



WELCOME TO PERITUM

Generic Management National Certificate

Finance and Risk Management CIN: 11500



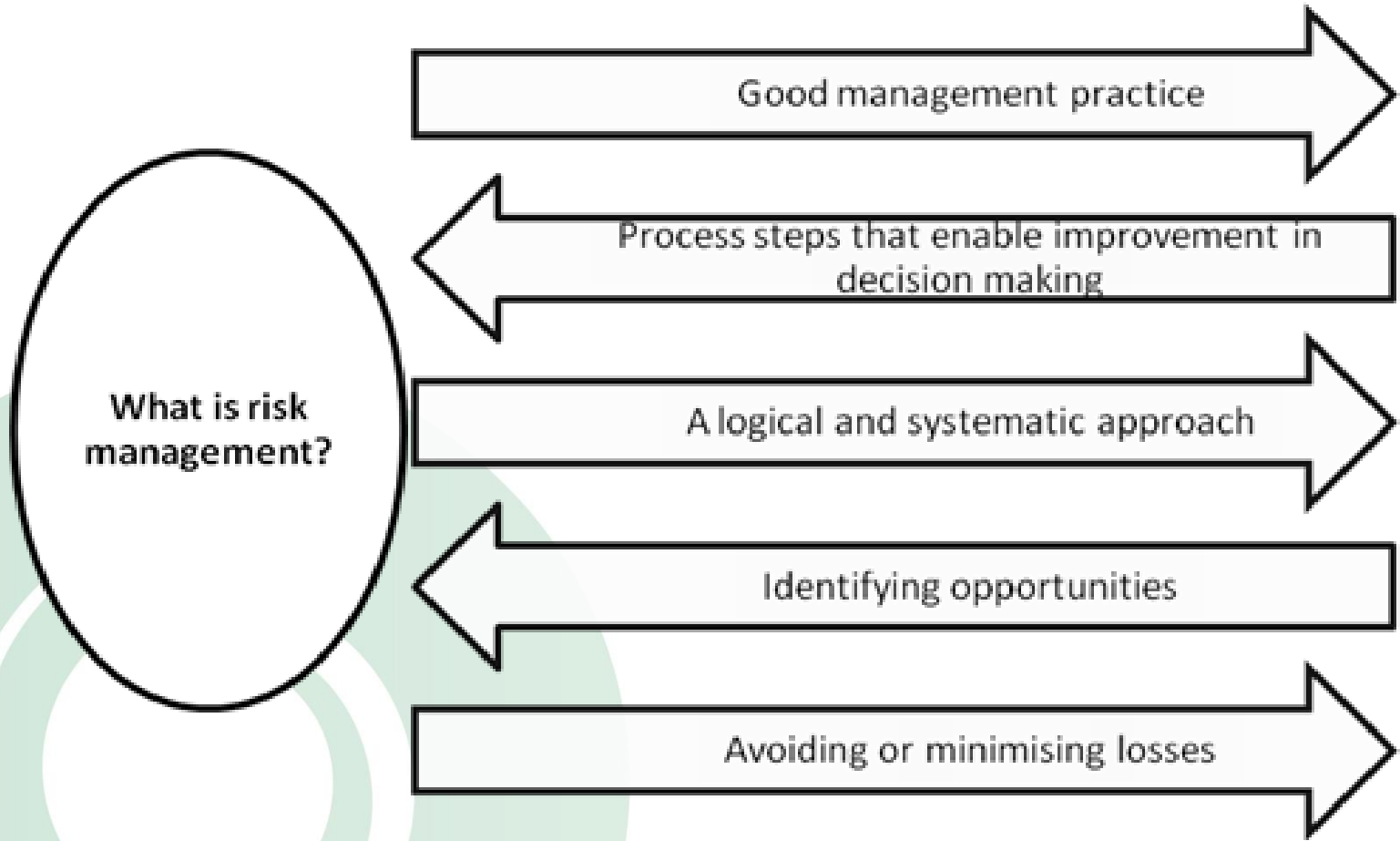
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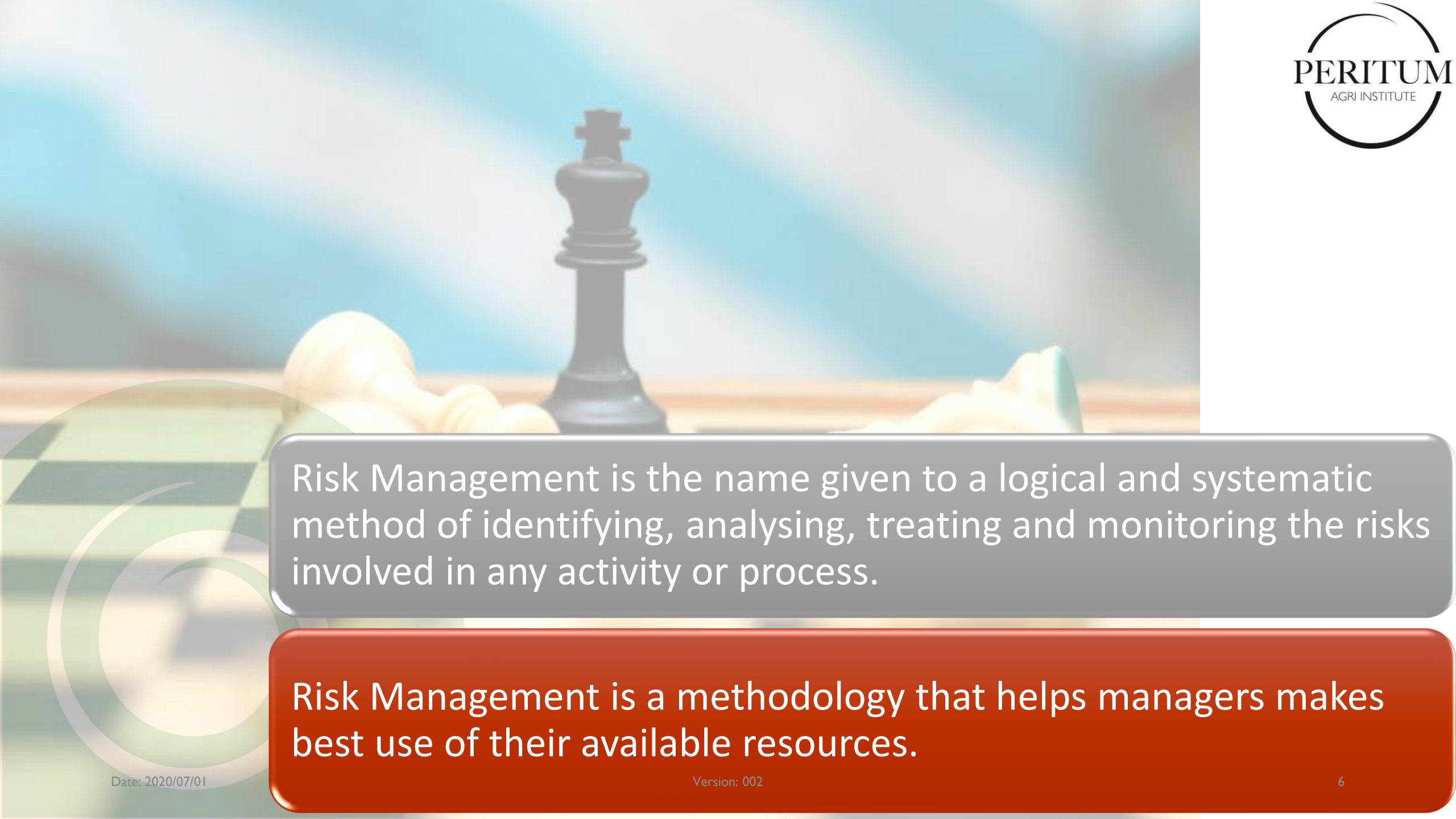
Risk Management

Unit standard ID:	Unit standard title:
252025	Monitor, assess and manage risk



Introduction To The Concept Of Risk Management



A background image showing a chessboard with several pieces, including a prominent black king in the center. The board is partially obscured by a large, semi-transparent green circular graphic on the left side.

Risk Management is the name given to a logical and systematic method of identifying, analysing, treating and monitoring the risks involved in any activity or process.

Risk Management is a methodology that helps managers makes best use of their available resources.

Risk Management practices are widely used in public and the private sectors.

These include

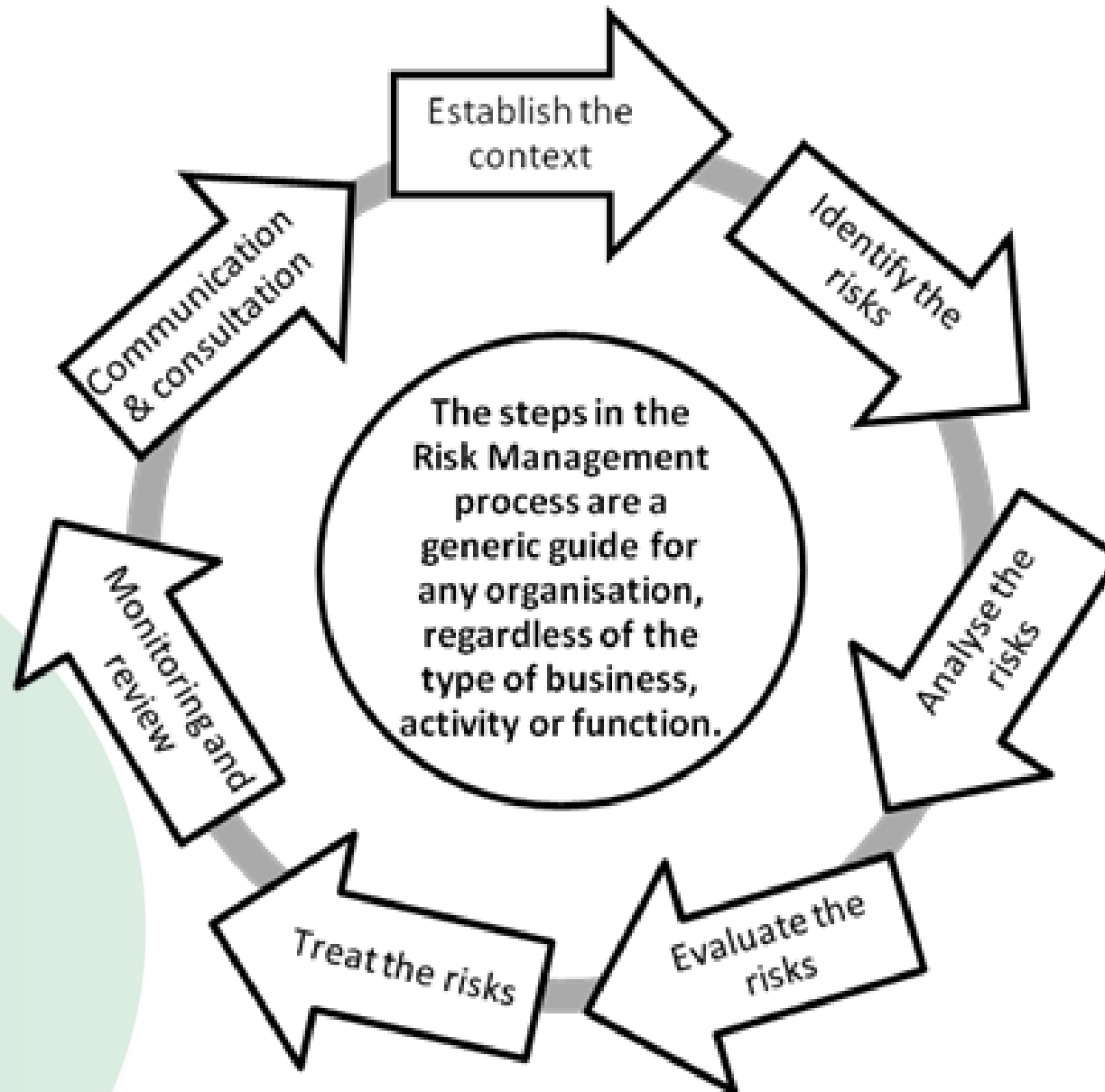
Finance and Investment

Insurance

Health Care

Public Institutions

Governments



A semi-transparent version of the Peritum Agri Institute logo is overlaid on a background of vibrant green clover leaves. The logo consists of the word "PERITUM" in a large, serif font above "AGRI INSTITUTE" in a smaller, sans-serif font, all enclosed within a circular border.

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Learning Unit 1

The Risks to a Specific Unit



Risk

Is a hazard: a source of danger; a possibility of incurring loss or misfortune

Risk Management

Risk is defined in ISO 31000 as the effect of uncertainty on objectives. Risk management can therefore be considered the identification, assessment, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events or to maximize the realization of opportunities.

WHAT IS “RISK”?

The main categories of risk for a business to consider are:

strategic,
for example a new competitor entering the market

compliance,
for example responding to the introduction of new health and safety legislation

financial,
for example non-payment by a customer or increased interest charges on a business loan

operational,
for example the breakdown or theft of key equipment



Other risks include:

environmental risks,
including natural
disasters

employee risk
management, such
as maintaining
sufficient staff
numbers and cover,
employee safety and
up-to-date skills

political and
economic instability
in any foreign
markets you export
goods to

health and safety
risks

What contributes to risks in a work unit?

Risks associated with projects can be classified into following 12 categories:

1. Operational Risk

2. Schedule Risk

3. Budget Risk

4. Business Risk

5. Technical Environment Risk

6. Information Security Risk

7. Programmatic Risks

8. Infrastructure Risk

9. Quality and Process Risk

10. Resource Risk

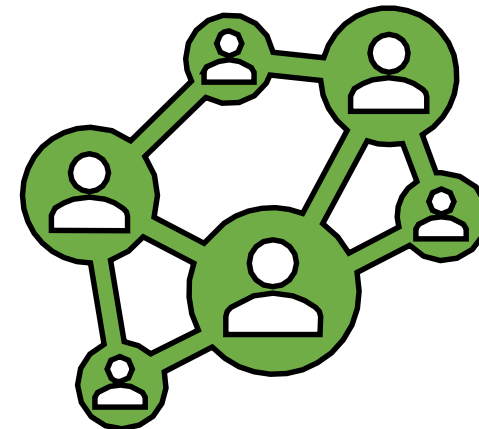
11. Supplier Risk

12. Technology Risk

Occupational health, safety and environmental risks

Occupational health and safety is a cross-disciplinary area concerned with protecting the safety, health and welfare of people engaged in work or employment. The goal of all occupational health and safety programs is to foster a safe work environment.

As a secondary effect, it may also protect co-workers, family members, employers, customers, suppliers, nearby communities, and other members of the public who are impacted by the workplace environment.



The reasons for establishing good occupational health and safety standards are frequently identified as:

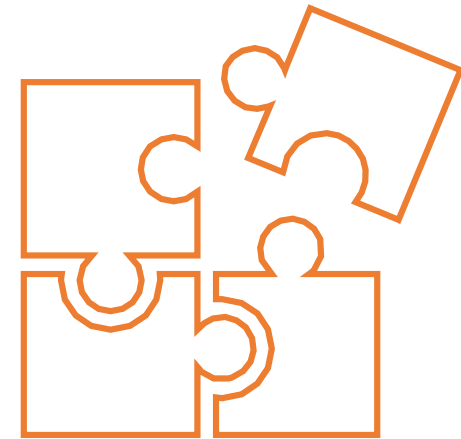
- Moral
- Economic
- Legal

Generally speaking:

- A hazard is something that can cause harm if not controlled.
- The outcome is the harm that results from an uncontrolled hazard.
- A risk is a combination of the probability that a particular outcome will occur and the severity of the harm involved.

Hazard analysis or hazard assessment is a process in which individual hazards of the workplace are identified, assessed and controlled/eliminated as close to source as reasonable and possible. As technology, resources, social expectation or regulatory requirements change, hazard analysis focuses controls more closely toward the source of the hazard.

Thus hazard control is a dynamic program of prevention. Hazard-based programs also have the advantage of not assigning or implying there are "acceptable risks" in the workplace. A hazard-based program may not be able to eliminate all risks, but neither does it accept "satisfactory" -- but still risky—outcomes.



Modern occupational safety and health legislation usually demands that a risk assessment be carried out prior to making an intervention. It should be kept in mind that risk management requires risk to be managed to a level which is as low as is reasonably practical.

This assessment should:

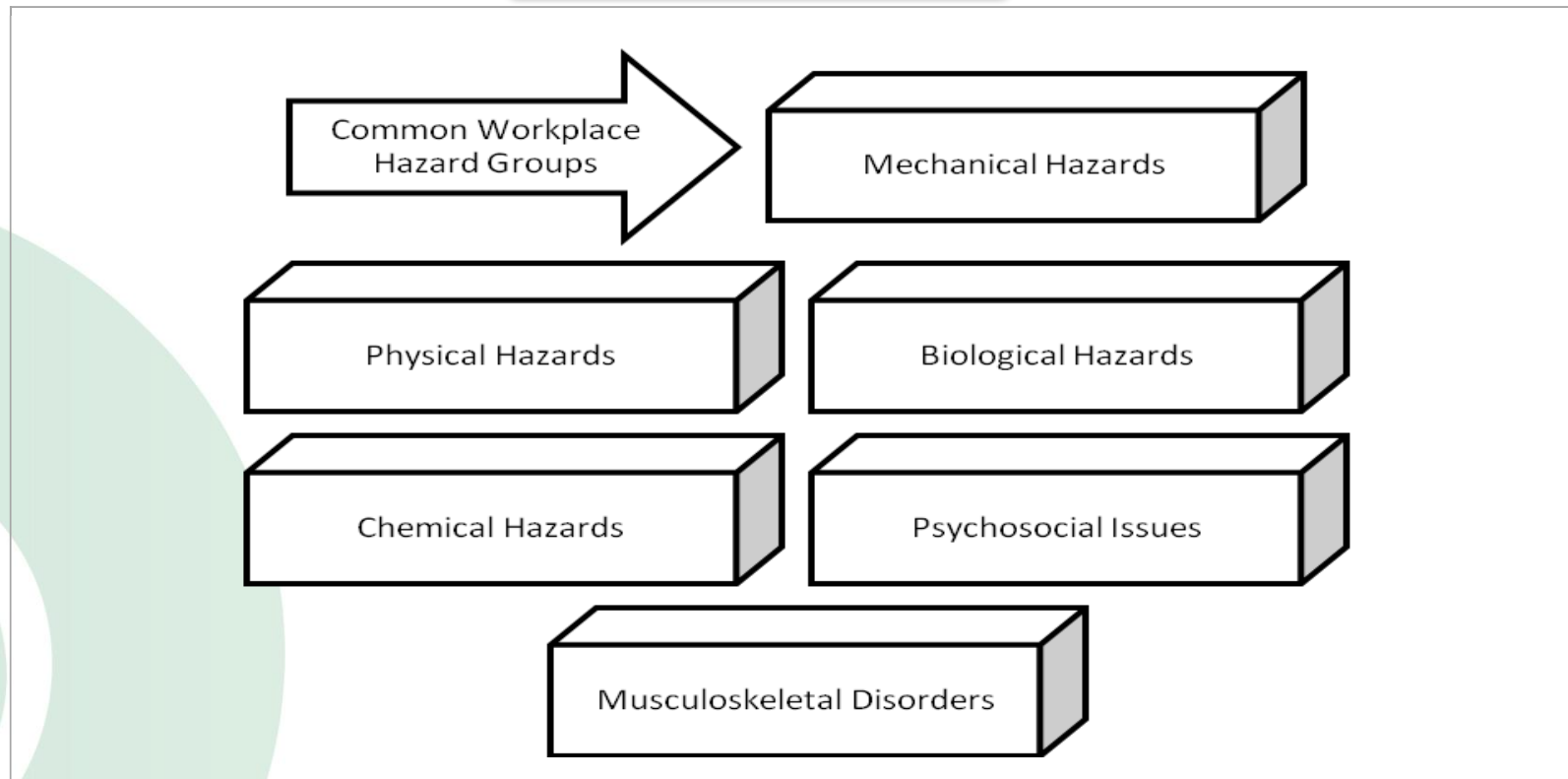
Identify the hazards

Identify who is affected by the hazard and how

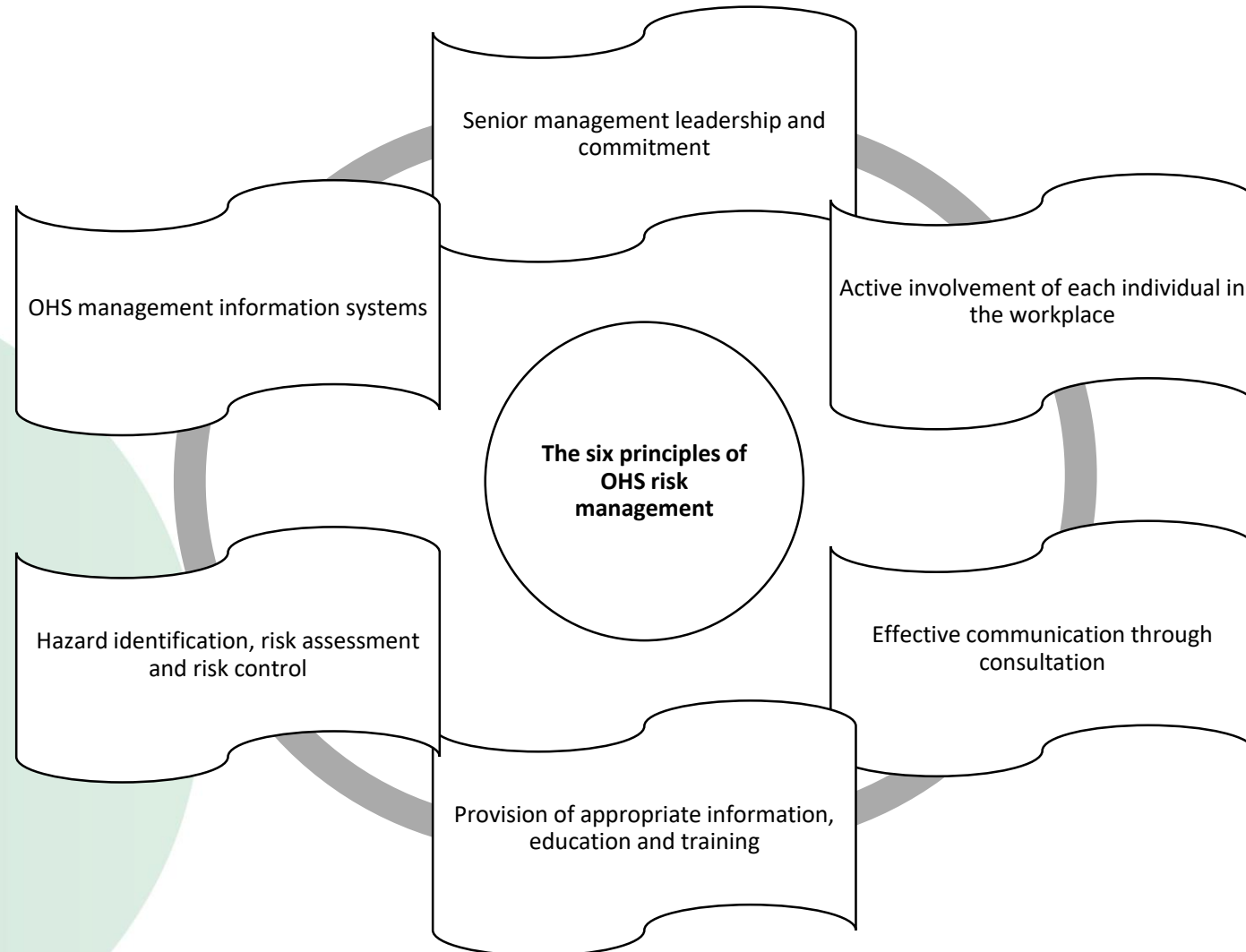
Evaluate the risk

Identify and prioritise appropriate control measures

Information



How acts such as the Occupational Health and Safety (OHS) Act link with risk management



Financial risks

Financial risk is normally any risk associated with any form of financing. Risk is probability of unfavourable conditions. In financial sector it is the probability of actual return being less than expected return. There will be uncertainty in every business; the level of uncertainty present is called risk.



