Lesson 5: Companies: Analysis and Interpretation

POSSIBLE QUESTIONS / SCENARIOS

Example 1

Comment on the profitability of the company.

Gross profit as % of cost of sales / Profit mark-up

Compare these % with the **expected profit margin** of the business.

If the profit mark-up is **below the expected profit margin**, it can be due to a few reasons (Notes, pg 2)

If sales (turnover) increase, gross profit will also increase.

Example 2

How well does the company control its expenses?

Operating expenses as % of sales

This indicates **what percentage of sales is spent on operating expenses**.

A percentage of 25%, for example, will indicate that for every R1 sales, 25 cents was spent on expenses.

A **decrease** in this percentage indicates that the business **controlled their expenses well**.

If this percentage is too high, the business should look at ways to cut expenses / overhead costs.

Ways to cut expenses / overhead costs:

- Use water and electricity sparingly
- Make sure that the employees did not use the telephone for personal calls and did not take stationery for own use.
- Keep control over the Trading stock so that theft and losses can be minimized.
- Make sure that you screen the Debtors well, so that bad debts can be minimized.
- Keep control over the fixed assets and keep service plans up to date so that maintenance cost can be minimized.

Example 3

Comment on the solvency of the company.

Solvency ratio

Total assets : Total liabilities means the Total assets (Balance Sheet → top part) to the Total Liabilities (Balance Sheet → lower part without the Shareholders equity).

An indication of how solvent / insolvent the company is.

A business is **insolvent/bankrupt** when their liabilities are more than their assets.

Example 4

Comment on the liquidity position of the company.

Quote the 5 liquidity financial indicators with figures:

- Current ratio
- Acid test ratio
- Stock turnover rate / Stock holding period
- Debtors collection period
- Creditors collection period

Comment on the ability of the company to pay their short term liabilities.

Some of the ratios will be positive and some negative. Combine the positive/negative ones in your comment. Or you can just comment on each one separately.

Example 5

Comment on the gearing/risk of the company.

Debt/Shareholders equity ratio → RISK

Return on average capital employed → GEARING

Information:

	2020	**2019**
Debt/Shareholders equity ratio	0,23 : 1	0,41 : 1
Interest on loan	18%	18%
Return on total capital employed (ROTCE)	36,6%	25,4%

The directors want to take out a loan for R500 000. Would you advice them to take out the loan? Quote TWO financial indicators that are relevant to their decision.

Debt/Shareholders equity ratio *improved* from 0,41 : 1 to 0,23 : 1. The company is at <u>low risk and creditworthy</u> because *for every R1 own capital they owed 23 cents borrowed capital*.

Return on total capital employed improved/increased from 25,4% to 36,6%.
It is a <u>positive gearing</u> because the ROTCE of 36,6% is more than the interest rate on the loan of 18%.

→ Therefore, the company will be able to take out a loan.

On the other hand:

The company will be at **high risk** and **not creditworthy** when the debt/shareholders equity ratio is higher than 1 : 1.

The company will be **negatively geared** when the ROTCE is less than the interest rate on loan.

Example 6

Explain why the shareholders are / are not satisfied with their return earned.

Return on shareholders equity (ROSHE)

The ROSHE can increase or decrease from the previous year.

They will be satisfied when the ROSHE is more than the return on alternative investments (interest on fixed deposit).

They will not be satisfied when the ROSHE is lower than the return on alternative investments.

Example 7

Explain why the shareholders are satisfied / not satisfied with the market price of the shares on the JSE.

Financial indicators on 28 February:

	2020	**2019**
Net asset value per share	652 cents	627 cents
Market price per share on JSE	640 cents	635 cents

2019: The shareholders will be satisfied when the market price on the JSE is higher than the NAV.

2020: The shareholders will not be satisfied when the market price on the JSE is lower than the NAV.

Supply and demand determine the market price. It means that the JSE valued the shares higher / lower than what the shares are worth at that moment (NAV).

Example 8

Comment on the price paid to repurchase the shares. Quote financial indicators with figures in your comments.

Issued shares comprised 800 000 shares at R9,50 each
200 000 additional shares were issued at R9,80 per share
120 000 shares were repurchased at R10 per share

The price paid was fair, because the R10 is very near the issued price of R9,80. It did not compromise the company or the shareholders.

