FINANCIAL SKILLS FOR SMALL BUSINESS

A PROGRAMME PROUDLY BROUGHT TO YOU BY

INSTITUTE OF BANKERS
IN
SOUTH AFRICA

P O Box 64120
Marshalltown
2107

BANK SETA
Thornhill Office Park, Block No.15, 94 Bekker Road, Midrand, 1685
PO Box 11678, Vorna Valley, 1686
Telephone: (011) 805 9661, Fax: (011) 805 8348

114 Grayston Drive,
Sandown, Sandton 2196
P.O. Box 781944, Sandton, 2146
Tel: +27 11 269 8034, Fax: +27 11 269 8163

TABLE OF CONTENTS

INTRODUCTION TO FINANCIAL SKILLS FOR SMALL BUSINESS

Welcome to this programme which will introduce you to financial statements of a small business, which in turn will enable you to better assess and the financial performance of the small business.

The overall purpose of the workshop is, therefore, to assist you in acquiring the applied competence to evaluate the financial performance and the financial position of a small business.

Overall Outcomes

You will be able to:

1. apply your understanding of the relationships between the Income Statement, Balance Sheet and the Cash Flow Statement in the context Small Business Finance.
2. recognise the value of Working Capital management for the small business.
3. identify the role and importance of Financial Leverage, Liquidity, and Profitability of the small business by
    iii. appraising the capital structure of a small business;
    iv. calculating the cost of Capital in the small business and the influence of tax benefits.
    v. evaluating the profitability of Fixed Assets.
    vi. calculating and analysing financial ratios for the small business

4. Evaluate Small Business' performance by:
    iii. Identifying the risks associated with a "growing" small business.
    iv. Identifying the sources and uses of cash and how it flows in the small business.

Delivery Approach

The programme is delivered during a half – day workshop. In conjunction with this learner guide, you will be exposed to an exciting interactive financial model, that is easy to understand, which is used to integrate the learning outcomes.

LEARNING UNIT ONE

THE INCOME STATEMENT

SPECIFIC OUTCOMES

By the end of this learning unit will be able to apply your understanding of:

- various accounting terms such as income, expenses, cost of sales, gross profit and net profit.
- the items that appear on the income statement.
- the flow of transactions through the income statement.
- important information contained in an income statement,

……to successfully assess a small business' profitability.

1.WHAT IS AN INCOME STATEMENT?

The Income Statement, also referred to as the ***Profit and Loss Account,*** presents the historical (transactions that have already taken place) results of the operations of a business for an accounting period, usually one year.

The elements of business operations and the results thereof may be expressed by the equation:

REVENUE – EXPENSES = NET INCOME (OR LOSS)

The income statement presents the details of that equation in a practical and generally accepted format. The extent of the details provided and the grouping of the revenue and expenses items in the income statement may however, differ considerably between businesses depending on their nature and size.

Revenues are usually earned by selling goods or providing services to customers. Expenses are best thought of as the costs incurred by the business in the process of generating income, e.g.

- When a business sells an item, the proceeds are considered as revenue; the sales/revenue account increases.

- Should the business pay a bill for electricity, the expenses account increases.

In other words, revenues contribute to profits and expenses reduce profits.

This accounting profit (or loss) is based on the accounting concept of matching and in no way reflects the cash position of the business. The matching concept demands that when the Income Statement is prepared, only expenses that match the *income received* over the accounting period must be shown.

The income statement can be broken up into two parts i.e.

1. **THE TRADING ACCOUNT** - this account is used to calculate the gross profit i.e. the profit achieved from trading (the buying and selling or manufacturing of goods).

2. **THE PROFIT AND LOSS ACCOUNT** - in which we calculate the net profit i.e. the profit achieved after deducting expenses from the gross profit and adding any other income received from non-operating activities. (e.g. interest, rent & profit on sale of fixed assets)

2.TERMINOLOGY USED IN THE INCOME STATEMENT

A. Example of an Income Statement

Have a look at the example of an income statement on the following page. Once you have studied it carefully, turn to page 11 for detailed explanations of each of the sections.

ZULULAND PLASTICS CC

INCOME STATEMENT FOR THE YEAR ENDED 28th FEBRUARY 20X1

		Note	20X1	20X0
Sales/Turnover			431 228	496 539
Less:	Cost of Sales		316 938	388 340
	Opening Stock		9 917	925
	Plus Purchases		307 756	397 332
	Less Closing Stock		735	9 917
Gross Profit			114 290	108 199
Commission Received			4 211	6 663
Interest Received			-	70
Discount Received			2 964	1 256
			121 465	116 188
Less: Expenditure			121 451	116 136
Accounting Officers Fee			2 150	2 150
Advertising			5 550	-
Bad Debts			-	4 570
Bank Charges			1 162	643
Cleaning			1 730	3 355
Commission Paid			5 929	2 451
Delivery expenses			1 333	
Depreciation			8 134	9 160
Discount allowed			2 028	2 427
Entertainment			12 317	4 089
General Expenses			1 722	2 232
Gifts			719	832
Insurance			4 044	3 482
Interest paid			1 238	1 149
Leasing charges			1 495	474
Loose tools			-	312
Member's remuneration			20 900	40 000
Motor Expenses			16 655	15 124
Rent			621	481
Repairs & maintenance			7 509	5 832
Secretarial fee			2 390	1 242
Stationary			500	
Telephone			1 561	459
Wages & salaries			1 773	1 798
Water & electricity			19 991	13 874
Net Profit before Tax			14	52
Taxation			7	26
Net Income after Tax			7	26
Un-drawn income at beginning of the year			994	968
Un-drawn income at the end of the year			1001	994

TERM	EXPLANATION
Turnover (Sales / Gross Sales / Sales Turnover)	This represents the total income received by a business for its trading activities, being sales and / or services. Often the figure is shown after discounts given to customers have been deducted. As the analyst is trying to establish whether a business is profitable or not, s/he is concerned with income generated from the business, i.e. sales, and not with money received in the form of loans or capital. Loans and capital represent a company's source of finance that enables it to commence or continue with business and hence appear in the Balance Sheet.
Less: Cost of Sales (Cost of goods sold)	This includes purchases to provide the finished goods, as well as Freight, Duty and Railage Inwards. For companies engaged in manufacture, this figure will include cost of raw material and factory labour, as well as overheads such as electricity, rent and supervision.
Opening Stock	The closing stock of a company represents the *opening stock* for the following year.
Less Closing Stock	This is basically unsold stock. Leftover stock that you didn't manage to sell during the accounting period. It represents something of value for the business and is therefore owned by the business.
Cost of Sales - Calculation	Taking the closing stock of the previous year and adding the purchases for the current year, less closing stock for the current financial year, determine this. Example Opening stock (1st March 19X0) 8 917 Plus purchases 207 500 216 417 Less Closing stock (28 February 19X1) 12 217 Cost of Sales 204 200 There will be no Cost of Sales reflected on the Income Statement if the business only renders services.

<table>
<tr><th>TERM</th><th>EXPLANATION</th></tr>
<tr><td rowspan="2">Gross Profit</td><td>Gross Profit is the difference between the actual sales that have taken place and the Cost of Goods sold. Gross profit can also be the difference between the total cost to render a service and the income generated.

Sometimes a Trading Account will be attached from where the Gross Profits can also be determined. Many companies have a policy of not disclosing all the information in the Income Statement reflecting the trading of the business. However, there are certain minimum disclosure requirements laid down by Schedule Four of the Companies Act.

