CHAPTER 11

Processes of financial management

OVERVIEW

11.1 Introduction
11.2 Planning and implementing
11.3 Debt and equity financing
11.4 Matching the terms and sources of finance to business purpose
11.5 Monitoring and controlling
11.6 Calculating financial ratios and strategies to improve performance
11.7 Identifying the limitations of financial reporting
11.8 Ethical issues related to financial reports

11.1 Introduction

An important part of financial management is establishing effective financial processes to monitor the financial health of the business and ensure the organisation meets its objectives. The main financial processes include:

- planning and implementing
- monitoring and controlling
- calculating financial ratios
- identifying limitations of financial reports
- identifying ethical issues related to financial reports.

11.2 Planning and implementing

Financial planning is essential if a business is to achieve its goals. Financial planning determines how a business's goals will be achieved. Figure 11.1 shows the process of financial planning and implementing.

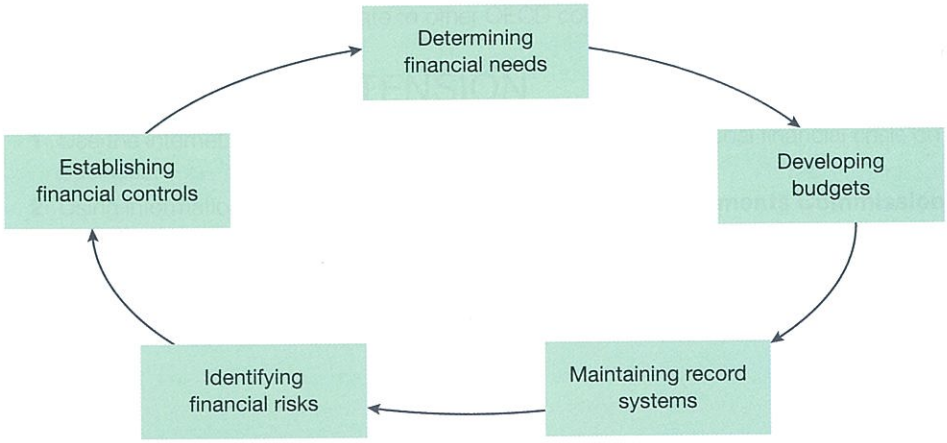


FIGURE 11.1 The planning and implementing cycle

11.2.1 Financial needs

To determine where a business is headed and how it will get there, it is important to know what its needs are. Important financial information needs to be collected before future plans can be made. This financial information includes balance sheets, income statements, cash flow statements, sales and price forecasts, budgets, bank statements, weekly reports from departments, break-even analysis, reports from financial ratio analysis and interpretation.

The financial needs of a business will be determined by:

- the size of the business
- the current phase of the business cycle
- future plans for growth and development
- capacity to source finance — debt and/or equity
- management skills for assessing financial needs and planning.

A business plan might be used when seeking finance or support for a project from a bank or other financial institution or other potential investors. These institutions need a guarantee that their financial commitment to the business will be successful. A business plan sets out finance required, the proposed sources of finance and a range of financial statements. The types of information included in a business plan's financial statements depend on the audience for the business plan — employees, owners, lenders or potential investors. Financial information is needed to show that the business can generate an acceptable return for the investment being sought and should, therefore, include an analysis of financial performance, income statement, cash flow statement, balance sheet and financial ratio analysis reports.

BizFACT

The form and content of the financial information in business plans vary but include some or all of the following:

- *income statement*
- *cash flow statement*
- *balance sheet*
- *cost-volume-profit analysis*
- *financial ratios.*

11.2.2 Budgets

Budgets provide information in quantitative terms (that is, as facts and figures) about requirements to achieve a particular purpose. Budgets can be drawn up to show:

- cash required for planned outlays for a particular period
- the cost of capital expenditure and associated expenses against earning capacity
- estimated use and cost of raw materials or inventory
- number and cost of labour hours required for production.

Budgets reflect the strategic planning decisions about how resources are to be used. They provide financial information for a business's specific goals and are used in strategic, tactical and operational planning.

BizWORD

Budgets *provide information in quantitative terms (facts and figures) about requirements to achieve a particular purpose.*



FIGURE 11.2 Budgets are important financial management tools. They enable managers to plan for the future, monitor past and present performance, and coordinate the plans made by different sections of the business.

BizFACT

Budgets provide the facts and figures for planning and decision making, and enable constant monitoring of progress and problem areas. They signal where things are not going according to plan so that adjustments can be made, and show where achievement towards objectives has occurred.

Budgets enable constant monitoring of objectives and provide a basis for administrative control, direction of sales effort, production planning, control of stocks, price setting, financial requirements, control of expenses and of production cost.

Budgets are used in both the planning and the control aspects of a business. As a control measure, planned performance can be measured against actual performance and corrective action taken as needed.

A budget is an important part of the planning process and various factors need to be considered in preparing it, such as:

- review of past figures and trends, and estimates gathered from relevant departments in the business
- potential market or market share, and trends and seasonal fluctuations in the market
- proposed expansion or discontinuation of projects
- proposals to alter price or quality of products
- current orders and plant capacity
- considerations from the external environment — for example, financial trends from the external environment, availability of materials and labour.

Budgets are often prepared to predict a range of activities relating to short-term and longer term plans and activities. Budgets can be classified as operating, project or financial budgets.

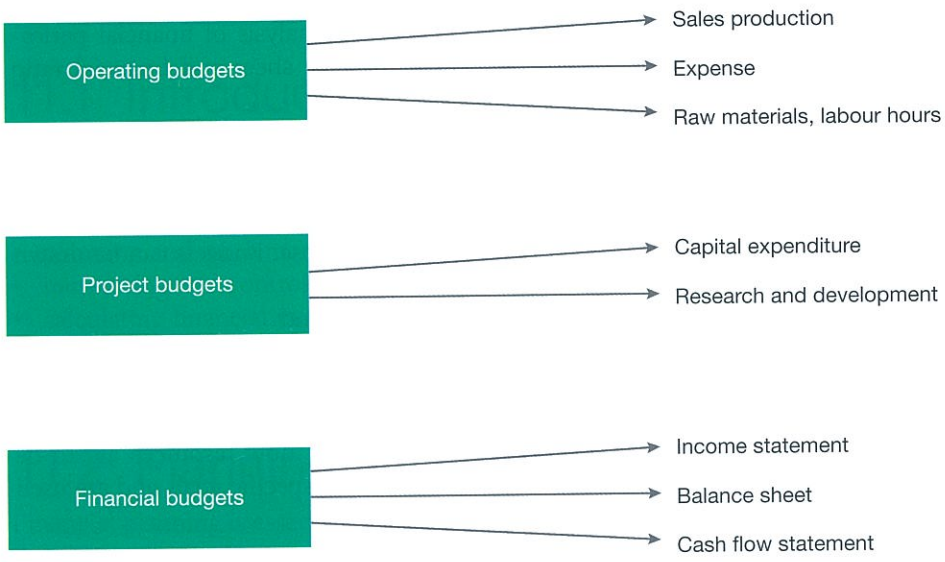


FIGURE 11.3 Operating, project and financial budgets

BizWORD

Operating budgets *relate to the main activities of a business and may include budgets relating to sales, production, raw materials, direct labour, expenses and cost of goods sold.*

Project budgets *relate to capital expenditure and research and development.*

Financial budgets *relate to financial data of a business and include the budgeted income statement, balance sheet and cash flows.*

Operating budgets relate to the main activities of a business and may include budgets relating to sales, production, raw materials, direct labour, expenses and cost of goods sold. Information from operating budgets is used in preparing budgeted financial statements.

Project budgets relate to capital expenditure, and research and development. Capital expenditure budgets in a business's strategic plan include information about the purpose of the asset purchase, life span of the asset and the revenue that would be generated from the purchase. Information from project budgets is included in the budgeted financial statements.

Financial budgets relate to the financial data of a business. The predictions of the operating and project budgets are included in the budgeted financial statements. Financial budgets include the budgeted income statement, balance sheet and cash flows. The income statement and balance sheet reflect the results of operating activities and the cash flow statement shows the liquidity of a business.

Budgeted Income Statement
for 3 months ended 30 June 2018

Sales			250 000	
less cost of goods sold			195 000	
Gross profit			55 000	
less selling and administrative expenses			22 000	
Net profit			33 000	

Sales budget

	April $	May $	June $	Total $
Sales	85 000	90 000	75 000	250 000

Selling and administrative expenses budget

	April $	May $	June $
Fixed costs			
Advertising	2000	2000	2000
Rent	500	500	500
	2500	2500	2500
Variable costs			
Salaries	2800	3000	3400
Delivery	1500	2000	1800
	4300	5000	5200
Total	6800	7500	7700

FIGURE 11.4 Budgeted income statement including sales and expense predictions

11.2.3 Record systems

Managers need to set up a record system that allows them to record all the information they need. **Record systems** are the mechanisms employed by a business to ensure that data are recorded and the information provided by record systems is accurate, reliable, efficient and accessible (see the following Snapshot). Management bases its decisions on the information when needed and must have guarantees that the information is accurate and reliable.

Minimising errors in the recording process, and producing accurate and reliable financial statements are important aspects of maintaining record systems. The double entry system of accounting is an important control aspect. By recording all items twice, the entries can be seen to balance, and checks to find errors can be carried out quickly.

Record keeping — financial management

Good business records help owners manage their business and make sound business decisions. In fact, record keeping isn't just good business practice; it's also a legal requirement. Businesses are required by the Australian Taxation Office (ATO) to keep certain records for a minimum of five years.

Businesses need to create a record keeping system that is simple, reliable, accurate and able to provide information in an accessible format when they need it. They can choose to operate a manual or electronic system.

Manual record keeping systems consist of paper-based journals. The journals are divided into separate sections for receipts, payments, bank reconciliation, wages and superannuation, inventory and others. Under this system, financial managers record business transactions manually in the appropriate sections for each month. Manual record keeping is less expensive to set up and data loss is less of a risk.

BizWORD

Record systems *are the mechanisms employed by a business to ensure that data are recorded and the information provided by record systems is accurate, reliable, efficient and accessible.*

BizFACT

According to statistics released by ASIC, poor record keeping is a major cause of business failure. This is why it is so important that businesses use an accounting program to manage records well.

SNAPSHOT



'Good business records help owners manage their business and make sound business decisions.'

Businesses can also choose to record financial information electronically, using an electronic spreadsheet or a software accounting package. Electronic record keeping systems are a more efficient way of keeping financial records. Computer programs allow financial managers to easily generate orders, reports, invoices, financial statements, pay records, and so on.

A variety of accounting software programs has been developed to assist businesses with their records. Many accounting programs also allow users to email and send financial information to clients, suppliers or to the ATO. Electronic systems require less storage space and make it easier for businesses to meet their tax and legal obligations.

Businesses that use electronic record systems should ensure that their records are secure and that they create a backup system to ensure their records are not lost. They also need to be familiar with accounting principles and may need training to understand how the software works.

SNAPSHOT QUESTIONS

1. **Outline** the benefits of a good record keeping system.
2. **Distinguish** between a manual and an electronic record keeping system.
3. **Create** a table summarising the advantages and disadvantages of both manual and electronic record keeping systems.

11.2.4 Financial risks

BizWORD

Financial risk *is the risk to a business of being unable to cover its financial obligations.*

Financial risk is the risk to a business of being unable to cover its financial obligations, such as the debts that a business incurs through borrowings, both short term and longer term. If the business is unable to meet its financial obligations, bankruptcy will result.

There are many questions that a business must answer in relation to financial risk:

- Should the business borrow to expand its operations?
- Will shareholders/owners be prepared to contribute to the business or will expansion be financed through borrowings?
- Should the business use its excess funds to purchase assets or invest on the short-term money market?
- Will interest rates go up?
- What about changing exchange rates?

In assessing financial risk for a business, consideration must be given to:

- the amount of the business's borrowings
- when borrowings are due to be repaid
- interest rates
- the required level of current assets needed to finance operations.

If the business is financed from borrowings there is higher risk. The higher the risk, the greater the expectation of profits or dividends.

To minimise financial risk, businesses must consider the amount of profit that will be generated. The profit must be sufficient to cover the cost of debt as well as increasing profits to justify the amount of risk taken by owners and shareholders. Consideration must also be given to the liquidity of a business's assets. If a business has short-term debt, it must have liquid assets so that debts including interest payments and the repayment of principal on loans can be covered. Careful consideration is needed to ensure that financial risk are minimised for a business.

11.2.5 Financial controls

Financial problems and losses prevent a business from achieving its goals. The most common causes of financial problems and losses are:

- theft
- fraud

- damage or loss of assets
- errors in record systems.

Theft and fraud include unnecessary or over-purchase of stock for personal use, conflict of interest, misuse of expense accounts, false invoices, theft of inventory or assets and credit card fraud.

Financial problems can be caused by both management and employees. **Financial controls** ensure that the plans that have been determined will lead to the achievement of the business's goals in the most efficient way.

The policies and procedures of a business are designed to ensure they are followed by management and employees. Control is particularly important in assets such as accounts receivable, inventory and cash. Some common policies and procedures that promote control within a business are:

- clear authorisation and responsibility for tasks in the business
- separation of duties — for example, one person is responsible for ordering and another for receiving inventories; one person writes the cheques and another signs the cheques
- rotation of duties — for example, staff are skilled in a number of areas and can rotate duties
- control of cash, such as the use of cash registers, cash banked daily, no money kept on premises overnight, payments made by cheque not cash
- protection of assets — for example, buildings are kept locked, a registry of assets is maintained, regular checks of inventory are carried out and security surveillance systems are installed
- control of credit procedures, such as following up overdue accounts and customer credit checks.

Budgets and variance reporting are financial controls used in businesses. As previously outlined, budgets are an important planning tool as they assist a business to estimate resource requirements for a specified future period to predict what will be achieved by a business. For example, preparing a cash budget enables a business to predict cash shortages.

BizWORD

Financial controls *are the policies and procedures that ensure that the plans of a business will be achieved in the most efficient way.*

SUMMARY

- Financial planning is essential if a business is to achieve its goals. Financial planning determines how a business's goals will be achieved.
- The financial planning and implementing process consists of: determining financial needs, developing budgets, maintaining record systems, identifying financial risks and establishing financial controls.
- Financial needs are essential to determine where a business is headed and how it will get there; it is important to know what its needs are.
- Budgets provide information in quantitative terms (facts and figures) about requirements to achieve a particular purpose.
- Budgets are often prepared to predict a range of activities relating to short-term and longer term plans and activities.
- Budgets can be classified as operating, project or financial budgets.
- Record systems are the mechanisms employed by a business to ensure that data are recorded and the information provided by records systems is accurate, reliable, efficient and accessible.
- Financial risk is the risk to a business of being unable to cover its financial obligations, such as the debts that a business incurs through borrowings, both short term and longer term.
- To minimise financial risk, businesses must consider the amount of profit that will be generated.
- The most common causes of financial problems and losses are:
  - theft
  - fraud

studyon
Syllabus area 3
Topic 3
Concept 1
Planning and implementing
Summary screen and practice questions

- damage or loss of assets
- errors in records systems.

