Learning outcomes

- Describe the purpose of accounting
- Explain the basic accounting cycle
- Define ‘entity’ and explain the concept
- Explain the purpose of financial statements
- Define and classify income, expenses, assets, equity, and liabilities
- Prepare an elementary statement of comprehensive income (income statement) and statement of financial position (balance sheet)
- Discuss the duality concept
Learning outcomes (cont.)

• Describe who uses financial statements and their information needs
• Discuss the management of assets, equity and liabilities
• Discuss the use of financial ratios and how it can help to manage your finances
• Conduct a financial-ratio analysis
• Discuss the use of the Balanced Scorecard as a financial performance management tool
• Name and discuss the various sources of finance and circumstances in which they can be used
Accounting defined

A continuous scientific process that involves bookkeeping and reporting. It can be divided into two domains:

- Financial accounting: reporting of financial activities to external users of financial information
- Management accounting: reporting of financial activities to internal users of financial information
Figure 10.1 A basic accounting cycle

1. Occurrence of a transaction
2. Recording a transaction in relevant journal
3. Summarising information from journal into general ledger
4. Preparing trial balance
5. Preparing and presenting financial statements
Entity

- An economic unit
- Operates separately from other units
- Financial statements are recorded separately from any other unit
- Can be a person, partnership, CC, company or charitable organisation
Purpose of financial statements

To provide information about the entity’s:

- Financial position, financial performance and cash flow situation, that is useful for economic decision-making
Purpose of financial statements
(cont.)

- Three primary financial statements used for reporting:
  - Statement of profit or loss and other comprehensive income (income statement)
  - Statement of financial position (balance sheet)
  - Statement of cash flows (cash-flow statement)
Elements of financial statements

Income:

• Increases in economic benefits

• During an accounting period

• In the form of an increase or inflow of assets, or otherwise the decrease in liabilities which leads to an increase in equity

• This excludes increases because of owners’ contributions
Elements of financial statements (cont.)

Expenses:

- Decreases in economic benefits
- During an accounting period
- In the form of an outflow or decrease in assets, or otherwise the increase in liabilities which leads to a decrease in equity
- This excludes decreases because of distributions to owners
- Any money that was spent or due to be spent in the operation of an entity during a specific accounting period
Elements of financial statements (cont.)

Assets:

• Resources
• Controlled by an entity
• As a result of past events
• From which future economic benefits will flow to the entity
• Non-current assets: assets that will not be converted into cash within the following 12 months
• Current assets: assets that will be converted into cash within the following 12 months
Elements of financial statements

Equity:

- The remaining interest in assets after liabilities (obligations) have been deducted from assets

Thus,

- An owner’s interest in assets against which creditors have no claim
Elements of financial statements

Liabilities:

- A present obligation
- That arose from a past event
- The settlement will cause an outflow of future economic resources
Duality concept

**Figure 10.3** Duality concept

Employment of funds for the acquisition of assets = Resources from which they are provided
Figure 10.4 Users of financial information

- **External users**
  - Controlling interests
  - Equity investors
  - Creditors
  - Clients
  - Employees
  - The state
  - The community

- **Internal users**
  - Management
  - Employees
Types of financial information

- Financial information: information expressed in numeric format of financial nature. Divided into:
  - Monetary information: financial information expressed in terms of a currency e.g. Rands
  - Non-monetary information: financial information not expressed in terms of a currency, but rather in financial ratios, quantities and percentages
Types of financial information (cont.)

- Non-financial information: information expressed in numeric format, but not of financial nature
Financial management

- Management: planning, organising, leading and controlling activities
- Management of assets
  - Non-current: land, buildings, equipment etc.
  - Current: debtors, inventory, cash and equivalents
- Management of equity
- Management of liabilities
Financial ratio analysis – Liquidity ratios

- **Current ratio:**
  
  Current assets ÷ Current liabilities

- **Acid-test ratio:**

  (Current assets – Inventory) ÷ Current liabilities
Activity ratios

- **Inventory turnover rate:**
  
  Cost of inventory sold ÷ Inventory

- **Debtors collection period:**
  
  Debtors (trade) ÷ Average sales per day
  
  = Debtors (trade) ÷ Annual sales ÷ 365
Activity ratios (cont.)

- **Creditors payment period:**
  
  Creditors (trade) ÷ Average purchases per day

  = Creditors (trade) ÷ (Average purchases ÷ 365)

- **Non-current asset turnover:**
  
  Sales ÷ Non-current assets (at carrying amount)

- **Total asset turnover:**
  
  Sales ÷ Total assets
Debt ratios

- **Debt ratio:**
  Total liabilities \( \div \) Total assets

- **Debt-equity ratio:**
  Non-current liabilities \( \div \) Equity

- **Times interest earned:**
  Earnings before interest and taxes \( \div \) Interest
Profitability ratios

- **Gross profit margin:**
  
  \[
  \left( \frac{\text{Sales} - \text{Cost of sales}}{\text{Sales}} \right) \times 100
  \]

- **Operating profit margin:**
  
  \[
  \left( \frac{\text{Earnings before interest and taxes}}{\text{Sales}} \right) \times 100
  \]

- **Net profit margin:**
  
  \[
  \left( \frac{\text{Profit for the year}}{\text{Sales}} \right) \times 100
  \]

- **Return on investment:**
  
  \[
  \left( \frac{\text{Profit for the year}}{\text{Total assets}} \right) \times 100
  \]
Return on equity: 
(Profit for the year ÷ Equity) x 100

Earnings per share: 
Profit available for ordinary shareholders ÷ Number of ordinary shares in issue

P/E ratio: 
Market price per ordinary share ÷ Earnings per share
Financing capital requirements

• Financing strategies:
  o Aggressive financing strategy
  o Conservative financing strategy
  o Mid-way strategy

• Choice of strategy depends on:
  o Combination of non-current and current external capital
  o Combination of ordinary share capital plus reserves together with external non-current capital
  o Financing through own internal funds
Sources of finance

- **Internal sources:**
  - Own equity
  - Profit or earnings
  - Speeding up collections from customers
  - Credit from suppliers

- **External sources:**
  - Long-term finance
    - Long-term loan
    - Debentures
Sources of finance (cont.)

- Intermediate (mid-term) finance:
  - Leases
  - Operating lease
  - Financial lease

- Short-term financing:
  - Trade credit
  - Bank credit
  - Banker’s acceptance

- Factoring
Sources of start-up finance for entrepreneurs

- **Business Partners Limited**: 
  e-mail: enquiries@businesspartners.co.za  
  web: www.businesspartners.co.za

- **Commercial Banks**:
  ABSA Bank: www.absa.co.za  
  First National Bank: www.fnb.co.za  
  Nedbank: www.nedbank.co.za  
  Standard Bank: www.standardbank.co.za

- **Khula Enterprise Finance**:
  e-mail: helpline@khula.org.za  
  web: www.khula.org.za
Sources of start-up finance for entrepreneurs (cont.)

- *Industrial Development Corporation* – (IDC):
  e-mail: callcentre@idc.co.za
  web: www.idc.co.za

- *Other useful websites include*:
  www.jse.co.za
  www.dti.gov.za
  www.businesscentral.co.za/businesstips/sourcesfinance.htm
  http://touchstonecapital.co.za
  www.nefcorp.co.za