The section covered above is referred to as the Trading Section of the Income Statement and need not be disclosed.
Below is an example of the Trading Section disclosing more information with the approval of the company's management.</td></tr>
<tr><td>
<u>Example</u> Trading Account

Sales 1 276 362
Gross Sales 1 278 362
<u>Less</u>: Returns 2 000
<u>Less</u>: Cost of Sales (Cost of Goods sold)
Opening stock 1st March 20X0 37 520
Plus: Purchases 988 787
Freight 4 111
Duty 1 759
Railage inwards 3 102 997 759
1 035 279

Less: Closing Stock 28th February 20X1 107 620

927 659

GROSS PROFIT 348 703
</td></tr>
</table>

TERM	EXPLANATION
Other Income (e.g. Interest Earned)	This is income reflected from sources other than normal trading activities of a company. These could be: ❑ Discount Received ❑ Commission Earned ❑ Dividend from unlisted investments ❑ Profit on disposal of fixed assets
Less Expenditure	All the expenses listed, represent the other expenses incurred by the company to retail or render a service. It covers items such as rent, salaries, telephone etc. Director's Remuneration is shown as an expense. If Directors exploit the company, this will have a very definite effect on the company's profits. If a director wishes to re-invest some of the money, it should not be seen as exploitation. An increase in the Shareholders Equity will reflect such reinvestments or alternatively the Director's / Shareholders Loan Account will increase.
Less Expenditure	Please note the difference between Director's Remuneration (Close Corporations and Companies) – which is reflected as an expense (Salary) on the Income statement and Drawings (Sole Proprietors and Partnerships) – which is reflected on the Balance Sheet. The expenditure made for the purpose of acquiring assets (purchase of machinery or equipment etc) is reflected in the Balance Sheet and is called *CAPITAL EXPENDITURE*. Capital expenditure is reflected in our books not as expenditure, but rather as the asset which was purchased.

TERM	EXPLANATION
Depreciation	Almost all Fixed Assets (e.g. Buildings, Machinery, Vehicles) but not land are subject to a decline in value through wear and tear. For this reason, a proportion of the initial cost of the asset is deducted each year from assets to show its reduced value. This depreciation represents an expense (loss in value) to the business and is therefore deducted in the income statement. The Receiver of Inland Revenue prescribes over what period assets are to be written-off taking into consideration the estimated useful life of the asset concerned.
Net Income Before Tax	This figure represents the total profit / loss earned after deducting all operating expenses from the Gross Profit before taking into consideration the tax. The Income Statement for a Sole Proprietor and Partnership will end here as they are not separate legal entities, in terms of tax payments.
Taxation	If a company makes a loss, tax is usually not payable. Tax allowances cause timing differences as to when tax becomes due and is deducted. A tax charge could appear in the financial statements of a company, which has incurred a trading loss for that period.
Net Income After Taxation	This is the amount a company has earned during the year, after incurring expenses and paying taxes.
Retained Income Or Accumulated Loss At Beginning Of Year	For companies, the net profit after tax can either be ploughed back into the business and this will be reflected in the Balance Sheet under Retained Income, or a portion can be paid out to the company's shareholders as dividends. The balance will then go to Retained Income. For Sole Proprietors the net profit is transferred to the capital account in the Balance Sheet. Retained Income at the beginning of the current year equals the retained income at the end of the previous year.

TERM	EXPLANATION
Retained Income Or Accumulated Loss At Beginning Of Year	Dividends are not a business expense. They are a distribution of corporate profit, after taxation, to the owners/shareholders. In a sense, they are a reward to the shareholders for investing in the Company.
Retained Income Or Accumulated Loss At Beginning Of Year	Example: Net Income after Taxation R 540 000 Dividends paid R 120 000 Retained Income R 420 000
Retained Income At The End Of The Year	The retained income at the end of the previous year, plus the net profits (after tax and dividends) for the current year equals the Retained Income at the end of the year. This figure is carried over to the Distributable Reserves in the Balance Sheet.

3.SUMMARY

- The Income Statement is drawn up to determine the profit or loss of a company for a particular period.
- Revenue Expenditure is the expenditure incurred in the day to day running of the company e.g. rent, electricity.
- Capital Expenditure relates to the purchase or improvement of the company's assets and is reflected in the Balance Sheet.
- Trading Account shows the calculation of gross profit.
- Gross profit is the profit achieved on trading (i.e. on buying and selling the goods of your business).
- Profit and Loss Account shows the calculation of net profit.
- Net profit is the profit achieved after deducting expenses from gross profit plus any other revenue received, such as discounts received.
- Discount Allowed is the amount of discount allowed to customers and treated in the same way as other expenses.
- Discount Received, like rent received and interest received, is a form of income, which is added to gross profit before deducting expenses.
- An Income Statement is for the year ending or for the month ending etc., as it reflects the profit or loss for that period. A Balance Sheet, being like a photograph of a company's assets and liabilities, is always as at a particular date.

Make your own summaries here……..

Now let's practice what we have learnt by completing the activities on the following pages.

Activity 1

Use the Income statement for Zululand Plastic (CC) to do the following exercise.
1) How many types of profit can you identify on the income statement of Zululand Plastic (cc) Ltd?
2) How much profit after tax (PAT) did Zululand Plastic (cc) make during the year ending February 20X1. Be specific!
3) Has PAT of Zululand Plastic (cc) improved or worsened during the year? Explain in detail

4) Which part of the income statement should you look at to find the problem areas of the business?
5) How can Zululand Plastic increase PAT?

Activity 1 - Answers

1) How many types of profit can you identify on the income statement of Zululand Plastic (cc) Ltd?
Gross Profit, profit before tax, profit after tax, un-drawn income

2) How much profit (PAT) did Zululand Plastic (cc) make during the year ending February 20X1. Be specific!
R7.00

3) Has part PAT of Zululand Plastic (cc) improved or worsened during the year? Explain in detail
PAT has declined by 73%, sales decreased by 13% and gross profit, increased by 60%. One would expect that these three numbers move at the same rate (Parallel).

4) Which part of the income statement should you look at to find the problem areas of the business?
Entire income statement is useful, approach the analysis analytically by applying ratios and a trend analysis.

How can Zululand Plastic increase PAT?
Reduce operating expenses, use debt so as to pay higher interest hence lower taxes. Use tax write offs like donations.

LEARNING UNIT TWO

THE BALANCE SHEET

SPECIFIC OUTCOMES

By the end of this learning unit you will be able to apply your ability to:

- define various accounting terms such as assets, liabilities and capital.
- identify items that appear on the balance sheet.
- describe how transactions flow through the balance sheet.
- extract the relevant information from a balance sheet

……in order to successfully assess the financial position of a small business.

1.WHAT IS A BALANCE SHEET?

The Balance Sheet reflects the state of affairs of a business enterprise at a particular point in time. It presents under separate and distinct headings the assets and liabilities of a business and the equity of the owners. It reflects what a business owns and owes on a specific date.

Owns = Assets = How money is used

Owes = Liabilities = Where money came from

The balance sheet therefore shows what assets the business is using and how these assets have been funded.

The classification, headings and accounting data presented in a balance sheet will vary considerably depending on the nature and size of the business and the type of business organisation.

However, provisions contained in the Fourth Schedule of the Companies Act and Guidelines on Annual Financial Statements published by the National Council of Chartered Accountants (S.A.) have assisted in establishing generally accepted forms of balance sheet presentation.

Items in a balance sheet are generally presented in such a way that significant information is readily understandable and that items not significant in themselves are grouped with such other items as most closely approximate their nature.