- Financial controls ensure that the plans that have been determined will lead to the achievement of the business's goals in the most efficient way.

EXERCISE 11.1 REVISION

1 **Outline**, with examples, the financial elements of the planning cycle.
2 **Identify** the factors that determine businesses' financial needs.
3 **Explain** why the preparation of financial information is essential as part of the business plan.
4 **Identify** the financial information that should be collected by a business when determining its future financial needs.
5 **Summarise** the different types of budgets and their importance in financial planning.
6 **Explain** the importance of record keeping to a business's financial success.
7 **State** the relationship between risk and the level of borrowings by a business.
8 **Recommend** reasons for implementing financial controls.
9 Write a memo to the manager of a web design company **explaining** how budget and variance analysis will assist the business.
10 Study the comparative report below and answer the following questions. (Note that a variance of 10 per cent is acceptable for this business.)

From the information in the comparative report, **recommend** where you think the performance of the business can be improved. **Justify** your recommendations.

Comparative Report — receipts and payments

	Budgeted $	Actual $	Variance $
Receipts			
Sales			
— Cash	3 000	3 000	—
— Accounts receivable	8 000	8 800	+10%
Total receipts	11 000	11 800	+7%
Payments			
Purchases			
— Cash	1 500	1 400	–6%
— Accounts payable	2 000	2 400	+20%
Wages	500	600	+20%
Insurance	100	100	—
Advertising	300	350	+17%
Total payments	4 400	4 850	+10%

EXERCISE 11.1 EXTENSION

1 'Sound planning is crucial to achieving the financial objectives of a business.' **Discuss**.
2 **Identify** the stages in the planning cycle. **Investigate** and **demonstrate** each stage using examples from your own knowledge of local businesses.
3 Using the following information on Kennedy's Gardening Supplies, answer the questions below.

Kennedy's Gardening Supplies

	2018 $	2019 $	2020 $
Forecast cash position	85 000	150 000	185 000
Forecast profits	40 000	75 000	90 000
Forecast net assets	350 000	390 000	410 000

Kennedy's is requesting an increase of overdraft facility from 2017 of $80 000 and a loan of $50 000 to fund their expansion.

(a) **Determine** what further financial information you would require in the business plan of Kennedy's Gardening Supplies.
(b) **Propose** how Kennedy's might prepare their information for their funding application to the bank.

4 Computerised accounting software programs are able to streamline the accounting process. **Examine** one such program and **evaluate** its key features, including the type of data that need to be entered and the type of reports that can be produced.

11.3 Debt and equity financing

As outlined in chapter 10, the finance for a business comes from both internal and external sources, and most businesses use a combination of both. External or **debt finance** is a liability to a business as it is money owed to external sources. **Equity finance** relates to the internal sources of finance in the business. Businesses must carefully consider whether to use debt or equity finance and how much of each is needed.

BizWORD

Debt finance *relates to the short-term and long-term borrowing from external sources by a business.*

Equity finance *relates to the internal sources of finance in the business.*

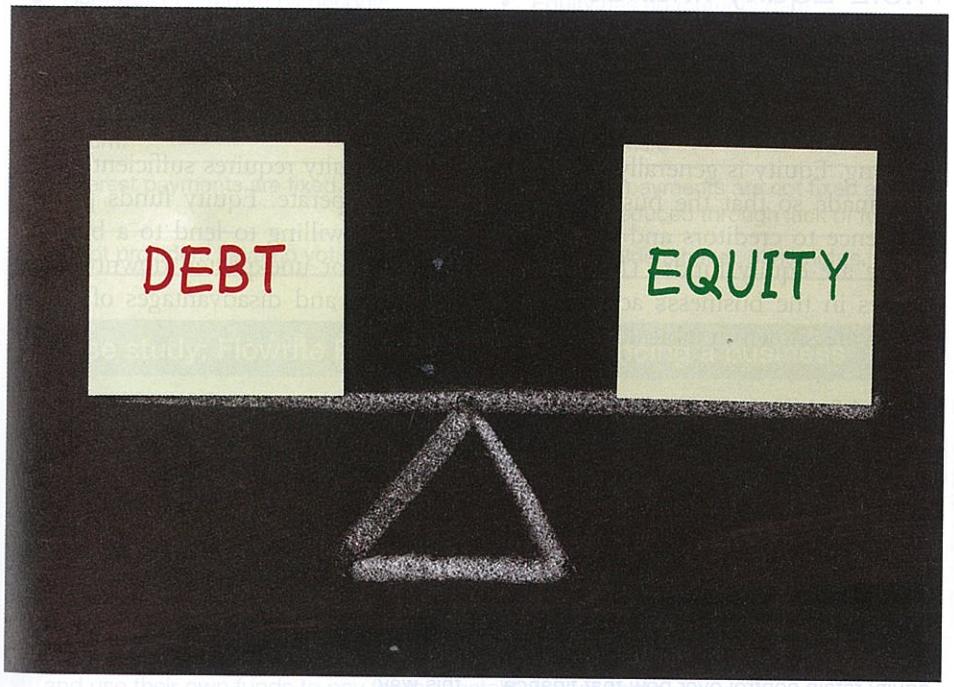


FIGURE 11.5 A balancing act — how much debt is too much? Borrowing the right amount of debt can make the difference between a business struggling to survive and one that is able to respond to changes in the external business environment. While debt provides businesses with the necessary funds, too much debt can cripple a business. Factors to consider when determining how much debt businesses take on include the industry risk, projected income and an analysis of cash flow.

BizFACT

If a business uses a high level of debt finance it takes a greater risk than if it uses equity finance. The amount of risk is affected by how much the business has borrowed, when loans have to be repaid and the required level of current assets for the business. The higher the risk of an investment, the higher the return to the business. Risk and return are interrelated and determine what makes up the share prices of corporations.

11.3.1 Debt finance

Debt can be attractive to businesses because funds are usually readily available and interest payments are tax deductible, therefore reducing the cost of debt financing. The amount of debt used by Australian businesses varies, but short-term borrowing (one year or less) is an important source of funding for businesses.

Risk and return must be carefully considered when determining whether debt or equity finance is used. For example, there is a greater level of risk associated with borrowing, and consideration has to be given to the impact of borrowing on the future profitability and financial stability of the business. Some advantages and disadvantages of debt finance are shown in table 11.1.

TABLE 11.1 Advantages and disadvantages of debt finance

Advantages of debt	Disadvantages of debt
• Funds are usually readily available and can be acquired at short notice.	• There is an increased risk if debt comes from financial institutions because interest, bank charges and government charges may increase.
• Increased funds should lead to increased earnings and profits.	• Security is required by the business.
• Interest payments are tax deductible.	• Regular repayments have to be made.
• Flexible payment periods and types of debt are available.	• Lenders have first claim on any money if the business ends in bankruptcy.
• It will not dilute the current ownership in the business.	• Debt can be expensive, e.g. interest must be paid.

11.3.2 Equity finance

In the case of equity finance, shareholders' funds represent the highest proportion of total funds to finance business operations and assets. Equity finance is the most important source of funds for companies because it remains in the business for an indefinite time, because funds do not have to be repaid at a set date as with debt financing. Equity is generally safer than debt, but equity requires sufficient profits to be made so that the business can continue to operate. Equity funds provide confidence to creditors and lenders, who are more willing to lend to a business if there are equity funds. They act as a safety net for unexpected downturns or changes in the business's activities. The advantages and disadvantages of equity finance are shown in table 11.2.

BizFACT

A simple example can illustrate the effective use of debt. Jai saved $500 of his own money to begin a skateboard company. He borrowed $1000 on short-term (30-day) loan to buy the parts to make the skateboards. He sold the skateboards for cash as soon as they were completed and made repayments on the loan. He then borrowed a further $2000, bought more parts, made more skateboards and paid off more of the loan. This process continued and the business grew. Jai matched the purpose of the finance to the appropriate source and used debt to finance his business success.

TABLE 11.2 Advantages and disadvantages of equity finance

Advantages	Disadvantages
Does not have to be repaid unless the owner leaves the business	Lower profits and lower returns for the owner
Cheaper than other sources of finance as there are no interest payments	The expectation that the owner will have about the return on investment (ROI)
The owners who have contributed the equity retain control over how that finance is used	Long, expensive process to obtain funds this way
Low gearing (use resources of the owner and not external sources of finance)	Ownership is diluted, i.e. the current owners will have less control
Less risk for the business and the owner	



FIGURE 11.6 Studies have shown that many small business entrepreneurs will often use their families' finances to fund their business. Others will seek external funding such as a loan from family or friends, a loan from a financial institution, equity or venture capital funds.

When deciding which type of finance to use, businesses will firstly compare debt with equity finance (see table 11.3) and then take into account what the finance is needed for: its purpose. That is, they must match the terms and sources of finance to business purpose.

TABLE 11.3 Comparison of debt and equity finance

Debt	Equity
• Lenders have prior claim in the event of liquidation.	• Shareholders have a residual claim on assets.
• Debt must be repaid by periodic repayments.	• Equity has no maturity date.
• Interest payments are tax deductible.	• Dividends are not tax deductible.
• Lenders usually require a lower rate of return.	• Shareholders require higher return due to higher risk.
• Interest payments are fixed.	• Dividend payments are not fixed and may be reduced through lack of funds.
• Debt providers have no voting rights.	• Equity holders have voting rights.

Case study: Flowrite Plumbing — self-financing a business

No matter what line of business you go into, you will need start-up capital to get your business going. While many entrepreneurs use some form of debt to finance their operations, self-financing is also commonly used by some business owners. This is where entrepreneurs invest their own money into the business without external help or credit. This is often referred to as 'bootstrapping', from the famous saying about pulling yourself up by your bootstraps.

After many years of experience in the plumbing industry, Anthony Daoud and John Franji decided to take the risk of starting their own business. They began Flowrite Plumbing in 2015. Rather than get a loan, they both decided to save up and use their own funds to pay for their establishment costs.

'If you have the resources to do it, you will benefit from complete financial and creative control over your business. You don't have to worry about periodic loan repayments, interest or creditors chasing you for money, especially if it takes a while for your business to start generating a positive cash flow.

SNAPSHOT



'It ensures you keep your business operating at a sustainable level ...'

It's also very hard to get funding when you're starting out and don't have a history. We didn't want to waste time putting together a formal glossy business plan to convince lenders to give us money and we didn't want to use our personal assets as security and put our personal assets at risk. Funding the business yourself means that you get to keep all the profits. The only disadvantage is that your budget and growth is dictated by your own personal finances.'

In the beginning, they each contributed just over $10 000 each, which they used to pay for tools, computers, office equipment and two vans. They distributed payments for other expenses, such as workers compensation and car insurance, and set up monthly repayments. They then waited until they started to have a positive cash flow to purchase more items, for example, they bought more tools, uniforms and signage with the cash that was generated from retained profits.

'If you fund a business yourself, you're forced to live within your means and you only purchase things like new equipment etcetera when you're sure you can afford them. It ensures you keep your business operating at a sustainable level and since it's your own money, you tend to be more careful and avoid excessive spending.'

The only form of short-term debt they use is trade creditors to purchase materials. Trade credit is an agreement between the supplier and the business which allows a business to delay payment for goods and services that have already been delivered. They use four different suppliers for their materials who each give them 30 days credit. John and Anthony use this source of finance to better manage their cash flow. They purchase the materials they need for a job on credit and then give their customers only 14 days to pay them. This ensures they are paid before their own repayments are due to their suppliers meaning they don't have to use any of their own money to make the repayments.

SNAPSHOT QUESTIONS

1. **Define** bootstrapping.
2. **Discuss** self-financing.
3. **Explain** trade credit.

BizFACT

Small businesses have a number of sources available when seeking debt finance, but the range of sources is not as great as with larger businesses because lenders are concerned about risk and security. The larger the equity capital on a business, the more secure the financial structure of the business and the more likely will be the opportunities to borrow. Lenders prefer to lend to firms with strong equity capital because this is an indication of the stability of the business and the commitment of the owners.

BizFACT

The structure of the business will also influence decisions about finance. For example, companies can raise funds by issuing shares to the public or by issuing debentures, whereas unincorporated businesses cannot.

11.4 Matching the terms and sources of finance to business purpose

Small businesses regularly face a number of decisions related to achieving their financial objectives, for example, the purchase of new equipment, stock and premises. Small businesses must find the source of finance that is most appropriate to fund the activities arising from these decisions.

The terms of finance must be suitable for the purpose for which the funds are required. The use of short-term finance to fund long-term assets, for example, causes financial problems because the amount borrowed must be repaid before the long-term assets have had time to generate increased cash flow. The use of long-term finance to fund short-term situations or assets means the business is still paying the mortgage long after the situation is resolved or the stock has been sold, and profits will be reduced.

Therefore, finance managers should match the length or term of the loan with the economic lifetime of the asset the finance is being used to purchase. This means that short-term finance should be used to purchase short-term assets and long-term finance should be used for long-term assets. For example, inventory, which is a current or short-term asset, could be purchased with trade credit whereas a new building, which is a non-current asset, should be purchased with a mortgage (see figure 11.7).

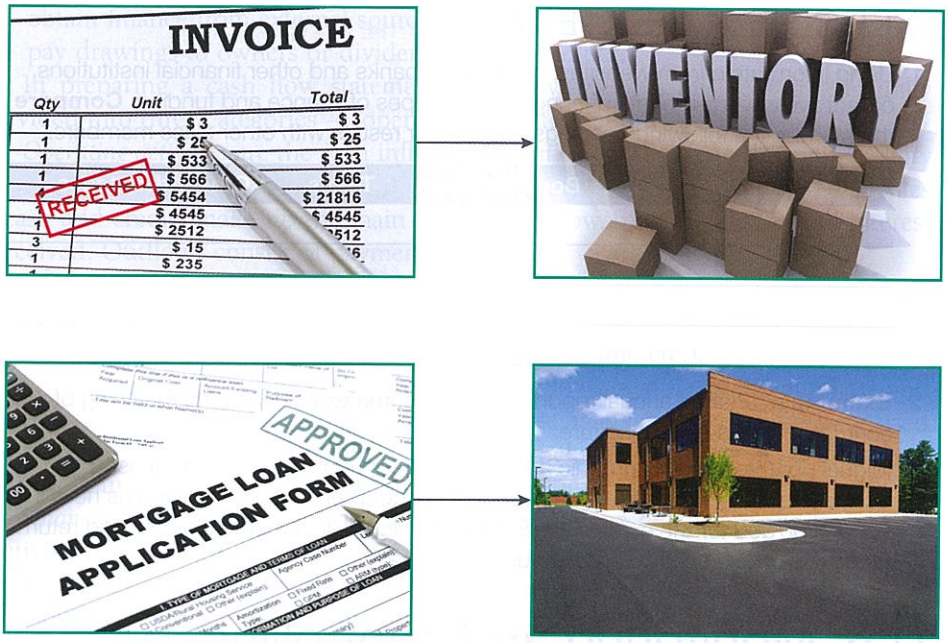


FIGURE 11.7 When matching the terms and sources of finance to business purpose, finance managers should use short-term finance for short-term assets and long-term finance for long-term assets.

