COMPANIES – INTERPRETATION OF FINANCIAL STATEMENTS

13 MARCH 2014

Lesson Description

In this lesson we:

- Look at analysing financial statements and its purpose
- Consider users of financial statements
- Discuss ratios that need to be calculated

Summary

Introduction

- There are a number of ratios that can be used to allow users of financial statements to interpret financial information more accurately and make informed decisions.
- The ratios help us to:
  - Check whether there is growth or stagnation in the business
  - Compare current results to previous results
  - Check results with competitors results
  - Compare results to alternate investments
  - Determine the degree of financial risk by investors/creditors

Stakeholders who use Financial Statements

- Board of Directors and Managers
- Suppliers
- Banks/Financial Institutions
- Investors
- Potential Investors
- Competitors
- Employees

Ratios

The ratios used can be classified under the following categories

1. Liquidity

   (The ability of the business to pay its short term debt)

   a.) Current ratio
   b.) Acid test ratio
   c.) Debtors average collection period
   d.) Creditors average payment period
   e.) No. of days stock on hand
   f.) Stock turnover rate

2. Risk

   (The degree of financial risk)

   a.) Debt/equity ratio
   b.) Return on Total Capital Employed

3. Returns

(What the shareholders are getting back in return for their investment)

a.) Return on shareholder's equity
b.) Return on Total capital employed
c.) Net Asset Value per share
d.) Dividends per share
e.) Earnings per share

4. Profitability/Operating Efficiency

(Indicates how profitable the business is and how well expenses are controlled)

a.) % Gross Profit on Sales
b.) % Gross Profit on Cost of sales
c.) % Operating Profit on Turnover
d.) % Net Profit on Sales
e.) % Operating expenses on Sales

5. Solvency

(Can the business settle all its debts)

a.) Current Assets : Current Liabilities

REMEMBER YOU MUST LEARN THE FORMULAS BELOW IN ORDER TO BE ABLE TO CALCULATE RATIOS.

RATIO	FORMULA
1. % Gross Profit on sales	Gross Profit / Sales x 100
2. % Gross Profit on cost of sales	Gross Profit / Cost of sales x 100
3. % Net Profit on Turnover (sales)	Net Profit / Sales x 100
4. % Operating expenses on sales	Operating expenses / Sales x 100
5. Solvency ratio	Total Assets : Total Liabilities
6. Current ratio	Current assets : Current Liabilities
7. Acid-test ratio	Current assets – Inventory : Current liabilities
8. Rate of stock turnover	Cost of sales / Average stock = times per year
9. Number of months of stock on hand/(months/days)	Average stock / Cost of sales x 12 (or 365)
10. Debtors ave collection period	Ave debtors / Credit sales x 365
11. Creditors ave payment period	Ave creditors / Credit purchases x 365
12. Debt/equity ratio	Non-current liabilities : shareholders' equity
13. Return on total capital employed	Net profit before tax + interest on loans / Average Capital employed x 100
14. Return on shareholders' equity	Net profit after tax / Ave shareholder's equity x 100
15. Earnings per share	Net profit after tax / No. of shares issued x 100c
16. Dividends per share	Ordinary share dividends / No. of shares issued x 100c
17. Net asset value per share	Shareholder's equity / No. of shares issued x 100c

Test Yourself

Question 1

Which of the following ratios is **not** a Liquidity ratio?

A. Debtors collection period
B. Current ratio
C. No. of days stock on hand
D. Total assets: Total Liabilities
E. None of the above

Question 2

Which of the following ratios is an indication that the business is **high-geared**?

A. 1,2 : 1
B. 0, 5: 1
C. 0,9 : 1
D. 0, 1 : 1
E. None of the above

Question 3

Earnings per share is calculated by using the following formula:

A. Net Profit before tax divided by no. of shares issued multiplied by 100c
B. Net Profit after tax divided by no. of shares issued multiplied by 100c
C. Operating profit divided by share capital multiplied by 100c
D. None of the above

Question 4

CC LTD provided you will the following information as at 1 July 2013.

Non- current liability – Mortgage loan: R200 000

Share Capital: R400 000

Retained income: R50 000

CC LTD decided increase their long term loan by R100 000 on the 1 December 2013. The business issued 25 000 additional shares at R2 each on the same day. All monies were received and shares were allotted.

