5. Interpretation of Accounts (100)

(a) **You are required to calculate the following for 2017:** (where appropriate calculations should be made to **two** decimal places.)

(i) Opening Stock if the rate of stock turnover is 11 based on average stock. (10)

Rate of Stock Turnover

$$= \frac{\text{Cost of Sales}}{\text{Average Stock}} = 11 \text{ times}$$

⇒ Average Stock

$$= \frac{\text{Cost of Sales}}{11} = \frac{880{,}000\ (2)}{11\ (1)}$$

= ••€80,000 (1)

Average Stock

$$= \frac{\text{Opening Stock} + \text{Closing Stock}}{2}$$

⇒ Opening Stock

= (Average Stock × 2) – Closing Stock = (••80,000 (1) × 2) (1) – 108,000 (2)

= •••€52,000 (2)

(ii) Cash Sales if the average period of credit given to debtors is 1·5 months (10)

Average period of credit given to debtors

$$= \frac{\text{Debtors}}{\text{Credit Sales}} \times \frac{12}{1} = 1{\cdot}5$$

⇒ Credit Sales

$$= \frac{\text{Debtors} \times 12}{1{\cdot}5} = \frac{84{,}000\ (2) \times 12\ (2)}{1{\cdot}5\ (1)}$$

= ••€672,000 (1)

⇒ Cash Sales

= Total Sales – Credit Sales = 1,600,000 (1) – •••672,000 (1)

= •••€928,000 (2)

(iii) Return on Capital Employed (8)

$$= \frac{\text{Net Profit before Interest}}{\text{Capital Employed}} \times \frac{100}{1} = \frac{292{,}000\ (1) + {}^{\bullet}28{,}000\ (2)}{1{,}760{,}000\ (2)} \times \frac{100}{1}\ (1)$$

= 18·18% (2)

• Must use figure for 'Interest Paid' (€28,000) and <u>not</u> calculated figure (7% of €400,000).

<u>or</u>

Return on Capital Employed

$$= \frac{\text{Operating Profit}}{\text{Capital Employed}} \times \frac{100}{1} = \frac{320{,}000\ (3)}{1{,}760{,}000\ (2)} \times \frac{100}{1}\ (1)$$

= 18·18% (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 answers 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.

5. Interpretation of Accounts (cont'd.)

(a) (cont'd.)

(iv) Dividend Yield (12)

Dividend per Share

$$= \frac{\text{Total Ordinary Dividends}}{\text{Number of Ordinary Shares Issued}} = \frac{146{,}000\ (1) - 20{,}000\ (2)}{700{,}000\ (2)} \times \frac{100}{1}$$

$$= \bullet\bullet 18 \text{ cent } (1)$$

$\Rightarrow$ Dividend Yield

$$= \frac{\text{Dividend per Share}}{\text{Market Price per Share}} \times \frac{100}{1} = \bullet\bullet\bullet \frac{18\ (1)}{130\ (2)} \times \frac{100}{1}\ (1)$$

$$= \bullet\bullet\bullet 13{\cdot}85\%\ (2)$$

(v) How long it would take one ordinary share to recover its value at present earnings. (10)

Earnings per Ordinary Share

$$= \frac{\text{Net Profit} - \text{Preference Dividend}}{\text{Number of Ordinary Shares Issued}} \times \frac{100}{1} = \frac{292{,}000\ (1) - 20{,}000\ (2)}{700{,}000\ (1)} \times \frac{100}{1}$$

$$= \bullet\bullet 38{\cdot}86 \text{ cent } (1)$$

$\Rightarrow$ Length of time to recover its value at present earnings

$$= \frac{\text{Market Price}}{\text{Earnings per Ordinary Share}} = \frac{130\ (2)}{\bullet\bullet\bullet 38{\cdot}86\ (1)}$$

$$= \bullet\bullet\bullet 3{\cdot}35 \text{ years } (2)$$

•• 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 answers 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.