2.TERMINOLOGY USED IN THE BALANCE SHEET

A. Example of an Balance Sheet

ZULULAND PLASTICS CC

BALANCE SHEET AS AT 28th FEBRUARY 20X1

	Notes	20X1	20X0
UTILISATION			
NON CURRENT ASSETS		**32 041**	**38 834**
Fixed Assets	3	32 041	38 161
Investments		0	673
CURRENT ASSETS		**65 250**	**55 234**
Stock		735	9 917
Debtors		58 283	45 217
Cash in Bank		6 232	100
TOTAL ASSETS		**97 291**	**94 068**
FUNDING			
EQUITY & LIABILITIES			
Member's Contribution	4	100	100
Undrawn Income		1 001	994
MEMBER'S INTEREST		**1 101**	**1 094**
NON CURRENT LIABILITIES		**56 915**	**48 285**
Member's Loan	4	44 915	36 285
Long term Loan	2	12 000	12 000
CURRENT LIABILITIES		**39 275**	**44 689**
Bank Overdraft		-	1 645
Accounts Payable		38 274	39 962
Current Portion of Long Term Debt		-	2 088
Tax Payable		1 001	994
TOTAL EQUITY & LIABILITIES		**97 291**	**94 068**

<table>
<tr><th>TERM</th><th>EXPLANATION</th></tr>
<tr><td>Capital Employed</td><td>This section represents the money-in or Liability side of the balance sheet.</td></tr>
<tr><td>Equity of Unincorporated Business</td><td>Equity is the accounting term used to designate the interest of the owners of a business enterprise, represented by the excess of the value of the assets of the enterprise over its liabilities. The relationship of assets, liabilities and equity may be expressed by the equation:

Assets – liabilities = Equity

The terminology used in the equity section of the balance sheet will vary according to the form of the business enterprise. On the balance sheet of a sole proprietorship business the owner's equity is usually reflected in the amount of the owner's Capital Account. The balance on this account comprises the amount of capital invested by the owner in the business including profits retained in the business, less any losses that have been incurred.

In the financial statements of a sole proprietorship it is customary to show the owner's equity as a single amount or in the form of a short statement. This statement reflects the balance of the owner's interest at the beginning of the year, the additions and withdrawals during the year and the closing balance at the end of the year, as follows:</td></tr>
<tr><td>Owner's Capital Account</td><td>Balance at the beginning of the year 50 000
<u>Add</u>: Net profit for the year, as per income statement 20 000
Additional amount invested during the year <u>10 000</u>
80 000

<u>Less</u>: Withdrawals during the year 3<u>5 000</u>
Balance at the end of the year 45 000</td></tr>
</table>

TERM	EXPLANATION
Owner's Capital Account	On the balance sheet of a partnership business the equities of the individual partners are kept separate so as to show each partner's interest in the business. A distinction is usually made between the amounts contributed by each partner in the form of capital and the amounts left in the business on current accounts represented by the amounts of past profits allocated to the partners and not withdrawn from the business by them.
Equity of Companies	**Share Capital** Capital is the name describing the funds, provided by owners or shareholders, which is normally used to set up a business. The most common ways for a company to raise capital is by selling shares in the company. The investors who buy these shares, are called shareholders and are in effect all joint owners of the company. By investing in a company, investors expect a return, which is paid to them in the form of dividends. This is normally a more profitable investment than ordinary savings and / or fixed deposit account. There are however a risk involved of losing money, should the company be declared insolvent (bankrupt). **Non–Distributable Reserves** As the name implies, Non-Distributable Reserves are not available for distribution by way of dividends. These reserves may not be distributable because of the provision of the company's act, the articles of association of the company, case law, resolutions of the directors or of resolution by the company in general meeting. The only Non-Distributable reserve arising from the Companies Act is the capital redemption reserve fund. The articles of association of a company may provide that certain profits cannot be distributed by way of a dividend – for example the profits on the sale of land & buildings, which were held as a fixed asset. Such profit will be reflected on the income statement as 'other income'.

TERM	EXPLANATION
Equity of Companies	The directors are usually given the power by the articles of association to put to reserve such profits as they think necessary and the directors have the implied authority to treat these as Non-Distributable. Directors may however decide to reclassify a Non-Distributable reserve as a distributable reserve in the next balance sheet. This may happen in the case of a fixed asset replacement reserve. **Distributable Reserve / Retained Income** A distributable reserve is defined as any amount, which has been carried to reserve and which may, in accordance with generally accepted accounting practice and legal principles, be taken to the income statement and distributed by way of a dividend. Retained income represents the accumulated balance of net income less losses arising from the operations of a business, after taking into account dividends that have been distributed out of this income. Where there have been losses and there is a debit balance on the income statement it is considered that the term "accumulated loss" is most appropriate. Retained income is transferred from the income statement to the balance sheet as a distributable reserve. **Shareholders' Interest / Shareholders' Equity** When the Share Capital, Non-Distributable Reserves and the Distributable Reserves are added together the total is called Shareholders' Interest. It is the total of all the funds invested into the company by the shareholders, plus all the profits earned by the company that have been re-invested in the company. **Long Term Liabilities** When a company borrows money over a period of longer than 12 months, such a borrowing becomes a long-term liability.

TERM	EXPLANATION
Equity of Companies	***Example:*** An Instalment Sale Agreement over a period of 42 months Total Debt: 42 Instalments @ R600 = 25 200 Less: Short-term portion Next 12 months' instalments 7 200 Balance = Long-term Liability (Last 30 instalments) 18 000 The Total Of Share Capital, Non-Distributable Reserves, Distributable Reserves And Long Term Liabilities Equals The Total Capital Employed
Employment of Capital	This section represents the money-out or Asset side of the balance sheet. Employment of capital is divided into 2 main sections, namely: ❑ Fixed Assets (and Other Assets) and ❑ Working Capital (Current Assets less Current Liabilities) Working Capital can be a negative value, if the current liabilities exceed the current assets.
Fixed Assets	Fixed assets are items of a *permanent or semi - permanent nature*, necessary for carrying out the business activities and therefore not normally changed in day-to-day trading. They are listed above current assets in order of permanence. Fixed assets consists of a number of items of which Land & Buildings are amongst the most valuable fixed asset a company can own, and are always shown at cost or market value in the balance sheet. Depreciation is usually not calculated and deducted from Buildings, although some companies where buildings are of a specialised nature, will depreciate their property. Land however does not depreciate. Other fixed assets such as plant, machinery, vehicles, equipment and furniture depreciates each year.

TERM	EXPLANATION
Other Assets	These are assets, which can neither be classified as fixed and or current. These are assets that are not used in the business but are also not for resale. They are usually listed between fixed and current assets on the balance sheet and often include assets which are intangible (i.e. cannot touch or see) like goodwill or certain rights. Other assets in this category are investments, loans to subsidiary companies, listed shares, patents, royalties, etc. Goodwill is an intangible value placed on a business' worth. The difference between the selling price and the net asset value of a business is called goodwill. This is an intangible and is normally ignored for credit assessment purposes. Goodwill can be written off (amortised) over a period of time.
Current Assets	Current assets are acquired with the intention to sell or use within the accounted period (i.e. 12 months). They are items acquired or produced for resale and conversion into cash (or cash itself) - the least liquid usually being listed first. The most common items found under current items are: **Stock / Inventory** Stock will be valued at the lowest of cost or market value. Stock can be in the form of raw materials, work in progress or finished goods. **Debtors / Accounts receivable** People who owe the business money are normally expected to pay their debt in the short term – 30 to 90 days. **Associated Company Loans (Subsidiary companies or directors or shareholders)** These are loans that must be repaid within 12 months. In a sense it is a debtor. **Cash in Bank** All cash on hand and in the bank sometimes include investments invested for a period less than 12 months. Short-term investments may also appear under Accounts Receivable or Marketable Securities.

TERM	EXPLANATION
Current Assets	**<u>Taxation</u> (Prepaid)** Companies are required to estimate their annual pre-tax profits for the year and to pay tax in advance. If the company overestimates and pays too much tax, the amount to be refunded, by the Receiver of Inland Revenue, is shown on the balance sheet under current assets as Taxation. The company will not receive a refund immediately, but will have a credit with the tax authorities equal to this amount.
Current Liabilities	These are all the monies owed by the company, payable within the next 12 months. The most common items found under current liabilities are: **<u>Bank Overdraft</u>** A Company may make use of an overdraft facility. These facilities are reviewed annually by the bank. As the bank may call up the facility at any time it is regarded as short-term debt. **<u>Creditors / Accounts Payable</u>** These are all amounts owed to suppliers of goods or services, which are to be paid within the next 12 months. The current portion of long-term debt is often included under creditors. **<u>Taxation Payable</u>** This figure represents an accrued expense due to the tax authorities, which is not yet paid at balance sheet date.

