Cutcher&Neale
FORENSIC

Making sense of the dollars–
Understanding Financial Statements

Presented by Nick Gaudion
AUSTLAW WEBINAR 2015

FEBRUARY 2015

1.0 Introduction

1.1 Have you ever looked at a set of financial statements and thought "what does this tellme?" "What do all these numbers mean?" or "I wish I understood what I am looking at"!

Perhaps you think to yourself "I became a lawyer because I like working with people and words, not numbers". However, many legal matters will involve a business, company or trust and the financial statements can tell you a lot about that entity. Therefore it is important for lawyers to have at least a basic understanding of how to read financial statements.

1.2 The capacity to navigate with confidence through a set of financial statements is a valuable skill. Whether you use financial statements in the administration of your

practice, for making and monitoring investment decisions or advising your clients, the fundamentals are relatively the same and the better your understanding of financial statements, the better your decisions will be.

1.3 It is the intention of this paper to provide you with a better understanding of financial statements to enable you to gain more information from the financial statements that you review. The paper deals with:

- The different types and purposes of financial statements,
- Each component and what they mean,
- Some common issues that may cause financial statements to appear misleading, and,
- Some basic ways in which financial statements can be analysed to provide a greater level of information about the business.

2.0 The different types, users, and objectives of financial statements

2.1 The term "financial statements" is most often used to refer to a report prepared annually that includes a Balance Sheet (listing of assets, liabilities and owners' equity) and a Profit and Loss Statement (summarising the performance for the year or period).

2.2 The term financial statements can also be used more broadly to include a large variety of reports with varying levels of detail that document a range of financial information about an economic entity, such as a company, partnership or trust.

2.3 This paper will go through each of the components most often included in a set of financial statements, before looking at other financial reports and how they have developed to meet the needs of different users.

2.4 What is included in a set of financial statements?
2.5 There are five components common in most annual financial statements, being;

- The Balance Sheet,
- The Profit and Loss Statement,
- The Cash Flow Statement,
- The Notes to the Financial Statements, and,
- The Accountants report.

Each of these is discussed in more detail below:

2.6 The Balance Sheet

2.7 The balance sheet represents the financial position of an entity at a point in time. It is a summary of the assets, liabilities and owner's equity as at a specified date. An example of a balance sheet is included at page 4 of the example financial statements attached.

2.8 Assets and liabilities are split into current and non-current categories, and then within each of these, grouped into common sub-categories as detailed below. The detail of the items comprising each category is often included in the Notes to the Financial Statements.

2.9 Current Assets are those assets that are either readily transferable into cash and cash equivalents, or expected to be converted into cash within a short period of time, normally within one year. These may include some of the following:

- Cash, both cash held physically and amounts held in bank accounts. Debtors or Receivables, being amounts owed to the entity, most often from its customers.
- Stock or Inventory, being the items the entity has for sale, including raw materials and work in progress that will be transformed into finished goods for sale.
- There may often be a category called “Other”, which will include miscellaneous items that do not fall within the common categories. For example, prepaid expenses and tax assets.

2.10 Non-Current Assets are those assets that are not readily convertible into cash, or are expected to be held for the longer term, normally being a period greater than 12 months. They are often classified into the following categorises.

- Property, Plant and Equipment, is as described, including real property as well as the plant and equipment of the entity, such as vehicles, manufacturing machinery, office and computer equipment
- Receivables, amounts owing to the entity that are not expected to be received within the next twelve months. This will usually include items such as loans, rather than amounts due from customers.
- Investments, where they are expected to be held for the longer term such as shares.
- Intangibles, such as goodwill, patents, trademarks, and licences.
- Deferred Tax Assets, the most common of which will be a Future Income Tax Benefit. The nature of these tax assets will be discussed in more detail later.

2.11 Current Liabilities are liabilities of the entity that are expected to be settled within the

next 12 months. They often include the following categories:

- Creditors, Trade Creditors, or Accounts Payable, being the amounts owed to suppliers for goods and services.
- Borrowings are loans, or a portion of a loan, that is due and payable within the near future, normally 12 months. This may also include bank overdrafts and the amounts payable under finance leases.
- Provisions, which are amounts, set aside on paper only, for future payments. The amount of the future payment is often not known, and therefore the provision is estimated. This may include provisions for income tax payable, dividends, employee entitlements (annual and long service leave) and warranty claims.

2.12 Non-Current Liabilities, include similar categories and individual items to the current liabilities, with the exception being that these are longer term liabilities with the intention that they be settled after at least 12 months.

2.13 Equity relates to the owner’s interest in an entity. In a company it can be comprised of the following:

- Capital is the paid up value of shares in the company. Assuming all shares are fully paid, the value will be the number of shares times the par value per share. Note that there may be different classes of shares with different values.
- Retained Profits/Accumulated Losses is the cumulative value of profits and losses that have not been distributed to the shareholders by way of dividend.
- Reserves are more common in larger companies and may include capital profits and asset revaluation reserves.

2.14 In a partnership, the equity is often referred to as Partners’ Capital Accounts. The equity will normally be divided amongst the partners and show the balance carried forward from the prior year, plus any contributions and share of profits, less any drawings and share of any losses.

2.15 Within a trust, the equity is referred to as Trust Funds. If the trust is a unit trust, there will be a value for issued units, which is similar to the issued capital of a company. However, a trust will generally not have any retained profits due to taxation considerations and other requirements to distribute any profits.

2.16 The Profit and Loss Statement

2.17 The profit and loss statement can also be called an "Income Statement. The statement provides a summary of the income earned, expenses incurred and income tax for a specified period, most often one year.

2.18 The level of detail contained in the profit and loss statement can vary. For those entities complying with Australian Accounting Standards, there will be a summary of revenue and expenses by function or nature (eg: Functions such as distribution costs or administrative expenses or Nature such as staff and finance costs). Refer to page 5 and 6 of the example financial statements attached. More information relating to certain types of expenses, such as foreign exchange losses are required by the accounting standard to be included in the notes to the financial statements.

2.19 As there is no requirement for many small entities to comply with accounting standards, they will often include a detailed profit and loss statement listing all revenue and expenses eg: postage, telephone, etc rather than these being summarised into administrative expenses (refer to page 7 to 9 of the example financial statements attached). This is because the owner/manager needs to know how the business has performed, and the financial statements are often the only document produced that summarise the performance of the entity.

2.20 The Cash Flow Statement

2.21 The cash flow statement contains information in relation to the cash position for the entity as at a specified date and details of how the cash balance has changed over the year (or other period of time). It is normally split into three sections, being the cash flows from Operating Activities, Investing Activities, and Financing Activities, with the movements in the cash held included as a summary. Refer to page 10 of the example financial statements attached.

2.22 Unlike the profit and loss statement, the cash flow statement does not include any noncash or book entries. Book entries are accounting adjustments that are made in an attempt to better match the revenue earned with the expenses incurred for the same period. Book entries include items like the depreciation of assets. For example, the full purchase price of a piece of machinery of say $100,000 would be disclosed in the cash flow statement. The cost for this asset would be apportioned over the life of the asset (say 10 years) as depreciation. It is the depreciation expense of say $10,000, rather than the amount paid, that would be recorded in the profit and loss statement as an expense for the year. In the subsequent year, the purchase of the machine would not be recognised in the cash flow statement as there is no repeat cash outflow in relation to the machine. However, the $10,000 depreciation expense would still be recorded as an expense in the profit and loss statement until the asset was fully depreciated.

