Environment Protection Authority

Assessing financial capacity: Procedure on financial risk assessment

Published by:
NSW Environment Protection Authority
6 Parramatta Square
10 Darcy Street, Parramatta NSW 2150
Locked Bag 5022, Parramatta NSW 2124

Phone: +61 2 9995 5000 (switchboard)
Phone: 131 555 (NSW only – environment information and publications requests)
Fax: +61 2 9995 5999
TTY users: phone 133 677, then ask
for 131 555
Speak and listen users:
phone 1300 555 727, then ask for 131 555

Email: info@epa.nsw.gov.au
Website: www.epa.nsw.gov.au

Report pollution and environmental incidents
Environment Line: 131 555 (NSW only) or info@epa.nsw.gov.au
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ISBN 978 1 922963 14 7
EPA 2023P4315
February 2023

Contents

This document explains how the EPA performs a financial risk assessment of a company it regulates when that company’s financial capacity is relevant to regulatory decisions.

Glossary

Term	Definition
Accrual accounting	An accounting method that records revenues and expenses when they are incurred, regardless of when cash is exchanged.
Accrued expenses	The expenses a company has incurred but not yet paid (such as employee costs and rent).
Accounts payable	An account that tracks the money a company owes to its suppliers, vendors, contractors, and others who provide goods and services to the company. Also known as 'trade creditors' or 'trade and other payables'.
Accounts receivable	An account that tracks individual customer accounts, listing money that customers owe the company for products and services they have purchased. Also known as 'trade receivables'.
Amortisation	The reduction in value of an intangible asset by a certain percentage each year to reflect that the asset is being used up (aging).
ASIC	Australian Securities and Investments Commission
Assets	Things a company owns, such as cash and investments, buildings, inventory, tools, equipment, vehicles, copyrights, patents, furniture, and any other items it needs to run the business.
Audit report	A letter from the auditors stating that a company's financial statements have been completed in accordance with generally accepted accounting principles; the company includes this letter in its annual report.
Balance sheet	The financial statement that gives you a snapshot of a company's assets, liabilities, and equity as of a particular date. Also known as 'statement of financial position'.
Cash debt coverage ratio	An indicator of a company's solvency, measured by comparing its net cash from operating activities to its total liabilities.
Consolidated financial statements	Financial statements that combine the assets, liabilities, revenues and expenses of a parent company with those of any companies it owns.
Current assets	Assets a company owns that it will use up in the next 12 months.
Current liabilities	Liabilities that a company must pay during the next 12 months.
Current ratio	An indicator of a company's liquidity, measured by comparing its current assets to its current liabilities.
Depreciation	The reduction in value of a tangible asset by a certain percentage each year to reflect that the asset is being used up (aging).
Dividend	A payment made by a company to its shareholders (owners) for their share of a portion of the company's profits. Commonly paid as cash or additional shares in the company.
EBIT (Earnings before interest and tax)	See profit from operations.
EBITDA (Earnings before interest, tax, depreciation and amortisation)	See profit from operations before depreciation and amortisation.
Equity	Issued capital plus profits generated by the business that are not paid out as dividends to shareholders. Represents the difference between the company's assets and liabilities. Also known as shareholders' equity.

Term	Definition
Finance costs	Interest costs related to a company's debt borrowings
Financial records	Documents and working papers that record or explain how the financial statements are made up, such as invoices, receipts, orders for payment, cheques, vouchers and accounting books or ledgers.
Financial report	A report prepared at each financial year end that includes a company's financial statements and additional information about items in the financial statements.
Financial statements	A company's reports of its financial transactions over various periods, such as monthly, quarterly or annually. Financial statements should be produced at each financial year end (e.g. 30 June). The three key statements are the balance sheet, profit & loss statement and statement of cash flows.
Going concern	An assumption that a company will be able to continue operating and pay its debts for the next 12 months.
Gross profit	The revenue earned minus any direct costs of generating that revenue, such as costs related to the purchase or production of goods before deducting any expenses such as operating expenses, depreciation, interest and tax.
Intangible asset	Anything that a company owns that is not physical, such as patents, copyrights, trademarks and goodwill.
Interest cover ratio	An indicator of a company's solvency, measured by comparing profit from operations to finance costs.
Inventory	Goods available for sale and materials used to produce goods available for sale that are on hand at the end of the reporting period. Inventory is shown on the balance sheet as a current asset. Also known as stock.
Issued capital	An amount of funding given to a company by its shareholders (owners) to establish or support the business or a particular project (e.g. expansion). Also known as share capital.
Liabilities	Money a company owes to its creditors for debts such as loans and unpaid bills.
Liquidity	A company's ability to pay short-term obligations, generally using assets it can readily convert to cash.
Net assets	Total assets less total liabilities
Net cash from operating activities	How much cash flowed into and out of the company during the day-to-day operations of the business.
Net cash used in financing activities	How much cash flowed into and out of the company due to borrowings and from shareholders, including any interest or dividend payments or receipts.
Net cash used in investing activities	how much cash flowed into and out of the company from activities to grow (or down-size) the business, such as purchase or sale of non-current assets.
Net profit	See profit after tax.
Non-current assets	Assets a company owns that it intends to hold for more than one year.
Non-current liabilities	Liabilities that a company does not have to pay within the next year.
Operating expenses	Any expense that goes into operating a business but is not directly involved in producing or selling the product, such as advertising or equipment rental.
Operating margin	An indicator of a company's profitability after meeting operating expenses, measured by comparing profit from operations before depreciation and amortisation to revenue.

Term	Definition
Profit and loss statement	A document that shows a company’s revenues and expenses over a set period. Also known as an income statement, operating statement or ‘profit or loss and other comprehensive income’.
Profit after tax	Profit before tax less income tax expenses. Also known as net profit.
Profit before tax	Profit from operations less finance costs.
Profit from operations before depreciation and amortisation	Revenue less operating expenses (also known as EBITDA).
Quick ratio	An indicator of a company’s liquidity, measured by comparing its current assets that are most easily convertible to cash (cash on hand, cash due from customers) to current liabilities.
Return on sales	An indicator of a company’s profitability that takes all costs into account, measured by comparing its profit before tax to revenue.
Revenue	How much products or services a business sold during the period. Also known as sales.
Solvency	A company’s ability to meet its long-term financial commitments.
Statement of cash flows	A document that reports a company’s performance over time, focusing on how cash flows through the business. Also known as cash flow statement.
Tangible asset	Any asset that you can physically touch, such as cash, inventory, equipment or buildings.
Total liabilities	Current liabilities plus non-current liabilities.
Working capital	Current assets minus current liabilities.

1. Introduction

When might we use this procedure?

We may perform a high-level analysis of a regulated company's financial risk when we are required to:

- assess under the *Protection of the Environment Operations Act 1997* (POEO Act) whether an environment protection licence holder is a 'fit and proper person' and we may consider under section 83(2)(m) whether the person has demonstrated financial capacity to comply with their licence obligations
- assess under the *Radiation Control Act 1990* (RC Act) whether a radiation licence holder or accredited radiation expert and security assessor is a 'fit and proper person' and we may consider under section 5(1)(j) whether the person has demonstrated financial capacity to comply with their licence or accreditation obligations
- assess under the *Pesticides Act 1999* whether a prescribed pesticides work licence holder is a 'fit and proper person' and we may consider under section 5B(j) whether the person has demonstrated financial capacity to comply with their licence obligations
- determine under the *Contaminated Land Management Act 1997* (CLM Act) who is an appropriate person to be made subject to a management order, and whether under section 13(4)(c) it is practicable to specify a person having regard to their ability to pay their debts.

We may also consider whether a regulated company has demonstrated the financial capacity to carry out its regulated activities when deciding whether a financial assurance is justified. We may need to perform a financial risk assessment to consider the financial capacity of the:

- holder or former holder of the environment protection licence or proposed holder of the licence under section 299(c1) of the POEO Act
- the holder or former holder of the radiation management licence or proposed holder of the licence under section 28D(c1) of the RC Act
- person subject to a management order, ongoing maintenance order, restriction or public positive covenant under section 42B(c1) of the CLM Act
- brand owner to meet the relevant product stewardship requirements and targets, whether through its action plan or otherwise under section 26(b) of the *Plastic Reduction and Circular Economy Act 2021* (PRCE Act).

We might also want to understand a licence holder's financial capacity to inform other regulatory actions such as when we are issuing environment protection notices or requiring pollution reduction programs or undertaking compliance action.

When making these assessments or determinations, we will consider all other relevant matters (and any applicable guidance), our own knowledge of the particular regulated company, premises or site and exercise our judgement. We will always keep in mind that this procedure is a guide only and is not a substitute for relevant considerations and requirements under relevant legislation.

What will we need to do?

To perform a financial risk assessment we will need to obtain certain financial information for the regulated company and use the financial risk assessment calculator to calculate some key indicators of the company's financial health.[1]

Larger companies and those that are publicly owned (including those listed on the Australian Stock Exchange (ASX)) prepare an annual report which includes financial statements along with other information about a company's activities. Financial statements include a profit and loss statement (also called an income statement, operating statement or 'profit or loss and other comprehensive income'), a balance sheet (also called a statement of financial position) and a statement of cash flows. The financial statements are where we will find the information to put into the financial risk assessment calculator.