TERM	EXPLANATION
Current Liabilities	**<u>Current Portion of Long Term Debt</u>** These are repayments on Instalment Sale, Rental and Lease agreements and Bond repayments payable within the following 12 months. **<u>Associated Company Loans (Subsidiary companies or directors or shareholders)</u>** These are loans that must be repaid within 12 months. In a sense it is a creditor. **<u>Dividends Payable</u>** This amount is set aside for dividends, because although a dividend has been declared, it is still unpaid on Balance Sheet date.

An Income Statement is always for the year ending... or for the month ending... etc, as you are calculating the profit achieved over that period.

A Balance Sheet, being a photograph of a company's assets and liabilities, is always as at a particular date and will change the following day.

3.SUMMARY

- A Balance Sheet reflects the financial position of a business at a particular date only.
- The only items to appear in the Balance Sheet of a company are the items owned or owed by the business not the personal assets of the owners. This is the Business Entity Concept.
- **Assets = Capital + Liabilities.**
- A Balance Sheet must always **balance**.
- **Assets** are items owned by the business e.g. premises
- **Fixed assets** are of a permanent or semi-permanent nature, necessary for the continuation of the business and therefore not normally changed on the day-to-day trading.
- **Current assets** are items acquired or produced for resale and conversion into cash.
- **Capital** is the amount contributed by the owners of the business.
- **Profits** are owed by the business to the owners and are therefore added to capital.
- **Drawings** represent the money withdrawn by the owners and are deducted from capital plus profits.
- **Liabilities** are amounts owed by the business.
- **Long term liabilities** are debts that are repayable after more than one year.
- **Current liabilities** are debts that are repayable within one year.
- **Overdrafts** are normally repayable on demand and are therefore considered to be a current liability.
- **Creditors** are people to whom the business owes money and are hence a liability, and if repayable within one year a current liability.
- **Debtors** are people who owe the business money and are hence a current asset.

Make your own summaries here……..

NOW LET'S PRACTICE WHAT WE HAVE LEARNT BY COMPLETING THE ACTIVITIES ON THE FOLLOWING PAGES.

Activity 2

Use the Balance Sheet for Zululand Plastic (CC) reflected on page 23 to do the following exercise.
1) Who has provided the money to finance the assets of the business and how much have they provided in 20X1?
2) If Zululand plastic cc goes into bankruptcy or liquidation today, how much will the shareholders receive? What assumptions are you making in the above statement?
3) What are the total assets of the business in 20X1?
4) What are the total liabilities of the business in 20X1?

Activity 2 - Answers

1) How many types of profit can you identify on the income statement of Zululand Plastic (cc) Ltd?
Gross Profit, profit before tax, profit after tax, un-drawn income

2) Who has provided the money to finance the assets of the business and how much have they provided in 20X1?
Members – R1101 Equity ***Creditors – R96 190 Debt***

3) If Zululand plastic cc goes into bankruptcy or liquidation today, how much will the shareholders receive? What assumptions are you making in the above statement?
It depends on the marker value of the assets. Usually a pro rata share of the net assets is done, e.g. 20 cents in the rand

4) What are the total assets of the business in 20X1?
R97 291

5) What are the total liabilities of the business in 20X1?
R96 190

LEARNING UNIT THREE

THE CASH FLOW STATEMENT

SPECIFIC OUTCOMES

By the end of this learning unit you will be able to apply your understanding of:

- The definitions of a cash flow statement;
- The components of a cash flow statement,

……in order to successfully analyse the financial performance of a small business.

1.WHAT IS A CASH FLOW STATEMENT?

☑ **The cash flow statement shows the flow of funds or cash in the business:**

- ❑ It focuses on the sources and uses of cash, focusing on cash from operations, cash from investing activities and cash from financing activities.

- ❑ The balance sheet and income statement do not adequately indicate changes in cash flow. Transactions such as the sale of ordinary shares and the purchase of equipment do not appear on the income statement. These types of transactions are reflected on the balance sheet, but they are not summarised in a meaningful manner.

- ❑ The balance sheet indicates the financial position of the entity at a point in time, however, it does not indicate how the entity arrived at this financial position.

- ❑ The income statement shows the profit or loss for a period of time, but it does not indicate how funds from operations were used.

☑ **The need for a cash flow statement arises from the following factors:**

- ❑ Financial managers need accurate forecast of cash flows to make accurate investment and financing decisions.

- ❑ Investment bankers and deal makers need to know how much to bid for a company in an acquisition and/or merger.

- ❑ Managers need to know how much cash flow is generated by assets to get feedback on their strategic decisions.

- ❑ Investors and creditors need to know how much cash is generated from assets and operations to determine the financial solvency of a company.

☑ **Generally Accepted Accounting Practice (GAAP) procedures lead to differences in net profit versus cash flows:**

- Accounting is concerned with presenting the net profit of the firm.

- One of the financial manager's duties is to ensure that the firm always has sufficient cash flow to meet demands for payments. However, cash flow does not equal GAAP net profit.

- Depreciation and other non-cash items are included in GAAP net profit.

- Items are recorded on an accrual basis not when the money actually comes into the firm.

- The use of market values in certain assets and liabilities versus book value.

2.COMPONENTS OF THE CASH FLOWS STATEMENT:

The statement of cash flow summarizes the flow of cash receipts (inflows) and cash payments (outflows) during a given period of time. It organizes cash flows into 3 primary categories, namely:

1. ***Operating cash flows:*** Cash flows from operation equal cash received from sales of goods and services minus cash paid for operating goods and services.

2. ***Investment cash flows:*** The acquisition of non-current assets, such as property, plant and equipment usually represent a major ongoing use of cash, and

3. ***Financing cash flows:*** A firm obtains cash from short- and long- term financing and equity issues. Cash is used to paid dividends, repay borrowings and repurchase shares of share outstanding.

In developing the statement of cash flows, it's important to distinguish between sources of cash and uses of cash.

Depreciation was taken off our sales hence the net profit is lower.
Depreciation being an expense is not an actual cash amount.

A. Analysing operating activities:

Profit before interest and tax (PBT + interest)
Add: Depreciation
Less: Profit on disposal of assets
Add/Less: (Decrease) increase in debtors
Add/Less: (Decrease) increase in inventories stock
Add/Less: Increase (Decrease) in creditors
Add/Less: Increase (Decrease) in shareholders for dividend
Less: Interest paid
Less: Taxation paid (opening tax + current tax – closing tax
Less: Cash dividends paid

B. Analysing financing activities:

Proceeds from sale of ordinary shares
Less/Add: (Repayments) Receipts of long term loans
Less/Add: (Repayments) Proceeds from overdraft facility

C. Analysing investing activities:

Purchase of property, plant and equipment
Proceeds from sale of fixed assets

Total sources less total uses of cash
Add: Cash and cash equivalents (beg of year)
= Cash and cash equivalents (end of year)

4.SUMMARY

Make your own summaries here……..

The cash flow statement for **ABC Ltd for the financial year ended 31 March 20X1** is reflected on the next page. Let's practice.

ABC Ltd Cash Flow Statement Year Ended 31 March 20X1			
	20X1	20X0	Diff
Analysing operating activities :			
Profit before interest and Tax	12465	9594	2871
Add: Depreciation	2519	1216	1303
Less: Profit on disposal of assets	-3354	-2500	-854
Less: Increase in debtors	-1410	-1000	-410
Less: Increase in inventories	-5307	-130	-5177
Add: Increase in creditors	725	575	150
Add: Increase in shareholders for dividend	249	-250	499
Less: Interest paid	-179	-254	75
Less: Taxation paid (Opening tax + Current tax – Closing Tax	-3686	-4112	426
Less: Cash dividends paid (shareholders for dividend)	-2433	-250	-2183
Cash Generating (used) in operations	**-411**	**2889**	**-3300**
Analysing financing activities :			
Proceeds from sale of ordinary shares Note 1	0	0	0
Repayments of long term loans	-121	-121	0
Proceeds from overdraft facility	24	187	-163
Cash used in financing activities	**-97**	**66**	**-163**
Analysing investing activities :			
Purchase of property, plant and equipment	-8760	0	-8700
Proceeds from sale of fixed assets	7155	0	7155
Cash used in investing activities	**-1605**	**0**	**-1605**
Total sources less Total uses of cash	-2113	2955	-5068
Cash and cash equivalents (beg of year)	11259	8304	2955
Cash and cash equivalents (end of year)	**9146**	**11259**	**-2113**

Activity 3

Use cash flow statement of ABC LTD on the previous page to complete the exercise
1) How much cash has been generated from the operations of the business?
2) How much cash has been generated from financing activities during 20X1?
3) How much cash has been generated from the buying and selling non current (fixed) assets?
4) Has ABC improved or worsened during 20X1 in terms of money generated operations?