Investment related

Depending on the nature of the investment, the type of 'investment' risk will vary. High risk investments have greater potential rewards, but also have greater potential consequences.

A common concern with any investment is that the initial amount invested may be lost (also known as "capital"). This risk is therefore often referred to as capital risk. If the invested assets are being held in another currency, there is a risk that currency movements alone may affect the value. This is referred to as currency risk.

Many forms of investment may not be readily saleable on the open market or the market has a small capacity and may therefore take time to sell.

Business related

The risk that a company or project will not have adequate cash flow to meet financial obligations; thus causing the business to file for liquidation.

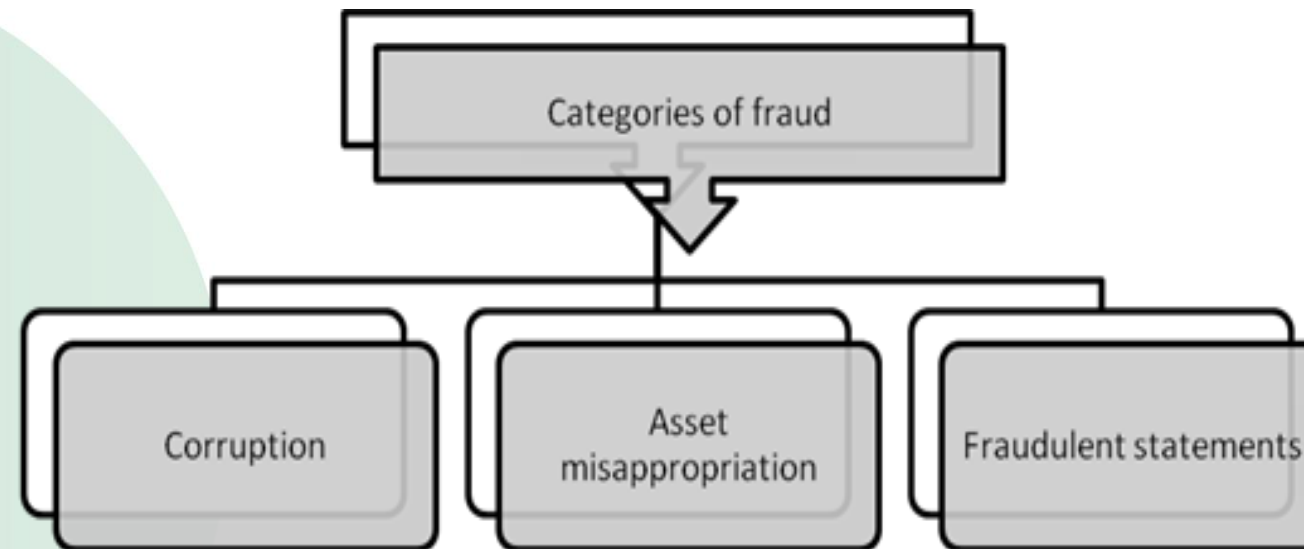
Financial risk is the additional risk a shareholder bears when a company uses debt in addition to equity financing. Companies that issue more debt instruments would have higher financial risk than companies financed mostly or entirely by equity.

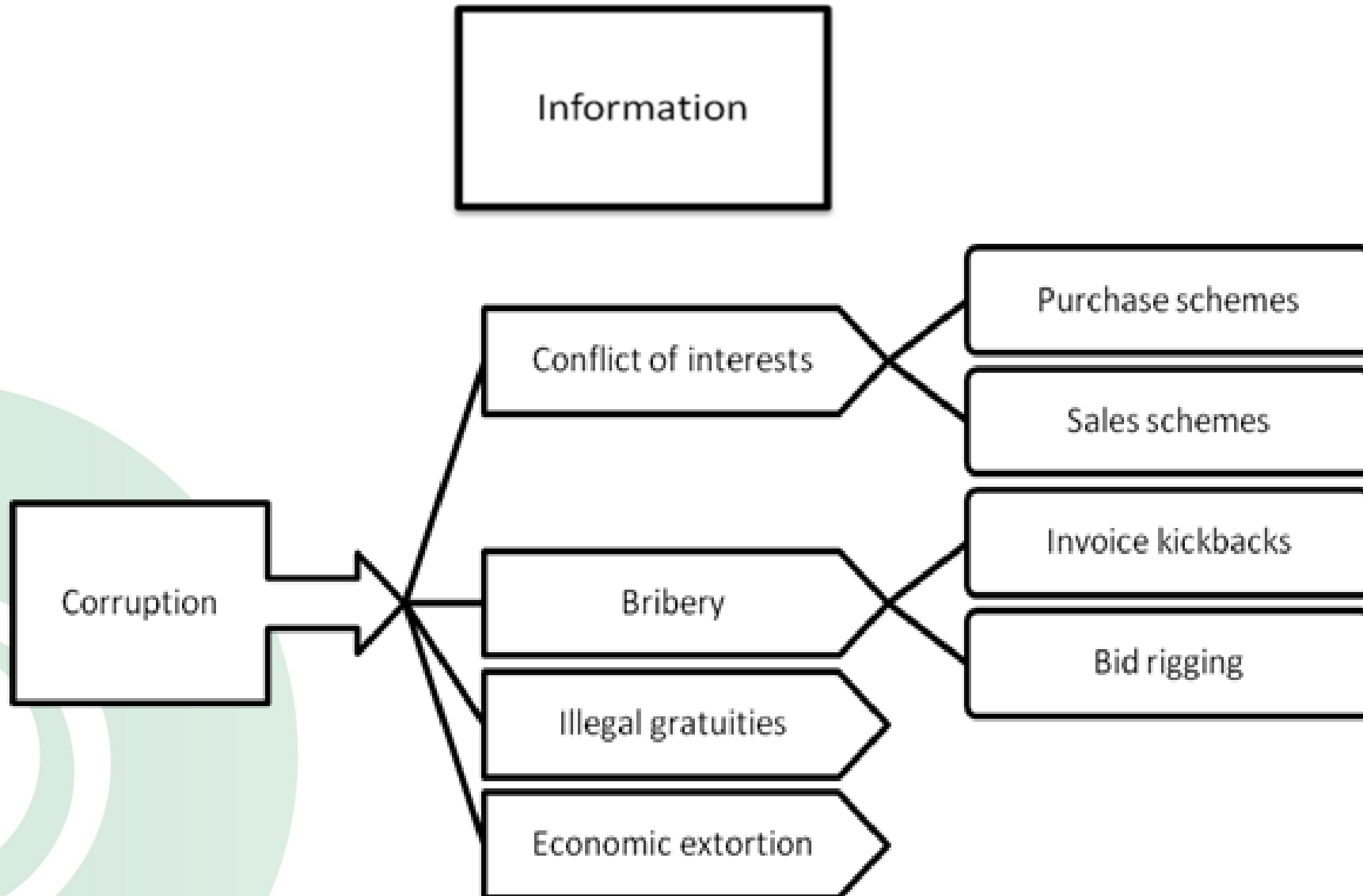
Whilst higher risk normally implies higher overall rewards, this is not always the case.



Fraud

Fraud is the unlawful, intentional making of misrepresentation which causes actual prejudice to another or holds potential prejudice to another.



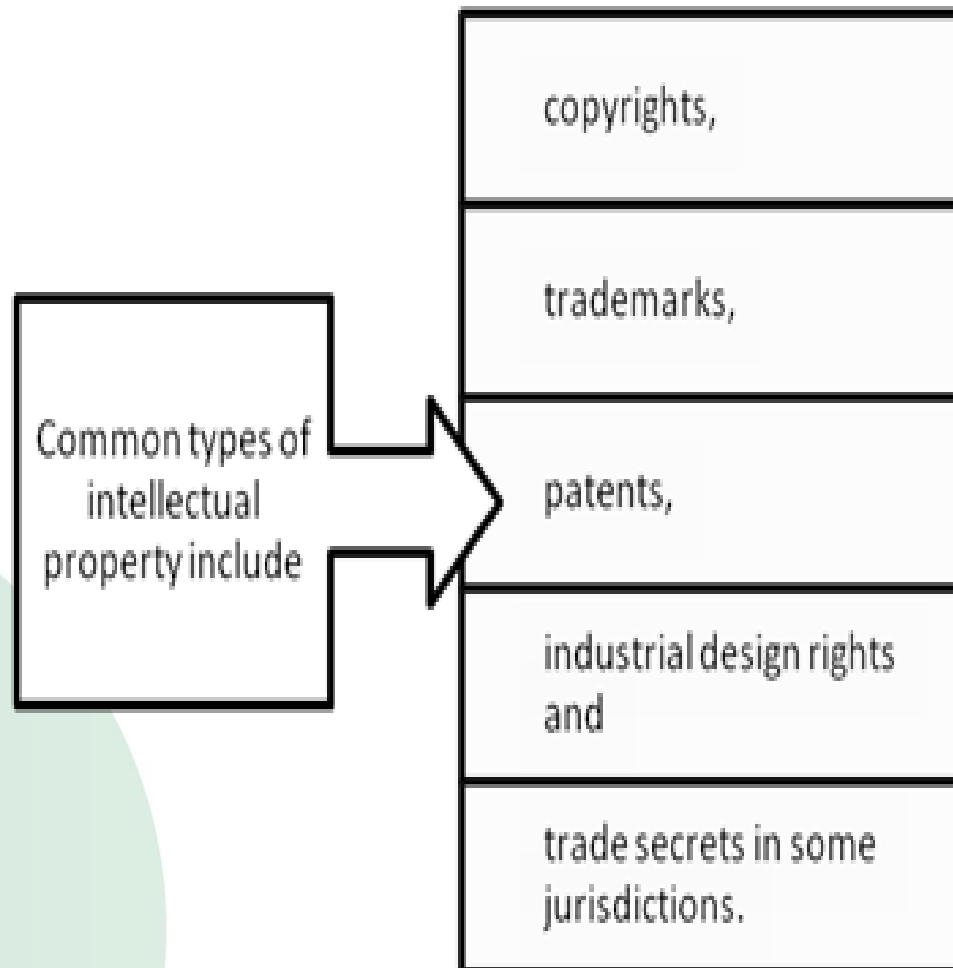




Theft of intellectual property

Intellectual property (IP) is a term referring to a number of distinct types of creations of the mind for which property rights are recognised--and the corresponding fields of law.

Under intellectual property law, owners are granted certain exclusive rights to a variety of intangible assets, such as musical, literary, and artistic works; discoveries and inventions; and words, phrases, symbols, and designs.



Intellectual property rights are the recognition of a property in an individual creation. The establishment of intellectual property rights represents a trade-off, to balance the interest of society in the creation of goods (by encouraging their production) with the problems of monopoly power.

Since the trade-off and the relevant benefits and costs to society will depend on many factors that may be specific to each product and society, the optimum period of time during which the temporary monopoly rights should exist is unclear.

A scroll-shaped graphic with the word "Organisation" written inside in a simple, sans-serif font.

Security reports within an organisation are important. Consider appointing a chief security officer, who reports to either the chief executive office or the chief financial officer. This person should hold the reins of personnel security, physical security and information security, and should not be a stranger to the board room.

A scroll-shaped graphic with the words "Awareness and Education" written inside in a simple, sans-serif font.

Educate your workforce on an ongoing basis about the threats of economic espionage, intellectual property theft, counterfeiting and piracy. Help them understand your expectation that they will protect the enterprise's intellectual property and, by extension, their own livelihood. Provide general education for the entire workforce, and specialized education for executives, managers, technical personnel, etc.

A scroll-shaped graphic with a black outline and a white background, containing the text "Personnel Security".

Personnel Security

Implement a “Personnel Security” program that includes both background investigations and termination procedures. You need policies that establish checks and balances, and you need to enforce them. Know the people you are going to hire. Don’t lose touch with them while they work for you. Consciously manage the termination process if and when they leave the enterprise.

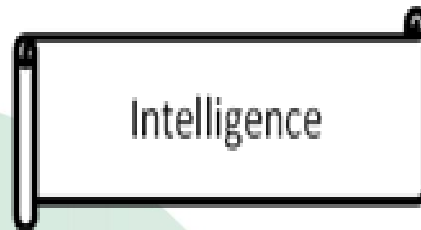
A scroll-shaped graphic with a black outline and a white background, containing the text "Information Security".

Information Security

Recruit certified information security professionals. Adopt best practices, and establish a baseline. Utilize appropriate information security technologies, such as firewalls, intrusion detection, encryption, strong authentication devices, etc. Pay attention to data retention and data destruction as well as data access.

A rectangular icon with a black border and a white background, containing the text "Physical Security". The icon has a small tab-like detail on the left side.

It is pointless to invest in information security, or commit to background investigations, if agents of an unscrupulous competitor or a foreign government can simply walk away with what they covet.

A rectangular icon with a black border and a white background, containing the text "Intelligence". The icon has a small tab-like detail on the left side.

You need both business and security intelligence. Know your competition, your partners and your customers. Research the market environment. Keep abreast of the latest trends in hacking, organized crime, financial fraud and state-sponsored economic espionage. You can outsource this expertise. But someone must be looking at both streams of intelligence, with the particulars of your enterprise in mind.

A scroll-shaped graphic with the text "Industry Outreach" written inside it.

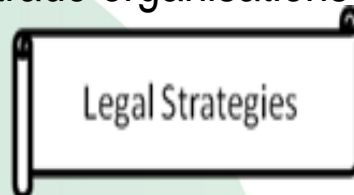
Industry Outreach

Actively participate in industry working groups appropriate to your sector and environment. Talk with your peers about the types of attacks or threats they are encountering.

A scroll-shaped graphic with the text "Government Liaison" written inside it.

Government Liaison

Use threat information from law enforcement, foreign ministries, elected officials, regulatory and trade organisations in South Africa, and in other countries where you conduct business.

A scroll-shaped graphic with the text "Legal Strategies" written inside it.

Legal Strategies

Realise that even when right is on your side, a market may be lost to you, and protecting a portion of the market is sometimes a viable survival strategy. Litigation is not the solution; it is confirmation that intellectual property theft has occurred. Work to protect your intellectual property and avoid the costs associated with litigation. Don't let a small legal mind make decisions about big legal issues. Get expert legal advice on intellectual property issues.

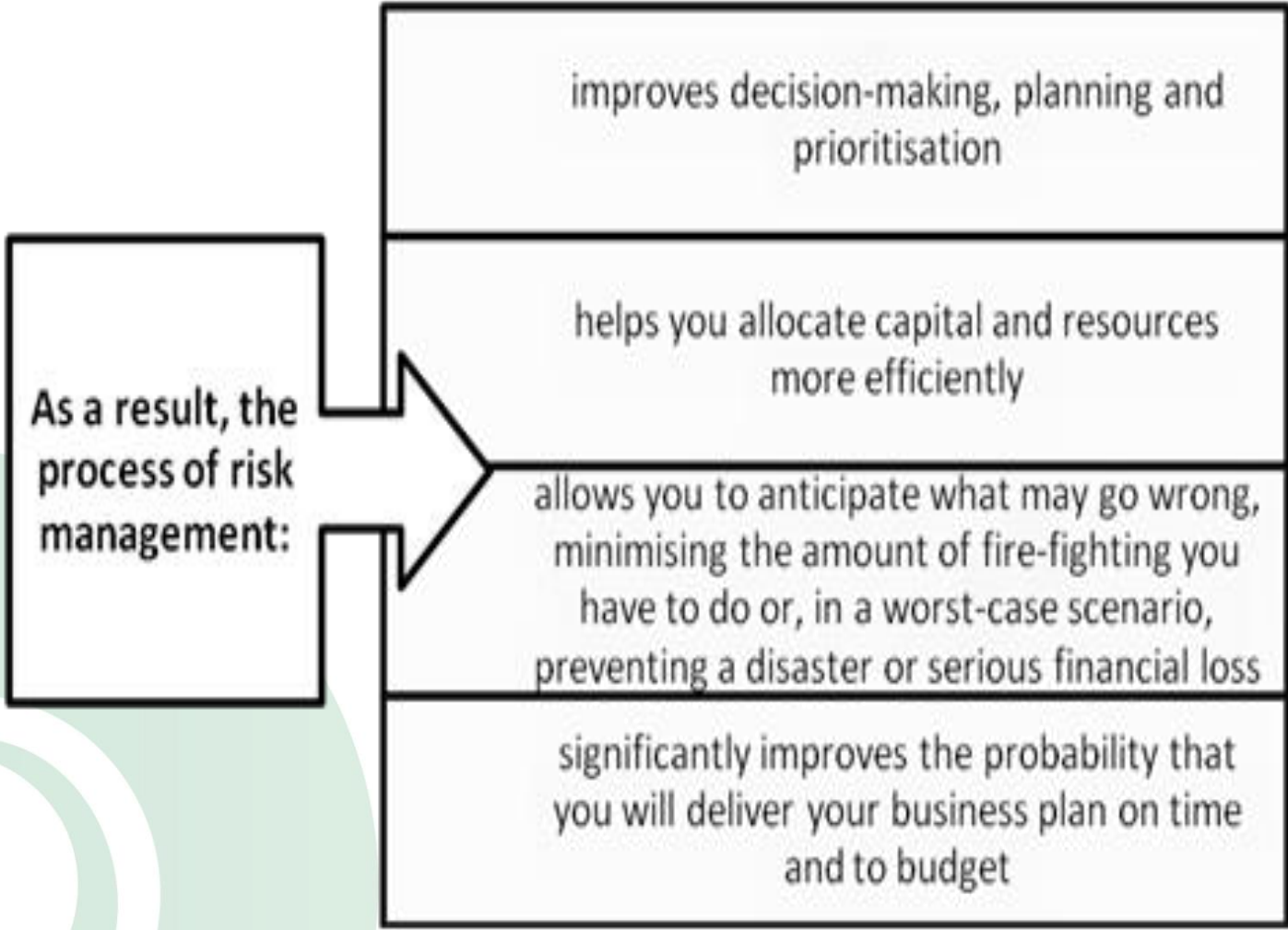
WHAT IS “RISK MANAGEMENT”?

Businesses face many risks; therefore risk management should be a central part of any business' strategic management.

Risk management helps you to identify and address the risks facing your business and in doing so increase the likelihood of successfully achieving your businesses objectives.







Risk management becomes even more important if your business decides to try something new, for example launch a new product or enter new markets. Competitors following you into these markets, or breakthroughs in technology which make your product redundant, are two risks you may want to consider in cases such as these.

