INTRODUCING CORPORATE FINANCE

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chapter 1

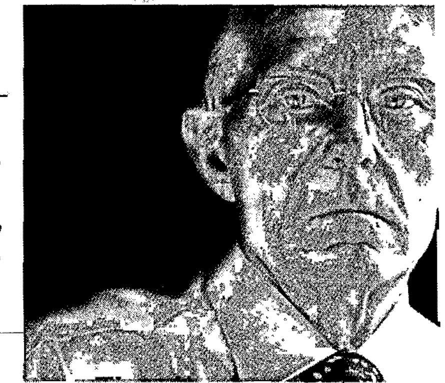
Introducing the firm and its goals

Learning objectives

After studying this chapter, you should be able to:

- *LO* **1** describe the range of goals of firms, including the significant wealth-maximisation objective
- *LO* **2** discuss the roles of financial managers
- *LO* **3** grasp the importance of the principal–agent problem
- *LO* **4** discuss the role of ethics
- *LO* **5** describe the forms of business organisation and their implications
- *LO* **6** describe the features of the Australian taxation arrangements for business
- *LO* **7** discuss the importance of incorporation of dividend imputation effects in business decisions
- *LO* **8** discuss some of the challenges facing modern firms
- *LO* **9** describe the nature of rationality in decision making.

HIH INSURANCE COLLAPSES WITH $5.5 BILLION OWING



HIH, a major insurance company in Australia, collapsed early in 2001. Its latest set of audited accounts at the time showed net assets of almost $1 billion, but it later transpired that, rather than having net assets, the company had net liabilities of about $5.5 billion. Ray Williams was managing director for most of the company's history.

The profligate philanthropist

DAVID BREARLEY

Wayne Martin, the [HIH] commission's tenacious counsel, hit hard when Williams finally appeared on Tuesday, day 129 of the hearing.

Dr Raymond Reginald Williams AM, he suggested, was a vain man who loved his honorifics and donated no end of HIH cash to secure them. Monash University, to which he channelled a good share of the HIH millions, bestowed the honorary doctorate. The Order of Australia came with a citation acknowledging his boundless generosity, but not HIH's role in underwriting it.

Anyone in Williams's sights – client, servant or otherwise – was liable for summary reward. Swiss watches worth $10 000 apiece were the standard thankyou for 15 years' service at HIH. An invoice for 38 of them arrived on January 9, 2000, the same day staff were told to stop processing claims because of cashflow problems.

There were baubles and trinkets for all – including high-end jelly beans – but those in Williams's inner orbit prospered in special ways. Stuart Korchinski received a Saab convertible from the boss and $20 000 worth of home airconditioning, apparently while occupying the position of audit general manager. There was also a $250 000 loan, which appears to have been written off.

Executive expense accounts for calendar 2000 show Korchinski's claims topping $100 000, although he was never, strictly speaking, an executive. He was, however, the ultimate Williams insider – his jogging partner. In May 2000, Williams authorised $17 000 for three Korchinskis to attend a family funeral in Canada; seven months later he signed off on a $910 000 termination payout for Korchinski, whose contract suggests he was entitled to considerably less than that.

...

On Williams's own evidence, his directors never once blinked at his loose ways with shareholders' money (Williams's personal shareholding in HIH was insubstantial), even as the company careered towards oblivion. But why would they, when executive bonuses were soaring, from $340 000 in 1998–99 to $7.2 million in 2001. The last days of Pompeii seem tame by comparison.

...

The donations, he [Williams] insists, are the legitimate acts of a good corporate citizen. The other gifts reflect a sense of common decency and a commitment to staff motivation. And the authority for it all resides in the office of chief executive, which invests its occupant with prudence and honour. This is an article of faith with Williams, who regards supreme executive status as Catholics regard the papacy.

...

Bad call.

Source: *The Australian*, 10 August 2002, p. 21.

What issues or problems for the firm does this news item suggest to you?

Chapter preview

The HIH report gives you a real-life example of what part of this chapter is about. The collapse of HIH was a major event in Australian business history. Not only did employees and shareholders lose considerable sums of money, but the market for many types of insurance products virtually collapsed overnight. This was because HIH had undercut reasonable market prices and thus put an artificial cap on pricing while at the same time capturing large market shares. The loss of insurance cover meant that, for a considerable period, builders could not work, some professionals could not risk working and many community events had to be cancelled.

Many of the issues raised by the HIH collapse are covered in this chapter: the goals of firms, the goals of finance managers, the roles of finance managers, the principal–agent problem and the need for ethical behaviour. Additionally, the chapter covers some basic information about the way business is organised and how it is taxed in the Australian context. We also consider some of the challenges facing modern business. Finally, we introduce some concepts from behavioural finance that help us understand the way people make decisions.

The following diagram shows how this chapter is structured.

INTRODUCING THE FIRM AND ITS GOALS

- **Goals of firms**
- **Roles of financial managers**
  - Financial governance and financial decisions
- **The principal–agent problem**
- **Ethics in business**
  - Corporate social responsibility
- **Forms of business organisation**
  - Sole proprietorship
  - Partnership
  - Company
  - Trust
  - The most appropriate business structure
- **Overview of Australian taxation arrangements**
  - Income tax
  - Capital gains tax (CGT)
  - Goods and services tax (GST)
- **The importance of dividend imputation for company business decisions**
  - Imputation from the company's viewpoint
  - Imputation from the shareholder's viewpoint
  - Effects of dividend imputation for corporate finance
- **Challenges facing modern firms**
- **How being a person affects decision making**
  - The nature of rationality

LO **1**

Describe the range of goals of firms, including the significant wealth-maximisation objective.

Goals of firms

Firms come in all sizes — small, medium and large. Firms are owned by sole operators, partnerships of two to 20 people or perhaps some hundreds, or by thousands of individual shareholders and large investment institutions in the case of listed public corporations. This book has been written to cover the financial decisions faced by all these firms, no matter how small or large and no matter how they are owned. However, in practice it is likely that small firms will take a less rigorous approach to decision making and financial analyses than is advocated here because these firms tend not to employ people trained in finance. Additionally, the management of many small firms judge that the benefits of employing a financial manager or a financial consultant do not exceed the costs. This judgement may in fact be an error, as time inevitably will reveal.

Every business has a reason or reasons for being. Because of different sizes and ownership structures, it is to be expected that there would be a range of goals among firms. For example, the Grey family partnership which owns a small auto electrical business might want to earn enough to live comfortably, put away some funds to educate their children, not work on Saturday or Sunday, earn a reputation for doing good work on time and at a reasonable cost, and have a good relationship with all their customers so that old ones return and new ones are attracted by word of mouth rather than expensive advertising campaigns. Eventually, the family might want to sell the business to fund a comfortable retirement.

In contrast, the ownership of a large corporation is much more removed from the operations of the company. The owners are you and me — through our direct shareholdings and indirectly through our superannuation funds and managed funds. What are our goals? Are they the same as the Greys? This is unlikely. Because the owners are not closely connected with the everyday operations of the firm, it is likely that the goals are simplified. Some owners will want only to make good returns; others will be concerned with returns, but would also want their firm to have good employment policies and labour relations or to make all possible attempts not to harm the natural environment in the course of business operations.

So the range of primary business goals includes:

- maximal wealth for owners
- maximal profits
- adequate profits — termed 'satisficing' where owners are happy with reasonable profits and company growth
- high revenue growth — especially for corporations where managers are rewarded for achieving such growth goals
- large market share
- limited working hours
- high reputation for product quality and service
- good employee relations and employment policies — a good place to work
- minimal or no harm to the natural environment — no pollution or land degradation
- ethical treatment of all parties associated with the business — a good corporate citizen.

Some of these goals will not be pursued by all businesses, some are difficult to achieve, some are difficult to measure and some need good returns in order to be able to fund their pursuit. Others are interdependent, and sometimes one goal must be sacrificed to some extent to achieve another. Take wealth maximisation, for example. Wealth maximisation by owners is a simple concept and must stem from at least good, if not maximal, returns in the form of either annual profits or capital appreciation. In turn, profit maximisation as a concept sounds simple enough, but can be difficult to achieve in practice. For example, are we thinking of short-run maximum profits or of long-run profits? Is there a difference? Yes, there is.

Consider the case of Jonno, a travelling house painter, who does paint jobs for people and then moves on. He is in business, and he buys paint and completes jobs by adding his labour. He has no plans to return to a particular area again and moves from state to state according to whim. He plans to stay in business only as long as it takes to save for a small fishing boat. He may well maximise his short-run profits by charging as much as he thinks the market will bear so he just gets each job. He could buy cheap paint. After all, the customers can not tell the difference, and he will be well away by the time the green paint fades and the white paint blisters and cracks. Why should he decrease his profits by buying expensive, high-quality paint? He will try to maximise his short-run profits, because the long term is not relevant to him. Jonno is pursuing **profit maximisation**.

Profit maximisation implies a business is managed to maximise the difference between revenues and expenses in any period.

By contrast, consider the case of Len, a lawnmowing and landscaping contractor, who works in the same region he lives in. He wants his customers to be pleased with the way he tends their gardens, and he wants them to get him back every two or three weeks. When he does landscaping jobs, he puts in durable timbers because he knows he will lose future business if the timbers rot or are eaten by termites within a few years. Thus, this businessman will tend to charge reasonable prices (not the maximum the market will bear) and will buy good-quality, more expensive materials. He is much more likely to try to maximise his long-run profits, and his pricing behaviour will be very different from the businessman in the first case. Thus, the element of time is important in our considerations. Len is pursuing **wealth maximisation**. He is managing his business to maximise the 'present value' of its present and future cash flows. We will learn more about this concept on the following pages. We will learn how to calculate present value in chapter 2.

Wealth maximisation implies that the business is managed so that the present and future cash flows discounted at an appropriate rate will give a present value (PV) which is maximised.

Both Jonno and Len in these two very different business scenarios try to run their business at a profit, probably as high a profit as they can achieve. But Len is putting in place the foundations for future profits and future wealth while Jonno is 'burning his bridges' and practically guaranteeing that he will not be invited back for future business.

Did you notice that we distinguished between profit maximisation and wealth maximisation in the range of business goals? Len and Jonno are operating their businesses with different time horizons. If we compare the profit figures for the two businesses, Jonno's will look to be the better performing business, but which business would you prefer to buy into?

The maximisation of owners' or shareholders' wealth is taken to be the optimal objective for the firm. This concept takes into account future earnings (and from this basis stems Len's concern to keep his current customers happy so that they provide the foundation for his future earnings). Earnings means profits and profits are a good thing for a firm to have. However, be aware it is possible for a firm to have large profits but not be able to pass these on to the owners because there is no spare cash. The profits are 'soaked up' by increased stock, debtors and necessary purchases of fixed assets.

Further, maximising profits ignores how much risk the firm had to take to generate the profits. As we will see in chapter 4, if owners of firms are exposed to increased risk, they will want a higher return than they would for safer investments. Risk can be incorporated into managers' decisions when the objective of the firm is maximising wealth.