5) How can you tell if ABC is experiencing difficulties (or not) in terms of its operations?
6) How much cash does ABC have in its bank account as of March 20X1?
7) Is there a way of improving cash from operations without increasing sales?

Activity 3 - Answers

1) How much cash has been generated from the operations of the business?
R411

2) How much cash has been generated from financing activities during 20X1?
R97

3) How much cash has been generated from the buying and selling non current (fixed) assets?
R1605

4) Has ABC improved or worsened during 20X1 in terms of money generated operations?
Cash generated from operations has dropped from R2889 in 20X0 to –R411. This is not good and implies the business is experiencing trouble operationally

5) How can you tell if ABC is experiencing difficulties (or not) in terms of its operations?
Turnover went up by 3%; Overheads increased by 17%, cash from operations declined by 114%

6) How much cash does ABC have in its bank account as of March 20X1?
R9146 (See cash flow and balance sheet for 20X0)

7) Is there a way of improving cash from operations without increasing sales?
By engaging in actions that affect working capital components (decrease debtors & stock and increase creditors

LEARNING UNIT FOUR

RATIOS

SPECIFIC OUTCOMES

By the end of this learning unit, you will apply your understanding of:

- the purpose of financial analysis.
- the critical success factors of a business.
- ratios, which assist in analysing critical success factors.
- key ratios calculations used to assess the financial position of a business.
- key ratios interpretations used to assess the financial position of a business.

….in order to assess the financial situation of a business.

1.WHAT ARE RATIOS?

A ratio describes the relationship between two figures and can be shown as a fraction or a percentage. It is the relationship between certain items in the Financial Statements. Ratios are accepted as useful aids in assessing managerial efficiency, profitability and the debt capacity of a company.

2. WHAT INFORMATION DO WE GET FROM RATIOS?

Ratio analysis essentially provides indicators of past performance in terms of profitability and operational activity. It also highlights financial strengths and weaknesses concerning solvency, liquidity and capital structure.

A Ratio itself is of very little value. It's significance increases when:

- It is compared with the same ratio for a series of consecutive years.
- Changes in ratios from year to year can be helpful in indicating trends.
- It is compared with other ratios in the same financial statements.
- It is compared with Industry norms (e.g. by comparing ratios with another company in the same line of business.)

When several ratios all point in the same direction, the trend cannot be ignored.

A vast number of ratios can be calculated from the data contained in a set of financial statements. Some ratios are of lesser significance than others, and we will concentrate on the most important ones, generally used by banks.

We will again use the same income statement and balance sheet of **Zululand Plastic – 20X0**

3.LIQUIDITY RATIOS

These ratios measure the ability of a company to cover its current liabilities out of its current assets. The following are the 3 most widely used measures of liquidity:

A. Current Ratio (Working Capital Ratio)

Indicates the extent of the liability of the company to cover it's current liabilities out of the proceeds of it's current assets. It takes into account the length of time it takes to complete the normal operating cycle of the business. By examining the amount of cash on hand and other current assets in relation to the maturing financial obligations, ratio analysis indicates a measure of liquidity.

It is calculated as follows:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$= \frac{55\ 234}{44\ 689} = 1.23:1$$

Explanation :

For every R1 of Current Liabilities the company has R1.23 in Current Assets. This ratio shows us what a business' current assets are in relation to its current liabilities. It shows the total money available against the total money required over the short term.

Depending on the type of business a Current Ratio of 2:1 is regarded as satisfactory. In the event of bankruptcy, and should the book value of the current assets shrink by 50% on liquidation, the current creditors may still receive full payment of their debts, provided there are no prior claims or long term creditors.

B. Quick Ratio (The Acid Test)

This ratio measures the ability of the company to pay its current liabilities out of immediate realisable current assets when there is an urgency to pay creditors. As

stock and other less liquid current assets, such as prepaid expenses, are the least liquid of assets, we have to exclude them from current assets.

It is calculated as follows:

$$\frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}} = \frac{55\,234 - 9\,917}{44\,689} = 1.01:1$$

Explanation:

Current Assets minus Stock is referred to as Quick Assets. The company has R1.01 Quick assets for every R1 Current liabilities.

A Company with a Quick ratio of more than 1:1 should pass the Acid Test, as there can be little doubt that such a company will be able to meet its current obligations at short notice. However it is not the ultimate measure, and a company with a lower ratio can still be liquid.

Clearly this ratio will be lower than the current ratio, but the difference between the two ratios; i.e. the gap will indicate the extent by which *current assets are made up of stock*. The wider the gap between the two ratios, the higher the proportion of stock and pre-paid expenses to other current assets.

The quick ratio can also assist the analyst in identifying a disproportionate increase (or decrease) in stock, relative to other current assets.

4. Activity Ratios

A. Average Collection Periods

The most relevant comparison here is between the debtors' and the creditors' period. If debts are collected before payments are made to creditors, the business has much less chance of running into cash flow problems. Conversely, if the business is paying creditors before receiving cash from debtors, this will place a strain on cash flow. The wider the *gap* between debtor receipts and creditor payments, the more beneficial to the company.

The average collection periods can be calculated in two ways. The analyst can:

- Calculate how many times debtors and creditors "turn over" (*activity*).
- Calculate the number of days it takes to pay creditors and receive payment from debtors (*liquidity*).

Let us look at each of these calculations, Creditors payment period and Debtor collection period separately:

B. Creditors Payment Period

This measures the number of days a company takes to settle the amounts they owe to creditors. The average period of settlement is usually calculated for trade creditors excluding amounts outstanding in respect of Instalment Sale or Finance Lease Agreements.

The average amount of outstanding creditors is often determined by adding the outstanding balances at the beginning and end of the financial year and dividing the total by 2.

A more satisfactory or correct average may be determined by adding the outstanding balances at the end of every month during the year and dividing the total by twelve.

It is calculated as follows:

Creditors payment Period (Days – Liquidity)

$$\frac{\text{Average Creditors}}{\text{Purchases}} \times \frac{365}{1} = \text{Days}$$

$$= \frac{39\,962}{397\,332} \times \frac{365}{1} = \frac{14\,586\,130}{397\,332} = 37 \text{ Days}$$

Explanation:- It will take the company an average of 37 days to pay its creditors OR the company pays its creditors ten times a year.

Companies normally have arrangements with their creditors, to settle accounts within 30, 60 or 90 days. If this period suddenly increases, it needs to be investigated as it could indicate a cash flow problem. If the average period of settlement of a firm is shorter than the average term of credit granted in the trade or industry, it may indicate that the business is not using this source of credit to the fullest extent. If the average settlement period is longer than the industrial credit terms generally granted in the trade or industry it may indicate a use of credit beyond the normal trade terms and a possible loss of creditworthiness.

Where you are analysing financial statements, which conform to the minimum disclosure requirements, a “Purchases” figure will not be given. The next best figure would be “Cost of Sales”, however, this figure is also not required in minimum disclosure figures. Therefore, you would have use the Sales / Turnover figure to calculate the number of creditors days. Provided that you use consistent figures to do your calculations, the trends will be the same even though individual figures may differ.

C. Debtors Collection Period

This ratio indicates the time taken to collect debts. It is the average number of days required to convert debtors / accounts receivable into cash. The quicker debts are collected, the more active the business is.