Strategic risks are those risks associated with operating in a particular industry. They include risks arising from:

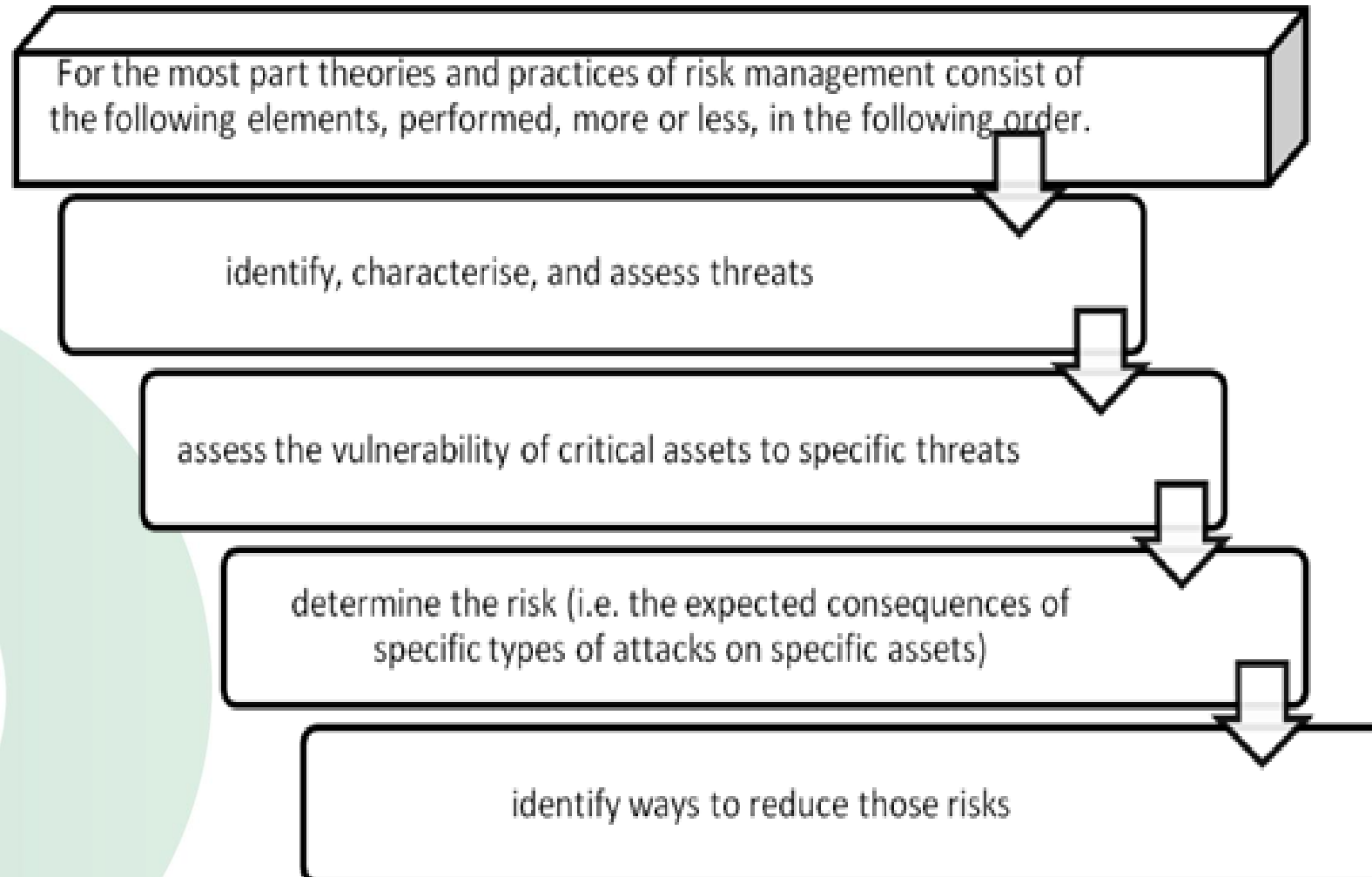
- merger and acquisition activity
- changes among customers or in demand
- industry changes
- research and development

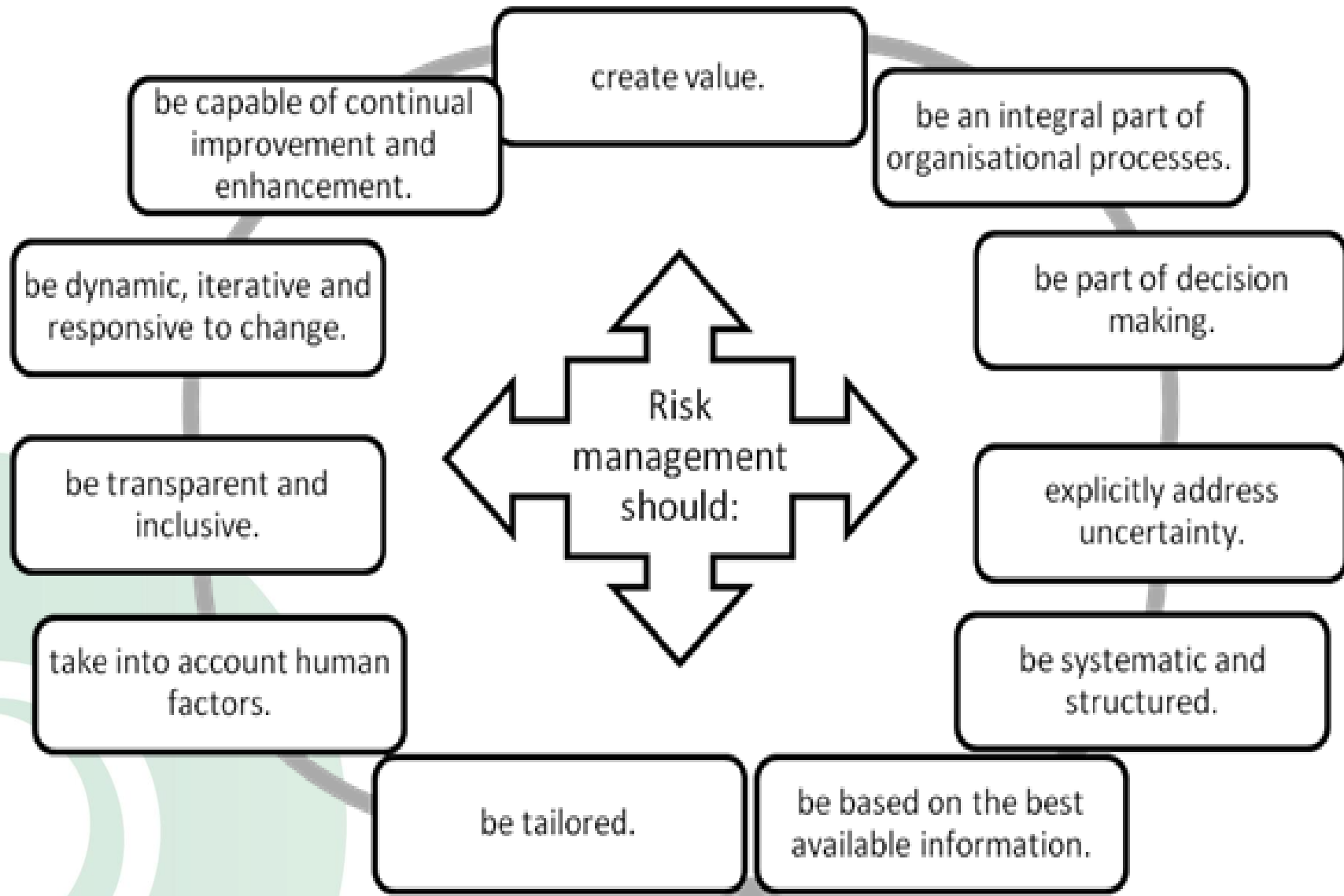
Financial risks are associated with the financial structure of your business, the transactions your business makes and the financial systems you already have in place.

Identifying financial risk involves examining your daily financial operations, especially cash flow. If your business is too dependent on a single customer and they are unable to pay you, this could have serious implications for your business' viability.



PRACTICES OF RISK MANAGEMENT





Step 1: Identify Risk

The first stage of a risk analysis is to identify threats facing you.

Threats may be:

Human

Operational

Reputational

Procedural

Project

Financial

Technical

Natural

Political

Step 2: Estimate Risk

Once you have identified the threats you face, the next step is to work out the likelihood of the threat being realised and to assess its impact.



Step 3: Determine Ways to Reduce the Risk

By using
existing
assets:

- Here existing resources can be used to counter risk. This may involve improvements to existing methods and systems, changes in responsibilities, improvements to accountability and internal controls, etc.

By
contingency
planning:

- You may decide to accept a risk, but choose to develop a plan to minimize its effects if it happens. A good contingency plan will allow you to take action immediately, with the minimum of project control if you find yourself in a crisis management situation. Contingency plans also form a key part of Business Continuity Planning (BCP) or Business Continuity Management (BCM).

By investing
in new
resources:

- Your risk analysis should give you the basis for deciding whether to bring in additional resources to counter the risk. This can also include insuring the risk: Here you pay someone else to carry part of the risk - this is particularly important where the risk is so great as to threaten your or your organisation's solvency.

Step 4: Review

Once you have carried out a risk analysis and management exercise, it may be worth carrying out regular reviews. These might involve formal reviews of the risk analysis or may involve testing systems and plans appropriately.

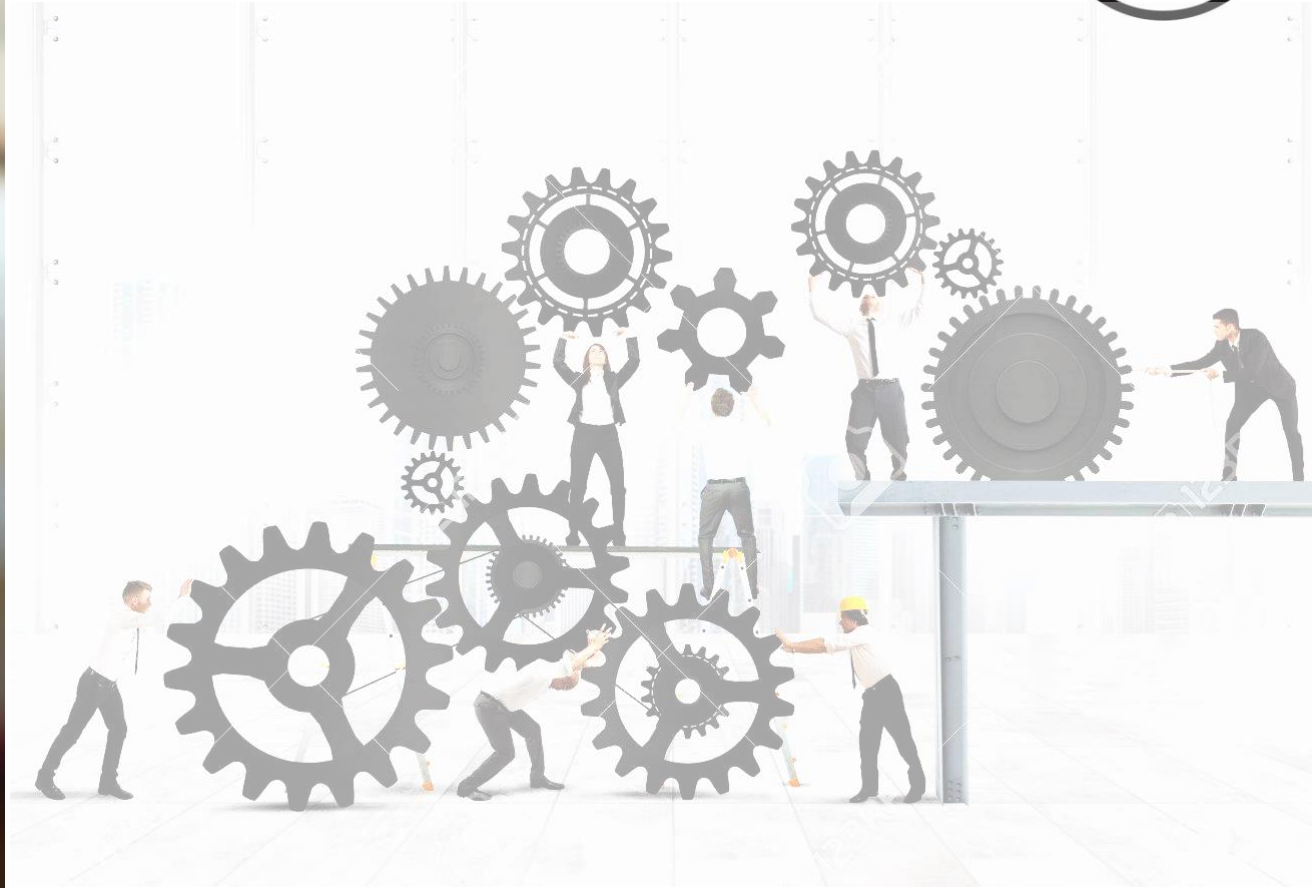


Individual Formative Exercise I A: Brainstorm activity



Learning Unit 2

Identify Potential risk and the impact it may have

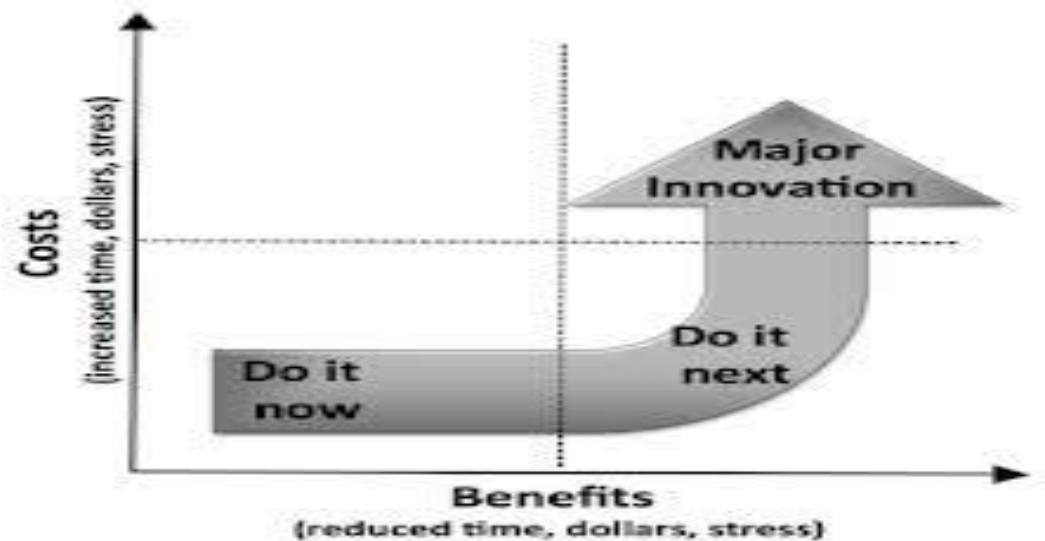


IDENTIFYING AND DOCUMENTING POTENTIAL RISK FACTORS FOR CRITICAL PROCESSES

Risk evaluation allows you to determine the significance of risks to the business and decide to accept the specific risk or take action to prevent or minimise it.

To evaluate risks, it is worthwhile ranking these risks once you have identified them. This can be done by considering the consequence and probability of each risk. Many businesses find that assessing consequence and probability as high, medium or low is adequate for their needs. These can then be compared with your business plan - to determine which risks may affect your objectives - and evaluated in the light of legal requirements, costs and investor concerns.

Prioritising risks, however if you do this, allows you to direct time and money toward the most important risks. You can put systems and controls in place to deal with the consequences of an event. This could involve defining a decision process and escalation procedures that your company would follow if an event occurred.



Risk management involves putting processes, methods and tools in place to deal with the consequences of events you have identified as significant threats for your business. This could be something as simple as setting aside financial reserves to ease cash flow problems if they arise or ensuring effective computer backup and IT support procedures for dealing with a systems failure.



Risk assessments will change as your business grows or as a result of internal or external changes. This means that the processes you have put in place to manage your business risks should be regularly reviewed. Such reviews will identify improvements to the processes and equally they can indicate when a process is no longer necessary.

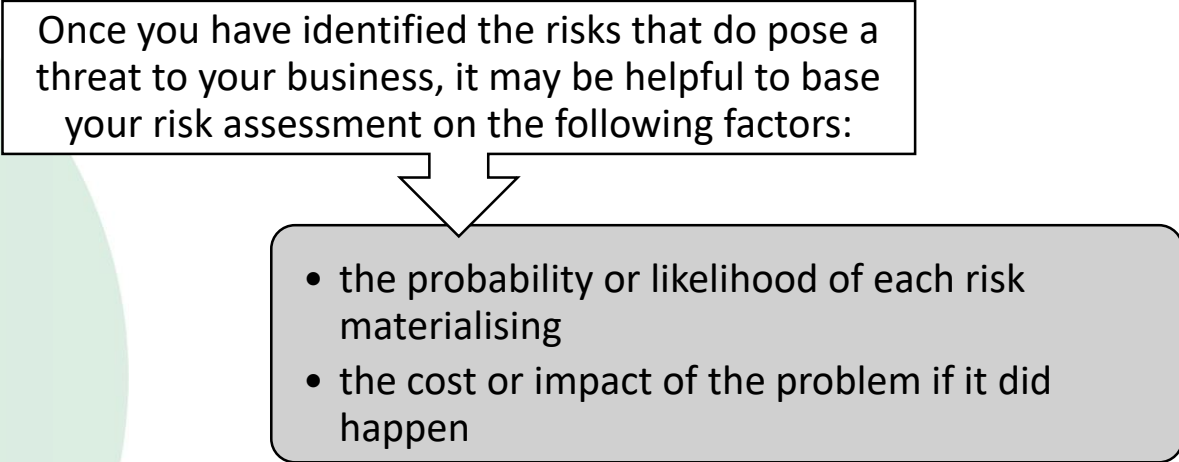


Analysing how likely it is that a “risk scenario” will occur

- Risk analysis is the systematic study of uncertainties and risks we encounter in business, engineering, public policy, and many other areas.
- Risk analysts seek to identify the risks faced by an institution or business unit, understand how and when they arise, and estimate the impact (financial or otherwise) of adverse outcomes.
- Risk managers start with risk analysis, and then seek to take actions that will mitigate or hedge these risks.

Impact assessment

The process of identifying the future consequences of a current or proposed action. It is used to ensure that projects, programmes and policies are economically viable, socially equitable and environmentally sustainable.

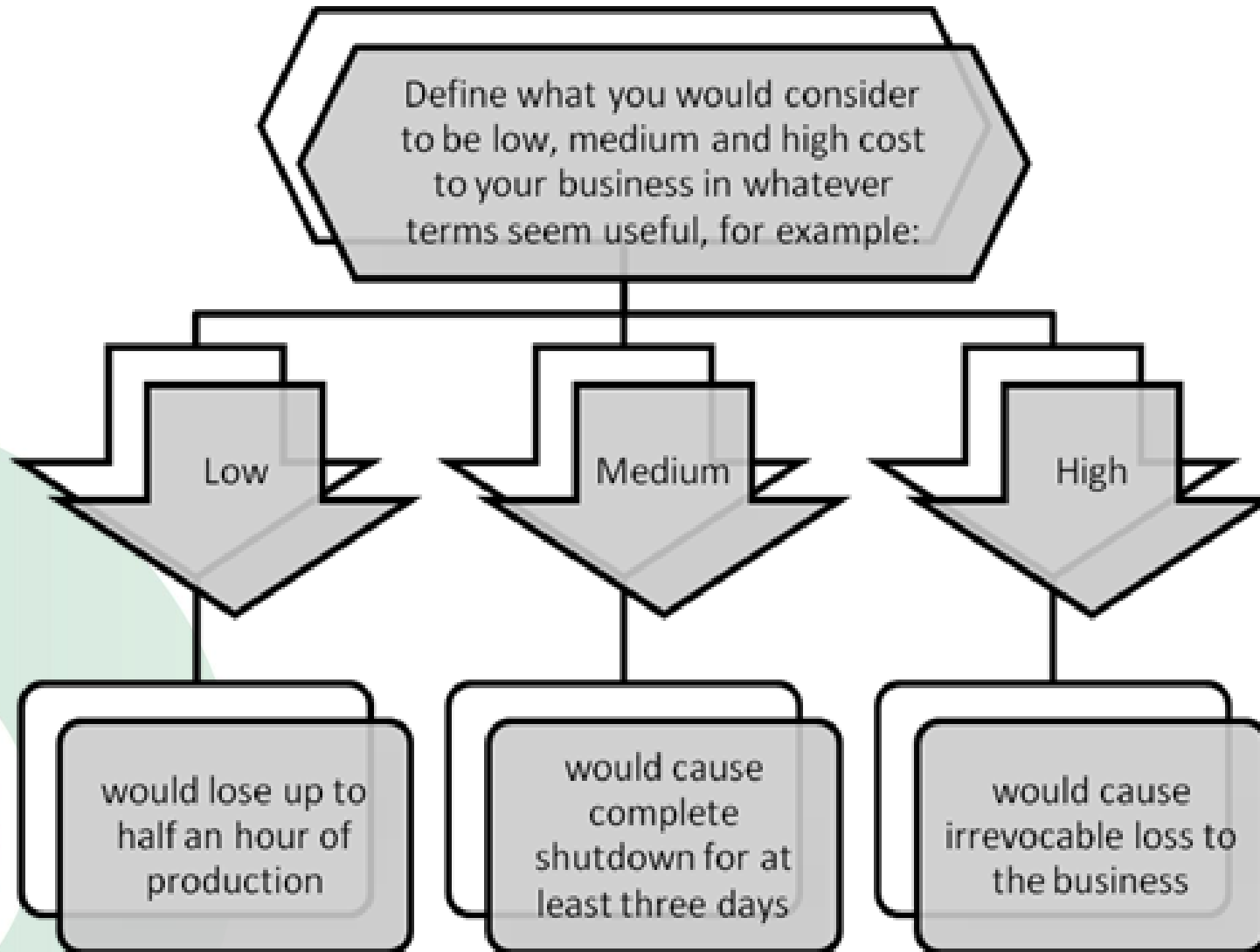
A diagram consisting of a rectangular text box at the top with a downward-pointing arrow leading to a rounded rectangular list box below it. The text box contains the sentence: "Once you have identified the risks that do pose a threat to your business, it may be helpful to base your risk assessment on the following factors:". The list box contains two bullet points: "the probability or likelihood of each risk materialising" and "the cost or impact of the problem if it did happen".