2.23 The cash flow statement categorises the cash flow from different activities.

2.24 The cash flows from operating activities include the cash receipts from the day to day trading or business activities. This will include cash received from customers and payments to suppliers and employees.

2.25 The cash flows from investing activities include the purchase and sale of assets used in the business, such as property, plant and equipment.

2.26 The cash flows from financing activities sets out how the operating and investing activities have been funded, including new borrowing and repayment of loans and any movement in equity, for example, an issue of new shares or dividend payments.

2.27 Notes to the Financial Statement

2.28 As opposed to the balance sheet, profit and loss statement and cash flow statement, which contain summarised information, the notes to the financial statements contain most of the detail. While the information is still in a summarised form, the notes contain information that allows a greater level of understanding of each component of the financial statements. For example, the balance sheet may contain an amount for current borrowings. The notes to the financial statements will detail the composition of the borrowings, which may be an overdraft, loan from a related party and the current portion of a finance lease.

2.29 Note 1 to the financial statements will usually contain a summary of accounting policies, which detail the accounting methodologies employed in preparing the financial statements. This note will also state whether the financial statements are general purpose or special purpose, the difference being special purpose financial statements do not need to comply with all of the accounting standards and in some instances will contain less information. However, where an entity does not need to comply with accounting standards because the owners are the only ones who will see and use the financial statements, the financial statements may contain some more detailed information that is not required by the accounting standards. This is explained in more detail below at paragraph 2.39

2.30 It is important to consider the accounting policy note as some accounting standards allow more than one method of recording the same transaction. Therefore, the selection of the accounting policies can have an impact on the profit disclosed by the company. It may also be of interest to determine whether any accounting policies have changed as that may affect the amounts reported in the financial statements.

2.31. An example of the Notes to the Financial Statements is included from pages 11 to 13 of the example financial statements attached.

2.32 The Accountant's Report

2.33 Where an external accountant, such as a CA (Chartered Accountant) or CPA (Certified Practising Accountant), has prepared the financial statements there will usually be an accountant's report attached to the financial statements. There are three types of accountant's reports generally in use. These are a Compilation Report, a Review Report and an Audit Report (refer to pages 1, 2 and 3 of the example financial statements attached).

If there is no accountant's report this will usually mean that the financial statements were prepared by the owner, employee or book-keeper and therefore could be what are referred to as management accounts. Management accounts are discussed in more detail at paragraph 2.42 below.

2.34 A Compilation Report gives relatively little assurance that the financial statements present a true and fair view. This does not necessarily mean that the financial statements are unreliable. Generally, where financial statements contain a compilation report, the accountant has prepared the financial statements based on records and information supplied to him/her without any review or verification. However, there may still be a requirement to comply with any relevant accounting standards (refer to discussion below at paragraph 2.51 for when accounting standards need to be complied with) and note any areas where there are obvious inconsistencies between the financial statements and the accountants' knowledge of the entity. It is important when reviewing the compilation report to understand the purpose for which the financial statements were prepared.

2.35 A Review Report will be found most often with the half year financial statements of public companies. A review is not as detailed as an audit and is limited primarily to enquiries of the entity's personnel and analytical procedures applied to financial data. The review report will detail any matters that do not comply with the applicable regulatory requirements only where they have come to the attention of the accountant in the course of their review. A review is generally considered to be of negative assurance, i.e. nothing has come to the attention of the auditor to suggest the financial statements are materially misstated.

2.36 An Audit Report attached to the financial statements provides a reasonable level of assurance that the financial statements are free of material errors. An audit report is only issued after an audit has been conducted on the financial statements. It should be noted that an Audit Report does not guarantee that the financial statements do not contain any errors, as only a sample of the transactions and balances are selected for audit testing. However, an audit report does indicate that the financial statements are likely to be free of material errors.

2.37 The mere existence of an audit report attached to the financial statements does not ensure that the financial statements reflect a true and fair view. The audit report should be thoroughly reviewed for scope limitations, qualifications and other matters of emphasis. A qualification to the audit report will detail any reasons why the auditor could not issue an unqualified audit opinion. This may be the inability to form an opinion due to lack of records or an isolated issue such as the entity not complying with an accounting standard.

2.38 An audit report may also highlight an issue that the auditor believes to be of significant interest, which is referred to as an "Emphasis of matter". Such a matter is usually included where an audit report is unqualified (because the financial statements present a true and fair view) but the auditor wishes to draw attention to some particular matter. For example, uncertainty over litigation in which the entity is involved and could have a material impact on the entity.

2.39 The different types of financial statements

2.40 There are many different types of financial statements, some more detailed than others. The reason for the wide variety of financial statements is the many and varied people who use and rely on the information. Their different needs and reasons for using financial statements led to the need for a regulatory environment that was developed to assist in ensuring there is a reasonable balance between the needs and wants of the users of financial statements with the costs of preparing and providing access to the information.

2.41 The different types of financial statements can be broadly defined in two groups, being internal and external financial statements. Internal, being financial reports prepared to assist management with their role in managing the company. External financial statements are often those prepared under statutory obligations and the users may include shareholders, government bodies such as Australian Securities & Investments Commission ("ASIC") and the Australian Tax Office ("ATO") or private bodies, such as banks and trade creditors.

2.42 Internal Financial Statements

2.43 The management of a company often requires both summarised and detailed information in order to effectively manage the business.

2.44 On a regular basis, management needs to know matters including:

- Is the company making a profit?
- Are the sales of the different products increasing or decreasing?
- Have the expenses been kept in line with the budget?

Such information is normally included in a type of financial statement often referred to as "management accounts", which are usually prepared on a monthly basis in most medium and large organisations. Many smaller organisations will use an accounting package such as MYOB to record the day to day activities and provide the ability to produce certain reports as and when required.

2.45 In maintaining this information, different companies maintain different levels of detail. For example, a relatively small company, or one with limited products and locations, may only produce a simple balance sheet and profit and loss statement for the month, year to date and occasionally a comparison against the budget.

Alternatively, a larger and more complex company may produce similar reports for the entity as a whole as well as by product and or location. There may also be reports focussing on different cost centres, such as manufacturing facilities or the marketing department, in order to assess their cost effectiveness. Depending on the procedures employed by the company, the management accounts may include written commentary and be presented and explained at monthly meetings.

2.46 The management will also require financial reports in order to make specific and one off decisions. This might include such things as the cost and benefits of purchasing new equipment, the impact on the financial results if a new branch was opened, or an existing one was closed. Such reports would not normally be referred to as a type of financial statement, but the schedules that are produced in order to support such a decision may often look very similar to the management accounts.

2.47 External Financial Statements

2.48 There is clearly a need for many people wanting to deal with a company to have access to financial information about the company. As noted above, the external users would include shareholders, government, private entities and the general public. Each is likely to want slightly different information for their own purposes.

However, it would be very costly for a company to produce financial information to meet the needs and mdesires of every external user. While there will always be instances where a user may be able to demand certain information, such as a large financier, this would generally be the exception. Shareholders wishing to invest or companies considering doing business with another company may not be in a position to request specific information other than that which is required by statute to be publicly available.

2.49 In an effort to make financial statement preparation cost effective, regulations have been introduced to ensure that one standard set of financial information can be produced that will satisfy the needs and desires of most external users. There are different regulations governing the components of financial statements, and whether or not they are publicly available.