We may ask the company for its annual report or look for it on the company's website. Larger companies must lodge financial statements with the Australian Securities and Investments Commission (ASIC). We can obtain publicly available financial statements from ASIC for a fee.

Financial statements for smaller companies are generally not publicly available and we will need to ask the company to provide them to us.

We should obtain financial statements for at least the last three years.

If the regulated person does not wish to provide us with the financial statements then we may be able to use a notice for information and records under section 191 of the POEO Act to require this information.

The checklist in the next section provides a snapshot of the steps we will need to take for a financial risk assessment and some signs a company may be in financial difficulty that we should look out for.

What does this document cover?

This document:

- provides an introduction to the key financial information we need to perform a financial risk assessment
- explains and illustrates financial performance indicators we will need to consider
- discusses different types of companies and their financial reporting requirements
- discusses corporate groups of companies and the additional considerations for a financial risk assessment in these situations
- outlines other non-financial information we can review as part of the financial risk assessment.

This document is purposely short. Where we identify a regulated company to be a high financial risk we may consider obtaining further expert advice.

To obtain a more comprehensive understanding of financial risk assessment, these resources might be helpful:

- CPA Australia guide to understanding financial reports[2]

[1] https://www.epa.nsw.gov.au/licensing-and-regulation/legislation-and-compliance/policies-and-guidelines/financial-capacity

[2] https://www.cpaaustralia.com.au/tools-and-resources/financial-reporting/understanding-annual-reports

- [ASIC's MoneySmart](https://moneysmart.gov.au/shares/keeping-track-of-your-shares) information and [ASX education resources](https://www.asx.com.au/documents/resources/shares_course_10.pdf?shares_course_10_text) for analysing financial information (from an investor's viewpoint)[3,4]
- Investopedia dictionary of financial terms[5]
- Investopedia introduction to ratio analysis.[6]

This document is current at the date of publication. However, some of its information – for example how ASIC describes different entity types and the thresholds applied to small and large entities – may change after publication.

Conventions used in this document

A glossary is provided at the beginning of this document. All words in blue are defined in this glossary.

This document uses the financial statements of ABC Company Limited (a fictional company that operates in the waste collection industry). The financial statements of ABC Company Limited are discussed later in this document.

Where you see this icon in this document, a **financial indicator**, called a ratio, is being discussed. A formula to calculate the financial ratio will be provided, together with a worked example based on ABC Company Limited. All of the ratios described in this procedure are automatically calculated for us by the *Financial risk assessment calculator*.

Where you see this icon in this document, an important piece of **information** is being discussed.

Where you see this icon in this document, an important **risk issue** is being discussed.

Financial risk assessment calculator

This document should be read in conjunction with the financial risk assessment calculator.[7] This is a Microsoft Excel-based spreadsheet that will help us make a financial risk assessment. The calculator automatically generates the financial ratios discussed in this document and makes an initial risk assessment. Comparisons are also made with industry benchmarks so we can see how the company we are assessing compares to other companies in the same industry.

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[3] https://moneysmart.gov.au/shares/keeping-track-of-your-shares

[4] https://www.asx.com.au/documents/resources/shares_course_10.pdf?shares_course_10_text

[5] https://www.investopedia.com/financial-term-dictionary-4769738

[6] https://www.investopedia.com/terms/r/ratioanalysis.asp

[7] https://www.epa.nsw.gov.au/licensing-and-regulation/legislation-and-compliance/policies-and-guidelines/financial-capacity

We use the financial risk assessment calculator in conjunction with other information and analysis, especially in relation to non-financial information.

Worked example of a financial risk assessment for the fictional company ABC Company Limited[8]

Checklist for financial risk assessment

This checklist provides a snapshot of steps we follow when performing a financial risk assessment of a regulated company and the sections in this document where you can find information about each step. it also summarises signs a company is experiencing financial difficulty or otherwise poses a financial risk that are discussed in this procedure. We will be alert to these signs when performing a financial risk assessment.

		In this document
1	**Obtain financial statements from the regulated company**	Section 2 – Understanding financial statements
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	Balance sheet	☑
	Statement of cash flows	☑
2	**Use the financial risk assessment calculator and information from the financial statements to calculate financial ratios**	Section 3 – Assessing financial performance
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	Assessing liquidity	☑
	Assessing solvency	☑
	What we will look out for:	
	Low operating margin	☑
	Low return on sales	☑
	Low current ratio	☑
	Low quick ratio	☑
	Low interest cover ratio	☑
	Low cash debt coverage	☑
3	**Obtain and consider other non-financial information**	Section 4 – Other information to consider
	What we will look out for:	☑
	Company does not have recent financial statements or does not provide them to us	☑
	Company displays signs of financial distress	☑
	Company's audit report contains an emphasis of matter	☑
	Company's auditor has issued a modified audit report	☑
	Company has provided a deed of guarantee to another company in a corporate group	☑

[8] https://www.epa.nsw.gov.au/licensing-and-regulation/legislation-and-compliance/policies-and-guidelines/financial-capacity

Recent media coverage highlights a significant potential risk	☑
ASX announcement highlights a significant potential risk	☑
Director of the company has been banned or disqualified	☑

4 Determine a final risk rating using the financial risk assessment calculator and consider whether further advice from an external expert is required

Risk ratings

The risk ratings provided by the financial risk assessment calculator are only **indicators** of a company's financial performance and position.

The 'comparative risk rating' evaluates how the company we are assessing compares to the industry it operates in as a whole for each ratio.

The 'overall comparative risk rating' averages these ratings across all ratios to give an overall assessment of the company's financial health. The table is a guide to the meaning of risk ratings.

Overall risk rating	Evaluation
Very good, good or OK	The company is likely to be of sound financial health.
Risk	There may be some areas of concern about the company's financial health that may need to be monitored.
High risk	There may be serious concerns about the company's financial health. Further investigation may be needed.

If we are unsure about your financial risk determination, or we identify a regulated company to be a high financial risk, we may consider obtaining further expert advice.

Other risk considerations

The financial risk assessment procedure covers financial risk factors but where other aspects of a company's operations can affect its financial position, such as poor environmental compliance, then these factors can be taken into account in the risk assessment and inform our final risk rating. For example, operational factors that might be signs a company is in financial difficulty might be:

- a site inspection reveals the premises are old and rundown, potentially indicating that the company cannot afford to maintain or repair plant and equipment
- the company has not been meeting monitoring or reporting requirements under its licence or management order, potentially indicating that it doesn't have the resources to carry out these functions
- the company operates in a sector that is experiencing an economic downturn or similar businesses are winding up.

When considering whether a person is fit and proper with financial capacity to comply with their licence obligations, or a person in taking steps to comply with a management order is able to pay their debts, we should consider all other relevant matters (and any applicable guidance) and our own knowledge of the particular company, premises or site, and exercise judgement.

2. Understanding financial statements

Financial statements give a snapshot of a company's financial health. Financial statements form the basis of a financial assessment of a company.

Introduction

Financial statements give a snapshot of a company's value at the end of a particular period (its financial position), as well as a view of the company's operations and whether it made a profit during that period (its financial performance). Financial statements normally comprise:

- profit and loss statement
- balance sheet
- statement of cash flows.

The profit and loss statement (also referred to as the P&L, income statement, operating statement or 'profit or loss and other comprehensive income') shows a summary of the financial activities of a company for a period of time (usually 12 months for annual financial statements that are prepared at the end of each financial year, and one, three or 12 months for internal management accounts). In the profit and loss statement you will find revenues, operating expenses and other costs of the business.

The balance sheet (also referred to as 'statement of financial position') shows a snapshot of a company's financial position as at a certain date, usually the financial year end such as 30 June. On a balance sheet we will find assets and liabilities.

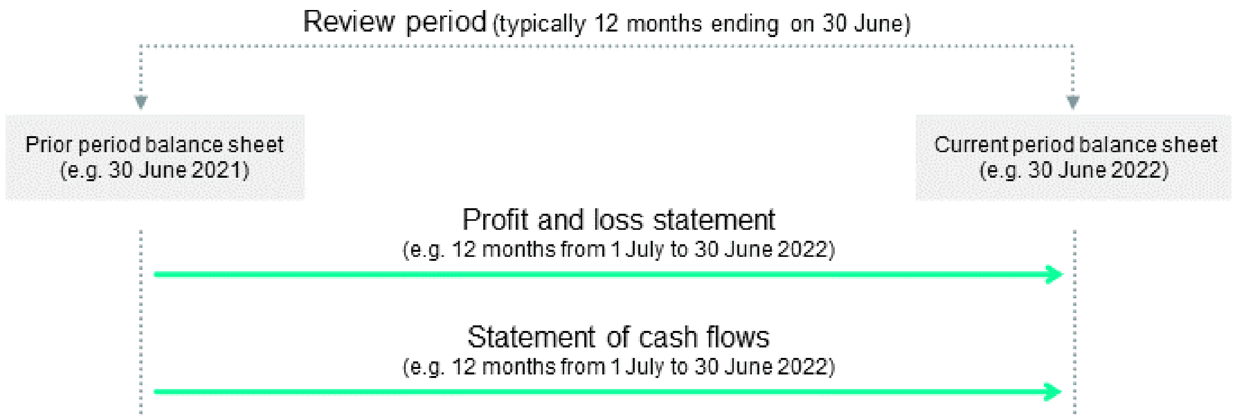
The statement of cash flows is similar to the profit and loss statement in that it covers the same time period as the profit and loss statement but it focuses on how cash flows through the business. Some companies (particularly smaller companies) may not prepare a statement of cash flows.

