting Expenses** |  |  |  |
| Accountant’s Salaries | 546 000 |  |  |
| Accountant’s Training Costs | 4 900 |  |  |
| Membership Fees (Accounting Organisations) | 3 000 | 553 900 |  |
| **Office Expenses** |  |  |  |
| Postage and Stationery | 2 600 |  |  |
| Office Wages | 98 000 |  |  |
| Office Rent | 48 000 |  |  |
| Depreciation of Office Equipment | 4 500 |  |  |
| Electricity | 7 500 | 160 600 |  |
| **Other Expenses** |  |  |  |
| Communication Costs | 10 500 |  |  |
| Insurance | 28 000 | 38 500 | 753 000 |
| **Profit for the Period** |  |  | 216 500 |

**Question 1.4**

|  |  |  |
| --- | --- | --- |
| **A to Z Electrical Pty Ltd** | | |
| **Statement of Financial Position** | | |
| **as at 30 June 2010** | | |
|  | **$** | **$** |
| **Current Assets** |  |  |
| Debtors/Accounts Receivable | 48 000 |  |
| *Less* Provision For Doubtful Debts | 500 | 47 500 |
| Inventory |  | 166 500 |
| Prepaid Expenses |  | 12 000 |
| Total Current Assets |  | 226 000 |
| **Non-Current Assets** |  |  |
| Delivery Vehicles, At Cost | 118 000 |  |
| *Less* Accumulated Depreciation | 21 700 | 96 300 |
| Fixtures and Fittings, At Cost | 135 000 |  |
| *Less* Accumulated Depreciation | 28 000 | 107 000 |
| Goodwill |  | 150 000 |
| Total Non-Current Assets |  | 353 300 |
| Total Assets |  | 579 300 |
| **Current Liabilities** |  |  |
| Bank Overdraft |  | 7 500 |
| Accrued Expenses |  | 10 800 |
| Creditors/Accounts Payable |  | 88 000 |
| Income Tax Payable |  | 25 000 |
| Bank Loan Payable |  | 10 000 |
| Total Current Liabilities |  | 141 300 |
| **Non-Current Liabilities** |  |  |
| Bank Loan Payable |  | 40 000 |
| Total Non-Current Liabilities |  | 40 000 |
| Total Liabilities |  | 181 300 |
| Net Assets |  | 398 000 |
| **Equity** |  |  |
| Share Capital |  | 300 000 |
| Retained Earnings |  | 98 000 |
| Total Equity |  | 398 000 |

**Question 1.6**

**Requirement A**

|  |  |  |  |
| --- | --- | --- | --- |
| **Mendafews Electrical Contractors** | | | |
| **Income Statement** | | | |
| **for the year ended 30 June 2010** | | | |
|  | **$** | **$** | **$** |
| Fees |  |  | 665 000 |
| *Less* Expenses |  |  |  |
| **Office Expenses** |  |  |  |
| Depreciation, Office Equipment | 1 200 |  |  |
| Wages – Office Staff | 87 000 |  |  |
| Office Expenses | 22 400 | 110 600 |  |
| **General Expenses** |  |  |  |
| Advertising | 2 400 |  |  |
| Depreciation, Motor Vehicles | 16 000 |  |  |
| Wages - Electricians | 366 000 |  |  |
| Insurance | 32 000 |  |  |
| Motor Vehicle Expenses | 29 200 |  |  |
| Electrical Materials Used | 11 000 | 456 600 |  |
| **Financial Expenses** |  |  |  |
| Interest Expense | 4 000 |  |  |
| Bad Debts | 600 | 4 600 | 571 800 |
| **Profit for the Period** |  |  | 93 200 |
|  |  |  |  |