Another drawback of profit maximisation where owners and managers are different people is that managers have been known to manipulate profit figures. They can do this by changing the way some items are accounted for, reporting revenues early or costs late, or by failing to report some items at all. The collapses of companies like Harris Scarfe and HIH in Australia and Enron in the USA have shown that the profit figures in financial statements are sometimes not representative of the real situation.

The **time value of money** is the concept that a dollar is worth more the sooner it is received.

The objective of maximising owners' wealth factors in the **time value of money**. The time value of money concept merely proposes, and I'm sure you will all agree, that $10 in the hand now is worth more to you than the same $10 if you were to receive it later; say, in one year's time. Regardless of the effects of inflation on your purchasing power, you could invest the $10 at, say, 5% with your local financial institution and have $10.50 at the end of 12 months. Put another way, we could say that the present value (PV) of $10.50 to be received in 12 months' time, when discounted back to the present at 5% pa, is $10.

Discounting is the process of calculating the present value (PV) of a future amount. The discount factor incorporates the possible or required earning rate for the funds.

Market capitalisation is the total value of a corporation as measured by the price of each issued share multiplied by the number of issued shares.

The **market value** of a firm (or a share) is the price that willing buyers are prepared to pay and willing sellers are prepared to accept.

Discounting is the process of calculating the present value (PV) of a future amount. It incorporates the possible or required earning rate for the funds. Thus, as we saw with Len's lawnmowing and landscaping business, wealth maximisation implies that the business is managed so that the present and future cash flows discounted at an appropriate rate will give a present value that is maximised. For corporations, the present value is the **market capitalisation** (share price multiplied by the number of issued shares) and, for non-corporate businesses, the **market value** of the firm.

The present value of the firm is thus the sum of all expected future cash flows discounted at an appropriate rate. Mathematically, this can be represented by equation 1.1.

$$PV = \frac{CF_1}{(1+k)} + \frac{CF_2}{(1+k)^2} + \frac{CF_3}{(1+k)^3} + \ldots + \frac{CF_n}{(1+k)^n} \qquad \textbf{[1.1]}$$

where CF = cash flow for the period
n = number of periods
k = an appropriate discount rate

We will learn how to calculate present values in chapter 2. We will investigate the matter of an appropriate discount rate in chapter 4 and learn to calculate it in chapter 6. For the time being, we can interpret equation 1.1 as the value of the firm. Equation 1.1 tells us that a firm is worth the total of its future cash flows when they are discounted to their present values. In the special situation of corporations that pay dividends, equation 1.1 can be restated in terms of dividends received by the shareholders. Thus, the present value of the company is the perceived current value of future dividends. We will examine this idea further in chapter 5 when we calculate the value of securities.

The total market capitalisation of a company is the price per share multiplied by the number of issued shares. For example, a company with one million issued shares, which are currently selling for $1 each, has a market capitalisation of $1 million, which is the investing public's perception of the present value of future dividends. The market's perception of firm value tends to change, sometimes quite rapidly, even when the underlying 'true' present value has not changed at all. This can happen because the market price can change rapidly; for example, under the influence of excessive supply or demand.

To sum up, maximising owners' wealth has the following advantages over maximising profit as the objective of the firm. Wealth maximisation:

- uses a long-run perspective of the business
- takes future cash flows into account
- takes risk into consideration
- does not rely on accounting numbers
- considers the time value of money.

Thus wealth maximisation is taken to be the chief financial goal of the firm within the context of other non-exclusive goals such as ethical operations. Assuming wealth maximisation as the goal of the firm has the further benefit of giving us a quantifiable objective. A quantifiable objective allows us to model the impact of decisions on firm value. Without this assumption, it becomes much more difficult to predict how owners will assess managers' decisions and invalidates many of the techniques covered in this book.

LO **2**

Discuss the roles of financial managers.

Roles of financial managers

If we accept wealth maximisation for owners to be the chief financial goal of the firm, what then are the goals and the roles of the financial manager? The goals should be the same as the owners' goals, as achieving the owners' goals is the task for which the financial manager is employed. In smaller firms, the owners and employed executives are much more likely to meet often, either formally or informally, and owners' goals are more easily transmitted. In large firms, this does not happen and we will discuss that issue in the next major section.

How do financial managers in large firms with many shareholders know what the owners (the shareholders) want? The transmission mechanism is the annual general meeting and the right of shareholders to request special general meetings. Shareholders at annual general meetings elect directors to represent them. Shareholders also on occasion are asked to vote on important issues or projects. If shareholders become strongly dissatisfied about the way their company is being run or about a particular project, they may request a special general meeting to have the issue discussed.

The financial manager has many roles to play in the essential task of managing the flow of funds through the firm. While some firms split the various functions between many individuals and other smaller firms may have one person doing the whole job, the roles or tasks of the financial manager may include overseeing or undertaking the following:

- the accounting and reporting functions
- managing cash and other short-term assets (discussed in chapters 9 and 10), raising funds (discussed in chapters 11, 12 and 13) and managing excess funds
- taxation management, including compliance, forecasts and planning
- risk management (discussed in chapter 15), on both the revenue and expenses sides of the business
- developmental financial analyses of projected investments and projects (discussed in chapters 6, 7 and 8) and capital restructures
- forecasting the impact of financial decisions (discussed in chapter 14)
- audit management, both internal and external
- investor relations, including share registers and advice to shareholders, dividend policy, and (for listed companies) managing discussions with investment analysts, disclosures to the relevant stock exchanges, such as the ASX, and compliance with exchange rules.

The accounting and reporting functions include the daily keeping of the accounts, invoicing, receipting payments and paying bills, the keeping of asset registers and depreciation schedules, and the annual or biannual compilation and summary accounts. In addition, the accounting function includes the presentation and reporting of the annual financial statements to all interested parties. These parties include shareholders, regulators, creditors and the general public.

The cash management function includes planning and implementing the cash needs of the business (which is a complex task, particularly in a retail business), banking and maintenance of security systems for the cash. Raising funds involves planning and organising loans from banks and other financial institutions, perhaps arranging lease finance and, for corporations, perhaps issuing equities.

Taxation management includes compliance with all the taxation legislation and submitting the appropriate returns, forecasting taxation liabilities and planning and organising business activities, where possible, to manage the taxation effects. A simple example of such taxation management is the case of a farmer who buys in more stock feed in late June. This purchase increases his costs and business tax deductions, thus reducing his tax liability, but is essentially 'money in the bank' until drought comes and he has to feed it out.

Risk management is undertaken on both the revenue and expenses sides of business operations. Depending on the nature of the business, price variations may be managed with futures and forward supply contracts that allow a firm to lock in future selling prices now; cost variations may be managed with similar **financial derivatives** contracts and forward supply contracts. Financial derivatives are contracts that are derived from the value of some underlying assets and are used to manage risk. Derivatives include futures, swaps and forward rate agreements (FRAs) which are all discussed in chapter 15.

Financial derivatives are contracts that are derived from the value of some underlying assets and are used to manage risk.

Financial managers employ a number of analytical techniques including net present value (NPV) and internal rate of return (IRR) to examine the viability of proposed investments, projects or products. In addition, they may undertake financial analyses of mergers, takeovers and other capital restructuring proposals. Financial managers should want to make decisions that increase the value of the firm. They can use the forecasting techniques outlined in chapter 14 to help them assess the likely impact of their decisions.

Another function of financial management is the audit of the firm's accounting and corporate governance systems. Internal audits are completed to ensure systems and processes are working well and to keep management informed. Qualified independent auditors conduct audits to ensure processes and transactions are properly managed and financial reports reflect a true and fair view of the financial position and performance of the entity. External auditors report their findings to the shareholders of companies and the owners of other types of business structures.

Investor relations are very important to public corporations. Public corporations can have thousands of shareholders and these stakeholders must be kept informed. They are advised of all the important news within the company. Additionally, firms with shareholders must keep an up-to-date share register. Most medium to large public corporations employ specialist firms to manage their share registration function. Dedicated share registries such as Computershare have developed the software and expertise to complete the transfer and registration tasks for share sales efficiently. The task can thus be completed at lower cost externally than a firm could achieve itself. Furthermore, listed public companies (not all public companies are listed on a stock exchange) must keep the listing exchange informed of any developments that might be price-sensitive. Any developments that might cause the share price to move up or down must be communicated to the exchange as soon as possible. Listed public companies also meet investment analysts reasonably frequently to brief them of current and future events within the business because such analysts can have a significant influence on institutional sale or purchase of the company's shares.

Financial governance and financial decisions

As you can see, the primary duty of a firm's financial manager (sometimes called the chief financial officer or CFO) is to assist the chief executive officer (CEO) and the other executives to carry out board policy to optimise the financial and economic benefits that stem from all investments. All of the systems and processes that are put in place to achieve this aim are called the financial governance in the firm. **Financial governance** therefore comprises all the financial and management accounting systems and processes including the accounting for both capital and external liabilities, financial reporting, internal controls and internal audit, external audit, forecasting, strategic planning, operational planning and budgeting, purchasing, payments and communication.

Financial governance comprises all the financial and management accounting systems and other financial processes that are put in place to achieve the objectives of the firm.

To illustrate the financial governance process for you, let's consider briefly what decisions are made in a going concern (an operating business) which is now contemplating a new project and therefore new investment. Suppose the firm is structured as a company and it grows sweet corn under irrigation in northern New South Wales and in north Queensland. It is geographically diversified to take advantage of the ability to extend the growing season so that it can supply corn to its major retail customers for as long a period as possible. The firm is thinking about investing in farmland in the Ord in Western Australia to increase its production dramatically, to reduce its production risk from pests and diseases and to further increase its supply period. The firm is also thinking about putting in a snap-freezing works so that excess production in the Ord can be frozen and sold throughout the year as frozen corn on the cob.

What decisions must be made in regard to this investment? First, assuming the firm has collected all the production and financial information necessary to make the decision, the firm (its financial managers) must decide whether the investment will return adequate and acceptable benefits, given the goals of the firm. You will find information on this decision in this chapter (in the section on taxation) and in chapters 3 (financial mathematics), 4 (required rates of return), 6 (cost of capital), and 7 and 8 (investment planning techniques).

Assuming the firm decides to go ahead with the investment, it must then make further financial decisions. How will the investment be funded? Will it use debt or equity? You will find answers to these questions after studying chapters 2 (overview of the financial markets), 11 (long-term external finance), 12 (internal finance), 13 (capital structure), 14 (financial evaluation) and 15 (risk management).

While this major task of planning a substantial new investment is taking place, the other responsibilities of the financial manager continue. Suppose the firm had funds which were in excess of current requirements; it would want to invest these funds at the best possible return for its desired level of risk. You will find information on this decision in chapters 2 (financial markets), 5 (valuation of bonds and shares), 9 (short-term finance) and 11 (long-term finance). Moreover, the firm must continue to manage its working capital and current assets effectively (see chapters 9 and 10). It must remember the needs of its owners (shareholders) and manage the returns to them (chapter 12).