How certain kinds of transactions are recorded and how information is presented in the profit and loss statement, balance sheet and statement of cash flows is set out to some degree in Australian accounting standards. This ensures there is some consistency between financial statements across companies.

The financial risk assessment procedure ideally requires annual financial statements for the preceding three years. However, if financial statements are only available for the most recent financial year, the financial risk assessment procedure can still be used, but it will not be able to provide any information about how financial ratios have trended over recent years.

The financial risk assessment procedure ideally also requires a profit and loss statement, balance sheet and statement of cash flows. All companies should at least prepare a profit and loss statement and a balance sheet. If the company doesn't prepare a statement of cash flows, the financial risk assessment procedure can still be used but we won't be able to calculate the cash debt coverage ratio (see section 3).

The relationship between the balance sheet, profit and loss statement and statement of cash flows



A business typically has operating, investing and financing activities. These all involve cash flows in or out of the company which are summarised in the statement of cash flows. But cash flows are not the same as profit and loss.

- A business generally buys and sells products and services throughout the year with the intention of making a profit. The profit and loss statement measures the revenues and expenses associated with these **operating** activities.
- The company might buy and sell plant and equipment or invest in other companies. These are **investing** activities and the assets are usually held long-term (greater than one year). The company might also borrow money from banks or raise money from its shareholders. These are **financing** activities and the liabilities are also usually held long-term. The assets and liabilities created by investing and financing activities (e.g. a piece of equipment or a bank loan) are shown in the balance sheet.
- The wear and tear on plant and equipment (a **non-cash** item called depreciation), earnings from investments such as interest and dividends and interest paid on borrowings are recorded each year in the profit and loss statement along with operating revenues and expenses. 'Profit' is then the difference between total revenues (income) and total costs and expenses (outgoings).
- A company's customers and suppliers may also buy or sell on credit. At the end of a reporting period, the cash for the goods or services may not have changed hands but the obligation for the cash exchange exists so is recorded in the company's accounts under what is known as accrual accounting. The revenue or expense will show in the profit and loss statement as described above and a corresponding amount owing or owed will appear in the balance sheet as accounts receivable or accounts payable. However, the cash flows won't show in the statement of cash flows until the period in which the cash actually changes hands.

This interrelationship of the financial statements is a fundamental basis for accounting. It is not vital to understand it, although for a more detailed explanation, see this video.

Profit and loss statement

The profit and loss statement shows a summary of the financial activities of a company for a period of time (usually 12 months for annual financial statements that are prepared at the end of each financial year, and one, three or 12 months for internal management accounts).

Below is a simple profit and loss statement for ABC Company Limited for the 2022 financial year (FY22). The names of the line items shown here are those commonly found in the profit and loss statements of actual companies but there are variations as noted below.

Item	$ million
Revenue	669.0
Operating expenses	(523.2)
Profit from operations before depreciation and amortisation	**145.8**
Depreciation and amortisation	(82.0)
Profit from operations	**63.8**
Finance costs	(9.7)
Profit before tax	**54.1**
Income tax expense	(16.8)
Profit after tax	**37.3**

Notes

Revenue	The value of the products or services a business sold during the period.
Operating expenses	What it cost the company to produce the products or deliver the services during the period.
Profit from operations before depreciation and amortisation	Revenue minus operating expenses (also known as earnings before interest, tax, depreciation and amortisation or EBITDA).
Depreciation and amortisation	A cost charged each year that represents the decrease in value over time of a tangible asset and intangible asset of the company respectively over its useful life, calculated as a percentage of the amount originally paid to buy or develop it.
Profit from operations	Profit from operations before depreciation and amortisation minus depreciation and amortisation (also known as earnings before interest and tax or EBIT).
Finance costs	Interest costs related to a company's debt borrowings.
Profit before tax	Profit from operations minus finance costs.
Income tax expense	Income tax costs for the period.
Profit after tax	Profit before tax minus income tax expense (also known as net profit).

More than one type of profit

The profit and loss statement includes more than one measure of profit. Profit from operations before depreciation and amortisation, profit from operations, profit before tax and profit after tax assess the profitability of a company on different bases reflecting items the company can control and those of a more fixed nature such as the decrease in an asset's value, interest charged by lenders and taxes charged by government.

- Profit from operations before depreciation and amortisation measures the operating profit or earnings of a company from its day-to-day operations, and investment activities if applicable, before the costs of depreciation, amortisation, interest and tax.
- Profit from operations measures the operating profit of a company after taking into account the costs of depreciation and amortisation.
- Profit before tax measures the overall profit of a company after all costs (including any costs of the company obtaining loan financing, such as interest expenses) except Income tax expenses.

- Profit after tax measures the overall profit of a company after all costs, including income tax expenses, have been taken into account.

There are other measures of profitability, such as gross profit, but this is outside the scope of this document.

Balance sheet

The balance sheet shows a snapshot of a company's financial position as at a certain date, usually the financial year end such as 30 June. On a balance sheet, you will find assets, liabilities and equity. The balance sheet gets its name because the total of assets must equal the total of liabilities plus the total of equity.

assets = liabilities + equities or *net assets = total assets – total liabilities = total equity*

Below is a balance sheet statement for ABC Company Limited for FY22.

Item	$ million
Cash and cash equivalents	21.6
Trade and other receivables (accounts receivable)	124.0
Inventories	5.6
Other current assets	16.2
Total current assets	**167.4**
Property, plant and equipment	492.6
Intangible assets	792.7
Other non-current assets	50.5
Total non-current assets	**1,335.8**
Total assets	**1,503.2**
Trade and other payables (accounts payable)	88.8
Borrowings	31.2
Other current liabilities	70.2
Total current liabilities	**190.2**
Borrowings	153.9
Other non-current liabilities	222.2
Total non-current liabilities	**376.1**
Total liabilities	**566.3**
Net assets	936.9
Total equity	**936.9**

Notes

Current assets	Anything the company owns that it can convert to cash in less than a year. Without these funds, the company would not be able to pay its bills and would become insolvent. Current assets include cash, other short-term investments, monies owed by customers (Trade Receivables or Accounts Receivable) and Inventories.
Non-current assets	Assets that a company plans to hold for more than one year. Long-term assets include land and buildings, plant and equipment and intangible assets. These are the assets that a company uses to build its products or deliver its services.
Total assets	Current assets plus non-current assets
Current liabilities	Any obligations that a company must pay during the year. These include short-term borrowings, amounts owed to suppliers (trade creditors or accounts payable) and other accrued liabilities such as employee costs or taxes due.
Non-current liabilities	Any obligations that a company must pay more than one year into the future. These are usually higher than current liabilities. Ultimately, they have to be paid, otherwise the company will be insolvent. They are usually paid from profit generated by the company, or by borrowing more debt or raising more funds from shareholders.
Total liabilities	Current liabilities plus non-current liabilities.
Net assets	Total assets less total liabilities.
Total equity	Must always equal net assets.

Statement of cash flows

The statement of cash flows is similar to the profit and loss statement in that it reports a company's performance over the same time period as the profit and loss statement, but instead of focusing on profit or loss, it focuses on how cash flows through the business. It derives the net change ((decrease)/increase) in cash from the start to the end of the year from all of the company's operating, investing and financing activities.

Below is a statement of cash flows for ABC Company Limited for FY22.

Item	$ million
Profit before income tax	54.1
(Increase)/decrease in receivables	(11.8)
Decrease/(increase) in inventories	2.8
(Decrease)/increase in payables	0.6
Net interest paid	(9.7)
Income tax (paid)/refunded	(16.8)
Adjustment for other non-cash items	75.6
Net cash from operating activities	**94.8**
Payments for property, plant and equipment	(72.1)
Payments for intangible assets	(5.6)
Payments for purchase of businesses	(15.8)
Other investing cash flows	1.6
Net cash used in investing activities	**(91.9)**
Net proceeds from borrowings	7.0
Payment of dividends to shareholders	(11.9)
Other financing cash flows	(0.6)
Net cash used in financing activities	**(5.5)**

Item	$ million
Net (decrease)/increase in cash	**(2.6)**
Cash at the beginning of the year	24.2
Cash at the end of the year	**21.6**

Notes

Net cash from operating activities	The total of how much cash flowed into and out of the company during the day-to-day operations of the business.
Net cash used in investing activities	Cash used for the purchase or sale of major assets (which are usually a drainer of cash).
Net cash used in financing activities	This reflects that companies cannot always raise the cash they need from their day-to-day operations. Financing activities are another means of generating cash and can include borrowing bank debt and raising cash from shareholders. Any cash raised usually has an ongoing obligation to make payments such as interest (to financiers) or dividends (to shareholders).
Net decrease/increase in cash and cash at the end of the year	This adds up cash flows from operating activities, investing activities and financing activities. This is the overall net cash for the company. It is added to cash at the beginning of the year to arrive at cash at the end of the year. Cash at the end of the year must agree with the cash and cash equivalents line on the balance sheet.

