FINANCIAL MANAGEMENT AND ACCOUNTING TERMINOLOGY AND CONCEPTS

Timeframe:	10 hours
Learning outcome:	• Examine financial management and accounting terminology and concepts
Recommended reading:	• Business Knowledge Resource Online, 2014, 'Choosing a Form of Business Organisation', *Business Government India*, http://business.gov.in/starting_business/location_industry.php (accessed 24 February 2014). • Ezwan, Z. 2010, 'Decision Functions of Financial Management', http://financialmanagementinfo.blogspot.com/2010/01/decision-functions-of-financial.html (accessed 22 September 2012). • Theamericancollege.edu n.d., 'Forms of Business Organisation', http://www.theamericancollege.edu/assets/pdfs/fa251-class1.pdf (accessed 22 September 2012). • Michigan.org n.d., 'Glossary of terms', http://www.michigan.gov/documents/hal_lm_finmanrefg_66313_7.pdf (accessed 22 September 2012).
Multimedia:	• aCOWtancy 2012, 'Agency Theory Basics' [video], http://www.youtube.com/watch?v=uzS3F8MgbK0 (accessed 22 September 2012).
Section overview:	The aim of this section is to provide you with descriptions to enhance your understanding of key concepts such as capital budget, working capital management, accruals, materiality and aggregation, offsetting and the duality concept.

Introduction

It could be argued that every business decision is actually, in some way, a financial decision as all decisions impact in one way or another on the financial soundness of an organisation (MTD Training, 2010). For this reason, it is imperative that non-financial managers obtain an understanding of financial concepts and applications and the relationship between their decisions and the financial wellbeing of the organisation.

In light of this, it is the aim of Section 1 to introduce you, as a non-financial manager, to the basic concepts and principles of financial management and management accounting.

This naturally begins with a look at the meaning of the terms "financial management" and "management accounting" (the core concepts underlying this module):

MSH (2006) defines **financial management** as the process of implementing and managing financial control systems, collecting financial data, analysing financial reports, and making sound financial decisions based on the analyses. Financial management requires knowing how to read and interpret three key documents: a cashflow projection worksheet, a balance sheet and an income statement.

Management accounting refers to the collection of information from financial accounting systems and other financial data (such as budgets) and combining this information with statistical data to produce information that is useful in making managerial decisions.

The goal of financial management is to maximise the current value per share of the existing shares on behalf of the investors or shareholders. The financial manager needs to identify those investments and financing arrangements that have a favourable impact upon the value of the shares. The financial manager identifies goods and services that add value to the firm because they are desired and valued in the marketplace.

Three Basic Finance Principles

MTD Training (2010) states that, if a manager wants to be financially aware, s/he as to be able to examine the actions of the team in terms of basic financial principles. It is important to take cognisance of the fact that all decisions impact – either directly or indirectly – on the finances of an organisation. There are three basic principles that form the framework for all corporate finance:

- **Investment principle**: Every organisation invests assets and incurs debts.
- **Financing principle**: Organisations can finance their operations with a mixture of tools that include investments, assets or borrowed money. The mixture can depend on several things such as capital availability, capital needs, and the business's willingness to take risks.
- **Dividend principle**: A successful organisation will eventually need to return some money to its investors.

The Basic Types of Financial Management Decision

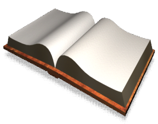
As already indicated, financial management requires efficient and effective planning and controlling of financial resources to maximise profitability and ensure liquidity (College Accounting Coach, n.d.)

This requires of the financial manager to be concerned with the three basic types of decision-making activities described in **Table 1.**

TABLE 1: FINANCIAL MANAGER DECISION-MAKING ACTIVITIES

Capital Budgeting	Capital budgeting refers to the process of planning and managing a firm's long-term investments. In capital budgeting, the financial manager tries to identify investment opportunities that are worth more to the firm than they cost to acquire. Evaluating the size, timing and risk of the cashflow is the essence of capital budgeting.
Capital Structure	The financial manager is also concerned with the ways in which the firm obtains and manages the long-term financing it needs to support its long-term investments. Capital structure refers to the specific mixture of long-term debt and equity that the firm uses to finance its operations. The financial manager must also decide how much the firm should borrow and the least expensive sources of funds for the firm.
Working Capital Management	Working capital refers to a firm's short-term assets (cash, inventory and accounts receivable) and its short-term liabilities such as money owed to suppliers, staff and lenders. Managing the firm's working capital is a day-to-day activity that ensures that the firm has sufficient resources to continue its operations and avoid costly interruptions.

You can read through the following source to obtain more information on these decisions:



- Ezwan, Z. 2010, 'Decision Functions of Financial Management', http://financialmanagementinfo.blogspot.com/2010/01/decision-functions-of-financial.html (accessed 22 September 2012).

Financial Implications of the Different Forms of Business Organisation

The focus of this section is to examine different forms of organisation and their impact on financial management. In the South African context these include:

- Companies;
- Close Corporations (no new close corporations to be registered from 1 May 2011); and
- Co-operatives.

The Companies and Intellectual Property Commission (CIPC) is mandated by the Companies Act, 2008 to register the above (CIPC, 2014).

For the purposes of discussion these forms of organisation are summarised below.

Profit Companies (according to the Companies Act 2008) (CIPC, 2014):

- Private Companies (Pty) Ltd
  - Prohibited to offer securities to the public and the transferability of their shares is restricted.
- Public Companies (Ltd)
  - A company whose securities are traded on a stock exchange (can be bought and sold by anyone).