To summarise, the most important classes of financial decisions comprise:

- new investment decisions
- investment funding decisions
- management of short-term funding and working capital
- management of long-term funding and capital structure
- dividend policy
- risk management.

LO **3**

Grasp the importance of the principal–agent problem.

The principal–agent problem

The **principal–agent problem** is the scope for conflict or division between principals (owners) and agents (managers) over the goals of the firm which are being pursued by its policy and management decisions.

Agency costs are the losses borne by the owners of the firm that can be attributed to the agent having different objectives from the owners (or principals).

Even though this phrase sounds like a difficulty with the chief agent, the **principal–agent problem** really has nothing to do with first agents or second agents. Instead, it concerns an owner as principal and a manager as agent. Managers work for the owners as their agents. As we have seen, the owners expect their agents to carry out their wishes and to run businesses with the goals of the owners as their primary objectives. However, managers may not do so. They may have other objectives and agendas.

Remember the report about HIH at the start of this chapter? The CEO of HIH donated millions of the company's funds to Monash University and was subsequently rewarded with a personal honour for his generosity with other people's (the shareholders') funds. The CEO could argue that this was good advertising for the firm but, if HIH was not acknowledged as the donor, then it did not constitute advertising expenditure and did not generate any benefits for the owners of HIH. This type of expenditure is an agency cost. **Agency costs** are the losses borne by the owners of the firm that can be attributed to the agent having different objectives from the owners (or principals). In addition to direct costs, as in the HIH donation, agency costs include the cost of monitoring the agent's behaviour (by requiring regular reporting) and bonding costs (or the cost of trying to align the manager's objectives to those of the owners).

FINANCE WORLD

CFO code — where the CFO fits in

A new code of conduct for CFOs has been developed in Australia by a group representative of Australia's largest companies — companies that recognise that accurate financial information is imperative if capital markets are to function properly.

The code and additional commentary may be found at the website of the Group of 100.

The Code of Conduct

This code provides that CFOs and senior finance officers influencing financial performance will:

1. Discharge their duties at the highest level of honesty and integrity having regard to their position and their organisation. Integrity is the quality from which public trust is derived and a benchmark against which the CFO must measure all decision making.
2. Observe the rule and spirit of the law and comply with the ethical and technical requirements of any relevant regulatory or professional body.
3. Respect the confidentiality of all 'confidential' information acquired in the course of business and not make improper use or disclose such confidential information to third parties without specific authorisation or legal requirement.
4. Observe the principles of independence, accuracy and integrity in dealings with the board, audit committees, board committees, internal and external auditors and other senior managers within the organisation and other relevant bodies external to the organisation.
5. Disclose to the board any actual or perceived conflicts of interest of a direct or indirect nature of which the CFO becomes aware and which the CFO believes could compromise in any way the reputation or performance of the organisation.
6. Maintain the principle of transparency in the preparation and delivery of financial information to both internal and external users.
7. Exercise diligence and good faith in the preparation of financial information and ensure that such information is accurate, timely and represents a true and fair view of the financial performance and condition of the organisation and complies with all applicable legislative requirements.
8. Ensure the maintenance of a sound system of internal controls to safeguard the organisation's assets and to manage risk exposure through appropriate forms of control.
9. Set a standard for honesty, fairness, integrity, diligence and competency in respect of the position of CFO that will encourage emulation by others within the organisation.
10. Remain committed, at all times, to observing, developing and implementing the principles embodied in this code in a conscientious, consistent and rigorous manner.

Source: Group of 100, viewed 3 December 2003, <www.group100.com.au/code.htm>.

One of the problems encountered with corporate governance is perverse incentives. In other words, incentive schemes are set up in order to achieve one thing but in fact they are structured in such a way that they achieve something else. For example, a board of directors might offer a CEO a large parcel of share options if certain revenue levels are reached, on the basis that if revenue increases, profit increases and owners' wealth increases. This is an example of a bonding cost. However, the CEO may just focus on increasing revenue, so the objectives of principal and agent remain divergent. This is what happened with HIH. HIH consistently underpriced risk in its insurance businesses and gained large market shares. This meant that revenue was large and kept on increasing, but profitability was low or negative, and the company ultimately failed as claims and costs exceeded the ability of the company to pay. The HIH collapse was so large that it precipitated crises in the professional indemnity, construction insurance and several other insurance markets.

FINANCE WORKSHOP 1.1

1. Briefly state the nature of the principal-agent problem.
2. Consider some of the other gifts reported in the HIH story as being given away by the CEO. Which gifts do you think were legitimate business expenses and which revealed different objectives on the part of the CEO from those we expect the shareholders would be interested in?

LO **4**

Discuss the role of ethics.

Ethics are moral principles or rules of conduct which indicate the acceptability of behaviour within a community.

Ethics in business

What actions are right or wrong? Such judgements are in the province of ethics. **Ethics** are moral principles or rules of conduct which indicate the acceptability of behaviour within a community. The answer to any specific question of ethical acceptability may be found in the social framework of the community concerned. In turn, the generally accepted codes of behaviour or social norms that make up the social fabric stem from religious, legal and traditional foundations. For a newcomer to any community, the last-named source of behavioural constraint may be the hardest to master, because tradition may be oral rather than written and based on tacit assumptions which native inhabitants inherently understand.

Ethical codes differ between cultures and communities. However, there are many common principles. If it is accepted that ethical laws are based on the desire of humankind to live without conflict with neighbours and without fear for life and property, then prohibitions on homicide, violence and injury to person and property, and attacks on honour and reputation will be universal prescriptions. In addition, duties such as protection, support and furthering the wellbeing of others, and being truthful and keeping promises are generally respected.

Ethical codes and standards have not always been applied universally to all parts of society. Things have improved in some areas, but not in others. People in lower social classes for a long time were considered fair game for oppression in the workplace; inhabitants of other communities or continents were prime candidates for slavery; draught animals were starved in the name of economy and flogged to death when weakness prevented them from exerting the required force; and other animals were killed slowly and painfully for sport. While the ethical pool has widened over time and additional classes of people and other species have had their rights recognised or have been given rights for the

first time, still more needs to be done. Even in our society, for example, there are still people who condone and profit from blood sports that the majority find unacceptable. Moreover, the need for thought about ethical problems has grown enormously as life has become more complicated and developing technology has expanded our views on what is possible.

Merchants and consumers who enter markets face not only possible contravention of basic social principles such as the integrity of property ownership (for example, fraud, misrepresentation, credit card theft and theft of information and intellectual property), but also the possibility of enhanced ethical violations due to the advance of technology. There are possibly hundreds of different types of cases; the following are just a few.

- *Exploitation of resources overseas by Australian firms using cheap technology that would not be acceptable legally or ethically here.* An example is the Australian mining company BHP at the Ok Tedi mine in Papua. It dumped enormous quantities of overburden (soil and rock) into the Ok Tedi and Fly rivers every day and this pollution has destroyed the ecology of the river. Apart from any ethical considerations for other species, the river used to provide the livelihood of local people.
- *Importation of goods which do not comply with Australian health and safety standards.* We have in place comprehensive standards for the quality of foodstuffs produced in Australia. For example, the maximum allowable limit for the heavy metal, cadmium, in peanuts is 0.5 mg/kg. On numerous occasions when the Australian peanut crop has produced less than the required output, importers have brought in peanuts from China to be used in manufactured peanut foods, such as peanut paste and chocolate products. Only the vigilance of the Quarantine Service has stopped peanuts with much higher levels of cadmium from entering the Australian food market.
- *Shifting of manufacturing offshore.* Closing down old plants in Australia and sourcing production from other countries, where labour costs are low, may improve profitability but there is an ethical question if costs are low in the new supply country because safety standards are compromised or hours of work are exploitive.
- *Industrial espionage.* An employee of a rival supplier bidding for a large contract offers to come to work for your firm — provided he is given a large 'golden hello' which is outside the normal remuneration in the industry — and he promises to bring his intimate knowledge of the rival's costings with him. Can the firm ethically employ this person?
- *Conspiracy with other firms to cheat consumers.* During the 1990s, the property market on the Gold Coast in Queensland boomed. House and unit construction increased dramatically. Unscrupulous developers devised a system whereby they could 'gouge' additional profits from the market by setting up a two-tier price system, called 'marketeering'. They charged the locals one price, but negotiated much higher prices with other people who did not know the market. They offered free trips to the Gold Coast to people living in other states and then subjected them to high-pressure sales techniques. Many people signed up only to find in a few months that their 'dream' investment property had been significantly over-priced and the year-round demand for accommodation by tenants had failed to materialise. Banks, solicitors and real estate agents were all implicated in this fraud. The Queensland Government strengthened the *Property Agents and Motor Dealers Act 2000* to deal with the issue and also introduced a compulsory five-day 'cooling off' period for all property deals.
- *Invasion of privacy through insecure system controls on databanks.* The *Privacy Act 1988* prohibits data collected for one purpose being used for another purpose without the consent of the affected people. Thus, for example, customer lists may not be sold to other firms so that those firms can direct advertising to people known to be interested in a particular issue. Merchants may build comprehensive databanks on their customers.

There are many aspects to the ethical management of these databanks. Not least, there is an arguable case that it is ethically incumbent upon managers to ensure data are as accurate as possible, up-to-date, and accessible only on a need-to-know basis. Such data, once recorded — accurately or inaccurately — may be shared with other computers. If security systems are not comprehensive, the potential to invade privacy is created in a way never before possible.

What do ethics have to do with making financial decisions? BHP was subjected to international condemnation for the decision not to construct a tailings dam to contain the Ok Tedi mine's waste. As we will see in chapter 7, large capital investment projects like the construction of a mine are difficult to reverse. BHP had to take substantial losses to get out of its Ok Tedi investment and has invested significant amounts trying to restore its environmental image. Similarly, moving production offshore may not increase the value of the firm if the firm's customers have strong feelings about purchasing domestically produced goods. The 'Buy Australian' campaigns specifically encourage consumers to purchase Australian made products when they can. Being ethical is not necessarily inconsistent with wealth maximisation, especially if we look beyond the short term.

Whistleblowing means informing (usually by employees of the perpetrators) the relevant authorities of malpractice or dangers to the public or the environment.

Whistleblowing presents a further threat to firms that behave either illegally or unethically. 'Whistleblowing' is a reasonably new term in the language and it means 'informing (usually by employees of the perpetrators) the relevant authorities of malpractice or dangers to the public or the environment'. Usually the actions that are the subject of whistleblowing are illegal as well as unethical. A person contemplating whistleblowing has to think very carefully about the consequences. Assuming there has been illegal activity, whistleblowers run several risks:

- sacking by disgruntled management if their identity is revealed
- personal vilification
- loss of future employment benefits
- no punishment for the miscreants because regulators or investigators are lax
- ingrained culture of corruption wins the power struggle and no changes are made.

