

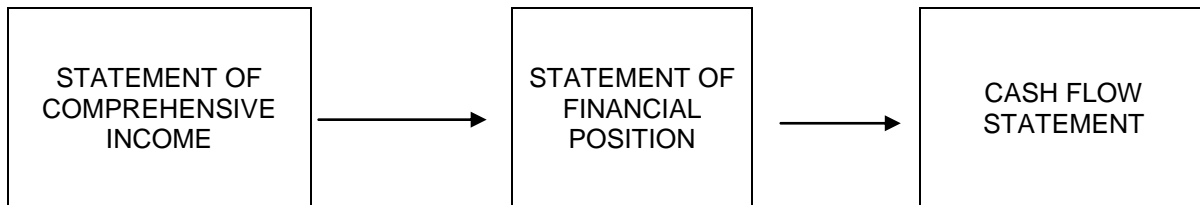
RATIO ANALYSIS & CASH FLOW

23 APRIL 2015

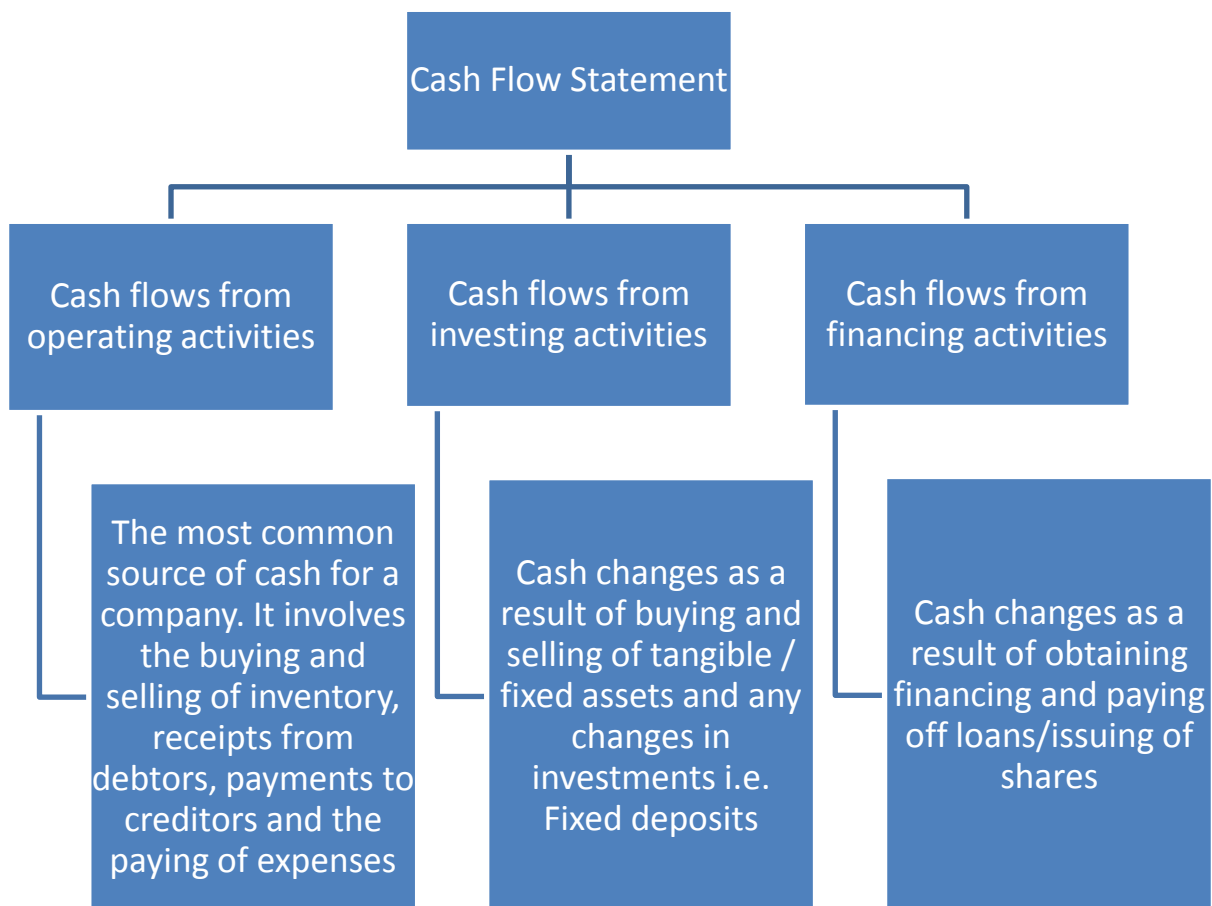
Section A: Summary Content Notes

1. Introduction

The cash flow statement reflects the movement of cash within an enterprise during a specific period. The Companies Act stipulates that a cash flow statement must be part of the company's financial statements



2. Format of the Cash Flow Statement (Components)



notes for...

<p>Inflows</p> <ul style="list-style-type: none"> • Money received from sales • Money received from other incomes <p>Outflows</p> <ul style="list-style-type: none"> • Money paid for stock • Money paid for expenses • Money paid for tax • Money paid for dividends

<p>Inflows</p> <ul style="list-style-type: none"> • Money received from the sale of assets • Fixed deposits maturing <p>Outflows</p> <ul style="list-style-type: none"> • Money paid for replacing tangible / fixed assets • Money paid for buying new assets • Investing in fixed deposits
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<p>Inflows</p> <ul style="list-style-type: none"> • Money received from issuing shares • Money received from obtaining loans <p>Outflows</p> <ul style="list-style-type: none"> • Money used for repaying loans • Money used for repurchasing shares
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Calculate the changes in working capital by considering the following:

AIULIG Assets increase utilised/ liabilities increase generated U INDICATES BRACKET (ANS)

(LOVE ARROW)	—————→		
	2013	2014	
Inventories	100 000	250 000	(150 000)

ADGLDU Assets decreased generated/liabilities decreased utilised U INDICATES BRACKET (ANS)

(LOVE ARROW)	←————		
	2013	2014	
Inventories	100 000	170 000	70 000

Section B: Exercises

Question 1

FIXED ASSETS, CASH FLOW STATEMENT, ANALYSIS AND INTERPRETATION

(75 marks; 45 minutes)

You are provided with information relating to Classico Limited. The financial year-end is on 31 October 2014. New shares were issued on the first day of the financial year.

