# FINANCIAL INDICATORS AND INTERPRETATION OF FINANCIAL STATEMENTS

## Grade 12 Accounting

### Companies and Financial Statements

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# CHAPTER OUTCOMES

After studying this chapter, you should be able to:

✓ Explain why financial indicators are important

✓ Calculate liquidity ratios

✓ Calculate solvency ratios

✓ Calculate profitability ratios

✓ Calculate shareholder indicators

✓ Interpret financial information

✓ Write examiner-quality comments

✓ Support comments using figures

✓ Avoid common interpretation mistakes

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# 1. INTRODUCTION

Imagine you are thinking of investing R100 000 in a company.

Before investing, you would want answers to questions such as:

- Is the company making profits?
- Can the company pay its debts?
- Is the company financially stable?
- Will I receive good returns?

Financial indicators help answer these questions.

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# WHAT ARE FINANCIAL INDICATORS?

Financial indicators are calculations used to analyse the financial performance and financial position of a company.

They help users make informed decisions.

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# WHO USES FINANCIAL INDICATORS?

### Shareholders

Want to know:

- Return on investment
- Dividends
- Growth

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### Directors

Want to know:

- Business performance
- Areas needing improvement

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### Banks

Want to know:

- Can the company repay loans?

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### Investors

Want to know:

- Is the investment worthwhile?

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# 2. FOUR MAIN CATEGORIES OF INDICATORS

In Grade 12 Accounting, indicators fall into four groups:

### Liquidity

Can the company pay short-term debts?

### Solvency

Can the company survive long-term?

### Profitability

Is the company making profits?

### Shareholder Returns

Are shareholders receiving value?

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# STUDYPACK MEMORY TIP

Liquidity = Short Term

Solvency = Long Term

Profitability = Profit

Shareholder Indicators = Investor Benefits

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# SECTION A

# LIQUIDITY

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## 3. WHAT IS LIQUIDITY?

Liquidity measures the company's ability to pay short-term debts.

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## QUESTION

Can the company pay creditors tomorrow?

Liquidity helps answer this question.

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## 4. CURRENT RATIO

One of the most important ratios in Grade 12 Accounting.

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## FORMULA

Current Ratio

=

Current Assets

÷

Current Liabilities

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## EXAMPLE

Current Assets

R600 000

Current Liabilities

R300 000

Current Ratio

=

2 : 1

---

# INTERPRETATION

For every:

R1 owed

the company has:

R2 available

---

# GOOD OR BAD?

Generally:

2 : 1

is considered healthy.

---

# EXAM COMMENT

The Current Ratio improved from:

1,5 : 1

to

2,1 : 1

This indicates improved liquidity.

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# COMMON EXAM MISTAKE

Learners often write:

"The ratio increased."

This is incomplete.

Always explain what the increase means.

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# 5. ACID-TEST RATIO

Also called:

Quick Ratio

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# WHY DOES IT EXIST?

Inventory may take time to sell.

Therefore inventory is removed.

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# FORMULA

Acid-Test Ratio

=

(Current Assets - Inventory)

÷

Current Liabilities

---

# EXAMPLE

Current Assets

R800 000

Inventory

R300 000

Current Liabilities

R250 000

Acid-Test Ratio

=

2 : 1

---

# INTERPRETATION

The company can pay short-term debts without selling inventory.

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# EXAM TIP

Acid-Test Ratio is a stricter measure than Current Ratio.

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# SECTION B

# SOLVENCY

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# 6. WHAT IS SOLVENCY?

Solvency measures long-term financial stability.

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# QUESTION

If the company closes today,

can all debts be paid?

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# 7. DEBT-EQUITY RATIO

Measures financial risk.

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# FORMULA

Debt-Equity Ratio

=

Total Liabilities

÷

Shareholders' Equity

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# EXAMPLE

Liabilities

R2 000 000

Equity

R4 000 000

Debt-Equity Ratio

=

0,5 : 1

---

# INTERPRETATION

For every:

R1 invested by shareholders

there is only:

50 cents debt

---

# GOOD OR BAD?

Lower ratio

=

Lower risk

---

# EXAM COMMENT

The Debt-Equity Ratio decreased from:

0,8 : 1

to

0,5 : 1

This indicates reduced financial risk.

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# 8. SOLVENCY RATIO

Measures ability to cover liabilities.

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# FORMULA

Solvency Ratio

=

Total Assets

÷

Total Liabilities

---

# EXAMPLE

Assets

R9 000 000

Liabilities

R3 000 000

Solvency Ratio

=

3 : 1

---

# INTERPRETATION

For every:

R1 owed

the company owns:

R3 in assets

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# SECTION C

# PROFITABILITY

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# 9. WHAT IS PROFITABILITY?

Profitability measures the company's ability to generate profit.

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# QUESTION

Is the company making enough profit?

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# 10. GROSS PROFIT PERCENTAGE

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# FORMULA

Gross Profit %

=

Gross Profit

÷

Sales

×

100

---

# EXAMPLE

Gross Profit

R400 000

Sales

R1 000 000

Gross Profit %

=

40%

---

## INTERPRETATION

The company earns:

40 cents gross profit

for every R1 of sales.