BizFACT

Availability of finance is affected by a business's credit rating because the credit rating indicates the business's 'track record' in meeting its financial commitments. The higher the credit rating, the greater number of available sources. Banks are more willing to supply funds for businesses with a high credit rating.

SUMMARY

- Finance for a business can come from either external or internal sources.
- External (or debt finance) is a liability as it is owed to sources external to the business. Equity finance relates to internal sources of finance.
- Most businesses have a combination of both internal and external finance.
- Although repayments of interest to an external provider of funds are costs to the business, debt finance can be attractive as it is readily available and interest payments can be tax deductible.
- Equity finance is the most important source of funds for a business as it remains in the business for an indefinite time and does not need to be repaid on a set date.
- When a business identifies and plans to meet its financial objectives, it is necessary to match the terms of finance with its purpose. This means that short-term finance should be used to purchase short-term assets and long-term finance should be used for long-term assets.

EXERCISE 11.2 REVISION

1 **Distinguish** between debt and equity finance.
2 **Clarify** the relationship between risk and the source of finance.
3 **To what extent** do the advantages outweigh the disadvantages of (a) debt finance and (b) equity finance?
4 **Why** is equity finance considered the least risky source of funds for companies?
5 **Why** is it important to match the term of a loan to the life of the asset for which the finance was obtained?
6 **Recommend** the type of finance you would suggest for the following. **Justify** your answer.
(a) Payment of inventory
(b) Purchase of a new motor vehicle
(c) Diversification of the business over the next five years
(d) Takeover of a competitor
(e) Expansion to double the volume of sales
(f) Purchase of new plant and equipment

studyon

Syllabus area 3
Topic 3
Concept 2

Financial controls: debt, equity and source of funds
Summary screen and practice questions

EXERCISE 11.2 EXTENSION

1 Using information from websites, magazines, banks and other financial institutions, collect five advertisements offering different types of finance and funding. **Compare** them under the following headings. Share your results with other class members.

Source	Interest rate	Borrowing limit	Terms	Other advantages

2 **Examine** a range of annual reports and note some examples of the matching of sources of funds to expenditure.

3 Miguel operates a small graphic art business from home, but, with increased business activity, he is ready to expand into larger premises. He anticipates he will need $100 000 for the expansion. **Explain** to Miguel, in a memo, the risk and return factors involved in expanding his business.

11.5 Monitoring and controlling

The process of monitoring and controlling is essential in all aspects of business functions, especially in the processes of financial management. This is because inconsistent methods of review and systems of control will have an immediate impact on the viability of the business and requires managements to monitor the internal and external factors that will impact financially on business operations. This may include changes to the economic outlook, internal production methods and changes to workplace laws.

The main financial controls used for monitoring include:

1. cash flow statements
2. income statements
3. balance sheets.

These statements indicate how effectively finance is being used in a business. They also provide information on whether the business has sufficient funds to meet unforeseen circumstances.

BizWORD

A **cash flow statement** *is a financial statement that indicates the movement of cash receipts and cash payments resulting from transactions over a period of time.*

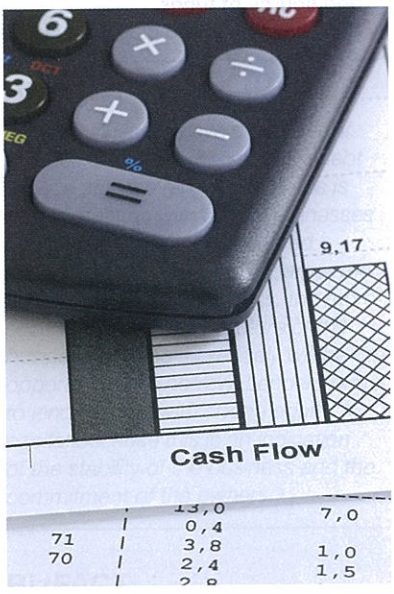


FIGURE 11.8 All businesses must have sufficient funds to carry out their daily functions. According to statistics released by ASIC, 41 per cent of small businesses that failed stated that inadequate cash flow was the driving factor.

11.5.1 Cash flow statements

A **cash flow statement** is one of the key financial reports that are part of effective financial planning. It provides the link between the income statement and balance sheet, as it gives important information regarding a firm's ability to pay its debts on time.

The cash flow statement indicates the movement of cash receipts and cash payments resulting from transactions over a period of time. It can also identify trends and can be a useful predictor of change.

Users of cash flow statements include creditors and lenders of finance, as well as owners and shareholders, who can assess the ability of the business to manage its cash. Potential shareholders check that a business has had positive cash flows over a number of years. A fluctuating pattern of cash flows might point to difficulties in the business.

Cash flows can be a better predictor of a business's status than profitability. A statement of cash flows can show whether a firm can:

- generate a favourable cash flow (inflows exceed outflows)
- pay its financial commitments as they fall due—for example, interest on borrowings, repayment of borrowings, accounts payable
- have sufficient funds for future expansion or change

- obtain finance from external sources when needed
- pay drawings to owners or dividends to shareholders.

In preparing a cash flow statement, the activities of a business are generally divided into three categories — operating, investing and financing activities.

Operating activities are the cash inflows and outflows relating to the main activity of the business — that is, the provision of goods and services. Income from sales (cash and credit) make up the main operating inflows plus dividends and interest received. Outflows consist of payments to:

- suppliers
- employees
- other operating expenses (insurance, rent, advertising, etc.).

Investing activities are the cash inflows and outflows relating to the purchase and sale of non-current assets and investments. These assets and investments are used to generate income for the business. Examples include the selling of an old motor vehicle, purchasing new plant and equipment or purchasing property.

Financing activities are the cash inflows and outflows relating to the borrowing activities of the business. Borrowing inflows can relate to equity (issue of shares or capital contribution from owner) or debt (loans from financial institutions). Cash outflows relate to the repayments of debt and cash drawings of the owner or payments of dividends to shareholders.

A cash flow statement is usually prepared from the income statement and balance sheet, as these summarise the transactions of the business. Remember that only cash transactions are included in the cash flow statement. An example of a cash flow statement is given in figure 11.9.

BizFACT

Managing cash flow effectively is not very difficult. It requires planning, accurate and up-to-date records, and commitment.

Burgess Enterprises Ltd
Cash Flow Statement for year ended 30 June 2018

Cash flows from operating activities	
Receipts from customers	30 000
Payments to suppliers and employees	(25 000)
Dividends received	4 000
Interest received	8 000
Interest paid	(5 500)
Net cash provided by operating activities	11 500
Cash flows from investing activities	
Proceeds from sale of assets	85 000
Payment of plant and equipment	(150 000)
Net cash from investing activities	(65 000)
Cash flows from financing activities	
Proceeds from issues of shares	90 000
Proceeds from borrowings	40 000
Repayments of borrowings	(15 000)
Dividends paid	(25 000)
Net cash from financing activities	90 000
Net increase in cash	36 500
Cash at the beginning of the reporting period	15 000
Cash at the end of the reporting period	51 500

Add all the cash receipts from operating activities and subtract the cash payments.

Add all the cash receipts from investing activities and subtract the cash payments.

Add all the cash receipts from financing activities and subtract the cash payments.

Add net cash provided from operating activities + net cash provided from investing activities + net cash provided from financing activities.

Cash at beginning of year + net increase in cash (this amount will then become the new 'cash at the beginning of the year' for the next period).

FIGURE 11.9 An example of a cash flow statement. Brackets ( ) are used to show cash payments.

11.5.2 Income statements (statements of financial performance)

BizWORD

The **income statement** *is a summary of the income earned and the expenses incurred over a period of trading. It helps users of information see exactly how much money has come into the business as revenue, how much has gone out as expenditure and how much has been derived as profit.*

The **income statement** is a summary of the income earned and the expenses incurred over a period of trading. It helps users of information see exactly how much money has come into the business as revenue, how much has gone out as expenditure and how much has been derived as profit.

The income statement shows:

- operating income earned from the main function of the business, such as sales of inventories, services and non-operating revenue earned from other operations, such as interest, rent and commission
- operating expenses such as purchase of inventories, payment for services and other expenses incurred in the main operation of the business, such as advertising, rent, telephone and insurance.

The difference between the income and expenses is the profit or — if expenses exceed income — the loss. The first step in completing a statement of financial performance is to record the income earned by a business. A café, for example, earns income by selling food and drinks. The second step is to record the **cost of goods sold**, which is the money spent on purchases of raw materials or finished goods for resale, and to use this figure to calculate **gross profit**. The gross profit/loss is the amount remaining when the cost of goods sold is deducted from revenue. The third step is to calculate **net profit**. The word 'net' means all expenses have been deducted. A net profit/loss is the amount remaining when operating expenses are deducted from gross profit.

BizWORD

The **cost of goods sold** *is the value of stock that a business has sold to its customers.*

Gross profit *is that part of a business's profit that represents operating income minus cost of goods sold.*

Net profit *is the difference between the gross profit and expenses.*

Expenses *are simply costs. Specifically, expenses are the costs incurred in the process of acquiring or manufacturing a good or service to sell and the costs (direct and indirect) associated with managing all aspects of the sales of that good or service.*

To earn revenue, a business will have a variety of **expenses**. Common expenses include wages and salaries, payments for telephone, electricity, postage, motor vehicle expenses and so on. Expenses can be broken down into three types, which are shown in table 11.4.

BizFACT

The income statement shows the operating efficiency of the business. It can be used to answer the following questions:

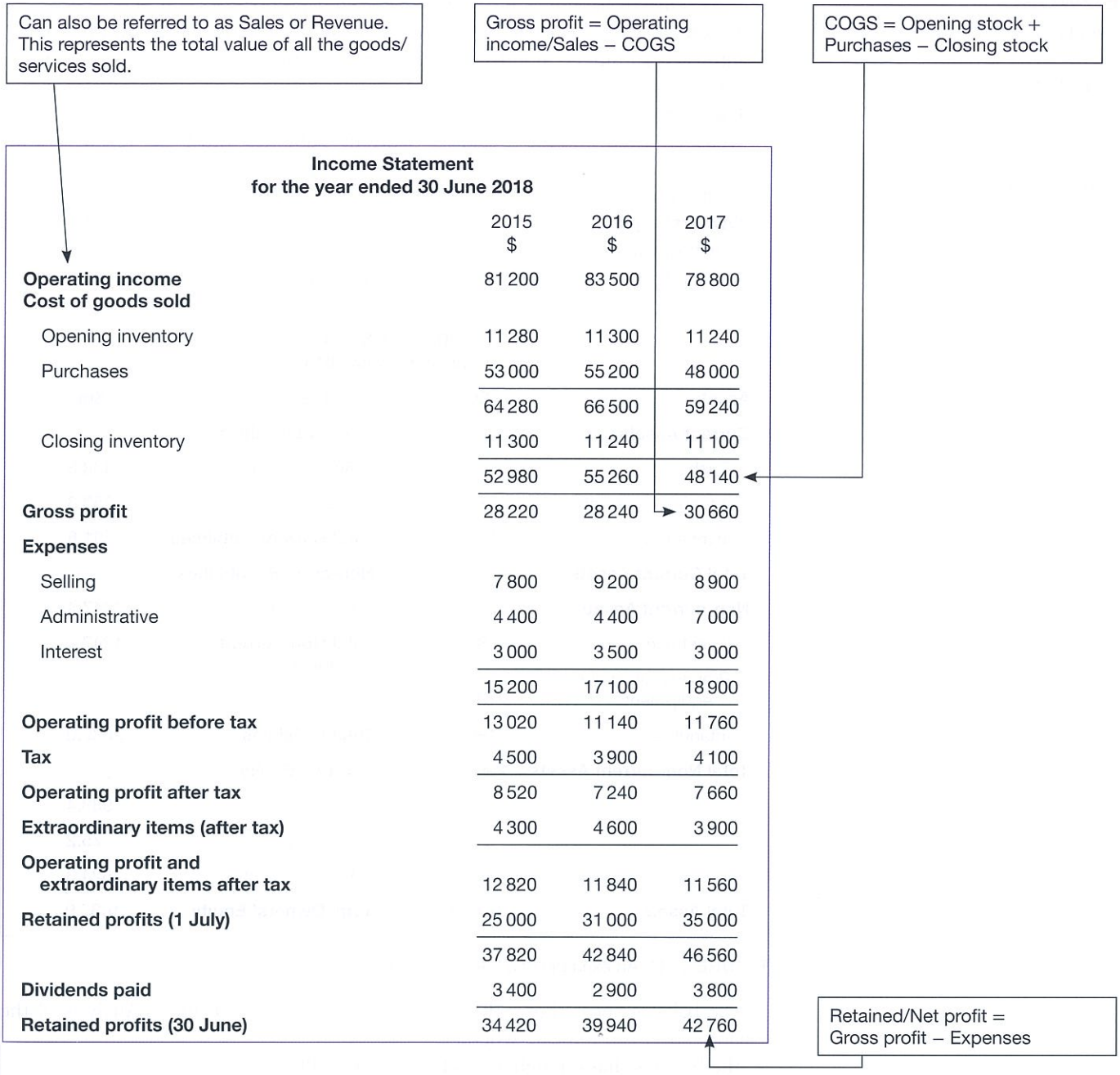
- *Is income high enough to cover expenses?*
- *Is the mark-up on purchases sufficient?*
- *Is the business making a good profit?*
- *Are the expenses in proportion to the revenue they are earning?*
- *Is inventory turnover appropriate for the business?*

TABLE 11.4 Income statement (or statement of financial performance) expense breakdown by type

Expenses*		
Selling	**Administrative**	**Financial**
• Commission • Salaries • Wages • Advertising • Delivery expenses • Electricity • Depreciation on shop fittings	• Stationery • Office salaries • Rent • Rates • Telephone • Depreciation on buildings • Audit fees • Accountant's fees • Insurances	• Interest payments • Lease payments • Dividends • Insurance payments
Selling expenses:	Costs related to the process of selling the good or service; can be directly traced to the need for sales	
Administration expenses:	Costs directly related to the general running of the business	
Finance expenses:	Costs associated with borrowing money from outside people or organisations and to minimising business risk	

*Costs of goods sold (COGS): this expense includes *only* the cost of stock sold and is shown separately in the income statement (or statement of financial performance).

An example of an income statement is given in figure 11.10.



Income Statement
for the year ended 30 June 2018

	2015 $	2016 $	2017 $
Operating income	81 200	83 500	78 800
Cost of goods sold			
Opening inventory	11 280	11 300	11 240
Purchases	53 000	55 200	48 000
	64 280	66 500	59 240
Closing inventory	11 300	11 240	11 100
	52 980	55 260	48 140
Gross profit	28 220	28 240	30 660
Expenses			
Selling	7 800	9 200	8 900
Administrative	4 400	4 400	7 000
Interest	3 000	3 500	3 000
	15 200	17 100	18 900
Operating profit before tax	13 020	11 140	11 760
Tax	4 500	3 900	4 100
Operating profit after tax	8 520	7 240	7 660
Extraordinary items (after tax)	4 300	4 600	3 900
Operating profit and extraordinary items after tax	12 820	11 840	11 560
Retained profits (1 July)	25 000	31 000	35 000
	37 820	42 840	46 560
Dividends paid	3 400	2 900	3 800
Retained profits (30 June)	34 420	39 940	42 760

FIGURE 11.10 An example of a cash flow statement. Brackets ( ) are used to show cash payments.