The above cash flow is an example of what is called the indirect method of cash flows. The indirect method starts with profit from the profit and loss statement (in this case profit before tax) and converts it from an accrual accounting basis to a cash basis to calculate net cash from operating activities. It does this by:

- adjusting for changes from the start to the end of the period in balance sheet items that are impacted by the company's operating activities (for example, current assets such as accounts receivable and inventories and current liabilities such as accounts payable)
- adding back non-cash transactions like depreciation and amortisation.

You might come across an alternative method of presenting cash flows called the direct method which reflects cash physically paid or received during the period. It groups major classes of **operating** cash receipts and cash payments: for example, cash collected from customers is shown separately from cash received on interest-earning bank accounts, and payments to suppliers and employees are shown separately from interest paid on loans or taxes paid. An example of a direct-method cash flow is shown in Appendix A: Example of a direct-method cash flow.

The direct and indirect methods differ only in the operating activities section of the cash flow. The investing activities and financing activities sections are the same. The financial risk assessment calculator only requires us to input cash flow numbers starting with net cash from operating activities, so, for the purposes of using the calculator, it does not matter if a company uses the direct or indirect method.

3. Assessing financial performance

To understand the financial performance of a company, we need to consider its profitability, liquidity and solvency.

A company's financial performance can be measured using information from its financial statements. We can enter this information into the financial risk assessment calculator and it will automatically calculate the financial ratios discussed in this section for us. It also compares the company to other companies in the same industry using industry benchmarks.

Financial risk assessment calculator

Instructions

The calculator should be used in conjunction with this document (the financial risk assessment procedure).

The calculator comprises three sheets: an instructions sheet, a results sheet and a financial statements sheet in which we input the financial statements of the company we are assessing.

Cells that are highlighted in orange require us to input something. These cells will turn blue when we have made the required input.

Starting with the financial statements sheet

1. Using the drop-down menu we select the number scale that corresponds with the financial statements for the company (dollars, thousands of dollars or millions of dollars).
2. Using the drop-down menu we select the financial year for the most recent financial statements for the company (e.g. FY21 or FY22).
3. We enter the profit and loss numbers for the last three years (taken from the financial statements for the company). If only the most current financial year is available, then we just input this.
4. We enter the balance sheet numbers for the last three years (taken from the financial statements for the company). If only the most current financial year is available, then we just input this.
5. We enter the cash flow numbers for the last three years (taken from the financial statements for the company). If only the most current financial year is available, then we just input this. If the company does not prepare statements of cash flow, then we leave this blank.
6. There should now be no orange cells highlighted in the sheet. There will be orange cells only if the most recent financial statements are available, and/or the company has not prepared a statement of cash flow.

Now selecting the results sheet

7. Using the drop-down menu we select the industry the company operates in. If the exact industry is not available, we select the broad industry group (these are in capitals).
8. Profitability, liquidity and solvency ratios are calculated for the last three years, along with line graphs showing trends in each of the ratios. (Refer to section 3 of this document for more information about each of these ratios.)
9. Industry benchmark ratios are also calculated, based on the industry we previously selected.
10. For each ratio, a comparative risk rating is shown. This is based on whether the current year ratio is less than, similar to or more than the corresponding industry ratio.
11. Based on the comparative risk ratings for each ratio, an overall comparative risk rating is also calculated.

12. Using the drop-down menu we select a final risk rating. This can be the same as the overall comparative risk rating calculated for us, or a higher or lower risk rating. Our choice will depend on the overall comparative risk rating along with any other additional information we have in relation to the company. (See section 4 of this document.)
13. We enter the reasons for the final risk rating we have selected – such as what other information we relied on and how this impacted our overall assessment of risk.

The financial risk assessment calculator automatically calculates profit, liquidity and solvency ratios for the company we are assessing and compares them with companies in the same industry using industry sector benchmarks.

Assessing profitability

Profitability is the amount of money a company makes and is calculated by deducting costs from revenue. Profitability is critical for a business because if its costs exceed revenue, then it will not be able to continue to operate.

What is considered low profitability will vary by the industry the company operates in. The financial risk assessment calculator compares the profitability of the company we are reviewing against the benchmark profitability for the industry the company operates in. If the company's profit, indicated by operating margin and return on sales ratios, is significantly less than the industry benchmark, then this is a risk.

In order to understand the profitability of a company, and compare it with companies in the same industry, we use profit ratios. Profit ratios are simple formulae. The most important profit ratios are described below.

Operating margin

Operating margin looks at what profit is left over after meeting all operating costs (essentially what profit is available for future use such as investment in new factories or repayment of debt).

ABC Company Limited's operating margin in FY22 was 21.8%. The benchmark for industries in the waste collection, treatment and disposal services industry is 14.7%. ABC Company Limited's operating margin was therefore significantly greater than the industry benchmark and the financial risk assessment calculator categorised ABC Company Limited's operating margin risk as 'good'.

The historic trend analysis done in the financial risk assessment calculator shows that ABC Company Limited's operating margin has increased from FY20 to FY21 and FY22. This is a good sign.

$$\text{operating margin \%} = \frac{\text{profit from operations before depreciation and amortisation}}{\text{revenue}}$$

$$\text{ABC Company Limited operating margin (21.8\%)} = \frac{\$145.8\text{ m}}{\$669.0\text{ m}}$$

Return on sales

The return on sales ratio measures how much profit the company is producing per dollar of sales, after all costs are taken into account. A company needs this cash to cover its expenses, develop new products and keep itself competitive. Financiers will also need borrowings to be repaid at some point in the future, and shareholders will want the company to pay a dividend.

ABC Company Limited's return on sales in FY22 was 8.1%, which is above the industry benchmark of 6.8%. The historic trend analysis done in the financial risk assessment calculator shows that ABC Company Limited's return on sales has increased from FY20 to FY21. This is a good sign.

$$\text{return on sales \%} = \frac{\text{profit before tax}}{\text{revenue}}$$

$$\text{ABC Company Limited return on sales (8.1\%)} = \frac{\$54.1\text{ m}}{\$669.0\text{ m}}$$

What do these profit ratios mean?

What is regarded as a 'good' or 'bad' operating margin percentage or return on sales percentage varies by industry. For example, retailers tend to have relatively low operating margin percentage and return on sales percentage (i.e. they do not make much profit on each individual product sold), but large retailers such as major supermarket chains have very high revenues because the numbers of items they sell (turnover) is high, so they make good profit in terms of actual dollars. By contrast, we would expect a custom motorcycle manufacturer to have a high operating margin percentage because they do not sell many motorcycles each year, and so need to make a relatively large profit on each motorcycle sold.

If we are not familiar with standard profit margins in a particular industry, we can still gain insight into the profitability of a company by comparing the company's profit margin over a number of years (typically at least three years). If operating margin or return on sales is increasing over this period, this means the company is becoming more profitable. Conversely, if operating margin or return on sales are decreasing, this means the company is becoming less profitable. If this downward trend continues into the future, this could mean the company will not make enough profit to pay its liabilities and reinvest in the business. This could ultimately lead to insolvency.

Assessing liquidity

Profitability is a good thing, but if a business ties up too much of its money in **illiquid** assets, which are assets that it cannot easily convert into cash (such as factories it cannot easily sell), or it carries too much debt, it may not be able to continue to operate long enough to make more money.

As well as good profitability, a company must also have good liquidity. Liquidity measures the ability of a company to pay its bills and pay back debt. Liquidity can be assessed by looking at a number of liquidity ratios.

Current ratio

One of the most commonly used liquidity ratios is the current ratio. This compares a company's current assets with its current liabilities.

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

$$\text{ABC Company Limited current ratio (0.88)} = \frac{\$167.4\text{ m}}{\$190.2\text{ m}}$$

Generally, the rule of thumb is that a company should have a current ratio of at least 1.2 to 2.0 (although remember that ratios vary among industries). This means the company has 1.2 to 2.0 times more current assets than current liabilities.

A current ratio of less than one is a potential risk sign because it means the company is operating with negative working capital (working capital is a company's current assets minus its current liabilities). In other words, its current debt obligations (those due to be paid over the next 12 months) are greater than the amount of money potentially available from current assets to pay those debts.

ABC Company Limited's current ratio in FY22 was 0.88. The benchmark for industries in the waste collection, treatment and disposal services industry is 0.95. As ABC Company Limited's current ratio was only slightly less than the industry benchmark, the financial risk assessment calculator categorised ABC Company Limited's current ratio risk as 'OK'. While ABC Company Limited's current ratio in FY22 was less than one (which is normally regarded as a rule-of-thumb risk sign), the financial risk assessment calculator has still categorised the risk as 'OK' because comparisons with industry benchmarks are generally more accurate than rules of thumb.

The historic trend analysis done in the financial risk assessment calculator shows an increase in ABC Company Limited's current ratio in FY21 and then a decrease in FY22. The decrease in FY22 might be a concern in the future if it continued into FY23 and later years.

Quick ratio

Stricter than the current ratio is the quick ratio, which measures a company's ability to pay its bills without taking inventory into account. This calculation includes only cash on hand and the current assets most readily convertible to cash, such as cash already due from customers (trade receivables or accounts receivable). These items are found on the company's balance sheet.

Generally, the rule of thumb is that a company should have a quick ratio of at least 1.0 (although remember that ratios vary among industries).

