Question 5 – Interpretation of Accounts

50

(a)

(i) **Closing Stock**

$\frac{\text{Cost of sales}}{\text{Average stock}}$	=	10			
Average stock × 10	=	565,000			
Average stock	=	$\frac{565{,}000}{10}$			
Average stock	=	56,500			
Closing stock	=	(56,500 × 2) **less** 73,000	=	**€40,000**	**[12]**

(ii) **Dividend Yield**

$$\frac{\text{Dividend per share} \times 100}{\text{Market price}} = \frac{9.44\text{c} \times 100}{135\text{c}} = \mathbf{6.99\%}$$ **[12]**

(iii) **Earnings per Ordinary Share**

$$\frac{\text{Net profit after preference dividend}}{\text{Number of ordinary shares}} = \frac{114{,}000 - 7{,}500}{450{,}000} = \mathbf{23.67c}$$ **[10]**

(iv) **Return on Equity Funds**

$$\frac{\text{Net profit after tax and dividends}}{\text{Equity funds}} = \frac{114{,}000 - 7{,}500 \times 100}{450{,}000 + 79{,}000} = \mathbf{20.13\%}$$ **[8]**

(v) **Interest Cover**

$$\frac{\text{Operating Profit}}{\text{Interest}} = \frac{130{,}000}{16{,}000} = \mathbf{8.13\ times}$$ **[8]**

40

(b) Bank Loan Application

Profitability [7]

The company is profitable. The return on capital employed has improved from 12% in 2015 to 14.79% in 2016. This is well above the return from risk free investments of 2% and the company's present cost of borrowing of 8%. It is also well above the 6% interest being charged on the loan.

Liquidity [6]

The company is liquid. The acid test ratio has improved from 0.8:1 in 2015 to 1.11:1 in 2016. It has €1.11 in liquid assets to cover each €1 owed in the short term. There should be no difficulty paying short term debts as they fall due. If the loan is granted the company should be able to pay the interest of €18,000.

Gearing [6]
The company is lowly geared. The gearing position has improved from 45% in 2015 to 39.82% in 2016 (or if using the debt/equity ratio it has disimproved from 45% to 66.16%). If the €300,000 loan is granted, the gearing will worsen to 55.13% (122.87%). This means the business will become highly geared. The business will be financed, on a long-term basis, more by debt than by equity. The interest cover has improved from 6 times in 2015 to 8.1 times in 2016.

Security [6]
The total value of fixed assets at cost is €830,000/€580,000/€680,000. The lender should question the depreciation policy of the company, to ascertain the real value of the fixed assets. The investments cost €100,000 but now have a market value of €120,000. There is already €200,000 of the fixed assets committed to securing the existing debenture. The value of tangible fixed assets is €580,000 leaving €380,000 as security against the new loan. The security for the new loan is adequate.

Dividend Policy [5]
The dividend cover has improved from 2.25 times in 2015 to 2.51 times in 2016. This indicates that sufficient profits are being retained while shareholders are receiving a reasonable dividend. This high retention of profits will ensure that the new loan is more easily repaid.

Sector [5]
JB plc is a health food manufacturer. This is currently a growth industry. People are more health conscious and are more careful about what they eat. Many people take a variety of supplements as part of their diet. Future prospects are good as our population starts to age. There are a few notes of caution. Health foods tend to be 'faddy' by nature. What is fashionable now can go out of fashion very quickly. There is also a view that taking enough exercise and avoiding processed food is the best way to good health.

Purpose of the loan [3]
The loan is required for the modernisation of the manufacturing facility. This is specific and is for a productive purpose which will help to reduce the unit cost of production and make the company more competitive. The extra production will generate more income to repay and service the loan.

Conclusion – Yes the bank manager should grant the loan. [2]

10

(c) **As an employee I would be interested in the financial information for the following reasons**:

To assess job security.
To see if shareholder dividends are increasing which could be used as a negotiation strategy.
To see if the company can continue to pay existing wage rates or can it afford a pay rise.
To see if the company plans to expand and thereby assess the prospects for promotion.
To assess pension security.

Identify two other users of financial information:

Lending institutions, trade creditors, shareholders, the revenue, competitors, directors.