Once you have identified the risks that do pose a threat to your business, it may be helpful to base your risk assessment on the following factors:

- the probability or likelihood of each risk materialising
- the cost or impact of the problem if it did happen

Rating the impact of each scenario

	Composite Risk Index = Impact of Risk event x Probability of Occurrence	
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Determining priorities in the event of the risk materialising

After identifying and analysing the risks, you can evaluate.

What is the likelihood of the risk event occurring?

Almost certain

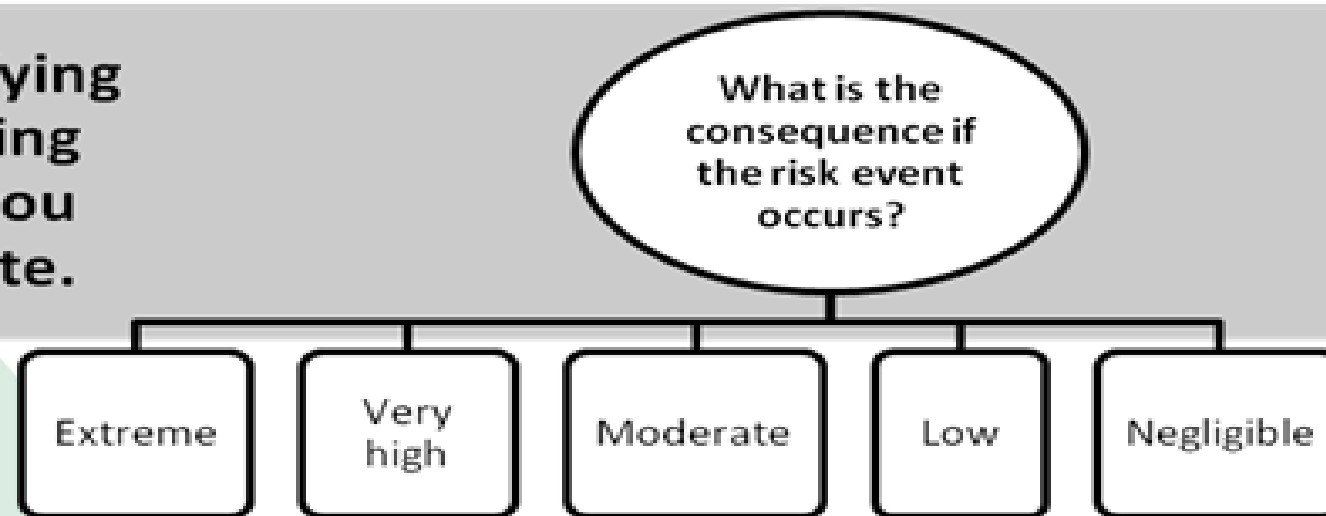
Likely

Moderate

Unlikely

Rare

After identifying and analysing the risks, you can evaluate.

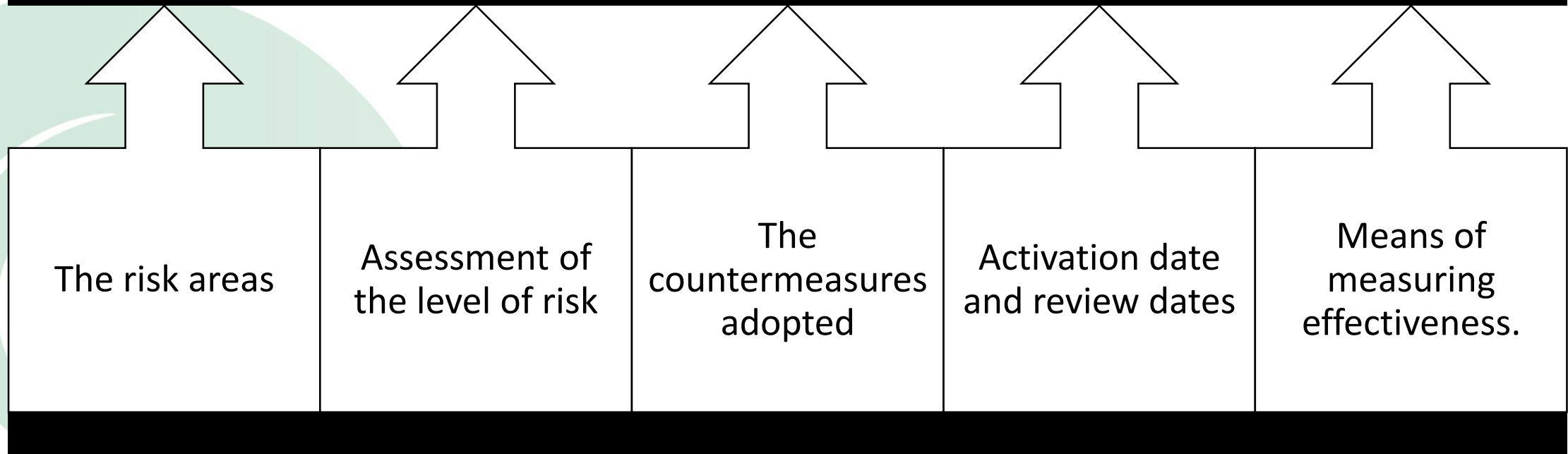


After establishing ‘Likelihood’ and ‘Consequence’ you can use a table like this to set a level of risk.

	Extreme	Very high	Moderate	Low	Negligible
Almost certain	Severe	Severe	High	Major	Moderate
Likely	Severe	High	Major	Significant	Moderate
Moderate	High	Major	Significant	Moderate	Low
Unlikely	Major	Significant	Moderate	Low	Very low
Rare	Significant	Moderate	Low	Very low	Very Low

Risk Profiles are developed as a means of putting risk management into practice at the Operational level.

A Risk Profile is normally specific to a work unit. It describes:

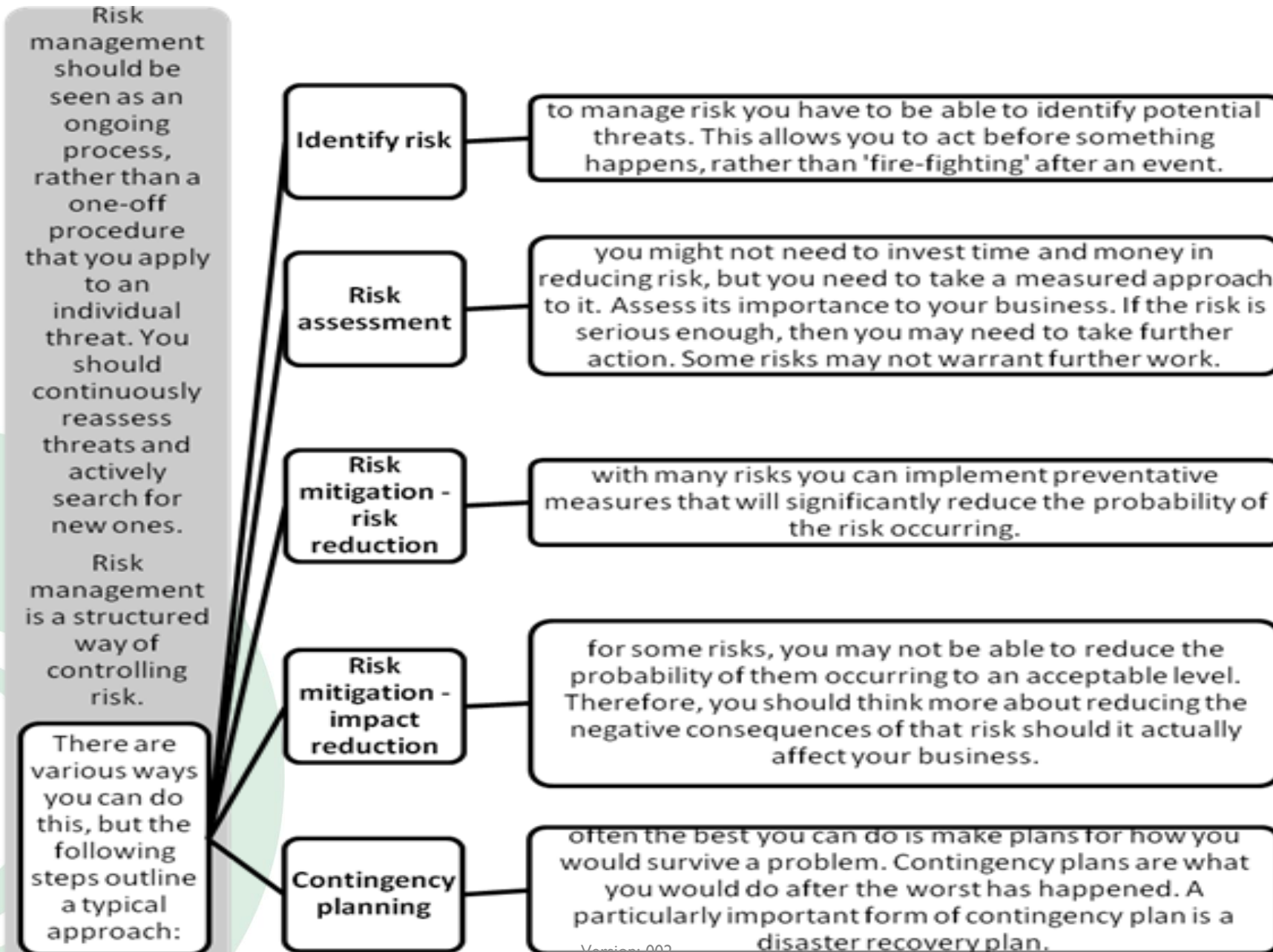



Individual Formative Exercise 2 A: Identify potential risks

WHAT ARE “CONTINGENCY PLANS”?

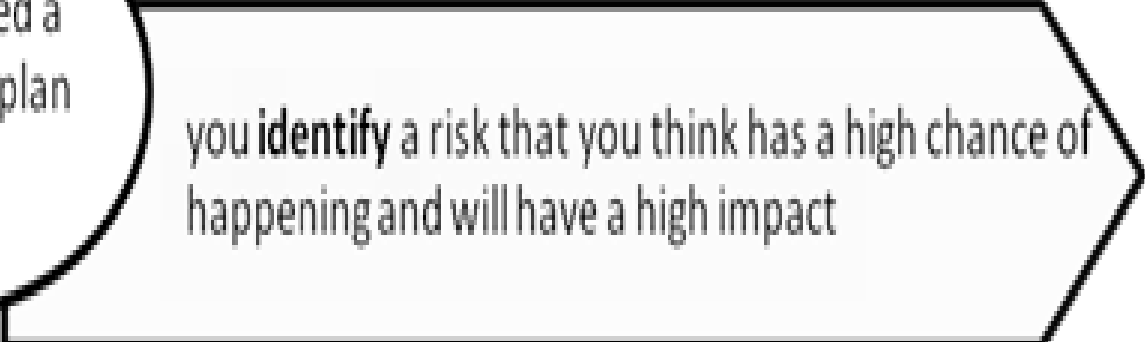
- A **contingency plan** is a plan devised for an outcome other than in the usual (expected) plan.
- A contingency plan is devised to respond to a negative event that can tarnish a company’s reputation or even financial livelihood.
- A contingency plan is a plan devised for an outcome other than in the usual plan. It is often used for risk management for an exceptional risk that, though unlikely, would have catastrophic consequences.
- The contingency plan is a proactive strategy, set up to account for those disruptive events, so you’re prepared if and when they arrive.

WHAT ARE “CONTINGENCY PLANS”?

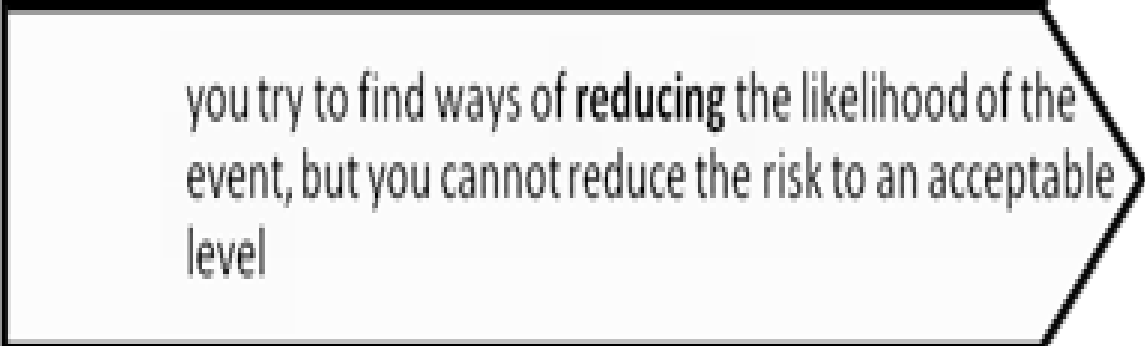




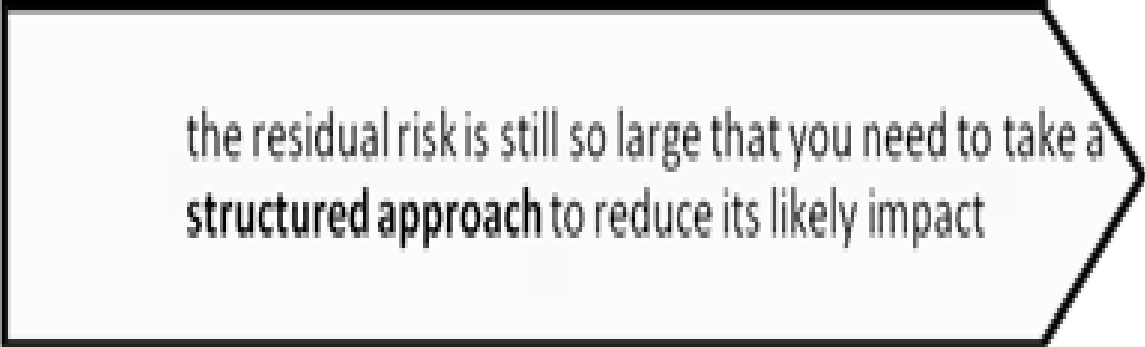
You may need a contingency plan when:



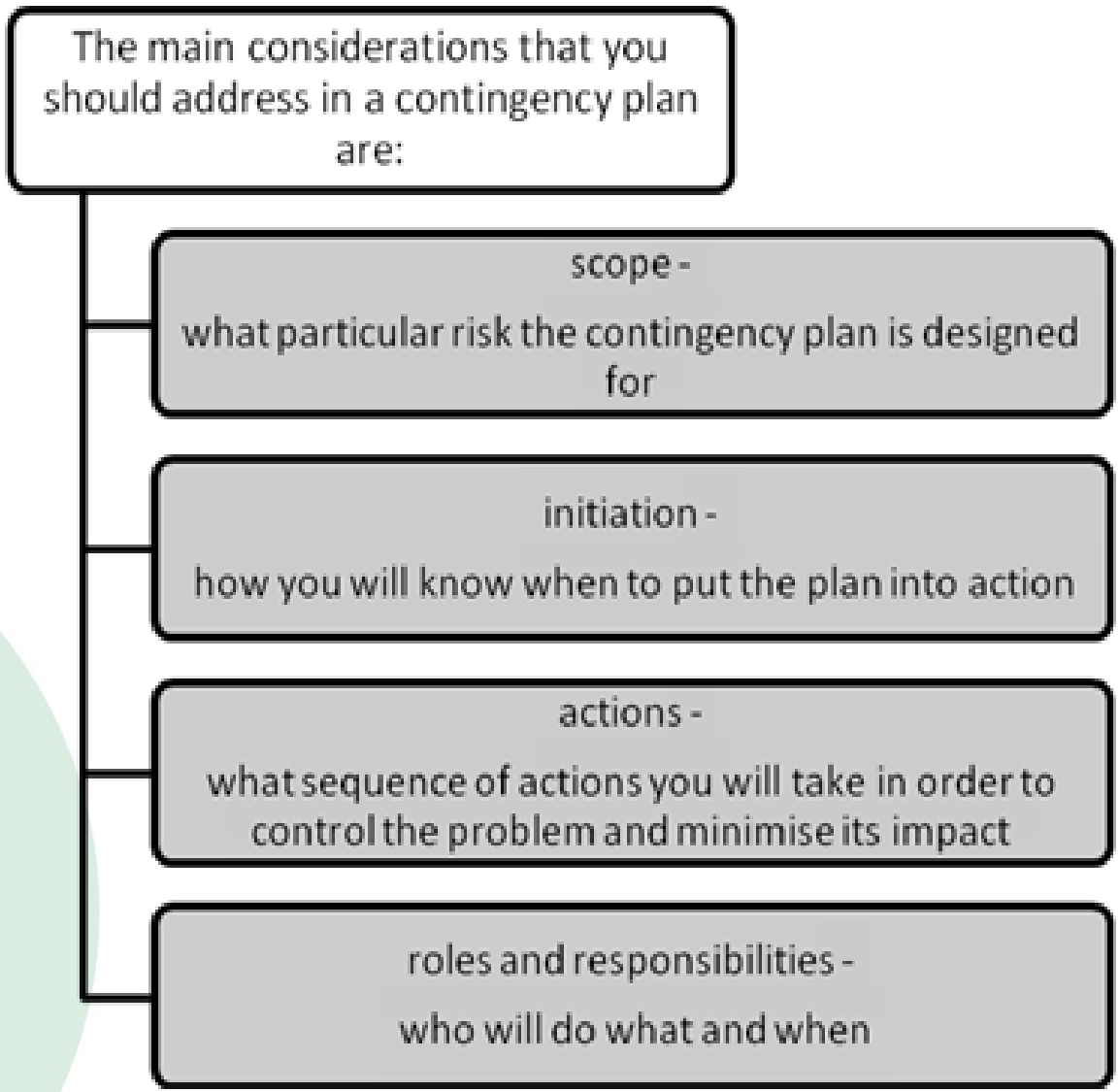
you **identify** a risk that you think has a high chance of happening and will have a high impact

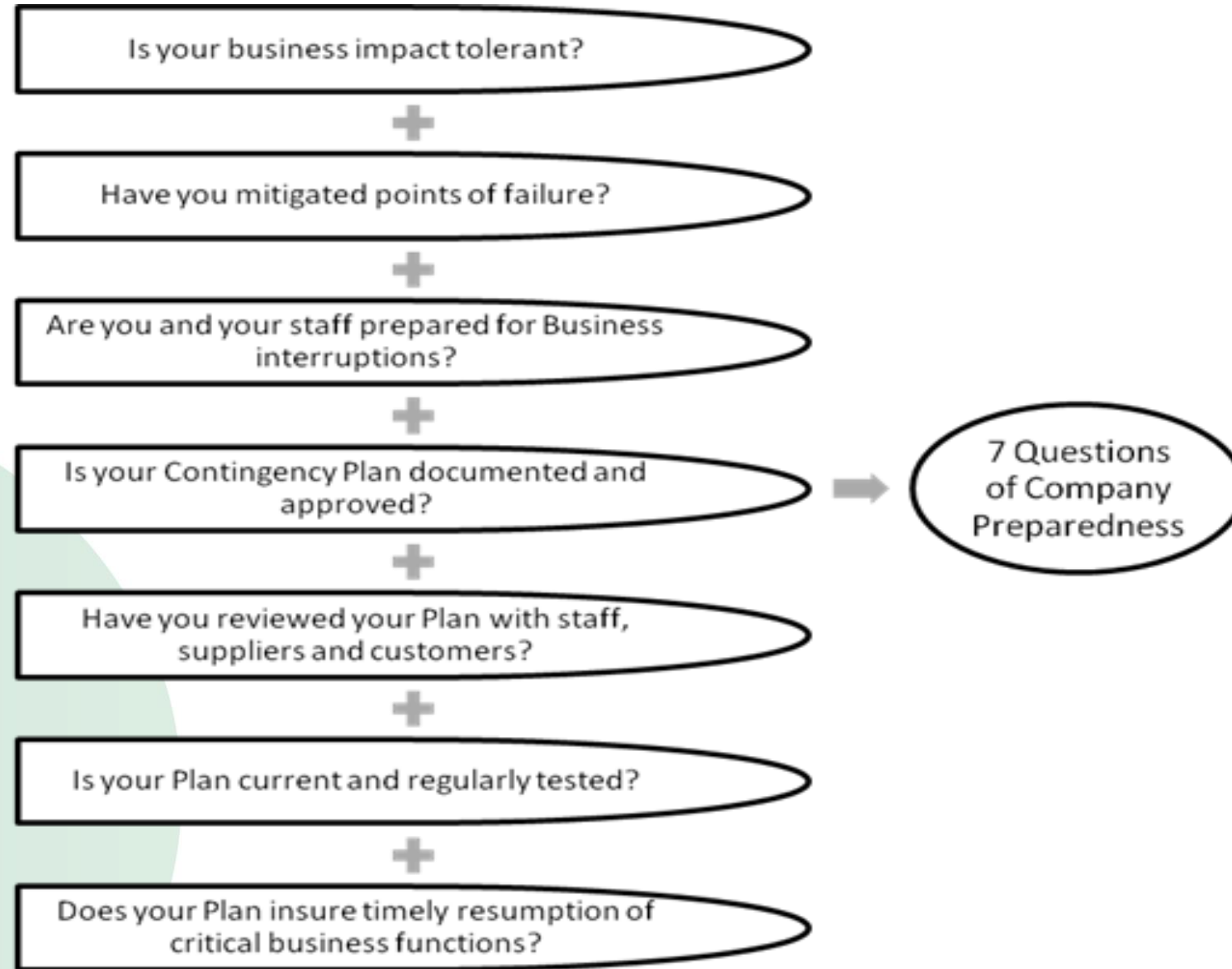


you try to find ways of **reducing** the likelihood of the event, but you cannot reduce the risk to an acceptable level



the residual risk is still so large that you need to take a **structured approach** to reduce its likely impact





HOW CONTINGENCY PLANS LINK UP WITH ORGANISATIONAL POLICIES AND PROCEDURES

A Contingency plan is a plan devised for a specific situation when things could go wrong. Contingency plans are often devised by businesses that want to be prepared for anything that could happen. They are sometimes known as "Back-up plans", "Worst-case scenario plans", "Scrap Situation" or "Plan B".

