Monyetla Project – Accounting Gr 11

Lesson 3: Analysis and interpretation of financial statements

How to answer this question:

★ *Calculate your answer*

★ ***Compare** the answer with the same ratio of the **previous year** – say whether it **decreased** or **increased.***
NB: QUOTE FIGURES!!!!!!!!

★ *Mention what could have **caused** the increase or decrease*

★ *Compare it with a **norm** if there is one*

★ *Make a **conclusion** and **possible suggestion** or **advice** to improve if necessary*

<table>
<tr><th>Questions answered</th><th>Financial indicators</th><th>Ratios</th><th>Possible comment</th></tr>
<tr>
<td rowspan="2">Profitability

(Margin ratio)
Did the business achieve their profit margin?</td>
<td>% Gross profit on cost of sales

(Gross profit = Sales - Cost of Sales)</td>
<td><u>Gross profit</u>
Cost of sales x 100

= x %</td>
<td rowspan="2">▪ % is compared to the previous year’s and companies in similar industries
▪ Also compare with the <u>profit margin of the business</u> = norm
▪ It shows how well a company controls the cost of its inventory
▪ If it is below the expected profit margin it can be due to the following:
○ Discount was allowed with sales to increase turnover (specials or sales)
○ Mistakes was made calculating prices with source documents or entries in the books
○ Strong competition thus pushing the selling price down
○ Suppliers increased their prices thus increasing the cost price
○ All normal stock losses including theft of stock, damage to stock, etc
▪ Generally, the larger the gross profit margin, the better
▪ If sales (turnover) can increase, gross profit will also increase</td>
</tr>
<tr>
<td>% Gross profit on sales (turnover)

(Turnover = Sales – Debtors allowance)</td>
<td><u>Gross profit</u>
Turnover x 100

= x %</td>
</tr>
</table>

Questions answered	Financial indicators	Ratios	Possible comment
Efficiency **(Margin ratio)** How well does the business **control** its **overheads or expenses**	% Operating profit on sales (turnover)	**Operating profit** **Sales** **x 100** **= x %**	▪ Measures **overall operating efficiency** ▪ It **test the cost control** of the business – does the business have control over operating expenses ▪ Compare **with previous year's** figures ▪ A **decrease** in this percentage indicates the business was **less efficient** in controlling expenses
	% Net profit on sales (turnover)	**Net profit after tax** **Sales** **x 100** **= x %**	▪ This percentage is very much the same as the previous one, but after interest expense and tax were taken into account ▪ A comparison of **operating profit on sales** with this figure will show **the effect finance costs** had on the business ▪ A percentage of 7% for instance would indicate that for every R1 in sales, 7 cents is profit ▪ A **decrease** in this percentage indicates the business was **less efficient** in controlling expenses
	% Operating expenses on sales (turnover)	**Operating expenses** **Sales** **x 100** **= x %**	▪ This indicates **what percentage of sales** is **spent on operating expenses** ▪ E.g. % Operating expenses on sales of 23% means for every R100 sales, R23 will be spend to pay expenses ▪ This also **tests the cost control** of the business and will be compared to **previous year's figures** ▪ A **decrease** in this percentage indicates the business was **more efficient** in **controlling expenses** ▪ If this percentage is **too high** the business should look at **ways to cut overhead costs**

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<tr><td rowspan="3">Liquidity

Will the business be able to pay short term obligations (debt), such as bank overdraft, creditors and short term loans?

How well did the business manage their working capital?</td><td>Current ratio</td><td>Current assets : Current liabilities
= x : 1</td><td rowspan="2">• Both these ratios test if the business has enough current (liquid) assets to pay creditors, bank overdrafts, short term loans, etc
• A good indication for the current ratio is that there should be at least TWO current assets for every ONE current liability (2 : 1)
• Acid test ratio test the ability of the business to settle current debts under abnormal circumstances such as a bad economic depression
• It is sometimes difficult to convert inventory into cash and the Acid test ratio tests if the business has enough liquid assets to do so, without taking inventory into consideration
• The current assets which can be readily liquidated (debtors and cash) should be at least equal to the current liabilities and not less, in other words 1:1 [acid test ratio]
• If it is less, the business might struggle to meet short-term obligations
• A possible way to improve the acid test ratio is to sell off excess stock and to collect debtors sooner
• This ratios should also not be too high as it could indicate that excess funds are tied up in current assets which are not earning a return for the business</td></tr>
<tr><td>Acid test ratio</td><td>(Current assets – Inventory) : Current liabilities

= x : 1

Or:

Trade and other receivables + Cash and cash equivalents) : Current liabilities

Inventory = Trading inventory (stock) + Consumable Stores on hand</td></tr>
<tr><td>Net working capital</td><td>Current assets – Current liabilities</td><td>• You should have a positive net working capital in order to pay short-term obligations</td></tr>
</table>

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<tr><td rowspan="2">Liquidity