2.50 To generalise, the requirements of the external financial statements will depend on the size and nature of the company and its users. The content will often differ significantly depending on whether the financials statements are general purpose or special purpose.

2.51 Due to differing requirements, it is important to identify whether or not the financial statements are "general purpose" or "special purpose". The primary difference is that there is no requirement for special purpose financial statements to comply with all the accounting standards and disclosure all of the information that is required with general purpose financial statements.

2.52 The best way to determine whether the financial statements are special or general purpose is to read the summary of accounting policies note in the financial statements, or it may also be identified in the accountant's report. Australian Accounting Standards are continually being updated including alignment with International Accounting Standards.

2.53 Some companies have a requirement to lodge their financials statements with ASIC and therefore the information will be publicly available. This will depend on the size and nature of the company. The three broad categories are Public Companies, such as those listed on the Australian Stock Exchange ("ASX"), Large Proprietary Companies (one with at least two of the following characteristics: gross operating revenue of more than $25 million, gross assets of more than $12.5 million and more than 50 employees) and Small Proprietary Companies (those companies which are not large). Generally, all public and most large companies are required to lodge annual financial statements with ASIC.

2.54 Most partnerships, sole traders and trusts, will not be required to make their financial statements publicly available. Where there is no requirement to make the financial statements publicly available, the external financial statements will often be prepared at the same time as the income tax return. This can mean the that financial statements will not be prepared until May in the year following the 30 June financial year end. Therefore, it is often necessary to consider the management accounts for more recent information about the entity.

2.55 For the time being, the important items to note are that some financial statements may be publicly available after being lodged through ASIC. Also, be aware of financial statements that are special purpose because the reporting and disclosure requirements are not as broad as general purpose financial statements.

3.0 Are there any Common Traps?

3.1 Unfortunately, the short answer to this question is YES. It goes without saying that unaudited financial statements that have not been prepared in accordance with the appropriate accounting standards could be misleading. However, it is also possible for properly prepared financial statements to be misinterpreted for a number of reasons.

3.2 Accounting standards ensure a level of consistency in the way in which financial statements are prepared. However, there is often more than one acceptable accounting method and therefore the same event can be recognised differently. The extent to which the financial statements may mislead, can be significantly reduced by the knowledge of the user and their understanding of the different accounting methodologies.

3.3 Set out below are some of the common traps that you should be aware of in order to limit the instances where you may be mislead by financial statements.

3.4 Cash or accrual method of accounting

3.5 The cash and accrual method of accounting refers to the method by which income and expenses are recognised.

3.6 As the name suggests, under the cash method income is recognised when the cash is received, and the expenses are recorded when the cash is paid.

3.7 The accrual method of accounting attempts to match the recognition of the income and expenses during the period in which it was generated or incurred. For example, if a company sold a product in this financial year, but did not receive payment until next financial year, the accrual method of accounting would recognise the sale when it occurred (this year), not when the cash was received (next year).

3.8 Accounting standards require that the accrual method of accounting be adopted. Therefore, you will only see the cash method of accounting adopted for special purpose financial statements, such as a company where the shareholders also run and manage the business, or where there is no requirement to prepare financial statements such as a sole trader.

3.9 Where the cash method of accounting is adopted, it is important to consider what assets and liabilities may not be recorded on the financial statements. Using the above example, the cash method of accounting would not recognise that, at the end the financial year, there was a debtor who owed money to the business for the goods purchased. Even greater care needs to be taken if it appears that the entity uses a combination of cash and accrual methods of accounting. For example, expenses accounted for on an accruals basis and income accounted for on a cash basis.

3.10 Assets recorded at the Lower of Cost and Net Realisable Value

3.11 Accounting standards and principles generally require assets to be recorded at the lower of cost and net realisable value.

3.12 Assets are usually recorded at their historical cost, being the amount at which they are purchased or an acquired. The net realisable value generally means the amount for which the asset could be sold, or the value of that asset based on its continued use in the business, i.e., the amount of profit that the asset can generate.

3.13 The requirement to value assets at the lesser of their cost and their net realisable value, means that when the value of an asset decreases, this must be reflected in the financial statements. However, where the value of the asset increases, there is no requirement to increase the value recorded the financial statements, except for some specific requirements in respect of land and buildings for general purpose financial reports.

3.14 To demonstrate this with an example, consider a company that purchased a block of land for $100,000 in 1980. It would be a reasonable to assume that this property is now worth significantly more than the price at which it was purchased. However, the amount recorded in the financial statements, could still be $100,000, leading to a material understatement in value of the net assets of the company.

3.15 If there was a significant issue that caused the value of the property to be significantly less, the accounting standards would require the property to be recorded in the financial statements at the lower value.

3.16 The common trap is where people assume the amount disclosed in the financial statements (the “book value”) is the market value of the asset. Therefore, when reviewing the balance sheet of an entity, consideration should be given to whether any assets are recorded at values that may be significantly more or less than their true value. If there is any concern, you should consider finding out more information, such as when the asset was purchased, or have a valuation performed on the asset.

3.17 It should also be noted that certain assets can be re-valued to reflect a market value higher than the book value, however in many circumstances there is no requirement to do so. If you identify that an asset has been re-valued, particular attention should be paid to when the asset was re-valued. If the revaluation occurred some time ago, then there is still a risk that the asset value may be misleading.

3.18 Depreciation charges against assets

3.19 Many assets, such as plant and equipment, used in the business will be depreciated over a period of time. This effectively apportions the cost of an asset over the useful life of the asset. For example, the cost of a piece of machinery may be spread over a ten year period.

3.20 In order to understand how this could be misleading and how to identify it, it is best to understand how the asset purchases and depreciation charges are recorded in the financial statements. On a balance sheet, you will normally only see the net value, meaning the cost of the asset less the accumulated depreciation charges against those assets. However, the notes to the financial statements will often include the historical purchase cost and the accumulated depreciation charges for different asset categories (refer page 12, note 5 of the example financial statements). It is therefore possible to see how much the asset cost in total, and how much their value has been written down by depreciation.

3.21 The depreciation charges can be misleading when they do not reflect the actual reduction in the value of the underlying assets. This can be demonstrated using the example of piece of machinery with an estimated useful life of 10 years, which we will assume cost $100,000. This asset could be depreciated by $10,000 each year, such that after three years, its net value would be $70,000 (this is the amount that would be shown on the balance sheet), being a cost of $100,000 less accumulated depreciation of $30,000 (these amounts would be shown in the notes to the financial statements).

3.22 It all sounds reasonable so far, but what if a new high tech line was developed, with improved specifications. This could render the resale value of the old production line to be only $50,000, being $20,000 less than its current value on the balance sheet.

3.23 The other way that depreciation can be misleading, is where the depreciation charges exceed the amount by which the asset value has reduced. This is most obvious when an asset has been fully depreciated. Using the same example, after ten years, the production line would show a net value of nil, being a cost of $100,000 less accumulated depreciation of $100,000. However, the production line, while possibly not as efficient as a new line, may still be capable of production, and have a resale value of say, $25,000.

3.24 One way to identify the possibility that the value of assets such as plant and equipment is more than the recorded value is to consider the difference between the cost value, and the net book value (cost less accumulated depreciation). Where the cost value is significantly higher than the net book value, it may mean that there are a number of fully depreciated assets, which have a value greater than their book value.

