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Support Pack | Grade 12

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Accounting

Financial statements

This revision pack for **Accounting Grade 12** provides support for learners revising the most important concepts and principles covered in the CAPS curriculum. These include concepts relating to companies, the acquisition of Fixed assets, inventories, VAT, Manufacturing and cost accounts, and budgeting. Summaries of the GAAP principles, theory of Accounting, and the format of Debtors and Creditors control accounts are provided. Furthermore, a detailed table to summarise the interpretation of Financial Statements is provided.

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Revision 4

Companies: Interpretation and analysis of financial statements

Summary of ratios used in the analysis and interpretation of financial statements of companies

Question answered	Financial indicator	Ratio	Possible comments
Margin ratios Did the business achieve its profit margin?	% gross profit on cost of sales	$\frac{\text{gross profit}}{\text{cost of sales}} \times \frac{100}{1}$	<ul style="list-style-type: none"> The percentage is compared with that of previous years and with companies in the same or similar industries. It shows how well a company controls the cost of its inventory. If the percentage is below the expected profit margin, it can be due to: discount allowed on sales to increase turnover; mistakes made when calculating prices, on source documents or in entries in the books; strong competition pushing the selling price down; suppliers increasing their prices thus increasing the cost price; and all normal stock losses, including theft of stock (periodic stock system). Generally, the larger the gross profit margin, the better.
	% gross profit on sales (turnover)	$\frac{\text{gross profit}}{\text{sales}} \times \frac{100}{1}$	
Margin ratios How well does the business control its overheads / expenses?	% operating profit on sales (turnover) (Also known as EBIT – Earnings before Interest and Tax)	$\frac{\text{operating profit}}{\text{sales}} \times \frac{100}{1}$	<ul style="list-style-type: none"> The percentage measures overall operating efficiency. It tests the cost control of the business; that is, the business control over operating expenses. It will be compared to previous years' figures. A decrease in the percentage indicates the business was less efficient in controlling expenses. This percentage is very similar to the previous one, but is calculated after interest expense and tax are taken into account. A comparison of operating profit on sales with this figure will show the effect finance costs had on the business. For example, a percentage of 7% would indicate that for every R1 in sales, 7c is profit. A decrease in this percentage indicates the business was less efficient in controlling expenses. The percentage indicates what percentage of sales is spent on operating expenses. This also tests the cost control of the business and is compared to previous years' 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.
	% net profit on sales (turnover)	$\frac{\text{net profit after tax}}{\text{sales}} \times \frac{100}{1}$	
	% operating expenses on sales (turnover)	$\frac{\text{operating expenses}}{\text{sales}} \times \frac{100}{1}$	

Question answered	Financial indicator	Ratio	Possible comments
<p>Liquidity Will the business be able to pay short-term obligations (debts), such as bank overdraft, creditors and short-term loans? How well did the business manage their working capital?</p>	Current ratio	current assets : current liabilities	<ul style="list-style-type: none"> Both ratios test to see if the business has enough current (liquid) assets to pay creditors, bank overdraft, 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. The acid test ratio tests the ability of the business to settle current debts under abnormal circumstances, for example during a bad economic depression. It is sometimes difficult to convert inventory into cash and this ratio tests to see if the business has enough liquid assets to do so, without taking inventory into consideration. The current assets that can be readily liquidated (debtors and cash) should be at least equal to the current liabilities and not less; in other words 1 : 1. If it is less than 1 : 1, 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. The acid test ratio 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.
	Acid test ratio	(current assets – inventory) : current liabilities OR (trade and other receivables + cash) : current liabilities Note: Inventory = trading stock + consumables on hand	
<p>Efficiency ratios How effective the business manages its working capital will have an effect on its liquidity.</p>	Net working capital	current assets – current liabilities	<ul style="list-style-type: none"> You should have a positive net working capital in order to pay short-term obligations.
	Stock turnover rate	$\frac{\text{cost of sales}}{\text{average trading stock}}$	<ul style="list-style-type: none"> 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.
	Stock holding period	$\frac{\text{average trading stock}}{\text{cost of sales}} \times \frac{365}{1}$ OR $\frac{\text{average trading stock}}{\text{cost of sales}} \times \frac{12}{1}$	<ul style="list-style-type: none"> The more effectively a business can increase their rate of stock turnover, the more profit they can make. It is compared to previous years' figures and some objectives the business has set. If stock turnover is too high, the business can run out of stock. If stock turnover is too low, stock can become obsolete.
	Average debtors collection period	$\frac{\text{average debtors}}{\text{credit sales}} \times \frac{365}{1}$	<ul style="list-style-type: none"> A business should try to collect debtors within 30 days. If the collection period decreases, the business should look at its credit and collection policy – the collection of debtors could improve by screening of new debtors, charging interest on late payments and setting credit limits.
	Average creditors payment period	$\frac{\text{average creditors}}{\text{credit purchases}} \times \frac{365}{1}$	<ul style="list-style-type: none"> A business should negotiate a longer payment period with creditors – it should also make sure it pays creditors on time to prevent interest charged on overdue accounts. An increase in the amount of days a business takes to pay creditors can indicate that the business has liquidity problems.

