(a) **You are required to calculate the following for 2015:** (where appropriate calculations should be made to **two** decimal places.)

(i) Cash Purchases if the average period of credit received from trade creditors is 2·5 months. (10)

Average period of credit received from creditors

$$= \frac{\text{Creditors}}{\text{Credit Purchases}} \times \frac{12}{1} = 2{\cdot}5$$

⇒ Credit Purchases

$$= \frac{\text{Creditors} \times 12}{2{\cdot}5} = \frac{50{,}000\ (1) \times 12\ (1)}{2{\cdot}5\ (1)}$$

= ••€240,000 (1)

Total Purchases

= Cost of Sales – Op. Stock + Cl. Stock = 660,000 (1) – 50,000 + 65,000

= ••€675,000 (1)

⇒ Cash Purchases

= Total Purchases – Credit Purchases = •••675,000 (1) – •••240,000 (1)

= •••€435,000 (2)

(ii) Return on Capital Employed. (8)

$$= \frac{\text{Net Profit + Debenture Interest}}{\text{Capital Employed}} \times \frac{100}{1} = \frac{70{,}000\ (1) + {}^{\bullet}25{,}000\ (2)}{980{,}000\ (2)} \times \frac{100}{1}\ (1)$$

= 9·69% (2)

• Must use figure for 'Interest Paid' (€25,000) and <u>not</u> calculate interest (7% of €300,000).

(iii) Ordinary Dividend Cover. (8)

$$= \frac{\text{Net Profit} - \text{Total Preference Dividends}}{\text{Total Ordinary Dividends}} = \frac{70{,}000\ (2) - 6{,}000\ (2)}{24{,}000\ (2)}$$

= ••2·67 times (2)

(iv) Dividend Yield. (12)

Dividend per Share

$$= \frac{\text{Total Ordinary Dividends}}{\text{Number of Ordinary Shares Issued}} = \frac{30{,}000\ (1) - 6{,}000\ (2)}{450{,}000\ (2)}$$

= ••5·33 cent (1)

⇒ Dividend Yield

$$= \frac{\text{Dividend per Share}}{\text{Market Price per Share}} \times \frac{100}{1} = \frac{{}^{\bullet\bullet\bullet}5{\cdot}33\ (1)}{140\ (2)} \times \frac{100}{1}\ (1)$$

= •••3·81% (2)

•• Award full marks for correct answer <u>even</u> if no workings are shown.
••• Allow full marks for student's own figure if consistent with previous work.

** Penalise 1 mark if ratios not given to two decimal places where appropriate.
** Penalise 1 mark if appropriate units (times, %, years) omitted from final answers.
** No deduction if '€' symbol omitted.
** Allow 3 marks for correct formula if no other work shown.

(a) (cont'd.)

(v) How long it would take one ordinary share to recover its value at present earnings. (12)

Earnings per Ordinary Share

$$= \frac{\text{Net Profit} - \text{Preference Dividend}}{\text{Number of Ordinary Shares Issued}} = \frac{70{,}000\ (2) - 6{,}000\ (2)}{450{,}000\ (2)}$$

$$= {}^{\bullet\bullet}14{\cdot}22 \text{ cent } (1)$$

⇒ Length of time to recover its value at present earnings

$$= \frac{\text{Market Price}}{\text{Earnings per Ordinary Share}} = \frac{140\ (2)}{{}^{\bullet\bullet\bullet}14{\cdot}22\ (1)}$$

$$= {}^{\bullet\bullet\bullet}9{\cdot}85 \text{ years } (2)$$

•• Award full marks for correct answer <u>even</u> if no workings are shown.
••• Allow full marks for student's own figure if consistent with previous work.