By examining figures from previous income statements, managers can make comparisons and analyse trends before making important financial decisions. They can see whether expenses are increasing, decreasing or remaining the same, why profits have increased or decreased and in which areas there has been significant change.

11.5.3 Balance sheets (statements of financial position)

A **balance sheet** represents a business's assets and liabilities at a particular point in time and represents the net worth (equity) of the business. It shows the financial stability of the business. The balance sheet is prepared at the end of the accounting period.

BizWORD

A **balance sheet** *represents a business's assets and liabilities at a particular point in time, expressed in money terms, and represents the net worth of the business.*

BizWORD

Assets *are items of value owned by the business.*

Liabilities *are claims by people other than owners against the assets (items of debt), and represent what is owed by the business.*

Owners' equity *is the funds contributed by the owner(s) and represents.*

The balance sheet shows the level of current and non-current assets, and current and non-current liabilities, including investments and owners' equity.

- **Assets** are items of value owned by the business. Current assets can be turned into cash within 12 months, whereas non-current assets are not expected to be turned into cash within 12 months.
- **Liabilities** are claims by people other than owners against assets, and represent what is owed by the business. Current liabilities must be repaid within 12 months, whereas non-current liabilities must be met some time after the next 12 months.
- **Owners' equity** is the funds contributed by the owner(s) and represents the net worth of the business.

An example of a balance sheet is given in figure 11.11.

Balance Sheet
as at 30 June 2018

Assets	**$m**	**Liabilities**	**$m**
Current Assets		**Current Liabilities**	
Cash	86.3	Accounts payable	438.3
Accounts receivables	578.5	Overdraft	253.3
Inventories	100.8	**Total Current Liabilities**	691.6
Total Current Assets	756.6	**Non-current Liabilities**	
Non-current Assets		Borrowings	1347.4
Investments	589.3	**Total Non-current Liabilities**	1347.4
Property, plant and equipment	2182.2		
Intangibles	189.8	**Total Liabilities**	2039.0
Total Non-current Assets	2961.3	**Owners' Equity**	
		Capital	988.4
		Reserves	75.2
		Retained profits	624.3
Total Assets	3726.9	**Total Owners' Equity**	1687.9

FIGURE 11.11 An example of a balance sheet

The balance sheet shows the financial stability of the business. Analysis of the balance sheet can indicate whether:

- the business has enough assets to cover its debts
- the interest and money borrowed can be paid
- the assets of the business are being used to maximise profits
- the owners of the business are making a good return on their investment.

The balance sheet shows the return on the owners' investment, the sources and extent of borrowings, the level of inventories, and so on. The figures also show whether the business has sufficient assets to continue to make profits in the longer term, how much of the assets are financed from outside borrowings, whether the business can expect to meet its financial obligations in the short and longer term, and how the year's figures compare with the previous year.

It is important that the presentation of figures in the balance sheet allows clear interpretation so that interested parties can draw meaningful conclusions and make important decisions about the business. Figures from previous years' balance sheets can also be analysed and presented to show the decision makers the trends and changes in the business that need to be investigated.

An example of a comparative balance sheet is given in figure 11.12.

Balance Sheet
as at 30 June 2018

	Consolidated	
	2017 $m	2018 $m
Current Assets		
Cash	4.8	20.6
Accounts receivable	102.0	81.6
Investments	14.9	—
Inventories	36.0	31.5
Total Current Assets	157.7	133.7
Non-current Assets		
Receivables	59.3	64.7
Investments	284.7	293.5
Inventories	17.3	79.5
Property, plant and equipment	831.4	882.9
Intangibles	5.1	5.6
Total Non-current Assets	1197.8	1326.2
Total Assets	1355.5	1459.9
Current Liabilities		
Creditors and borrowings	190.0	118.2
Provisions	59.6	51.7
Total Current Liabilities	249.6	169.9
Non-current Liabilities		
Creditors and borrowings	238.7	417.6
Provisions	210.2	208.4
Total Non-current Liabilities	448.9	626.0
Total Liabilities	698.5	795.9
Owners' Equity		
Capital	132.3	182.7
Reserves	228.3	235.1
Retained profits	161.9	111.7
Equity attributable to owners of the chief entity	522.5	529.5
Reserve account	134.5	134.5
Total owners' equity	657.0	664.0

FIGURE 11.12 An example of a comparative balance sheet

Balance sheet — the accounting equation and relationships

The **accounting equation**, which forms the basis of the accounting process, shows the relationship between assets, liabilities and owners' equity.

Assets are what is owned by a business; liabilities and owners' equity are what is owed by a business. The business and the owner are separate; therefore, owners'

BizWORD

*The **accounting equation**, which forms the basis of the accounting process, shows the relationship between assets, liabilities and owners' equity.*

equity is what is to be repaid (hopefully with increased profits) by the business to the owner. The accounting equation shows that the assets of the business may be financed by either the owners or by parties external to the business.

The balance sheet shows the outcome of the accounting process. The accounting equation can be represented in different ways but, because it is an equation, it must always be equal.

BizFACT

It is important to remember that the accounting entity assumption means that financial information records for a business are kept separate from those of the owner.

Assets = Liabilities + Owners' equity
Owners' equity = Assets – Liabilities
Liabilities = Assets – Owners' equity

The balance sheet can be displayed in different forms to show the different ways of expressing the accounting equation. In the first example (figure 11.13), the balance sheet represents the accounting equation Assets = Liabilities + Owners' equity.

Balance Sheet as at 30 June 2018

	$	$
Current Assets		
Cash	30 400	
Inventories	4 100	92 500
Accounts receivable	58 000	
Non-current Assets		
Plant and equipment	68 000	
Land and buildings	85 000	153 000
		$245 500
Current Liabilities		
Accounts payable	82 000	
Non-current Liabilities		
Loan	25 000	107 000
Owners' Equity		
Capital	100 000	
Net profit	38 000	138 500
		$245 500

FIGURE 11.13 A balance sheet showing Assets = Liabilities + Owners' equity

The accounting equation shows the effect of the business's operations on owners' equity. Owners' equity comprises two elements: capital, or funds contributed by the owner or owners to the business, and retained profits (see figure 11.14).

Owners' Equity	
Paid up capital	285 000
Reserve for contingencies	37 000
Retained profits	33 000
	$355 000

FIGURE 11.14 Owners' equity showing proportion of capital and retained profits

The balance sheet and income statement show the outcomes of the accounting process on the accounting equation. The revenue statement shows the resulting profit from revenue, less expenses. The profit (or loss) figure is transferred to the owners' equity as retained profits.

SUMMARY

- Monitoring and controlling is essential for maintaining business viability, and affects all aspects of business operations — especially financial management.
- The main financial controls used for monitoring include cash flow statements, income statements and balance sheets.
- A cash flow statement provides the link between the income statement and the balance sheet. It provides information about a firm's ability to pay its debts on time.
- The cash flow statement specifically records the movement of cash receipts and cash payments that result from transactions over a given time, for example a month.
- Creditors, lenders, owners and shareholders all use a cash flow statement to assess the ability of the business to manage its cash and identify trends in cash flow over time.
- The income statement is a summary of the income earned and the expenses incurred over a period of trading. It helps users of information see exactly how much money has come into the business as revenue, how much has gone out as expenditure and how much has been derived as profit.
- Profit is the difference between revenue and expenses.
- A balance sheet represents a business's assets and liabilities at a particular point in time, expressed in money terms, and represents the net worth of the business.
- The accounting equation, which forms the basis of the accounting process, shows the relationship between assets, liabilities and owners' equity.

studyon

Syllabus area 3
Topic 3
Concept 3

Monitoring and controlling
Summary screen and practice questions

EXERCISE 11.3 REVISION

1 **Why** must businesses monitor and control all business functions?
2 **Identify** the three main financial controls.
3 **Identify** three stakeholders who would most likely view a cash flow statement. **Outline** the key information they would be looking for.
4 **Summarise** the three categories of activities of a cash flow statement.
5 **Clarify** the purpose of income statements.
6 If the income statement shows operating efficiency, **explain** the relationship between income and expenses regarding this financial control.
7 Answer the questions using the balance sheet below.

Balance Sheet of Biq & Son as at 30 June 2018

Current Assets		**Current Liabilities**	
Cash at bank	3 000	Accounts payable	9 500
Inventories	2 500	**Non-current Liabilities**	
Accounts receivable	8 500	Loan	50 000
Non-current Assets			
Furniture	2 500	**Owners' Equity**	
Vehicle	16 500	Capital	100 000
Land and buildings	140 000	Profit	13 500
	173 000		173 000

(a) **Explain** why the balance sheet is written 'as at 30 June 2018'.
(b) **State** who the business owners are and what their original investment was.
(c) **What** is the value of the owners' investment on 30 June 2018?
(d) **Propose** how the assets of the business were financed.
(e) **Determine** how much is owed by the business.
(f) **Recommend** how the business will pay its debts.
(g) Would you offer credit to this business? **Justify** your response.

8 **Distinguish** between a balance sheet and an income statement.

9 **Outline** the difference between an asset and a liability.

10 Your friends Tony and Yung have a small business making novelty party accessories. They have been running the business for three months and it appears to be going well. They want to know if they are making a profit or a loss. You agree to help them. They provide you with the following information. **Construct** an income statement to **calculate** their profit or loss.

- Raw materials and supplies to make the novelties cost them $2000.
- At the end of the month they still have $700 worth of raw materials and supplies.
- During the month, they sold 1000 of their novelty products for $5 each.
- They paid their friends Sandy and Max $300 to help them.
- They sent flyers to department stores advertising their product, and this cost them $220.
- They paid the telephone bill ($340) and courier for delivery ($90).

11 **Why** is the accounting equation important?

12 **Identify** the most appropriate terms to complete the following accounting equation.

Assets = _____ + _____

13 **Calculate** the missing amounts in the following table (financial year is 1 July–30 June).

	Business A	Business B	Business C
Assets 1 July	275 000	221 000	—
Liabilities 1 July	135 000	—	353 000
Owners' equity 1 July	—	114 000	206 000
Assets 30 June	293 000	—	481 000
Liabilities 30 June	141 000	153 000	—
Owners' equity 30 June	—	189 000	242 000
Sales	484 000	521 000	—
Cost of goods sold	385 000	—	292 000
Gross profit	—	174 000	145 000
Expenses	—	135 000	105 000
Net profit	39 000	—	—

14 Using the information from question 13, answer the following questions. **Justify** your answers.

(a) Which owner is making the highest gross profit?
(b) Which owner is making the highest net profit?
(c) In which business would you invest and why?
(d) In what information would employees be interested?
(e) Each business has applied for a loan of $50 000 from a bank. Which business is most likely to be successful in their application?

15 Given the following information for July 2018, **construct** a cash flow statement for Eat Well Pty Ltd.

Closing cash balance at end of June	$15 400
Monthly wages	$ 3 200
Weekly rent	$ 500
Fortnightly loan repayment	$ 550
Proceeds from issue of shares	$75 650
Receipts from customers	$32 440
Payments to suppliers	$ 5 800

Interest received	$ 2 600
Proceeds from sale of equipment	$18 700
Dividends paid	$24 000

16 **Calculate** the value of purchases, the gross profit, cartage and net profit for the income statement below.

Income Statement for the year ended 30 June 2018		
	$	$
Operating income		258 400
Cost of goods sold		
Opening inventory	57 300	
Purchases	—	
Closing inventory	12 700	154 500
Gross Profit		—
Expenses		
Selling:		
— Advertising	22 300	
— Cartage	—	
Administrative:		
— Rent	14 000	
— Insurance	3 000	
Financial:		
— Bad debts	2 200	50 200
Net Profit		—

17 Using the balance sheet below, **calculate** the value of Total Non-current Assets, Debtors and the Mortgage.

Balance Sheet as at 30 June 2018			
	$		$
Current Assets		**Current Liabilities**	
Cash	7 800	Creditors	2 500
Debtors	—	Overdraft	4 670
Stock	17 600	Credit cards	4 750
Total Current Assets	28 650	**Total Current Liabilities**	11 920
Non-current Assets		**Non-current Liabilities**	
Property	579 460	Mortgage	—
Equipment	8 600		
Total Non-current Assets	—	**Total Non-current Liabilities**	
		Owner's Equity	
		Capital	53 000
	—	Retained profits	75 340
Total Assets	616 710	**Total Owner's Equity**	128 340

EXERCISE 11.3 EXTENSION

1 Financial management is concerned not so much with what has happened in the past but with what is going to happen in the future. **Discuss** this statement.

2 **Examine** the financial reports of a number of businesses. **Identify** for which business would you be most interested in working. **Determine** what other information you might need to help you make a decision.

3 **Create** a list of questions to which the following groups of people might seek answers from a business. The first one is done for you.

Group	Questions
Creditors	Is your cash flow sufficient to pay your account on time?
Bank	
Employee	
Owner	
Investor	
Customer	

11.6 Calculating financial ratios and strategies to improve performance

Many important questions cannot be answered by simply 'looking' at the financial statements of a business. Financial statements summarise the activities of a business over a period of time and must be analysed to increase understanding of the implications of those activities.

Analysis is an important part of the accounting process. It involves working the financial information into significant and acceptable forms that make it more meaningful and highlighting relationships between different aspects of a business. Analysis involves comparing similar items in the income statement and balance sheet.

The main types of analysis are vertical, horizontal and trend analysis.

- Vertical analysis compares figures within one financial year; for example, expressing gross profit as a percentage of sales and comparing debt to equity.
- Horizontal analysis compares figures from different financial years; for example, comparing 2017 and 2018.
- Trend analysis compares figures for periods of three to five years.

The methods of analysis involve calculations of figures, percentages and ratios. Ratios are one of the main tools used to analyse financial information and assist in answering more clearly the questions relating to profits, solvency, efficiency, growth and liquidity. But analysis without **interpretation** is meaningless. Interpretation is making judgements and decisions using the data gathered from analysis.

The type of analysis chosen will depend on the reasons that the information is required and the decisions to be made from the information. Users of information may be interested to compare figures, percentages or ratios for departments, different products, different branches or against the industry. They may also wish to monitor trends over a number of years or make comparisons between items within a financial statement, selling expenses and sales.

Analysis of financial statements is usually aimed at the areas of:

- liquidity
- gearing
- profitability
- efficiency.

BizWORD

Analysis *involves working the financial information into significant and acceptable forms that make it more meaningful, and highlighting relationships between different aspects of a business.*

Interpretation *is making judgements and decisions using the data gathered from analysis.*

BizFACT

Careful analysis can provide signals regarding the success of the business or impending problems. For example, management may be interested to know:

- *how effectively assets have been used in a business*
- *why an increase in advertising expenses has not generated more sales revenue than anticipated*
- *why sales have decreased over the past two years*
- *why overdrafts have continued to increase.*

BizWORD

Liquidity *is the extent to which a business can meet its financial commitments in the short-term (less than 12 months).*

11.6.1 Liquidity

Liquidity is the extent to which the business can meet its financial commitments in the short term, which usually refers to a period of less than 12 months.