Contingency plans include specific strategies and actions to deal with specific variances to assumptions resulting in a particular problem, emergency or state of affairs. They also include a monitoring process and “triggers” for initiating planned actions.



Business contingency plans need to include planning for marketing to gain stakeholder support and understanding. Stakeholders need to be kept informed of the reasons for any changes, the vision of the end result and the proposed plan for getting there.

The level of stakeholders' importance and influence should be considered when determining the amount of marketing required, the timescales for implementation and completion, and the overall effectiveness of the plan.

- A basic planning process will outline the requisite content for contingency plans including objectives, requirements, and a desired format.
- This process will also determine: which type of disaster is most threatening to organisational survival, which key locations and critical functions must be protected, and it will establish time-lines for unacceptable loss of capabilities.
- Each determination should include a critical, holistic, functional assessment.
- One of the vital talents that any contingency planner should acquire is the ability to think backward.

The end product of the analysis will be a well-documented contingency plan. It is this document that details the specific threat, requirements, assumptions, constraints, and outlines a proposed general course of action. In “global” terms, it states what needs to be done and forms the foundation document for the follow-up plans that deal in specifics.

Furthermore, care must be taken to ensure that it is not driven by a single solution. All possible solutions must be explored, analysed, and each compared to the other. Only after all other solutions have been eliminated, should the remaining solution be used as the basis for the concept.

To develop a contingency plan, three basic options -or some combination of the three are available to the contingency planner.

In-house	Obtain assistance from a specialized disaster software and/or storage vendor	Hire an outside (disinterested) contingency planning consultant
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CONTINGENCY STRATEGIES

There are four ways of dealing with, or managing, each risk that you have identified. You can:

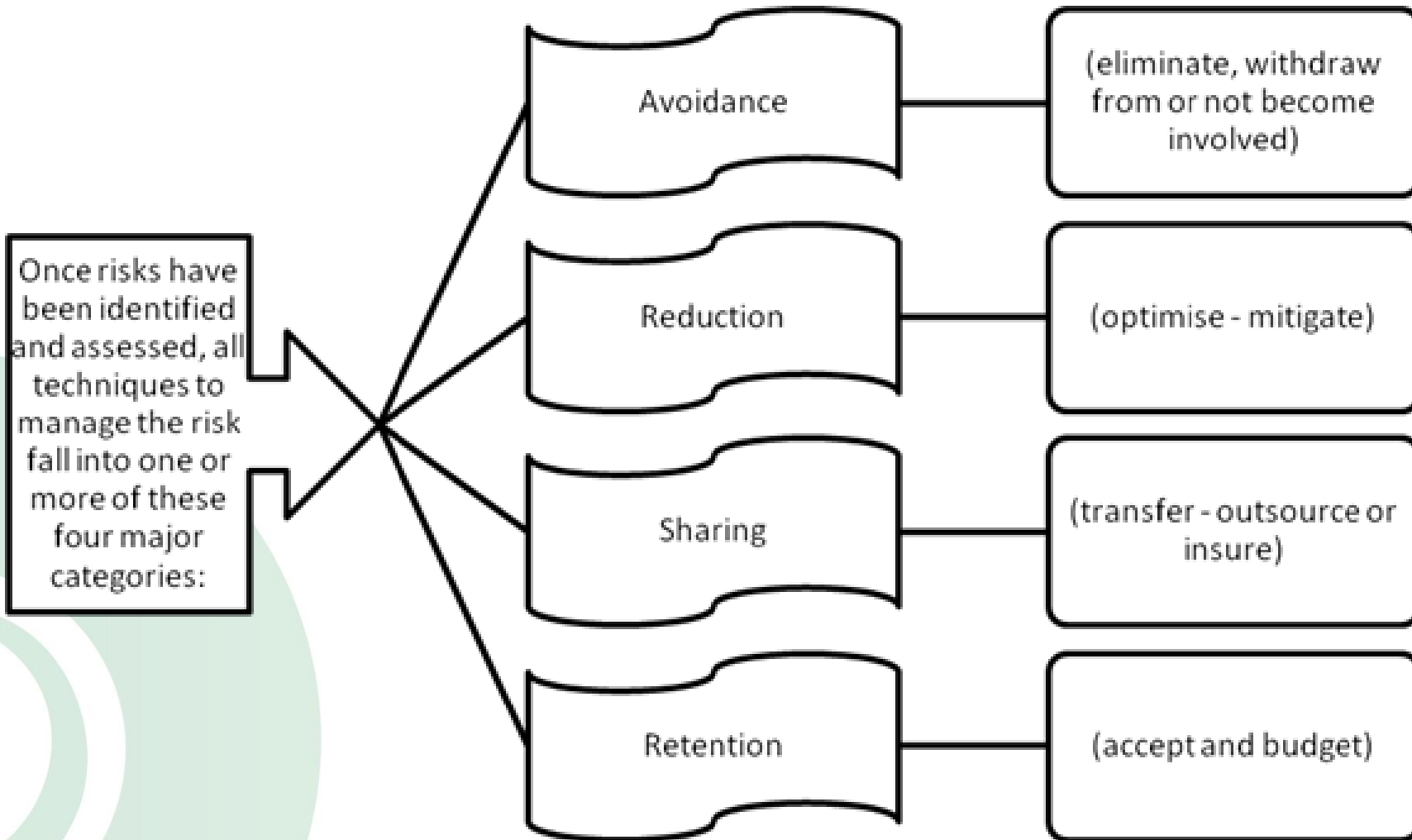
accept it

transfer
it

reduce it

eliminate
it







This includes not performing an activity that could carry risk. Another would be not flying in order to not take the risk that the airplane could be hijacked.

Avoidance may seem the answer to all risks, but avoiding risks also means losing out on the potential gain that accepting (retaining) the risk may have allowed. Not entering a business to avoid the risk of loss also avoids the possibility of earning profits.



Risk reduction or "optimisation" involves reducing the severity of the loss or the likelihood of the loss occurring. For example, sprinklers are designed to put out a fire to reduce the risk of loss by fire. This method may cause a greater loss by water damage and therefore may not be suitable.

Acknowledging that risks can be positive or negative, optimising risks means finding a balance between negative risk and the benefit of the operation or activity; and between risk reduction and effort applied.



Briefly defined as "sharing with another party the burden of loss or the benefit of gain, from a risk, and the measures to reduce a risk."

The term of 'risk transfer' is often used in place of risk sharing in the mistaken belief that you can transfer a risk to a third party through insurance or outsourcing. In practice if the insurance company or contractor go insolvent or end up in court, the original risk is likely to still revert to the first party



Risk retention is a viable strategy for small risks where the cost of insuring against the risk would be greater over time than the total losses sustained.

All risks that are not avoided or transferred are retained by default. This includes risks that are so large or catastrophic that they either cannot be insured against or the premiums would be infeasible.



Mitigation

If your assessment shows that you have unacceptably high levels of risks to your business, then you need to take some action to counter them.

You could:

- Reduce the probability of the risk affecting your business
- Limit the impact of the risk if it does occur



Avoidance

Risk avoidance is a technique of risk management that involves

- (1) Taking steps to remove a hazard,
- (2) Engage in alternative activity, or
- (3) Otherwise end a specific exposure.

Risk avoidance is just that, avoiding the risk associated with a specific task, activity or project. Often, following the review of a contract, it is determined that a project is just too risky.

Eliminations

Most businesses have to live with some level of risk. The only guaranteed way of totally eliminating risk is by not getting involved in business. One area in which it is vital to eliminate risk is that of occupational health and safety.

Every workplace is different, but all present some form of risk to the people working there - whether it be air quality, electrical hazards, noise levels or even back injury. Steps should be taken to eliminate the causes of such risks.

Acceptance

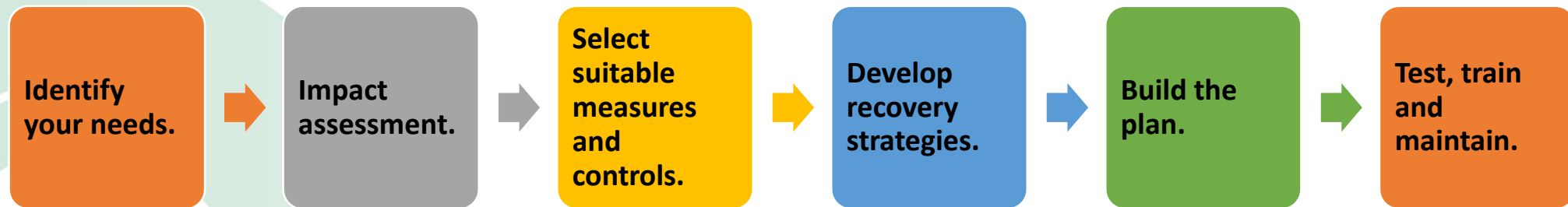
Every enterprise has to have a level of risk that it will accept otherwise it is impossible to do business. Risk represents both an opportunity to make profit and the potential to make losses. What is important to the organisation is to manage its risks so as to balance the opportunities against the potential losses for the overall good of the business.

The amount of risk that an organisation is prepared to take is often known as its 'risk appetite' or 'risk tolerance'.

Risk acceptance is used in risk management to describe an informed decision to accept the consequences and likelihood of a particular risk.

HOW TO DEVELOP A CONTINGENCY PLAN

The process of developing an effective contingency plan can be broken down into six key stages:




Identify your needs

Starting out with a clear examination of the specific requirements of your organisation helps to make sure the plan you develop is the one you actually need. It can help clarify your thinking to create a contingency planning policy statement as part of your analysis.

Select measures and controls


The impact assessment stage will help to identify areas where disruption can be significantly reduced by implementing preventative measures. Although in principle prevention is always better than cure, whether this is true in any specific case will come down to a cost assessment.

Recovery strategies

A large, hollow downward-pointing arrow indicating a flow from the title to the text below.

Recovery strategies enable operations to be rapidly normalized in the event of disruption. Strategies should be based on the data gathered in the impact assessment, in order to ensure that they are appropriate to the organisation's core requirements. They should also take into account the full range of possible incidents and disruptions.

Build the plan

A large, hollow downward-pointing arrow indicating a flow from the title to the text below.

The plan development phase involves pulling together all the information gathered in the previous steps into clear and precise outlines of the actions to be taken under various emergency conditions.



Testing, training and maintenance are essential follow-up activities that must be carried out after the completion of the plan.

It is vital that the plan is thoroughly tested in all its aspects.

An untested plan is worthless, as there is a high probability of it failing under the pressure of an actual emergency.

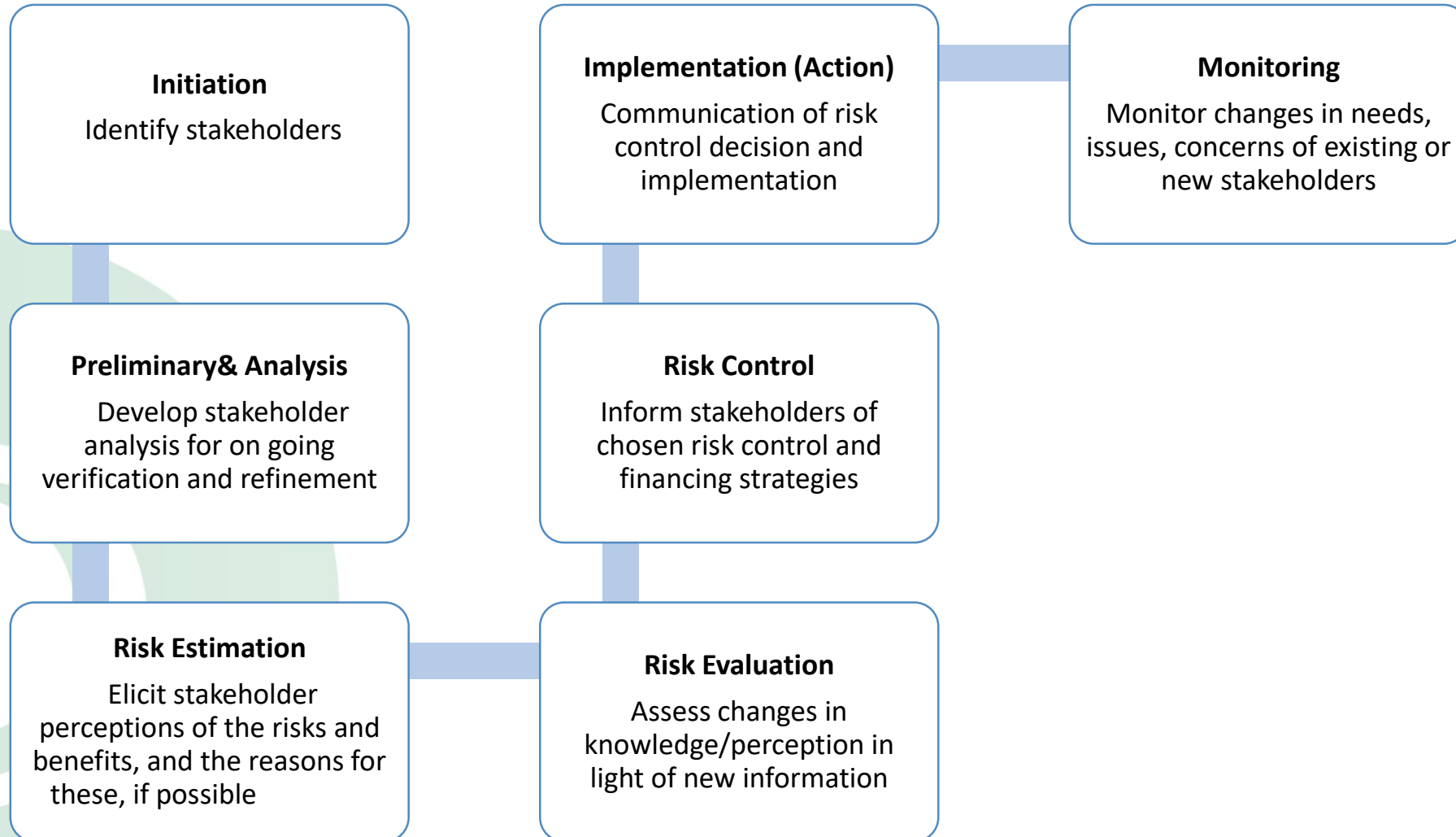
COMMUNICATING THE CONTINGENCY PLAN TO THE RELEVANT STAKEHOLDERS

Risk communication is defined as any two-way communication between stakeholders about the existence, nature, form, severity, or acceptability of risks.

It is vitally important to understand the basic concepts of risk communication and to ensure that communication among stakeholders is integral to the risk management process.



RISK COMMUNICATION TASKS IN THE RISK MANAGEMENT PROCESS



Risk communication among stakeholders is deemed integral to all stages of the risk management process. Communicating well has benefits for good risk management.

During the Initiation step, the risk communication tasks include identifying stakeholders and assessing stakeholder perspectives on the risk issue for the purpose of defining the scope of the issue to be addressed.

Stakeholders include groups that are affected or potentially affected by the risk, risk managers, and groups that will be affected by any efforts to manage the source of the risk.

Individual Formative Exercise 3 A: Contingency Plans



Learning Unit 4

Testing and revising your contingency plan



TESTING A CONTINGENCY PLAN IN ACCORDANCE WITH THE ENTITY'S RISK MANAGEMENT PROCEDURES

It has often been said that a plan isn't a plan until it has been tested. The adage that plans must be maintained to accommodate change is also well known.

Despite this awareness, surprisingly large numbers of organisations commit significant resources to contingency plan development only to see the value of the investment dwindle as time passes.

- Contingency plans are extremely dynamic.
- Things change.
- Most emergency and contingency operations usually require a complete rewrite of all procedures every five years.
- These rewrites should be based on a refinement of requirements, exploit new technology and use fresh eyes to look at old solutions to new problems.
- This process is called plan maintenance.



Types of Testing

Desktop Testing

Testing By Review

Testing by Analysis

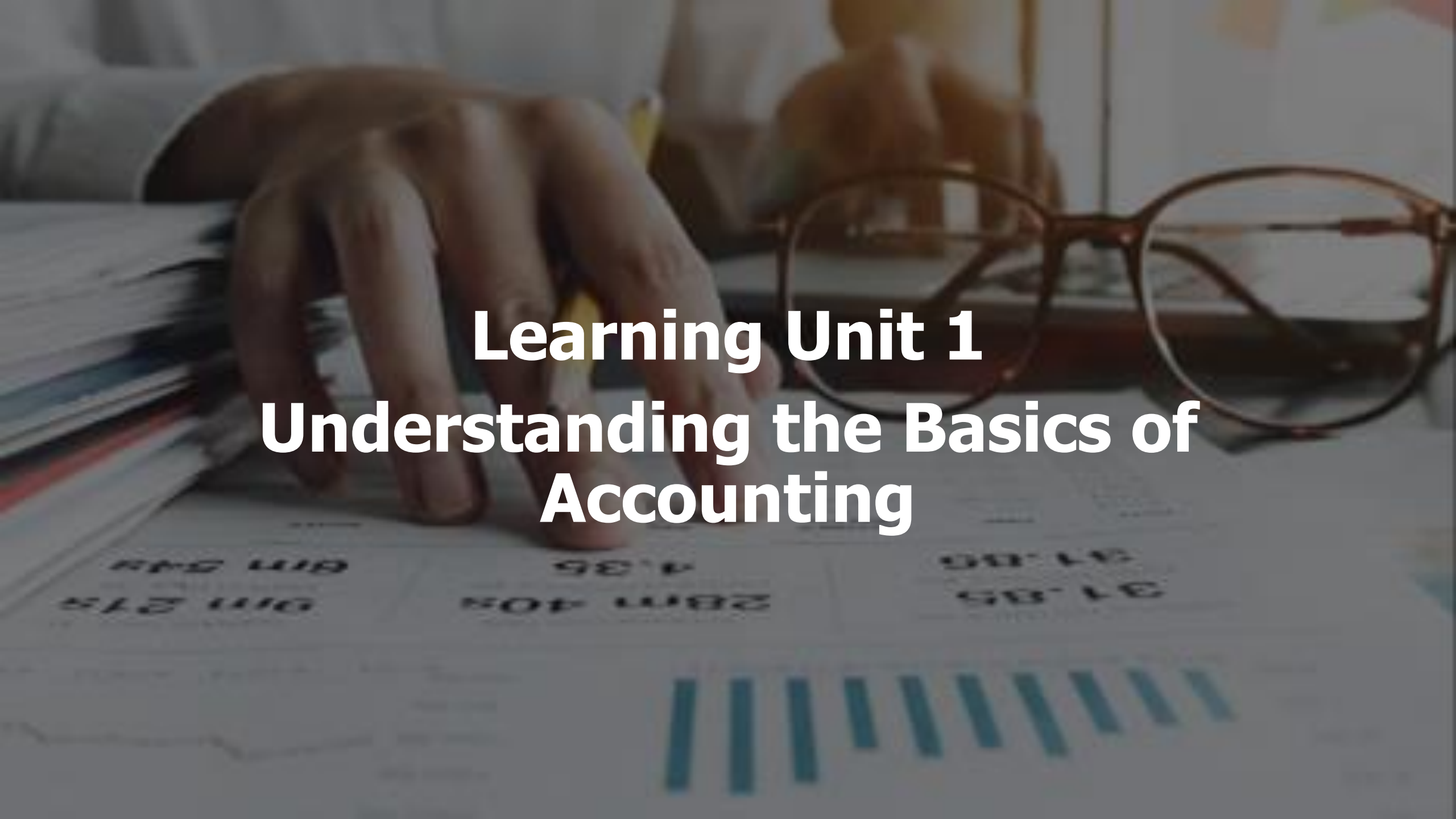
Testing by Disaster Simulation

Desktop Testing	Testing by Review	Testing by Analysis	Testing by Disaster Simulation
<p>Messages and situation reports are relayed to a select group of managers to test their reactions and to challenge the plan. This enables the whole or part of the contingency plan to be reviewed every six to twelve months. Full “live” testing is undertaken less frequently, for example when significant changes to the plan have been made.</p>	<p>A review can be a simple test to check the accuracy of contingency plan documentation. For instance, a reviewer could check if individuals listed are still in the organisation and still have the responsibilities that caused them to be included in the plan.</p>	<p>An analysis may be performed on the entire plan or portions of it, such as emergency response procedures. It is beneficial if the analysis is performed by someone who did not help develop the contingency plan but has a good working knowledge of the critical function and supporting resources.</p>	<p>Organisations may also arrange disaster simulations. These tests provide valuable information about flaws in the contingency plan and provide practice for a real emergency.</p>

Summative Assessment: Risk Assessment Report

The background of the image is dark and features a faint line graph with several data points connected by thin lines. In the foreground, there are two stacks of coins. From the top of each stack, a small green seedling with two leaves is growing. The overall theme is financial growth and investment in agriculture.