The debtor's collection period also gives a very strong indication of liquidity, as the quicker debtors are converted to cash, the more liquid the business becomes. It also provides information about a company's credit policies. For instance, if the average collection period is increasing over time, or is higher than the industry average, the firm's credit policies may be too lenient, and accounts receivable not sufficiently liquid. The loosening of credit could be necessary to boost sales, but at an increasing cost to the firm. On the other hand, if credit policies are too restrictive, as reflected in an average collection period that is shortening and is less than industry average, the firm may be losing qualified customers.

The average collection period should be compared to the firm's stated credit policies. If the credit policy calls for collection within 39 days, and the average collection period is 60 days, the implication is that the company is not sufficiently stringent in its collection efforts.

It is calculated as follows:

Average Collection Period *(Days – Liquidity)*

$$\frac{\text{Average Debtors}}{\text{Sales/Turnover}} \times \frac{365}{1} = \text{Days}$$

$$= \frac{45\,217}{496\,539} \times \frac{365}{1} = 33 \text{ Days}$$

Explanation

It will take the company an average of 33 days to collect their debtors OR debtors are collected 12 times a year.

Obviously the shorter the period, the better the firm's cash flow. Ideally this period should also be shorter than the credit payment period. It is desirable to first collect money from the debtors before you have to pay your creditors. Interest could therefore be earned on the money collected before paying the creditors on due date.

D. Stock Turnover (Inventory Turnover Ratio)

Inventory turnover measures the efficiency of the firm in managing and selling inventory. It is thus a gauge of the liquidity of a firm's inventory. Generally, a high stock turnover is a sign of efficient stock management and profit for the firm; the faster the stock sells, the less funds are tied up in stock. But a high stock turnover can also mean under-stocking and lost orders, a decrease in prices, a shortage of materials, or more sales than planned. A relatively low turnover could be the result of a company's carrying too much stock or stock that is obsolete, slow moving, or inferior. On the other hand, low turnover could also stem from a stockpiling for legitimate reasons, such as increased demand or an expected strike.

The type of industry is important in assessing stock turnover. The analyst should expect florists and produce retailers to have a relatively high stock turnover because they deal in perishable products, while retailers of jewellery or farm equipment would likely have a lower stock turnover but higher profit margins.

It is calculated as follows:

$$\frac{\text{Purchases (or Cost of Goods Sold)}}{\text{Stock}} = \text{Times} \qquad \frac{\text{Stock}}{\text{Purchases}} \times \frac{365}{1} = \text{Days}$$

$$= \frac{397\,332}{9\,917} = 40 \text{ Times a year} \qquad \frac{9917}{397332} \times \frac{365}{1} = 9 \text{ Days}$$

Explanation:- The stock was turned over 40 times during the accounting period.

The Inventory turnover Ratio is an average for all stock. Some stock will move faster than others, if different lines are carried.

FIXED ASSET AND TOTAL ASSET TURNOVER

The fixed asset and total asset turnover ratios are two approaches to assessing management's effectiveness in generating sales from investments in assets. The fixed asset turnover considers only the firm's investment in property, plant and equipment, while the total asset turnover measures the efficiency of managing all of a firm's assets. Generally, the higher these ratios, the smaller is the investment required to generate sales and thus the more profitable is the firm. When the asset turnover ratios are low relatively to the industry or the firm's historical record, either the investment in assets is too heavy and / or sales are sluggish. Of course, there may be plausible explanations; for example, the firm may have undertaken an extensive plant modernisation during the current year.

It is calculated as follows:

Fixed Asset Turnover:

$$\frac{\text{Net Sales}}{\text{Net Property, Plant \& Equipment}}$$

$$= \frac{496\ 539}{38\ 834} = 12.8 \text{ Times}$$

Explanation:- The firm has generated sales, 12.8 times their investment in Fixed Assets

Total Asset Turnover:

Net Sales .
Total Assets

= 496 539 = 5,3 Times
94 068

Explanation:- The firm has generated sales, 5,3 times their investment in Total Assets.

5. LEVERAGE RATIOS

The amount and proportion of debt in a company's capital structure is extremely important to the analyst because of the trade-off between risk and return.

Use of debt risk because, debt carries with it a fixed commitment in the form of interest charges and principle repayment. Failure to satisfy the fixed charges associated with debt will result in bankruptcy. A lesser risk is that a business with too much debt has difficulty in obtaining additional debt financing when needed or finds that credit is available only at extremely high rates of interest. While debt implies risk, however, it also introduces the potential for increased benefits to the firm's owners. When debt is used successfully - if operating earnings are more than sufficient to cover the fixed charges associated with debt - the returns to shareholders are magnified through financial leverage.

A. Debt to Equity

The debt to equity ratio measures the riskiness of the firm's capital structure in terms of the relationship between the funds supplied by creditors (debt) and investors (equity). The higher the proportion of debt, the greater is the degree of risk because creditors must be satisfied before owners in the event of bankruptcy. The equity base provides, in effect, a cushion of protection for the suppliers of debt.

If the owners invest more capital than the amount borrowed, it is commonly known as *low gearing*. If outside interest exceeds the owners' interest it is commonly known as *high gearing*.

B. Gearing Ratio or Debt/Equity Ratio

It is calculated as follows:

$$\frac{\text{Total Liabilities}}{\text{Stockholders' / owners' Equity}}$$

$$= \frac{48\,285 + 44\,689}{1\,094} = \frac{2\,974}{1\,094} = 84.99 : 1$$

Explanation:- For every one R1 invested by the member this Close Corporation has borrowed R84.99. This company operates mainly on outside funds.

Ordinary shareholders interest includes share capital, share premium, Non-Distributable as well as Distributable reserves. Preference share capital is NOT included.

6.PROFITABILITY RATIOS:

All the ratios we have looked at up to now, have measured management efficiency and risk. As profitability is the result of a large number of policies and decisions, the profitability ratios will show the combined effect of liquidity, asset management (activity) and debt management (gearing) on operating results.

The overall measure of success of a business is the profitability, which results from the effective use of its resources. Profitability is essential for long-term survival and is therefore the first and foremost purpose of a business, ie the reason for its existence.

The effective use of resources is judged by the flow of income that is obtained from these resources. Income generated from any accounting period does not provide in itself a very meaningful figure unless it is related to the amount of resources used. It is for this reason, that profitability, as an indicator of efficiency and success is generally measured by the rate of return on investment, i.e. Capital Employed, Owners Equity or Fixed Assets. We therefore concentrate on ratios of *RETURN* when analysing profitability ratios.

Such rates of return may be used to measure the:

- Operational efficiency with which the assets of a business have been used in generating earnings *(Rate of Return on Total Assets).*
- Managerial ability with which the capital employed in a business has been used *(Rate of Return on Capital Employed).*
- Effectiveness of the total investment made by the owners of the business, after taking into account the effect of financial leverage *(Rate of Return on Owners Equity).*
- Individual investor's return on funds invested by him, expressed in terms "*Earnings Per Share*" (EPS).

Different profitability ratios are used in different phases of a company's ability to translate Sales into Earnings. It therefore measures the relationship between the generation of Profit and the actual sales (Turnover).

A. Gross Profit Margin

Measures the difference between cost price and actual selling price of goods. Commonly referred to as "Mark-up". It shows the relationship between sales and the cost of products sold and thus measures the ability of a company to control costs of stock and to pass along price increases through sales to customers.

If the gross profit margin remains constant, then the gross profit should rise and fall proportionately to sales. Analysing movements in the margin, therefore, will be more fruitful and informative than merely looking at the gross profit figures. It can also be useful to compare the gross profit margin across similar businesses although there will often be good reasons for disparity. An improving trend in the margin is to be welcomed and, as long as overheads are controlled, will result in an enhanced net profit. Where the trend in the margin is downwards, the analyst must not automatically assume that disaster is around the corner.

A businessperson may, as a matter of policy, reduce prices and therefore margins, to improve sales. If the ultimate outcome is a higher gross profit, then there can be little cause for complaint. However, there may well be some cause for concern where the margin is falling and questions may have to be asked of the customer.