- Personal Liability Companies (Inc)
    - The directors and past directors (where applicable) of these companies are *"jointly and severally liable together with the company for any debts and liabilities arising during their periods of office."*
- State Owned Companies (SOC Ltd)
    - Either a company defined as a "state-owned enterprise" as per the Public Finance Management Act 1999 or a company owned by a municipality. *"The majority of the provisions of a public company will apply to state-owned companies as well."*
- Foreign and External Companies
    - Companies incorporated outside of South Africa (irrespective of whether it is a profit or non-profit company or carrying on business in South Africa or not). *"A foreign company is prohibited from offering securities to the South African public unless it follows specific provisions of the Companies Act, relating to offers to the public."*

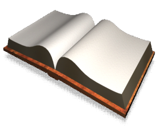
Non-profit Companies (NPC)

- This is a company that is incorporated for public benefit (relating to cultural or social activities, communal or group interests).
- The income and property of these companies are distributable to its incorporators, members, directors, officers or persons related to any of them.

For the purposes of comparison consider the ownership and organisation of different forms of business in India (business.gov.in, 2014):

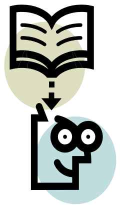
- Proprietorship (eg small scale and direct services such as doctors, lawyers, and tailors);
- Private Limited Company (eg relatively large scale operations such as a manufacturing organisation);
- Partnership Firm (eg business requiring the pooling of skills and funds such as accounting firms);
- Co-operatives (eg promotes the interests of its members in accordance with the principles of cooperation; voluntary and comprises 10 or more members residing or working in the same locality who join on the basis of equality for the fulfilment of their economic or business interest, eg consumer cooperatives, farming cooperatives, credit cooperatives);
- Public Limited Company (eg very large scale operations that require extensive funding with products and/or services that cater to national and international markets);
- Joint Hindu Family Business (eg an extended family arrangement prevalent among Hindus under Hindu law); and
- Limited Liability Partnership (LLP).

Full texts relating to the above can be found at the following web site:



- Business Knowledge Resource Online, 2014, 'Choosing a Form of Business Organisation', *Business Government India*, http://business.gov.in/starting_business/location_industry.php (accessed 24 February 2014).

As the above website points out, *"the right choice of the form of business is very crucial because it determines the power, control, risk and responsibility of the entrepreneur as well as the division of profits and losses".*

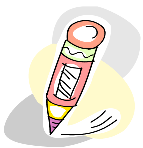


- Selecting the form of business should be made after considerable thought, as this is a long-term commitment.
- Key elements to consider include:
    - Legislative considerations (including costs);
    - Size of the organisation and how it will be funded;
    - Liability (risk); and
    - Control and division of profits and losses.

Agency and the Control of the Company

In a small business, the owner might also be the manager of the firm. The owner-manager will pursue the goal of wealth maximisation and act in his/her own best interests. In larger firms, ownership is spread over a large number of shareholders.

Modern organisational theory views an organisation as being comprised of various stakeholders. The relationships between the various interested parties in the firm are often described in terms of agency theory.

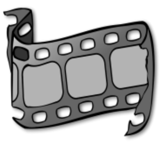


Investopedia (2012a) defines agency theory as a theory concerning the relationship between a principal (shareholder) and agent of the principal (company managers). An agency relationship occurs when one party, the principal, employs another party, the agent, to perform a task on their behalf.

For example, directors can be seen as agents of shareholders, employees as agents of the directors and auditors as agents of shareholders.

Because an agent will have interests of his/her own to protect, the principal needs to ensure actions that are in the agent's self-interest are also in the best interests of the principal. In spite of agency relationships, shareholders still retain control of the firm as they have the power to appoint directors.

Watch this video clip to obtain more information on agency theory:



- aCOWtancy 2012, 'Agency Theory Basics' [video], http://www.youtube.com/watch?v=uzS3F8MgbK0 (accessed 22 September 2012).

Financial Institutions, Financial Markets and the Company

As seen earlier, the primary advantages of the corporate form of organisation are that ownership can be transferred more quickly and easily than with other forms and that money can be raised more readily. Both of these advantages are significantly enhanced by the existence of financial institutions and markets.

- **Financial institutions**

  Financial institutions act as intermediaries between investors and the firms raising funds. They include banks, life insurers, pension funds, unit trust companies as well as the Reserve Bank and development corporations.

- **Financial markets**

  Financial markets are regarded as consisting of the money markets and the capital markets:

  - **Money markets** are markets wherein short-term debt securities are bought and sold. The money market is a dealer market. Dealers buy and sell something for themselves, at their own risk. The main participants in money markets are banks, other financial institutions and large companies.
  - **Capital markets** are markets for the raising and trading of securities of a long-term nature. The instruments traded include company shares and debentures and government bonds. The Stock Exchange is a capital market.

Financial markets function as both primary and secondary markets for debt and equity securities.

Debt securities refer to all long-term borrowing incurred by a firm, including bonds. Equity securities are long-term funds provided by the firm's owners, the shareholders.

- **Primary markets** refer to the original sale of securities by governments and companies. Secondary markets, by contrast, are where these securities are bought and sold after the original sale. In a primary market, the company is the seller and the transaction raises money for the company.
- **A secondary market** transaction involves one owner or lender selling to another. The secondary market provides the means for transferring ownership of corporate securities.