3.25 This should only be used as an indication of when it may be beneficial to consider further investigation. The only way that you will know for certain, is to have a valuation performed. When considering the cost benefit of this, remember that with the exception of property, most plant and equipment would not be worth more than the price that was originally paid for the asset. Therefore, if the purchase cost, that is the book value before the depreciation charge, is not material in relation to the issues you are concerned with, then it is likely that the difference between the book value and the resale value would also be immaterial.

3.26 To complicate things a little further, over recent years the Australian Tax Office has been changing the rules regarding depreciation for small businesses. A business with less than $2,000,000 of annual sales will generally be considered a small business.

3.27 The main change amends the rules relating to the pooling or grouping of depreciating assets. Prior to any of the asset pooling options which were first introduced in 2001[1], assets were depreciated individually based on a depreciation rate for that class of asset. Small businesses were then given the option to pool assets into a general pool and a long life pool with the long life pool having a lower depreciation rate. The changes introduced from 1 July 2012 combine both pools and most depreciating assets that cost more than $1,000 or more (regardless of their effective life) can be pooled under the simplified depreciation rules. The depreciation that can be claimed is 30% of the balance of the pooled assets held at the start of the year and 15% for the first year in which any new assets are purchased (and thereafter they form part of the opening balance of pooled assets and depreciated at 30% in the year after purchase).

3.28 So what do all of these changes mean for the valuation of small businesses?

3.29 As noted above, prior to all of the pooling options, assets of a small business were depreciated individually based on a depreciation rate for that class of asset. This meant that the book value of the assets were often a reasonable reflection of the actual value of the plant & equipment held by the business. Therefore, the value set out in the financial statements for plant & equipment and other depreciable assets was often adopted as reasonable estimate of the value of those assets for the purposes of the valuation.

3.30 However, it must be considered for many small businesses, the financial statementsare prepared on the same basis as the tax rules allow.

3.31 The pooling of assets and depreciating all assets at 30% per annum can also lead toassets being depreciated much faster than their useful life. This can result in the bookvalue of the pool of assets being lower than the actual value of the plant & equipment.The book value can even be further reduced by the way in which the sales of assets in the pool are accounted for.

[1] The rules relating to the pooling of assets for depreciation were optional and with the changes over the years have generally become more favourable.

3.32 The following is an actual example in a valuation that I completed (I only rounded the numbers for simplicity, the size of the impact was real). My analysis of plant & equipment identified that the written down book value of the plant & equipment decreased from $335,000 as at 30 June 2011 to $61,500 as at 30 June 2012, a reduction of $273,500. Further analysis of this decrease identified that the Company adopted a “Pooled Approach" to its accounting for the depreciation of its plant & equipment. As noted above, this means that all assets are grouped together in a pool ("the Asset Pool") and are depreciated at the same rate, being 30% (with the exception that the rate of 15% is applied to individual assets in the financial year in which they are purchased). When an asset is sold, the proceeds of the sale are deducted from the written down book value of the Asset Pool. No profit or loss on sale of an individual asset is realised.

3.33 During the year ended 30 June 2012, a grinder was sold for $173,000. The grinder had been purchased in the year ended 30 June 2009. If it had been separately depreciated, it would have had a written down book value of approximately $73,000 when sold, resulting in a profit on sale of approximately $100,000 (being $173,000 less $73,000).

3.34 A non-pooled approach to accounting for depreciation would have resulted in the profit of $100,000 being recognised as income in the Company's profit and loss account. The written down value of the plant & equipment disclosed in the Company's balance sheet would have been reduced by the grinder's written down value on sale (being $73,000).

3.35 Given the Poled Approach adopted by the Company, the proceeds from the sale of an asset are deducted from the carrying value of the pool of assets. The sale of the grinder had the effect of reducing the written down book value of plant & equipment bythe proceeds of sale, being $173,000 as all of the proceeds from the sale of an asset reduces the “pooled value” of the assets. Therefore, the decrease of $273,500 in the written down book value of plant & equipment during the year ended 30 June 2012 is made up of:

- depreciation for the year being 30% of the pooled written down book value of plant & equipment as at 30 June 2011 ($335,000 multiplied by 30%, or $100,500); plus
- the proceeds on sale of the grinder, being $173,000.

3.36 Adoption of the Pooled Approach resulted in an additional decrease in written down book value of plant & equipment of $100,000 (being $173,000 less $73,000) in comparison to a non-pooled approach.

3.37 My valuation report was completed using the book value of the assets but included a an appropriate qualification. I understand that the plant & equipment was subsequently valued resulting in a significant increase in the value of the company.

3.38 In addition to considering the impact of these tax changes on the value of assets disclosed in the financial statements, care also needs to be given to the reported profits in the early years of these changes. This is because the accelerated depreciation can also have the impact of recording a higher depreciation expense in the early years and therefore a lower profit. This could result in the reported profits being lower than what could be generated on a maintainable basis and an adjustment should be considered to the reported earnings when determining the future maintainable earnings of the entity.

3.39 Treatment of finance leases

3.40 There are different methods by which the purchase of an asset can be financed and different types of leasing arrangements available. There are also different methods of accounting for leases. The appropriate accounting method to adopt is determined by the type and structure of the lease.

3.41 It is not necessary to fully understand the different methods of accounting for finance leases. However, you should be aware that the purchase of an asset under a finance lease is not always recorded as an asset and a liability on the balance sheet. The reason why you should be aware of this is that there can be equity in the asset that is not recorded on the balance sheet (where the value of the asset is more than the outstanding lease liability) or a liability not recorded (where the value of the asset is less than the lease liability). This should only occur in entities that are not required to comply with accounting standards.

3.42 In order to identify if this may be an issue, review the profit and loss statement for any lease, hire purchase or similar expenses. If there is a lease or similar expense, it would be appropriate to identify the nature of the lease, the value of the asset and the amount outstanding on the lease in order to consider the extent of any asset or liability that is not properly recognised on the balance sheet.

3.43 Internally generated assets are not recorded on the financial statements

3.44 Internally generated assets are those that have been developed by the business and not acquired by an identified transaction. The best example is goodwill, which develops over time based on the performance, location and reputation of the business. An externally generated asset is one that has been purchased.

3.45 The accounting standards do not permit the recognition of internally generated assets such as goodwill or trademarks as assets.

3.46 Where goodwill is recorded on a balance sheet, it will generally be as a result of the acquisition of another business. This would be referred to as purchased goodwill, and can be included in the balance sheet. However, the goodwill value will often be written off over a period not greater than twenty years, and must not be re-valued to an amount greater than its acquisition cost. This is regardless of whether the goodwill value has remained constant or even increased.

3.47 It is however not uncommon to see internally generated goodwill included as an asset in some small companies that are not required to comply with accounting standards. Where this occurs, the goodwill is not usually amortised and would be stated at the same value each year. Where the value of goodwill is the same each year, the basis on which the goodwill was included as an asset should be established.

3.48 Therefore, internally generated assets such as goodwill can be misleading. For example, internally generated goodwill may have a value but not be recorded on the balance sheet, or, if goodwill is recorded on the balance sheet, its value may be greater or less than that at which it is recorded.

3.49 Provisions, Accruals and Prepayments

3.50 Provisions, accruals and prepayments are all book entries used to better match revenue and expenses in the period in which they were actually generated or incurred. A book entry could be described as a transaction that occurs within the entity and does not directly involve a third party. Provisions and accruals are often an accounting entry to record an estimate of a revenue or expense that has been incurred, but either the actual amount is not known, or the revenue/expense is dependent upon a certain event.