ABC Company Limited's quick ratio in FY22 was 0.77. The benchmark for industries in the waste collection, treatment and disposal services industry is 0.17. ABC Company Limited's quick ratio was therefore significantly greater than the industry benchmark and the financial risk assessment calculator categorised ABC Company Limited's quick ratio risk as 'very good'. While ABC Company Limited's quick ratio in FY22 was less than one (which is normally regarded as a rule-of-thumb risk sign), the financial risk assessment calculator has still categorised the risk as 'very good' because comparisons with industry benchmarks are generally more accurate than rules of thumb.

The historic trend analysis done in the financial risk assessment calculator shows an increase in ABC Company Limited's quick ratio in FY21 and then a decrease in FY22. The decrease in FY22 might be a concern in the future if it continued into FY23 and later years. However, as ABC Company Limited's quick ratio in FY22 is more than the industry benchmark, the quick-ratio risk is OK.

$$\text{quick ratio} = \frac{\text{cash + trade receivables}}{\text{current liabilities}}$$

$$\text{ABC Company Limited quick ratio (0.77)} = \frac{\$21.6\text{ m} + \$124.0\text{ m}}{\$190.2\text{ m}}$$

Assessing solvency

While liquidity refers to a company's ability to pay short-term obligations, solvency refers to the ability to meet long-term financial commitments.

A company with adequate liquidity may have enough cash available to pay its bills, but it could still be heading for financial disaster down the road. A solvent company is one that owns more than it owes; in other words, it has a positive net worth and a manageable debt load.

Solvency and liquidity are equally important, and healthy companies are both solvent and possess adequate liquidity.

Assessing solvency requires an understanding of a company's ability to generate cash, and an understanding of how much debt a company has (which will require cash to meet interest payments and debt repayments).

A number of ratios are used to assess solvency.

Interest cover ratio

Although the current and quick ratios look at a company's ability to pay back creditors by comparing items on the balance sheet, the interest cover ratio looks at income to determine whether the company is generating enough profits to pay its interest obligations.

If a company does not make its interest payments on time, its ability to get additional credit will be impacted. Eventually, if non-payment continues, the company may become insolvent.

A ratio of less than one means a company is generating less cash from operations than needed to pay its interest. Generally, a rule of thumb is that a company should have an interest cover ratio of at least 1.5 (although remember that ratios vary among industries). The buffer of 0.5 is needed to take account of a drop in sales or other events that may impact the company.

ABC Company Limited's interest cover ratio in FY22 was 6.58. The benchmark for industries in the waste collection, treatment and disposal services industry is 7.37. ABC Company Limited's interest cover ratio was therefore less than the industry benchmark and the financial risk assessment calculator categorised ABC Company Limited's interest cover ratio risk as 'risk'. While ABC Company Limited's quick ratio in FY22 was greater than 1.5 (which is normally regarded as a rule-of-thumb risk sign), the financial risk assessment calculator has still categorised the risk as 'risk' because comparisons with industry benchmarks are generally more accurate than rules of thumb.

The historic trend analysis done in the financial risk assessment calculator shows a consistent increase in ABC Company Limited's interest cover ratio in FY21 and FY22. This is a positive sign of improvement. Given ABC Company Limited's interest cover ratio was only slightly less than the industry benchmark, and the upward historic trend, it is appropriate to 'override' the financial risk assessment calculator in this instance, and assign an 'OK' risk rating to the company, rather than 'risk'. (See points 12 and 13 in the financial risk assessment calculator instructions earlier in this document.)

$$\text{interest cover ratio} = \frac{\text{profit from operations}}{\text{finance costs}}$$

$$\text{ABC Company Limited interest cover ratio (6.58)} = \frac{\$63.8\text{ m}}{\$9.7\text{ m}}$$

Cash debt coverage ratio

The cash debt coverage ratio looks at a company's ability to pay debt that is due over the long term. Although a company may generate enough cash to meet its current liabilities, if long-term debt levels are too high, the company may eventually run into trouble paying off its debt and meeting its interest obligations. We can measure a company's cash position to meet its long-term debts using the cash debt coverage ratio. The higher the cash debt coverage ratio, the more cash the company has to pay its debts that are due over the long term.

ABC Company Limited's cash debt coverage ratio in FY22 was 0.17. The benchmark for industries in the waste collection, treatment and disposal services industry is 0.16. ABC Company Limited's cash debt coverage ratio was therefore slightly higher than the industry benchmark and the financial risk assessment calculator categorised ABC Company Limited's cash debt coverage ratio risk as 'OK'.

The historic trend analysis done in the financial risk assessment calculator shows an increase in ABC Company Limited's cash debt coverage ratio in FY21 and then a slight decrease in FY22. Given the decrease in FY22 was not significant, and ABC Company Limited's cash debt coverage ratio in FY22 is more than the industry benchmark, the risk is OK.

$$\text{cash debt coverage ratio} = \frac{\text{net cash from operating activities}}{\text{total liabilities}}$$

$$\text{ABC Company Limited cash debt coverage ratio (0.17)} = \frac{\$94.8\text{ m}}{\$566.3\text{ m}}$$

4. Other information to consider

Annual reports, audits and lodgement with ASIC

All companies are required to keep financial records so they can prepare annual financial statements. But some companies are also required by law to prepare annual reports, have their annual report audited and lodge it with Australia's corporate regulator, the Australian Securities and Investments Commission (ASIC).

Financial statements

All companies are required to keep written financial records that will enable them to prepare annual financial statements. Some companies must also prepare a financial report that includes the financial statements and additional information about items in the financial statements.

However, in practice, some companies do not prepare financial statements or financial reports. And of those that do, some do not prepare them consistently or to a high quality.

Failure by a company's directors to maintain adequate financial records is a serious offence and the courts may deem a company to be insolvent (meaning it can no longer pay its bills and debt obligations) if it has not maintained financial records and is unable to prepare financial statements.

Additionally, there are serious consequences for a director who fails to fulfil their duties. These consequences may affect a director personally and a director may face civil penalties for breaches of their duties. In certain circumstances, a director may also be disqualified from holding a position as a director or managing a company for a period of time.

It is not possible to undertake a risk assessment (and calculate the ratios described in section 3) without financial statements or, at the very least, a profit and loss statement and balance sheet for the most recent financial year. If the company we are assessing does not have recent financial statements, or does not provide them to us, then the company will be treated as very high risk.

Annual reporting

Large companies and those that are publicly owned generally have more comprehensive annual reporting obligations, which they fulfil in an annual report. An annual report is a detailed report on a company's activities throughout the preceding year and is intended to give shareholders and other interested people information about the company's activities and financial performance. An annual report provides much more information on which to base a risk assessment.

The table and flow chart below show which companies are required to prepare annual reports. These are typically large companies (both private and public). If we are unsure, we will ask the company we are reviewing or obtain an ASIC current or historic company report (see later in this section).

Audit of an annual report

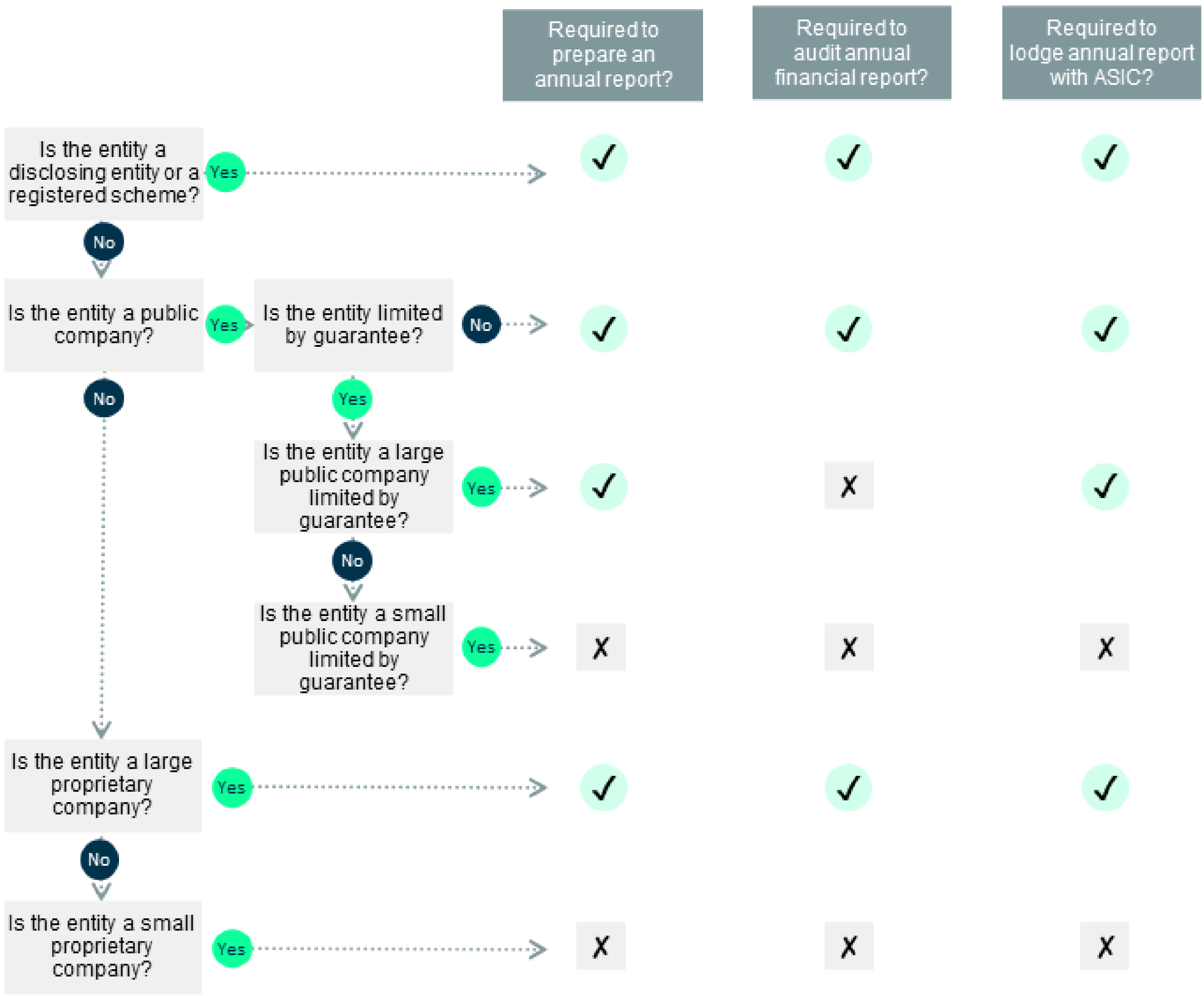
Some annual reports are required to be audited. The table and flow chart below show which companies are required to have their annual reports audited. If we are unsure, we will ask the company we are reviewing or obtain an ASIC current or historic company report (see later in this section).

