ANALYSIS OF COMPANY FINANCIAL STATEMENTS 09 MAY 2013

Lesson Description

In this lesson we:

- Focus on ratios affection liquidity, solvency, risk & returns
- Discuss ratio calculations & relevant comments

Key Concepts

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.

Ratio Analysis

	Description	Formula	Guidance to Comment
1	**% Gross profit on turnover**	$\frac{\text{GROSS PROFIT}}{\text{SALES}} \times 100$	• Illustrates mark-up on selling price. • Mark-up achieved may be compared to policy of business.
2	**% Gross profit on cost of sales**	$\frac{\text{GROSS PROFIT}}{\text{COST OF SALES}} \times 100$	• Illustrates mark-up on cost price. • Mark-up achieved may be compared to policy of business. • Possible reasons for difference: - Seasonal sales - Cash discounts - Incorrect pricing - Theft
3	**% Net income on turnover**	$\frac{\text{NET PROFIT}}{\text{TURNOVER}} \times 100$	• Portion of net income for every Rand of sales. • Compare to previous results
4	**% Total expenses on turnover**	$\frac{\text{NET EXPENSES}}{\text{TURNOVER}} \times 100$	• Indicates absorption rate of expenses on turnover. • A lower rate is more favourable.

5	**Solvency ratio**	Total assets : Total liabilities	• The ratio is used to answer the question whether the business is solvent / an indication of its solvency situation. • If assets are more than liabilities the business is solvent. The higher the ratio the better the solvency. • If solvency is close to 1 : 1 there is possible risk of insolvency in the future.
6	**Current ratio**	Current assets : Current liabilities	• Determines liquidity of business. • Compare to previous results • However if the ratio is very high it can also indicate excessive investment in current assets. Funds could be used for a better return on other investments.
7	**Acid-test ratio**	Current assets - inventory : Current liabilities	• Determines liquidity of business. • Compare to previous results • If current ratio is favourable and acid-test ratio is unfavourable, it shows possibility of too much investment in stock.
8	**Rate of stock turnover**	$\frac{\text{COST OF SALES}}{\text{AVERAGE STOCK}}$ • Average stock = stock at beginning + stock at end divide by 2. • Note the answer must be in times per year.	• Compare to previous results. • Compare to industry. • Quicker rate is more favourable.
9	**Number of months of stock on hand**	$\frac{\text{COST OF SALES} \times 12}{\text{AVERAGE STOCK}}$	• Gives an indication of how long we can expect the stock on hand to last. • This can help with determining ordering times. • We can also comment on the amount of stock carried by the business.
10	**Debtors average collection period**	$\frac{\text{AVERAGE DEBTORS} \times 365 \text{ or } 12}{\text{CREDIT SALES}}$ • If x 365 answer in days • If x 12 answer in months	• Compare to term allowed • If longer, then unfavourable. • How to improve: - Send statements more regularly - Charge interest on overdue accounts - Control credit

11	**Creditors average payment period**	$\frac{\text{AVERAGE CREDITORS} \times 365 \text{ or } 12}{\text{CREDIT PURCHASES}}$ • If x 365 answer in days • If x 12 answer in months	• Compare to term allowed • If longer, then unfavourable. • Aim for shorter time: - Good relation with suppliers - Negotiate better terms and conditions - Obtain regular supplies
12	**Debt / Equity ratio**	Non-current liabilities : Shareholders equity	• Measures degree of financial risk of the business • A lower ratio is more favourable, the business is less of a financial risk. • Easier to obtain loans • A high ratio indicates that funds have to be obtained by other means, besides borrowing.
13	**Return on total capital employed**	Net profit **before** tax + interest on loans x 100 Average capital employed Capital employed = Shareholders equity + non-current liabilities. Average therefore will be the above for two years, divided by two.	• Compare to previous results. • Compare to other outside investments, such as return on a fixed deposit.
14	**Return on shareholders' equity**	$\frac{\text{NET PROFIT } \textbf{AFTER} \text{ TAX} \times 100}{\text{AVERAGE SHAREHOLDERS' EQUITY}}$ • Shareholders equity = Share capital + share premium + retained income. • Average therefore would be the above for two years, divide by two.	• Compare to previous results. • Compare to other outside investments, such as return on a fixed deposit. • Compare to returns by other companies with a similar share price.
15	**Earnings per share**	$\frac{\text{NET PROFIT } \textbf{AFTER} \text{ TAX} \times 100}{\text{NUMBER OF SHARES ISSUED}}$ • Number of shares issued = Share capital divided by par value	• Compare to previous results. • Compare to earnings by other companies with a similar share price. • Comment in relation to general economic conditions • Comment in relation to JSE performance in general
16	**Dividends per share**	$\frac{\text{TOTAL DIVIDENDS} \times 100}{\text{NUMBER OF SHARES ISSUED}}$	• Compare to previous results. • Compare dividends to earnings per share. If a huge difference exists then it means that a large amount has been kept as retained income. Is there justification for that? • Comment in relation to general economic conditions. • Comment in relation to JSE performance in general

17	**Net asset value per share**	$$\frac{\text{SHAREHOLDERS EQUITY} \times 100}{\text{NUMBER OF SHARES ISSUED}}$$	• Used to determine current value of shares • Can influence the decision whether to buy a particular share or not. • If the net asset value is more than the par value, one is inclined to buy the share. • The difference between dividend per share and earnings per share represents the amount retained by the company and thus increases the net asset value per share

Questions

Question 1

(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)

b.) 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)

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

d.) Calculate the premium at which the new shares were issued. (5)

e.) 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 (par value R5)	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**

3. ADDITIONAL INFORMATION:

A. Additional new shares were issued at a premium halfway through the year on 31 August 2008. These shares did not qualify for interim dividends.

B. Fixed assets were sold for R100 000 cash at carrying value.

C. 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

D. 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.