REVISION: COMPANIES - FINANCIAL STATEMENTS 13 JUNE 2013

Lesson Description

In this lesson we revise:

- the users of financial statements and its purpose
- the format of the cash flow statements (the components)
- year end adjustments relating to a Balance Sheet
- ratios affecting liquidity, solvency, risk & returns

Key Concepts

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

Users of Financial Statements and its Purpose

There are four main financial statements which companies prepare, namely:

- Income statement
- Balance sheet
- Cash flow statement
- Statement of changes in equity

For the purposes of the curriculum we only need to know how to prepare the first three. We first prepare the income statement, then the balance sheet and thereafter the cash flow statement.

INCOME STATEMENT → BALANCE SHEET → CASH FLOW STATEMENT

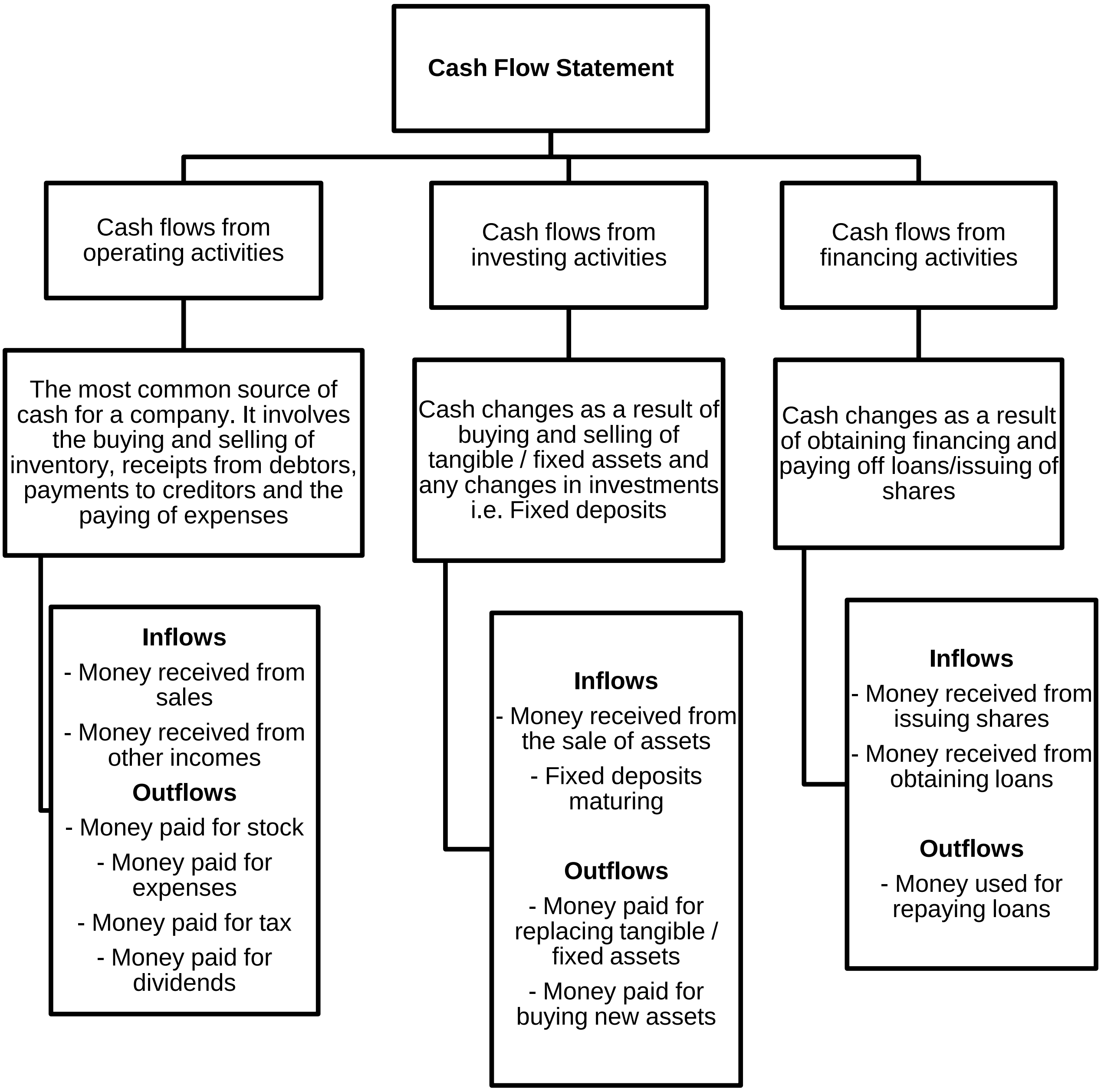
The purpose of doing the cash flow statement is to:

- Determine the cash inflows for the financial period and their sources
- Determine the cash outflows for the financial period and what it was spent on
- Determine the net effect of the changes in cash
- Prepare it as part of the published financial statements of a public company
- Help assess the liquidity of the company
- How were capital developments projects financed?
- Does the company generate sufficient cash from its operations to maintain its current operating capacity

Some users of the Cash Flow Statement:

- Management
- Directors
- Banks
- Investors

Format of the Cash Flow Statement (Components)



Liquidity

The ability of the company to pay its short- term debts.

- Current ratio
- Acid test ratio
- Debtors collection period
- Creditors payment period
- Stock turnover rate
- No. of days stock on hand

Current Ratio

Current Assets : Current Liabilities

Acid Test Ratio

Current Assets – Stock : Current Liabilities

Debtors Collection Period

$$\frac{\text{AVERAGE DEBTORS } \times 365}{\text{CREDIT SALES}}$$

Rem Average = ½ (Current Year + Previous Year)

- Ratios tell the business how long their debtors are taking to pay their accounts.
- Debtors should settle their accounts within 30 days.

