

ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS

LO1 - Financial Information *AS5 Prepare final accounts and financial statements analyse and interpret the financial statements of a company.

1. ANALYSING AND INTERPRETING THE FINANCIAL STATEMENTS OF A COMPANY

1.1 Who uses financial statements?

As already mentioned, a public company is compelled by law to publish its financial statements. The following persons/bodies use these statements for decision-making processes:

The **shareholders** need to see how the company is doing, as they “own” the company. The statements also indicate whether shareholders and prospective shareholders should sell or buy shares in the company.

The **board** goes to great lengths when preparing the financial statements, as these statements reflect the degree of success with which it has managed the company. The board uses the statements as its basis for its decisions, for compiling budgets, and so on.

The **auditors** study the statements, comment on them and provide financial advice. They are also responsible for ensuring that internal controls are in place.

The Registrar of Companies exercises control over companies.

Financial institutions such as banks and building societies use a company's statements to determine its credit rating when it applies for an overdraft or a long-term loan.

Creditors consult a company's statements to see whether it is able to meet its short term commitments.

The **SARS** bases its tax assessment on a company's financial statements.

2. EQUATIONS AND PERCENTAGES

2.1 Profit margin

$$\begin{aligned} \text{Gross profit as a percentage of cost price} &= \frac{\text{gross profit}}{\text{cost price}} \times 100 \\ \text{Gross profit as a percentage of sales} &= \frac{\text{gross profit}}{\text{sales}} \times 100 \end{aligned}$$



Both calculations indicate whether a company is achieving the necessary profit margin.

The results are usually compared with those of the previous year.

Should a company not achieve the necessary profit margin, it could be attributed to sales (lower sale prices), incorrect inventory or losses due to theft or damage.

2.2 Cost Control

$$\begin{aligned} \text{Net profit as a percentage of sales} &= \frac{\text{net profit before tax}}{\text{sales}} \times 100 \\ \text{Operating expenses as a percentage of sales} &= \frac{\text{operating expense}}{\text{sales}} \times 100 \end{aligned}$$

Both the calculations test the cost control of a company, namely whether the company's overheads are in line with its sales, or whether the overheads exceeds it.

The percentage net profit of sales must be as high as possible, about 1/3 of the % gross profit of sales.

Total expenses as a percentage of sales should be as low as possible.

If the percentages are too high or too low, the company has to reduce its overheads/expenses.

2.3 Inventory

$$\text{Rate of stock turnover} = \frac{\text{cost of sales}}{\text{average stock}} = \text{number of times per year}$$

$$\text{Number of months for which stock is on hand} = \frac{\text{average stock}}{\text{cost of sales}} \times 12$$

Average stock = stock at the end of the previous year + stock at the end of the current year.

This depends on the type of company: for example it is done about four times per year in a clothing shop and 24 times or more for a café.

The results are compared with those of the previous year. The higher the turnover, the better.

2.4 Solvency

Solvency is determined by comparing the total assets with the total liabilities.

Total assets = total assets + financial assets + current assets

Total liabilities = long-term liabilities + current liabilities

This ratio indicates the financial position of the company.

The conservative accepted norm is that the ratio should be 1:1, but ideally it should be higher.

2.5 Liquidity

Current ratio = current assets: current liabilities

Acid test ratio = (current liabilities - stock): current liabilities

Both ratios test whether a company is able to meet its short-term commitments. The current ratio has to be 2:1 and the acid-test ratio has to be 1:1

2.6 Credit control

$$\text{Debtors collection period} = \frac{\text{average debtors}}{\text{credit sales}} \times 365$$

If the debtors collection period of a company is longer than 30 days, its credit control is not good. It can be improved by giving its discount to debtors who pay their accounts before the due date and charging interest on accounts that are in arrears.

$$\text{Creditors' payment period} = \frac{\text{average creditors}}{\text{credit purchases}} \times 365$$

Companies should negotiate with creditors to be allowed to settle their bills in 90 days.

2.7 Debt/shareholders' equity ratio

Long-term liabilities: shareholders' equity

This ratio indicates the financial position of a company

Own capital = shareholders' contribution

Borrowed capital = money borrowed from outside institutions such as banks.

This ratio indicates the degree of creditworthiness of a company. If this ratio is higher than 1:1, the company concerned is high-gearred and not creditworthy. It would not easily qualify for further loans. If the ratio is less than 0.5:1, the company concerned is low-gearred and creditworthy, namely a low Risk.

$$\text{Shareholders' equity} = \text{ordinary share capital} + \text{share premium} + \text{accumulated profits}$$

2.8 Return on average shareholders' equity

$$\frac{\text{net profit after tax}}{\text{average shareholders' equity}} \times 100$$

The result can be compared to those of previous years or with the interest earned on other investments.



2.9 Return on average capital employed

$$\frac{\text{profit before interest expense}}{\text{average capital employed}} \times 100$$

This calculation indicates whether a company is earning good returns on capital invested. The percentage obtained should be higher than the interest paid on borrowed capital.

$$\text{Capital employed} = \text{shareholders' equity} + \text{long-term loans}$$

2.10 Earnings per share (EPS)

$$\frac{\text{net profit after tax}}{\text{number of shares issued}} \times 100$$

Compare the result to EPS of previous years.

Profitability has an effect on the EPS.

2.11 Dividend per share (DPS)

$$\frac{\text{ordinary share dividends}}{\text{number of shares issued}} \times 100$$

Compare the result to DPS of previous years.

Profitability has an effect on the DPS.

The maximum amount available for dividends = net profit + accumulated profit - income tax

2.12 Net asset value per share

$$\frac{\text{shareholders' equity}}{\text{number of shares issued}} \times 100$$

Compare the results with those of previous years and with the par/nominal value of shares.

When making notes, keep the economy and market-related issues in mind.