The business must have sufficient resources to pay its debts and enough funds for unexpected expenses. To assess a business's liquidity, its managers must assess whether the business can pay its debts when they are due. Is there sufficient cash and a level of assets and inventories that can be converted to cash quickly to repay the firm's debts — that is, the firm's accounts payable, interest and loans?

The holding of outstanding debts means the business has less cash to earn revenue. The quicker the firm receives cash from its accounts receivable, the quicker those funds can be used to earn revenue. Current assets and current liabilities determine the liquidity or short-term financial stability of a business. The firm must be careful to ensure that it has enough current assets that could be used to generate cash quickly, but not so much that the resources are not being used for producing revenue.

There are a number of ratios to show liquidity (short-term financial stability), calculated from balance sheet figures. An example is the current ratio (or working capital ratio).

BizFACT

Current assets and current liabilities determine the liquidity or short-term financial stability of a business.

Current ratio (working capital)

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

The current ratio measures a business's ability to pay back their current liabilities with their current assets. The higher the current ratio, the more capable the business is of meeting their short-term obligations.

It is generally accepted that a ratio of 2:1 indicates a sound financial position for a firm. That is, the firm should have double the amount of current assets to cover its current liabilities. However, an 'acceptable' ratio will also depend on a number of factors, such as the type of firm, how other firms in the industry are operating and factors in the external environment (see the BizFACT on the right). In other words, the current ratio gives only a limited indication of the ability of the business to meet its short-term liabilities. The nature and composition of current assets may vary considerably. It is not a good idea to give rule-of-thumb standards for the current ratio.

BizFACT

Many firms operate successfully with current ratios of less than 2:1. Firms that sell finished goods and keep large levels of inventories need a higher ratio than firms selling on credit rather than cash. Large businesses in the food industry, for example, Woolworths, use a lower ratio of approximately 0.6:1. Businesses in service industries, such as doctors and dentists who rely on cash payments for their services, also do not need as high a ratio and operate on ratios of less than 2:1.

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{300\,000}{195\,000} = 1.54$$

Comment: This firm has $1.54 of current assets to cover $1 of current liabilities. A ratio of less than 1:1 indicates there are insufficient assets to pay current commitments or liabilities. If this firm has previously operated successfully, it may find a ratio of 1.54:1 acceptable. However, if this is not the case, the firm may have to sell non-current assets to cover liabilities, which will reduce its capacity to earn profits; or it may have to borrow in the short term and incur higher interest repayments. In most instances, a firm would be unwise to allow this ratio to fall below 1.5:1.

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{450\,000}{150\,000} = 3{:}1$$

Comment: This firm has $3 of current assets for every $1 of current liabilities. This indicates that the firm is in a sound financial position — that is, it is liquid and will be able to pay for its debts in the short term. If the firm has a high demand for its product, for example, food products, there may be reason to reduce the level of its current ratio. Even for a firm that has a low demand, for example, jewellery, its working capital may be too high. Too high a ratio can mean that current assets are not being used fully. Action is needed to ensure that sufficient use is being made of the assets in the business.

FIGURE 11.15 Examples of current ratio

studyon

Syllabus area 3
Topic 3
Concept 4

Financial ratios: liquidity
Summary screen and practice questions

A variety of strategies can improve a business's liquidity. Section 12.2 on working capital management examines these strategies in greater detail. Other strategies businesses could use to improve liquidity include factoring, selling non-essential non-current assets and using those funds to reduce current liabilities, or injecting more equity into the business to pay off liabilities.

11.6.2 Gearing (solvency)

The capital structure of a business is determined by the mix of debt and equity, and the proportion of each is known as gearing (or solvency).

Gearing ratios determine the firm's **solvency** — that is, its ability to meet its financial commitments in the longer term. Potential investors and creditors are interested in gearing ratios, as they show whether the creditors will be paid or whether investors can expect a good return on their money.

Gearing measures the relationship between debt and equity. Gearing is the proportion of debt (external finance) and the proportion of equity (internal finance) that is used to finance the activities of a business. The degree of gearing depends on the type of industry and management of the business. An industry that carries higher risk but is likely to generate large profits (for example, mining) may have a higher debt to equity ratio — that is, it is highly geared. Manufacturing industries with strong markets often have high debt as the potential for profit is greater.

Gearing is an important consideration for businesses as the more highly geared the business (that is, those that have a higher proportion of debt to equity), the greater the risk for the business but the greater potential for profit.

Debt affects stakeholders and potential investors because the high risk involved may discourage investment.

BizWORD

Solvency *is the extent to which the business can meet its financial commitments in the longer term (more than 12 months).*

Gearing *is the proportion of debt (external finance) and the proportion of equity (internal finance) that is used to finance the activities of a business. Gearing ratios determine the firm's solvency.*



FIGURE 11.16 An average debt to equity ratio depends on economic factors and the industry in which a company operates. The average debt to equity ratio for companies listed on the ASX is 0.47:1

The business's level of gearing is an important decision. Factors such as risk, return and degree of control over the enterprise influence the level of leverage that is appropriate for a business.

In balancing the gearing of a business, consideration must be given to the level of control by owners. For example, profits earned must be sufficient to cover interest payments. If funds are not available to meet interest charges and accounts are not paid, lenders and creditors have the right to claim payment from the business.

There is no optimal level of gearing for a business, although it is rare for a company to have no gearing. A business must consider:

- return on investment
- cost of debt
- size and stability of the business's earning capacity
- liquidity of the business's assets (the greater the cash flow and the more liquid the assets, the more likely the interest charges will be paid)
- purposes of short-term debt.

A number of ratios show solvency (long-term financial stability), calculated from balance sheet figures. An example is the debt to equity ratio.

Debt to equity ratio

$$\text{Debt to equity ratio} = \frac{\text{Total liabilities}}{\text{Total equity}}$$

The debt to equity ratio shows the extent to which the firm is relying on debt or outside sources to finance the business. This ratio is an important control aspect for management because the relationship between debt and equity must be carefully balanced. A ratio of greater than 1 means that the business has less equity than debt. A ratio of between 0 and 1 means that the business has more equity than debt.

The higher the ratio, the less solvent the firm. That is, the higher the ratio of debt to equity, the higher the risk. The firm must look carefully at interest rates, business confidence and economic indicators to determine if the balance between debt and equity is appropriate for its particular business or industry. A highly geared firm — a firm that uses more debt than equity — carries more risk with regard to longer term financial stability. Investors would be less attracted to a firm with a higher debt to equity ratio because this indicates a greater financial risk.

Financial ratios — gearing

A highly geared business offers greater potential for profit. For example, Ruby has $50 000. One financial institution is willing to lend her 50 per cent of the purchase price of a new clothing store. She has $100 000 to spend on a store. If another financial institution is willing to lend her 95 per cent she can buy a $1 000 000 store.
Scenario 1 — financial institution lends 50 per cent
Ruby's $50 000 = 50 per cent ($50 000 + $50 000 = $100 000)
Scenario 2 — financial institution lends 95 per cent
Ruby's $50 000 = 5 per cent
($50 000 + $950 000 = $1 000 000)

The more highly leveraged business of scenario 2 offers greater possibilities for Ruby because (a) debt finance is tax deductible, (b) she owns a larger asset and (c) the increased size of the business will lead to increased business activity and profits.

SNAPSHOT QUESTIONS

Using the information on Ruby's financial options for borrowing (and your own knowledge), **assess** the impacts of gearing on a business. **Discuss** the different levels of gearing while remembering impacts can be both positive and negative.

SNAPSHOT



To improve a business's gearing, they will need to look at ways of either reducing their debt or increasing equity. In an attempt to decrease debt businesses could sell non-essential assets to pay off their debts, or they could even re-negotiate their loans to spread their payments over a longer period. Alternatively, the business could lease assets as opposed to purchasing them. Strategies to increase equity include retaining more profits, or injecting more equity funding by either selling more shares (if a public company) or inviting new owners.

BizFACT

The financial sector as a whole has one of the highest debt to equity ratios. This is because banks borrow large amounts of funds to then loan large amounts of money. A debt to equity ratio of higher than 2:1 is quite common in this industry. Other industries that have a higher debt to equity ratio are capital-intensive industries, such as large manufacturing companies and the airline industry, who commonly use high levels of debt.

The type of business will determine how highly geared a business can be. For example, a business that is less influenced by economic fluctuations can be more highly geared. A shop selling essential food items will not be affected by economic downturns so it can carry more debt than a business that sells luxury items.

An interesting question is posed by the debt to equity ratio. Should the owners of a business have as much at stake as the creditors (that is, should the ratio be at least 1:1)? Different firms have different financial structures and the attitude of the owners to financial risk determines what levels of debt to equity are appropriate for the business. The debt to equity ratio also has a direct effect on the short-term and immediate solvency of a business. The greater the owners' financial interest in the business, the more solvent in the short term the business is likely to be. Ultimately, the level of solvency in a business reflects its financial structure — that is, its control of debt and equity. This is important for the long-term survival of the business.

Balance Sheet for Young's Store as at 30 June 2018

	$	$
Current Assets		
Cash	20 000	
Accounts receivable	50 000	
Inventories	80 000	150 000
Non-current Assets		
Delivery vehicles		50 000
		200 000
Current Liabilities		
Accounts payable		20 000
Non-current Liabilities		
Mortgage		30 000
Owners' Equity		
Capital	140 000	
Add net profit	10 000	150 000
		200 000

$$\text{Debt to equity ratio} = \frac{\text{Total liabilites}}{\text{Owners' equity}}$$
$$= \frac{50\,000}{150\,000}$$
$$= 0.3{:}1 \text{ or } 33\tfrac{1}{3}\%$$

Comment: The firm has $0.33 in external debt (liabilities) for every $1 of internal debt (owners' equity). A ratio of 1:1 indicates a sound financial position so this company is in a safe position. Depending on the type of firm, the industry and past trends, the firm could possibly increase its rate of external debt.

FIGURE 11.17 An example of a debt to equity ratio

studyon

Syllabus area 3
Topic 3
Concept 5

Financial ratios: gearing
Summary screen and practice questions

11.6.3 Profitability

Profitability is the earning performance of the business and indicates its capacity to use its resources to maximise profits. Profitability depends on the revenue earned by a business and the ability of the business to increase selling prices to cover

purchase costs and other expenses incurred in earning income. The ability of the business to generate profits is its most important financial objective.

A number of parties are interested in a business's profitability:

- Owners and shareholders want to know whether the firm is earning an acceptable return on their investment.
- Creditors want to know whether they will be paid and should offer credit in the future.
- Lenders want to know whether the principal on the loan and interest will be repaid and whether to lend to the firm in the future.
- Management uses profitability to decide on the need for adjustments to policies.

The amount of profit is determined by a number of factors, such as the volume of sales, the mark-up on purchases and the level of expenses. Financial information must be examined to see where changes have occurred and where changes need to be made in the future.

The income statement is used to measure the profitability or earning capacity of the firm. Three profitability ratios are the:

- gross profit ratio
- net profit ratio
- return on equity ratio.

Gross profit ratio

Gross profit is the difference between sales revenue and the direct cost of goods sold. It represents the amount of sales that is available to meet expenses resulting in net profit. A fall in the rate of gross profit may mean a fall in the amount of net profit. The amount of that decrease depends on such factors as price reductions due to specials or sales, mark-downs on out-of-date stock, theft of stock, errors in determining prices, changes in the mark-up policies or changes in the mix of sales.

The gross profit ratio (shown below) gives the percentage of sales revenue that results in gross profit. It is one way that a business can measure profitability. A business's gross profit must be sufficient to pay the expenses of a business and still provide a profit for the small business owner. It is important to note that the gross profit ratio is only calculated by businesses that sell stock and not service businesses; that is, it is only used by those businesses that purchase goods from suppliers and sell them at a higher price to customers.

$$\text{Gross profit ratio} = \frac{\text{Gross profit}}{\text{Sales}}$$

The gross profit ratio shows changes from one accounting period to another, and indicates the effectiveness of planning policies concerning pricing, sales, discounts, the valuation of stock and so on. If the ratio is low, alternative suppliers may need to be sourced and competitors investigated. Since all the other expenses incurred by businesses such as wages, electricity and advertising are deducted from the gross profit to determine net profit, the net profit ratio therefore gives a more accurate indication of the profitability of a business.

Net profit ratio

Net profit represents the profit or return to the owners, which is revenue less expenses. For sole traders and partnerships, net profit represents a return on their contribution to the business. It is usual for a company to return part of net profit to shareholders as dividends and retain a part for future expansion.

BizFACT

In 2013 economic and business forecaster IBISWorld revealed the most profitable industries with the lowest barriers to entry. The top five industries and their respective average net profit ratios were: dating services (21%); accommodation for short-term rentals (18.3%); smartphone app development (50%); painting and decorating services (22%); and tiling and carpeting services (23%).

$$\text{Net profit ratio} = \frac{\text{Net profit}}{\text{Sales}}$$

The net profit ratio shows the amount of sales revenue that results in net profit. The costs or expenses after gross profit must be low enough to generate a net profit. The amount of sales must be sufficiently high to cover the costs or expenses of the firm and still result in a profit. Since businesses vary greatly, there is no set figure for profit ratios. A business would be aiming at a higher gross and net profit ratio. Comparisons need to be made with a business's past performance, their competitors and the industry average.

Strategies to improve the gross profit and net profit ratios are examined in greater detail in section 12.3 on profitability management. Businesses need to focus on strategies to reduce costs and increase revenue.

This means that for every dollar of sales revenue the business earned, it retained 20 cents as gross profit. Another way of looking at this ratio is that cost of goods sold consumed 80 cents of every dollar of sales revenue.

Income Statement for Young's Corner Store, 2017

	$	$
Revenue	100 000	
less Cost of goods sold	80 000	
Gross profit		20 000
less Selling expenses	3 000	
less Administrative expenses	1 500	
less Financial expenses	500	5 000
Net profit		15 000

(a) Gross profit ratio $= \frac{\text{Gross profit}}{\text{Sales}}$

$= \frac{20\,000}{100\,000} \times 100$

$= 20\%$

(b) Net profit ratio $= \frac{\text{Net profit}}{\text{Sales}}$

$= \frac{15\,000}{100\,000} \times 100$

$= 15\%$

This means that for every dollar of sales revenue the business earned, it retained 15 cents as net profit.

FIGURE 11.18 Examples of profitability ratios

study on

Syllabus area 3
Topic 3
Concept 6

Financial ratios: profitability
Summary screen and practice questions

Return on equity ratio

$$\text{Return on equity ratio} = \frac{\text{Net profit}}{\text{Total equity}}$$

The return on equity ratio shows how effective the funds contributed by the owners have been in generating profit, and hence a return on their investment. The return for the owners has to be better than any return that could be gained from alternative investments, such as bank investments. If return on equity rises due to increased leverage (debt) the improved result should be seen as carrying increased risk.

$$\text{Return on equity} = \frac{\text{Net profit}}{\text{Total equity}}$$
$$= \frac{15\,000}{150\,000} = 0.1\% \text{ or } 10\%$$

Comment: This means that for every $1 of equity contributed by the owners, they receive 10 cents in return. In this example, a return of 10 per cent would be seen as a reasonable investment. Depending on other information, the owner would need to consider alternatives for investment, such as bank interest rates.

