Question 5

(a) **50**

(i) **Opening stock**

$$\frac{\text{Cost of sales}}{\text{Average stock}} = 12$$

Average stock × 12 = 720,000

$$\text{Average stock} = \frac{720{,}000}{12}$$

Average stock = 60,000

Opening stock = (60,000 × 2) less 51,500 = **€68,500** **[12]**

(ii) **Earnings per share**

$$\frac{\text{Net profit after preference dividend}}{\text{Number of ordinary shares}} = \frac{49{,}000}{650{,}000}$$ **7.54c** **[10]**

(iii) **Dividend Yield**

$$\frac{\text{Dividend per share} \times 100}{\text{Market price}} = \frac{6c \times 100}{95c}$$ **6.32%** **[12]**

(iv) **Price earnings ratio**

$$\frac{\text{Market price}}{\text{Earnings per share}} = \frac{95c}{7.54c}$$ **12.60 years** **[8]**

(v) **Interest Cover**

$$\frac{\text{Net profit before interest}}{\text{Debenture Interest}} = \frac{54{,}000 + 14{,}000}{14{,}000}$$

$$= \frac{68{,}000}{14{,}000}$$ **4.86 times** **[8]**

(b) **40**

Advice concerning the possible purchase of 150,000 shares @ €0.90 per share

[3]

To: Tom Murphy

From: Barry Ryan (Financial consultant)

Date: 15th June 2015

Market Price/value of shares **[8]**
The share price is on a downward trend. This trend is negative. The shares can be purchased at 90c. This is below the market price of 95c and further below the market price in 2013 of 97c. This is a worrying trend and should **not** be ignored. It indicates a lack of confidence by the stock market. The purchase price may seem good value but one should be cautious and question why such a large block of shares is available. By purchasing 150,000 shares a shareholder would own 23.08% of the company.
The price/earnings ratio is 12.6 years and in 2013 was 10.66 years. This is not very appealing if one is seeking a quick return on investment. It indicates that the period necessary to get ones investment back is getting longer.

Dividend Policy **[8]**
The dividend yield is 6.32% in 2014 but was 8.25% in 2013.
The dividend cover is 1.26 times in 2014 and in 2013 was 1.14 times. Although the dividend per share has been reduced from 8c in 2013 to 6c in 2014, GJ plc is still paying out too much of its profits in dividends.
In the short term the interest on borrowings of €85,000 [(150,000 x €0.90) – 50,000] would amount to €7,650. The income available from dividends of €9,000 seems favourable when compared to this interest. This annual surplus of €1,350 would need to be compared to the loss of interest which could have been earned on €50,000.
The real return to ordinary shareholders would be 7.94% compared to 9% interest on borrowed money.

Profitability **[6]**
GJ plc is a reasonably profitable firm. Its ROCE was 8.2% in 2013 and disimproved to 6.97% in 2014. This trend is a cause for concern and if it continues the firm could find itself in a very serious position.
It indicates that the firm is making poor use of its resources.
GJ plc is currently earning 6.97% on Capital employed but paying 7% on €200,000(Debentures) of this investment. Although the ROCE is above the return from risk free investments of 1% to 3%, it leaves little return for risk taking but perhaps it is satisfactory in the current economic climate.
It will take **15** years for the friend to receive back the cost of the shares at the current pay out rate. It will take longer if dividends decline further.

Liquidity **[6]**
The company has a liquidity problem. The quick ratio in 2013 was 0.90 to 1 but this deteriorated to 0.66 to 1 in 2014. The company has only 66c of liquid assets available to pay every €1 owed in the short term. The deterioration of this ratio indicates difficulty in paying debts and possible future dividends. This would be a worry for both current shareholders and the purchaser of shares as it could result in the company becoming unable to pay dividends even though it had made a profit.

Gearing [6]
GJ plc is a low geared company. Its gearing is 30.77%. Its gearing in 2013 was 28%. This is a worsening situation as the gearing has risen by 2.77% and gives more control to outside investors. If this trend continues they could be at risk from outside investors. However, at the moment there is little risk from outside investors.
The interest cover is 4.86 times and this shows that the company has the ability to meet its interest charges. However the cover has dropped from 6 times in 2013 and this reveals that the profit before interest has dropped from €84,000 in 2013 to €68,000in 2014. If this trend continues there is a risk that the company will not be able to meet its interest charges.

Sector [3]

GJ plc is in the food processing sector. In the short term the sector is under pressure from cheaper imports and shortage of ready cash in the economy.
However, in the long-term the prospects are more encouraging. It is expected that demand for food will increase due to food shortages as world population continues to grow and spending power increases.

Or

Investment Policy and Long-term liabilities.

The investments made by the company cost €110,000. These investments now have a market value of €100,000. This shows poor management of resources although one must take into account the economic downturn globally in 2014. If these investments are sold in the near future there will be a loss of €10,000. This will reduce the real value of the assets and consequently the value of shareholder' funds. The debentures are due to be repaid in 2016. This will require further borrowing or sale of fixed assets.

Recommendations/advice/conclusions:

I would advise you **not** to borrow money to purchase 150,000 shares in GJ plc.

Signature: **Barry Ryan**

(c) **10**

Limitations of ratio analysis [5] + [5]

It analyses past figures only and these figures are quickly out of date (historical). It merely gives us clues to the future.
Ratios do not show seasonal fluctuations
Firms use different accounting bases and therefore company comparisons are not accurate
Financial Statements give limited pictures of a business.
Financial Statements do not reveal other important aspects of a company
Accounts alone cannot measure aspects which may be extremely significant such as monopoly position, economic climate, staff morale and management/staff relationships.