Financial Management

A hand is pointing at a document on a desk. The document features a bar chart with several blue bars of varying heights. To the right of the hand, a pair of glasses is resting on the desk. The background is slightly blurred, showing a desk with various items.

Learning Unit 1

Understanding the Basics of Accounting

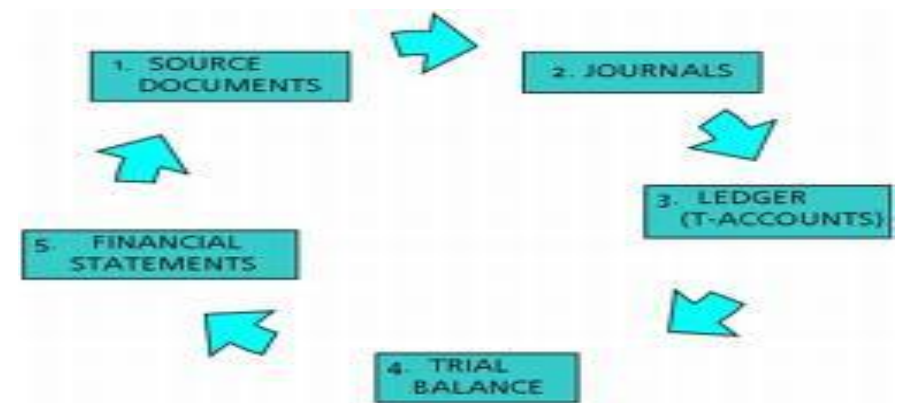
WHAT IS THE DIFFERENCE BETWEEN FINANCIAL MANAGEMENT AND ACCOUNTING?

Accounting is about recording how money is spent and financial management is about controlling how money is spent.

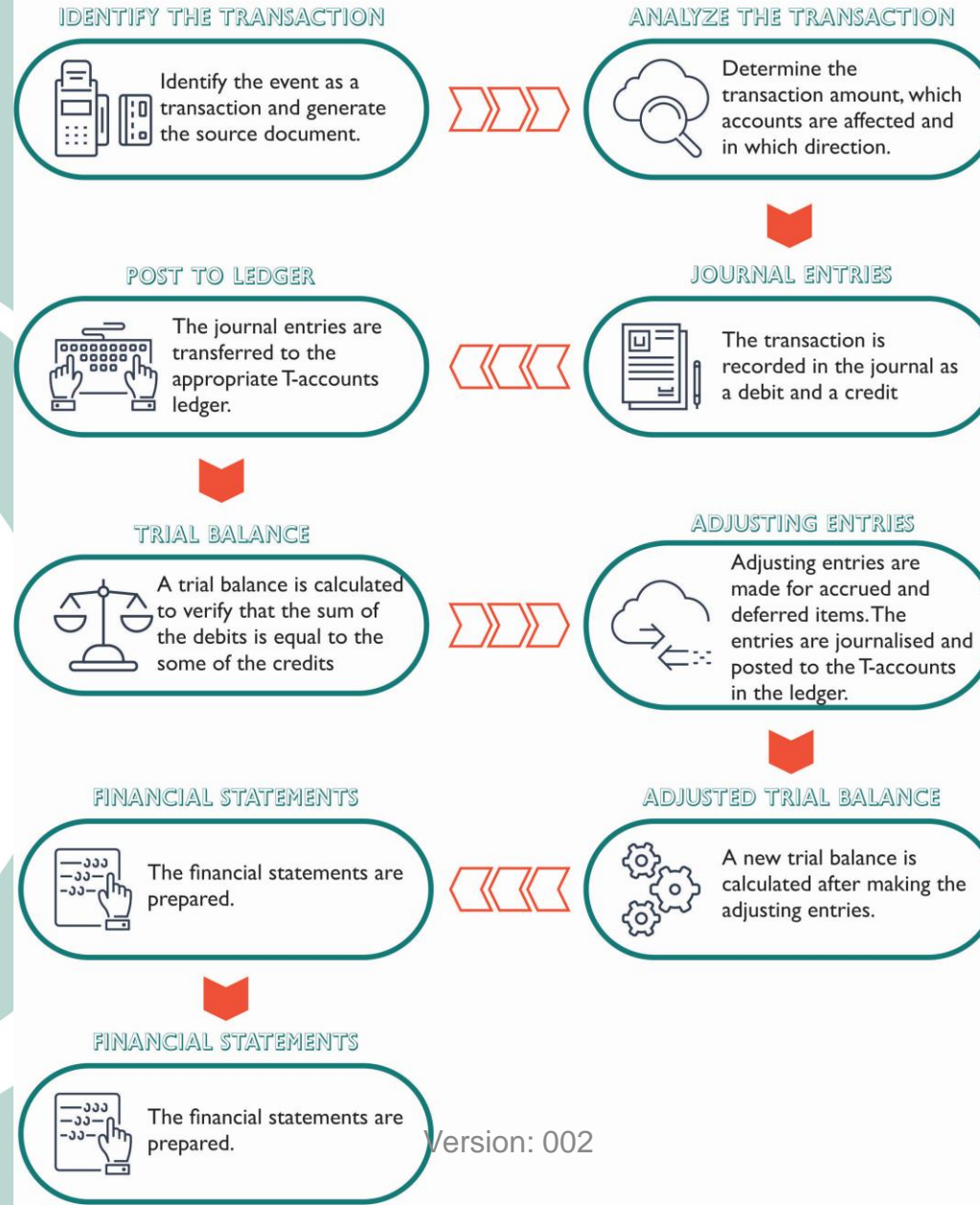
Financial management requires an understanding of accounting records in order to exert better control.

THE ACCOUNTING CYCLE

- Accountants work through a cycle called the Accounting Cycle.
- A manager does not need to go into great depth in terms of understanding the accounting behind the financials; however it does help to have a basic idea of where the numbers are coming from.
- The accounting profession is made up of various degrees of qualifications. You get accountants, chartered accountants, financial accountants, management accountants, auditors and bookkeepers.



THE ACCOUNTING CYCLE ILLUSTRATED:



Trial Balance

A trial balance is calculated to verify that the sum of the debits is equal to the sum of the credits

Adjusting entries

Adjusting entries are made for accrued and deferred items. The entries are journalised and posted to the T-accounts in the ledger.

Adjusted Trial Balance

A new trial balance is calculated after making the adjusting entries.

Financial Statements

The financial statements are prepared.



Step one: Identify the Transaction

Step one:

Identify the Transaction

Identify the event as a transaction and generate the *source document*.

Transactions will include things like purchases, making a sale and issuing credit. Source documents are the documents that show proof of the transaction.

Source documents include things like invoices, receipts, cheque counterfoils and credit notes.

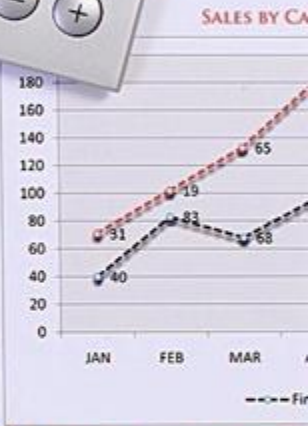


Legend: Oil, Gas, Electric power, Medicine, Textile, IT, Electronics, Media

TOTAL SALES BY REGION		SALES BY CATEGORY	
REGION SALES		SALES	
West	€ 1 236 345,0	Copper	85
East	€ 1 896 354,0	Steel	89
South	€ 2 569 345,0	Gold	74
North	€ 1 893 543,0	Silver	50
Other	€ 7 595 587,0	Platinum	27

SALES BY CATEGORY

Region	Sales
West	85
South	89
North	74
East	50
Other	27



DAT	BID	ASK	PRO	QUA
JAN	€ 241,00	€ 558,00	€ 104,00	339
FEB	€ 955,00	€ 348,00	€ 374,00	223
MAR	€ 116,00	€ 415,00	€ 930,00	269
APR	€ 262,00	€ 146,00	€ 107,00	437
MAY	€ 839,00	€ 890,00	€ 801,00	934
JUN	€ 706,00	€ 579,00	€ 691,00	933
JUL	€ 700,00	€ 870,00	€ 933,00	691
AUG	€ 775,00	€ 934,00	€ 934,00	801
SEP	€ 300,00	€ 437,00	€ 437,00	107
OCT	€ 81,00	€ 269,00	€ 269,00	930
NOV	€ 173,00	€ 223,00	€ 223,00	374
DEC	€ 608,00	€ 339,00	€ 339,00	104

DAT	BID	ASK	PRO
JAN	€ 598,00	€ 391,00	€ 820,00
FEB	€ 891,00	€ 958,00	€ 784,00
MAR	€ 748,00	€ 627,00	€ 934,00
APR	€ 589,00	€ 335,00	€ 559,00
MAY	€ 949,00	€ 885,00	€ 386,00
JUN	€ 843,00	€ 296,00	€ 974,00
JUL	€ 836,00	€ 628,00	€ 575,00
AUG	€ 349,00	€ 341,00	€ 645,00
SEP	€ 221,00	€ 441,00	€ 941,00
OCT	€ 886,00	€ 943,00	€ 802,00
NOV	€ 661,00	€ 949,00	€ 715,00
DEC	€ 297,00	€ 440,00	€ 551,00

Step two: Analyze the Transaction

Step two:

Analyze the Transaction

Determine the transaction amount, which accounts are affected and in which direction.

For example, if there was increase in the asset account, the entry would be recorded on the debit side of the account. If the asset had decreased, the entry would be recorded on the credit side of the account.

Accountants follow what is called “The Double Entry Rule”. An accounting equation must always balance, so a transaction always affects two elements at the same time. One element will be debited and one element will be credited.

Table depicting examples of debits and credits for expenses and incomes:

Debits (usually expenses)	Credits (usually incomes)
Cost of sales	Sales
Wages	Rent income
Water and electricity	Interest on a fixed deposit
Salaries	Discount received
Telephone	Bad debt recovered
Stationery	Provision of bad debt
Depreciation	Profit on sale of assets
Interest paid	Interest received

Table depicting examples of debits and credits for assets and liabilities:

Debits (usually assets)	Credits (usually liabilities)
Fixed assets such as land, buildings, vehicles and equipment	Long term liabilities such as long term loans.
Financial assets such as fixed deposits, fixed investments and any other deposits.	Current liabilities such as overdrafts and income received in advance.
Current assets such as inventory or prepaid expenses.	Dividends or distributions to members.

A close-up photograph of a person's hands in a dark blue suit jacket typing on a silver laptop. The laptop screen displays a financial chart with blue and red bars. In the foreground, there is a stack of papers, one of which has the word 'CHOICE' visible. A white diamond-shaped graphic is overlaid on the right side of the image, containing the text 'Step three: Journal Entries'.

Step three: Journal Entries

Step three:

Journal Entries

The transaction is recorded in the *journal* as a debit and a credit.

Once the accountant knows which accounts to debit and which accounts to credit, the records are made in the books of first entry or Journals.

The examples used in Step two are shown as journal entries below:



Step four: Post to Ledger

Step four

Post to Ledger

The journal entries are transferred to the appropriate T-accounts in the *ledger*.

The ledger is simply a summary of the transactions that were recorded in the journals.

The example from Step two and Step three are shown in a simple ledger below. CPJ stands for “Cash Purchases Journal” and CRJ stands for “Cash Receipts Journal.”



Step five: Trial Balance

Step five:

Trial Balance

A trial balance is calculated to verify that the sum of the debits is equal to the some of the credits

A trial balance is a list of all the balances of the accounts that were depicted in the general ledger.

The trial balance can be used to confirm that the total of accounts with debit balances still equals the total of the accounts with credit balances.



Step six: Adjusting entries

Step six:

Adjusting entries

Adjusting entries are made for accrued and deferred items. The entries are journalised and posted to the T-accounts in the ledger.

In accounting, adjustments are made at the end of the financial year to reflect any transactions that did not appear in the source documents.

These adjustments are made for the sake of accuracy. Adjusting entries would need to be made in the journal and the ledger.



Step seven: Adjusted Trial Balance

Date: 2020/07/01

Version: 002

Step seven:

Adjusted Trial Balance

A new trial balance is calculated after making the adjusting entries.

Once the adjustments have been made, a new trial balance has to be drawn up



Step eight: Financial Statements

Step eight:

Financial Statements

The financial statements are prepared.

The financial statements are then prepared from the trial balance.

ACCOUNTING CONVENTIONS

An accounting convention is a common practice that is universally followed in recording and presenting accounting information.

Accounting conventions help in comparing accounting data across business units. It is important for a manager to be aware of these accounting conventions when interpreting financial reports.



1. Business entity concept
2. Going concern
3. Accounting period
4. Historical cost
5. Matching principle
6. Conservatism / Prudence
7. Consistency
8. Money measurement
9. Objectivity
10. Accrual concept

Learning Unit 2

The Financial Reports

Different forms of business will have different legal requirements in terms of financial reports:

Sole proprietorship (1 owner): - *The owner has a personal interest in the business.*

- *Not necessary to publish and audit financial statements.*

Partnerships (2-20 partners) - *Partners have a personal and unlimited liability for the debts of the partnership.*

- *It is not necessary to publish and audit the financial statements.*

Private Company (1-50 directors /shareholders – Pty Ltd) - *Financial statements must be drawn up and must be audited by a chartered accountant, but not compulsory to publish.*

Public Company (+7 people – Ltd) - *Financial statements must be drawn up and must be audited by a chartered accountant.*

- *Compulsory disclosure of statements and constitution of the company's affairs.*

Close Corporation (1-10 members – CC) - *Financial statements are only required in simplified form, not necessary to audit or publish.*



THE BALANCE SHEET

THE BALANCE SHEET

A Balance Sheet is very simply a statement of position at a given date. It is like a snapshot at the close of a given day of a business

The balance sheet lists all the money owned or owed to a business (the assets) and the money owed by a business (the liabilities).

The balance sheet also includes what the owners or shareholders have put into the business (in other words the source of financing of the business) otherwise known as the shareholder's equity.

$$\text{ASSETS} = \text{LIABILITIES} + \text{EQUITY}$$

The Balance Sheet: Assets equal Liabilities plus Shareholder's Equity

ASSETS

Amounts owned or owed to by business.

Examples:

- Fixed assets
- Bank deposit
- Trade credit given
- Prepaid expenses
- Inventory
- Land
- Buildings
- Machinery and equipment
- Vehicles
- Other investments

=

LIABILITIES

Amounts owed by a business

Examples:

- Loans
- Trade credit taken
- Unpaid (accrued) expenses
- Other items for future payment

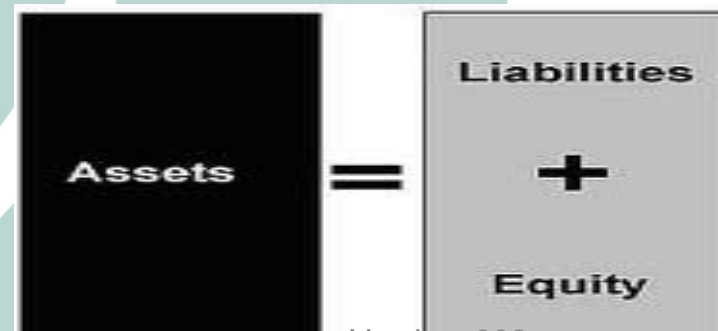
SHAREHOLDER'S EQUITY

Sources of financing

Examples:

- Share capital
- Retained earnings

- Assets and liabilities may be classified as short term (current assets and current liabilities) or as long term.
- Short term assets and liabilities are usually those recorded as of the current financial year, whereas long term assets and liabilities are those that are recorded over periods greater than one year.



Dividends & Spillover
*Forward Annual Dividend Rate * 1.92*

Income Statement

Revenue
Total Revenue
Cost of Revenue
Gross Profit
Operating Expenses
Research Development
General and Administrative
Marketing

All numbers in thousands

89,716,000 91,9

89,716,000 91,97

39,014,000

THE INCOME STATEMENT

THE INCOME STATEMENT

The Income Statement (or Profit and Loss Account) is basically the organisation's record of sales and costs for a specified period of time, usually a month, quarter or year.

The bottom line of the Income Statement is the bottom line of the organisation or the net profit or loss.

The simplest equation to describe an Income Statement is:

$$\text{NET INCOME} = \text{REVENUE} - \text{EXPENSES}$$

The Income Statement does not include capital transactions such as investments, fixed assets or borrowing; however it does include the current income and costs related to these items such as interest and depreciation.

INCOME

The revenue or turnover of an organisation. The inflows form the delivery or manufacture of a product or from the rendering of a service. Income could be reflected by Sales, Revenue or Turnover.

COST OF SALES



Includes all the spending directly associated with sales. For wholesalers and retailers, the cost of sales is essentially the prices paid to acquire the services or goods that will be resold. For manufacturers, the cost of sales is all the spending directly attributed to production.



GROSS PROFIT



The Sales less the Cost of Sales is the Gross Profit.

Operating Expenses

- All expenses related to administering the business and marketing and distributing the product or service.
- Operating expenses might include:
 - Rent
 - Telephone
 - Wages
 - water and electricity
 - Advertising
 - Bank charges
 - Insurance
 - Fees
 - Salaries
 - Repairs and other expenses
 - Depreciation is also considered an operating expense.

PROFIT (OR LOSS) BEFORE TAX

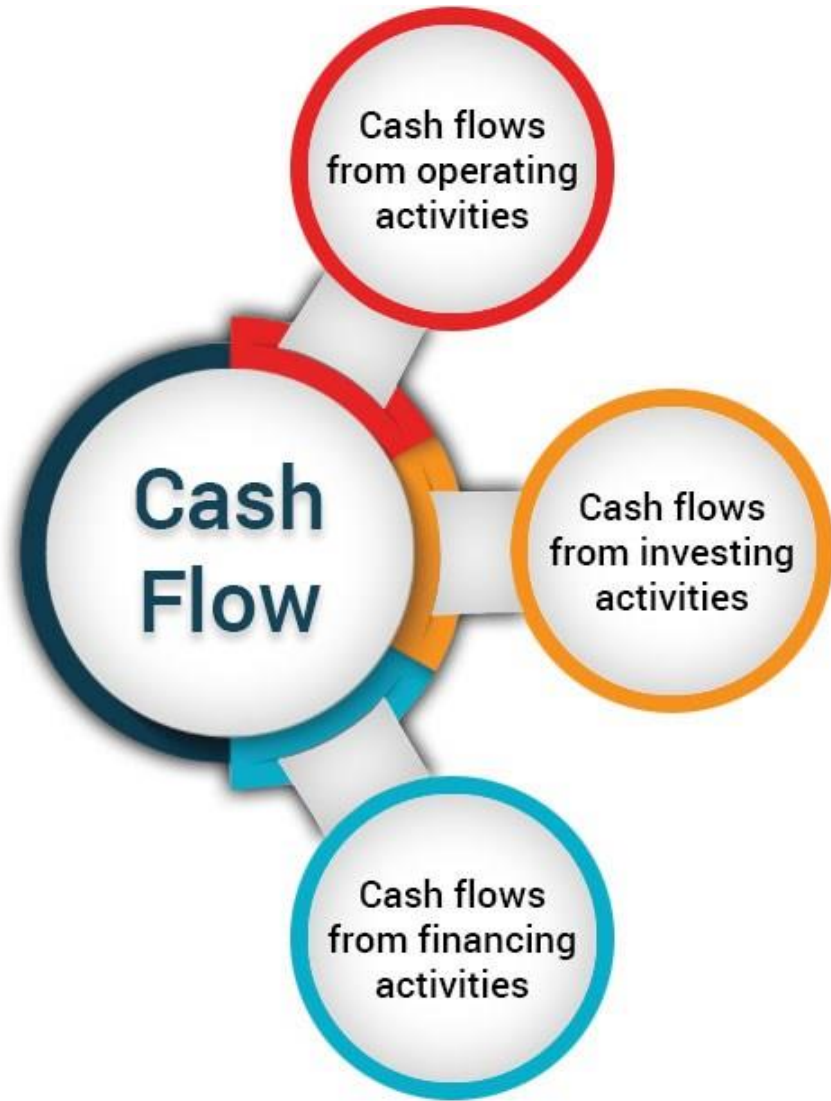
This is the operating profit (or loss) less the other revenue / expenses or gains or losses that are not part of the company's normal operations.

TAX

Company taxes that are payable in accordance with legislation. These would be based on taxable income.

NET PROFIT (OR LOSS)

This is the net income (or loss) after tax.



THE CASH FLOW STATEMENT

THE CASH FLOW STATEMENT

The Cash Flow Statement is the third major financial statement.

Income Statements show the passing relationship between money that changes hands, while the Cash Flow Statement focuses on changes in liquidity.