Question answered	Financial indicator	Ratio	Possible comments
Solvency ratio Do the assets exceed the liabilities?	total assets : total liabilities	$\frac{\text{total assets}}{\text{total liabilities}}$	<ul style="list-style-type: none"> This ratio indicates whether the business will be able to settle its total obligations. It can also show how many assets are financed with debt. This ratio 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.
Financial leverage – risk indicator How is the business financed? Is the business credit worthy / low geared? Will the bank grant the business a loan?	Debt : equity ratio	$\frac{\text{non-current assets} : \text{shareholder's equity}}{\text{Long-term liabilities} : \text{shareholder's equity}}$ OR $\frac{\text{net profit after tax}}{\text{average shareholders' equity}} \times \frac{100}{1}$ where average shareholders' equity = $\frac{1}{2}(\text{shareholders' equity at beginning of the year} + \text{shareholders' equity at end of the year})$	<ul style="list-style-type: none"> This ratio indicates how the business is financed. Capital provided by the shareholders = own capital. Funds borrowed from other institutions = foreign capital. A business that relies mainly on own capital is often seen as a low-risk business and would obtain a loan more easily. One can assume that a business with a debt : equity ratio of under 0.5 : 1 is low geared and credit worthy, while a business with a ratio above 1 : 1 is highly geared. This percentage indicates how much return the shareholders earned on the capital invested in the business. It allows them to compare the rate of return of the business with the rate of alternative investments, for example a fixed deposit. There are several factors that could influence this ratio: how long the business has been operating, economic climate and whether new shares were issued during the year.
Return Does the business offer a good return on the capital invested in the business?	Return on average capital employed (ROACE)	$\frac{\text{profit before tax} + \text{finance cost (EBIT)}}{\text{average capital employed}} \times \frac{100}{1}$ where capital employed = shareholders' equity + long-term loans	<ul style="list-style-type: none"> This percentage indicates how effectively funds were used through operating activities. The percentage obtained should be higher than the interest paid on borrowed capital. EBIT = Earnings Before Interest and Tax
Market value ratios Financial indicators are specific to companies. They evaluate the economic status of a company.	Net asset value per share (NAVPS) Dividends per share (DPS)	$\frac{\text{shareholders' equity}}{\text{number of shares issued}} \times \frac{100}{1}$ $\frac{\text{dividends on ordinary shares}}{\text{number of shares issued}} \times \frac{100}{1}$	<ul style="list-style-type: none"> This percentage can be compared to market prices – bear in mind, though, that market prices will usually be higher because of the historical cost principle of GAAP: This principle states that asset values are usually understated, which means NAVPS will be lower, while supply and demand forces of the marketplace generally push stock prices above book value. NAV = book value per share = what is it worth You usually compare the result to the DPS of previous years. An increase in DPS is usually a good sign as it shows the directors of the company believes that the growth can be sustained. A decrease in DPS can indicate to investors that the company is not doing so well financially, and could lead to a drop in market price as investors might sell their shares. DPS and EPS can be compared to each other, as earnings per share shows how much the profit the business made per share and dividends per share shows how much of that profit per share was paid out to the shareholders.
	Earnings per share (EPS)	$\frac{\text{net profit after tax}}{\text{number of shares issued}} \times \frac{100}{1}$	<ul style="list-style-type: none"> This percentage can be compared to the EPS of previous years. Profitability has an effect on the earnings per share. There are several factors that could influence this ratio: how long the business has been operating, economic climate and whether new shares were issued during the year.