FIGURE 11.19 An example of a return on equity ratio

BizFACT

As a general rule, most investors would want at least 10 per cent return. This is because most investors would not risk investing in a business when they could get the same return by investing their money in a bank or in government bonds, for example.

Owners are interested not only in the return for the current year but also in comparing the current year's return with previous years and against industry averages. It is also useful to compare the return with alternative investment considerations; for example, interest earned through a financial institution.

The higher the ratio or percentage, the better the return for the owner. If returns compare favourably, owners might consider expansion or diversification of the business. If the return is unfavourable, the owners would consider alternative options, including selling off the business.

11.6.4 Efficiency

Efficiency refers to the ability of a business to use its resources effectively in ensuring financial stability and profitability of the business. Efficiency relates to the effectiveness of management in directing and maintaining the goals and objectives of the firm. The more efficient the firm, the greater its profits and financial stability.

BizWORD

Efficiency *is the ability of a business to minimise its costs and manage its assets so that maximum profit is achieved with the lowest possible level of assets.*

Expense ratio

$$\text{Expense ratio} = \frac{\text{Total expenses}}{\text{Sales}}$$

The expense ratio compares total expenses with sales. The ratio indicates the amount of sales that are allocated to individual expenses, such as selling, administration, cost of goods sold and financial expenses. The expense ratio indicates the day-to-day efficiency of the business. A business aims to keep expenses at a reasonable level.

Management use this ratio to determine where the highest expenses are from and why the ratio has either increased or decreased. For example, if the selling expense ratio has increased, it may be that advertising costs have not generated the expected increase in sales. Alternatively, a decline in the financial expense ratio may be a result of lower interest rates or less debt being used by the firm.

As businesses vary greatly, there is no rule of thumb for the expense ratio. The expense ratio should be examined carefully. Businesses need to compare their results with their past performance and industry averages. Obviously the lower the percentage, the better. If the expense ratio is too high, then the business would need to look at ways of monitoring and controlling their expenses and avoiding unnecessary expenses.

Accounts receivable turnover ratio

$$\text{Accounts receivable turnover ratio} = \frac{\text{Sales}}{\text{Accounts receivable}}$$

Accounts receivable turnover ratio measures the effectiveness of a firm's credit policy and how efficiently it collects its debts. It measures how many times the accounts receivable balance is converted into cash or how quickly debtors pay their accounts. By dividing the ratio into 365, businesses can determine the average length of time it takes to convert the balance into cash. If a firm's accounts receivable turnover is 84 days but its credit policy allows 30 days before payment, the firm would need to examine its cash flow, its credit policies, its credit collection procedures and costs, and its policies relating to doubtful debts.

If a business is not efficient in collecting their accounts receivable they need to implement strategies to improve this, such as charging interest on overdue payments, offering discounts for early payments or being more selective when granting credit.

BizFACT

The average time taken by Australian businesses to pay their invoices is 44.4 days.

Income Statement for Young's Corner Store, 2017

	$	$
Revenue	100 000	
less Cost of goods sold	80 000	
Gross profit		20 000
less Selling expenses	3 000	
less Administrative expenses	1 500	
less Financial expenses	500	5 000
Net profit		15 000

Additional information: Accounts receivable = $10 000

(a) Expense ratio (selling expenses) $= \dfrac{\text{Selling expenses}}{\text{Sales}}$

$= \dfrac{3000 \times 100}{100\,000} = 3\%$

(b) Expense ratio (administrative expenses) $= \dfrac{\text{Administrative expenses}}{\text{Sales}}$

$= \dfrac{1500 \times 100}{100\,000} = 1.5\%$

(c) Expense ratio (financial expenses) $= \dfrac{\text{Financial expenses}}{\text{Sales}}$

$= \dfrac{500 \times 100}{100\,000} = 0.5\%$

(d) Accounts receivable turnover ratio $= \dfrac{\text{Sales}}{\text{Accounts receivable}}$

$= \dfrac{100\,000}{10\,000} = 10$

$\dfrac{365}{10} = 36.5 \text{ days}$

Comment: Depending on the type of business and past trends, the firm has made a reasonable gross and net profit and their expense ratios are quite low. For every $1 returned as sales, 3 cents is absorbed by selling expenses, 1.5 cents by administrative expenses and 0.5 cents by financial expenses. While this is quite low, these figures would need to be compared to previous years' results.

Debt collection figures indicate relative efficiency in the collection of debts. Debts are being repaid on an average of 36.5 days (assuming that the firm has a billing cycle of 30 days). There is no meaningful average for this ratio, mainly because credit terms differ among businesses. Businesses should therefore compare this result to their credit policy to see if customers are taking too long to pay. As a general rule, however, a high accounts receivable turnover ratio can be improved by demanding payment of overdue accounts.

FIGURE 11.20 Examples of efficiency ratios

studyon

Syllabus area 3
Topic 3
Concept 7

Financial ratios: efficiency
Summary screen and practice questions

TABLE 11.5 Types of financial ratio

Ratio	Formula	Example on page	Analysis of which aspect of the financial statement	What does analysis of this ratio show about a business?	Interpretations of ratio results
Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	317	Liquidity	Shows the short-term financial stability of a business (i.e. its ability to meet its short-term financial commitments)	It is generally accepted that a ratio of 2:1 indicates a sound financial position (i.e. a firm should have double the amount of assets to cover its liabilities).
Debt to equity ratio	$\frac{\text{Total liabilities}}{\text{Total equity}}$	320	Gearing (Solvency)	Shows the extent to which the firm is relying on debt or outside sources to finance the business	The higher the ratio, the less solvent the firm (i.e. the higher the ratio of debt to equity, the higher the business risk).
Gross profit ratio	$\frac{\text{Gross profit}}{\text{Sales}}$	322	Profitability	Shows the percentage of sales revenue that results in gross profit	The higher the ratio the better. If the ratio is low, alternative suppliers may need to be sourced and competitors investigated.
Net profit ratio	$\frac{\text{Net profit}}{\text{Sales}}$	322	Profitability	Represents the profit or return to the owners	A firm will be aiming for a high net profit ratio. A low net profit ratio indicates strategies to reduce expenses and increase revenue need to be investigated.
Return on equity ratio	$\frac{\text{Net profit}}{\text{Total equity}}$	323	Profitability	Shows how effective the funds contributed by the owners have been in generating profit and so the return on investment (ROI)	The higher the ratio or percentage, the better the return for the owner, although comparisons need to be made with alternative investments.
Expense ratio	$\frac{\text{Total expenses}}{\text{Sales}}$	324	Efficiency	Each of the categories of expenses is compared with sales. The ratio indicates the amount of sales that are allocated to individual expenses such as selling, administration, COGS and financial expenses.	Expense ratios indicate day-to-day efficiency of the business. Expense ratios need to be kept at a reasonable level, and management must monitor each type of expense in relation to sales. Higher expense ratios may be the result of poor management.
Accounts receivable turnover ratio	$\frac{\text{Sales}}{\text{Accounts receivable}}$	324	Efficiency	Measures the effectiveness of a firm's credit policy and how efficiently it collects its debt	High turnover ratios indicate the business has efficient debt collection.

11.6.5 Assess business performance using comparative ratio analysis

Figures, percentages and ratios do not provide a complete picture for analysis. For analysis to be meaningful, comparisons and benchmarks are needed. Judgements are then made by comparing a firm's analysis against other figures, percentages and ratios. This is known as comparative ratio analysis and is important for firms. Comparisons can be made in a number of ways. Businesses could compare ratios with their results from previous years, with similar businesses and against common industry standards or benchmarks.

Ratios provide a 'snapshot' at a particular point in time and should be used carefully along with other information. Sales and stock levels may vary significantly throughout

BizFACT

Comparisions can be made over different time periods, against standards, or with similar businesses.

a year so financial information will also vary. It is important to look at trends in the financial information over several years. Figures from at least the previous two years can indicate directions or trends and make ratio analysis more meaningful.

BizFACT

Coca-Cola Amatil revealed a 29.3 per cent decline in net profit in 2017 compared with the previous period. This decrease in profitability has been attributed to the decline in consumption of soft drinks, increased competition and price pressure in its water business as well as the refusal of their two major suppliers, Coles and Woolworths, to stock their full range of beverages.

Income Statement

	2015		2016		2017	
	$	%	$	%	$	%
Sales	100 000	100	120 000	100	150 000	100
less Cost of goods sold	40 000	40	40 000	33	50 000	30
Gross profit	60 000	60	80 000	67	100 000	67
less Other expenses	20 000	20	30 000	25	45 000	30
Net profit	40 000	40	50 000	42	55 000	37

Although sales have increased steadily, cost of goods sold has risen only slightly over the three-year period. Cost of inventories may have decreased due to the suppliers being used or more efficient stock control methods being developed. Expenses have shown no great variation, with figures of 20 per cent, 25 per cent and 30 per cent of sales for the three-year period, resulting in a steady profit percentage (40 per cent, 42 per cent and 37 per cent respectively).

FIGURE 11.21 An example of profitability trends over a number of years

Analysis can also include budget figures so that predicted figures can be compared against actual figures, usually over short time periods such as per month. This information is usually available for interested parties within a firm rather than for external stakeholders.

Income Statement

	Actual		Budget	
	$	%	$	%
Sales	75 000	100	100 000	100
less Cost of goods sold	42 000	56	55 000	55
Gross profit	33 000	44	45 000	45
less Other expenses	20 000	26	35 000	35
Net profit	13 000	17	10 000	10

Although actual sales is considerably less than budget, the reduced amount for expenses has led to an increased profit against sales (17 per cent rather than 10 per cent).

FIGURE 11.22 An example of comparing budget to actual figures

Comparison with other businesses and benchmarking — comparing results against standards that have been developed for a particular industry — are common. However, care must be taken to ensure that the same things are compared. Also, each firm has differences, and finding comparable firms may be difficult. Benchmarks are useful but are merely a guide. For example, financial gearing is often used to compare firms, so that if the industry average of debt to equity was 80 per cent and a particular firm had 40 per cent, then it would need to examine the risks and analyse the reasons for the differences.

In the past, Australian businesses have mainly used Australian standards but, with the globalisation of business, world standards are more commonly used for benchmarking.

Inter-business comparisons are useful and firms may access relevant business statistics from a number of sources, including the Australian Bureau of Statistics. They must ensure information is up to date and accurately reflects industry norms.

SUMMARY

- The financial statements of a business must be analysed to gain a thorough understanding of the activities of a business. The analysis involves comparing similar figures contained in the financial statements and balance sheets.
- The main types of analysis include: vertical (within one year), horizontal (between different years) and trend (over a period of 3–5 years).
- The analysis of financial statements is usually aimed at the areas of financial stability (liquidity and gearing), profitability and efficiency.
- Liquidity is the extent to which the business can meet its financial obligations in the short term. This means a business must have enough resources to pay its debt and cover unexpected expense.
- Current assets and current liabilities determine the liquidity or short-term financial stability of a business.
- A current ratio of 2:1 indicates a sound financial position.
- Gearing measures the relationship between debt and equity.
- Gearing is the proportion of debt (external finance) and the proportion of equity (internal finance) that is used to finance the activities of a business.
- Profitability is the earning performance of the business and indicates its capacity to use resources to maximise profit.
- The income statement is used to measure the profitability or earning capacity of the business. Figures from this statement are used to calculate the gross profit and net profit ratios.
- The return on equity ratio shows how effective the funds contributed by the owners have been in generating profit, and hence a return on their investment.
- Efficiency is the ability of the business to use its resources effectively to ensure financial stability and profitability. It relates specifically to management's ability to achieve its goals and objectives.
- The two main ways to calculate efficiency include the expense ratio and the accounts receivable turnover ratio.
- The expense ratio indicates the amount of sales allocated to individual expenses. The accounts receivable turnover ratio measures how effective a business is in collecting its debts.
- Figures, percentages and ratios do not provide a complete picture for analysis. For analysis to be meaningful, businesses need to make comparisons with their past performance, similar businesses and against common industry standards.

studyon

Syllabus area 3
Topic 3
Concept 8

Comparative ratio analysis
Summary screen and practice questions

EXERCISE 11.4 REVISION

1 **How** are financial reports analysed and interpreted?
2 **Explain** how financial reports are analysed and interpreted.
3 **Describe** the purposes of analysing financial ratios.
4 **Construct** a table listing the types of financial ratios under the following headings (the first one has been completed for you).

Financial management objective	Type of ratio	Financial statement	Purpose
Liquidity	Current ratio	Balance sheet	Short-term financial stability

5 **Determine** the ratio that would help to answer the following questions.
(a) Are assets being used efficiently?
(b) Is the business able to pay its debts in the short term?
(c) Is the business able to pay its debts in the long term?
(d) Are owners/shareholders receiving value for their investment?
(e) Are credit policies of the business being used effectively?
(f) How is the business being financed?

6 Using the information below, **create** a report for Bobbie and Lee at the end of their first year in business as 'T-shirts and More', commenting on:
(a) return on owners' equity (Bobbie and Lee invested $50 000 in the business)
(b) gross profit ratio
(c) net profit ratio.

Income Statement for T-shirts and More, 2018

	$	$	$
Sales of T-shirts			40 000
less Cost of goods sold			25 000
Gross profit			15 000
less Selling expenses			
Advertising	1 000		
Wages	3 300	4 300	
less Administrative expenses			
Telephone	1 400		
Rent of premises	1 500	2 900	7 200
Net profit			7 800

7 Using the following information, **create** a report commenting on the efficiency of accounts receivable of Blossoms Tyres. **State** the reasons for the trend. **Determine** what comment you would make if the business was Blossoms Trucks rather than Blossoms Tyres.

Average days sales uncollected			
2014	2015	2016	2017
104 days	110 days	120 days	120 days

8 The following ratios were calculated for Ventura Ltd. **Outline** what trends are indicated by the ratios and **propose** possible causes of the trends.

	2016	2017
Current ratio	2:1	1.5:1
Profit %	15	12%
Debt: equity	1:1	1.5:1%
Accounts receivable turnover	35 days	50 days

9 Using the information from the income statement below, answer the questions below.
(a) **Calculate** and comment on the expense ratio for 2016 and 2017.
(b) **Recommend** what expenses (if any) you would cut in 2018. Give reasons.
(c) **Describe** what the trend in advertising expenses has been as a percentage of sales over the last two years.
(d) **Discuss** the profitability of the business for the past two years.

Income Statement for year ended 30 June 2017		
	2016	2017
	$	$
Sales	130 000	135 000
less Cost of goods sold	80 000	82 000
Gross profit	50 000	53 000
less Expenses		
Advertising	20 000	23 000
Rent	13 000	13 500
Interest — short term	1 200	1 200
Motor vehicle expenses	8 500	10 100
Net profit	7 300	5 200

10 Look at the income statement and balance sheet for Business Z.
(a) **Discuss** the profitability of Business Z.
(b) **Discuss** the gearing of Business Z.
(c) **Summarise** your recommendations for the following year.