A Cash Flow states the sources and uses of funds and explains the changes in cash and cash equivalents over the period of accounts.

Cash flows can be done using one of two methods, the direct method or the indirect method. Cash flow statements do not include the amounts recorded from credit, only cash.

Operations

The operations component reflects how much cash is generated from a company's products or services.

Generally speaking, changes made in cash, accounts receivable (receipts from customers), depreciation, inventory, and accounts payable (payments to suppliers and employees) are reflected in cash from operations.

Date: 2020/07/01

Investing

Investing activities are the acquisition and disposal of long-term assets and investments not included in cash equivalents. When an investment is made, this is a "cash-out" item. When a company divests of an asset, this is a "cash-in" item.

Version: 002

Financing

Financing activities result changes in the size and composition of the organisation's capital and borrowings.

The Cash Flow statement reveals the following:-

- Cash earnings
- How the organisation is utilising its funds
- How the organisation is being financed
- Any need for outside financing
- The ability of the organisation to obtain outside financing
- The organisation's investments or divestments
- The organisation's ability to generate future cash flows.
- The organisation's ability to meet its obligations

In summary, cash flow is essentially a key indicator of the organisation's health.



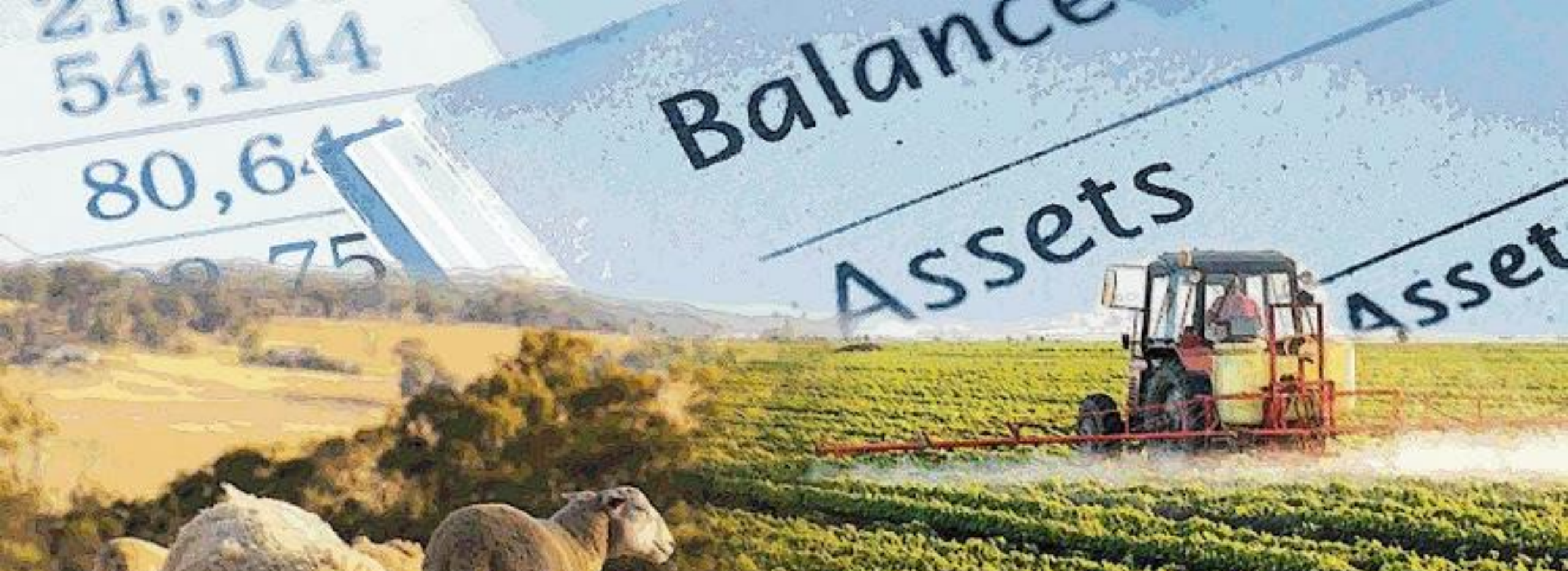
A magnifying glass is positioned over a tax form, specifically Form 1040. A large, red, rectangular stamp with the word "AUDIT" in bold, capital letters is centered over the form. The background shows various sections of the tax form, including "Schedule A", "Form 1040", "U.S. Individual", and "Department of the Treasury". A pencil is visible on the right side of the form, and a pen is at the bottom right. The overall scene suggests a tax audit or a detailed review of tax documents.

THE AUDIT REPORTS

THE AUDIT REPORTS

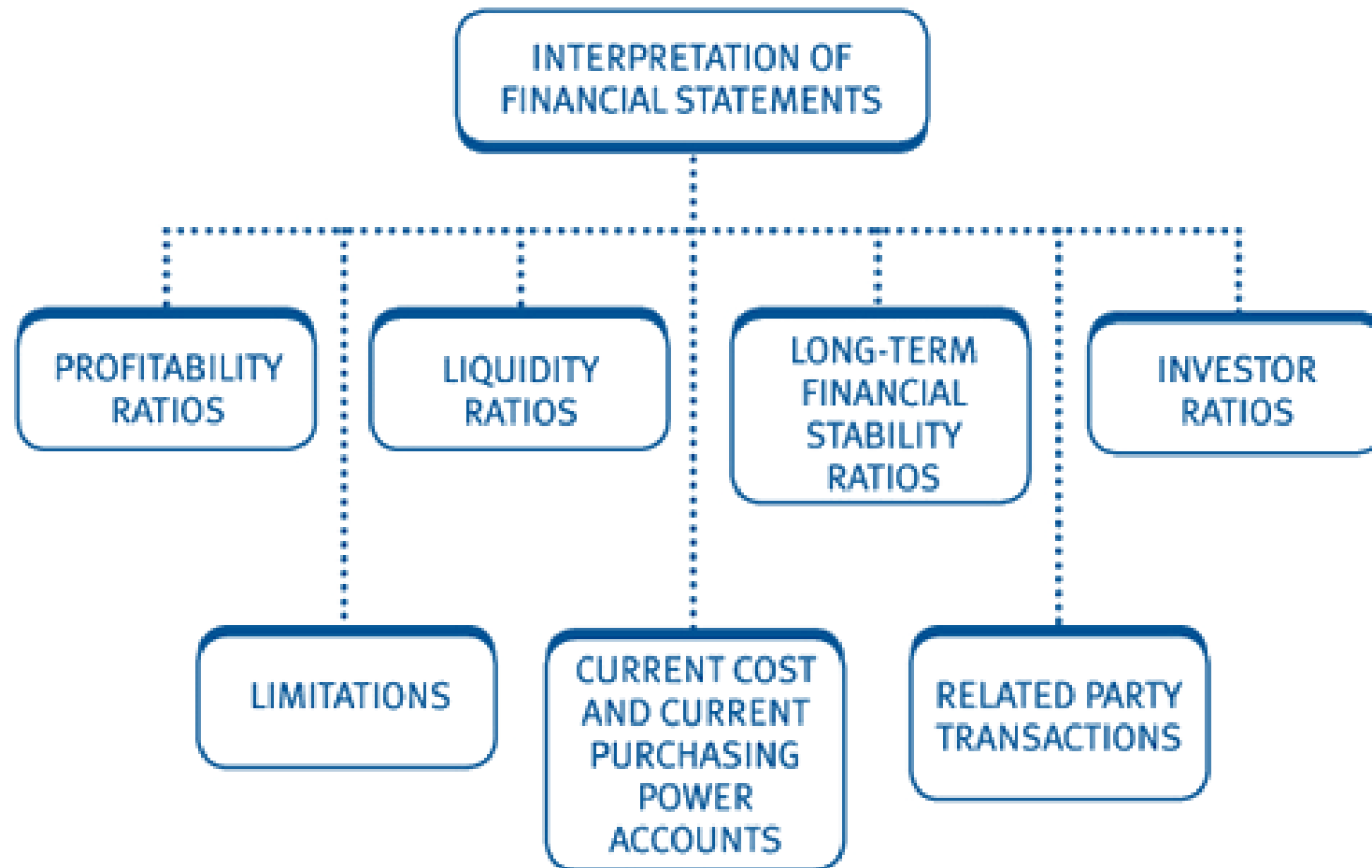
An audit checks to see that the financial statements comply with reporting regulations are a true view of the state of affairs in the organisation. An auditor will also look out for any suspicious activity such as possible fraud.

If an auditor finds something that appears is not being done properly, he or she will qualify the report with suitable warnings? If a report has been qualified by an auditor, it generally means that the organisation has to deal with the issues raised.



Learning Unit 3

Interpreting Financial Statements



- ✓ These financial reports provide information about an entity's financial position and its financial performance over a period of time.
- ✓ It also important for managers to measure long term trends of performance.



The four key areas of measurement are:

Efficiency	Liquidity	Profitability	Capital structure
Looks at how effectively an organisation is managing its assets	A measure of how easily an organisation's assets can be converted to cash.	Provides information about whether the performance is improving or getting worse.	Provides information about whether owner's capital or borrowed capital is used.

A financial ratio is a relationship between two different items from the financial statements and can consist of figures taken from both the Balance Sheet and the Income Statement. Once the ratios are calculated, they can then be interpreted.

Ratio analysis can assist a manager to answer questions such as:

- How effectively are assets being managed?
- How much debt can we afford?
- Is there enough cash to pay short-term debts?

LIQUIDITY

- All current assets are eventually transformed into cash.
- All current liabilities eventually have to be paid for with cash.
- The source for the cash, which is needed to pay current liabilities, is current assets.
- There should, therefore, always be sufficient current assets in relation to the level of current liabilities.
- This relationship is called liquidity.
- Liquidity refers to a firm's ability to meet its obligations over the short term, that is to have the necessary cash available from cash reserves, cash sales and debtors to pay for sufficient stock and to make payments due to creditors.

Two ratios are commonly used to measure a firm's liquidity:

Current ratio = current assets ÷ current liabilities

= 24 000 000 ÷ 10 000 000

= 2.4 times

Quick ratio = (current assets - stock) ÷ current liabilities

= (24 000 000 - 12 000 000) ÷ 10 000 000

= 1.2 times

There are two good reasons for selling stock as quickly as possible:

- There are costs involved in keeping stock on hand e.g. storage costs, insurance costs and the cost of the funds tied up in capital.
- The only way to get the gross profit connected to stock is to sell it.

The speed at which stock is sold is measured by the stock turnover ratio.

$$\begin{aligned}\text{Stock turnover ratio} &= \text{cost of goods sold} \div \text{stock} \\ &= \text{R38 000 000} \div \text{R12 000 000} \\ &= \text{3.17 times per year}\end{aligned}$$



It is customary to express stock turnover in days.
This is done by dividing 365 by the stock turnover ratio just calculated.

Stock turnover in days

$$= 365 \div 3.17$$

= Therefore, it takes 115 days, on average, to sell Jimco's stock.



Creditors payment ratio:
= credit purchases ÷ creditors
= R38 000 000 ÷ R3 000 000
= 12.67 times

Once again, it is more customary to express this ratio in days:

Creditors' payment period:
= 365 ÷ 12.67
= 28.81 days

Jimco takes, on average, 28.81 days to pay its creditors. Cross sectional or time series analysis is needed to judge this figure. If Jimco received credit terms of 30 days from its suppliers, a payment period of 28.81 days may indicate that they have no difficulty in meeting creditor payments on time.



DEBT

- A company's ability to survive over the long term, which is related to its debt position, is measured by these ratios.
- The debt position of a firm indicates the amount of non-owner or non-self-generated funds used by the business

Debt ratio:

= total liabilities ÷ total assets

= R10 000 000 + R10 700 000 ÷ R31 000 000

= 0.668 or 66.8%

Industry norm 47.7%

For each rand invested in assets, R0.66 was financed by debt. Put differently, only R0.34 of each rand invested in assets belongs to the owners.

Times interest earned (TIE)

= Earnings before interest and tax ÷ Interest paid

= R4 000 000 ÷ R1 000 000

= 4 times



PROFITABILITY

Companies need profits to survive, without profits there would not be much point in continuing to trade. Profits vary from year to year, even from season to season. If there is a trend in profits, especially downwards, this should be identified as soon as possible.

Gross profit margin = gross profit ÷ sales

= R13 000 000 ÷ R51 000 000

= 25.49 %

Industry margin – 27.5 %



Operating profit margin = operating income ÷ sales

= R4 000 000 ÷ R51 000 000

= 7.84 %

Industry average – 8.1 %

Net income margin = net income ÷ sales

= R1 800 000 ÷ R51 000 000

= 3.53 %

Industry Ave – 3 %

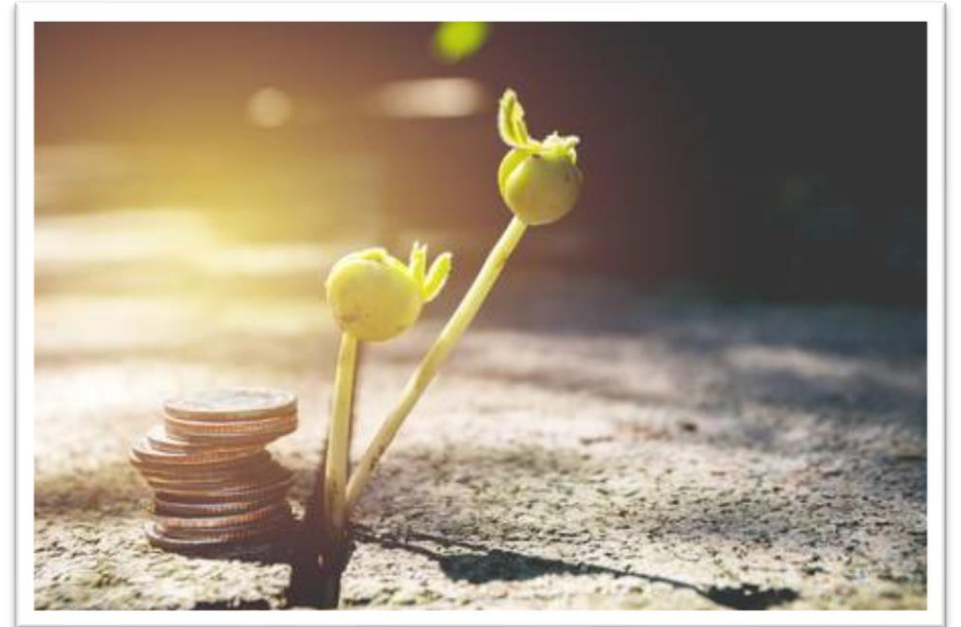
Return on Assets {ROA)
= **net income ÷ total assets**
= **R1 800 000 ÷ R31 000 000**
= **5.81%**

Industry Ave – 4.2 %

Net income after tax x 100 Owners' equity

Debt Equity Ratio:

TOTAL DEBT
TOTAL EQUITY



DIFFERENCE BETWEEN FIXED AND VARIABLE COST

Fixed Cost	Variable Cost	Total Cost
<p>Fixed costs are those cost that will stay fairly constant within a period of time like a month or a year even if no production or sales are generated.</p> <p>Typical fixed costs are rent of building or interest on a bond, salaries of managers, hire of equipment and depreciation on equipment.</p> <p>Date: 2020/07/01</p>	<p>The total variable cost will vary (increase or decrease) proportionally with the quantity manufactured or used.</p> <p>Typical variable costs are materials, direct labour, water and electricity, etc.</p> <p>Version: 002</p>	<p>Total cost is simply the fixed cost and variable cost added together.</p>



LEARNING UNIT 4

FORECASTING

- Forecasting in most businesses almost always comes down to first forecasting sales volumes (quantity rather than value).
- Once the sales volumes have been determined, it follows that everything else can be estimated based on this forecast.
- The initial forecast of sales requires educated guesswork, while the estimations based on these forecasts requires arithmetic and logic.

FORECASTING

Forecasts are often simply done based on past patterns and hunches, however good forecasting utilises a combination of the following two methods:

- History of the numbers
- Knowledge of the environment (the economy, competitors, the product, your market, etc.).



History

When looking at the history of the numbers, you should firstly look for patterns and then project patterns.

Patterns could include:

- The company is expanding.
- The company is in decline.
- The company is seasonal.
- Sales trends.
- Sales cycles.



Knowledge of the environment

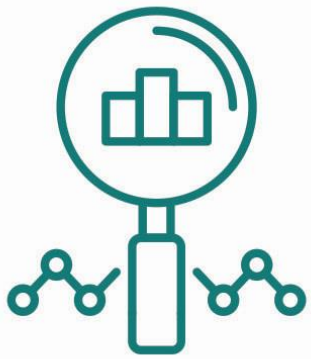
Once you have determined the existing patterns, you will need knowledge of the market and environment in which you operate in order to project future patterns.

Knowledge of the market and the environment can be obtained from the following:-

- Published economic forecasts and other published forecasts
- Your own research and knowledge
- The media
- Knowledge in your organisation
- The internet
- Industry networks

The background is a stylized world map composed of various colored shapes and patterns. The colors include shades of blue, green, brown, and black. Some areas are filled with small white dots, while others have solid colors or simple line art patterns. The overall style is abstract and modern.

**Some economic indicators
you might want also want to
consider include:**



INTEREST RATES:

Interest is the cost of money. When money is borrowed, the cost involved in using the money is that the borrower will pay back more than the amount that was borrowed. This is true for a personal loan as it is for an investor who borrows capital. Interest is charged for all kinds of 'borrowing' including loans, hire purchase, rental, lease agreements, credit cards, bank overdrafts, and even in case of late payments of accounts



EXCHANGE RATES:

Is how much of one currency (Rands) can be exchanged for another currency (US \$). If the Rand is poor against the dollar, it is good for exports, but bad for imports. If the Rand is strong against the \$ it is bad for exports but good for imports.



INFLATION:

Inflation is a sustained and significant increase in general price level. This means that the same R1.00 which bought you a bread in 1990 can now only buy 1/5 of a bread.



GDP:

(Gross Domestic Product) is the total value of goods and services produced by the factors of production located in SA over a specified period. Because some part of domestic production is destined for foreign markets and therefore not sold in South Africa, exports are added to calculate the GDP.

PRICES OF COMMODITIES:



In economics, a commodity is defined as a tangible good that can be bought and sold or exchanged for products of similar value. Natural resources such as oil as well as basic foods like corn are two common types of commodities. Commodities are traded on open markets or stock exchanges. Commodity prices are not set by a single individual or entity and many economic factors that will have an effect on the price of a commodity. However, each commodity is unique and will have a different set of catalysts that can move the price each day.

UNEMPLOYMENT LEVELS:



The unemployment rate is a useful measure of the underutilization of the labour supply. It reflects the inability of an economy to generate employment for those persons who want to work but are not doing so, even though they are available for employment and actively seeking work. It is thus seen as an indicator of the efficiency and effectiveness of an economy to absorb its labour force and of the performance of the labour market.

CONSUMER SPENDING:



Consumer spending is the total money spent on final goods and services by individuals and households for personal use and enjoyment in an economy.

ESTIMATING

As discussed previously, once you have forecasted the main element of sales, everything else from your projections follows on from this.

The following items form an important part of your projections:

1. Capital spending
2. Employee costs
3. Non-employee costs
4. Other income and costs



The following steps should be followed when projecting capital spend:

1. Ask yourself what assets you are going to need.
2. Estimate their expected cost as well as any payment terms.
3. Estimate their useful life spans, residual values and any other costs or benefits.
4. Determine the method of depreciation that you should use.
5. Draw up a depreciation schedule.
6. Set the cost of the acquisitions against your bank balance
7. Record depreciation as an expense.
8. Record any other possible expenses, such as maintenance costs or insurance.
9. Take note of any benefits that the assets would have that might impact on other aspects of your projections



Depreciation

Depreciation is essentially writing off the costs over the working life of your assets.

Different terms are used to describe writing off costs. 'Depreciation' is used for physical assets, 'Amortization' is used for intangible assets and 'Depletion' is used for natural resources.

The Straight Line method

An equal amount of depreciation for each year over the assets life.

Example:

An R10 000 asset with a five-year life span, no maintenance costs and no residual value.

Divide the depreciable base (the acquisition price plus maintenance costs less residual value) by the number of years of expected life span:

$$10\ 000 / 5 = 2\ 000 \text{ per year.}$$

Sum-of-the-year's digits.

- Estimate the number of years of the assets useful life in reverse order (5,4,3,2,1)
- Add the reverse order years ($5+4+3+2+1 = 15$)
- Divide each year by the sum ($5/15$; $4/15$; $3/15$, $2/15$; $1/15$)
- Multiply the depreciable base (acquisition cost plus maintenance costs less residual value) by each fraction above (for example, if the depreciable base is R10 000, then $10\ 000 \times 5/15 = 3\ 333$ for the first year and so on.)

Double-declining balance

- Calculate the straight-line depreciation
- Calculate the percentage depreciation in the first year and then double it. Using the same example, this would be $2000/10000 \times 2 = 0.4$ or 40%)
- Use this factor to calculate depreciation on the outstanding balance.
- Use the straight line figure if the depreciation is higher when calculated using the straight line method.