Even with knowledge of the risks that are being run, there are fortunately still people in our society who feel so strongly when they observe consistent and organised malpractice being effected for profit that they are willing to risk their personal financial health in making the wrongs publicly known. Legislation has been passed to try to protect whistleblowers, but it does not always achieve that aim.

Corporate social responsibility

Corporate social responsibility (CSR) means that the firm has wider responsibilities in relation to objectives and people apart from the owners or shareholders.

Corporate social responsibility (CSR) is a concept that has gained some prominence in the last decade or so. CSR means that the firm has responsibilities in relation to objectives and people apart from the owners or shareholders. Objectives often associated with CSR include a responsibility to manage natural assets sustainably and not to pollute by chemical discharge, smell, noise, dust or other irritants; fair treatment of employees and ethical attitude towards clients. The other people or stakeholders include employees, customers, suppliers, regulators and the public at large.

Contemporary academic literature contains many references to corporations 'doing well by doing good'. The motivation behind these corporate actions can be explained within the conventional economic framework of wealth maximisation, as well as through ethical motivation. The involvement of public relations is the reason that CSR can be fitted within conventional theory, as a favourable corporate image will tend to enhance the ability to continue in business and to maximise long-run wealth.

The article about the NAB in the next 'finance world' feature illustrates a commercial world in transition. People who are aware of the need to conserve what little high-conservation-value ecosystems we have left understand that the financial services sector funds the activities that are destroying those ecosystems. If those funds were withdrawn or denied, then there would be less uncaring destruction. A vote of as much as 20% on an issue not supported by management shows strong community support, if not yet financial-institutional support for more sympathetic (in the CSR sense) funding decisions.

FINANCE WORLD

Green NAB resolution receives 20 per cent support

A Wilderness Society-backed shareholder resolution received support from over 20 per cent of votes cast at the National Australia Bank's AGM held in Melbourne yesterday.

The resolution sought to amend the constitution of the NAB so that it would no longer be able to conduct business that encourages the destruction of high conservation value forests. The resolution needed to achieve over 75 per cent support to succeed.

The resolution was supported by 125 477 191 votes while 468 981 427 were opposed and 16 276 663 abstained. The support represented roughly $3.9 billion dollars worth of shareholder capital and sent a strong message to NAB and its clients according to Leanne Minshull, corporate campaigner for the Wilderness Society.

'The support that was received from individual and institutional shareholders demonstrates the high level of community support on this issue,' she said. 'We are confident that the National Australia Bank will now develop a responsible investment policy for the forestry sector.'

'This vote signals a warning to the less progressive sectors of the timber industry who continue to log the last remains of Australia's old growth forests,' Minshull said.

The vote follows the pattern set at the Commonwealth Bank's AGM last month where an identical resolution received roughly 23 per cent of the votes cast at the meeting.

No NAB spokesperson was available to comment on the resolution earlier today.

Source: *Ethicalinvestor*, 20 December 2002, viewed 23 December 2002, <www.ethicalinvestor.com.au/news/story.asp?Story_ID=615>.

LO **5**

Describe the forms of business organisation and their implications.

Forms of business organisation

The form of business organisation adopted by the owners of the firm has several important implications that we will consider in this section. One major difference attributable to the choice of business organisation is how the firm is taxed. Taxation is discussed in the next section.

The main types of business organisation or legal entities are sole trader or sole proprietor, partnership, company and trust. Of these, by far the most common structure used by Australian businesses is, perhaps surprisingly, the sole proprietorship. In 1999–2000 (the latest data available at the time of writing) there were more than one million individuals owning businesses structured as sole proprietorships. This number constituted about 46% of declared businesses at the time. Company structures were next most numerous with about 480 000 entities (25%), with a further 437 000 (19%) partnerships and 243 000 (10%) trusts.[1] The vast majority (98%) of companies run small businesses, with businesses classified as medium accounting for 1.5% and large businesses, including most of the listed public companies, accounting for 0.2% of companies.

The **ABN** is a discrete number that identifies each business registered with the ATO to facilitate the regulation of taxation.

Regardless of the business structure adopted, Australian businesses are required, almost without exception, to have an Australian business number (**ABN**). The ABN system was introduced in 2000 to try to increase compliance with taxation laws. It was widely believed that perhaps another one million small businesses would be identified in the economy once businesses were forced to quote their ABNs when invoicing payments or suffer the compulsory withholding by payers of 48.5% withholding tax from each payment. The choice of the highest marginal rate for the withholding tax was driven by the government's desire to close down the 'black' economy; that is, the illegal cash economy which evades taxation laws. By suffering an enforced reduction in payments if ABNs are not quoted, potential cash economy operators are given an incentive to report all their revenue, so that they enjoy a net gain if their assessed taxation rate is less than the maximum 48.5% marginal rate.

Sole proprietorship

A **sole proprietorship** is a business owned by an individual who owns assets used in the business, incurs liabilities and reaps the annual profits or losses.

A **sole proprietorship** is a business owned by an individual who owns assets used in the business, incurs liabilities and reaps the annual gains or losses. The owner is liable for debts and other potential liabilities and must fund any losses. Owners do not pay themselves wages; instead, they make periodic drawings against potential profits.

The whole of the calculated profits are taxed as income in the hands of the proprietor, regardless of whether the cash is paid out. (In many cases, proprietors continue to invest profits in their businesses as either higher inventories or increases in fixed assets.)

A sole proprietorship is the easiest business structure to set up. Typically people with urges to start businesses just put together the assets necessary and open their doors for business under their own names. If they want to use trading names, such as *Seafresh Seafoods* or *Nifty Gadgets*, instead of their own names they must register the name with state authorities under the relevant state business names Act.

Sole proprietors have freedom to run their businesses any way they wish, so long as their activities remain within the law. In terms of legal liability for debts and costs of their actions, for example, legally proved negligence, they carry unlimited liability. Sole proprietors may expand their businesses by arranging debt finance but, by definition, they cannot raise funds by selling equity. Although legally they can do so, they would no longer be sole proprietors if they did.

Sole proprietors may sell or transfer ownership of their businesses by transferring the trading names and the assets. Normally, any debts are settled at the time of transfer, so that the new proprietors may bring in their own new liabilities, but the debts of the old owners would not continue. Liabilities such as accrued long-service leave of employees, if properly accounted for in the books, would probably carry over to the new owner, rather than being paid out to the employees at the time of transfer. At the death of a sole proprietor, the sole proprietor structure in itself is dissolved, even though the business as such may be sold as a going concern, and may indeed keep its old trading name.

Partnership

A **partnership** is an association of two or more people carrying on a business in common with a view to profit.

A **partnership** is an association of two or more people carrying on a business in common with a view to profit. Partners may agree on their relationship and duties with either an oral or a written agreement. An agreement written specifically to cover each possible situation is the most prudent way to operate a partnership.

Partnership agreements, at a minimum, should include full details of:

- contributions of capital by partners
- contributions of labour by partners
- how profits or losses are to be shared
- duration of the partnership
- procedures for admitting a new partner or withdrawal (including death) of a partner
- powers of partners to write cheques, raise funds and operate the bank accounts.

Like the sole proprietorship, partnerships are easy to set up with a minimum of formalities. Many partnerships use their own names as their trading names; for example, *AS* and *JB Cato*, but can use a registered trading name such as *Cato Plumbing*. In terms of legal liability for debts and costs of their actions, they carry unlimited liability. Partnerships may expand their businesses by arranging debt finance. In addition, they can raise extra funds by selling equity through admission of more partners who would bring in additional cash or other assets.

Partnerships may sell or transfer ownership of their businesses by transferring the trading names and the assets. More commonly, with the consent of all partners, one or more partners withdraw or new partners are admitted with the financial consideration being computed in accordance with the partnership agreement. In these cases, the assets of the partnership, including intangibles such as goodwill, that may not have appeared up to that time in the books, are valued and liabilities are subtracted to estimate the value of each partner's share.

Profits from partnerships are taxed in the hands of the individual partners. All profits are considered to be distributed. Partnerships submit a tax return, which shows the taxable income of the partnership and how that income was distributed among the partners. The partners then show those amounts on their individual returns.

Company

A **company** is an entity, formed under the *Corporations Act 2001*, which is legally separate from its owners.

A **company** is a separate legal entity from its owners. As such, the company structure has been a significant force in the development of business in the past 300 years. Because the company is separate from its owners, legal liability of the owners is limited, and that limit is the amount of each owner's investment in the company. The limitation of legal liability has made the company structure popular where the underlying business carries high risk.

Companies in effect make a trade-off with the society in which they operate. In return for the limitation of legal liability, they are subjected to greater regulation and compliance costs than either partnerships or sole proprietors. Mostly, companies in Australia are formed under the system of regulation provided for in the *Corporations Act 2001*. Prospective companies apply to the Australian Securities and Investments Commission (ASIC), the companies' regulator. If all legal requirements have been complied with, ASIC issues a certificate of incorporation; the company assumes a legal identity of its own from the moment of issue.

Companies raise funds by issuing shares or by contracting for debt finance. Debt may be secured by a charge over assets or over uncalled capital. The relevant part of the Corporations Act, section 124, provides that:

A company has the legal capacity and powers of an individual both in and outside this jurisdiction. A company also has all the powers of a body corporate, including the power to:

(a) issue and cancel shares in the company;
(b) issue debentures;
(c) grant options over unissued shares in the company;
(d) distribute any of the company's property among the members, in kind or otherwise;
(e) give security by charging uncalled capital;
(f) grant a floating charge over the company's property.

The owners of companies are the shareholders who meet at least annually at the annual general meeting (AGM). At the AGM, shareholders vote on significant decisions for the company and/or suggested changes in its constitution, as well as elect the board of directors. The board is responsible for the policy direction and day-to-day running of the company, and normally the day-to-day management is undertaken by a group of employed management executives.

Corporate governance means the management of corporations.

While this situation theoretically should work well, globally there have been many instances recently where the system has broken down to a spectacular degree. 'Corporate governance has broken down!' shout the tabloid headlines. **Corporate governance** as a term sounds complicated, but it is not. It merely means the management of corporations so that decisions and actions are made and taken in accord with acknowledged corporate objectives. In Australia, there have been the recent collapses of One.Tel, Pasminco, Harris Scarfe and HIH Insurance, while the USA has suffered the demise of WorldCom and Enron. In all cases, evidence has come to light of directors failing in their oversight duties (through personal incompetence and having too many directorships), auditors not being sufficiently removed from the firms and managers being allowed to get away with extravagant behaviour. Legislators and regulators have vowed to put stronger controls in place.

Moreover, as we have seen previously in this chapter with the discussion of the principal–agent problem, the company structure runs the risk of a division developing between the objectives of the owners and the motives of the managers. Nowhere is this more apparent than in the matter of executive salary packages. The next 'finance world' article on fair pay for executives shows how this one issue has deepened the divide between shareholders and executives.