Income Statement, Business Z			
	2015	**2016**	**2017**
Sales	80 000	74 000	95 000
less Cost of goods sold	57 500	54 000	73 800
Gross profit	22 500	20 000	21 200
less Administrative and finance expenses	16 500	15 000	16 500
Net profit	6 000	5 000	4 700

Balance Sheet, Business Z			
Inventory	80 000	72 500	87 500
Non-current Assets	70 000	77 500	62 500
	150 000	**150 000**	**150 000**
Overdraft	35 000	38 000	32 000
Other Current Liabilities	35 000	32 000	38 000
Capital	80 000	80 000	80 000
	150 000	**150 000**	**150 000**

11 Use the balance sheet and the industry averages below to answer the questions that follow.

Balance Sheet as at 30 June 2018		
Current Assets		
Cash	300	
Accounts receivable	1 200	
Inventory	3 000	4 500
Non-current Assets		5 500
		10 000

(continued)

(continued)

Current Liabilities		
Accounts payable		1 000
Non-current Liabilities		5 000
Owners' Equity		
Contributed capital	1 000	
Retained earnings	3 000	4 000
		10 000

Industry averages	
Current ratio	2:3
Debt: equity	2:3
Accounts receivable turnover 55 days	
Return on owners' equity 30%	

(a) **Calculate** the current ratio, debt to equity ratio, return on equity ratio and accounts receivable ratio (sales $15 000 of which 60 per cent were on credit).

(b) Using the industry averages, **identify** the strengths and weaknesses of the firm's financial position and **determine** where improvements would need to be made.

12 You have been given the following analysis of the financial reports of JY Enterprises. **Create** a report for management giving your interpretation of the data under the headings 'Liquidity', 'Gearing' and 'Profitability'.

	2014 $	2015 $	2016 $	2017 $
Current Assets				
Inventory	90 000	100 000	100 000	150 000
Accounts receivable	120 000	140 000	150 000	150 000
Non-current Assets	250 000	250 000	300 000	200 000
Total Assets	**460 000**	**490 000**	**550 000**	**500 000**
Current Liabilities				
Overdraft	40 000	50 000	60 000	60 000
Accounts payable	80 000	100 000	110 000	120 000
Non-current Liabilities	100 000	120 000	150 000	150 000
Total Liabilities	**220 000**	**270 000**	**320 000**	**330 000**
Owners' Equity				
Capital	150 000	150 000	150 000	150 000
Retained earnings	90 000	70 000	80 000	20 000
	240 000	**220 000**	**230 000**	**170 000**
Current ratio	210 000 / 120 000 = 1.75	240 000 / 150 000 = 1.6	250 000 / 170 000 = 1.48	300 000 / 180 000 = 1.67
Debt to equity ratio	220 000 / 240 000 = 0.92	270 000 / 220 000 = 1.22	320 000 / 230 000 = 1.4	330 000 / 170 000 = 1.94
Return on equity ratio	90 000 / 240 000 = 0.38	70 000 / 220 000 = 0.32	80 000 / 230 000 = 0.35	20 000 / 170 000 = 0.12

13 **Why** is it difficult to compare businesses over time?

14 **Why** do businesses compare their results with industry standards and benchmarks?

15 **Explain** why it is often difficult to compare ratios for businesses with industry averages.

EXERCISE 11.4 EXTENSION

1 'The objectives of financial management often conflict with one another.' **Explain** this statement.

2 'Financial analysis is the beginning of an investigation of a business.' **Discuss**.

3 **Examine** a range of financial reports from a business.
   (a) **Calculate** liquidity, gearing, profitability and efficiency ratios using figures from the reports.
   (b) **Create** a report commenting on the ratios.

4 Use the internet to find the most recent annual report and financial statements of three companies.
   (a) **Determine** their operating profit (or loss), total assets and total liabilities.
   (b) Print screenshots of the sites where you found the results and share them with others in the class. **Compare** your results.

BizFACT

The law requires accuracy, transparency and disclosure of all financial details to the stakeholders and it is always in the interest of a business to conduct itself ethically.

11.7 Identifying the limitations of financial reporting

Financial reports and ratio analysis provide information on the state of the business and indicate trends in its operations. However, caution needs to be exercised when analysing financial reports because they may not give a completely accurate assessment of a business's financial position. Businesses often work hard to make their financial reports look good. Therefore, investors need to exercise caution when examining these reports. Misleading information impacts on business decision making and puts the business at risk. The following issues must be considered when analysing financial reports.

TABLE 11.6 Limitation of financial reports

Issue	Description
Normalised earnings	Normalised earnings are earnings that have been adjusted to take into account changes in the economic cycle or to remove one off or unusual items that will affect profitability. This is done to give a more accurate depiction of the true earnings of a company. This makes it easier to compare profitability figures for a business from one year to the next, and against other businesses. An example is the removal of a land sale, which would achieve a large capital gain.
Capitalising expenses	This refers to an accounting method where a business records an expense as an asset on the balance sheet rather than as an expense on the income statement. This does not accurately represent the true financial condition of the business as it understates the expenses and overstates the profits as well as the assets of the business. Examples of capitalising expenses include research and development, and development expenditure.
Valuing assets	This is the process of estimating the value of assets when recording them on a balance sheet. This can be difficult for financial managers or accountants to estimate, especially for non-current assets. Sometimes when an asset is recorded on a balance sheet, its value is written as its historical cost. Historical cost is an accounting method where assets are listed on a balance sheet with the value at which they were purchased. The main advantage of using the historical cost is that the cost can be verified. The disadvantage is that this value may distort the business's balance sheet, meaning that it will not accurately represent the true worth of the business's assets. This is because the original cost of an asset may be different from its current market value. Some non-current assets, such as land, typically increase in value over time. Other non-current assets, such as vehicles or machinery, may actually lose value over time. This is known as depreciation.

(continued)

BizFACT

Calculating, and adjusting, the value of a company's goodwill is the issue that takes up the most time and effort of auditors of ASX 200 listed firms. Research by KPMG found that the valuation, and possible impairment, of goodwill and other intangible assets such as brand value were listed as a key audit matters by around two-thirds of companies.

BizFACT

Intangible assets are difficult to quantify and put a value on. One of the most commonly valued intangible assets are brand names. In 2017 the Apple brand, worth $170 billion, topped Forbes' annual study of the most valuable brands in the world for the seventh straight year. Google ranked second at $101.8 billion, then Microsoft ($87 billion), Facebook ($73.5 billion) and Coca-Cola ($56.4 billion).

BizWORD

Debt repayments *refer to either money owed to the business or by the business.*

TABLE 11.6 *continued*

Issue	Description
Valuing assets	With assets that typically lose value over time, businesses have to estimate how much value they lose every year. Financial managers are allowed to depreciate assets using accounting standards so that the value of the assets on the balance sheet presents a more accurate picture of the business. While there are rules governing how depreciation is calculated, financial managers are free to choose from several methods, which may mislead some investors. This is therefore a limitation when interpreting financial reports because the depreciation rate is an estimate and this may give a false impression about how much the business is actually worth. Another limitation of financial reports is that some assets are very difficult to value. Intangible assets are items of value to a business, but they do not physically exist; for example, goodwill, trademarks, patents and brand names. While these assets are of value to the business, sometimes they are not included on a balance sheet because their value is too difficult to work out since there is no set formula for their calculation. If financial managers decide to include these assets on the balance sheet, there may be a temptation to overvalue them to make the business appear more financially stable than it really is.
Timing issues	When analysing a financial report, limitations can arise due to timing issues. One of the basic accounting concepts is the matching principle. Under the matching principle, expenses incurred by a business must be recorded on the income statement for the accounting period in which the revenue, to which those expenses relate, is earned. In other words, when an accountant records revenue, they should also record at the same time any expenses that were directly related to that revenue. For example, a real estate agent may have sold a property in June. They receive a 2% commission for sales, but their employer did not pay them until July. This expense should be recorded in June. When this principle is followed, the revenue earned will match the costs that were incurred to earn that revenue. The matching principle results in the presentation of a more accurate representation of the financial position of a business.
Debt repayments	When analysing a financial report, the gearing ratio is often used to determine whether businesses are at risk of meeting their long-term financial commitments. A business that is highly geared may be alarming for some stakeholders. However, while a highly geared business has increased risk, their potential for profit is greater. For example, higher levels of debt to fund growth can lead to increased profits in the future. Financial reports, when considered in isolation, can therefore be limited. Financial reports can be limited because they do not have the capacity to disclose specific information about **debt repayments** such as: • how long the business has had or has been recovering the debt • the capacity of the business or its debtor to repay the amount/s owed (What if a debtor is close to bankruptcy and will not be able to repay a debt?) • the adequacy of provisions and methods the business has for the recovery of debt (Larger businesses have the ability to outsource debt recovery by hiring an agent to undertake this process, but smaller business may not have the resources to do the same as it is costly and time consuming.) • what provision the business has in place for doubtful debts and how this is evident in the financial reports • whether debt repayments have been held over until another accounting period, therefore giving a false impression of the situation • when the debts are due. The recording of debt repayments on financial reports can be used to distort the 'reality' of the business's status and this may be undertaken to provide a more favourable overview of the business at that point in time.
Notes to the financial statement	Notes to the financial statements report the details and additional information that are left out of the main reporting documents, such as the balance sheet, income statement and cash flow statement. They contain information that may be useful to stakeholders to help them

Issue	Description
Notes to the financial statement	make sense of these financial statements and to explain them. These notes contain important information such as the accounting methodologies used for recording and reporting transactions that can affect the bottom-line return expected from an investment in a company. They may also contain further details about how the figures in the financial statements were calculated and the procedures that were used to develop them.

Case study: Bega Cheese — normalised earnings

A crash in global dairy prices and strong demand for milk has hit the Bega Cheese bottom line.

Bega Cheese announced yearly earnings of $12 million profit after tax, down 81 per cent on the previous year.

Executive chairmen of Bega Cheese, Barry Irvin, said it had been a challenging year for the dairy industry.

"The reality is it was an extraordinarily challenging year for global commodity prices for dairy products," he said.

"I think in terms of the way we would look at the business, we would look at the underlying profitability and the normalised result.

"You'll have to remember that last year's result included the benefit of the sale of our Warrnambool Cheese and Butter shares, which of course made a significant contribution to the bottom line last year.

"On a normalised basis, without the impact of the Warrnambool Cheese and Butter shares and the Milk Sustainability and Growth Program in there, that sees the profit down about 26 per cent.

"That really does show the impact that global commodities had on the business last year."

Despite the global market being flooded with dairy products, there is still hot competition between processors in Australia.

This meant that the crash in global dairy prices was not able to be passed on as big price cuts to local farmers.

"As we came into FY15, there was great competition for milk and all companies offered a strong price at the upper end of the commodity cycle and of course no one was predicting the commodity drop would be quite as big as we saw this year," Mr Irvin said.

"Prices have come off to farmers in the last three years, falling from $7 down to $6 and this season an opening price of $5.60 for milk solids.

"But there is still strong competition for milk and all companies are trying to give some stability to farmers, because we are still looking forward to business growth in the future."

Mr Irvin acknowledged that the milk prices on offer in Australia were not in sync with the global market.

"It is a fair comment to say that Australian milk prices are not aligned with global milk prices," he said.

"Compared to New Zealand, we do have a different mix with the domestic consumer goods market and just the size of the domestic market here,

"It's not the case that the international market should reflect *all* of the impact of the global commodity prices but the reality is it should reflect *some*."

Source: Joshua Becker, 'Bega Cheese defends investment in extra production after global dairy crash hits yearly profit', *ABC News*, 28 August 2015

SNAPSHOT QUESTIONS

1. **Outline** the external factors in the business environment that have had an impact on Bega Cheese.
2. **How** have normalised earnings affected the company's profit figures?

SNAPSHOT



'... the sale of our Warrnambool Cheese and Butter shares ... made a significant contribution to the bottom line ...'

studyon

Syllabus area 3
Topic 3
Concept 9

Limitations of financial reports
Summary screen and practice questions

11.8 Ethical issues related to financial reports

Financial managers and accountants who prepare financial reports should ensure the decisions they make are ethical and that they act with the highest standards. They have an ethical and legal obligation to ensure financial records are accurate. Any attempt to engage in creative accounting to portray a more favourable but inaccurate financial picture should always be avoided. In recent years, unethical practices have been highlighted and increasingly questioned (see figure 11.23).



FIGURE 11.23 Sigma Pharmaceuticals is the owner of some of Australia's best known pharmacy brands such as Amcal and Guardian. In 2016, the former chief executive, Elmo de Alwis, and former chief financial officer, Mark Thomas, received a 12-month suspended prison sentence and $25 000 fine each for falsifying Sigma's books and providing false information to the company's board and auditor. They were sentenced after admitting they overstated Sigma's revenue in 2010 by $15.5 million dollars and its profits by $9.6 million. Due to their breaches, Sigma suffered a loss of approximately $59.3 million. Sigma is now suing the two former executives and are seeking compensation, damages and costs associated with their crimes.

It is generally accepted that financial management decisions must reflect the objectives of a business and the interests of owners and shareholders. For example, an area in which ethical considerations are important is in the valuing of assets, including inventories and accounts receivable. Such valuations influence the level of working capital and, hence, the short-term financial stability of a business. If inventories and accounts receivable are overvalued (the business makes no provisions for bad or doubtful debts), working capital will be high and indicate an untrue working capital figure for a business.

If debt funds are used extensively to finance activities in a business, although debt funds may be used to increase profits, there is added risk for shareholders. The impact of debt funds on risks to shareholders is an ethical issue that must be considered.

In preparing budgets, the expenditures and revenues are estimated. The common practice in business of overestimating expenditures and understating revenues to allow for unexpected and uncertain events is an ethical issue for a business.

Ethical considerations are closely related to legal aspects of financial management. Legislation is in place to guard against unethical business activity but there is often a time lag between the recognition of a problem and its implementation through law.

Laws relating to corporations include the responsibilities of directors and requirements for disclosure for corporations. For example, in relation to financial management, directors have a duty to:

- act in good faith
- exercise power for proper purpose in the name of the corporation

- exercise discretion reasonably and properly
- avoid conflicts of interest.

The Australian Securities Exchange (ASX) corporate governance council officiates the requirements of corporations listed with the ASX and their responsibilities in regard to compliance with law, disclosure and transparency of company details to shareholders and the public.

11.8.1 Examine ethical financial reporting practices

Some ethical issues related to financial reports include audited accounts, record keeping, GST obligations and reporting practices.

Audited accounts

In all activities of a business the goals of the business remain paramount. Planning, monitoring, control and corrective action are all part of the process. The **audit** is an independent check of the accuracy of financial records and accounting procedures, and it has an important role in this process.

BizWORD

*An **audit** is an independent check of the accuracy of financial records and accounting procedures.*

Potential users of information include financial institutions, owners and shareholders and potential investors who rely on the independent check of the auditor before making decisions about the business.