REQUIRED:

- 1.1 What is the main purpose of a Cash Flow Statement? (2)
- 1.2 Refer to the fixed asset note under Information C.
Calculate the missing amounts (indicated by a, b, c and d) in the Fixed/Tangible Asset Note for the year ended 31 October 2014. (9)
- 1.3 Complete the Cash Flow Statement for the year ended 31 October 2014. Show ALL workings in brackets. (24)
- 1.4 The directors issued more shares and sold fixed assets in order to improve the cash flow. A shareholder, John Meanwell, has criticised them for these decisions.
In each case:
- Provide a reason to support John's opinion.
 - Other than improving the cash flow, provide a reason to support the directors' decision. (8)
- 1.5 Calculate the following financial indicators on 31 October 2014:
- Acid-test ratio (4)
 - Earnings per share (3)
 - Return on average shareholders' equity (5)
 - Debt-equity ratio (3)
- 1.6 The directors are proposing that the business operations be expanded in the new financial year. One of the directors suggested that they finance the expansions by taking a loan of R1 000 000, instead of issuing new shares to the public. Quote and explain TWO financial indicators to support his opinion. (6)
- 1.7 Bongani is a shareholder in Classico Limited. He owns 32 000 shares which he purchased two years ago at R4,75 each.
- 1.7.1 Calculate the amount of dividends Bongani would earn for the financial year ending 31 October 2014. (3)
- 1.7.2 Should Bongani be satisfied with the dividend policy of Classico Limited? Quote and explain relevant financial indicators to support your answer. (4)
- 1.7.3 Bongani wants to sell his shares in Classico Ltd and invest his funds in an alternative investment. You disagree with him. Quote and explain ONE relevant financial indicator, other than dividends, to discourage him from selling his shares. Your answer must include the actual figure/ratio/percentage. (4)