Ownership is easily transferred through the sale of shares. Companies are formed in either of two categories — private or public. Private companies are designated 'Pty Ltd' or 'Proprietary Limited'. Public companies merely carry the designation 'Ltd'. Many public companies are listed on the stock exchange (in Australia, the ASX) although not all public companies are so listed. Listing brings its own regulation and compliance issues, together with benefits. One benefit for shareholders of a listed firm is that they know the value of their shares because the market provides up-to-date share prices every business day. Thus, the owners of shares in a listed company may check the current share price, sell if it is acceptable and have the funds in hand in three days. Owners of unlisted public companies or of private companies have to find a potential buyer first, negotiate a price, sell if that is acceptable and wait until payment is made.

Because of the separate entity structure, companies continue to operate if one part-owner dies or indeed if all shareholders died at the same time. The shares would be transferred eventually to beneficiaries and the company would continue, essentially without noticing the change in ownership, at least in the short term.

Companies are taxed as separate entities. Thus, each company submits an income tax return and pays the assessed amount of tax. In Australia today, the dividend imputation system allows tax credits to shareholders for the dividends received, so that the tax that has already been paid by the company on taxable income is recognised. Dividend imputation is discussed further later in this chapter and is especially relevant to chapters 8, 12 and 13.

Trust

A **trust** is a legal structure where property is nominally owned by one party, the trustee, on behalf of others, who are the beneficiaries.

The **trust** is a creation of common law that has developed from medieval times. Trusts as business structures wax and wane in popularity, depending on current taxation legislation. During the 1980s and 1990s, for example, the number of trusts used as business vehicles in Australia increased dramatically, because there were taxation advantages, especially for family businesses. Trusts are not separate legal entities.

Trusts comprise five essential elements:

- the trustee, who is the legal owner of the trust property
- the trust property
- the beneficiary or beneficiaries, who have rights to receive financial benefits
- the personal obligation on the part of the trustee to deal with the property
- the trust deed which contains the arrangements for the management of the trust.

Among the types of trusts available, the most commonly used business structure is the discretionary trust. Other trust structures, such as unit trusts, superannuation trusts, family trusts and charitable trusts — all of which are classed as 'express' trusts — are available and may be used to advantage depending on the situation and type of business. Discretionary trusts give the trustee unlimited discretion to allocate both capital and income among the beneficiaries, and even to select beneficiaries from among a designated group.

Trustees may be natural persons or bodies corporate (that is, companies). Hence, many trustees are proprietary limited companies to limit legal liability and to provide for long-term continuity and succession. Trusts submit income tax returns, but do not pay tax directly on taxable income. Trustees provide the details of the distribution of income on the tax return and the individual beneficiaries pay the assessed taxation on their total taxable incomes.

The chief advantage of the trust structure is the ability of the trustee to direct income where it will be least tax-disadvantaged. In other words, income may be directed to beneficiaries who otherwise have low incomes and enjoy low marginal rates of tax, rather than to beneficiaries with high marginal rates of tax. For example, the annual income of \$100 000 from running a hardware store set up as a trust, if directed to one beneficiary who had other income of more than \$60 000 and thus was levied tax at the top marginal rate, might attract income tax of \$48 500. If the trust income was directed to and split evenly among five family member beneficiaries who otherwise had low incomes, it might attract only the 31.5% marginal rate, and thus result in an aggregate after-tax advantage of more than \$36 000.

The most appropriate business structure

Students and people new to business often ask which is the best (most beneficial) business structure. The best depends on individual circumstances and individual motivations. Table 1.1 provides a guide to the most appropriate structures for achieving given objectives.

Table 1.1 Appropriate business structures for given objectives

Objective	Best structures
Ease of establishment	Sole proprietorship; partnership
Low cost of establishment	Sole proprietorship; partnership
Limited legal liability	Company
Ease of management and control	Sole proprietorship; partnership
Low regulatory oversight, compliance costs	Sole proprietorship; partnership
Ease of raising capital	Company
Ease of managing income taxation	Company; trust
Ability to manage capital gains tax (CGT)[a]	Sole proprietorship; partnership; trust
Likelihood of business continuity	Company
Ease of transfer of ownership	Listed company

a. Companies pay the same rate of tax on capital gains as on ordinary income.

FINANCE WORKSHOP 1.2

1. Without looking back at the previous sections, see if you can list from your understanding of each business structure five objectives best achieved by:
   (a) a sole proprietorship or partnership
   (b) a company structure.
2. Greg Gringovitch is a fitter and turner by trade. He identified a gap in the medical appliances market after his son developed a muscular degeneration problem. Greg developed a gadget called the 'Thing', which helped his son stay mobile. After Greg and his wife joined a support group that helped families cope with this disease, Greg made a number of 'Things'. As it became apparent that the 'Things' could help many people, it was suggested to Greg that he develop both Australian and export markets. Suggest a business structure that you believe would serve Greg well for the first stage of the development of his business. Would this recommendation change if Greg's turnover increased to $1 million per annum?

LO **6**

Describe the features of the Australian taxation arrangements for business.

Overview of Australian taxation arrangements

Taxation impacts to a greater or lesser extent on many decisions taken in business. As you read through the later chapters of this book, you will find taxation arrangements affect many issues of concern to financial managers — not least the planning of investments, sourcing finance, dividend policies and capital structures. The most important taxes from the points of view of financial managers are income tax, capital gains tax (CGT) and the goods and services tax (GST).

FINANCE WORLD

This extract will boost your understanding of business structures and the potential for principal–agent issues to impact on owners' wealth.

What is fair pay?

JOHN STENSHOLT

Big executive salaries are here to stay, but it might be time to reconsider how they are paid.

People can complain about the multi-million-dollar salary packages paid to the chief executives of some of Australia's largest companies, but the situation is not going to change. Executives from the recruitment and management consulting industries say big packages — a mixture of salary, cash bonuses and equity — will remain. However, there is scope to review the way in which bonuses and equity are offered to chief executives, and to restructure their remuneration packages.

Issuing share options to chief executives, on generous terms and often with relatively low performance targets, has not provided the incentives for executives to improve company performances. The reasoning behind the granting of options is sound: part of the chief executive's pay is directly linked to the share price, which, in theory, closely aligns the interests of management and shareholders. The problem is that some chief executives, fixated on improving the short-term share price and reaping the rewards on the stockmarket, have been losing focus on the long-term outlook of the company.

Companies have begun to respond to criticism of options. The Commonwealth Bank announced on August 21 that it had suspended its options scheme for executive directors from July 1. Previously, half of executive benefits were options and half normal shares. The mining group WMC also stopped allocating share options to senior managers from July 1. Perpetual Trustees' managing director, Graham Bradley, says his company is happy to show the expense of options on its balance sheet. Bradley says the value of Perpetual's executive options in the year to June 30, 2002, was only about $1 million.

Source: *Business Review Weekly*, 4 September 2002, p. 66.

Income tax

Income tax is levied in Australia on individuals' and companies' taxable income. Taxable income is assessable income less legitimate deductions. Assessable income includes most forms of income earned by resident taxpayers, both in Australia and overseas. Because there is a long history of people trying to avoid paying tax, the taxation legislation, regulations, cases, rulings and determinations form a complex and comprehensive web which serves to catch almost all forms of monetary benefits. The most notable exemptions for individuals are some war service pensions, legacies, gifts, lottery prizes and gambling wins (unless the gambler is running a gambling business). For businesses and companies, almost all monies received are assessable. The only exceptions are receipts that are not revenue, such as loans and capital injections.

Distinguishing between income and capital can sometimes be difficult. Income is often received frequently or periodically, whereas capital may be received infrequently. However, this is not a fail-safe test. There is a large body of case law which builds the pattern of what is assessable income and what constitutes capital. (Some parts of capital receipts may still be taxable under the capital gains tax legislation.) Some of the classes of transactions that the courts have identified as income include:

- compensation received for cancellation of trade contracts
- compensation, such as insurance recovery, for the loss of trading stock
- compensation for the loss of profits.

Assessable income may be reduced by allowable deductions. For individuals, allowable deductions are few. For businesses, allowable deductions include many classes of expenses and the general rule is that expenditure incurred to earn assessable income is an allowable deduction.

Income tax is collected under the authority of two Income Tax Assessment Acts, 1936 and 1997. The 1997 Act introduced some new material, clarified some of the old and left some of the old so that the 1936 Act still applies in part. Allowable deductions were covered in the 1936 Act under section 51(1) and this is considered to be the most litigated section of the Act as taxpayers battled to reduce their tax liability and the Commissioner of Taxation fought to increase the public revenue. The comparable section under the new Act is s. 8.1.

Section 8.1 can be divided into two parts, the so-called positive and negative limbs. There are two positive and four negative limbs. Taxpayers should test first against the positive to see if a deduction is possible, then test against the negative to ensure that the deduction is not denied. Section 8.1(1) provides:

> You can deduct from your assessable income any loss or outgoing to the extent that:
> (a) it is incurred in gaining or producing your assessable income; or
> (b) it is necessarily incurred in carrying on a business for the purposes of gaining or producing your assessable income.

Section 8.1(2) provides:

> However, you cannot deduct a loss or outgoing under this section to the extent that:
> (a) it is a loss or outgoing of capital, or of a capital nature; or
> (b) it is a loss or outgoing of a private or domestic nature; or
> (c) it is incurred in relation to gaining or producing your exempt income; or
> (d) a provision of this Act prevents you from deducting it.

Even though the term 'necessarily' in s. 8.1(1)(b) appears to be strict in meaning, the courts have interpreted this section liberally to mean that the outgoing must have an appropriate relationship to carrying on a business. The negative limbs are comparatively straightforward. An example of a specific denial of deductibility in another part of the Act is superannuation contributions for employees who are supported by their employers with superannuation contributions.

Examples of business deductions are advertising, borrowing expenses, cost of sales, depreciation, electricity, freight, insurance, legal and motor vehicle expenses, rent, repairs and salaries. Some classes of expenses have been the subject of more legal battles than others, and these difficult areas may include interest expenses, repairs, bad debts, legal expenses, gifts and car expenses.

Taxation rates for individuals (including their partnership and trust income) are progressive, meaning that higher income brackets attract increased rates of tax. The taxation rates for resident individuals are given in table 1.2. The taxation on exactly $62 500 of taxable income is $16 182, made up of the marginal rates of each of the lower steps in the tax scale. No tax is paid on the first $6000 of taxable income, 17% is paid of the next $15 600, 30% is paid of the next $30 400 and so on. Thus, the average rate of tax on $62 500 is 25.89%, but the marginal rate for any income in excess of that figure is 47%. In addition, most individuals pay a 1.5% Medicare levy, the exceptions being some low-income earners and people who are otherwise supported for their medical needs, such as some Veterans' Affairs pensioners.

