

# ORIENTATION TO FINANCIAL MANAGEMENT

Timeframe:	Minimum of 40 hours
Learning outcomes:	<ul style="list-style-type: none"><li>• Describe the core functions of financial management;</li><li>• Outline the framework for financial reporting; and</li><li>• Explain financial management terminology, concepts and principles.</li></ul>
Prescribed reading:	<ul style="list-style-type: none"><li>• <i>'Financial Management: Fresh Perspectives'</i>, Stoltz <i>et al</i>, 2007. Chapters 1, 2, 4 and 6.</li><li>• <i>'IAS 1 – Presentation of Financial Statements'</i>, [Video] IFRS.</li><li>• <i>'Time value of money'</i>, [Video] Ahmed, 2010.</li><li>• <i>'Cost-Benefit Analysis'</i>, [Video] O'Loughlin, 2010</li></ul>
Section overview	<p>In our opening section we look at a range of fundamental terminology, concepts and principles including: the relationship between investing, financing and operating; financial reporting; the time-value-of-money principle; the risk-return principle; and the cost-benefit principle.</p> <p>Please ensure you complete <b>all the prescribed reading including tasks</b> to ensure the successful completion of this module.</p>

## The Building Blocks of Financial Management

There are three major financial building blocks, with interdependent relationships, that underpin the effective financial management of an enterprise. These are **financing**, **operations** and **investment** building blocks. Each of these will be considered below and are illustrated in **Figure 1**.

**FIGURE 1: BUILDING BLOCKS OF FINANCIAL MANAGEMENT**



(Adapted from: Stoltz, Viljoen, Gool, & Cronjé, 2007:2)

### **Financing building block**

This is where funds are sourced for investment into the enterprise. These can be obtained from a number of sources:

- Enterprise's own capital;
- Shares issued (sold) to the public; and
- Borrowed funds raised through financial intermediaries (e.g. banks).

(Stoltz, Viljoen, Gool, & Cronjé, 2007:3-10)

**Liabilities** are the amounts of money that the enterprise owes to other people or entities, such as banks and suppliers.

### **Investment building block**

This is where we utilise the funds raised in the financing building block to purchase assets for the running of the business or for investments.

**Assets** are resources with an economic value that are controlled by the business and from which the business expects to derive future benefit.

These two pillars, the **financing** and the **investment building block**, make up the balance sheet of an enterprise (Stoltz *et al.*, 2007:3-10). The balance sheet is now known as the **Statement of Financial Position** and we will refer to it as such throughout this study guide

## Operations building block

The operations area includes the assets that are acquired with the funds raised and that are used to conduct business activities. This is where the revenue, expenses and profitability are managed in order to ensure that maximum profitability is achieved (leveraging the assets of the business effectively and efficiently). This activity is recorded in the income statement of the business (Stoltz *et al.*, 2007:3-10). The income statement is now known as the **Statement of Comprehensive Income** and again we will refer to it as such throughout this Study Guide.

## The role of the financial manager

Given the above, we can therefore say that the role of the financial manager is to make investment decisions, decide how best the funds should be raised and, from an operations perspective, ensure that the utilisation of resources is effective and efficient. He/she also ensures that the financing and investment decisions, together with the allocation of these resources, are **consistent with the strategic direction of the enterprise**.



- What long-term assets/investments should the organisation invest in (Assets)?
- How will the organisation pay for/finance these new assets/investments (Equity and Liabilities)?
- How will the organisation use the assets/investments to make a profit (Operations)?



### Using a bakery as an example:

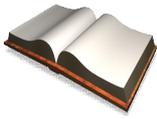
The first decision is of a strategic nature; for example the bakery may be expanding its market and to do this requires a new oven. The second decision relates to how the bakery will finance this new asset; for example the owner could use his/her own savings (owner's equity), he/she could borrow the money (debt financing), or he/she could get other people to invest in the bakery (make them co-owners/ shareholders). The last question relates to how day-to-day operations will be managed in the most effective, efficient, and economical way to ensure the new asset achieves the strategic aim (maximises owner/shareholder wealth).

## Framework for Financial Reporting

### From SA GAAP to IFRS (or IFRS for SMEs)

The new Companies Act, 2008 (refer to **Appendix 1** for key points) has brought about changes to the standard setting process, which means the continued existence of South African Statements of Generally Accepted Accounting Practice (SA GAAP) is being re-evaluated (refer to **Appendix 2** regarding SA GAAP announcement).

The following should be noted (SAICA, 2013a):



1. "SA GAAP will be withdrawn and will cease to apply in respect of financial years commencing on or after 1 December 2012;
2. Companies with a public interest score below 350 and other entities that are currently applying SA GAAP need to prepare for conversion to IFRS or IFRS for SMEs;
3. The commencement of APB's voluntary winding-up; and
4. Close co-operation between the APB and the FRSC to ensure a smooth handover of the standard setting function and related matters from the APB to the FRSC, before the winding-up process of APB is completed." (SAICA, 2013b).