Creditors Payment Period

$$\frac{\text{AVERAGE CREDITORS } \times 365}{\text{CREDIT PURCHASES}}$$

- Indicates how long the business is taking to pay its creditors
- The business should negotiate a payment period of 60 to 90 days to pay its creditors.

Rate of Stock Turnover

$$\frac{\text{COST OF SALES}}{\text{AVE STOCK}}$$

- Indicates how quickly the business sells stock (turnover's stock)
- The higher this ratio the better

Number of Months Stock on Hand

$$\frac{\text{AVERAGE STOCK X 12}}{\text{COST OF SALES}}$$

- The lower this ratio the better (keep minimum amount of cash tied in stock).
- A business should not overstock.

Solvency

- The ability to pay off total liabilities/debts after selling total assets.
- Total assets : total liability

Risk

- Two very important ratios
- Looks at borrowing capital vs using own capital (sale of shares)

Debt : Equity Ratio

- Non-current liabilities: shareholders equity
  - low geared (low risk)
  - high geared (high risk)

Return on Total Capital Employed

$$\frac{\text{NET PROFIT BEFORE TAX} + \text{INTEREST EXPENSE}}{\text{AVE CAPITAL EMPLOYED}}$$

- Capital employed = non-current liabilities + shareholders equity

Returns

- Five ratios in total
- Shareholders want these to be as high as possible.
- The higher the ratio, the more they want to invest in the company i.e. they want to buy more shares
- May have to distinguish between long term and short term investors.

Earnings per Share (EPS)

$$\frac{\text{NET PROFIT AFTER TAX } \times 100\text{c}}{\text{NUMBER OF SHARES ISSUED}}$$

- The higher this ratio the better (compare to previous year)
- Indicates the max that shareholders can earn per share.
- Sometimes may be asked to compare to DPS
- Very important for exams!

Dividends per Share (DPS)

$$\frac{\text{ORDINARY SHARE DIVIDEND}}{\text{NUMBER OF SHARES ISSUED}} \times 100\text{c}$$

- The higher the better (compare to p/y)
- May be asked to discuss together with EPS
- May need to distinguish between long term and short term investors.

Net Asset Value per Share

$$\frac{\text{ORDINARY SHAREHOLDERS EQUITY}}{\text{NUMBER OF SHARES ISSUED}} \times 100\text{c}$$

- Indicates the worth of shares (per share)
- The higher the NAV the better (compare to p/y)
- Also compare to PAR value as well as to JSE
- This ratio indicates to a share holder whether or not to sell his/her shares and at what price.

Return on Shareholders Equity

$$\frac{\text{NET INCOME AFTER TAX}}{\text{AVE SHAREHOLDERS EQUITY}} \times 100\%$$

- The higher the % the better
- Compare to current interest rate offered by banks.

Questions

Question 1

(Adapted from Nov 2010, NSC, Question 4)

COMPANY CONCEPTS, FINANCIAL STATEMENTS, RATIOS AND AUDIT REPORTS

Matching Items – Company Concepts

The information below was extracted from the financial records of Modjaji Limited.

REQUIRED:

c.) Prepare the Balance Sheet on 28 February 2010.
(ALL workings must be shown in brackets – **the notes are NOT required**.)
Adjustment based on Information 2 & 3 only

Information

1. The following balances/totals appeared in the General Ledger on 28 February 2010:

BALANCE SHEET ACCOUNTS SECTION	
Ordinary share capital	R1 750 000
Share premium	50 000
Retained income (1 March 2009)	26 000
Long-term loan: Oka Lenders	235 200
Fixed assets at carrying value (1 March 2009)	2 106 500
Trading stock	61 200
Debtors' control	52 000
Provision for bad debts (1 March 2009)	2 500
Creditors' control	81 300
Bank – debit	54 500
Cash float	12 500
Fixed deposit at Leakage Bank (matures in 2013)	80 000
Deposit: Water and electricity	1 100
SARS: Income tax – **debit**	95 000
ML Pension Fund	11 500
NOMINAL ACCOUNTS SECTION	
Ordinary share dividends (interim)	80 000
FINAL ACCOUNTS SECTION	
Trading account (gross profit)	459 000
Profit and Loss Account (net profit)	344 000

2. The company has an authorised share capital of 2 000 000 shares with a par value of R2 each.

3. The following adjustments must still be considered:
   3.1 The directors declared a final dividend of 10 cents per share on 28 February 2010.
   3.2 The assessment received from SARS reflects income tax of R103 200 for the financial year.

Question 2

(Adapted from November 2009, NSC, Question 5)

The information given below was extracted from the financial statements of Manchester Ltd, distributors of exquisite perfumes.

REQUIRED

a.) Calculate the following for 2009:
   i.) Current ratio (3)
   ii.) Acid-test ratio (4)
   iii.) Net asset value per share (4)
   iv.) Debt/Equity ratio (Gearing ratio) (3)

Answer Sheet

Question 1

c.)

MODJAJI LIMITED

BALANCE SHEET AS AT 28 FEBRUARY 2010

ASSETS	
Non-current assets	
Current assets	
TOTAL ASSETS	
EQUITY AND LIABILITIES	
Ordinary shareholders' equity	
Non-current liabilities	
Current liabilities	
TOTAL EQUITY AND LIABILITIES	