3.51 A simple example would be an entry to record the future liability to pay annual and long service leave for employees. This would recognise the expense in the period during which the employee's leave was accrued, even though payment is not expected to be made until some time in the future. The requirement to pay the long service leave to the employee may be dependant on whether the employee continues for the required period before being legally entitled to receive long service leave.

3.52 The nature of these book entries means that they can be used to influence the results and profitability in an individual year.

3.53 Consider the following example examining the provision for bad or doubtful debts. Assume that a business has $1,000,000 of trade debtors (amounts owed to the business from its customers) as at the end of its financial year. Of the total amount, it might be estimated that between $50,000 and $150,000 will be bad debts, i.e. the business will not receive the amounts from their customers. It would therefore be reasonable to record a provision to reflect the estimate of amounts that are not expected to be received. This will recognise the expense of the bad debts in the year that the revenue was generated, ensuring a proper matching of revenue and expenses.

3.54 As you can see, there is a reasonable amount of room for someone to use their judgement when deciding what amount the provision should be. If there is a reasonable amount of pressure to deliver profits in the current year, then the provision might be set at $50,000, thereby recording an expense of only $50,000.

3.55 If it has been a relatively good year and profits are higher than expected, management may choose to record a provision of $150,000. This will record an expense of $150,000 in the current year. The provision can then remain there, until it is used when the debts go bad, or it could be reversed in a subsequent year. This could be done to increase the profits in future periods. This is a method that can be used to try and smooth profits, or transfer profits from one year to the next.

3.56 To try and identify if this is being done, you should review the profit and loss for any expenses increasing provisions, or in the balance sheet considering the movement in the provisions from one year to the next. You should also consider whether the provisions are reasonable. For example, if a business consistently recorded bad debts of approximately $20,000 per year, a provision for doubtful debts of $100,000 would appear to be high.

3.57 Changes to accounting standards means that general provisions for doubtful debts are no longer allowed. However, many small entities prepare special purpose financial reports which do not need to comply with accounting standards and therefore may still include general provisions for doubtful debts.

3.58 Be aware that provisions can be created for a variety of reasons. These may be for reasonable matters such as warranty claims or more creative such as unused discount vouchers issued to customers and not used.

3.59 Non- Arm's Length Transactions

3.60 A non-arm's length transaction is a transaction between two related parties. These types of transactions often occur in family or owner-managed businesses. For example, a salary paid by the company to the owner of the company would be considered a non-arm's length transaction.

3.61 It is important to consider these transactions, because the amount is often not reflective of the real market conditions. For example, if the owner of the business also owns the premises that are rented to the business, then the rent paid, if any, may not be at market value.

3.62 There is also the possibility for other expenses, which might ordinarily be of a personal nature, to be included in the business for tax purposes, such as company cars or travel expenses. The best way to identify these transactions is to review a detailed profit and loss statement, and / or discuss any personal and non-arm's lengths transactions with the owner / manager of the business.

3.63 Deferred Tax Assets and Liabilities

3.64 Deferred tax assets and liabilities arise due to differences in the recognition of income and expenses by the accounting standards in comparison to the income tax laws. The area of tax effect accounting can be complex. Should the financial statements include significant deferred tax assets or liabilities, it would be beneficial in discussing the nature of these with the accountant who prepared the financial statements in order to get an understanding of how and when the benefits of the tax assets will be realised and the expected timing of the payment of the tax liabilities.

4.0 Basic analysis of financial statements

4.1 Once you have a reasonable understanding of the type and content of the financial statements you are looking at, you can perform some basic analysis. To start with, this could include a simple comparison to prior years to identify any trends or unexpected increases or decreases. This could also often include some ratio analysis, which examines one or more balances by comparison to another balance/s.

4.2 Ratio analysis can be used to display a picture of where the business is now as well as to compare to industry benchmarks or averages. It is also very important to consider the trends that are occurring in the business. The trends can be on individual accounts as well as ratios. For example, calculating the turnover of debtors and identifying that customers currently take an average of 65 days to pay is useful, but calculating this ratio over a number of years will identify if the ratio is going up or down, and whether attention is this area is needed.

4.3 Some of the common rations used are explained below:

Balance Sheet ratios

- Liquidity ratios compare groups of asset balances in comparison to group's liabilities. For example, a comparison of businesses current assets to its current liabilities can provide an indication of its ability to pay its debts as and when they fall due.
- Debt to equity ratios compares the value of the debt relative to the owner's equity in the entity. This can be used to assess the relative risk of debt finance and the percentage of funding provided by the owners may assist when considering the capacity for further borrowing.

Profit and loss statement ratios

- Cost of goods sold as a percentage of sales: It can be used to determine the average costs required in order to produce $1 of sales and monitor the relationship between the cost of goods and the price they can be sold for.
- Gross margin as a percentage of sales: The gross margin (or gross profit) is the sales less the cost of goods sold (the profit before the overhead expenses). This ratio calculates the gross profit produced by $1 of sales.
- Expenses as a percentage of sales: Many expenses will vary with sales, such as wages, fuel, warranty claims etc depending on the type business. The ratio can be used to compare how these expenses vary in comparison to sales over a period of time, or to compare against an industry benchmark.

Turnover ratios

- Debtor's turnover can be calculated by dividing the debtors by the sales for the year and multiplying by 365 to give the number of day's sales currently in debtors. This provides the average number of days from the time the product is sold until payment is received.
- Inventory turnover can be calculated by dividing the value of stock held by the sales for the year and multiplying by 365. This ratio calculates the average period a product would be held before it is sold.

4.4 The use of trend analysis on both ratios and individual balances can be very useful to identify matters for investigation, and providing explanations.

4.5 For example, in performing a trend analysis on the profit and loss statement (i.e., review the last few years results together), it might be identified that sales have been increasing consistently, yet the profit achieved by the business has remained relatively stable. By reviewing the cost of goods sold as a percentage of sales, it is identified that this ratio is increasing, i.e. the cost of goods to produce the same level of sales is increasing. This could then be followed up to identify the cause of the increase couldbe an increase in the cost of imported raw materials due to a change in the exchange rate.

4.6 Ratio and trend analysis can also be a useful tool for budgeting and planning. While it cannot predict the future, it can provide a good indication of the direction the business is travelling.

4.7 Analysing the true profitability of private entities

4.8 One of the most common reasons for reviewing financial statements will be to analyse the profitability of an entity. As discussed above, financial statements can be misleading if you do not understand them. If you simply look at the last line in the profit and loss statement to determine the profit of an entity, you may not be seeing the real picture. This can be more so when reviewing privately owned entities.

4.9 Sometimes, it may be necessary to take a closer look at the true profitability of a privately owned entity. This could be looking at the earnings of an individual for a Family Law or Personal Injury matter or the earnings of a business where a loss of profit is claimed. In such cases, you may simply be referred you to their tax return which confirms the income that is asserted. Are they right? Or is there a way to make their income on their tax return higher or lower than their real income under their control?

4.10 Where the business is operated by an entity other than the individual such as a company, the business will often pay a salary to the owner/s that is not reflective of an arms length market salary. If the person owns the company, then it might be appropriate to look at the profit of the company that is under their control and how it has been allocated. Set out below is a table summarising some of the common methods by which profit is allocated. The total of these items will then approximate the earnings of the business that are under the control of the business owner and that may be more appropriate to consider as their income as opposed to the salary on their tax return.

