5. Interpretation of Accounts **(100)**

(a) Ratios (50)

(i) The Earnings per Ordinary Share (10)

$$= \frac{\text{Net Profit} - \text{Preference Dividend}}{\text{Number of Ordinary Shares Issued}} = \frac{45{,}000\ \mathbf{(3)} - 20{,}000\ \mathbf{(3)}}{600{,}000\ \mathbf{(2)}}$$

= €0.0417 <u>or</u> 4.17 cent* **(2)**

(ii) The Cash Purchases if the average period of credit received from trade creditors is 1.5 months (12)

Average period of credit received from creditors

$$= \frac{\text{Creditors}}{\text{Credit Purchases}} \times \frac{12}{1} = 1.5$$

⇒ Credit Purchases

$$= \frac{\text{Creditors}}{1.5} \times \frac{12}{1} = \frac{68{,}000\ \mathbf{(2)} \times 12\ \mathbf{(2)}}{1.5\ \mathbf{(1)}}$$

= 544,000* **(1)**

Total Purchases

= Cost of Sales – Opening stock + Closing Stock = 840,000 **(1)** – 42,000 **(1)** + 48,000 **(1)**

= 846,000* **(1)**

⇒ Cash Purchases

= Total Purchases – Credit Purchases = 846,000 – 544,000 **(1)**

= €302,000* **(1)**

(iii) The Dividend Yield (10)

Dividend per Share

$$= \frac{\text{Total Ordinary Dividend}}{\text{Number of Ordinary Shares Issued}} = \frac{22{,}000\ \mathbf{(2)}}{600{,}000\ \mathbf{(2)}}$$

= €0.0366 / 3.67 cent* **(1)**

⇒ Dividend Yield

$$= \frac{\text{Dividend per Share}}{\text{Market Price per Share}} \times \frac{100}{1} = \frac{3.67\ \mathbf{(1)} \times 100\ \mathbf{(1)}}{110\ \mathbf{(2)}}$$

= 3.34%* **(1)**

(iv) How long it would take one ordinary share to recoup (recover) its 2011 market price (assume current performance is maintained) (8)

Length of time

$$= \frac{\text{Market Price}}{\text{Earning per Share}} = \frac{1.10\ \mathbf{(3)}}{0.0417\ \mathbf{(3)}}$$

= 26.38 years* **(2)**

(v) Return on capital employed (10)

$$= \frac{\text{Net Profit} + \text{Debenture Interest}}{\text{Capital Employed}} \times \frac{100}{1} = \frac{45{,}000\ \mathbf{(2)} + 24{,}000\ \mathbf{(2)}}{1{,}085{,}000\ \mathbf{(2)}} \times \frac{100}{1}\ \mathbf{(2)}$$

= 6.36%* **(2)**

* Allow marks for student's own figures if consistent with previous work.

** Full marks awarded for correct answer even if no workings or wrong workings are shown.
** Figures in brackets show breakdown of marks if answer incorrect.
** Penalise 1 mark if ratios not given to 2 decimal places where appropriate.
** Penalise 1 mark if appropriate units (cent, €, times, %, years) omitted from final answers.
** Allow 3 marks for each formula with no calculation.

(b) Indicate whether the ordinary shareholders would be satisfied with the performance, state of affairs and prospects of the company. Use relevant ratios, percentages and other information to support your answer. (40)

Performance

(i) Profitability **(8)**

Any 4: (4 × 2)

- Dowling plc is a profit able business
- Return on Capital Employed has disimproved from 10.4% in 2010 to 6.36%* in 2011 //
- this indicates that the firm is earning over twice the return from risk-free investments of about 2-3% //
- the return is below the rate being paid on debentures (9%) //
- profitability has disimproved by approximately 4% since 2010 showing a less efficient use of resources // *etc*.

(ii) Dividend policy **(7)**

- dividend per share has disimproved from 4.8c in 2010 to 3.67c 2011 - a deterioration of 1.13c since 2010 (1)

Any 3: (3 × 2)

- the company's dividend cover has disimproved from 2.6 times in 2010 to 1.14 times in 2011 //
- a smaller percentage of the profits is being retained in 2011 than 2010 - the company may not be re-investing sufficient profits back into the business //
- dividend yield has disimproved from 5.2% in 2010 to 3.34%* in 2011 – a deterioration of 1.86% since 2010 //
- dividend yield is only slightly higher than the return available from risk-free investments of about 2-3% - shareholders would prefer to see a higher yield //
- the real return to ordinary shareholders has disimproved from 13.52% (2.6 × 5.2) in 2010 to 3.81%* (1.14 × 3.34) in 2011 based on available profits as a percentage of market value // *etc*.

State of Affairs

(i) Liquidity **(5)**

- the company has a slight liquidity problem (1)

Any 2: (2 × 2)

- the working capital ratio in 2010 is 1.4:1 //
- quick ratio has disimproved from 1.2:1 in 2010 to 0.92:1 in 2011 //
- the company only has €0.92 in liquid assets for every €1 that it owes

(ii) Gearing **(5)**

- the company is lowly geared and is not dependent on outside borrowing (1)

Any 2: (2 × 2)

- gearing has disimproved from 35% in 2010 to 41.47% in 2011 //
- interest cover has disimproved from 4.7 times in 2010 to 2.88 times in 2011 //
- this worsening could jeopardise future interest payments //
- there is a lesser chance of getting a dividend and there is higher risk from outside investors

(iii) Investment policy **(5)**

- investments made by the company cost €95,000 (1)
- these investment now have a market value of €80,000, a drop in value of 15.79% (2)
- indicates poor management of resources but shareholders must take into account the current global economic downturn (2)

Prospects

(i) Value of Share **(5)**

- the market value of each share has fallen from €1.30 in 2010 to €1.10 in 2011, an decrease of 15.38% (1)
- earnings per share have disimproved from 12.5c in 2010 to 4.17c* in 2011 (2)
- indicates a lack of confidence in the company by the market and the shareholders should not be happy with this (2)

(ii) Sector **(5)**

- the company operates in the dairy industry (1)

Any 2: (2 × 2)

- this industry is not performing well and the future is unsure //
- the overall economic recession has had a negative effect on this industry //
- risks of overproduction and competition from low-cost competitors

(c) The gross profit percentage for 2010 was 35%. Give **five** different explanations for the increase/decrease in 2011. (10)

Any 5: **(5 × 2)**

- cash losses //
- stock losses //
- mark downs during sales //
- incorrect valuation of stock //
- increased purchase prices without a corresponding increase in sale price(s) //
- change in sale mix // *etc*.

** Accept other appropriate answers.