Question 5 – solution

(a)

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(i) Return on Capital Employed

Net Profit + Debenture Interest x 100 / Capital Employed	=	72,000 + 18,000 x100 / 842,000	=	10.68% ❾

(ii) Opening stock

Cost of sales / Average stock	=	8	=	740,000 / 8 x Av stock	
Average stock	=	92,500			
Opening stock	=	(92,500 x 2) less €110,000		=	€75,000 ❾

(iii) Earnings per share

Net profit after Pref Div / Number of ordinary shares	=	72,000 -16,000 / 400,000	=	14c ❾

(iv) Period to recoup share

Market price / Earnings per share	=	2.08 / 14c	=	14.86 years ❾

(v) Dividend cover

Net profit after Pref Div / Ordinary dividend	=	72,000 – 16,000 / 36,000	=	1.55 times ❾

(b)

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Performance

Profitability: ❽

Equip Ltd is a profitable business as its return on capital employed of 10.68% in 2004 and 9.5% in 2003. Its return on equity funds is 12.12% in 2004 and 12% in 2003.
This indicates that the firm is earning nearly 3 times the return from risk free investments of about 3%.
The profitability has improved by 1.18% since 2003.

Dividend policy: ❽

Dividend per share in 2004 is 9c and 7.5c in 2003. This has improved by1.5c since 2003.
The company's dividend cover is 1.55 times in 2004 but was 1.73 times in 2003. More profits are retained in 2004.
The dividend yield is 4.3% in 2004 and 3.75% in 2003. This has improved by 0.55% since last year. This yield is above the return on a risk free investment of 3%. The shareholders would be happy with the increase in dividend but would prefer a higher dividend yield. The real return to ordinary shareholders would be 6.7% based on available profits.

State of Affairs

Liquidity: ❽

Equip Ltd does not have liquidity problem and is well able to pay their debts as they fall due. The company has €1.34 in liquid assets to pay each €1 in debts. This has improved from 2003 when the company had €1.20 to pay each €1 owed.
The current ratio has also improved since 2003 when the company had €1.80 in assets to cover each €1 of debt. They now have €1.95 to cover each €1 owed. This is slightly below the ideal of 2:1 but is not a cause of worry to shareholders.

Gearing: ❹

The gearing of the company is 45%. This is a low geared company. This would please the shareholders as it increases their chance of getting a dividend and there is little risk from outside.
The interest cover is 5 times and shows the ability of the company to meet their interest charges is good. This would please the shareholders.

Investment Policy: ❹

The investments made by the company cost €100,000. These investments now have a market value of €90,000, a drop in value of 10%. This indicates poor management of resources and would not please the shareholders.

Prospects

Value of shares: ❹

Last year a share in Equip Ltd cost €2. The share price has now increased to €2.08. The price has increased by 4%. This would please the shareholders as it shows confidence in the company by the market.

Sector: ❹

Equip Ltd is a manufacturer of sports equipment. This is a good sector to be in as people are always interested in sport and with the heightened awareness of the need to exercise and avoid obesity it should also be a growing sector. There is also an increase in disposable income.

(c) **5 x 3 marks** 15

The gross profit percentage has dropped from 32% in 2003 to 22% in 2004. This could be caused by:

- Cash losses
- Stock losses
- Mark downs during sales
- Incorrect valuation of stock
- Increased cost of sales without an increase in sales price
- Change in sales mix