Efficiency ratio
How effective did you manage working capital and what effect did it have on liquidity?</td><td>Stock turnover rate</td><td>Cost of Sales .
Average Trading stock
= x times per year</td><td rowspan="2">The number of days / months stock on hand will vary from one business to the next depending on the type of business and products they sell
This helps the business to plan for stock replenishment
The more effective a business can increase their rate of stock turnover, the more profit they can make
It will be compared to the previous year's figures and some objectives the business set for themselves
If stock turnover is too high, the business can run out of stock
It stock turnover is too low, stock can become obsolete
A low stock turnover rate means: over investment in stock, excessive purchases of stock, slow moving (selling) of stock.
Too high stock levels implicate: increase in insurance cost, and additional risk like fire or theft
A way to improve the stock turnover rate is to have special sales, discounts or rewards
Good control over stock will ensure that the business do not run out of stock or prevent stock from becoming obsolete</td></tr>
<tr><td>Stock holding period (availability of stock)</td><td>Average Trading stock
Cost of Sales x 365

-= x days

Or

Average Trading stock
Cost of Sales x 12

= x months</td></tr>
</table>

Questions answered	Financial indicators	Ratios	Possible comment
Liquidity **Efficiency ratio** How effective did you **manage working capital** and **what effect** did it have on liquidity?	Average debtors collection period	**Average debtors** **Credit sales x 365** **= x days** *Average debtors = ½ (Debtors at the beginning + Debtors at the end)* ***(Only Trade debtors)***	• A business should try to **collect debts** within **30 days** • The business may experience **cash flow problems** if the debtors exceed credit terms. • If the collection period **decreases** (e.g. 30 to 35 days), the business should look at its **credit and collection policy** • The collection of debts could **improve** by: ✓ **Proper screening** of new debtors (credit worthiness) ✓ Charging **interest** ✓ Setting **credit limits** • **Enourage** debtors to settle accounts by offering **discounts**
	Average creditors payment period	**Average creditors** **Credit purchases x 365** **= x days** *Average creditors = ½ (Creditors at the beginning + Creditors at the end)* ***(Only Trade creditors)***	• A business should **negotiate** a **longer payment period** with creditors (60 – 90 days) – they should, however, make sure they **pay creditors on time** to **prevent interest charged** on overdue accounts • A business may experience **cash flow problems** if **creditors demand payment** before receipts from debtors • An **increase in the number of days** a business takes to pay creditors can be **an indication** that the business has **liquidity problems**.
Solvency Do the assets exceed the liabilities?	Total assets: Total liabilities	**Total assets : Total liabilities** **= x : 1**	○ This indicates whether a business will be able to **settle total obligations** ○ It can also show **how many assets** are **financed through debt** ○ Banks and other financial institutions inspect solvency to determine whether the business **can meet its total commitments** ○ This should be **at least 1:1** for a business to be solvent ○ It is, however, **more acceptable if it is 2:1** as that would indicate there are **TWO assets** for every **ONE liability**

Questions answered	Financial indicators	Ratios	Possible comment
Financial leverage / **Risk indicator** * By what means is the business **financed?** * Is the business **credit worthy / low geared?** * Will the **bank** grant the business a **loan?**	Debt/Equity ratio ↓ **The lower, the better**	**Non-current liabilities : Shareholders' Equity** **= x : 1** OR **Long term liabilities : Shareholders' Equity**	▪ This ratio gives an indication **how the business is financed** ▪ Capital provided by the **shareholders = own capital** ▪ Funds **borrowed** from other institutions = **foreign capital** ▪ This indicate the **ratio between borrowed capital and own capital** ▪ A business that relies mainly on **own capital** is often seen as a **low-risk** business and would more **easily obtain a loan** ▪ One can assume that a business with a debt : equity ratio **under 0,5:1** is **low geared** and **credit worthy** (The firm does not depend on outside funding) ▪ A business with a ratio **above 1:1 is highly geared** ▪ Compare with **interest rate** and **comment on gearing** ▪ A **decrease** indicates that a company is **relying less** on **debts financing –** indication of **financial health** ▪ An **increase** means **more risk.** The company has **less cash** available for **general operations** and to **pay suppliers**, since it needs to **cover its interest expense and installments**

Questions answered	Financial indicators	Ratios	Possible comment
Return Does the business **earn a good return** on the **capital invested** in the business *(Return = something you get back)*	Return on owner's equity (gearing)	$\frac{\textbf{Net profit}}{\textbf{Average Owner's Equity}}$ **x 100** *Owner's Equity = Capital + Current accounts* *Average Owner's' Equity = ½ (Owner's equity beginning of the year + owner's equity end of the year)* ***OR*** *Average owner's Equity = ½ (Capital and Current account balances beginning of the year for both partners + Capital and Current account balances end of the year for both partners)*	• This percentage gives an indication **how much return** the owners earned on the capital invested in the business • It allows them to compare the **rate of return** in the **business** with the **rate** of **alternative investments** such as a fixed deposit • There are a couple of factors that could have an influence on this ratio, for instance **how long the business has been running and economic climate**

Questions answered	Financial indicators	Ratios	Possible comment
Return Does the business **earn a good return** on the **capital invested** in the business *(Return = something you get back)*	Percentage earnings by a partner	**Total earnings by partner** / **Partner's average owner's equity** **x 100** *Total earnings by partner = Salary + Bonus + Interest on capital + Remaining profit [or minus Remaining losses]* *Partner's average owner's equity = ½ (Capital and current account opening balances beginning of the year + closing balances end of the year for one partner only]*	• This indicates **how effective** the funds were used through operating activities to **generate revenue** • The **percentage obtained** should be higher than the **interest paid** on borrowed capital