5. Interpretation of Accounts (100)

(a) Ratios

(i) The Earnings per Ordinary Share (10)

$$= \frac{\text{Net Profit} - \text{Preference Dividend}}{\text{Number of Ordinary Shares Issued}} = \frac{40{,}000\ \mathbf{(2)} - 21{,}000\ \mathbf{(3)}}{500{,}000\ \mathbf{(3)}}$$

= 3.8 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

$$= \frac{\text{Creditors}}{1.5} \times \frac{12}{1} = \frac{70{,}000\ \mathbf{(1)} \times 12\ \mathbf{(1)}}{1.5\ \mathbf{(1)}}$$

= €560,000 **(1)**

Total Purchases

= Cost of Sales – Opening Stock + Closing Stock = 740,000 **(1)** – 41,000 **(1)** + 47,000 **(1)**

= €746,000 **(1)**

⇒ Cash Purchases

= Total Purchases – Credit Purchases = 746,000* **(1)** – 560,000* **(1)**

= €186,000** **(2)**

(iii) The Dividend Yield (12)

Dividend per Share

$$= \frac{\text{Total Ordinary Dividend}}{\text{Number of Ordinary Shares Issued}} = \frac{14{,}000\ \mathbf{(2)}}{500{,}000\ \mathbf{(2)}}$$

= 2.8 cent** **(2)**

⇒ Dividend Yield

$$= \frac{\text{Dividend per Share}}{\text{Market Price per Share}} \times \frac{100}{1} = \frac{2.8^*\ \mathbf{(1)} \times 100\ \mathbf{(1)}}{85\ \mathbf{(2)}}$$

= 3.29%** **(2)**

(iv) The Ordinary Dividend Cover (8)

$$= \frac{\text{Net Profit} - \text{Preference Dividend}}{\text{Ordinary Dividend}} \times \frac{100}{1} = \frac{40{,}000\ \mathbf{(2)} - 21{,}000\ \mathbf{(2)}}{14{,}000\ \mathbf{(2)}}$$

= 1.36 times* **(2)**

(v) How long it would take one ordinary share to recover its value at present pay-out rate? (8)

$$= \frac{\text{Market Price}}{\text{Dividend per Share}} = \frac{85\ \mathbf{(3)}}{2.8^*\ \mathbf{(3)}}$$

= 30.36 years** **(2)**

* Allow full marks for student's own figure if consistent with previous work.
** Full marks awarded for correct answer even if no workings or wrong workings are shown.
** Penalise 1m if ratios not given to 2 decimal places where appropriate.
** Penalise 1m if appropriate units (cent, times, %, years) omitted from final answers.
** Allow 3m 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)

– debenture holders would be dissatisfied with the following:

❶ Performance

(i) Profitability **(7)**
- Return on Capital Employed in 2013 is *5.48% (1)
- in 2012, Return on Capital Employed was 9.4% (1)
- disimproved by 3.92% and this indicates an unhealthy trend (1)
- if this trend continues, there is a risk of having to sell some of the fixed assets in order to repay the debenture holders (1)
- the return is only slightly ahead of the return from risk-free investments of 3-4% (1)
- the return is below the rate being paid on debentures which are secure (1)
- the company is making less efficient use of resources in 2013 (1)

* Accept student's own figure.
** Figures in brackets show breakdown of marks if answer incomplete.

(ii) Dividend Policy **(7)**
- dividend cover in 2013 is *1.36 times (1)
- in 2012, dividend cover was *2.5 times (1)
- dividend cover has worsened significantly (1)
- based on this year's profit of €40,000, dividends of €35,000 are excessive (1)
- percentage of profits paid out in 2013 is *73.68% which is much higher than the figure of 40% in 2012 (1)
- more of the profits should be retained (1) for the repayment of debentures (1)

* Accept student's own figure.
** Figures in brackets show breakdown of marks if answer incomplete.

❷ State of Affairs

(iii) Liquidity **(7)**
- quick ratio in 2013 is *0.93:1 (1)
- in 2012, the quick ratio was 1.1:1 (1)
- quick ratio has worsened in the last year (1)
- company has a slight liquidity problem as it has fallen below the ideal of 1:1 (1)
- the company now has only 93c available to pay every €1 owed in the short-term (1)
- if this trend continues, the company may have difficulty paying its debts, including future interest (1), and funds will not be available for the purpose of repaying the debenture loan (1)

* Accept student's own figure.
** Figures in brackets show breakdown of marks if answer incomplete.

(iv) Gearing **(7)**
- the company is highly geared (1)
- gearing ratio in 2013 is *50.23% (1)
- gearing has slipped from 42% in 2012 (1)
- interest cover has worsened from 4.8 times in 2012 (1) to 3 times in 2013 (1)
- the company is now more dependent on outside borrowings/debt capital (1) and, if this trend continues, it could make interest payments more difficult (1)

* Accept student's own figure.
** Figures in brackets show breakdown of marks if answer incomplete.

(v) Security - Real Value of the Assets **(7)**

– the debentures are secured on the fixed assets (1)
– the debenture holders would be interested in the size of the assets to ensure there is sufficient security for the loan (1)
– fixed assets of €1,055,000, of which intangible assets are €150,000, leaving net fixed assets excluding intangibles of €905,000 (1)
– debenture holders should feel secure because of the excess in value of the fixed assets over the loan (1)
– cover over value of loan, $\frac{905,000}{200,000}$ = *4.53 / $\frac{890,000}{200,000}$ = *4.45 / $\frac{820,000}{200,000}$ = *4.1 (1)
– would be prudent to ascertain the real value of fixed assets as there are no write-offs like depreciation in the accounts (1)
– investments which cost €85,000 now have a current value of €70,000, which is disappointing (1)

* Accept student's own figure.
** Figures in brackets show breakdown of marks if answer incomplete.

❸ Prospects

(vi) Sector **(5)**

– the company operates in the clothing industry (1)
– this industry has declined significantly with the slow-down in economic growth (1)
– consumers nowadays have less disposable income (1)
– major risks include over-production and low-cost competition (1)
– prospects are not encouraging in the medium term (1)

** Figures in brackets show breakdown of marks if answer incomplete.

(c) Explain the limitations of ratio analysis. (10)

Any 3: **(4 + 3 + 3)**

– it analyses past figures only (2) which are quickly out-of-date (2)
– it does not show seasonal (2) fluctuations (1) //
– firms use different accounting bases (2) and therefore company comparisons may not be accurate (1) //
– financial statements give a limited picture of a business (2), monopoly position, economic climate, staff morale or management/staff relationships are not measured (1) // *etc.*

** Accept other appropriate answers.
** Figures in brackets show breakdown of marks if answer incomplete.