Item	Amount ($)	Description
Profit	100,000	This is the profit that has not otherwise been paid to the owner. The owner has the ability to pay themselves a higher salary or pay the profits as a dividend.
Salary	50,000	This can be obtained from their individual income tax return. Consider amounts paid to all related parties (spouses, children) and the work performed, if any, in case more than one salary should be included.
Superannuation	25,000	Excessive contributions to superannuation are discretionary and could be reduced in order to increase the salary.
Motor vehicle	5,000	Motor vehicles are often used in a business. However, sometimes the costs of other nonbusiness vehicles are included as expenses of the business, or there is no contribution paid by individuals who use business vehicles owned by the company for personal use.
Personal expenses	1,000	Personal expenses are sometimes included as business expenses – however it can be difficult to determine how much, if any have no business purpose.
Total	181,000	This is the total profit that can be allocated at the discretion of the owner

4.11 In the above example, the company only disclosed a profit of $10,000 and the owner only disclosed a salary of $50,000 on their tax return. However, when both the individual and the company are analysed together, it can be seen that the income available to them from the operation of the business was in fact $181,000.

4.12 Analysing the value of an entity

4.13 Another very common reasons for reviewing financial statements will be to analyse the value of an entity. The financial statements of an entity will usually include a balance sheet – being a summary of the assets and liabilities of the entity. As discussed above, due to the method of recording transactions and the accounting policies adopted by an entity, it is common for the current value of assets or liabilities to have a different value to that recorded on the balance sheet.

4.14 The balance sheet of the entity can be adjusted to provide a better indication of the value of the entity. To do this, it is necessary to review the balance sheet and the notes and consider questions such as:

a) Are there any assets that are not recorded at their current value?

b) Are there any assets of the entity that are not recorded on the balance sheet (eg. debtors)?

c) Are there any liabilities not recorded at the current amount payable?

d) Are there any liabilities that are not recorded on the balance sheet?

4.15 To provide a simple example, assume a company has reported net assets of $200,000. Its principal asset is a commercial property that is rented out. The property was purchased at a cost of $150,000 but its current value is $500,000. The tenant has paid a bond of $20,000 to the company but the financial statements do not record this as a liability to the tenant.

4.16 The following table sets out how to record these adjustments to the net assets:

Net Assets per balance sheet		$200,000
Add value of property	500,000	
Less book value of property	(150,000)	350,000
Less liability to tenant not recorded		(20,000)
Adjusted Net Assets		$530,000

4.17 In some matters, such as Family Law matters, it is also important to consider the value of that entity to an individual. Where this is the case, it is important to look for loans payable by the parties to the entity or by the entity to the parties. A loan payable by the parties to the entity will be recorded as an asset of the entity – however it is a liability of the parties. Similarly, a loan payable by the entity to the parties is a liability of the entity and an asset of the parties.

4.18 For example, assume that included in the net assets of the above example was a loan payable by the shareholder to the company of $25,000. This would be a liability of the shareholder. When determining the value of the shareholder's net interest in the company, the indicative value of the company of $530,000 should be considered along with the loan payable by the shareholder to the company such that the shareholder's net interest in the company is $505,000 ($530,000 less $25,000). However, it will often be more appropriate the value of the company and the loan payable separately.

5.0 Conclusion: and what to do when you next pick up a set of financial statements to review.

5.1 You now understand that there are different types of financial statements, such as management accounts or an annual financial report. Importantly, with your improved understanding of the types and content of financial statements, you also have an increased awareness of some of the common traps.

5.2 A quick check list for the next time you pick up some financial statements to review could be as follows:

1. Look for the accountant’s report. If there is no accountant’s report, it may mean that the financial statements were prepared by management, for management,and not necessarily guided by formal accounting standards. If there is a report by an external accountant, an audit report will give greater assurance than a compilation report that the financial statements are free from material error. Also look to the audit report for any qualifications on the audit opinion provided.

2. Identify if the financial statements are “special purpose” or “general purpose” financial statements. In the notes to the financial statements, the first note will normally be a summary of accounting policies. This note should disclose whether the financial statements are general purpose or special purpose. Remember that special purpose financial statements are not required to comply with all accounting standards and may include less information than general purpose financial statements.

3. Once the type and reliability of the financial statements has been established, you can then review:

    a) The balance sheet, to give you an indication of the financial position at a point in time,

    b) The profit and loss statement, to give you an indication of the financial performance over a period (normally a year), and,

    c) The cash flow statement to give an indication of the cash position and the ability to generate cash.

If you want to find out more detail about the information in these statements, look for a reference to a note to the financial statements. Also, review the accounting policy note to gain an understanding of the accounting policies adopted.

4. Consider calculating some basic ratios and reviewing some trends in order to identify any matters requiring further investigation and to assist in providing explanations for any matters identified. Consider determining the true profitability and whether the balance sheet shows a reasonable indication of the value of the entity.

5. If you need any more assistance, or confirmation that your thoughts are correct, seek professional assistance from a qualified CA or CPA.

Important Disclaimer:

This paper has been prepared for the purpose of an educational seminar and does not constitute advice by the authors or by Cutcher & Neale Forensic Accounting Pty Limited. It is not intended to be a comprehensive statement of the law or practice and should not be relied on as such. If specific advice is required, it should be sought on a formal professional basis. While care has been taken in the preparation of this paper, no warranty is given as to the correctness of the information contained herein and no liability is accepted by the authors or Cutcher & Neale Forensic Accounting Pty Limited for any statement or opinion or for any error or omission. The liability of Cutcher & Neale Forensic Accountanting Pty Limited is limited by, and to the extent of, the Accountants' Scheme under the Professional Standards Act 1994 (NSW).

The material contained in this publication should not be considered as advice and has not been prepared to provide specific Personal Advice to any particular individual(s). It does not take into account the individual circumstances, risk profile, needs and objectives of specific individuals. The examples are used for the purposes of illustration only. Readers should not act upon any matter or information contained in or implied by this publication without seeking appropriate professional advice. The publishers and authors expressly disclaim all and any liability to any person, whether a client of Cutcher & Neale or not, who acts or fails to act as a consequence of reliance upon the whole or any part of this publication.

EXAMPLE FINANCIAL STATEMENTS

FINANCIAL REPORT

FOR THE YEAR ENDED

30 JUNE 2014

EXAMPLE FINANCIAL STATEMENTS

CONTENTS

Example Compilation Report	1
Example Review Report	2
Example Audit Report	3
Example Balance Sheet	4
Example of Profit and Loss by nature of expense	5
Example of Profit and Loss by expense function	6
Example Trading Statement	7
Example of detailed Profit and Loss statement	8
Example Statement of Cash Flows	10
Example Notes to the financial statements	11

COMPILATION REPORT

To Frozone's Air-conditioning Pty Limited

Scope

On the basis of information provided by the directors of Frozone's Air-conditioning Pty Ltd we have compiled in accordance with APS 9 'Statement on Compilation of Financial Reports' the special purpose financial report of the company for the period ended 30 June 2014, as set out on pages 2 to 9.

The specific purpose for which the special purpose financial report has been prepared is set out in Note 1. The extent to which Accounting Standards and other mandatory professional reporting requirements have or have not been adopted in the preparation of the special purpose financial report is set out in Note 1.

The directors are solely responsible for the information contained in the special purpose financial report and have determined that the accounting policies used are consistent with the financial reporting requirements of the company's constitution and are appropriate to meet the needs of the directors and member of the company.

Our procedures use accounting expertise to collect, classify and summarise the financial information, which the directors provided into a financial report. Our procedures do not include verification or validation procedures. No audit or review has been performed and accordingly no assurance is expressed.