Table 1.2 Taxation rates for Australian resident individuals, 2003–04

Taxable income ($)	Tax on income up to the threshold ($)[a]	Marginal rate of tax (%)
0–6000	nil	nil
6001–21 600	nil	17
21 601–52 000	2652	30
52 001–62 500	11 772	42
> 62 500	16 182	47

a. The tax on the threshold of each income range is the sum of the tax on each of the lower ranges. For example, the tax on $21 600 is the sum of 0 plus $15 600 x 0.17, which equals $2652.

Marginal rates of tax are important because we often analyse alternative income-producing activities in terms of how they affect marginal income. For example, an investor with a salary of $65 000 may invest in a property to gain a $5000 net return each year or invest in shares to gain a $10 000 gross return. Any analysis of the after-tax effects uses the marginal rate of tax, because of the assumption that the base income of $65 000 will continue no matter what decision is made about this investment. This technique allows us to do the analysis more efficiently because we do not have to calculate the full taxable income and taxation liability for each scenario. We just consider the incremental income of the $5000 net return and the $10 000 gross return less the allowable deductions for expenses.

The taxation rate for companies is currently a flat 30%. Companies generally pay their tax in quarterly instalments, 21 days after the end of each quarter. The ATO advises each quarterly payer of its instalment rate, which is the tax rate that is applied to the taxable income earned each quarter.

Capital gains tax (CGT)

Capital gains tax (CGT) is paid on gains made on the disposal of assets purchased after 19 September 1985. No CGT is payable until a CGT event occurs. The *Income Tax Assessment Act 1997* exhaustively lists events which have CGT consequences and labels them from A1 to L7, thus grouping transactions into classes of CGT events. The most common such event is the sale of an asset. For example, the sale of land is CGT event A1. Other CGT events are loss or destruction of an applicable asset (label C1), transfer to a trust, grant of a lease and owners' cessation of Australian residency. The CGT system has been simplified since September 1999 so that individuals pay CGT at their marginal rates on half of any gains made. Thus, for an investor on the top marginal rate, the CGT rate is 24.25% including the 1.5% Medicare levy. Companies are not granted this 50% discount on realised capital gains.

Capital losses cannot be claimed against ordinary income to reduce income tax, but must be written off against current capital gains or quarantined and carried forward until sufficient capital gains are made so that they may be written off. In a future year when capital gains are made, the carried-forward capital loss is first deducted from the total gain, then the net gain, if any, is subjected to the 50% discount rule before the tax rate is applied.

Goods and services tax (GST)

While the GST regime has imposed a good deal of paperwork on business and has prompted many business managers to improve their record-keeping and accounting systems, it is not a tax on business. Business collects the tax on most sales and pays the tax on most purchases. The tax collected from consumers is remitted to the ATO and the tax paid on purchases is refunded by the ATO. In practice, only the net tax is paid to the ATO and any excess tax businesses have paid above their collections in any period is reimbursed by the ATO.

Some supplies (sales) made by business are GST-free. These include food, health supplies, education, child care, religious services, water and sewerage services, precious metals and farmland. However, as with most things associated with taxation, nothing is simple. Not all foods are tax-free. Live animals (such as beef cattle consigned to an abattoir — not food yet!), unprocessed grains, hot takeaway food and restaurant meals are all subject to GST.

Businesses conducting an enterprise have to register for GST administration if their annual turnover exceeds $50 000. Smaller businesses may register voluntarily. Once registered, entities are liable to account for GST collected on their sales and taxable supplies and they may claim the tax paid on their purchased inputs, so long as they keep the tax invoices setting out the amounts of tax paid on each purchase. Marked prices must include the GST amount.

FINANCE WORKSHOP 1.3

1. Explain to a friend the differences in the nature of income and capital. What are some of the areas where the courts have identified complicated cash flows as income?
2. Su Chee Zong runs a 'retail trading warehouse'. His 2004–05 receipts include: cash sales; credit-card sales; insurance recoveries for stock lost in a fire; funds from the sale of a one-fifth share in the business to his cousin; compensation for the loss of an exclusive agency for a kitchen mixer; compensation for the sale of a strip of land along the fence line with his neighbouring business; and compensation from the manufacturer of rubber goods for the loss and disposal of some hose stock which perished. Which of these do you think are ordinary assessable income?
3. Identify the three most important taxes from the points of view of financial managers. Explain the main features of each of these taxes.

LO 7

Discuss the importance of incorporation of dividend imputation effects in business decisions.

The importance of dividend imputation for company business decisions

Dividend imputation is the system where dividends carry an additional benefit in the form of an attached tax credit for the relevant amount of tax paid by the company on its profits.

A **franked dividend** is a dividend carrying an attached franking or tax credit.

A **fully franked dividend** carries a tax credit equal to the full 30% company tax paid on the underlying profit.

A **partly franked dividend** carries a tax credit less than the full 30% company tax paid on the underlying profit.

An **unfranked dividend** carries no tax credit.

Dividend imputation was introduced into the Australian financial scene in 1987. This change in the tax system was made to encourage investment in equities and to quell complaints of double taxation of dividends (dividends had been taxed once through the tax on company profits and again as personal income in the hands of shareholders). Dividend imputation is the system where **franked dividends** carry additional benefits in the form of attached tax credits for the relevant amount of tax paid by the company on its profits.

Where a company pays full tax on profits,[2] it may distribute **fully franked dividends** which carry with them an amount of franking credits or tax credited against the shareholder's account at the ATO. A fully franked dividend carries a tax credit equal to the full 30% company tax paid on the underlying profit. A **partly franked dividend** carries a tax credit less than the full 30% company tax paid on the underlying profit. An **unfranked dividend** carries no tax credit. A company paying a fully franked dividend is shown in example 1.1. Partly franked and unfranked dividends are paid by companies that have not paid sufficient Australian tax in the past to have enough franking credits in their accounts to pay fully franked dividends. For example, the NAB is a profitable bank which normally pays a great deal of tax and usually pays fully franked dividends. However, in 2002 it could attach only 90% franking to its 75 cent final dividend because it had insufficient franking credits available to pay a fully franked dividend following losses sustained on its overseas operations the previous year.

EXAMPLE 1.1

Dividend imputation — paying fully franked dividends

Suppose a company makes an initial $120 million profit. It will pay $36 million in tax (30% of $120 million). The company's franking account would increase from zero to $36 million. The company then pays out a fully franked dividend of $21 million.

The franking credit attached to the $21 million dividend at the 30% franking rate is $9 million ($\$21\text{ m} \times \frac{0.3}{0.7}$). The franking account would be reduced by $9 million, so the balance of the franking account after these two transactions would be $27 million ($36 m – $9 m).

FINANCE WORKSHOP 1.4

Smart Electronics, a resident Australian company, has $235 million in its franking account and wants to pay a fully franked $140 million dividend. By how much will the franking credit reduce its franking account?

Imputation from the company's viewpoint

The dividend imputation system works like this. A company calculates its net profit and estimates its tax liability. It debits Income Tax Expense and credits a Provision for Income Tax account. When it pays its tax, it debits the Provision account and credits its Bank account for the assessed amount of tax as advised by the ATO. In addition to these accounts, the company keeps track of the net balance of tax paid in a separate account outside the double-entry accounting system.

Keeping track of tax paid rather than the net income on which tax had been paid was a reform to the tax system that came into effect from 1 July 2002. Amounts of tax paid by resident franking entities (that is, companies), imputation credits received from subsidiaries, or other investments and franking deficit taxes incurred all increase the balance in a new franking account. On the other hand, the amounts of franking credits distributed with franked dividends and refunds of income tax reduce the balance. Example 1.2 shows how a company tracks its franking credits.

EXAMPLE 1.2

Dividend imputation — keeping track of franking credits

From 1 July 2002, companies must record in their franking accounts the amount of Australian income tax paid less the franking credits issued with dividends.

Balance *1 July 2004*	\$108 500 800
plus Tax paid 2004–05 (30% rate on \$500m profit)	\$150 000 000
plus Credits (franking credits received from investments)	\$5 000 000
less Franking credits issued with \$360m dividends ($360\text{m} \times \frac{0.3}{0.7}$)	\$154 285 700
Balance *1 July 2005*	\$109 215 100

Imputation from the shareholder's viewpoint

Shareholders appreciate the dividend imputation system as it enhances the benefits gained by investing in equities. For example, with the 30% company tax rate, a \$700 fully franked dividend is worth \$1000 as it will carry a \$300 franking credit. The full \$1000 must be declared as assessable income, but the \$300 is already lodged with the ATO and serves to reduce the actual cash tax payable. People on the highest marginal rate of tax will effectively have to pay only the difference between the two rates, 18.5% (48.5% – 30%), on the dividend or \$185 on the \$1000 benefit. People on the lower marginal rates of tax, 0% (up to \$6000 taxable income) and 17% (\$6001 to \$20 000 taxable income), receive a refund of any excess franking credits.

Investors use the dividend yield (dividend paid divided by the price of the share) of shares to compare the returns to be gained from a particular share with the returns from other investments such as fixed interest products or property investments. At a time when fixed interest products may be returning say, 4%, the dividend yield of an investment in one of the major banks may be 4.2%. There appears to be little margin between them. However, the bank dividend will be fully franked and will actually be returning 6.0% before tax. This additional yield makes the bank investment comparatively more attractive. Of course, investors must also consider the element of risk attached to each investment.

Effects of dividend imputation for corporate finance

Dividend imputation credits are available to most resident taxpayers (the few exceptions will be discussed later). Where a company believes the majority of its shareholders can take advantage of the system, it should undertake investments and manage the firm's operations to maximise its before-tax earnings. Maximising the company's before-tax earnings will

maximise shareholders' wealth. Shareholders measure their wealth by using their after-tax income and this measure for each shareholder when aggregated will not necessarily be the same as company after-tax income. *Tax paid by the company on its earnings is irrelevant.*

Effectively, where a company believes itself to be in this situation, the company is no longer paying tax in its own right. It pays tax on behalf of its shareholders, who are treated as if they were sole traders or partners in their own businesses. The final reckoning for each year's tax payments comes only with the submission of each individual shareholder's tax return and the tax assessment that is issued soon afterwards. Thus, shareholders should not be concerned about, and should not support managers who are concerned about, minimising their company's income taxation. Shareholders' after-tax income is dependent purely on:

- their share of the company's pre-tax income which is paid as dividends, and
- their own individual marginal rate of tax.

There are some exceptions to these conclusions. In any case where shareholders cannot claim the full benefits of the tax credits, *the full integration of the two tax regimes cannot be realised and the tax paid by the firm on its income becomes relevant to business finance decisions.* Cases where shareholders cannot claim full benefits include non-resident shareholders, tax-exempt shareholders and shareholders who do not qualify under certain share holding period requirements which were introduced to reduce tax minimisation. In addition, the dividend imputation scheme is available only to companies paying dividends. The owners of firms run under all the other business structures pay tax on their business profits at their own individual marginal rates. *Taxation effects are relevant to business decisions for owners who cannot take full benefit of tax credits.* These issues are discussed further in chapters 6 and 13.