INFORMATION:

- A. The following information was extracted from the Income Statement for the year ended 31 October 2014:

Interest on loan (all capitalised)	175 500
Income tax	375 000
Net profit after tax	975 000

- B. Information extracted from the Balance Sheet:

	31 October 2014	31 October 2013
Current assets	4 804 000	2 820 000
Inventories	1 437 500	1 656 250
Trade and other receivables (see D)	1 075 000	956 250
Cash and cash equivalents	2 291 500	207 500
Ordinary shareholders' equity	4 450 000	4 000 000
Ordinary share capital (see F)	3 450 000	3 150 000
Retained income	1 000 000	850 000
Loan: Freeport Bank (12% p.a.)	2 000 000	1 375 000
Current liabilities	1 450 000	1 262 500
Trade and other payables (see E)	1 450 000	1 262 500

- C. Fixed/Tangible assets:

	Land and buildings	Vehicles	Equipment
Carrying value at beginning of financial year	3 000 000	660 000	?
Cost	3 000 000	900 000	?
Accumulated depreciation	0	(240 000)	(52 500)
Movements			
Additions at cost	0	0	48 000
Disposals at carrying value	(a)	(c)	0
Depreciation	0	(b)	(55 500)
Carrying value at end of financial year	2 500 000	446 000	(d)
Cost	2 500 000	750 000	258 000
Accumulated depreciation	0	(304 000)	?

- D. Trade and other receivables include:
- | | 31 October 2014 | 31 October 2013 |
|------------------|-----------------|-----------------|
| SARS: Income tax | R22 500 | 0 |

- E. Trade and other payables include:
- | | 31 October 2014 | 31 October 2013 |
|----------------------------|-----------------|-----------------|
| SARS: Income tax | 0 | R27 500 |
| Shareholders for dividends | R450 000 | R385 000 |

- F. Details of ordinary share capital:

- Ordinary share capital at the beginning of the 2014 financial year consisted of 700 000 ordinary shares with a total value of R3 150 000.
- On 1 November 2013, 50 000 additional shares were issued at R6,00 each.
- There were no further changes to share capital.

notes for...

- G. The dividends (interim and final) for the financial year ended 31 October 2014 amounted to R825 000.
- H. **Financial indicators for the past two financial years:**

	31 October 2014	31 October 2013
Current ratio	3,10 : 1	2,23 : 1
Acid-test ratio	?	0,92 : 1
Earnings per share	?	94 cents
Dividends per share	110 cents	75 cents
Return on average shareholders' equity	?	15%
Debt-equity ratio	?	0,34 : 1
Return on average capital employed	26%	18%
Net asset value per share	593 cents	571 cents
Prices of Classico Ltd shares on the JSE	950 cents	725 cents
Interest on fixed deposit	5,5%	5,5%
Interest rate on loans	12%	12%

Additional information in respect of fixed assets:

- A vehicle was sold at its carrying value on the LAST day of the financial year. Depreciation is written off on vehicles at 20% p.a. on the diminishing-balance method.
- Land and buildings were sold at cost during the financial year.

[75]

Answer Sheets

1.1 What is the main purpose of a Cash Flow Statement?

2

1.2 Calculate the missing amounts (indicated by a, b, c and d) in the Fixed/ Tangible Asset Note for the year ended 31 October 2014.

	Workings	Amount
a		
b		
c		
d		

9

notes for...