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## 11. NET PROFIT ON SALES

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## FORMULA

Net Profit After Tax

÷

Sales

×

100

---

## EXAMPLE

NPAT

R200 000

Sales

R1 000 000

Net Profit %

=

20%

---

## INTERPRETATION

The company earns:

20 cents profit

for every R1 sales.

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## EXAM COMMENT

Net Profit % increased from:

12%

to

18%

This indicates improved profitability and expense control.

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## SECTION D

## SHAREHOLDER INDICATORS

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## 12. RETURN ON SHAREHOLDERS' EQUITY (ROSHE)

One of the most tested company indicators.

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## WHAT DOES IT MEASURE?

Return earned by shareholders on their investment.

## FORMULA

Net Profit After Tax

÷

Average Shareholders' Equity

×

100

## EXAMPLE

NPAT

R1 200 000

Average Equity

R8 000 000

ROSHE

=

15%

## INTERPRETATION

Shareholders earned:

15%

return on investment.

# EXAM TIP

Compare ROSHE with:

Interest on Fixed Deposits

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# EXAMPLE COMMENT

ROSHE

18%

Fixed Deposit

10%

Investment in the company is worthwhile because shareholders earn higher returns.

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# 13. EARNINGS PER SHARE (EPS)

Measures profit earned per share.

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# FORMULA

Net Profit After Tax

÷

Number of Shares

×

100

(in cents)

---

# EXAMPLE

NPAT

R1 000 000

Shares

500 000

EPS

=

200 cents

---

# INTERPRETATION

Each share earned:

200 cents profit.

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# 14. DIVIDEND PER SHARE (DPS)

Measures dividends distributed per share.

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# FORMULA

Total Dividends

÷

Number of Shares

×

100

---

# EXAMPLE

Dividends

R500 000

Shares

500 000

DPS

=

100 cents

---

# INTERPRETATION

Each shareholder receives:

100 cents per share.

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# 15. DIVIDEND PAYOUT RATE

Measures percentage of profit distributed as dividends.

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# FORMULA

DPS

÷

EPS

×

100

---

# EXAMPLE

DPS

100 cents

EPS

200 cents

Dividend Payout Rate

=

50%

---

# INTERPRETATION

50% of earnings were distributed.

50% retained.

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# 16. NET ASSET VALUE (NAV)

Very popular in NSC examinations.

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# WHAT DOES NAV MEAN?

Value of each share if the company sold all assets and paid all liabilities.

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# FORMULA

Shareholders' Equity

÷

Number of Shares

×

100

---

# EXAMPLE

Equity

R5 000 000

Shares

500 000

NAV

=

1 000 cents

---

# INTERPRETATION

Each share is worth:

1 000 cents.

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# EXAM TIP

Compare:

NAV

and

Market Price

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# IF MARKET PRICE > NAV

Investors expect future growth.

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# IF MARKET PRICE < NAV

Investors may lack confidence.

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# HOW TO ANSWER INTERPRETATION QUESTIONS

Examiners award marks for:

✓ Figure

✓ Trend

✓ Explanation

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# BAD ANSWER

Liquidity improved.

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# GOOD ANSWER

The Current Ratio improved from 1,4 : 1 to 2,1 : 1, indicating that the company is now better able to meet short-term obligations.

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# DISTINCTION FORMULA

Figure

+

Trend

+

Explanation

=

Full Marks

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# COMMON EXAM MISTAKES

❌ No figures

✓ Quote figures

---

❌ No comparison

✓ Compare years

---

❌ No explanation

✓ Explain meaning

---

❌ Memorised comments

✓ Comment using data provided

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# PRACTICE QUESTIONS

QUESTION 1

Define liquidity.

(2)

QUESTION 2

Calculate Current Ratio:

Current Assets

R900 000

Current Liabilities

R450 000

(2)

QUESTION 3

Calculate Acid-Test Ratio:

Current Assets

R800 000

Inventory

R300 000

Current Liabilities

R250 000

(3)

QUESTION 4

Explain why ROSHE is important to shareholders.

(4)

QUESTION 5

Calculate NAV:

Equity

R12 000 000

Shares

2 000 000

(3)

QUESTION 6

The Current Ratio improved from 1,3 : 1 to 2,0 : 1.

Comment on liquidity.

(3)

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# MEMORANDUM

QUESTION 1

Liquidity is the ability of a company to meet short-term obligations.

(2)

QUESTION 2

900 000 ÷ 450 000

=

2 : 1

(2)

QUESTION 3

(800 000 - 300 000)

÷ 250 000

=

2 : 1

(3)

QUESTION 4

It measures the return shareholders earn on their investment.

(4)

QUESTION 5

12 000 000

÷ 2 000 000

×

100

=

600 cents

(3)

QUESTION 6

Liquidity improved because the Current Ratio increased from 1,3 : 1 to 2,0 : 1, indicating a stronger ability to pay short-term debts.

(3)

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# CHAPTER SUMMARY

You should now understand:

✓ Current Ratio

✓ Acid-Test Ratio

✓ Debt-Equity Ratio

✓ Solvency Ratio

✓ Gross Profit %

✓ Net Profit %

✓ ROSHE

✓ EPS

✓ DPS

✓ Dividend Payout Rate

✓ NAV

✓ Interpretation Techniques

✓ Examiner Expectations

These indicators form a major part of Grade 12 Accounting Paper 1 and are frequently tested in interpretation questions worth high marks.