The following table illustrates the different depreciation methods:

<i>Straight line method</i>			<i>Sum-of-years method</i>				<i>Double declining balance method</i>		
Year	Depreciation	Net asset value	Year	Factor	Depreciation	Net Asset Value	DDB calculation	Depreciation	Net asset value
0		10,000				10,000			10,000
1	2,000	8,000	5	5/15	3,333	6,667	4,000	4,000	6,000
2	2,000	6,000	4	4/15	2,667	4,000	2,400	2,400	3,600
3	2,000	4,000	3	3/15	2,000	2,000	1,400	2,000	1,600
4	2,000	2,000	2	2/15	1,333	667	864	1,600	0
5	2,000	0	1	1/15	667	0	518	0	0
Totals	10,000		15		10,000		9,222	10,000	

Projecting employee costs

Projecting employee costs is fairly simple – use each person’s cost to company and take into account any additional employees that may be required based on your forecasts and their costs to company.

Remember that employee costs include the following:

- Salaries and wage
- Overtime
- Bonuses
- Benefits such as pension and transport allowances
- Other costs such as recruitment costs and training costs.

Projecting non-employee costs

Non-employee costs would include all those costs not associated with employees. Once you have your forecasts, you can estimate these costs.

Examples of operating costs would be:

- Marketing and sales related costs
- Communications costs such as telephone and internet
- Fees such as legal or accounting fees.
- Occupancy costs such as security, water and electricity.
- Computer costs
- Office costs such as stationery
- Travel costs such as petrol and vehicle rentals.
- Other fees and costs such as insurance and bank charges.

PROJECTED FINANCIAL STATEMENTS

Once you have your forecasts and estimations, you can actually create projections that take the format of your financial statements.



Projected Income Statement



An example of a projected Income Statement is shown below:

Key		Month one	Month two	Month three	Month four	Month five	Month six	Total
A	Sales	-	20 000	-	40 000	-	50 000	110 000
B	<i>Less: Cost of Sales</i>	-	13 591	-	27 183	-	33 979	74 753
C	Gross Profit	-	6 409	-	12 187	-	16 021	35247
D	<i>Less: Operating Costs</i>							
E	Employee costs	54 278	55 400	55 400	62 045	62 045	64 715	353 883
F	Other expenditure	12 500	33 814	25 255	17 268	16 596	18 796	124 229
G	Total operating costs	66 778	89 214	80 655	79 313	78 641	83 511	478 112
H	Net profit (loss) before interest and tax	(66 778)	(82 805)	(80 655)	(79 313)	(78 641)	(67 490)	(442 865)
I	Interest and/ or tax	6 678	8 921	8 066	7 931	7 864	8 351	47 811
J	<u>Net profit (loss)</u>	<u>(73 456)</u>	<u>(91 726)</u>	<u>(88 721)</u>	<u>(74 427)</u>	<u>(86 505)</u>	<u>(75 841)</u>	<u>(490 676)</u>

Key	
A	Sales are your sales forecasts as discussed in sections 4.2.1 and 4.2.2
B	Cost of sales needs to be calculated. (For example) Opening stock + Purchases – Closing stock. Cost of sales is calculated based on your sales forecasts.
C	Gross profit projections are your Sales Forecasts less your related Cost of Sales
D	Operating costs include employee and non-employee costs as discussed in sections 4.3.2 and 4.3.3
E	Employee costs would be calculated by using total cost per employee as per current headcount, as well as adding total costs for any additional employees that you project you will need based on your sales forecasts.
F	Other expenditure would include all non-employee costs. You would need to list and add all these to get a total figure. Your list would include things like marketing expenses, travel expenses, depreciation, communication expenses etc. You could list each item separately on your projections or have one total figure as in this example. All of these costs are estimates based on your sales forecasts.
G	Total operating costs is the total of employee and non-employee costs.
H	Net profit or loss before interest and tax is Gross Profit less Total Operating Costs
I	Interest and tax would be calculated based on forecasts and knowledge of the amount of interest earned / owed and tax that needs to be paid. In this example it is shown in one row for the sake of simplicity, however they interest, and tax would be on separate lines.
J	The Net Profit or Loss projections can now be calculated.

Projected Balance Sheet



An example of a simple projected Balance Sheet is shown below:

Assets	Start	Jan	Feb	March	Apr	May	Jun
RANDS							
<i>Current Assets</i>							
Cash Balance		55	15	21	7	15	93
Accounts Receivable		395	371	474	576	644	803
Inventory		251	332	444	545	701	878
Other Current Assets		25	25	25	25	25	25
Subtotal		726	743	964	1153	1385	1799
<i>Capital Assets</i>							
Capital Assets		350	375	375	390	390	440
Accumulated Depreciation		50	51	52	53	54	55
Subtotal		300	324	323	337	336	384
TOTAL ASSETS		1026	1067	1287	1490	1721	2184
Liabilities							
<i>Current liabilities</i>							
Accounts payable		224	268	371	431	564	704
Current Notes		90	90	190	220	320	320
Other Current Liabilities		15	15	15	15	15	15
Subtotal		329	373	576	666	899	1039
Non-current liabilities		285	282	279	376	373	370
Total Liabilities		614	615	855	1012	1272	1119
Capital							
<i>Capital</i>							
Paid-in Capital		500	500	525	525	525	825
Retained Earnings		(163)	(88)	(88)	(88)	(88)	(88)
Earnings		75	0	5	11	12	38
Total Capital		412	412	432	448	449	775
CAPITAL AND LIABILITIES		1026	1067	1287	1490	1721	2184

The following are some important points to remember for a Balance Sheet Projection:

Fixed assets in the Balance Sheet projections forms part of projecting your capital spending as detailed in section 4.3.1.

Inventory projections will stem from the sales forecasts, as well as some analysis of production or delivery schedules in relation to your forecasted sales. Inventory projections should also take into account buffer stocks in case there are unexpected changes in demand.

The retained earnings entries will change by the amount of net profit in any one period.

Accounts payable can be projected as follows:-

Accounts payable can be projected as ratios. For example, if you receive an average of the same deliveries each month and your suppliers give you credit of 30 days and you make one payment per month, projected payables will average one-half of one month's spending on supplies.

Accounts payable is not a change figure, but an actual figure.

Accounts receivable can be projected in a similar manner to accounts payable. Accounts receivable is also not a change figure, but an actual figure.

Projecting cash, loans and share capital will depend on your cash flow and financing policies. The following section will cover information on financing policies and Section 4.4.3 will give you some more information on cash flows.

FINANCING POLICIES

Let us take a moment now to look at some financing policies which will assist you to compile your balance sheet projections.

An organisation will be financed using either debt or equity. The finance may be short-term, medium-term or long term.

When projecting financial requirements, you would need to relate back to your sales forecasts and cost estimates in order to determine whether or not you need to finance your operation and how you should finance your operation.





Let us look at some examples of sources of each type of finance:

Short-term finance:

- **Trade credit** (buying “on account”)
- **Bank overdraft or bank loans:** banks will usually require some form of security for this.



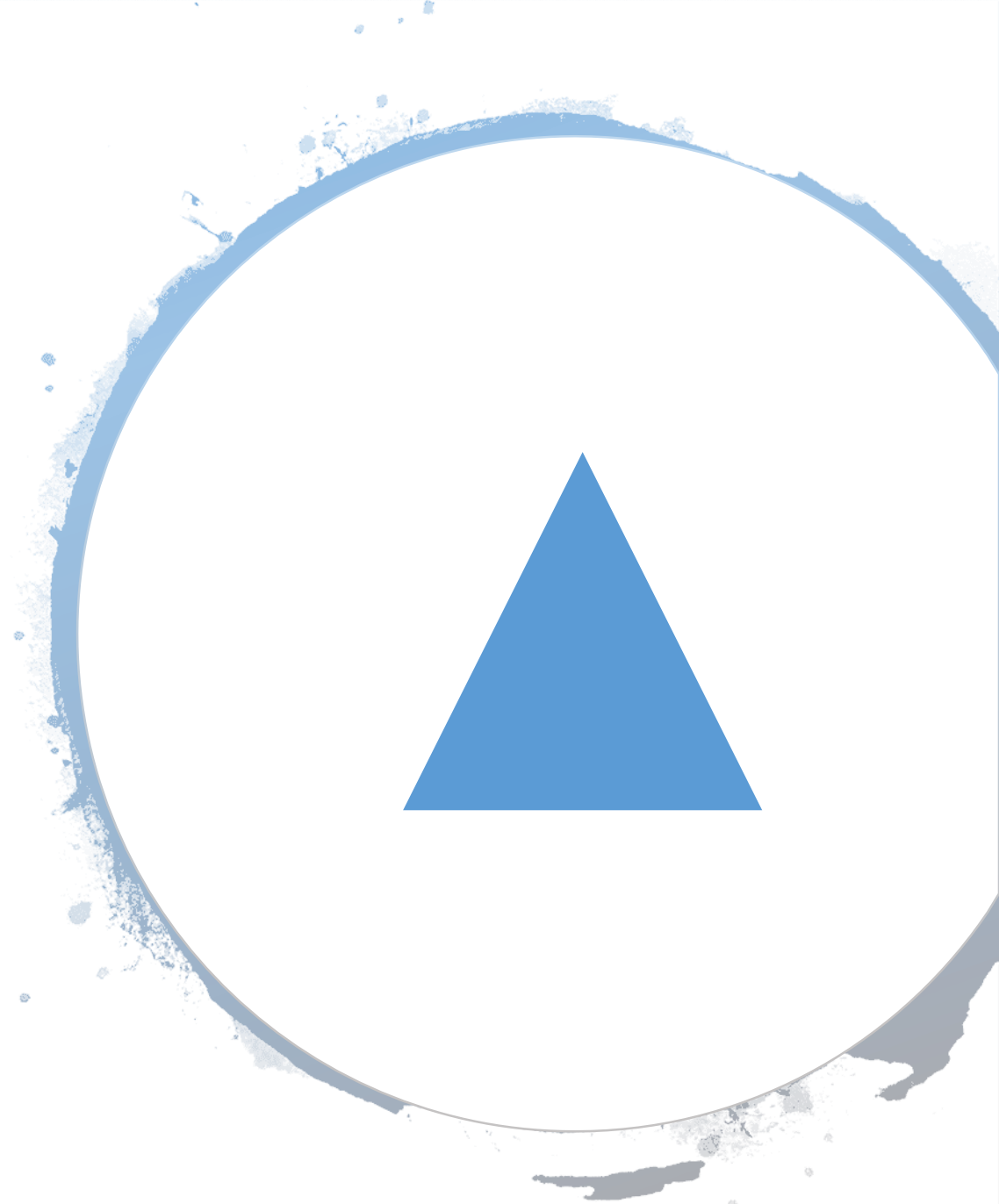
Medium-term finance:

- **Leasing:** monthly payments for purchase or rent of plant, property and equipment.
- **Hire purchase:** Similar to leasing, done through Finance Company.
- **Medium term-loans:** will usually also incur interest and security will need to be provided.



Long-term finance

- **Long-term loans:** will probably be needed to be secured by land or property and will incur interest.
- **Corporate bonds:** Borrowing by a company which is a “paper” traded on secondary financial markets at a fixed interest rate. The borrowing may be secured against specific assets. A debenture is essentially an unsecured bond.
- **Equity:** Shares issued by a company. (Shareholders are owners or part owners of the company)



Equity

Investors accept higher risk

Some ownership and control will need to be given up

Dividend payments are optional and are a distribution of equity

Equity can end up costing more than debt, equity investors are looking for a return on equity that is greater than the rate of interest they could earn on a lower-risk investment

Debt

Lenders do not like risk

Ownership and control is not lost

Interest has to be repaid and is an expense

A ratio that can be used to analyse debt is called the *gearing ratio*:

Gearing ratio = $\frac{\text{Debt}}{\text{Equity}}$

Equity

How to interpret this ratio:

This ratio indicates the extent to which an organisation is dependent on debt or equity. A low gearing indicates a low reliance on debt; a high gearing indicates a high reliance on debt and a possible cash flow problem.

PROJECTED CASH FLOW STATEMENT

Cash Flow Statements

- The Cash Flow Statement identifies the inflows and outflows of cash during a specific period. The Cash Flow Statement presents the users of financial statements with useful and relevant information, for example, answers to the following
 - Was sufficient cash generated from operations to pay the interest charges, dividends and taxation
 - How was the expansion financed, etc.



CONCEPTS TO UNDERSTAND IN CASHFLOW PROJECTIONS



Before we discuss the format of the Cash Flow Statement, we are going to discuss the meaning of certain concepts that are used in the Cash Flow Statement.

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Concepts

1. Cash

Cash, for the purpose of this statement, is cash at bank and on hand and any other highly liquid investment that are **readily retainable** to known amounts of cash.

2. Funds

Funds can be defined as the financial resources possessed by a company and which now flow from transactions concluded **third parties**. This means that there can only be a flow of funds if a transaction occurs between the business and a person outside the business. Your main task will be to determine whether there was an inflow or outflow of funds during the past financial year. One can say that the concepts cash and funds go hand in hand.

3. Investment Activities

Investment activities are those activities relating to the acquisition and disposal of fixed assets and investments. You are referred to the increase of R50 000 IN Land and Buildings and the decrease of R10 000 in vehicles in the previous example.

4. Financing activities

Financing activities are those activities which result in changes in the size and composition

Of the debt and capital funding of the business. In other words, the financing activities indicate where the funds were obtained from to finance the investment activities and daily operating activities.

The increase in R 20 000 in the Ordinary share capital is a good example of financing activity (example to explain the concept funds).

Will an increase in long term liabilities be an inflow or outflow of funds?

Yes, it will be an inflow of funds because more money is borrowed from outside the business.

5. Operating activities

Operating activities include all transactions and other events that are not investing and financing activities. Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of income.

Examples of these type of activities are:

Dividends paid for the year

Taxation paid for the year and

Interest paid (finance cost) for the year

In our discussion later you will see that the information for operating activities is found in the Income Statement.



6. Cash flows from operating activities

The cash flows from operating activities represent the first section of the Cash flow Statement. In this section all those items which have an effect on the determination of income will be taken into account.

The following items are involved.

- Investment income for example dividends received
- Financing charges for example interest paid
- Taxation paid
- Dividends paid
- Changes in working capital which consist of:
 - Increase/decrease in inventory
 - Increase/decrease in debtors
 - Increase/decrease in creditors
- Profit before taxation adjusted with all the non-cash flow items

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Non-Cash Flow items are all those items that have an influence on the profit but that are not a flow of funds because no third party is involved.

The following are examples of non-cash flow items:

- Profit or Loss on disposal of a fixed asset
- Depreciation
- Increase or decrease in the provision for bad debts
- Transfer to reserves

7. Cash flows from investment activities

The cash flows from investment activities represent the second section of the Cash Flow Statement.

In other words, this section indicates how the funds were utilised to maintain or to expand operations. The following items are involved:

- Replacement of fixed assets
- Proceeds on the disposal of fixed assets
- Additions to fixed assets
- Investments purchases
- Investments sold



8. Cash flows from financing activities

The cash flows from financing activities represent the third section of the Cash Flow Statement. In this section all those items which have an effect on the debt and capital funding of the business, will be taken into account.

In other words, this section indicates where the funds were obtained from to Finance the investment activities and the daily operating activities. The following items are involved:

- Increase or decrease in long term borrowings
- Proceeds from issue of share capital
- Increase in share premium



FORMAT CASH FLOW STATEMENT AC 118

Work through examples in LG pg. 78 -88





LEARNING UNIT 5 BUDGETING

- A budget is a short-term financial plan, usually for a twelve month period. On approval, a budget ultimately becomes a target and tool for management control.
- A budget will record the budgeted figures, the actual figures and the variance between the actual figures and the budgeted figures.
- Budgets should ideally not be treated as the only way to control finances, but as one of the tools in a range of measurement control.

REPORT

ADJUST

CONTINUOUS
BUDGETING

BUDGET

Budgets should be consistent across the organisation, prepared using the same headings expectations and assumptions so that they can be aggregated into the final budget.

Where do Budgets fit in?



THE DEVELOPMENT OF SPENDING PLANS

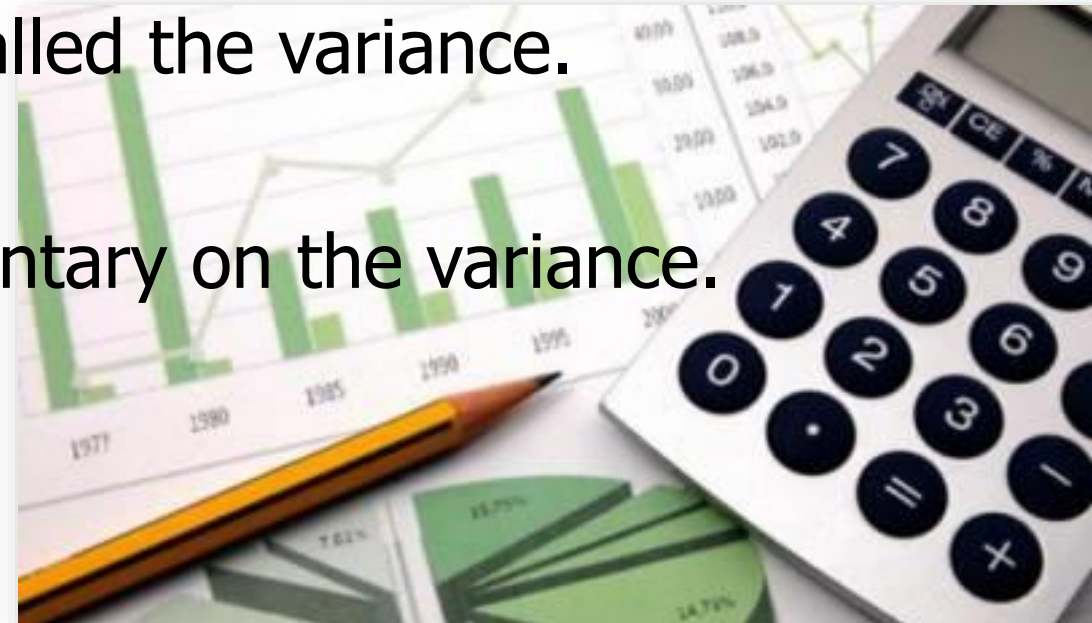
Each business unit or department will create a spending plan or budget which are ultimately brought together to create the final budget plan for the organisation. Bear in mind the overlap with forecasting which you learnt in the previous learning unit.

The process usually takes place as follows:

1. Each business unit draws up their own budgets/ forecasts of expenditure
2. Each business unit also draws up their own budgets / forecasts of capital expenditure
3. In addition to these, the sales business unit will also produce a sales budget / forecast.
4. The production department will also create product volumes and costings budgets/ forecasts.
5. All of these are brought together to form the enterprise budget/ forecast.

THE MANAGEMENT OF A BUDGET

- Managing a budget requires comparing actual figures with budgeted figures (what actually happened compared to what you expected to happen).
- The difference between the two is called the variance.
- A budget should also include commentary on the variance.



An example of the management of a monthly budget for a business nit is shown below:

Marketing Department - Budget Report June 2008						
Rands						
	Month of June			Year to end June		
	Actual	Budget	Variance	Actual	Budget	Variance
Salaries	12000	10000	2000	72000	60000	12000
Stationery	2000	2000	0	12000	12000	0
Telephone	950	500	450	5700	3000	2700
Travel	2500	1200	1300	15000	7200	7800
Total Spending	<u>17450</u>	<u>13700</u>	<u>3750</u>	<u>104700</u>	<u>82200</u>	<u>22500</u>

Budget Commentary

1. Salaries were over budget by R2000 per month due to the salary increase authorised in line with additional responsibilities allocated.
2. Stationery was line with budget.
3. Telephone expenditure was way over budget by R450 per month – the reasons for this need to be investigated and telephone expenditure needs to be curbed.
4. Travel expenditure exceeded more than 100% of the budgeted figure. Urgently requires a check and control or possibly a revision of budget.

When reviewing a budget, a manager should keep an eye out for some of following problem indicators:

Sales are on target, but spending is not.

Spending is on target, but sales are not.

Large variances (more than 10%).

Trends that show a decline, even if still within target.

Sudden big changes.

Single items of expenditure that exceed business unit spending limits.

Large increases in accounts receivable (credit given to customer) and aging accounts receivable (debts not being collected).

Headings that might conceal payments to third parties.



PLANNING, MONITORING, EVALUATION AND CORRECTIVE ACTION



Planning

Budget planning should be done from the bottom up, but frameworks and assumptions for budgeting should be set from the top down. Ensure that individual managers are involved in the budgeting process and are held responsible.

It is important to remember that budgets should not be confused with performance management and that budgets should form part of performance management and not the entire yardstick against which people are measured.

Monitoring

An organisation can be affected by a multitude of factors and a manager should be prepared to reset the budget targets as necessary. A manager should look out for trends and measure them (for example, sales are running below target or spending is running above target). Charts can be created to monitor trends.

Non-financial indicators that ultimately affect the numbers should also be monitored, such as headcount, quality control problems and production levels. Ratio analysis also forms an important part of monitoring.

Evaluation



Evaluating requires taking monitoring one step further and is usually done at set intervals. Use the numbers to determine if you are in line with the business strategy. Evaluate whether cost –cutting measures can be put in place and what these measures should be.

Ask yourself how efficiency can be improved and if more revenue can be generated. Question where things went wrong and why they went wrong.

A manager should also use their knowledge of financial management to benchmark against competitors.

Corrective Action

Monitoring and evaluation does not mean anything unless corrective action is taken. Managers should be required to prepare reports and action plans based on the budget variances and any ratio analysis they have done.

A typical action plan will include goals, objectives (measurable steps towards achieving those goals), timeframes and persons responsible. An action plan should be monitored and checked to see if items are being actioned on time.

END