LO **8**

Discuss some of the challenges facing modern firms.

Challenges facing modern firms

Perhaps the most significant challenge of all those facing modern firms can be encapsulated in one word — change — or more correctly in two words — rapid change. Firms face rapid change in all facets of their business dealings. Successful firms will rise to the challenge and turn threats into opportunities. Less proactive (or slowly reactive) firms will become overwhelmed by change, will become less profitable and will eventually die or be taken over.

We can construct a framework to help us consider the most important aspects of change. Change affects businesses by means of:

- the external environment
- advancing technology
- social advances and the expectations of customers and the community.

In Australia, the external environment for businesses has changed predominantly through globalisation and all its implications and the deregulation of the financial markets. Globalisation has led to an increasingly interconnected world where national economies are becoming more and more dependent on each other. It could be argued that globalisation started when the first people moved north out of Africa, but the movement to interconnectedness has accelerated rapidly in the last few decades. For business, globalisation may be viewed as either a threat or an opportunity as firms increasingly specialise, they source materials and labour from the optimal locations globally, not just nationally, and in turn market their goods and services worldwide.

Deregulation of the financial markets in Australia has taken place in the last two decades in an environment of deregulation globally. Deregulation has seen an increase in market efficiency and competition, the introduction of many new financial products and the pricing of financial products much more in line with the 'true' market prices. This trend towards more accurate pricing has seen the consequent decrease in cross-subsidisation between products, where excess profits on one set of products made up for under-charging on another set. This is the reason that financial institutions seem to charge more in fees these days than in the past. Previously, they made higher returns from interest charges and absorbed some of the costs of providing other services; now they earn lower interest margins, have cut cross-subsidisation and charge higher fees for services rendered.

A further consequence of deregulation is the rapid introduction and adoption of improved technology in the financial markets. Electronic banking, including Internet banking services and EFTPOS (electronic funds transfer at point of sale), has brought significant benefits to businesses which have welcomed this technology and adopted it quickly. The same is true for many of the other changes brought about by deregulation in the financial markets. Businesses which have decided to welcome and deal with change have benefited, while businesses which have been forced belatedly to adopt new measures have generally not shared in the benefits to the same degree.

Advancing technology allows businesses to do things better and cheaper. For manufacturers, new technology allows them to produce more efficiently. For example, car manufacturers have installed hundreds, if not thousands, of robots in their plants to produce cars both more cheaply and of higher quality than car workers were able to do previously. Plants using the new technology gain the advantages. Plants not quickly adopting the same new technology put themselves at a disadvantage, as their competitors are able to offer high-quality cars more cheaply.

New technology is continually being developed for all sorts of processes in all sorts of businesses. It is by no means limited to manufacturers. Retailers, for example, may benefit from advances in payment systems (EFTPOS, credit and debit cards, smart cards); stock control and re-order systems using bar coding; and Internet commerce. As in the case of production technology, some firms will adopt new technology quickly and reap the benefits. Others will be slow and lose competitiveness. The slowest and most reactionary will normally lose the race altogether and in time go out of business.

The final facet of change that is important to business is social change. Views of what is right and acceptable within a society or community are continually changing. Possibly the most important aspects for businesses to be aware of relate to employees and employment conditions, safety of products and the treatment of the natural environment. Not so long ago, employers were able to treat employees harshly. They were able to sell unsafe products and dump their waste products into the natural environment, virtually without penalty. Over the last few decades, the situation with regard to all these matters has changed dramatically. For example, excess employees now are routinely offered redundancy packages and retraining rather than being sacked with little warning and no compensation. Products found to be unsafe are routinely recalled for modification or destruction and purchasers are compensated. Pollution of the air or waterways is controlled or prohibited in many cases.

While the situation with many of these issues is much better now than it was even a few decades ago, change has not stopped. People's views will continue to evolve and modify, and successful businesses will alter their behaviour to accommodate the changing social environment in which they operate. Honouring the social contract between businesses and the societies in which they operate will mean that businesses have to continue to be ready to meet new obligations socially, legally and economically. The most successful businesses will meet the challenges by employing new people with tertiary education and well-developed skills as well as by developing skills and insights among current employees through mind-expanding staff development programs.

LO **9**

Describe the nature of rationality in decision making.

How being a person affects decision making

Throughout this book, we will discuss methods and tools that financial managers can use to analyse problems and to assist them to make decisions. Underlying all decisions are either specifically enunciated or assumed goals. In this chapter, we have discussed the goal of maximising wealth. But even as we accept this objective as a reasonable goal for business, we may observe in everyday events that not all decisions are taken to maximise wealth. In reality, many other factors come into consideration and many decision makers have an attitude that 'near enough is good enough' or 'she'll be right'.

We noted earlier that an advantage of assuming wealth maximisation as the goal of the firm was that it provides a quantifiable objective that allows us to predict how the owners of the firm will respond to management's decisions. There is no generally accepted alternative goal that can challenge and supplant wealth maximisation as a driving force for our decisions. This does not, however, mean that wealth maximisation is a universal description of the way people really behave in all circumstances. Included throughout this book you will find special 'people dimensions' features. In these, we deal with some observed phenomena that reveal non-maximisation anomalies in order to share with you some common behaviour in the real business world.

Given that we have the technology to allow carefully programmed computers to make logical decisions based solely on the wealth maximisation criterion, why do we still leave the financial decisions of firms to people? People are not computationally equipped to make perfect decisions — we make mistakes. Some mistakes can be attributed to random error and others occur because we have biases in our decision making processes. Understanding the way we make decisions helps us to overcome biases that are negative and allows us to capitalise on the short cuts that the human mind uses effectively that can't yet be replicated by computers! The 'people dimensions' features will help you to detect the flaws in your own decisions and to understand why other people make the choices they do. We begin our discussion of the impact that people have on decisions by considering the role and nature of rationality.

The nature of rationality

Rational behaviour implies decisions are made after an amount of reasoning so that ultimate decisions are not foolish or absurd, and are based on the desire to satisfy objectives and maximise or at least optimise outcomes.

Finance theory stems from the theories of economics, a discipline that prides itself among all the branches of the social sciences on its strong framework of rigorously developed theory. A fundamental principle of the traditional finance and economics disciplines is that decision makers behave rationally. **Rational behaviour** implies decisions are made after an amount of reasoning so that ultimate decisions are not foolish or absurd, and are based on the desire to satisfy objectives and maximise or at least optimise outcomes. Normally, optimised outcomes are taken to relate to material wellbeing and would include owner's objectives such as limited working hours.

The traditional finance and economics literature is resplendent with the assumption that people are 'rational wealth maximisers'. These people always have the objective of increasing their wealth as much as possible because they, rationally, prefer to have more dollars than less. Rational wealth maximisers do systematic and comprehensive analysis before they make decisions, and the choices they make are always in favour of the option that is most likely to increase their wealth by the largest amount possible.

However, economics is not the only strongly theory-based social science that studies human behaviour. Psychology is strictly the study of the human soul and mind and, as such, has much to contribute to the study of decision making. Unlike economists, psychologists perceive rationality 'in terms of the process employed to make a decision, whether or not it happens to lead to the best results'.[3] In recent years economists — not satisfied to accept the versions of rationality which have been handed down by their predecessors, and aware of the many observed anomalies among decision makers — have adopted the psychologists' view of rationality and have incorporated process rationality into their thinking.

Thus, new branches of both economics and finance have developed — behavioural economics and behavioural finance. Both sub-disciplines are endeavouring to develop new theory to better explain human decision making. Especially, the new theory should be able to explain the systematic errors and inconsistencies that are commonly observed in both consumer and business decisions.

Summary

LO **1** ▫ **describe the range of goals of firms, including the significant wealth-maximisation objective.**

- Firms have a wide range of goals, which stem from the goals of the owners and, to some extent, the managers.
- Goals are often interdependent and not all may be achievable simultaneously.
- Maximisation of owners' wealth is taken to be the premier objective.
- Maximisation of owners' wealth takes into account a long-term view, future cash flows and the time value of money, and includes risk.

LO **2** ▫ **discuss the roles of financial managers.**

- The financial manager plays many roles:
  - the accounting and reporting functions
  - cash management, raising funds and managing excess funds
  - taxation management, including compliance, forecasts and planning
  - risk management, on both the revenue and expenses sides of the business
  - developmental financial analyses of projected investments, projects, capital restructures
  - forecasting the impact of financial decisions
  - audit management, both internal and external
  - investor relations, including share registers and advice to shareholders, and (for listed companies) managing discussions with investment analysts, disclosures to the relevant stock exchanges and compliance with exchange rules.

LO **3** ▫ **grasp the importance of the principal–agent problem.**

- The principal–agent problem is the scope for conflict between owners and managers over the goals which are being pursued through policy and management decisions.
- The principal–agent problem can cause transfers of wealth from owners to others, as in the HIH case.
- Agency costs are the losses borne by the owners of the firm that can be attributed to the agent having different objectives to the owners.

LO **4** ▫ **discuss the role of ethics.**

- Ethical behaviour is conduct that is acceptable within a given community.
- Ethical codes differ among communities, but there are many common principles that facilitate people living together in reasonable harmony.
- Acceptable behaviours change over time.
- Business faces continual demands to act with greater responsibility towards those entities with recognised rights.
- Corporate social responsibility, meaning that business has responsibilities towards others apart from owners, is gaining greater acceptance as a management issue.

LO **5** ▫ **describe the forms of business organisation and their implications.**

- A sole proprietorship is a business owned by an individual, who owns assets used in the business, incurs liabilities and reaps the annual profits or losses.

- Sole proprietors have freedom to run their businesses any way they wish, so long as their activities remain within the law.
- A partnership is an association of two or more people carrying on a business in common with a view to profit.
- Partnerships are easy to set up with a minimum of formalities and many partnerships use their own names as their trading names.
- A company, which is legally separate from its owners, is an entity formed under the *Corporations Act 2001*.
- Companies make a trade-off with the society in which they operate: in return for the limitation of legal liability, they are subjected to greater regulation and compliance costs than either partnerships or sole proprietors.
- A trust is a legal structure where property is nominally owned by one party, the trustee, on behalf of others who are the beneficiaries.
- The chief advantage of the trust structure is the ability of the trustee to direct income where it will be least tax-disadvantaged.

LO 6 ▫ describe the features of the Australian taxation arrangements for business.

- Income tax is levied in Australia on individuals' and companies' taxable income.
- Taxable income is assessable income less legitimate deductions.
- Assessable income includes most forms of income earned by resident taxpayers both in Australia and overseas.
- Distinguishing between income and capital receipts can sometimes be difficult, but income is often received frequently or periodically whereas capital may be received infrequently.
- For businesses, allowable deductions include many classes of expenses and the general rule is that expenditure incurred to earn assessable income is an allowable deduction.
- Marginal rates of tax are important because we often analyse alternative income-producing activities in terms of how they affect marginal income.
- Capital gains tax (CGT) is paid on gains made on the disposal of assets purchased after 19 September 1985.
- No CGT is payable until a CGT event occurs and the most common such event is the sale of the asset.
- GST is not a tax on business even though the GST regime has imposed a good deal of paperwork on business.