To the extent permitted by law, we do not accept liability for any loss or damage which any person, other than the company may suffer arising from any negligence on our part. No person should rely on the special purpose financial report without having an audit or review conducted.

The special purpose financial report was prepared for the benefit of the directors and member of the company and the purpose identified above. We do not accept responsibility to any other person for the contents of the special purpose financial report.

Smith and Sons
Chartered Accountants
King Street
NEWCASTLE NSW 2300

____

John Smith
12 January 2015

INDEPENDENT REVIEW REPORT TO THE MEMBERS OF NATURE DESIGNS PTY LIMITED

Scope

We have reviewed the financial report of Nature Designs Pty Limited for the half-year ended 31 December 2014 as set out on pages 1 to 2. The disclosing entity's directors are responsible for the financial report. We have performed an independent review of the financial report in order to state whether, on the basis of the procedures described, anything has come to our attention that would indicate that the financial report is not presented fairly in accordance with Accounting Standard AASB 1029 "Interim Financial Reporting" and other mandatory professional reporting requirements in Australia and statutory requirements, so as to present a view which is consistent with our understanding of the disclosing entity's financial position, and performance as represented by the results of its operations and its cash flows, and in order for the disclosing entity to lodge the financial report with the Australian Securities and Investments Commission.

Our review has been conducted in accordance with Australian Auditing Standards applicable to review engagements. A review is limited primarily to inquiries of the entity's personnel and analytical procedures applied to the financial data. These procedures do not provide all the evidence that would be required in an audit, thus the level of assurance provided is less than given in an audit. We have to perform an audit, and, accordingly, we do not express an audit opinion.

Statement

Based on our review, which is not an audit, we have not become aware of any matter that makes us believe that the half-year financial report of Nature Designs Pty Limited is not in accordance with:

(a) the Corporations Act 2001, including,
   i. giving a true and fair view of the disclosing entity's financial position as at 31 December 2004 and of its performance for the half-year ended on that date; and
   ii. Complying with Accounting Standard AASB 1029 "Interim Financial Reporting" and the Corporations Regulations 2001; and

(b) Other mandatory professional reporting requirements in Australia

SMITH AND SONS

J Smith
Partner
Chartered Accountants
Newcastle, 01 February 2015

INDEPENDENT AUDIT REPORT TO THE MEMBERS OF NATURE DESIGNS PTY LIMITED

Scope

We have audited the attached financial report, being a special purpose report, of Nature Designs Pty Limited (the company) and the consolidated entity for the financial year ended 30 June 2014 as set out on pages 4 to 23. The consolidated entity comprises thee company and the entities it controlled at the year's end or from time to time during the financial year.

The company's directors are responsible for the financial report and have determined that the accounting policies used and described in Note 1 to the financial statements which form part of the financial report are appropriate to meet the requirements of the Corporations Act 2001 and are appropriate to meet the needs of the members. We have conducted independent audit of the financial report in order to express an opinion on it to the members of the Nature Designs Pty Limited. No opinion is expressed as to whether the accounting policies used, and described in Note 1, are appropriate to the needs of the members. The financial report has been prepared for distribution to members for the purposed of fulfilling the directors' financial reporting requirements under the Corporations Act 2001. We disclaim an assumption of responsibility for any reliance on this audit report or on the financial report to which it relates to any person other than the members, or for any purpose other than which it was prepared.

Our audit has been conducted in accordance with Australian Auditing Standards. Our procedures included examination, o n test basis, of evidence supporting the amounts and other disclosures in the financial report and the evaluation of significant accounting estimates. These procedures have been undertaken to form an opinion whether, in al material respects the financial report is presented fairly in accordance with the accounting policies described in Note 1, so as to present a view which is performance as represented by the results of their operations and their cash flows. These policies do not require the application of all Accounting Standards and other mandatory professional reporting requirements in Australia.

The audit opinion expressed in this report has been formed on the above basis.

Opinion

In our opinion, the financial report of Nature Design Pty Limited is in accordance with:

(a) the Corporations Act 2001, including the:
   i. giving a true and fair view of the company's and consolidated entity's financial position as at 30 June 2014 and of their performance for he financial year ended on that date in accordance with the accounting policies described in Note 1' and
   ii. complying with the Accounting Standard in Australia to the extent described in note 1 and the Corporations Regulations 2001; and

(b) other mandatory professional reporting requirements in Australia to the extent described in Note 1.

SMITH AND SONS
J Smith
Partner
Dated at Newcastle this   day of December 2015

Frozone's Air-conditioning Pty Limited
ABN 12 345 678 901

BALANCE SHEET
AS AT 30 JUNE 2014

	Notes	$ 2014	$ 2013
Current assets			
Cash	2	4,300	12,700
Receivables	3	50,000	65,000
Inventory		25,000	20,000
Other	4	5,000	2,500
Total current assets		84,300	100,200
Non-current assets			
Plant & equipment	5	34,900	12,250
Investments	6	7,500	7,500
Intangibles	7	20,000	20,000
Total non-current assets		62,400	39,750
Total assets		**146,700**	**139,950**
Current liabilities			
Payables	8	26,450	22,500
Interest bearing liabilities	9	27,700	29,500
Provisions	10	10,000	10,000
Tax liabilities	11	4,300	2,600
Total current liabilities		68,450	64,600
Non-current liabilities			
Payables	12	50,000	50,000
Total non-current liabilities		50,000	50,000
Total liabilities		**118,450**	**114,600**
Net assets		**28,250**	**25,350**
Equity			
Issued capital			
Fully paid shares		1,000	1,000
Retained profits		27,250	24,350
Total Equity		**28,250**	**25,350**

The accompanying notes form part of these financial statements

This report should be read in conjunction with the attached compilation report.

Nature Designs Pty Limited
Income Statement (by nature of expense)

for the financial year ended 30 June 2014

	Note	**$ 2014**	**$ 2013**
Sales revenue		2,100,000	2,000,000
Cost of sales		(835,000)	(800,000)
Gross profit		1,265,000	1,200,000
Other revenue from ordinary activities		235,000	265,000
Employee benefits expense		(695,000)	(625,000)
Other production expenses		(140,000)	(160,000)
Distribution expenses		(30,000)	(30,000)
Marketing expenses		(30,000)	(25,000)
Occupancy expenses		(40,000)	(25,000)
Administration expenses		(320,000)	(375,000)
Borrowing expenses		(15,000)	(25,000)
Profit from ordinary activities before income tax expense		230,000	200,000
Income tax expense relating to ordinary activities		(70,000)	(60,000)
Profit from ordinary activities after income tax expense		160,000	140,000
Total changes in equity other than those resulting from transactions with owners as owner		160,000	140,000

Corporate Functions Pty Limited
Income Statement (by expense function)

for the financial year ended 30 June 2014

	Note	$ 2014	$ 2013
Sales revenue		1,225,000	870,000
Cost of sales		(800,000)	(660,000)
Gross profit		425,000	210,000
Other revenue from ordinary activities		10,000	10,000
Distribution expenses		(110,000)	(50,000)
Administration expenses		(150,000)	(85,000)
Other expenses		(25,000)	(20,000)
Restructuring costs		(20,000)	-
Profit from operations		130,000	65,000
Finance costs		(35,000)	(30,000)
Income from associates		10,000	-
Income from investments		5,000	10,000
Profit on disposal of discontinuing operations		10,000	-
Profit from ordinary activities before income tax expense		130,000	65,000
Income tax expense relating to ordinary activities		(40,000)	(20,000)
Profit from ordinary activities after income tax expense		90,000	45,000
Total changes in equity other than those resulting from transactions with owners as owner		90,000	45,000

Frozone's Air-conditioning Pty Limited
ABN 12 345 678 901

TRADING STATEMENT
FOR THE YEAR ENDED 30 JUNE 2014

	Note	$ 2014	$ 2013
SALES			
Sales		575,000	520,000
Cartage charged		1,000	500
		576,000	520,500
LESS COST OF GOODS SOLD			
Opening Stock		20,000	15,000
Purchases		315,000	250,000
		335,000	265,000
Closing stock		25,000	20,000
Total cost of goods sold		310,000	245,000
LESS DIRECT COSTS			
Subcontractors		100,000	110,000
GROSS PROFIT		166,000	165,500

The accompanying notes form part of these financial statements

This report should be read in conjunction with the attached compilation report.