Different answers will be given if the issued and repurchased prices differ drastically.

Example 9

Calculate and comment on the dividend pay-out rate/ policy of the 2 years. Quote financial indicators with figures.

Financial indicators on 28 February:

	2020	**2019**
Earnings per share	165 cents	813 cents
Dividend per share	182 cents	552 cents

2019: DPS / EPS x 100
= 552 / 813 x 100
= 68%

The company **paid out 68%** of their earnings as dividends to the shareholders, and **retained 32%** for future expansion.

2020: DPS / EPS x 100
= 182 / 165 x 100
= 110%

The company **paid out 110%** of their earnings as dividends to the shareholders. As it is more than 100% of their earnings, the 10% extra came from the retained income.

Example 10 (refer to Ex 9)

Explain why the shareholders are satisfied / not satisfied with the dividend pay-out policy. Quote financial indicators with figures in your explanation.

2019: 68%
2020: 110%

68% → 110%

Explanation: The shareholders may be satisfied with their dividends as the company decided to pay out a larger percentage of the earnings (110%) than the previous year (68%).

On the other hand, when the pay-out rate was 110% in the previous year and decreased to 68%:

110% → 68%

Explanation: The shareholders may be dissatisfied with their dividends as the company decided to retain a larger percentage of the earnings than the previous year.

The directors may have explained their strategy in the annual reports.

Example 11

Majority shareholding means the shareholder should earn more than 50% of the total shares issued by a company.

How do you calculate this?

50% x shares issued + 1 share
51% x shares issued ***OR***

When shares are only issued in batches of e.g. 100, then you calculate the 50% of the shares issued and round it up to the nearest 100.

The company is registered with an authorized share capital of 2 000 000 ordinary shares. The financial year ended on 28 February 2020.

1. The CEO, Nikola Pelser, currently **owns 40%** of the issued shares. The board of directors decided to issue **50% of the unissued shares** in July 2020.

a) Calculate the minimum number of shares that Nikola must buy in July 2020 to gain control of the company.

b) Nikola wants to purchase the additional shares at R12 per share without advertising the shares to the public. Give two reasons why you would not approve of this arrangement.

2. New shares were issued at the beginning of the financial year at R10 each. Explain why the existing shareholders would or would not be happy with this issue price.

   Quote two financial reasons why you would not approve of this arrangement.

Financial indicators on 28 February:

	2020	**2019**
Shares issued	1 200 000	450 000
Net asset value per share	1 600 cents	1 400 cents
Market price per share on JSE	1 700 cents	1 600 cents

Q 1a)

There were 1 200 000 shares issued at the end of the year!!

40% x 1 200 000 = **480 000** (Shares owed by Nikola on 28 Feb 2020)

2 000 000 – 1 200 000 = 800 000 (Shares available to issue)

50% x 800 000 = **400 000** (New shares to issue in July 2020)

1 200 000 + 400 000 = **1 600 000** (Total shares that will be issued in July 2020)

50% x 1 600 000 = 800 000

800 000 – 480 000 = 320 000 **+ 1** / rounded up to nearest 100
= **320 001** or **320 100**

OR

51% x 1 600 000 = 816 000 – 480 000 = **336 000**

Q 1b)

- As this is a public company the shares should be offered to the public. This is inside trading and it is unethical to withhold information to the public.
- The shares should be issued at the current market value of R17 which will bring in R6 800 000 to the company. NAV is R16 and the market price R17 and the CEO wants to buy at R12. Company will lose money.
- She would therefore be benefiting while the other shareholders will be disadvantaged through dilution of the share price.

Q 2

The shareholders would not be happy.

Shares were issued at a price below the NAV of 2019. NAV was R14 and shares were issued at R10.

Shares were issued at a price lower than the market price of 2019. Market price was R16 and shares were issued for R10.

Example 12

New shares sold to the CEO

Existing shareholders are dissatisfied that the new shares issued on 1 April 2020 were sold to the CEO. Give two reasons why you consider their feelings to be justified. Quote figures.

Financial indicators on 31 March:

	2021	**2020**
Net asset value per share	332 cents	409 cents
Market price per share on JSE	410 cents	540 cents

Information:

1. Share capital:

On 1 April 2020 the company issued an additional 250 000 shares.

