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

(a) Ratios (45)

(i) The Opening Stock if the rate of stock turnover is 11 times (10)

Rate of Stock Turnover $= \dfrac{\text{Cost of Sales}}{\text{Average Stock}} = 11 \text{ times } \mathbf{(2)}$

$\Rightarrow$ Average Stock $= \dfrac{451{,}000\ \mathbf{(2)}}{11}$

$= 41{,}000\ \mathbf{(1)}$

$\Rightarrow$ Opening Stock $= (41{,}000 \times 2)\ \mathbf{(2)} - 38{,}000\ \mathbf{(2)}$

$= ^*€44{,}000\ \mathbf{(1)}$

* Accept student's own figures if consistent with previous work.

(ii) Return on Capital Employed (8)

$$= \frac{\text{Net Profit + Interest}}{\text{Capital Employed}} \times \frac{100}{1} = \frac{112{,}000\,\mathbf{(1)} + 18{,}000\,\mathbf{(2)}}{891{,}000\,\mathbf{(2)}} \times \frac{100}{1}\,\mathbf{(1)}$$

$= ^*14.59\%\ \mathbf{(2)}$

* Accept student's own figures if consistent with previous work.

(iii) The Earnings per Ordinary Share (8)

$$= \frac{\text{Net Profit} - \text{Preference Dividend}}{\text{Number of Ordinary Shares Issued}} = \frac{112{,}000\,\mathbf{(2)} - 12{,}000\,\mathbf{(2)}}{400{,}000\,\mathbf{(2)}}$$

$= ^*25 \text{ cent } \mathbf{(2)}$

* Accept student's own figures if consistent with previous work.

(iv) The Dividend Yield (10)

Dividend per Share $= \dfrac{\text{Total Ordinary Dividends}}{\text{Number of Ordinary Shares Issued}} = \dfrac{31{,}500\ \mathbf{(3)}}{400{,}000\ \mathbf{(1)}}$

$= 7.88 \text{ cent}$

$\Rightarrow$ Dividend Yield $= \dfrac{\text{Dividend per Share}}{\text{Market Price per Share}} \times \dfrac{100}{1} = \dfrac{7.88}{190\ \mathbf{(3)}} \times \dfrac{100}{1}\ \mathbf{(1)}$

$= ^*4.15\%\ \mathbf{(2)}$

* Accept student's own figures if consistent with previous work.

(v) How long it would take one ordinary share to recover its value at present pay out rate. (9)

Length of time $= \dfrac{\text{Market Price}}{\text{Dividend per Share}} = \dfrac{190\ \mathbf{(3)}}{^*7.88\ \mathbf{(4)}}$

$= ^*24.11 \text{ years } \mathbf{(2)}$

* Accept student's own figures if consistent with previous work.

** Full marks awarded for correct answer even if no workings or wrong workings are shown.
** Penalise 1 mark if ratios not given to 2 decimal places where appropriate.
** Penalise 1 mark if appropriate units (cent, %, years) omitted from final answers.
** Allow 3 marks for correct formula if no other work shown.

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

(i) Profitability **(7)**
- last year the return on capital employed was 11.9% (1)
- this year it is *14.59% (1), which is better (1)
- the company is profitable (1)
- 14.59% is about 4 times risk-free rates of 3-4% (1)
- it is also above the debenture interest rate of 9% (1)
- there is no risk of having to sell fixed assets to repay debentures (1)

* Accept own figure.

(ii) Dividend Policy **(7)**
- the dividend per share has improved from 6.5c to *7.88c (1)
- last year the dividend cover was 2.7 times (1)
- this year it is 3.17 times (1), which is better (1)
- 31.5% (1) of profits are paid out, which is acceptable (1)
- enough profits are being retained to repay debentures (1)

* Accept own figure.

(iii) Liquidity **(7)**
- last year the quick ratio was 0.95:1 (1)
- this year it is 0.74:1 (1), which is worse (1)
- now only 74c is available to pay each €1 owed (1) in the short term (1)
- the company has a serious liquidity problem (1)
- it has a difficulty paying debts including future interest (1)

(iv) Gearing **(7)**
- last year the gearing ratio was 49% (1)
- this year it is 44.89% (1), which is better (1)
- the company is lowly geared (1) and is now less dependent on debt capital (1)
- interest cover has improved from 5.8 times last year to 7.22 times this year (1)
- it is now easier to make interest payments (1)

(v) Security **(7)**
- the debentures are secured on fixed assets of €870,000 (1)
- debenture holders would feel secure (2) as this is over 4 times the loan €200,000 (2)
- the real value of fixed assets is uncertain since there are no write-offs (1)
- investments, cost €110,000, now have a market value of €120,000, which is good (1)

(vi) Sector **(5)**
- long-term prospects in the dairy industry (1) are not encouraging (1)
- the economic recession (1) is having a negative effect on the industry (1)
- the industry is also at risk from over-production and low-cost competition (1)

(c) Having assessed Fogarty plc, what actions would you advise the company to take? (15)

<u>Assessment</u> **(3 × 1)**
- the acid test ratio has decreased from 0.95:1 to 0.74:1
- the company has a liquidity problem
- Fogarty plc should try to raise cash and improve liquidity

<u>Actions</u>

Any 4: **(4 × 3)**
- sell investments rather than issuing debentures //
- pay out lower or no dividends //
- issue the remaining shares //
- improve gross profit percentage of 45% by reducing cost of sales or by passing on increased costs //
- diversify into other areas //
- collect debts from debtors more quickly //
- sale and lease back