5. Interpretation of Accounts (cont'd.)

(b) Indicate if the ordinary shareholders would be satisfied with the performance, state of affairs and prospects of the company.
Use relevant ratios, percentages and other information to support your answer. (40)

– ordinary shareholders should consider the following:

❶ Performance

(i) Profitability (7)

- in 2016, Return on Capital Employed / ROCE was 12·2% (1)
- in 2017, the ratio is ••18·18%, which is better (1)
- ratio shows that Dory plc is a very profitable company (1)
- company profitability has improved on the previous year (1), which represents a more efficient use of resources in 2017 (1) - this indicates a healthy trend that will satisfy ordinary shareholders
- the return is significantly above the return from risk-free investments of 1-2% (1)
- the return is also well above the 7% being paid on debentures / the rate being paid on debentures, which are secure (1)

(ii) Dividend Policy (7)

- in 2016, Dividend per Ordinary Share was 13c (1)
- in 2017, the dividend is ••18c, which is better (1) - ordinary shareholders will be satisfied with this trend
- Dividend Yield has increased from •10·83% $\left[\frac{13}{120} \times \frac{100}{1}\right]$ in 2016 to ••13·85% in 2017 (1)
- ordinary shareholders will be satisfied with this trend as they are receiving a good return for taking a risk - in both years, Dividend Yields have been significantly above the return from risk-free investments of 1-2% (1)
- Dividend Cover has improved from 1·92 times in 2016 to •2·16 times $\left[\frac{292{,}000 - 20{,}000}{146{,}000 - 20{,}000} \,/\, \frac{38{\cdot}86}{18}\right]$ - this means that a higher proportion of earnings were retained by the company in the current year (1)
- percentage of profits paid out in 2017 is ••46·32% $\left[\frac{146{,}000 - 20{,}000}{292{,}000 - 20{,}000} \times \frac{100}{1} \,/\, \frac{1}{2{\cdot}16} \times \frac{100}{1}\right]$, which is slightly less than the figure of ••52·08% $\left[\frac{1}{1{\cdot}92} \times \frac{100}{1}\right]$ in 2016 (1)
- ordinary shareholders will be satisfied that adequate profits / earnings are being retained by the company for growth and development of the company and repayment of loans and debentures while at the same time adequate profits / earnings are being paid to shareholders in dividends (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.
** Accept other appropriate material.
** 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.

5. Interpretation of Accounts (cont'd.)

(b) (cont'd.)

❷ State of Affairs

(iii) Liquidity (7)

- in 2016, the Quick Ratio / Acid Test Ratio was 0·85:1 (1)
- in 2017, the ratio is •1·84:1 $\left[\dfrac{270{,}000 - 108{,}000}{88{,}000}\right]$ (1)
- ratio has improved in the last year (1)
- the company has increased its liquidity well above the ideal of 1:1 (1)
- the company should have no difficulties in paying its short-term debts as they fall due for payment if this trend continues (1)
- the company has €1·84 / 184c available to pay every €1 owed in the short term (1)
- ordinary shareholders will be pleased with this as it shows the company's ability to pay dividends and interest as well as retaining funds available for investment (1)

(iv) Gearing (7)

- in 2016, the Gearing Ratio was 41% (1)
- in 2017, the ratio is •45·45% $\left[\dfrac{400{,}000 + 400{,}000}{1{,}760{,}000} \times \dfrac{100}{1}\right]$ (1)
- ratio indicates that the company currently has low gearing (1)
- this will please ordinary shareholders as it shows the company's ability to pay dividends and that the company is not dependent on outside borrowings / not at risk from outside investors (1)
- however, gearing is less favourable after rising from 41% in 2016 to ••45·45% in 2017 - the company is slightly more dependent on outside borrowings (1)
- Interest Cover has improved from 8·2 times in 2016 to ••11·43 $\left[\dfrac{292{,}000 + 28{,}000}{28{,}000}\right]$ times in 2017 (1)
- ordinary shareholders will be satisfied as this will make the payment of both interest and dividends easier, if this trend continues (1)

(v) Investment Policy (4)

- investments made by the company costing €200,000 now have a market value of €225,000, which represents an increase in value of €25,000 / 12·5% (1)
- this will satisfy shareholders as it shows good management of resources (1)
- the company can use these investments to part repay debentures in 2019 (1)
- however, shareholders may not be fully satisfied that sufficient resources are in place to repay debentures in 2019 and this may affect the payment of future dividends (1)

• Penalise once for incorrect ratio figure but accept thereafter if used consistently.
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5. Interpretation of Accounts (cont'd.)

(b) (cont'd.)

❸ Prospects

(vi) Market Price of Share **(4)**

- at the end of 2016, the market price of one share was €1·20 (1)
- at the end of 2017, it was €1·30, which represents an increase of 10c / 8·33% (1)
- this will please shareholders as it indicates market confidence in the company (1)
- based on current earnings, the time it takes to recover its value is ••3·35 years, which is extremely short (1)

(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 which may 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*.

• 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.
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(c) Briefly discuss whether a rising liquidity ratio is a sign of prudent management. (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 elsewhere in the firm to earn more profits (1)

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** Accept other appropriate material.
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