2. Cash Flow Statement:

Proceeds from shares issued = R375 000

Quoting figures: The shares were sold to the CEO at R375 000 / 250 000, a price of **R1,50** while the NAV was R3,32 and the market price was R4,10.

- **Market-related reasons**, e.g. The company is losing out on additional funding as shares could have been sold at a higher price.

  Market price has dropped from R5,40 to R4,10.
- **Ethical reasons**, e.g. This is a very low price and the CEO is exercising undue influence over the issue price.

  The CEO is receiving preferential treatment.

  This is against the Companies Act or King Code because of a lack of transparency.

Example 13

Your family owns 10 000 shares in Cling Limited

Questions:

1. According to the books of the company, how much was each share worth on 28 February 2019?
2. Why is the price on the JSE different to the figure quoted above? Provide one reason.
3. Your family are tempted to sell their 10 000 shares at market price on the JSE.

a) Provide one point to support their decision to sell their shares. Quote indicators with figures.

b) Provide one point against their decision to sell their shares. Quote indicators with figures.

4. Calculate the total final dividend earned by your family for the 2019 financial year.

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Information:

Figures from the Balance Sheet on 28 February:

	2019	**2018**
Shareholders for dividends	R149 600	R90 000

Financial indicators on 28 February:

	2019	**2018**
Shares issued	340 000	305 000
Earnings per share	138,7 cents	125,3 cents
Return on shareholder's equity	27,3%	22%
Net asset value per share	564 cents	502 cents
Market price per share on JSE	550 cents	650 cents

Q 1

The NAV shows the value of a share at a specific time = 564c

Q 2

- NAV is determined by historical prices of shares issued.
- Supply and demand of shares determines the market price.
- Market price does not always reflect future prospects and true book value (NAV).

Q 3

a) One point to <u>support their decision</u> to sell their shares

- Market price has dropped from 650c to 550c.
- Market price (550c) is lower than NAV (564c).

b) One point <u>against their decision</u> to sell their shares

- EPS increased from 125,3 cents to 138,7 cents per share.
- NAV has increased from 502 cents to 564 cents per share.
- Return on shareholder's equity has increased from 22% to 27,3%.

Q 4

Remember, the balance for Shareholders for dividends is the final dividends declared at the end of the year.

R149 600 / 340 000 shares = R0,44 x 10 000 = R4 400

Example 14

Extract from the Cash Flow Statement on 31 March 2021

Cash flow from operating activities	(148 080)
Cash generated from operations	1 281 620
Interest paid	(232 000)
Dividends paid	(925 000)
Taxation paid	(272 700)
Cash flow from investing activities	101 580
Cash flow from financing activities	1 026 500
Proceeds from shares issued	375 000
Increase in loan	651 500
Cash and cash equivalents: Net change	980 000
Opening	(330 000)
Closing	**650 000**

The Cash Flow Statement reflected a positive change in R980 000.

Provide two points why this should **still be a concern** to directors. Quote figures.

→ Be negative ☹

- Cash flow from operating activities is negative R148 080
- Additional shares issued for only R375 000
- Large increase in loan, R651 500
- High interest payment on the increased loan, R232 000
- Very high payment for dividends, R925 000
- Cash from investing activities is only R101 580

Example 15

Extract from the Cash Flow Statement on 28 Feb 2017

Cash flow from operating activities	233 350
Cash generated from operations	878 600
Interest paid	(78 750)
Dividends paid	(280 000)
Taxation paid	(286 500)
Cash flow from investing activities	1 203 000
Purchase of fixed assets	(94 000)
Proceeds from sale of fixed assets	1 047 000
Increase in financial assets	250 000
Cash flow from financing activities	272 500
Proceeds from shares issued	1 100 000
Repurchase of shares	(12 500)
Decrease in loan	(815 000)
Cash and cash equivalents: Net change	1 708 850
Opening	(920 000)
Closing	**788 850**

The Cash Flow Statement **reflects some important decisions** taken by the directors over the past year.

List two of these decisions and explain why each of these decisions will have an important effect on the future results of the company. Quote figures to support your answer.