Lodgement of an annual report with ASIC

Some annual reports are required to be lodged with the corporate regulator ASIC so that they are publicly available. The table and flow chart below show which companies are required to lodge their annual reports with ASIC. If we are unsure, we may ask the company we are reviewing or obtain an ASIC current or historic company report (see later in this section).

Type of entity	Description
Disclosing entity	An entity that issues enhanced disclosure securities (typically managed investment products or debentures) These types of entities are not common.
Registered scheme	A managed investments scheme. These types of entities are not common.
Public company	More than 50 non-employee shareholders. Public companies registered in Australia are listed on the Australian Stock Exchange (ASX). Annual reports will be publicly available.
Large public company limited by guarantee	A public company in which the liability of its members (shareholders) is limited to the amount that they agree to contribute to the company if it is wound up. More than 50 non-employee shareholders. Revenue of $250,000 or more.
Small public company limited by guarantee	A public company in which the liability of its members (shareholders) is limited to the amount that they agree to contribute to the company if it is wound up. More than 50 non-employee shareholders. Revenue of less than $250,000.
Large proprietary company	A company that is not limited by guarantee. Fifty or fewer non-employee shareholders. Satisfies at least two of the following conditions: ○ revenue of $50 million or more ○ total assets of $25 million ○ 100 employees or more.
Small proprietary company	A company that is not limited by guarantee. Fifty or fewer non-employee shareholders. Satisfies at least two of the following conditions: ○ revenue of less than $50 million ○ total assets of less than $25 million ○ less than 100 employees.

The companies we are most likely to deal with will be large or small public or proprietary companies. Smaller companies are less likely to prepare annual reports or have their financial reports audited.



Note: The table and flowchart above are simplified but should be sufficient for most risk assessments.

If the company we are assessing does not prepare an annual report or its annual report is not publicly available we will need to ask the company to provide its financial statements. If the company is unwilling to provide them to us, we can consider issuing a notice under section 191 of the POEO Act to require them to provide information or records in connection with any matter relating to the EPA's responsibilities or functions under the Act. This includes provision of financial information for assessing regulatory actions. Section 96B of the CLM Act, section 15 of the RC Act and section 40 of the *Pesticides Act 1999* extend POEO Act section 191 to the exercise of the EPA's responsibilities and functions under those Acts.

Understanding annual reports

Large public and proprietary companies must prepare an annual report. The annual report comprises information about the company and is the primary source of information about a company's activities and strategies.

Information found in the annual report includes:

- the directors' report
- the corporate governance report (for public companies listed on the ASX only)
- the financial report (incorporating the financial statements)
- the auditor's report on the financial report.

Additional non-compulsory reporting which supports good corporate governance is normally included in reports from the company's chairman and the chief executive. Corporate social responsibility and sustainability reports are examples of non-compulsory reporting that companies are increasingly choosing to provide shareholders with, to enhance market knowledge and understanding of their strategies and performance in operating the business.

Annual reports of public companies listed on the ASX are generally available on the internet. If we would like to look at examples of annual reports, we google the company name followed by 'annual report'. Details of companies listed on the ASX can be found on the ASX website here.

The amount of information and level of detail provided in an annual report will vary between companies. Large public companies (listed on the ASX) will provide the most information. Not all companies the EPA may deal with would be expected to provide this level of information.

Directors' report

While a company's financial report provides useful information about its financial position and performance, additional explanatory information including underlying reasons for the company's results is often provided in the directors' report.

The directors' report will also provide information about business strategies and prospects relevant to future financial performance.

This information is complemented by:

- a review of operations
- details of significant changes in the company's state of affairs
- a statement of the company's principal activities and any significant changes in the nature of those activities
- details of matters since the end of the year that may significantly affect the company's future operations, results or state of affairs
- reference to likely developments in the company's future operations and expected results of those operations
- details of the company's performance in relation to any particular and significant environmental regulation.

When reading an annual report, we look for signs of financial distress. Below are some signs that may indicate a company is in financial difficulty. A more detailed list, including other signs that may not be evident in the annual report, is provided in Appendix C: ASIC 'signs that may indicate a company is in financial difficulty'.

Signs that may indicate a company is in financial difficulty

- ongoing losses
- poor cash flow
- increasing debt (liabilities greater than assets)
- problems selling stock or collecting debts
- unrecoverable loans to associated parties
- solicitors' letters, demands, summonses, judgements or warrants issued against the company
- overdraft limit reached or defaults on loan or interest payments
- change of bank, lender or increased monitoring/involvement by a financier
- inability to raise funds from shareholders
- overdue taxes and superannuation liabilities
- board disputes and director resignations, or loss of management personnel.

Where the company we are assessing does not produce an annual report or directors' report, we may consider asking management about any of these matters that we think are relevant. For example, we might ask whether any major changes to operations, expansion of facilities, acquisition or disposal of sites or significant new borrowings occurred or are planned. This information may help explain the financial ratios we calculate.

Financial report

Financial reports consist of:

- four financial statements (see below) for the current financial period and the comparative previous financial period
- notes to the financial statements
- a declaration by the directors as to whether they believe the company can pay its debts when due and has complied with all relevant accounting standards.

The four financial statements are:

- profit and loss statement
- balance sheet
- statement of cash flows
- statement of changes in equity.

The first three financial statements are the three previously discussed in section 2 of this document and are required to be prepared by all companies (although some smaller companies may not prepare a statement of cash flows), regardless of whether they are also required to prepare an annual report. The fourth statement (statement of changes in equity) is outside the scope of this document.

Notes to the financial statements

The notes to the financial statements explain the accounting policies used in their preparation and provide additional information on many of the amounts.

The notes also provide financial information that is not contained in the primary financial statements, such as information about the uncertainties facing the company. These include contingent liabilities and commitments that the company is aware of but cannot record in its financial statements because their amount and/or timing cannot be reliably estimated, such as outcomes of legal proceedings, taxation reviews, warranty claims, environmental obligations or lease renegotiations.

Audit report

What is an audit report?

Auditors are independent accountants appointed by the directors or shareholders of the company to provide an independent opinion on the financial report prepared by the directors.

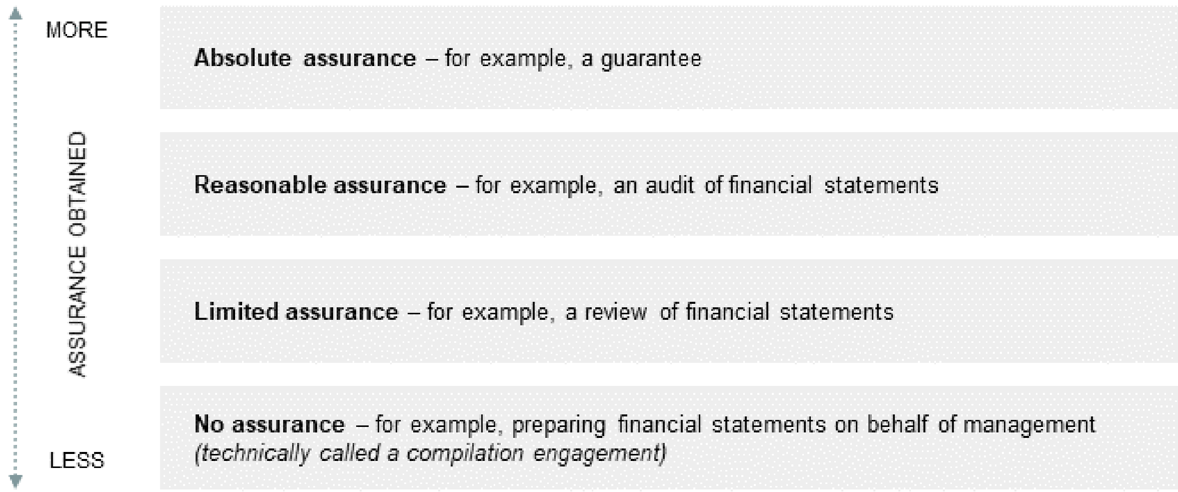
Just like there are accounting standards governing the preparation of financial statements, extensive auditing and assurance standards and legislative requirements set the framework and minimum requirements for financial statement audits.

