5. Interpretation of Accounts (100)

(a) You are required to calculate the following for 2014: (where appropriate calculations should be made to **two** decimal places.) (50)

(i) Cash Purchases if the period of credit received from trade creditors is 2 months (12)

Average period of credit received from creditors

$$= \frac{\text{Creditors}}{\text{Credit Purchases}} \times \frac{12}{1} = 2$$

$\Rightarrow$ Credit Purchases

$$= \frac{\text{Creditors} \times 12}{2} = \frac{42{,}000\ \textbf{(1)} \times 12\ \textbf{(1)}}{2\ \textbf{(1)}}$$

$= $ ••€252,000 **(1)**

Total Purchases

$=$ Cost of Sales – Op. Stock + Cl. Stock $=$ 481,000 **(1)** – 32,000 **(1)** + 36,000 **(1)**

$=$ ••€485,000 **(1)**

$\Rightarrow$ Cash Purchases

$=$ Total Purchases – Credit Purchases $=$ •485,000 **(1)** – •252,000 **(1)**

$=$ •€233,000 **(2)**

(ii) Ordinary Dividend Cover (8)

$$= \frac{\text{Net Profit} - \text{Preference Dividend}}{\text{Ordinary Dividend}} \times \frac{100}{1} = \frac{105{,}000\ \textbf{(2)} - 12{,}000\ \textbf{(2)}}{30{,}500\ \textbf{(2)}}$$

$=$ ••3·05 times **(2)**

(iii) Interest Cover (8)

$$= \frac{\text{Net Profit before Interest}}{\text{Interest}} = \frac{105{,}000\ \textbf{(2)} + 20{,}000\ \textbf{(2)}}{20{,}000\ \textbf{(2)}}$$

$=$ ••6·25 times **(2)**

** Must use figure for 'Interest Paid' (€16,000) and <u>not</u> calculate interest (8% of €200,000).

(iv) Dividend Yield (12)

Dividend per Share

$$= \frac{\text{Total Ordinary Dividends}}{\text{Number of Ordinary Shares Issued}} = \frac{30{,}500\ \textbf{(3)}}{400{,}000\ \textbf{(2)}}$$

$=$ ••7·63 cent **(1)**

$\Rightarrow$ Dividend Yield

$$= \frac{\text{Dividend per Share}}{\text{Market Price per Share}} \times \frac{100}{1} = \frac{•7{\cdot}63\ \textbf{(1)}}{195\ \textbf{(2)}} \times \frac{100}{1}\ \textbf{(1)}$$

$=$ •3·91% **(2)**

(v) How long it would take one ordinary share to recover its value at present pay-out rate. (10)

$$= \frac{\text{Market Price}}{\text{Dividend per Share}} = \frac{195\ \textbf{(4)}}{•7{\cdot}63\ \textbf{(4)}}$$

$=$ •25·56 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 are shown.

** Penalise 1m if ratios not given to 2 decimal places where appropriate.
** Penalise 1m if appropriate units (times, %, years) omitted from final answers.
** Allow 3m for correct formula if no other work shown.

(b) Indicate if the ordinary shareholders 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)

– ordinary shareholders would be satisfied with the following:

❶ Performance

(i) Profitability **(7)**

- in 2013, Return on Capital Employed / ROCE was 11·7% (1)
- in 2014, it is •14·04% $\left[\dfrac{105{,}000 + 20{,}000}{890{,}000} \times \dfrac{100}{1}\right]$ (1), which is better (1)
- the company is profitable (1)
- •14·04% is well above risk-free rates of 3-4% (1)
- •14·04% is also well above the cost of borrowing at 8% (1)
- represents an efficient use of resources in 2014 (1)

• Penalise once for incorrect ratio figure but accept thereafter if used consistently.
** Figures in brackets show breakdown of marks if answer incomplete.

(ii) Dividend Policy **(7)**

- in 2013, the dividend per share was 6·7c (1)
- in 2014, it is •7·63c, which is better (1)
- in 2013, the dividend cover was 2·6 times (1)
- in 2014, it is •3·05 times, which means more earnings were retained in the company (1)
- in 2013, the dividend yield was 3·72% (1)
- in 2014, it is •3·91%, which is better (1)
- insufficient return for taking a risk - only approximately the same as risk-free investments of 3-4% (1)

• Allow full marks for student's own figure if consistent with previous work.
** Figures in brackets show breakdown of marks if answer incomplete.

❷ State of Affairs

(iii) Liquidity **(7)**

- in 2013, the quick ratio / acid test ratio was 0·95:1 (1)
- in 2014, the ratio is •0·75:1 $\left[\dfrac{85{,}000 - 36{,}000}{65{,}000}\right]$ (1), which is worse (1)
- the company has a liquidity problem (1)
- the company now has only •75c available to pay every €1 owed in the short term (1)
- the worsening of the ratio indicates a difficulty in paying debts as they fall due (1)
- the company will have difficulty in paying dividends (1)

• Penalise once for incorrect ratio figure but accept thereafter if used consistently.
** Figures in brackets show breakdown of marks if answer incomplete.

(iv) Gearing **(7)**

- in 2013, the gearing ratio was 48% (1)
- in 2014, it is 44·94% $\left[\dfrac{200{,}000 + 200{,}000}{890{,}000}\right]$ (1), which is better (1)
- the company is low geared (1) and is now less dependent on debt capital (1)
- interest cover has improved from 5·6 times in 2013 to •6·25 times in 2014 (1)
- (improving trend) should make both interest and dividend payments easier (1)

• Penalise once for incorrect ratio figure but accept thereafter if used consistently.
** Figures in brackets show breakdown of marks if answer incomplete.

(b) (cont'd.)

(v) Investment Policy **(4)**
- investments made by the company cost €120,000 (1)
- these investment now have a market value of €140,000, which represents a rise of €20,000 (1)
- this indicates good management of resources (1)
- these investments can be used to repay debentures in 2018 (1)

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

❸ Prospects

(vi) Value of Shares **(4)**
- at the end of 2013, the market value of one share was €1·80 (1)
- at the end of 2014, it was €1·95, which represents an increase of 15c (1)
- this would please the shareholders and indicates market confidence in the company (1)
- (based on the current dividend pay-out rate,) the price recoup period is •25·56 years, which is not short (1)

• Allow full marks for student's own figure if consistent with previous work.
** Figures in brackets show breakdown of marks if answer incomplete.

(vii) Sector **(4)**
- the company operates in the pharmaceutical sector (1)
- with an aging and increasingly health conscious population, prospects are good in the short and medium terms (1)
- however, the prospects are not as certain in the long term as:
  Any 2: (2 × 1)
  - the cost of developing new drugs can be prohibitive expensive //
  - existing patented drugs will come out of patent and will be open to increased competition from generic versions of these drugs and drive prices down //
  - the government / HSE seek lower prices for medicines prescribed for people with medical cards / over 70 years of age / children under 5 years of age // *etc.*

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

(c) A rising Quick Ratio is a sign of prudent management. Briefly discuss. (10)

❶ Overall / Conclusion **(2)**
- a rising quick ratio is not always a sign of prudent management

** Accept other appropriate material.

❷ Explanation **(8)**
- it can be a sign of prudent management because it indicates that it is easier for the firm to pay its short-term debts on time (2) and thus avoid interest / avail of cash discounts (1)
- however, if the ratio rises significantly above 1:1 (2), too much of the firm's resources may be tied up in liquid assets (2) when they could be used to earn more profits (1)

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