**Requirement B**

|  |  |  |
| --- | --- | --- |
| **Mendafews Electrical Contractors** | | |
| **Statement of Financial Position** | | |
| **as at 30 June 2010** | | |
|  | **$** | **$** |
| **Current Assets** |  |  |
| Cash |  | 27 200 |
| Accounts Receivable |  | 59 200 |
| Total Current Assets |  | 86 400 |
| **Non-Current Assets** |  |  |
| Motor Vehicles (Work Vans), At Cost | 126 000 |  |
| *Less* Accumulated Depreciation | 62 000 | 64 000 |
| Office Equipment, At Cost | 12 000 |  |
| *Less* Accumulated Depreciation | 5 600 | 6 400 |
| Total Non-Current Assets |  | 70 400 |
| Total Assets |  | 156 800 |
| **Current Liabilities** |  |  |
| Accounts Payable |  | 1 600 |
| Total Current Liabilities |  | 1 600 |
| **Non-Current Liabilities** |  |  |
| Mortgage (Repayable 2013) |  | 50 000 |
| Total Non-Current Liabilities |  | 50 000 |
| Total Liabilities |  | 51 600 |
| Net Assets |  | 105 200 |
| **Equity** |  |  |
| Capital |  | 100 000 |
| *Add* Operating Profit |  | 93 200 |
|  |  | 193 200 |
| *Less* Drawings |  | 88 000 |
| Total Equity |  | 105 200 |
|  |  |  |

**Question 1.9**

**Part A**

In this scenario, the financial reports need to comply with Australian Accounting Standards, as the organisation meets the definition of a Reporting Entity in SAC 1 (they are an organisation that has users of its reports who rely upon those reports as their sole or main source of information to assist them in making economic decisions about that organisation). As the GPFR (General Purpose Financial Report) is being made to the Australian Securities Exchange, it will be made available to the shareholders of the company (users of its reports). Additionally, the business will need to follow the regulations set out in SAC 2 when producing their GPFR’s (General Purpose Financial Reports), so that the users of those reports can interpret them easily.

**Part B**

In this scenario, the financial reports would not need to comply with Australian Accounting Standards as, even though the organisation does not meet the definition of a Reporting Entity in SAC 1 (that is, they are an organisation that has users of its reports who rely upon those reports as their sole or main source of information to assist them in making economic decisions about that organisation), this particular report is being prepared for the management of the company, regarding their performance for the month. It is not intended to be seen by any external users.

**Part C**

In this scenario, the financial reports would not need to comply with Australian Accounting Standards as the organisation does not meet the definition of a Reporting Entity in SAC 1 (that is, they are not an organisation that has users of its reports who rely upon those reports as their sole or main source of information to assist them in making economic decisions about that organisation).

**Part D**

In this scenario the financial reports need to comply with Australian Accounting Standards as, even though the organisation does not meet the definition of a Reporting Entity in SAC 1, the bank is an external user who will rely upon those reports as their sole or main source of information to assist them in deciding about whether to give the business the loan or not. Based on this, the business will need to follow the regulations set in SAC 2 when producing their GPFR’s (General Purpose Financial Reports) so that the bank can interpret the reports easily.

**Question 1.10**

**Part A**

This practice is unacceptable. First, if paying by cheque, the person signing the cheque should be specified, not either/or. It might even be wise to have two people within the organisation to sign the cheques. All payments should be by cheque. At no point should cash be taken out of the till to pay expenses as proper records are not being kept of cash coming in and going out of the organisation. In fact, the best way to pay expenses would be to use electronic banking services as proper records would automatically be generated.

**Part B**

This practice is unacceptable. Whenever a business organisation receives monthly statements from the bank, they should be checked and reconciled against the business’s records, to ensure extra, and unnecessary, payments are not made, or that scammers have not accessed the bank account and stolen money. When a business conducts a bank reconciliation process, they are more likely to find discrepancies and can then follow them up with the bank.

**Part C**

This practice is unacceptable. The business runs the risk of running out of stock if no one notices an item is running low. A stock control system should ensure the firm has the stock it needs, but not an excessive amount, and that this stock is safeguarded against loss or damage. With the use of computers, firms can control their stock effectively. If a business uses the perpetual inventory system, it will allow easier identification of losses due to theft and reports can be easily produced to identify slow – and fast-moving lines of stock.