**IFRS** refers to the **International Financial Reporting Standards**

**APB** refers to the **Accounting Practices Board**

**FRSC** refers to the **Financial Reporting Standards Committee**

The primary purpose of **International Financial Reporting Standards (IFRS)** is to create a common accounting framework in order to facilitate international standards and comparability.

The **International Accounting Standards Board (IASB)** has the responsibility for setting and developing IFRS standards.



By adopting IFRS, a business can present its financial statements on the same basis as its foreign competitors, making comparisons easier. Furthermore, companies with subsidiaries in countries that require or permit IFRS may be able to use one accounting language company-wide. Companies also may need to convert to IFRS if they are a subsidiary of a foreign company that must use IFRS, or if they have a foreign investor that must use IFRS. Companies may also benefit by using IFRS if they wish to raise capital abroad.

You are probably familiar with financial terms such as 'balance sheet' and 'income statement'. However, with the changes proposed by IFRS, these terms have now been replaced as given below. You will also notice, as you progress through the Study Guide, that the formats including some of the line items have also changed.

The required financial statements include (CFA Institute, 2012a:127-128):

1. A **Statement of Financial Position** (formerly known as the balance sheet);
2. A **Statement of Comprehensive Income** (a single statement of comprehensive income or two statements – an income statement and a statement of comprehensive income that begins with the profit or loss from the income statement);
3. A **Statement of Changes in Equity** (separately showing changes in equity resulting from profit or loss, each item of other comprehensive income, and transactions with owners in their capacity as owners);
4. A **Statement of Cash Flows** (showing cash flows from operating, investing and financing activities); and
5. **Notes** (comprising a summary of significant accounting policies and explanatory notes that provide information relevant to the understanding of the financial statements).



## Task Questions

Public companies provide their financial statements on their websites. Access the annual reports of two or more listed companies and locate the above required statements. Note how, together, the financial statements paint a comprehensive picture of the company's position and performance.

The primary international accounting standard that provides the guideline for presentation of financial statements is **International Accounting Standard 1: Presentation of Financial Statements** or **IAS No. 1** as adopted by the IASB.

## Accounting Principles and Reporting Standards

Accounting is governed by certain rules and concepts. These rules are referred to as accounting principles and form the basis for recording and reporting financial results for an enterprise. These principles are outlined in the table below (CFA, 2012a).

**TABLE 1: ACCOUNTING PRINCIPLES AND MEASUREMENT**

Principle	Explanation
Accrual accounting	This principle assumes that financial statements reflect transactions in the period when they actually occur, not necessarily when cash movements occur. This means that a company must report revenues when they are earned (when the performance obligations have been satisfied), regardless of whether the company received cash before delivering the product or service, after delivering the product, or at the time of delivery.
Going concern	This refers to the assumption that the company will continue in business for the foreseeable future (i.e. without the intention or threat of liquidation for the foreseeable future).
Materiality	Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.
Measurement	Explanation
Historical cost	This is the amount of cash (or cash equivalents) paid to purchase an asset (including any costs of acquisition and/or preparation).
Amortised cost	This is the historical cost adjusted for amortisation, depreciation, or depletion and/or impairment.
Current cost	This is the amount of cash (or cash equivalents) that would have to be paid to buy the same or an equivalent asset today.
Realisable (settlement) value	This is the amount of cash (or cash equivalents) that would currently be obtained by selling the asset in an orderly disposal.
Fair value	This is the amount at which an asset could be exchanged, or liability settled, between knowledgeable, willing parties in an arm's length transaction (an arm's length transaction is where none of the parties are related to each other or have any common interests).

(Adapted from: CFA Institute, 2012a:125-128; Accounting Simplified, 2013a)



## Task Questions

Consider the following example on materiality and then reflect on the question that follows (Adapted from Accounting Simplified, 2013a).

**Example 1:** A default by a customer who owes only \$5 000 to a company having net assets worth \$20 million is immaterial to the financial statements of the company. However, if the amount of the default was say \$8 million the information would have been material to the financial statements omission of which could cause users to make incorrect business decisions.

**Example 2:** A company is planning to decrease its operations in a geographic segment, which has traditionally been a major source of revenue for the company in the past. This information should be disclosed in the financial statements.

1. In the first example, explain why \$5 000 is considered immaterial and \$8 million material.
2. In the second example, explain why this information is material.

Whilst we have focussed on 'materiality' in this task, ensure you know the meaning and application of the terms given in **Table 1** above and that you can support your explanations with examples (refer to the **Glossary of Terms** at the end of this study guide for definitions).