

Q.5 Interpretation of Accounts

(a)

(i) Cash purchases if the period of credit received from trade creditors is 2½ months

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

$$\frac{80,000}{X} \times 12 = 2\frac{1}{2} \times 960,000 = 2\frac{1}{2}x \quad x = 384,000$$

$$\begin{aligned} \text{Total purchases} &= \text{cost of sales} + \text{closing stock} - \text{opening stock} \\ &= 560,000 + 90,000 - 60,000 = 590,000 \end{aligned}$$

$$\begin{aligned} \text{Cash purchases} &= \text{total purchases} - \text{credit purchases} \\ &= 590,000 - 384,000 = \text{€}206,000 \end{aligned}$$

[12]

(ii)

$$\text{Dividend yield} = \frac{\text{dividend per share}}{\text{market value}} \times 100 = x\%$$

$$\text{DPS} = \frac{\text{ordinary dividend}}{\text{market value}} \times 100 = \frac{29,000}{350,000} \times 100 = 8.29 \text{ cent}$$

$$\text{Dividend yield} = \frac{\text{dividend per share}}{\text{market value}} \times 100 = \frac{8.29}{135} \times 100 = 6.14\% \quad [10]$$

(iii)

$$\text{Price earnings ratio} = \frac{\text{market value}}{\text{earnings per share}} = x \text{ years}$$

$$\text{Earnings per share} = \frac{\text{net profit} - \text{preference dividend}}{\text{no. of issued ordinary shares}} \times 100 = x \text{ cent}$$

$$\text{EPS} = \frac{82,000 - 16,000}{350,000} = \frac{66,000}{350,000} \times 100 = 18.86 \text{ cent}$$

$$\text{P/E Ratio} = \frac{\text{market value}}{\text{earnings per share}} = \frac{135}{18.86} = 7.16 \text{ years} \quad [10]$$

(iv)

$$\text{Return on capital employed} = \frac{\text{net profit} + \text{interest}}{\text{capital employed}} \times 100 = x\%$$

$$\frac{82,000 + 18,000}{930,000} \times 100 = 10.75\% \quad [9]$$

(v)

$$\begin{aligned} \text{Interest cover} &= \frac{\text{net profit} + \text{interest}}{\text{interest}} \\ &= \frac{82,000 + 18,000}{18,000} = 5.56 \text{ times} \end{aligned} \quad [9]$$

(b)

40

The debenture holders would **not be** satisfied with the performance, state of affairs and prospects of the company for the following reasons: [4]

Performance

Profitability [7]

The company is profitable earning a return on capital employed in 2017 of 10.75% which is well above the return from risk-free investments of 2% and the cost of borrowing of 6%. Profitability, however, has disimproved (negative trend) by 1.65% compared to 2016 when the return was 12.4%. Born2Run plc is definitely making less efficient use of its resources this year and the debenture holders would not be pleased with the dip in performance in 2017.

The earnings per share has fallen from 20 cent in 2016 to 18.86 cent in 2017. This is also a negative trend and cause for concern.

Dividend Policy [4]

The dividend cover is 2.28 times and this is an improvement on last year's dividend cover of 1.3 times (2 times). Debenture holders would be happy that Born2Run plc is retaining more of its profits for expansion and future repayments of loans.

The percentage of the profits distributed to shareholders is 43.96% which is an improvement on the 50% distributed in 2016.

If there is any evidence that candidates' dividend cover figure has been affected by the incorrect dividend cover figure in 2016 accept candidates own figure for dividend cover.

State of Affairs

Liquidity [7]

Born2Run plc has liquidity problems with an acid test ratio of 0.88:1, for every €1 of short-term debt the firm has only 88 cent in liquid assets. This is also a disimproving trend compared to 2016 when the acid test ratio was 1.3:1. The worsening of the ratio is a major cause of concern to debenture holders because the company may have difficulty paying future interest. If this trend continues, the ability to pay interest would come under pressure and funds would not be available to invest for the purpose of repaying the loan.

Gearing [7]

Born2Run plc is highly geared with a debt to capital employed of 53.76% and a debt to equity ratio of 116.28%. The company's long-term finance is sourced more by long-term debt than by equity which means it is a higher risk and will have high interest payments. The gearing position has worsened from 2016 when it was lowly geared with a gearing percentage of 41%. Born2Run are now more dependent on outside borrowing.

Interest cover has worsened from 6.3 times in 2016 to 5.5 times in 2017. The company is still well able to meet its interest commitments, but the worsening trend combined with poor liquidity would concern debenture holders.

Security [6]

Fixed assets are valued at €650,000. Debenture holders would like to know does this reflect their true value and has depreciation been accounted for. However, as the debentures are €300,000, it would appear that there is more than adequate security to cover the loans.

Born2Run plc also has investments which cost €200,000 but the debenture holders would be disappointed at the fact that the investments now have a market value of €150,000. This would indicate poor investment decisions by management.

Prospects

Sector [5]

Short-term prospects are not that encouraging due to the fact that the company operates as a retailer in the sportswear industry, which is highly competitive, with leading brands dominating the industry.

Long-term prospects are better with rising incomes and a greater emphasis on keeping fit and buying new sportswear, on a regular basis. However to protect itself from the intense competition in the industry, Born2Run would need to spend large amounts of money on brand proliferation and advertising but considering their current liquidity situation, this may prove difficult.

(c)

10

Period of credit allowed to debtors

The length of time it takes a debtor to settle their account has improved by 20 days (from 60 days to 40 days). This is a good trend. The liquidity position of the business is improving as it is collecting debts more efficiently/quickly. However, while its liquidity position has improved, the collection period from debtors is longer than the average credit period of 34 days received from creditors.

Period of credit received from creditors

The length of time the business has to settle accounts with suppliers has improved by 14 days. (It has increased from 20 – 34 days.) This is improving the liquidity position as it is taking longer to settle its accounts with suppliers. However, the business may lose out on discounts for prompt payment which may have a negative effect on its liquidity.

Stock Turnover

Stock turnover has worsened. It has fallen from 12 times to 6 times. This is a negative trend. The liquidity position of the business has worsened as it is taking much longer to sell stock. This may mean it may have too much money tied up in stock, when it could have been used for other purposes. If the decrease in stock turnover is as a result of decreasing sales, this will also have a negative effect on liquidity as it will have less revenue.

I would not recommend that Born2Run plc should invest in this business.