Decision taken	Effect on the company future
Issued shares, R1 100 000	Money flowing into the business will improves the cash flow of the company and the business can take advantage of investment opportunities. Will enable the business to use funds for expansion to generate more profits.
Purchase fixed assets, R94 000	Expanding in fixed assets for expansion / new branches. Less maintenance on new fixed assets.
Sold fixed assets, R1 047 000	Losing out on appreciation of fixed assets in future. Cash more useful than unused assets/buildings. Could negatively affect profitability in future as infrastructure has reduced.
Financial assets matured, R250 000	Financial asset matured resulted in better cash flow to help pay the bank overdraft.
Loans were repaid, R815 000	Less interest to pay. Improves debt/equity ratio / risk / gearing.
If the loans increased	*The increase in the loan will lead to bigger interest expenses.*
The bank overdraft of R920 000 at the beginning of the year was repaid	Positive balance of R788 850 at the end of the year. Improvement in liquidity.

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Example 16

Comment on the earnings, dividends and & return earned by the shareholders in the 2017 financial year. Quote financial indicators with figures.

Financial indicators on 28 February:

	2017	2016
Earnings per share	140 cents	157 cents
Dividend per share	114 cents	104 cents
Return on shareholder's equity	38,4%	55%
Interest rate on investments	8%	8%

Earnings per share
- EPS decreased from 157 cents to 140 cents per share.
- This shows a decrease in the profits of the company / Shareholders will be worried because of the drop in earnings.

Dividends per share
- DPS increased from 104 cents to 114 cents per share.
- Shareholders should be satisfied with the increase in dividends.
- Shareholders can be satisfied seeing that the dividend pay-out rate increased from 66% (104/157) to 81% (114/140). Less funds are being retained for future expansion.

% Return on shareholder's equity
- % Return on shareholder's equity decreased substantially from 55% to 38,4%.
- The return still exceeds returns on alternative investments of 8%.

Example 17

Provide two possible reasons why the NAV (book value) is higher than the market price.

Bad publicity of the company / Bad name.
Lack of demand of shares → market price ↓.
Perception that the directors are not making good decisions.

Example 18

Information:

Figures from the Balance Sheet on 30 June:

	2018	2017
Fixed assets (cost price)	R3 510 800	R2 664 000
Mortgage loan	R1 142 000	R920 000
Bank overdraft	R905 000	R91 000

Jim Jeffs, a shareholder, is very concerned about the liquidity and profitability situation of the company and has decided to sell his shares. The directors repurchased all 80 000 ordinary shares from him at a price of R4,20 per share. The average issue price on this date was R3,05.

1. The following statement was taken from the minutes of the annual general meeting (AGM): "We, the shareholders, would like to express our concern over the directors' decision to repurchase the 80 000 shares during this financial year."

   Provide a reason supported by information as to why the shareholders feel this way.

2. After an investigation, it has come to light that Jim Jeffs, the shareholder from whom the company repurchased the shares, is a close friend of the financial director.

   Briefly explain why you as a shareholder may find this to be a problem.

Q 1

- The business has a very big overdraft because of fixed assets purchased. They cannot afford to buy back the shares.
- The business had to take out another loan.

Q 2

- This is a **conflict of interest** and **unethical** to repurchase the shares.
- The shares were repurchased at a price higher than the average issue price.

AUDIT REPORT /CORPORATE GOVERNANCE

Example 1

The directors want to donate computers with a value of R180 000 to a local school. Give two reasons why companies take such decisions.

- This forms part of their corporate social investment/ responsibility in accordance with the Kind Code.
- This leads to goodwill from the community / support / positive image / good publicity.
- Contributes to better facilities for learners.
- The cost can be subtracted from tax / Tax deductible.

Example 2

Briefly indicate how a disclaimer of opinion / adverse audit report would possibly affect the value of the shares of the company on the JSE. Mention two points.

- Potential investors and shareholders would lose confidence in the company and directors and would not want to invest in the company.
- Current shareholders will lose confidence in the company and directors and will try to sell their shares.
- The share price of the company will drop because of supply and demand on the JSE.
- Negative image and bad publicity of the company.

Example 3

You have been appointed as the external auditor of a company. The managing director, Shawn Pillay, has asked you to reflect his directors' fees of R2,1 million under "Salaries and wages" in the Income Statement instead of Directors fees.