** Penalise 1 mark if ratios not given to two decimal places where appropriate.
** Penalise 1 mark if appropriate units (times, %, years) omitted from final answers.
** No deduction if '€' symbol omitted.
** Allow 3 marks 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 <u>Performance</u>

(i) Profitability (7)
- in 2014, Return on Capital Employed / ROCE was 8·4% (1)
- in 2015, it is ••9·69%, which is better (1)
- the company is profitable (1)
- this return is well above the return from risk-free investments of 3-4% (1)
- this return is also above the cost of borrowing at 7% (1)
- in 2015, profitability has improved by 1·29% over 2014 (1)
- represents a more efficient use of resources in 2015 (1)

(ii) Dividend Policy (7)
- in 2014, the Dividend per Share was 4·8c (1)
- in 2015, it is ••5·33c, which is better (1)
- in 2014, the Dividend Cover was 2·9 times (1)
- in 2015, it is ••2·67 times, which means that a higher proportion of earnings was retained in the company (1)
- in 2014, the Dividend Yield was •3·69% $\left[\frac{4{\cdot}8}{130} \times \frac{100}{1}\right]$ (1)
- in 2015, it is ••3·81%, which is better (1)
- insufficient return for taking a risk - only approximately the same as risk-free investments of 3-4% (1)

• Penalise once for incorrect ratio figure but accept thereafter if used consistently.
•• Allow full marks for student's own figure if consistent with previous work.
** Figures in brackets show the breakdown of marks if answer incomplete.
** Accept student's own wording if equivalent meaning conveyed.
** For the purposes of presentation and clarity, headings and bullets are shown in this marking scheme but are not necessary in a student's answer.

(b) (cont'd.)

❷ State of Affairs

(iii) Liquidity (7)

- in 2014, the Quick Ratio / Acid Test Ratio was 0·97:1 (1)
- in 2015, the ratio is •0·47:1 $\left[\frac{105{,}000 - 65{,}000}{85{,}000}\right]$ (1), which is worse (1)
- the company has a liquidity problem (1)
- the company now has only •47c 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)

(iv) Gearing (7)

- in 2014, the Gearing Ratio was 45% (1)
- in 2015, it is •40·82% $\left[\frac{300{,}000 + 100{,}000}{980{,}000}\right]$ (1), which is better (1)
- the company is low geared and is now less at risk from outside investors / less dependent on debt capital (1)
- in 2015, Interest Cover is •3·8 times $\left[\frac{70{,}000 + 25{,}000}{25{,}000}\right]$ (1)
- ratio has improved from 2014, when it was 3·1 times (1)
- (improving trend) should make both interest and dividend payments easier (1)

(v) Investment Policy (4)

- investments made by the company cost €110,000 (1)
- these investment now have a market value of €140,000, which represents a rise of €30,000 (1)
- this indicates good management of resources (1)
- these investments can be used to repay debentures in 2019/2020 (1)

❸ Prospects

(vi) Value of Shares (4)

- at the end of 2014, the market value of one share was €1·30 (1)
- at the end of 2015, it was €1·40, which represents an increase of 10c (1)
- this would please the shareholders and indicates market confidence in the company (1)
- (based on current earnings,) the price recoup period is ••9·85 years, which is short (1)

(vii) Sector (4)

- the company is in the renewable energy industry (1)
- this is a growing market with emphasis on the environment (1)
- prospects are average in the short-term due to the removal of previous government grants to householders, *e.g.* insulation grants in homes (1)
- however, prospects are good in the long-term particularly due to anticipated oil shortages and higher oil prices (1)

• Penalise once for incorrect ratio figure but accept thereafter if used consistently.
•• Allow full marks for student's own figure if consistent with previous work.
** Figures in brackets show the breakdown of marks if answer incomplete.
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(c) A rising liquidity ratio is a sign of prudent management. Briefly discuss. (10)

❶ Overall / Conclusion **(2)**

– a rising liquidity ratio is not always a sign of prudent management

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)

** Figures in brackets show the breakdown of marks if answer incomplete.
** Accept student's own wording if equivalent meaning conveyed.
** Accept other appropriate material.
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