Audits are an important part of the control function and are generally used to examine the financial affairs of a business. There are three types of audits:

1. *Internal audits.* These are conducted internally by employees to check accounting procedures and the accuracy of financial records.
2. *Management audits.* These are conducted to review the firm's strategic plan and to determine if changes should be made. The factors affecting the strategic plan may include human resources, production processes and finance.
3. *External audits.* These are a requirement of the *Corporations Act 2001* (Cwlth). The firm's financial reports are investigated by independent and specialised audit accountants to guarantee their authenticity. The auditor issues a statement indicating that the firm's records and financial reports are accurate, to the best of the auditor's knowledge, and give a true and fair view of the state of affairs, and that they comply with Australian auditing standards. In 2005, businesses were required to adopt new international accounting standards or international financial reporting standards (IFRS). These standards aimed for greater transparency and accountability for all businesses regardless of size. Globally standardised accounting also assists transnational corporations.

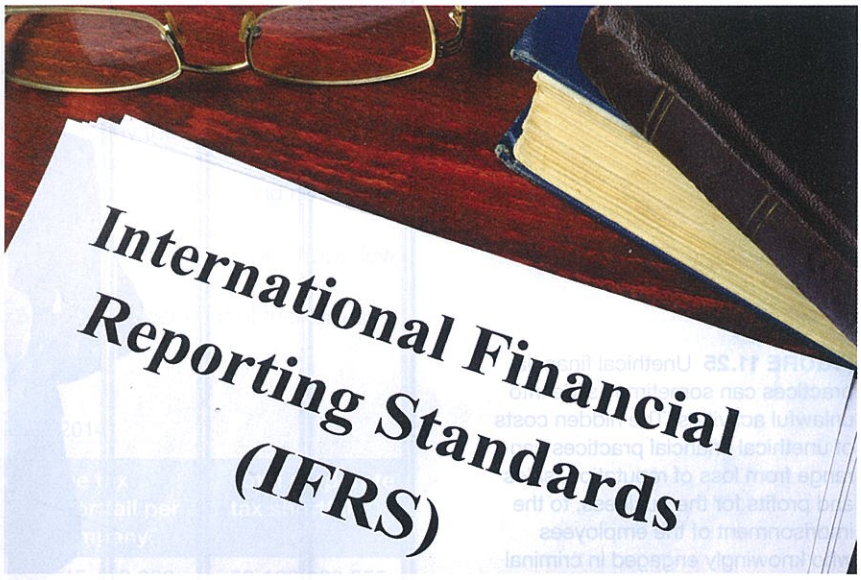


FIGURE 11.24 Accounting standards are a set of principles that companies follow when they prepare their financial statements, ensuring that companies' financial performance are published in a standardised way. The International Financial Reporting Standards (IFRS) Foundation is a not-for-profit organisation that was established to develop and promote a single set of high-quality, enforceable and globally accepted accounting standards — IFRS Standards.

Internal and external audits assist in guarding against unnecessary waste, inefficient use of resources, misuse of funds, fraud and theft. Audits are carried out on the financial records of a business to see if they are prepared in line with accepted accounting standards and that records provide accurate information for users. They check the control procedures of a business by physically checking assets. For example, cash is counted, the condition and amount of the inventory is

BizFACT

In 2017, Caltex initiated internal workplace audits of its entire franchise network after suspicions were raised about wage fraud. The audit revealed that almost 80 per cent of its franchisees were underpaying their staff. Many franchisees have since left the network after being terminated. The company has also established a $20 million assistance fund to support those employees who were underpaid.

checked, and accounts receivable and non-current assets are checked. Records are checked to see if they match the physical count.

External auditors are used to provide an annual audit of accounting practice and procedures. In small businesses, external auditors are usually used only if the business is for sale or as a check against theft and fraud. An external audit is conducted by an independent accounting business. Such businesses employ highly trained certified public accountants (CPAs) who provide expert accounting and financial management services. When they are satisfied, the auditor certifies that the financial data presented in the business's financial reports is in accordance with generally accepted accounting standards and practices.

Record keeping

All accounting processes depend on how accurately and honestly data is recorded in financial reports. Source documents must be created for every transaction, even those in which cash has changed hands. There is a temptation in some cases to receive payment in the form of notes and coins, and not record the transaction. If cash received in this way is not recorded, it will not show up as business revenue, and will reduce the business's profit for the year, possibly resulting in a lower tax burden. While reducing the tax burden in this way may be tempting, the Australian Taxation Office (ATO) regularly monitors business operators, and those found to be evading their taxation responsibilities can receive fines far in excess of the amount they may believe they have saved in tax. Prosecutions for tax evasion can harm the reputation of the business, and alienate customers who wish to deal with honest and ethical businesses.

BizFACT

Proper financial records must be kept for a minimum of five years.



FIGURE 11.25 Unethical financial practices can sometimes slide into unlawful activities. The hidden costs of unethical financial practices can range from loss of reputation, sales and profits for the business, to the imprisonment of the employees who knowingly engaged in criminal conduct.

Reporting practices

Not only are accurate financial reports necessary for taxation purposes, but other stakeholders are entitled to access to a business's financial information. Shareholders in a private company are legally entitled to receive financial reports annually, even if the company is a small business and the shareholders are family members. To pretend that profit is lower than it should be is to attempt to defraud the ATO. This is not only illegal and unethical, but can have other negative consequences. Should the business wish to raise additional capital from existing

shareholders or from a bank, understating profit may make it more difficult to persuade those sources of finance to lend to the business. If a business decided to sell the business as a going concern, any purchaser would want to see financial reports for a number of years prior to the sale. Understating profit or overstating the value of assets may prove counter-productive when a potential buyer subjects the reports to close scrutiny.

Unethical financial practices — tax minimisation

"Technically legal, morally bankrupt" — that is the key finding of a new study into the tax operations of the biggest multinationals doing business in Australia.

The study put together by a team of researchers at the University of Technology, Sydney found 76 of the largest multinationals in Australia pay an effective tax rate of 16.5 per cent, roughly half corporate tax rate of 30 per cent.

The report argued that, had the full tax rate been paid, the federal budget bottom line would have been boosted by $5.36 billion in 2013 and 2014.

The study originally looked at the top 100 multinationals and eliminated 24 firms that were found to have experienced genuine – not artificially inflated – losses.

Big pharmaceutical companies were the most effective at driving down their tax rates, paying on average just 5.7 per cent, while technology companies managed it down to 7.5 per cent and energy companies 20 per cent.

The study noted there were two principal ways of slashing tax rates: profit alienation and debt loading.

- Profit alienation is the technique favoured by 'Big Pharma' and high-tech enterprises. The valuable intellectual property rights for the drugs and IT operations are held in low or zero tax jurisdictions. The profits made in Australia are then used to pay the parent company for the use of its expensive intellectual property.
- Debt loading – also known as thin capitalisation – is the domain of the energy and resource sector. To reduce tax bills the foreign multinational company finances its Australian subsidiary with unusually high interest rates. Profits made here are then funnelled back offshore to repay the loans and recorded as a loss in the form of an interest payment on a loan.

The UTS study cited energy giants Chevron and ExxonMobil as paying no tax on their combined revenue of over $12 billion.

"Chevron borrowed over $2.5 billion from foreign subsidiaries, many in known low or no tax jurisdictions," the UTS research found.

"The interest payments on these loans added up to 62.5 per cent of their sales revenue in 2014 and 45 per cent in 2013.

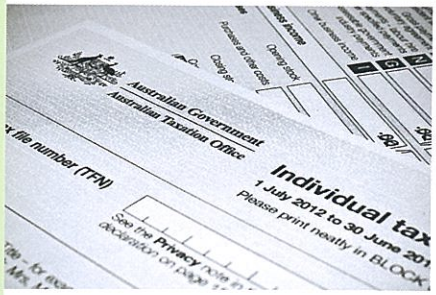
"The result? Chevron paid no tax in 2013–14."

Top foreign multinationals operations in Australia 2013–2014

Sector	Number of companies	Ave % tax paid on profits	Ave tax shortfall per company	Total corporate tax shortfall
Technology, electronics & media	48	7.5%	$45,418,089	$2,180,068,255
Pharmaceuticals & health	13	5.7%	$35,777,183	$465,103,385
Energy	15	20.0%	$181,364,419	$2,720,466,283
All	76	16.2%	$70,600,499	$5,365,637,923

Source: ASIC 'Copy of financial statements and report', Form 388 / UTS
Note: Effective tax rate is based on Generally Accepted Accounting Principles (GAAP)

SNAPSHOT



'... 76 of the largest multinationals in Australia pay an effective tax rate of 16.5 per cent ...'

However, it should be noted that Chevron and Exxon, along with Shell, are joint venture partners in Australia's single biggest resource project — the $US55 billion Gorgon LNG project — which has suffered massive cost overruns and delays and finally started shipments last month.

The big users of "profit alienation" include tech giants Apple and Google, as well as drug companies Glaxosmithkline, Roche, Pfizer and the consumer goods conglomerate Proctor and Gamble.

The UTS researchers found Apple managed to get its effective tax rate down to just 1.2 per cent with the aggressive use of the profit alienation strategy known as the "Double Irish with Dutch Sandwich".

"Apple Inc subsidiaries sell products to one another at prices so high that they make little to no commercial sense — save for aggressive tax minimisation," the study argued.

"Apple's net profit margins in Australia are typically 75 per cent lower than the corporation's global margins."

The issue of multinational tax minimisation and profit shifting is increasingly gaining a higher political profile and is likely to form a prominent part of the economic debate through the upcoming election campaign.

Source: Stephen Letts, 'Tax minimisation: foreign multinational average just 16pc rate', *ABC News*, 20 April 2016

SNAPSHOT QUESTIONS

1. **Summarise** some of the key findings from the study conducted by researchers at UTS.
2. **How** have some companies minimised their tax debt?
3. **Assess** the impact of these tax minimisation strategies.

studyon

Syllabus area 3
Topic 3
Concept 10

Ethical issues relating to financial reports
Summary screen and practice questions

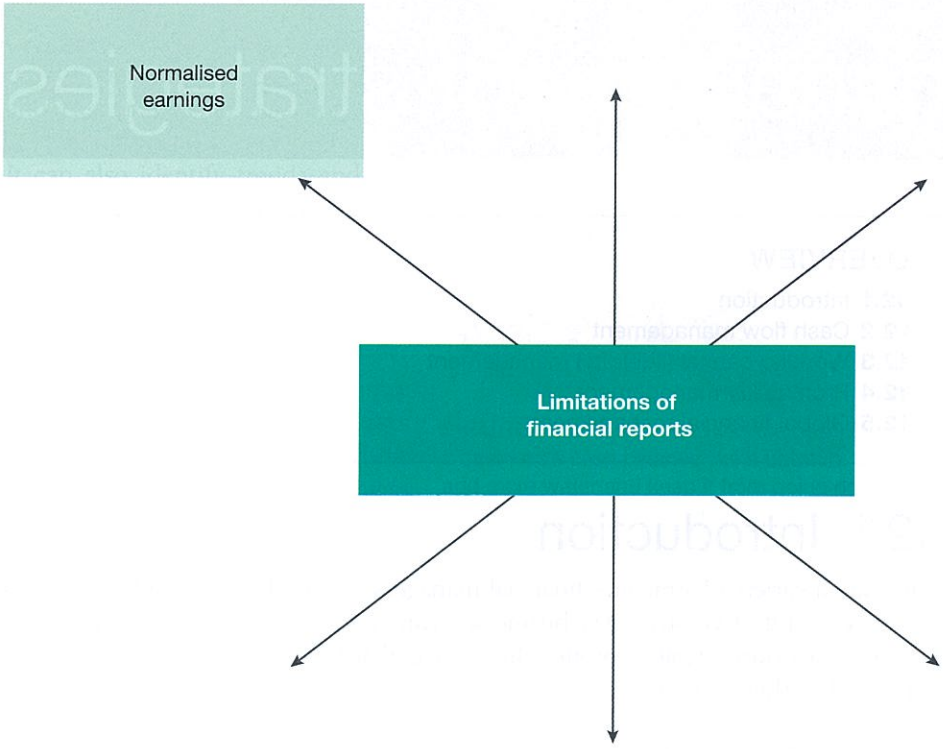
SUMMARY

- There are limitations to financial reports. They can be misinterpreted and can be misleading, both of which will impact on the decision making of management and potentially put the business at risk.
- The limitations of financial reports are:
  - normalised earnings: earnings that have been adjusted to take into account changes in the economic cycle or to remove one off or unusual items that will affect profitability
  - capitalising expenses: an accounting method where a business records an expense as an asset on the balance sheet rather than as an expense on the income statement
  - valuing assets: the difficulties in estimating the value of assets when recording them on a balance sheet
  - timing issues: when revenues and expenses are recorded
  - debt repayments: financial reports don't have the capacity to disclose specific information about debt repayments
  - notes to the financial statement: these report the details and additional information left out of the main reporting documents.
- Businesses have an ethical and legal responsibility to provide accurate financial records.
- Laws relating to corporations regulate the conduct of directors and the requirement for disclosure of all information to be accurate.
- An audit is an independent check of the accuracy of financial and accounting procedures and is an important part of the control function of the business.
- All accounting processes depend on how accurately and honestly data is recorded in financial reports.
- Accurate financial reports are necessary for taxation purposes as well as for other stakeholders.

EXERCISE 11.5 REVISION

1 **Why** is it important for investors to be aware of the limitations of financial reports?

2 Complete the following concept map **identifying** the limitations of financial reports. Provide a brief **summary** of each. The concept map has been started for you.



3 **Explain** the importance of ethics in financial management.

4 A business decides to undervalue its inventories and accounts receivable to indicate a favourable working capital ratio and, therefore, the short-term financial stability of the business. **Discuss** the advantages and disadvantages of this decision and its ethical implications.

5 Is it ethical to overestimate budgets to allow for uncertain or unknown risks? **Justify** your answer.

6 **Explain** the role of the ASX in the supervision of business.

7 **Outline** the role of audits in financial management.

8 **Distinguish** between internal audits, management audits and external audits.

9 **Clarify** why financial record keeping should be accurate and honest.

EXERCISE 11.5 EXTENSION

1 'Analysis of financial information identifies only symptoms, not causes.' Do you agree or disagree with this statement? **Justify** your response.

2 In pairs, use the internet to research and report on businesses that are involved in some form of legal action due to their unethical financial management practices. **Determine** how the business may have avoided this litigation if it had acted ethically.

3 'Timely and valid internal and external audits are a primary safeguard against unethical financial behaviour.' **Assess** the accuracy of this statement.

4 Outline the role of Auditing and Assurance Standards Board (AUASB) Australia using the internet to find information. **Determine** why the federal government would be involved in maintaining auditing assurance standards.

5 KPMG is one of the world's leading professional services companies specialising in audit, taxation and business advice. Use the internet to **examine** KPMG's financial statement audit services.

on Resources

- **Digital doc:** Chapter summary (doc-24813)
- **Interactivity:** Chapter crossword (int-7169)
- **Interactivity:** Multiple choice quiz (int-7170)
- **Weblink:** Auditing and Assurance Standards Board (AUASB)
- **Weblink:** KPMG

studyon

Sit HSC exam