1.3 **CLASSICO LIMITED**
CASH FLOW STATEMENT FOR THE YEAR ENDED 31 OCTOBER 2014

CASH FLOW FROM OPERATING ACTIVITIES		
Cash generated from operations		1 985 500
Interest paid		(175 500)
Taxation paid		
Dividends paid		
CASH FLOW FROM INVESTING ACTIVITIES		
CASH FLOW FROM FINANCING ACTIVITIES		
NET CHANGE IN CASH AND CASH EQUIVALENTS		
CASH AND CASH EQUIVALENTS AT BEGINNING		
CASH AND CASH EQUIVALENTS AT END		

24

1.4

Decisions by directors	Reason to support John's opinion	Reason to support directors' decision (other than improving cash flow)
Issued more shares		
Sold fixed assets		

8

notes for...

1.5

Calculate the acid-test ratio.

4

Calculate the earnings per share.

3

Calculate the return on average shareholders' equity.

5

Calculate the debt-equity ratio.

3

1.6

The directors are proposing that the business operations be expanded in the new financial year. One of the directors suggested that they finance the expansions by taking a loan of R1 000 000, instead of issuing new shares to the public. Quote and explain TWO financial indicators to support his opinion.

6

notes for...

1.7

1.7.1 Calculate the amount of dividends Bongani would earn for the financial year ending 31 October 2014.

3

1.7.2 Should Bongani be satisfied with the dividend policy of Classico Limited? Quote and explain relevant financial indicators to support your answer.

4

1.7.3 Quote and explain ONE relevant financial indicator, other than dividends, to discourage Bongani from selling his shares. Your answer must include the actual figure/ratio/percentage.

4

notes for...

Section C: Solutions

Question 1

1.1 What is the main purpose of a Cash Flow Statement?

Good answer = 2; Average = 1; Incorrect = 0 ✓✓

It provides users of financial statements with information on the inflow and outflow of the cash resources of the company

To see how monies were generated or spent and what the cash flow position is.

To account for the difference in opening and closing bank balances

2

1.2 Calculate the missing amounts (indicated by a, b, c and d) in the Fixed/Tangible Asset Note for the year ended 31 October 2014.

	Workings	Amount
a	3 000 000 – 2 500 000	500 000
b	660 000 x 20%	132 000
c	660 000 – (b) – 446 000 OR 150 000 – 68 000	82 000
d	157 500 + 48 000 -55 000 OR 258 000 – 108 000	150 000

✓✓

✓✓

✓✓ one part correct

✓✓

9

notes for...

1.3 CLASSICO LTD
CASH FLOW STATEMENT FOR THE YEAR ENDED 31 OCTOBER 2014

NOTE: Ticks in final column are for operation AND correct use of brackets/no brackets.

CASH FLOW FROM OPERATING ACTIVITIES	625 000	☑
<i>one part correct</i>		
Cash generated from operations	1 985 500	
Interest paid	(175 500)	
Taxation paid (27 500✓ + 375 000✓ + 22 500✓)	(425 000)	☑
<i>one part correct</i>		
Dividends paid (385 000✓ + 825 000✓ - 450 000✓)	(760 000)	☑
<i>one part correct</i>		
9		
CASH FLOW FROM INVESTING ACTIVITIES	534 000	☑
<i>one part correct</i>		
Fixed assets purchased	(48 000)	✓
Proceeds from sale of fixed assets	582 000	☑
(500 000✓ + 82 000 ☑see4.1.2 c)	<i>one part correct</i>	
5		
CASH FLOW FROM FINANCING ACTIVITIES	925 000	☑
<i>one part correct</i>		
Proceeds from the sale of shares	300 000	✓✓
Change in loan (2 000 000 ✓ - 1 375 000 ✓)	625 000	☑
<i>one part correct</i>		
6		
NET CHANGE IN CASH AND CASH EQUIVALENTS	2 084 000	☑✓
<i>check operation</i>		
CASH AND CASH EQUIVALENTS AT BEGINNING	207 500	✓
CASH AND CASH EQUIVALENTS AT END	2 291 500	✓

24

1.4

Decisions by directors	Reason to support John's opinion	Reason to support directors' decision (other than improving cash flow)
Issued more shares	Dilutes the returns to existing shareholders ✓✓ / No apparent need to issue shares as there is considerable cash on hand	Cheaper option of raising funds as loans carry interest ✓✓
Sold fixed assets	Prevents the company from benefiting through capital gains ✓✓	Unproductive or unused assets will incur maintenance expenses. ✓✓

8

notes for...

