OXFORD

5th EDITION

Chapter 10 Basic financial concepts

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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

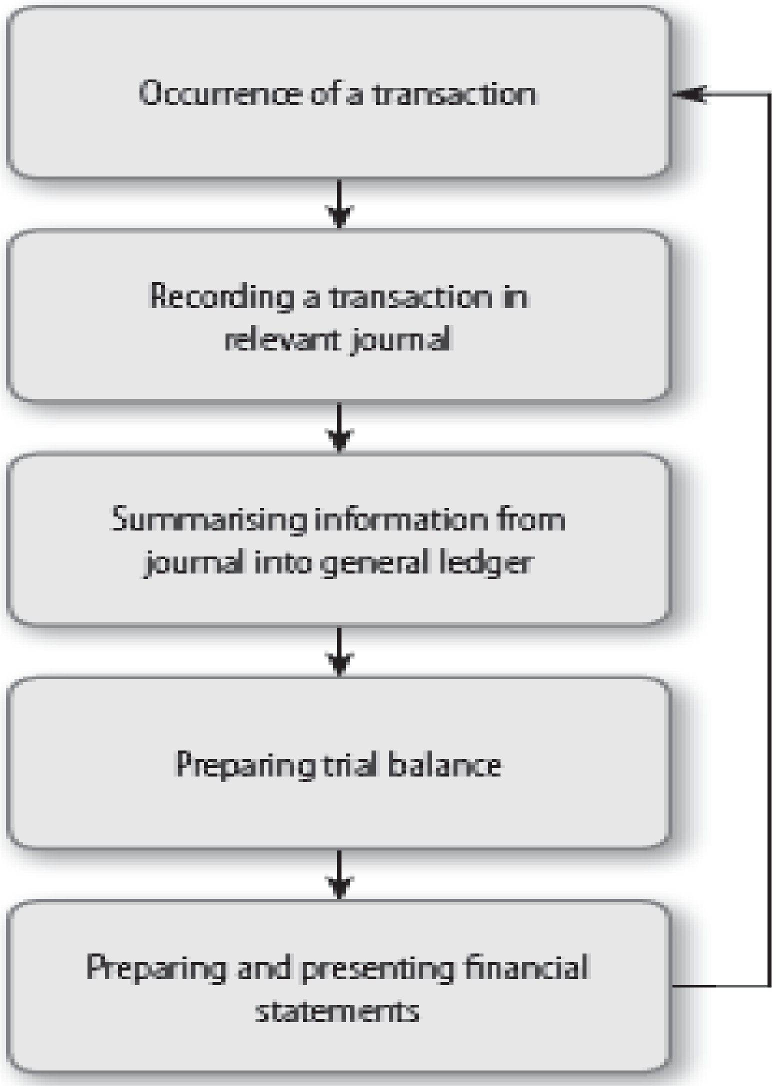
Accounting defined

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



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

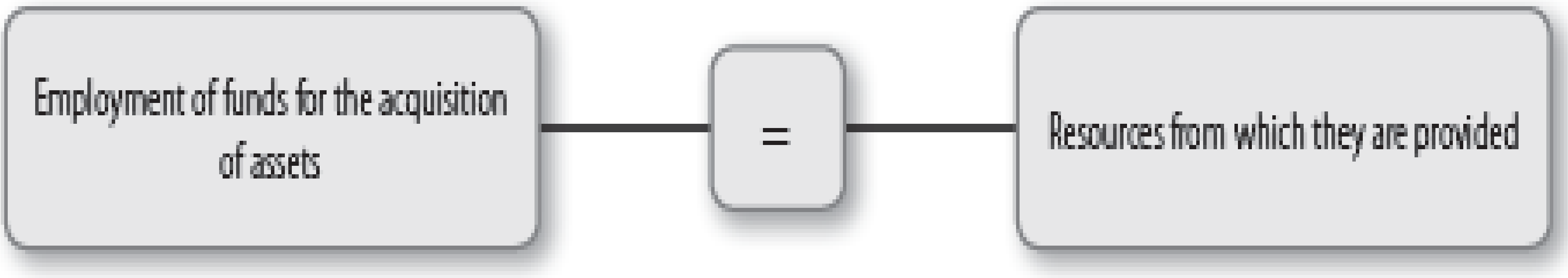
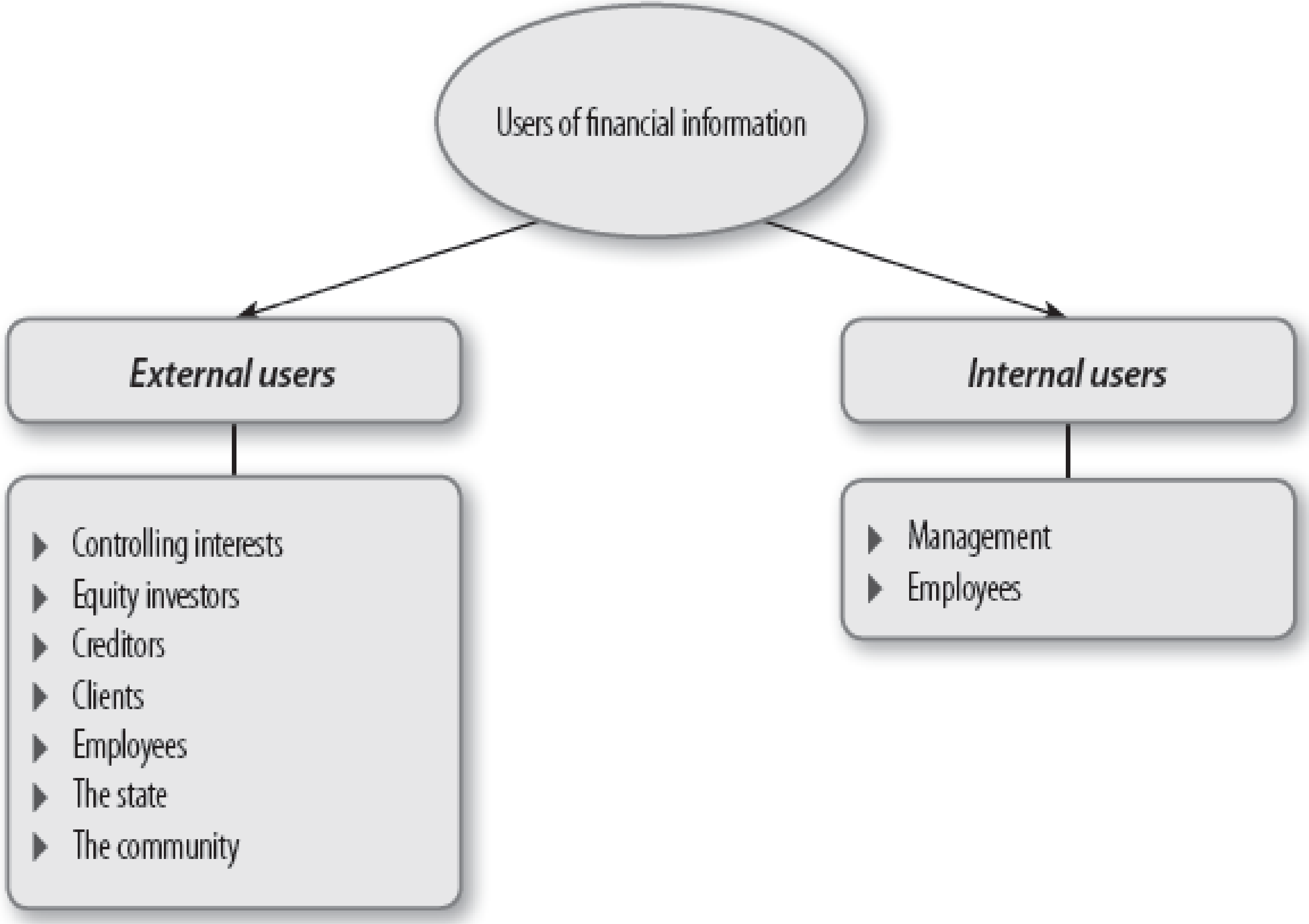


Figure 10.4 Users of financial information



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 ÷ Total assets

- Debt-equity ratio:

  Non-current liabilities ÷ Equity

- Times interest earned:

  Earnings before interest and taxes ÷ Interest

Profitability ratios

- Gross profit margin:

  [(Sales – Cost of sales) ÷Sales] x 100
- Operating profit margin:

  (Earnings before interest and taxes ÷ Sales) x 100
- Net profit margin:

  (Profit for the year ÷ Sales) x 100
- Return on investment:

  (Profit for the year ÷ Total assets) x 100

Profitability ratios (cont.)

- 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:
  - Aggressive financing strategy
  - Conservative financing strategy
  - Mid-way strategy
- Choice of strategy depends on:
  - Combination of non-current and current external capital
  - Combination of ordinary share capital plus reserves together with external non-current capital
  - 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