One or more of the following could cause any deterioration, in the Gross Profit Margin:

- Failure to pass on higher material or production costs.
- Poor buying decisions.

- Increased competition on prices.
- Pilferage, wastage, returned goods.

Stock valuation has a direct bearing on the calculation of gross profit and margins. Changes in the method of valuation will change the gross profit and consequently the ratios.

While the gross margin analysis can give useful information, the gross profit figure is not always given in Annual Financial Statements, in which case the analysis cannot be made.

Note that it is impractical to expect a business to show a trend of increasing gross margins. In essence, the business must endeavour to maintain its margin, as then any real increase in sales will improve gross profitability.

It is calculated as follows:

$$\frac{\text{Gross Profit}}{\text{Sales}} \times \frac{100}{1}$$

$$= \frac{108\,199}{496\,539} \times \frac{100}{1} = 21.79\%$$

Explanation:-

The gross profit margin on sales is 21.79%. Every R1 spent on the purchase of stock, generated 22 cents profit.

In order to find out whether or not a gross profit percentage is at an acceptable level it must be compared with previous years' figures. Any deterioration is a warning signal that the situation needs to be investigated.

B. Net Profit

The net profit margin measures the profitability after consideration of all revenue and expenses, including non-operating items and income taxes. It is a widely used measure of performance and is comparable across companies in similar industries.

The fact that a business works on a very low margin need not necessarily cause alarm because there are some sectors of industry that work on a basis of high turnover and low margins, for example supermarkets and motor car dealers.

It is more important to focus on any trend in the margin and whether it compares well with similar businesses. If you compare the trends in the gross and net margins you may be able to isolate problems. Where the gross margin is constant or improving but the net margin is declining, this may indicate a lack of control on costs or exceptional increases in overheads. It is therefore important to the *GAP* between the gross profit margin and the net profit margin.

In analysing the net margin, the question arises whether to use the "Before Tax or After Tax Net Profit" figures. Remember that tax is a fairly manageable cost, which can fluctuate dramatically, especially when large allowances are made, for any reason in a particular year. It is for this reason, that some analysts would use the "Before Tax" figure.

However, when you are analysing profitability, it is the "bottom line" that is meaningful and therefore the after tax figure is preferred. There is also a question as to whether interest should be excluded (EBIT), since interest is a function of the source of finance and depending on the source of finance used, interest expense can change dramatically. Most banks appear to favour the Profit after Tax figure.

It is calculated as follows:

$$\frac{\text{Net Profit after Tax}}{\text{Sales}} \times \frac{100}{1}$$

$$= \frac{26}{496\ 539} \times \frac{100}{} = 0.01\%$$

Explanation:-

This means that a net profit of only .01 cents was generated for each R1 of Turnover. This ratio shows that this business operates off an extremely low net margin, which could again be indicative of the fact that they are in the business of high turnovers with low margins (mass market).

C. Return on Total Assets and Return on Equity

Return on investment and return on equity are two ratios that measure the overall efficiency of the firm in managing its total investment in assets and in generating return to shareholders.

i. Return on assets

Return on investment or return on assets indicates the amount of profit earned by a company relative to the level of investment in total assets. It indicates the degree of efficiency with which management has used the assets of the enterprise during an accounting period. Income is earned by using the assets of a business productively. The more efficient the production, the more profitable the business.

Investors have placed funds with the managers of the business. These managers have used the funds to purchase assets, which will be used to generate a return. If the investors feel that their return is below that which they can achieve elsewhere, they may instruct the managers to sell the assets and they will invest elsewhere.

This may result in the managers' losing their jobs and the business may have to liquidate.

This ratio is calculated as follows:

$$\frac{\text{Net Profit after Tax}}{\text{Total Assets}} \times \frac{100}{1}$$

$$= \frac{26}{94\,068} \times \frac{100}{1} = 0.03\%$$

Explanation: -

The firm has generated a profit of 0.03c for every Rand invested in assets.

Again, the question of which profit figure to use, comes up. The one that appears to be most preferred by banks is the Net Profit after Tax divided by Total assets. The reason for using the After Tax Profit figure, is to show the "Bottom Line Return on Assets". Investors want to know what the yield on their investment is after all costs including tax, have been paid.

ii. Return on Equity

Return on Equity, also calculated as return on common equity (if the company has preferred stock outstanding, this amount would be subtracted from the denominator and preferred dividend payments would be deducted from the numerator), measures the return to the ordinary shareholder. Therefore the Owners Equity refers to Ordinary Shareholders and includes Share Capital, Share premium, Distributable and Non-Distributable reserves.

This ratio is calculated as follows:

$$\frac{\text{Net Profit after Tax}}{\text{Shareholders' Equity}} \times \frac{100}{1}$$

$$= \frac{26\ .}{1\ 094} \times \frac{100}{1} = 2.38\%$$

Explanation:-

The firm has generated a profit of R2.38 for every one Rand invested by shareholders.

As this ratio shows how much profit can be attributed to the amount invested, by the owners of the business, it gives potential investors into the business, an indication as to what they might receive as a return.

7.SUMMARY

Make your own summaries here……..

Activity 4

Now that you have the answers for year 20X0 try 20X1 on your own.

	20X0	20X1
LIQUIDITY:		
Current Ratio :		
Quick Ratio :		
Solvency Ratio :		
STABILITY RATIO:		
Gearing Ratio :		
Debt :		
Equity :		
ACTIVITY:		
Creditors Payment Period :		
Debtors Payment Period :		
Stock Turnover :		
PROFITABILITY:		
Gross Profit % :		
Net Profit % :		
Return on Assets :		
Return on Equity :		

LEARNING UNIT FIVE

WORKING CAPITAL

SPECIFIC OUTCOMES

In this learning unit, you will be able to apply your demonstrated understanding of:

- the term " working capital";
- the importance of working capital in a small business;
- the components of working capital, that need to be managed in a small business.

…….to successfully assess the financial performance of a small business.

1.WHAT IS WORKING CAPITAL?

Working capital can be defined as working money or money available to pay for the day-to-day running of the business. It is represented in your customer's balance sheet as being the difference between current assets and current liabilities.

Working Capital = Current Assets *less* Current Liabilities = Net Current Assets

From the above illustration of the working capital equation, one can deduce that working capital is the money invested by the business in goods and services or current assets (which are made up of stock, debtors and cash) less the value of the goods and services owed to suppliers or creditors.

Managing working capital effectively has always been a challenge for many businesses.

2. WHAT IS THE IMPORTANCE OF WORKING CAPITAL?

One cannot underestimate the importance of managing working capital. As indicated in the introduction of this unit, working capital is the heart of the business and managing working capital will ensure that cash flow, which is the life-blood, does not dry up. That, in a nutshell, summarises why working capital management is important.

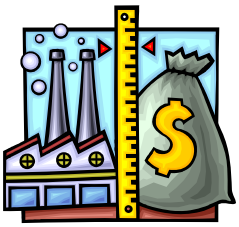
There are other reasons why a business should manage its working capital. Before we indulge ourselves in what these reasons are, let us answer the question of what the objective of managing working capital is?

As working capital is money invested by the business in goods and services or current assets, the objective of managing working capital is therefore to limit the amount of resources committed by the business at any given point in time, whilst at the same time, ensuring that the operational needs of the business are met.

By committed resources, we mean resources committed in increasing stock, debtors and even cash itself as well as committed resources towards the payment of creditors. It must be remembered that the more money tied up in those items, the less money will be available for other things in the business. Managing working capital therefore ensures that the money resources are freed.

The reasons why businesses should manage working capital, are as follows:

- It measures a business's liquidity.
- It is a source of funds.
- It is a double-edged cost.



A. Measure of a Business's Liquidity

Working capital is a measure of a business's liquidity, the ability of the business to meet its short-term obligations when due. The liquidity ratios we covered had to do with the ability to convert its current assets into cash as quickly as possible. We found that liquidity had little to do with the quantity of current assets, but rather about their quality.