Will you agree to this request? Give a reason for your answer.

No

This is a material amount which is of interest to the shareholders who have appointed the directors – **GAAP principle of materiality**. The Companies Act of 2008 and King Code requires for the director's fees to be disclosed separately.

Example 4

Shareholders and employees associated with a company will be particularly interested in whether the company is well governed and managed by the directors.

At the AGM, the shareholders will elect two types of directors:
Executive directors: They attend board meetings and work at the company on a full-time basis.
Non-executive directors: They attend board meetings and do NOT work at the company.

You are provided with four aspects of corporate governance that will be of concern to the stakeholders.

1. **Audit Report**

Explain why a qualified audit report is not a good reflection of a company. Provide two points.

2. **The Board of Directors**

Explain why it is important for a company to include non-executive as well as executive directors on the Board of Directors.

3. **The Remunerations Committee** – According to the Companies Act, 2008 (Act 11 of 2008), a company must have a Remunerations Committee.

Explain the role/responsibility of this committee and give a reason why this committee is necessary.

4. **Directors engage with clients** on a regular basis in an effort to negotiate contracts and increase sales and services.

Explain why there should be a company policy that directors must declare to the Board all gifts, donations or favours received by them from clients. Provide two points.

Q1

- Certain information on financial statements are not clear / missing.
- There is insufficient audit evidence for significant items. Auditors cannot verify certain information.
- Lack of internal controls, possible negligence.
- Negative impact on the future. Consequences on the image of the company / decreased demand for shares from potential shareholders will have an influence on the share price.
- Existing shareholders might decide to sell their shares.

Q 2

Executive shareholders:

- Are involved with internal operations of the company / hand-on / decisions may be based on a narrow view.
- Would be more vigilant and professional in their duties / not tempted to engage in unethical activities.

Non-executive shareholders:

- Have a wider perspective of the business environment and act in the best interest of the company.
- Would exercise a watch-dog role: keep executive directors in check.
- Their inputs would be unbiased and independent.
- They share accountability with the other directors / more people have the interest of the company in mind.
- They can be paid less than the other directors because they do not work permanently in the company.
- The more directors there are, the more opinions will be generated, which could benefit the company.

Q 3

Explanation:

- Review all salaries, bonuses and other earnings.
- To prevent directors from paying themselves too much.
- They must approve and give advice on the proposal of fees, bonuses, etc.

Reasons:

- To ensure fairness / transparency in the payment of salaries.
- To prevent fraud / corruption / wastage.
- Detect mismanagement or fraudulent activities.
- They can compare the remuneration / earnings against financial information of other companies in the industry / fairness to the workers.

Q 4

- Transparency in awarding contracts, tenders or appointing service providers.
- Could result in not appointing the best suited client for the job / not adhering to or flouting company policy.
- Policy would prevent colluding with service providers.
- Directors / service providers would know the consequences or not abiding by policy and therefore not be tempted to engage in fraudulent activities / corruption.
- This could be viewed as bribery for contracts.
- This could be viewed as nepotism (if family and friends are involved0.
- To protect the image of the business.
- Conflict of interest which could be corrupt / fraudulent.

Example 5

Explain one of the consequences if the independent auditors do not do their jobs carefully:

- for the shareholders
- for the independent auditors

For the shareholders:

The financial statements would be unreliable.

Shareholders will invest money in a company on the basis of false information.

They could suffer severe financial loss if the money is not used properly – it could affect their share price and they will not find buyers for their shares.

The existing shareholders will sell their shares because they lose trust in the company.

For the independent auditors:

Disciplinary action will be taken by the professional body if they are guilty of negligence.

Their professional body SAICA would deregister them if they are guilty of negligence.

Not be re-appointed as auditors.

The auditors could face civil action in court if they are sued by shareholders for being negligent.

More information:

The punishment imposed by SAICA on a member found guilty of misconduct will depend on the severity of the offence.

A member who is found guilty of a ***minor transgression*** may be:

- cautioned, or
- reprimanded, or
- fined.

If a member is found guilty of a ***more serious act***, the member may be:

- suspended from membership, or
- struck off the membership roll.

If the Professional Conduct Committee considers the offence to be so serious that it might warrant a more severe penalty, such as suspension, they will refer the matter to the Disciplinary Committee.