4.1 Calculate the **Gearing ratio** as at **1 July 2013?**
A. 0,44: 1
B. 1 : 0,44
C. 0,5 : 1
D. 1 : 0,5
E. None of the above

4.2 Calculate the **Gearing ratio** as at **31 December 2013**?
A. 1 : 0,6
B. 0,6 : 1
C. 0,44 : 1
D. 1 : 1
E. None of the above

Question 5

Solvency ratio determines

A. The ability of the business to pay its short term debt
B. The ability of the business to pay its long term debt

C. The ability of the business to pay its total debt i.e. long term + short term.
D. Current assets + non-current assets : Current liability + non-current liability
E. (c) and (d)

Question 6

Mr Smith owns 20 000 shares in BGH LTD. He wants to sell his shares but is not sure about the selling price.

The following financial indicator will determine the **selling price** of shares by Mr Smith:

A. Debt/equity ratio
B. NAV
C. DPS
D. JSE
E. (b) and (d)

Improve your Skills

Question 1

(Adapted from November 2009, Question 5)

CASH-FLOW STATEMENT AND RATIO ANALYSIS

The information given below was extracted from the financial statements of Sports Ltd, distributors of various sporting equipment.

Required

1.1 Calculate the following for 2009:

1.1.1 Current ratio (3)

1.1.2 Acid-test ratio (4)

1.1.3 Net asset value per share (4)

1.1.4 Debt/Equity ratio (Gearing ratio) (3)

1.2 Explain why the directors decided to reduce the long-term loan significantly during the current financial year. In your opinion, was this a wise decision? Explain, quoting evidence (figures/financial indicators) from the question. (6)

1.3 Comment on the return on shareholders' equity, earnings and dividends earned by the shareholders. Quote evidence (figures/financial indicators) from the question. (6)

1.4 The existing shareholders are unhappy with the price at which the additional shares were sold. Discuss, quoting ONE figure or financial indicator to support your answer. (3)

Information

1.	**Extract from the Income Statement**	**R**
	Depreciation	33 500
	Interest expense	164 450
	Net profit before tax	844 300
	Income tax (rate 30% of net profit)	?

2.	BALANCE SHEET	28 February 2009	28 February 2008
	ASSETS		
	Non-current assets	**3 490 885**	**3 017 500**
	Fixed/Tangible assets at carrying value	3 440 885	2 967 500
	Fixed deposit at PDV Bank	50 000	50 000
	Current assets	**320 000**	**231 250**
	Inventories	251 250	110 250
	Trade debtors	60 000	76 000
	Cash and cash equivalents	1 250	45 000
	SARS – Income tax	7 500	0
	TOTAL ASSETS	**3 810 885**	**3 248 750**
	EQUITY AND LIABILITIES		
	Capital and reserves	**3 120 000**	**1 443 000**
	Ordinary share capital	2 085 000	1 050 500
	Share premium	268 970	0
	Retained income	766 030	392 500
	Non-current liabilities	**300 000**	**1 525 000**
	Loan: Enid Bank at 15% p.a.	300 000	1 525 000
	Current liabilities	**390 885**	**280 750**
	Trade creditors	209 945	220 475
	Bank overdraft	47 500	0
	Shareholders for dividends	133 440	52 525
	SARS – Income tax	0	7 750
	TOTAL EQUITY AND LIABILITIES	**3 810 885**	**3 248 750**

Additional Information

A. 206 900 shares were sold during the financial year at R6,30.

B. Earnings and dividends per share were as follows:

	2009	2008
Earnings per share	189 cents per share	135 cents per share
Total dividends	72 cents per share	105 cents per share
Interim dividends	40 cents per share	80 cents per share
Final dividends	32 cents per share	25 cents per share

C. You are also provided with the following financial indicators:

	2009	2008
% return on shareholders' equity	26%	21%
% return on capital employed (after tax)	24%	10%
Net asset value per share	?	687 cents

E. The price of the shares on the Johannesburg Securities Exchange (JSE) has fluctuated between 680 cents and 780 cents over the past year.