Chapter 2: The Business Environment

Activity 2.1

1 A business transaction is an economic event that should be recorded in the accounting records of an entity.

2 **a** Selling a tractor for cash.
b Trading a pig for a sheep.
c Buying petrol for your car.
d Buying a movie ticket.
e Paying the fortnightly rent.

3 To create wealth for its owner(s).

Activity 2.2

1 An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

2 **a** Land.
b Buildings.
c Cash.
d Machinery.
e Motor vehicles.

3 Financing activities – finding funds so that the business can operate.

Investing activities – using the funds to obtain assets so that the business can carry out its business activities.

Operating activities – undertaking activities to produce the goods or services that the business offers to its customers.

Activity 2.3

1 **a** Sole trader – a plumber operating his/her own business.
b Partnership – a business jointly owned by two or more individuals, such as a firm of lawyers.
c Limited liability company, or corporation – Steel & Tube Holdings Ltd.
d Non-trading enterprise – a club such as an orienteering club, bridge club, etc.
e Government and semi-government organisations – a state-owned enterprise such as Mighty River Power.

2 The disadvantages of owning your own business (sole trader) are:
a Unlimited liability – if things go wrong, the owner may lose his/her entire wealth in satisfying the claims of creditors or others who may sue the owner.
b Lack of continuity – when the owner dies, the business goes out of existence.
c Difficulty in raising capital – the ability to raise capital is limited to the wealth of the owner and the earning power of the business.

d Management responsibility – the owner is responsible for the administration of the business. Some sole traders are experts at engineering or carpentry, for example, but may have few or no skills in management or finance.

Activity 2.4

1 Business resources are assets – the things of value that a business uses to benefit its future operations.

2 **a** The output question – what are we going to do/produce?

b The input question – what resources do we need to use to produce the outputs?

c The distribution question – who gets our outputs?

Activity 2.5

1 An accountant records, analyses and interprets business transactions, reports on the business activities of a company and, therefore, produces information to aid the decision-making process.

2 The business cycle is the time it takes a business to convert cash into goods or services, sell these goods or services, and receive cash for them.

3 The accounting cycle is the process of gathering, preparing, analysing and reporting on the activities of the business during one accounting period so that business and other decisions can be made.

Activity 2.6

1 It is a value-added tax applied at the time goods and services are sold.

2 The impact of GST on business is that it requires registered businesses to maintain a record of all GST paid and received on its transactions so that the net difference can be forwarded to the Inland Revenue Department.

Activity 2.7

1 Stakeholders are parties affected in some way by the activities of a business.

2 Stakeholder groups are:

a owners and investors

b managers

c creditors and lenders

d employees

e unions

f the government

g the general public.

3 The general public wants to know that businesses are using resources efficiently and effectively and that they are meeting their social responsibilities. The public as consumers are also interested in the future well-being of the business – that it will continue to produce quality goods at reasonable prices, provide employment and so on.

Activity 2.8

1 It is important to understand the influence of government on business because, through Acts and Regulations, it has considerable control of the economy as it pursues its economic, social and political objectives.

2 The role of the New Zealand Accounting Standards Board (NZASB) is to develop accounting standards.

3 The External Reporting Board (XRB) is responsible for general governance of the organisation, overall financial reporting strategy, standards strategy, and oversight of the standards setting boards – the New Zealand Accounting Standards Board (NZASB) and the New Zealand Auditing and Assurance Board (NZAuASB).

4 Factors that influence business include:

- **a** social factors – such as population growth and distribution, consumer lifestyles and public awareness
- **b** competition
- **c** technology
- **d** communication
- **e** marketing
- **f** information systems.

Review exercises

1 The business cycle, or operating cycle, is the time it takes for a business to obtain its raw materials, convert them into finished goods, sell them, and receive the cash payment for these sales.

Businesses are concerned with transformation, or change. They obtain raw materials from a supplier and change these by adding value to them, and then sell them to another person who either uses them for his or her own purposes, or continues to add value to the goods before selling them to another user. The link between the initial supplier and the end user is cash.

Cash is needed to buy the original materials, and to pay for the value added to these materials, and is obtained for these purposes from the people who buy the finished goods. The end users are usually the ones who have been employed to either produce the raw materials or to add value to these materials. They receive their cash supply in the form of wages from the businesses that transform the materials.

The cycle is a repetitive one but, because there are 'cycles within cycles', they have differing time periods. To enable businesses to report at regular intervals, and to maintain reasonable control, the general practice is to convert this business cycle into a 12-month period.

When sales are made on a cash basis the cycle is simplified and shortened. However, if the business manufactures its products or offers extended credit or hire purchase terms, the cycle becomes much more complex. Under these latter circumstances, funds will be 'tied up' in the business for longer periods and a greater return on investment will be required by the owners.

2 The users of financial information include:

a owners

b managers

c creditors

d investors

e employees

f government

g the general public.

The needs of these users are:

Owners: Because these people provide the initial funds, or capital, they are interested in the return earned on their funds, and in the financial stability of the business. Therefore, they need information that tells them how much the company has earned (has it increased its wealth?), and whether it can pay its bills as they fall due.