Auditors review (audit) financial statements using a systematic process including looking at evidence such as customer sales invoices, supplier purchase invoices, contracts and bank statements to support the numbers in the financial statements to assess whether they are valid, accurate and complete. An audit is designed to identify instances of **material misstatement** in the financial statements. The **materiality concept** is the accounting principle that in financial reporting, companies may disregard trivial matters, but they must disclose everything that is important to the audience who will read the report. Items that are important enough to matter are **material items**. Items that are not important enough to matter are **immaterial items**. There is no single formula to determine whether an item is material or immaterial. It is a subjective decision which is determined by a company and reviewed by its auditors.

The audit report provides the reader with the added assurance of an independent opinion on the information contained in the financial report, but it **does not guarantee** the accuracy of the financial information or the continued viability of the company.

At best the auditor will provide reasonable assurance on the financial report information. This is a high level of assurance, but it is not absolute assurance (a certification that the financial statements are completely correct). Obtaining absolute assurance is not possible in financial statement audits for a number of reasons, including:

- it would be impractical for the auditor to test and audit every transaction (the **materiality concept** is applied to help the auditor decide what to test)
- financial statements involve judgements and estimates which often cannot be determined exactly, and may be contingent on future events.



An example of an audit report is attached in Appendix B: Example auditor's report. Regardless of the size or complexity of the company being audited, audit reports are very short (no more than one or two pages). Within the audit report will be a section titled 'opinion'. This section contains the audit opinion and is the most important part of the audit report.

Audit opinions can be:

- unmodified
- emphasis of matter or other matter
- modified.

Audit opinion – unmodified

An unmodified auditor's report effectively states that the auditor believes the financial statements present a true and fair view and are in accordance with accounting standards and relevant legislation. This is sometimes also called an 'unqualified' or a 'clean' audit opinion. Unmodified auditor's reports are the most common type we are likely to come across. This is, in part, because management usually addresses most of the problems or adjustments that auditors discover before the financial statements are issued.

Appendix B: Example auditor's report contains an example of an unmodified auditor's report with an explanation.

Unmodified audit reports should be treated with a healthy scepticism. They should be read together with the notes to the financial statements where we can find more detailed information about particular financial statement items. For example, an item shown as a non-current liability may be due in just over one year and from a risk-assessment perspective might better be considered a current liability.

Audit opinion – emphasis of matter or other matter

In some circumstances the auditor will include additional wording in the auditor's report directing users to information that in the auditor's view is fundamental to understanding the financial statements. This may be information included in the financial statements, such as a note (called an 'emphasis of matter' paragraph), or information that is included elsewhere in the annual report (called an 'other matter' paragraph).

Type of paragraph	Examples
Emphasis of matter	There is a significant uncertainty as to the company's ability to continue as a going concern (an assumption that a company will be able to continue to operate and pay its debts for the next 12 months), which has been appropriately disclosed in the financial statements.
Other matter	There is information included in an annual report that is inconsistent with the audited financial statements (for example, the figures in the operating review are inconsistent with those disclosed in the financial statements).

While it is important to note that an 'emphasis of matter' or 'other matter' paragraph is not a qualification, limitation or adverse conclusion, if it relates to matters that may impact profitability, liquidity or solvency, this may represent a significant financial risk.

Audit opinion – modified auditor's reports

Modified auditor's reports are issued when the auditor believes the financial statements contain a material misstatement, or when the auditor is unable to obtain enough evidence to form an opinion. The following table sets out the different types of modified auditor's reports that may be issued in these situations.

Type of modified audit opinion	Description	Situations where this type of report may be issued	Examples
Qualified or 'except for' opinion	The opinion states the financial statements present a true and fair view, and are in accordance with accounting standards except for the effect of a specific matter or matters. The issues are described in a separate paragraph within the report.	A specific part of the financial statements contains a material misstatement or adequate evidence cannot be obtained in a specific, material area, and the rest of the financial statements are found to present a true and fair view, in accordance with accounting standards.	The auditor has a different view on the valuation of an asset than that applied by management in the financial statements, but the rest of the financial statements were found to be free of material misstatements.
Disclaimer of opinion	The auditor cannot reach an opinion overall on the financial statements and therefore disclaims any opinion on it.	The auditor cannot obtain adequate evidence to form an opinion on the financial statements overall.	The company's financial reporting information system is damaged and key data is lost, meaning adequate evidence is not available to support the disclosures in the financial statements.
Adverse opinion	The opinion states that the auditor believes the financial statements **do not** present a true and fair view, and **are not** in accordance with accounting standards.	The auditor believes misstatements are so pervasive that the financial statements do not present a true and fair view, or are not in accordance with accounting standards.	The auditor believes that management has applied an inappropriate financial reporting framework in preparing the financial statements.

Modified audit reports are not common. Unless we can be comfortable there is not a material impact on profitability, liquidity or solvency, a modified audit report will be regarded as high risk in our financial risk assessment.

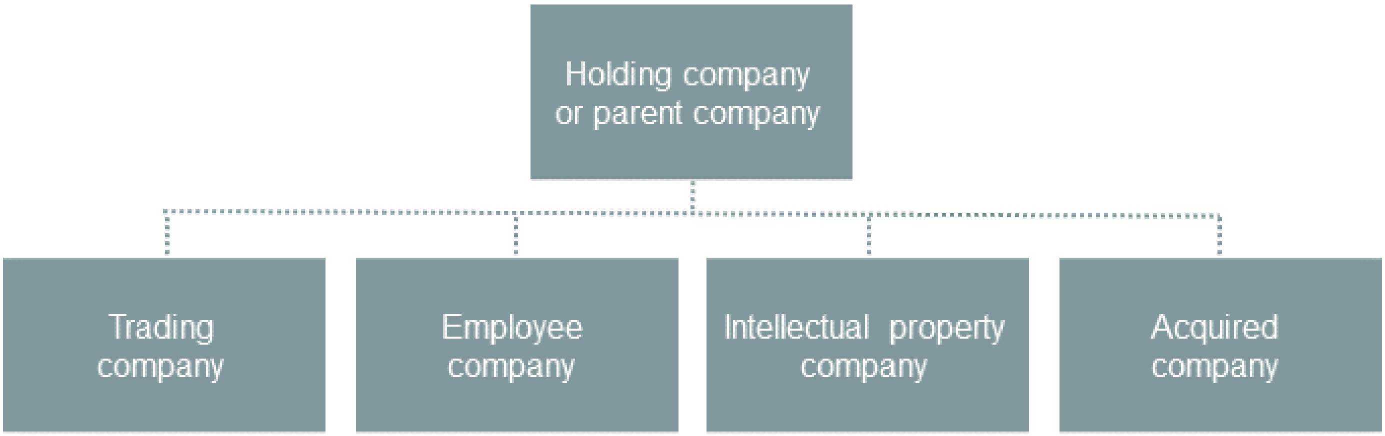
Read more about annual reports and audit reports.

Corporate groups and consolidated financial statements

Not all businesses are owned by a single company. Many businesses are owned by a number of related companies. This is called a corporate group.

Corporate groups

So far we have assumed the business we are assessing is represented by a single company. In reality many businesses comprise multiple related companies. These are referred to as corporate groups. An example of a simple corporate group is shown below.



In this example, the trading operations of the business are transacted through the 'trading company', but the employees are employed by the 'employee company' and intellectual property is held by the 'intellectual property company'. In addition, a recently acquired business is held in the 'acquired company'. All of these companies (known as subsidiaries) are owned by the 'holding company' or 'parent company'. Some businesses are structured this way to minimise tax or to protect intellectual property if the trading company became insolvent.

NSW EPA will normally issue regulatory instruments to a particular company in a corporate group (the company that is legally responsible for the licensed activity or contaminated land). We need to make sure we carry out the financial risk assessment on the right company. In some cases this might be the company with the environmental obligation, provided it prepares financial statements, but in other cases we might find that we need to review the financial statements of the corporate group as a whole. These are called consolidated financial statements.

Consolidated financial statements

In a corporate group the holding company will prepare consolidated financial statements. Consolidated financial statements are the financial statements of the entire group in which the assets, liabilities, equity, income, expenses and cash flows of the parent company and its subsidiaries are presented as though they were the statements of a single company.

Each company within the group usually still prepares its own individual financial statements. Some of the companies won't prepare financial statements if they are part of a sub-set of a corporate group called a 'closed group'. In this arrangement, the Australian Securities and Investments Commission grants relief from financial reporting requirements if the companies are 100% owned by the holding company (or other companies within the corporate group) and the holding company and those companies agree to guarantee each other's debts under what is called a deed of cross guarantee (see next section). If the company we are assessing is in a 'closed group', we should review the consolidated financial statements.