B. A Source Of Funds

Working capital is a source of funds to the business, if managed correctly. Following from the above point, if the quality of those current assets is good and they are easily converted to cash, the business can then fund itself with very little reliance on outside funding.

C. A Double-Edged Cost

Managing working capital has a double-edged cost to it, which every business must be aware of in order to manage it appropriately. An example would be a business choosing between carrying too much stock and bearing the costs associated with this, for example storage costs, or carrying too little stock and risk the cost of stock shortage situations.

The fact that there is a double-edged cost to deciding what levels of current assets one has in its books, is reason enough why working capital should be managed.

3. WHAT ARE THE MANAGEABLE COMPONENTS OF WORKING CAPITAL?

A. Debtor's and creditor's control

This is usually one area where the cash is tied up.

Effective management of debtors' and creditors' control is critical, as the business can pay for itself in this way. It has to do with the timing of cash outflows to pay creditors and inflows from collections from debtors.

In the unit called "ratio", we discussed the debtors' collection period and the creditors' payment period. To apply that to the business will mean ensuring that debtors are collected before creditors are paid. We will explore this further when we discuss the working capital cycles later in this section.

B. Inventory control

It is impossible to be everything to everyone. A business should certainly not attempt to please everyone by carrying inventory of everything, even slow moving items, just in case a customer may want it in future.

Carrying too much inventory can be very expensive for a business, so is carrying too little. We will explore these below:

Excessive inventory means cash had to flow out of the business in order to acquire it. In addition to that, there are other costs associated with holding too much inventory, for example:

- cost of storage.
- cost of pilferage and shrinkage very high.
- risk due to obsolescence is high especially if it becomes outdated and or damaged.
- buying inventory using borrowed funds attracts interest.
- cost of security as you put in place security measures to guard the stock.
- cost of stock control.

Carrying too little inventory also has its disadvantages and this needs to be considered and weighed up against holding too much. These are as follows:

- Opportunity cost due to loss in sales as prospective clients go somewhere else and may never come back.
- Stock out situations may mean low productivity as employees sit idle and yet the business has to meet that fixed cost of paying salaries irrespective.

Businesses, in avoiding such situations, prefer to carry a safety or minimum level of inventory to ensure that they will not run out. This would be the permanent level of stock in a business. You will appreciate how discouraging it is to walk into a business with empty shelves. For a shop to have that respectability it must carry a certain level of permanent stock. This must not be allowed to fall below a certain figure.

C. Cash or bank overdraft

We have combined the cash and bank overdraft component, because in practice the management thereof will fall under the auspices of one person or role in a business, usually a finance person.

People that manage working capital should be sensitive to the fact that there are costs involved in holding too much cash, too little or no cash at all, in which case the business would go into an overdraft position. What it means is that cash flowing in and out of the business should be watched very carefully to avoid unnecessary cash shortages or surpluses.

D. Consequences of excessive cash

Working capital funds cannot be placed in a high interest earning account, because most result in the cash not being readily available. You usually have to give notice, which is not always possible, as funds may be needed immediately. What it means is that your extra cash sits in a low interest earning bank account. The interest earned is almost negligible, meaning a lower return on assets for the business.

E. Consequences of insufficient cash

If a business carries insufficient cash, it may be forced to borrow to meet its short-term obligations. The costs will be interest payable on borrowed funds, for example, an overdraft facility. This interest obligation becomes even higher when the facility is exceeded through the payment of penalty interest. It becomes a danger for a business:

- when reliance on an overdraft becomes a norm due to inefficient cash management,
- and when interest rates are rising.

F. The Cash Cycle

Inventory (stock) days
Plus: Debtors collection period
= Operating cycle
Less: Creditors payment period
= * Cash cycle

When this number (* Cash cycle) is positive it means that the business pays out money before they have collected it from debtors and therefore will need funding for that period of time. When this number (* Cash Cycle) is negative it means that the business collects its money from debtors before paying it's creditors and therefore will need no funding and rather have funds available for short term investment purposes.

4.SUMMARY

Make your own summaries here……..

Activity 5

Use the information calculated in the Learning Unit 4 : Ratios, to calculate and answer the following:
1) Calculate the cash cycle for Zululand Plastic cc for year 20X0
2) What does the above tell you?

Activity 5– Answers

Use the information calculated in the Learning Unit 4 : Ratios, to calculate and answer the following:

1) Calculate the cash cycle for Zululand Plastic cc for year 20X0

The cash Cycle

Inventory (stock) days	09
Plus: Debtors collection period	33
= Operating cycle	**42**
Less: Creditors payment period	37
= * Cash cycle	**05**

2) What does the above tell you?

It means that Zululand Plastics collects their cash within 42 days after purchasing and pays out to their creditor within 37 days. Therefore requiring finance for 5 days.

LEARNING UNIT SIX

THE GROWING SMALL BUSINESS

SPECIFIC OUTCOMES

In this learning unit, you will be able to :

- Define the term “overtrading”;
- Identify the signs of overtrading in a small business;
- Predict the effects of overtrading on a small business.

….in order to successfully analyse the financial performance of a small business.

1.ANALYSING A SMALL BUSINESS' GROWTH PATTERN

A very common experience for bankers when doing financial analysis in the case of credit risk assessment business applications is to come across the problem of OVERTRADING.

A. What is Overtrading?

This simply means that the business has too few resources for the turnover, it is trying to achieve, i.e. it is to maintain a certain scale of operation with insufficient capital, equipment, etc. It is especially noticeable amongst small to medium sized fast growing businesses.

It is often experienced that businesses tend to believe that rapid growth and expansion is the ultimate sign of success. The sad side of this problem is that it is actually very common to find the very successful businesses operating on a smaller scale, often to be the ones that run into serious financial difficulties due to excessive growth and expansion.

When a business overtrades in this way it can be compared to an individual who constantly strives for a higher lifestyle, but does not have the financial means to maintain it. It often happens that businesses initiate the problem of future overtrading during times of prosperity. The severe cash shortages experienced due to uncontrolled growth and expansion cannot be solved by further contracts and new business ventures.

B. What are the Effects or Results of Overtrading?

The main effect is that of a shortage of cash, but it will manifest itself in the following problem areas:

- Difficulties to pay wages and salaries.
- Pressure on debtors to pay sooner and this can be harmful to customer relations
- Difficulties to pay creditors and in the process the obtaining of goods and services for purposes of trade and manufacturing, can be negatively effected.
- Special schemes and high interest, unsecured loans are sure signs of problems with cash flows.
- Selling inventory at huge discount to obtain cash.
- Inability to replace old and worn-out machinery and equipment will lead to inefficiency and the eventual loss of customers.

C. What are the Signs of Overtrading when doing a Financial Analysis?

During the process of doing a financial analysis of the business, the following signs could be pointers in the direction of overtrading:

- When the debtor's collection period is becoming shorter and the creditor's payment period longer. A strong trend in this direction must always be of concern to the analysis especially if the change is quite rapid.

- A sharp increase in revenue, turnover, production with no corresponding increase in the level of working capital.
- A trend of decreasing net profit margins, due to increase expenses. If overtrading continues for a time the gross profit margins will also begin to decline at a later stage.
- Selling of fixed assets to obtain cash resources.

- Sharp increase in loans and borrowing from the bank, inventory and accounts payable without an increase in turnover.
- A sharp decline in generating cash resources as seen in the cash flow statement.
- Management's attitude of "selling at all cost".

2. SUMMARY

Make your own summaries here……..

Activity 6

1) Describe in your own words what overtrading means
2) What are the effects/ results of overtrading?
3) What are the signs of overtrading when doing a financial analysis?

Activity 6– Answers

REFER TO YOUR NOTES FOR GUIDELINES

NOTE: Overtrading consumes cash!!

QUOTE: From the CEO of a shipping company, who was liquidated a few years ago, said to the media:

"We are not bankrupt, we merely ran out of cash".