1.5

Calculate the acid-test ratio.

$$\frac{(1\,075\,000 \checkmark + 2\,291\,500 \checkmark)}{3\,366\,500} : 1\,450\,000 \checkmark$$

$$= 2,3 : 1 \checkmark \text{ or } 2,32 : 1 \text{ one part correct}$$

OR

$$\frac{4\,804\,000 - 1\,437\,500}{1\,450\,000}$$

$$= 2,3 : 1 \text{ or } 2,32 : 1$$

4

Calculate the earnings per share.

$$\frac{975\,000 \checkmark}{750\,000 \checkmark} \times 100c$$

$$= 130 \text{ cents } \checkmark \text{ one part correct}$$

3

Calculate the return on average shareholders' equity.

$$\frac{975\,000 \checkmark}{\frac{1}{2} \checkmark (4\,450\,000 \checkmark + 4\,000\,000 \checkmark)} \times \frac{100}{1}$$

$$= 23,1\% \checkmark \text{ or } 23,08\% \text{ or } 23,07\% \text{ or } 23\% \text{ one part correct}$$

5

Calculate the debt-equity ratio.

$$2\,000\,000 \checkmark : 4\,450\,000 \checkmark$$

$$= 0,45 : 1 \checkmark \text{ (or } 0,5:1) \text{ one part correct}$$

3

1.6

The directors proposed to expand the business operations in the new financial year. One of the directors suggested that they finance the expansions by taking a loan of R1 000 000, instead of issuing new shares to the public. Quote and explain TWO financial indicators to support his opinion.

Financial indicator	✓	✓
Trend	✓	✓
Explanation	✓	✓

Debt/Equity ratio

- It has increased from 0,34: 1 to 0,45:1.
- Company still has a low financial risk.

Return on average capital employed

- It has increased from 18% to 26%
- Company is positively geared as it exceeds the rate of borrowing which currently is 12%.

6

notes for...

1.7 1.7.1

Calculate the amount of dividends Bongani would earn for the financial year ending 31 October 2014.

32 000 ✓ x 110 cents ✓ = R35 200 **one part correct**
(R1,10)

3

1.7.2

Should Bongani be satisfied with the dividend policy of Classico Limited? Quote and explain relevant financial indicators to support your answer.

Yes/No ✓

Consider calculation in 4.2.6 above when marking

Indicator ✓
Figures ✓
Explanation ✓

Explanation for yes:

EPS was 130 cents and DPS was 110 cents.

$(110/130 \times 100)$ 85% of earnings given to shareholders, compared to $(75/94 \times 100)$ 80% given in the previous financial year.

The dividends have increased from 75 cents to 110 cents

Explanation for no:

EPS was 130 cents and DPS was 110 cents.

$(110/130 \times 100)$ 85% of earnings given to shareholders, compared to $(75/94 \times 100)$ 80% given in the previous financial year.

More is being paid out on dividends and less is being retained for future expansion.

4

1.7.3

Bongani wants to sell his shares in Classico Ltd and invest his funds in an alternative investment. You disagree with him. Quote and explain ONE relevant financial indicator, other than dividends, to discourage him from selling his shares. Your answer must include the actual figure/ratio/percentage.

ROSHE is 23,1% **see 4.1.5**

Greater than the return on fixed deposits, 5,5%. ✓

Strong performance of the company may continue in the future to offer greater returns to Bongani. ✓✓

OR

The value of his share has increased from R4,75 (475 cents) to R9,50 (950 cents). (two marks)

This is a capital growth of 100% in just three years. His investment in the company has increased from R152 000 $(32\ 000 \times R4,75)$ to R304 000. Such high returns will not be earned on outside investments. (two marks)

4