LO 7 ▫ discuss the importance of incorporation of dividend imputation effects in business decisions.

- Dividend imputation is the system where dividends carry an additional benefit in the form of an attached tax credit for the relevant amount of tax paid by the company on its profits.
- A franked dividend is a dividend carrying an attached franking or tax credit.
- A fully franked dividend carries a tax credit equal to the full 30% company tax paid on the underlying profit.

- A partly franked dividend carries a tax credit less than the full 30% company tax paid on the underlying profit.
- An unfranked dividend carries no tax credit.
- Where a company believes the majority of its shareholders can take advantage of dividend imputation, it should undertake investments and manage the firm's operations to maximise its before-tax earnings.
- Where shareholders cannot claim the full benefits of the tax credits, the full integration of the two tax regimes cannot be realised and the tax paid by the firm on its income becomes relevant to business finance decisions.

LO 8 ▫ discuss some of the challenges facing modern firms.

- Firms face rapid change in all facets of their business dealings.
- Successful firms will rise to the challenge posed by change and turn threats into opportunities.
- Less proactive (or slowly reactive) firms will become overwhelmed by change and will become less profitable.
- Change affects businesses by means of:
  - the external environment
  - advancing technology
  - social advances and the expectations of customers and the community.
- Globalisation and the deregulation of the financial markets have been the chief forces of change in the external environment.
- Advancing technology allows businesses to do things better and cheaper. Firms using new technology gain advantages and firms not quickly adopting the same new technology put themselves at a disadvantage.
- Social change continues, with views of what constitutes acceptable behaviour continually altering.
- Possibly the most important aspects of social change for businesses relate to employment conditions, product safety and the treatment of the natural environment, and standards for all these are continually being raised.

LO 9 ▫ describe the nature of rationality in decision making.

- Rational behaviour implies decisions are made after an amount of reasoning, so that ultimate decisions are not foolish or absurd and are based on the desire to satisfy objectives.
- Traditionally the finance and economics disciplines assume that decision makers behave rationally; that is, that they make their decisions to maximise results or at least optimise outcomes.
- Psychology is strictly the study of the human soul and mind and has much to contribute to the study of decision making. Unlike economists, psychologists perceive rationality in terms of the process employed to make a decision, whether or not it happens to lead to the best results.
- In recent years economists have adopted the psychologists' view of rationality and have incorporated process rationality into their thinking.

Key terms

ABN, p. 16
agency costs, p. 10
company, p. 17
corporate governance, p. 18
corporate social responsibility, p. 14
discounting, p. 7
dividend imputation, p. 25
ethics, p. 12
financial derivatives, p. 8
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franked dividend, p. 25
fully franked dividend, p. 25
market capitalisation, p. 7
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partnership, p. 17
principal–agent problem, p. 10
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trust, p. 19
unfranked dividend, p. 25
wealth maximisation, p. 6
whistleblowing, p. 14

Questions

1.1 Now that you have studied this chapter, what do you consider to be the key issues raised by the HIH news report reproduced at the start of the chapter?

1.2 Toowoomba Computer Works (TCW) has employed a programmer to write business programs for their clients. She writes a program that will be ideal to use to teach first-year accounting students the rudiments of electronic financial record keeping. It sells for $200 per copy. TCW decides to give 100 copies free to the local university, to be distributed to students in whatever way the course lecturer decides. The firm also gives the university a free site licence.

(a) Would this action tend to work against TCW's avowed objective of wealth maximisation?

(b) Is there an ethical problem here for any of the parties?

1.3 Dan Levy is in partnership with three others in their business, Outdoor Camping World. (Outdoor World had been Dan's business and Camping World had been run by the other three until they merged the businesses last year. They merged the names, too, so they might keep all their old customers, even though it doesn't make much sense.) Dan argues that the firm should maximise gross profit margins $\left[\frac{\text{selling price} - \text{buying price}}{\text{selling price}}\right]$ on each item of stock.

(a) Do you think this is a valid financial objective?

(b) Is this objective consistent with maximisation of partners' wealth?

(c) What problems do you see in operationalising this objective?

1.4 Would a manager confronted with given circumstances necessarily make the same decision when pursuing either profit- or wealth-maximising objectives? Explain with an example.

1.5 What are some of the reasons that might motivate a corporate chief executive officer (CEO) not to try to maximise his shareholders' wealth in relation to the firm's activities?

1.6 Steve Preston is a veterinary surgeon who has worked for 10 years with other practitioners in a range of country practices. He now feels it is time to 'go out on his own'. He finds a medium-sized country town with no veterinarian and sets up a practice. His wife answers the phone, makes up the accounts, pays the bills and keeps the financial records.

(a) Which business structure in your view is best for Steve to use?

(b) What are the advantages of this structure?

(c) What are the disadvantages of this structure?

1.7 Peter and Eleanor Dante grow Australian native flowers for the cut-flower trade. They export to South-East Asian countries and occasionally send flowers to the Amsterdam markets. They employ their three sons and one daughter in the firm and employ 10 casual pickers. Currently, the business is structured as a partnership, just as they set it up 25 years ago when they first started.

(a) Which business structure in your view should the Dantes use now?

(b) What are the advantages of this structure?

(c) What are the disadvantages of this structure?

1.8 What is the difference between assessable income and taxable income?

1.9 Why are marginal rates of tax used in judging the after-tax effects of new business investments by sole proprietors and partnerships?

1.10 (a) Why was the dividend imputation system introduced in Australia in 1987?

(b) Using a numerical example, explain the effects of dividend imputation for an individual investor receiving a fully franked dividend and having a marginal tax rate of 48.5%.

(c) What effect does a fully integrated taxation system have on business decision making for corporations?

1.11 How is the concept of rationality different in the disciplines of finance and psychology?

Self-test problems

1. Spot-on Consultants is an agricultural extension and consultancy firm. It is run by Bill Burton as a sole proprietorship. Bill made $67 000 taxable income last year. What is his tax liability, including Medicare levy?
2. Training Solutions Company (TSC) had a turnover of $1 234 534 in 2003–04. Allowable deductions were $834 034. TSC has no carry-forward losses or any other tax allowances. What is its income tax liability?
3. Pavi has a medium-sized equity portfolio. She receives the following dividends, all fully franked at the 30% rate: $450, $520, $530, $1500, $2050, $1950, and $2500. She also receives $345, $2795 and $3250 in unfranked dividends. She adds her recorded franking credits for her tax return and calculates a total of $4071.43. Is this correct?

Solutions to self-test problems

1 From table 1.2:

Tax on $62 500 (from table) = $16 182

Tax on $4500 (at 47c in the dollar) = $2115

Total tax = $18 297

Medicare levy, 1.5% of $67 000 = $1005
Total tax and Medicare levy = $19 302

2 Tax = taxable income × company tax rate
Taxable income = $1 234 534 – $834 034 = $400 500
Company tax rate = 30%
Tax = $400 500 × 0.3 = $120 150

3 The franked dividends total $9500. To find the correct franking credits value:

$9500 \times \frac{0.3}{0.7}$ = $4071.43. The calculated value is correct.

Problems

1.1 Tinsel Tin Company, an Australian company, mines tin using cheap, resource-wasteful techniques in a tropical country. The effects of the mining include pollution of freshwater streams from almost their sources to the sea. The local people used to fish, hunt near, get drinking water from and swim in these streams, but now none of these things is possible. Local people now buy canned meat for protein. It is relatively cheap and tends to be very poor quality with a very high fat content. As a result, the local people are now much fatter than they used to be and their health is poorer. Tinsel has supplied a fully equipped medical clinic but expects the local people to supply the staff. Discuss each of the following questions.

(a) Has Tinsel contravened, in your view, its ethical responsibilities?
(b) Is it possible to trade off an ethical 'bad' with an ethical 'good'?
(c) Has Tinsel done enough to compensate for the change they have brought about in the local people's lives?

1.2 Sunshine Fruits made $100 000 taxable income last year. What would be the tax payable by Sunshine, disregarding the Medicare levy, if:

(a) Sunshine was structured as a sole proprietorship?
(b) Sunshine was structured as a partnership with 2 equal partners?
(c) Sunshine was structured as a partnership with 3 equal partners?
(d) Sunshine was structured as a partnership with 4 equal partners?
(e) Sunshine was structured as a partnership with 5 equal partners?
(f) Sunshine was structured as a company (company tax only)?

1.3 Jim earns a salary of $60 000 and has legitimate deductions, mainly donations, of $1000. He has investments and receives $5600 in fully franked dividends.

(a) What would be his tax (and 1.5% Medicare levy) liability if the dividends had been unfranked?
(b) By how much does his taxable income increase through receipt of the franking credits?
(c) What is his net tax (including 1.5% Medicare levy) if the dividends are fully franked?

1.4 Frank South Entertainments Ltd (FSE) is a company that provides after-dinner speakers. Its total fee income last year was $9.8 million and its disbursements to the speakers were $8.2 million. In addition, it had $600 000 in tax-deductible expenses.

(a) What are FSE's taxable income and tax liability for the year?

(b) FSE has a policy of paying out 80% of taxable income as dividends and has one million issued shares. What is the dividend per share and what amount will be the franking credit per share?
(c) What will be the balance in the franking credit account at FSE after the dividend payment, if the balance at the start of the year was $200 000?

1.5 IXL Ltd is a manufacturer which has carried forward past losses of $5 million from 2001–02. It made a profit in 2002–03 and wrote off all the past losses. Its taxable income was thus reduced and it paid only $1.5 million in income tax. It had a nil balance in its franking credit account at the start of 2002–03.

(a) What was its taxable income in 2002–03?
(b) The directors decide to distribute $7 million in dividends of $1 per share. Can these dividends be fully franked?
(c) How much is the franking credit per share?

Further resources

To enhance your understanding of the material presented in this chapter, go to the website that accompanies this textbook to access further learning resources such as online self-testing, case studies and study tips at **<www.johnwiley.com.au/highered/corpfin>.**

End notes

1 ATO 2003, 'Statistics', viewed 28 October 2003, <www.ato.gov.au>.

2 You may wonder how a company may not pay the full 30% on its current year's income. One explanation is the case where a company has past year losses that it writes off against current income. Thus, for example, a biotechnology company makes $100 million in profits this year, but has $60 million in past losses that it writes off against those profits. Its taxable income is $40 million and it may pay $12 million in tax. However, it may decide for various reasons to distribute $50 million in dividends. In this case, if it has no previous excess franking credits to distribute, the dividend to its shareholders cannot be fully franked. That is, there is only $12 million in the franking account and a fully franked dividend would require about $21.4 million.

3 Schwarz, H 1998, *Rationality gone awry: decision-making inconsistent with economic and financial theory*, Praeger, Westport, Connecticut, p. 13.