Managers: These people fall into different categories (top, middle and lower), and the information needs of each kind of manager depends on their level in the organisation.

Top managers want information that:

a shows how their policy decisions have affected the performance of the company, and

b enables them to make policy decisions for the future activities of the company.

Middle management wants information about the performance of their departments such as how efficient and effective they have been in carrying out the policy decisions of top management.

Lower management wants information that tells them how well their sections have performed.

Creditors: These people provide goods and services (such as raw materials) to the company. They are concerned with the financial stability of the company and whether or not it will pay its bills as they fall due. Thus, they are mainly concerned with the company's liquidity, and with the security it offers to cover any advances made to it.

Investors: We have already covered the owners. Here, we are mainly concerned with prospective investors. These are people who are contemplating buying a share in the company. They are concerned with financial stability and with return on investment. Thus, profitability and measures of management performance are important to them. They will use this information to predict future performance, and thus aid their decision on whether to buy the shares.

Employees: The workers are also concerned about the performance of the company, and its future prospects. They want information about these items to assess their future job security and to ensure they receive a fair wage for the work they do. The information will also indicate whether they should stay with this employer, or seek employment elsewhere.

Government: The information wanted by this user includes profit figures to assess the tax liability of the company, and to assess the need for price controls, tariff restraints and so on. Several government departments collect information about sales levels, profits, investments, inventories, liquidity, dividend levels, proportion of profits absorbed by taxation and so on. This information is very important in setting policies for managing the economy, and it is produced by the accounting system of organisations.

The general public: As customers, the general public wants to know the quality of the goods and services it is offered, the fairness of the pricing policies (such as the relative proportion unit price which consists of costs, profits and taxes), and the prices of the company and its competitors.

With the increased interest in conservation and other social effects of business, the general public also wants to know how well business is using the resources it has available and what it is doing to maintain the 'quality of life' in regard to such matters as pollution control, recycling and replacement of resources.

3 Advantages

The advantages of incorporating a business include:

a limited liability

b transferability of ownership

c ease of raising finance.

Limited liability: This limits the liability of an owner to the amount agreed to be contributed towards the capital of the company. Once this amount has been paid, there is no further claim on the owner's personal wealth, regardless of how much debt the company may incur.

Transferability of ownership: Because a limited liability company is a separate legal entity, its existence is not affected by the demise of its owners. Each shareholder is able to deal with his or her share of the company without needing the consent of the other shareholders. Thus, shares may be bought and sold so long as there are willing buyers and sellers available for a trade to take place. Should a shareholder die, for example, and there is no one who wants to buy the shares of the deceased, then the shares vest in the deceased's estate, and pass on to whoever is entitled to receive the estate.

Ease of raising finance: Because of the size of most limited liability companies, it is relatively easy to raise funds from investors. The incorporation of a company places a number of legal restrictions on what it can and cannot do, and these provide the lenders of money some security for their advances. For example, a public company must produce annual and half-yearly financial statements, and must be audited annually. Thus, regular information about its activities must be made available to investors. If it is raising money from the public, it must produce a prospectus before it can make an issue of shares or debentures. These and other requirements allow prospective investors and lenders to assess the security offered for their funds.

Disadvantages

There are also a number of disadvantages of incorporation. These include:

a the company is subject to regulation by the government

b it is costly and time-consuming to establish incorporation

c it is costly to raise finance.

Subject to regulation: A company must fulfil regulatory requirements and prepare annual statements and file an annual return with the Registrar of Companies.

Costly and time-consuming: There are fees to be paid for incorporation as well as the costs of preparing other regulatory requirements. A lot of time and energy has to be put into setting up the organisation structure and in meeting the regulatory requirements.

Costly to raise finance: The costs of issuing a prospectus to raise the initial capital, the costs of underwriting the issue, stamp duties, and the costs of having expert opinion obtained to assess the company's prospects are large – especially for a small company. Many of these costs are relatively fixed and so the size of the issue does not affect them greatly.

4 **a** Jeffrey is fully liable for all of Bill the Builder Company's liabilities. Thus, he must pay the $95,000 of unpaid debts – assuming he has sufficient assets to cover this amount.

b The partners are jointly and severally liable for the debts. Thus, if Stephen King is not able to meet any part of his share of the $95,000, Jeffrey must meet the liability.

c In this case, Jeffrey's liability ceases once he has fully paid the value of shares he holds in the company. It is the company, not Jeffrey, that is responsible for the liabilities.

5 Apart from the effect it has on every one of us as consumers (that is, the effect on our pockets), as budding accountants or business managers, you should see the need for GST recording in the accounting system. There is also the added work needed to collect and pay the tax to the Inland Revenue Department. Also, the accounting system must be able to produce business performance figures that are not distorted by the tax. If this did not happen, the management information system could not provide accurate data for assessing the effectiveness and efficiency of the organisation. Further, the financial statements that are produced at the end of each accounting period would give a false impression of the business's activities for the period if this tax were not removed from the figures.