**Part D**

This practice is unacceptable. Reviewing/finalising accounts at the end of the year is way too long, and it is probably too late to chase up some accounts. The process of reviewing accounts, identifying overdue ones, and sending out reminder letters, should happen a day or two after an account has not been paid, and reminders should be sent out every few days after that. By the end of the year all overdue accounts should be finalised one way or another.

**Question 1.13**

**Requirement A**

* The current assets total - this will indicate how liquid the business is and whether it will be able to repay the loan in the short term.
* The current liabilities total – this will indicate how highly geared the business is.
* The capital total – this will indicate whether there are other sources within the business to pay off the loan with.
* The profit forecast for the year – this will indicate whether they are generating enough profit to pay off the bank loan.

**Requirement B**

**Tina’s Tyres**

* Their current assets ($180 000) are quite good.
* Their current liabilities ($90 000) are a little high, but not exorbitant.
* Their capital total ($60 000) is a little low.
* They have an excellent profit forecast for next year.

**Norma’s Nursery**

* Their current assets ($150 000) are good but could be a little higher.
* Their current liabilities ($160 000) are higher than their current assets figure, which is not good.
* Their capital total ($425 000) is excellent.
* Their profit forecast is a little low.

**Requirement C**

**Tina’s Tyres**

* If the loan was approved for Tina’s Tyres, due to the high risk of lending to this business, the interest rates might be a little higher than usual, so that the risk is financially viable. Additionally, the repayments terms might include the loan defaulting as soon as a repayment is late, again, due to the risk.

**Norma’s Nursey**

* If the loan was approved for Norma’s Nursery, there is still a level of risk involved due to the level of their current liabilities, and the profit forecast being low, so the interest rate might be a little higher than average. However, they are a lot lower risk than Tina’s Tyres so there probably wouldn’t be any need to adjust the repayment terms.

**Question 1.14**

**Requirement A**

There are several issues with the working capital management of the company including:

* The fact that sales must be made on a cash basis from 2011 onwards. This is problematic as many companies prefer to purchase their stock using credit due to the convenience as well as delaying cash outflow of the business. In fact, Lawrence Ltd has very probably lost sales due to this policy.
* The fact that cash on hand at the bank must be maximised. If a business has too much cash sitting idle in bank accounts, that do not accrue high interest, they are missing out on opportunities to invest in other projects with higher returns. Lawrence Ltd is running the risk of underutilising their cash.
* The fact they are minimising holdings of inventory. This is risking not having the required amount of inventory required to cover all sales and, as a result, losing customers.
* The fact that payments to creditors should be delayed as long as possible. This, in itself, is not an issue unless they are not meeting the terms of their credit by not making payments by the due date. Additionally, they may be missing out on discounts offered by creditors to pay their accounts early.

**Requirement B**

The main issue with the management of the non-current assets of the company is that no plant and equipment has been purchased over the past three years. This runs the risk of not having up-to-date or reliable equipment needed to meet their sales demands.

**Requirement C**

The financial structure of the company is showing some signs of concern. Their accounts payable and debentures figures have both gone up over the past few years, indicating the use of quite a bit of credit. This is probably how the assets have been financed which is not a good practice, especially when sales revenue have been going down over the same period of time. Additionally, the profit figures have slowly declined over that period of time as well. I would say the underlying cause of dissatisfaction from the shareholders is the declining financial structure of the company, including the decline in sales, profits and dividends paid to shareholders.

**Requirement D**

I would strongly advise the company to not go ahead and purchase the extra non-current assets and finance them through a share issue as, financially, they are in a precarious position that can still be fixed. Purchasing the extra non-current assets might push them over the edge. Instead I would suggest fixing the issues in the company, to try to get it to a position where it can purchase the assets without as much risk including:

* Reinstating credit sales to try to boost the sales figures;
* Paying off accounts in a timely manner in order to take advantages of discounts offered;
* Stop minimising inventory and keep it at a level where it won’t affect the sales of the company; and
* Attempt to reduce the accounts payable and debenture figures.