Deeds of guarantee

While the overall corporate group may be financially strong, the company with the environmental obligation that we are assessing may not have strong profitability or may not own many assets and therefore not have strong liquidity or solvency.

Deeds of guarantee are helpful in this situation as another company in the corporate group, usually the holding company, agrees to be responsible for the debts or other obligations of the financially weaker subsidiary if that subsidiary cannot meet its obligations. A deed of guarantee is a legally binding undertaking.

If this arrangement is in place, the financial risk assessment can then be conducted on the consolidated financial statements of the group rather than the individual financial statements of the subsidiary.

A deed of guarantee may exist between all companies in a 'closed group' as indicated above, or it can be arranged between just one subsidiary, for example, the company that we are assessing, and the holding company or another company in the corporate group.

While deeds of guarantee from the holding company or another company within the corporate group can be useful where the responsible subsidiary is not financially strong, deeds of guarantee can also raise risk issues. If the subsidiary we are assessing itself has issued deeds of guarantee to other companies within the corporate group, a financial risk assessment of the subsidiary may overstate its financial strength. This is because deeds of guarantee granted by the subsidiary expose it to potential liabilities of the other companies that are not recorded in its own balance sheet.

If we are assessing the financial risk of a company within a corporate group, we make sure we are reviewing the financial statements for the company that has the legal responsibility for the licensed activity or contaminated land.

If we are assessing a subsidiary company that does not appear to have a strong financial position, we will ask if the holding company has provided a deed of guarantee. if it hasn't, we will consider asking if the holding company could provide a deed of guarantee.

We may also check whether the company we are assessing has issued a deed of guarantee to any other company within the corporate group. If it has, we may try and obtain a deed of guarantee from the holding company and assess financial risk based on the consolidated financial statements of the corporate group.

If the company we are reviewing has issued deeds of guarantee to other companies within the corporate group, this will be regarded as a high risk unless the potential liabilities can be assessed as being only a small percentage (e.g. less than 5% of the companies' total liabilities).

Other sources of information

While financial statements are the primary basis for a financial risk assessment (and annual report if available), other non-financial information can be useful in our overall assessment.

Introduction

Other sources of information include:

- recent media coverage about the company
- ASX announcements
- ASIC searches.

When reviewing other sources of information, we look out for signs of financial distress. Appendix C: ASIC 'signs that may indicate a company is in financial difficulty' lists a number of 'signs that may indicate a company is in financial difficulty', as prepared by ASIC.

Recent media about the company

Recent media articles about a company can reveal much. While paid media searches are available, Google News is a free and comprehensive service.[9] If there are many articles, we can target our review by adding keywords to our search such as the following:

- insolvent *or* insolvency
- distress
- litigation
- cash
- debt
- loss
- sell *or* dispose
- acquisition.

ASX announcements

If the company is listed on the ASX, it is required to issue public announcements about key issues affecting the company. You can read these announcements for free.[10] While many will relate to the appointment of new directors or changes in major shareholders, particularly important announcements will be marked as 'price sensitive'.

[9] https://news.google.com/topstories?hl=en-AU&gl=AU&ceid=AU:en

[10] https://www2.asx.com.au/markets/trade-our-cash-market/todays-announcements

When reviewing ASX announcements, we look out for ASX trading halts. These show if trading in a company's shares was stopped due to a major issue. While these issues might ultimately turn out to be positive (such as the acquisition of a major new customer) they can also be negative (such as the loss of a major new customer or cash flow difficulties). There will normally be an ASX announcement shortly after the announcement of an ASX trading halt that will tell us why the halt was put in place.

ASIC searches

A number of searches are available via ASIC. We can search for a company here and obtain copies of the following documents.

Current and historic company extracts

These provide details of:

- the company type (for example, proprietary company, public company)
- company address
- directors and company secretary
- whether any financial reports that were due to be lodged with ASIC are outstanding
- all documents lodged with ASIC (including financial reports if the company is required to lodge them with ASIC).

Relational company extracts

These provide details of whether the company is part of a corporate group and, if so, details of the other companies within the corporate group.

Obtaining these reports involves a small fee (~$10 to $50).

We can also obtain publicly available financial statements for larger companies from ASIC for a fee.

Banned and disqualified persons

We can also search here for persons who have been banned and disqualified from being involved in the management of a company, including from acting as a director of a company. This will tell us:

- their name and address
- type of banning or disqualification
- date of commencement
- date of cessation (or whether it is permanent).

There is no charge for this search.

If we are dealing with a person who is listed by ASIC as banned or disqualified, this will be regarded as very high risk.

Appendix A: Example of a direct-method cash flow

ABC Company Limited – FY22

Item	$ million
Cash received from customers	657.2
Payments to suppliers and employees	(587.3)
Interest received	2.1
Interest paid	(11.8)
Income taxes paid	(17.4)
Other cash received/(paid)	52.0
Net cash from operating activities	**94.8**
Payments for property, plant and equipment	(72.1)
Payments for intangible assets	(5.6)
Payments for purchase of businesses	(15.8)
Other investing cash flows	1.6
Net cash used in investing activities	**(91.9)**
Net proceeds from borrowings	7.0
Payment of dividends to shareholders	(11.9)
Other financing cash flows	(0.6)
Net cash used in financing activities	**(5.5)**
Net (decrease)/increase in cash	**(2.6)**
Cash at the beginning of the year	24.2
Cash at the end of the year	**21.6**

This section of the statement of cash flows is the same for both direct and indirect methods

Appendix B: Example auditor's report

The report is addressed to the members or the shareholders of the company.

▶ To the members of ABC Company Ltd.

This section sets out the basic details of the engagement: the applicable reporting period, the name of the company, and what was audited.

▶ **Report on the financial report**

We have audited the accompanying financial report of ABC Company Ltd., which comprises the statements of financial position as at 30 June 2022, the statements of comprehensive income, the statements of changes in equity and the statements of cash flows for the year then ended, notes comprising a summary of significant accounting policies and other explanatory information, and the directors' declaration of the company and the consolidated entity comprising the company and the entities it controlled at the year's end or from time to time during the financial year.

The directors are responsible for preparing the financial statements and for the company's internal controls.

▶ **Directors' responsibility for the financial report**

The directors of the company are responsible for the preparation of the financial report that gives a true and fair view in accordance with the Australian Accounting Standards and the *Corporation Act 2001* and for such internal control as the directors determine is necessary to enable the preparation of the financial report that gives a true and fair view and is free from material misstatement, whether due to fraud or error. In Note X, the directors also state, in accordance with Accounting Standards AASB 101 *Presentation of Financial Statements*, that the financial statements comply with International Financial Reporting Standards.

The auditors are responsible for auditing the financial statements. This section also briefly describes what auditors do. (See also *What do auditors and reviews do?*)

▶ **Auditor's responsibility**

Our responsibility is to express an opinion on the financial report based on our audit. We conducted our audit in accordance with Australian Auditing Standards. Those standards require that we comply with relevant ethical requirements relating to audit engagements and plan and perform the audit to obtain reasonable assurance about whether the financial report is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial report. The procedures selected depend on the auditor's judgement, including the assessment of the risks of the material misstatement of the financial report, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the company's preparation of the financial reports that gives a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control. An audit also includes evaluation of the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the annual report.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

The auditor confirms they have met the required independence standards.

Independence

In conducting our audit, we have complied with the independence requirements of the *Corporations Act 2001*. We confirm that the independence declaration required by the *Corporations Act 2001*, which has been given to the directors of ABC Company Ltd., would be in the same terms if given to the directors as at the time of this auditor's report.

The auditor sets out their overall finding in the opinion. This is an example of an unmodified or 'clean' audit opinion. See also *The auditor's report* for information on modified opinions.

Opinion

In our opinion:

a. the financial report of ABC Company Ltd. is in accordance with the *Corporations Act 2001*, including:

i. giving a true and fair view in all material respects of the company's and consolidated entity's financial positions as at 30 June 2022 and of their performance for the year ended on that date, and

ii. complying with Australian Accounting Standards and the Corporations Regulation 2001, and

b. the financial report also complies with International Reporting Standards as disclosed in Note X.

Signed: Audit firm

Signed: Audit partner

Sydney, 30 September 2022

Appendix C: ASIC ‘signs that may indicate a company is in financial difficulty’

- Ongoing losses
- Poor cash flow
- Absence of a business plan
- Incomplete financial records or disorganised internal accounting procedures
- Lack of cash-flow forecasts and other budgets
- Increasing debt (liabilities greater than assets)
- Problems selling stock or collecting debts
- Unrecoverable loans to associated parties
- Creditors unpaid outside usual terms
- Solicitors’ letters, demands, summonses, judgements or warrants issued against the company
- Suppliers placing the company on cash-on-delivery (COD) terms
- Issuing post-dated cheques or dishonouring cheques
- Special arrangements with selected creditors
- Payments to creditors of rounded sums that are not reconcilable to specific invoices
- Overdraft limit reached or defaults on loan or interest payments
- Problems obtaining finance
- Change of bank, lender or increased monitoring/involvement by a financier
- Inability to raise funds from shareholders
- Overdue taxes and superannuation liabilities
- Board disputes and director resignations, or loss of management personnel
- Increased level of complaints or queries raised with suppliers
- An expectation that the next big job/sale/contract will save the company