6 Some relevant Acts of Parliament are:

- Income Tax Act 2007. The government needs money to fund its operations. Much of this money it raises from tax on incomes. This Act prescribes the circumstances under which tax is payable of personal and business income.
- Goods and Services Tax Act 1985. This Act sets out the circumstances under which businesses are required to become a 'registered person' and when a taxable supply of goods and services is made.
- Resource Management Act 1991. The main aim of this Act is to prevent damage to the environment through unsuitable activities by private persons and businesses.
- Privacy Act 1993. This Act seeks to protect personal information and prevent its inappropriate use.
- Employment Relations Act 2000. This Act is aimed at encouraging the maintenance of productive and cooperative workplaces.
- Financial Reporting Act 1993. This Act sets out the reporting requirements of organisations that must produce financial statements that comply with generally accepted accounting practices.
- Companies Act 1993. This Act sets out the legal framework under which companies may be formed and operated.

7 The management process involves three functions – planning, organising and controlling the activities of the company.

Planning involves setting objectives and establishing ways to achieve these objectives. The information needed for this involves the setting of budgets and producing 'pro forma' financial statements – that is, developing financial statements that show what is hoped to be achieved if the plans go as expected. Thus, this information is future-orientated.

Organising is setting up the systems needed to carry out the plans properly. This includes the development of various data-gathering systems in an orderly and efficient manner.

Controlling involves comparing actual results with expected results, investigating any differences, and undertaking any action needed to correct the differences. Thus, the information needed here is historical – showing what has happened for comparison to the intended outcome.

8 a

Type of business	Advantages	Disadvantages
Sole trader	Low start-up costs Freedom from regulation Owner has direct control Low working capital needs Owner retains profits	Unlimited liability Lack of continuity Difficult to raise finance Management responsibility
Partnership	Ease of formation Low start-up costs Additional finance sources Broader management base Limited regulation	Unlimited liability Divided authority Lack of continuity Difficult to raise external finance
Company	Limited liability Transferability of ownership Ease of raising capital	Regulatory requirements Time-consuming start-up Higher start-up costs Personal guarantees

b Generally, you should prefer to lend to companies because these entities have limited liability and have resources (assets) that can be pledged as security against the loan. However, this does not preclude you from lending to sole traders or partnerships. With these forms of entity, you would need to look at the businesses' abilities and desires to meet interest and repayment commitments as they fall due.

9 The role of business in society is built around the primary objectives of business – to make money and create wealth for its owners. In achieving these objectives, business provides (either directly from its own activities, or through government via the taxes it pays) the goods and services needed or desired by the community. Also, in providing these goods and services, the business needs to be mindful of its social and economic responsibilities – such as being a good employer, providing goods of acceptable quality and price, and protecting the environment and its resources for future generations.

10 The Framework is a two-sector, multi-tiered Framework. This approach has been adopted in order to meet the differing information needs of each sector's users of financial statements.

The for-profit entity framework is based on International Financial Reporting Standards (IFRS).

Tier 1	Publicly accountable (as defined); or large (as defined) for-profit public sector entities	NZ IFRS
Tier 2	Non-publicly accountable and non-large for-profit public sector entities *which elect to be in Tier 2*	NZ IFRS Reduced Disclosure Regime (NZ IFRS RDR)
Tier 3	Non-publicly accountable and either all of its owners are members of the entity's governing body; or not large (as defined) *which elect to be in Tier 3**	NZ IFRS Differential Reporting (NZIFRS Diff Rep)*
Tier 4	Non-publicly accountable, not required to file financial statements, and not large (as defined) *which elect to be in Tier 4.**	Old GAAP*

Transitional tier which will be removed when legislative changes come into force.

The criteria for, and reporting requirements for, For-Profit Tiers 3 and 4 will reflect the status quo for entities currently using NZ IFRS differential reporting or Old GAAP (SSAPs and FRSs). These will be transitional tiers which will be removed when legislative changes provided for in the Financial Reporting Bill 2012 come into force. Those legislative changes will remove the statutory requirement from most small- and medium-sized companies to prepare financial statements in accordance with GAAP. (Source: External Reporting Board – www.xrb.govt.nz)

11 Role of the New Zealand Institute of Chartered Accountants (NZICA)

NZICA is the largest professional accounting body in New Zealand. Their members work in, or have relationships with, almost every business in New Zealand. They have professional roles that are as diverse as their workplaces: in public practice, corporates, educational institutions, and government and not-for-profit organisations.

NZICA's role is to:

- ensure that the quality, expertise and integrity of their members meet the highest standards, so businesses and individuals can be assured that they are working with the best and brightest accounting professionals
- deliver the professional education and training people need to achieve an NZ Institute of Chartered Accountants designation, and provide the continuing professional development required to maintain the high standards of those designations
- work on behalf of New Zealanders to advocate for sound public policy in the financial, regulatory and taxation areas. Internationally, they advocate for New Zealand's interests

through their membership of international accountancy bodies.