Frozone's Air-conditioning Pty Limited
ABN 12 345 678 901

PROFIT AND LOSS STATEMENT
FOR THE YEAR ENDED 30 JUNE 2014

	Note	$ 2014	$ 2013
INCOME			
Dividends received		50	-
Interest received		50	150
Other revenue		-	5,000
Profit on sale of non-current assets		1,000	-
Loss on sale of non-current assets		-	(4,000)
Rebates		6,000	6,000
Gross profit from trading		166,000	170,500
Total sales		173,100	177,650
LESS EXPENDITURE			
Accountancy fees		3,700	4,500
Advertising		13,800	12,700
Amortisation expense		200	200
Bad debts written off		300	-
Bank charges		1,800	1,600
Cleaning		50	50
Consumables		900	700
Depreciation - motor vehicles		6,200	3,400
Depreciation - furniture & fittings		50	-
Depreciation - low value pool		500	150
Discount allowed		200	200
Entertainment expenses		3,600	2,800
Equipment hire		1,200	-
Filing fees		200	200
General expenses		1,700	1,900
Hire purchase charges		300	-
Insurance		5,100	5,000
Interest paid		1,000	2,600
Leasing charges		2,500	-
Light & power		1,600	1,800
Motor vehicle expenses		21,000	23,000
Postage		800	500
Printing & stationery		1,500	500
Rent		23,000	22,500
Repairs & maintenance		4,900	7,000
Security costs		50	500
Staff amenities		600	500
Subscriptions		1,000	700
Superannuation contributions		3,300	3,000
Telephone		12,200	14,000
Training		600	1,000
Travelling expenses		2,900	1,300
Uniforms		50	900
Wages & salaries		45,000	61,000
Total other expenses		161,800	174,200

The accompanying notes form part of these financial statements

This report should be read in conjunction with the attached compilation report.

Frozone's Air-conditioning Pty Limited
ABN 12 345 678 901

PROFIT AND LOSS STATEMENT
FOR THE YEAR ENDED 30 JUNE 2014

	Note	$ 2014	$ 2013
NET OPERATING PROFIT (LOSS) BEFORE INCOME TAX		11,300	3,450
Income tax expense		3,400	1,100
OPERATING PROFIT (LOSS) AFTER INCOME TAX		7,900	2,350
Retained profits at the beginnings of the financial year		24,350	22,000
TOTAL AVAILABLE FOR APPROPRIATION		32,250	24,350
Dividends paid or proposed		5,000	-
RETAINED PROFITS AT THE END OF THE FINANCIAL YEAR		27,250	24,350

The accompanying notes form part of these financial statements

This report should be read in conjunction with the attached compilation report.

STATEMENT OF CASH FLOWS

for the financial year ended 30 June 2014

	Note	$ 2014	$ 2013
Cash flows from operating activities			
Receipts from customers		2,570,000	2,180,000
Interest received		1,000	1,500
Rent received		28,000	23,000
Payments to suppliers and employees		(2,510,000)	(2,000,000)
Income tax paid		60,000	(40,000)
Interest paid		15,000	(25,000)
Net cash inflow (outflow) on operating activities		164,000	139,500
Cash flows from investing activities			
Receipts from sale of plant and equipment		-	500
Payments for property, plant and equipment		(105,000)	(27,000)
Net cash inflow (outflow) on investing activities		(105,000)	(26,500)
Cash flows from financing activities			
Proceeds from borrowings		-	-
Repayments of borrowings		(85,000)	(70,000)
Net cash inflow (outflow) on financing activities		(85,000)	(70,000)
NET INCREASE (DECREASE) IN CASH HELD		(26,000)	43,000
Cash at beginning of the financial year		65,000	22,000
CASH AT END OF THE FINANCIAL YEAR		39,000	65,000

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2014

This financial report is a special purpose report prepared for use by directors and the members of the company. The directors have determined that the company is not a reporting entity.

The financial reporting has been prepared in accordance with the requirements of the following Australian Accounting Standards.

AAS 5: Materiality
AAS 8: Events Occurring after Reporting Date

No other Australian Accounting Standards or other authoritative pronouncements of the Australian Accounting Standards Board have been applied.

The financial report is prepared on an accruals basis and is based on historic costs and does not take into account changing money values or, except where specifically stated, current valuations of the non-current assets.

The following material accounting policies, which are consistent with the previous period unless otherwise stated, have been adopted in the preparation of this report:

(a) Inventories

Inventories are measured at the lower of cost and net realisable value.

(b) Property, Plant and Equipment

Each class of plant and equipment is carried at cost or fair value less, where applicable, any accumulated depreciation.

Plant and Equipment

Plant and Equipment are measured on the cost basis.

Depreciation

All fixed assets, excluding freehold land, are depreciated on a straight line basis over their useful lives to the company.

(c) Investments

Non-current investments are measured on the cost basis. The carrying amount of investments is reviewed annually by directors to ensure it is not in excess of the recoverable amount of these investments. The recoverable amount is assessed from the quoted market value for shares in listed companies or the underlying net assets for other non-listed corporations.

(d) Employee Benefits

Contributions are made by the company to an employee superannuation fund and are charged as expenses when incurred.

NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 2014

2 Cash		
Petty cash	300	200
Cash at bank	4,000	12,500
	4,300	12,700
3 Receivables		
Debtors	70,000	85,000
Provision for doubtful debts	(20,000)	(20,000)
	50,000	65,000
4 Other assets		
Prepayments	5,000	2,500
5 Plant and Equipment		
Motor vehicles	42,000	16,000
Less accumulated depreciation	10,200	4,000
	31,800	12,000
Furniture and fittings	1,200	-
Less accumulated depreciation	50	-
	1,150	-
Low value pool	2,700	500
Less accumulated depreciation	750	250
	1,950	250
Total Plant and Equipment	34,900	12,250
6 Investments		
Shares in public companies	7,500	7,500
7 Intangibles		
Goodwill	20,000	20,000
8 Payables		
Trade creditors	23,950	20,000
Sundry creditors and accruals	2,500	2,500
	26,450	22,500
9 Interest bearing liabilities		
Loan from other persons	27,700	29,500

NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 2014

10 Provisions		
Provision for warranty claims	10,000	10,000
11 Tax liabilities		
Income tax payable	2,300	600
GST payable	2,000	2,000
	4,300	2,600
12 Non-current payables		
Loan from shareholder	50,000	50,000

These notes should be read in conjunction with the attached compilation report