**5. Interpretation of Accounts (cont'd.)**

**(a)** **You are required to calculate the following for 2018** (where appropriate calculations should be made to **two** decimal places):

(i) Cash Sales if the average period of credit given to debtors is 1·5 months. (12)

Average period of credit given to debtors

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

⇒ Credit Sales

$$= \frac{\text{Debtors} \times 12}{1{\cdot}5} \quad = \quad \frac{82{,}000\ \textbf{(2)} \times 12\ \textbf{(2)}}{1{\cdot}5\ \textbf{(2)}}$$

= ●●€656,000 **(1)**

⇒ Cash Sales

= Total Sales – Credit Sales = 1,900,000 **(2)** – ●●●656,000 **(1)**

= ●●●€1,244,000 **(2)**

(ii) Return on Equity Funds. (10)

Equity Funds

= Issued Ordinary Share Capital + Reserves

⇒ Return on Equity Funds

$$= \frac{\text{Net Profit after Tax} - \text{Preference Dividend}}{\text{Equity Funds}} = \frac{215{,}000\ \textbf{(2)} - 25{,}000\ \textbf{(2)}}{850{,}000\ \textbf{(2)} + 225{,}000\ \textbf{(2)}} \times \frac{100}{1}$$

$$= \frac{190{,}000}{1{,}075{,}000} \times \frac{100}{1}$$

= 17·674418...

= ●●17·67% **(2)**

(iii) Earnings per Ordinary Share. (8)

$$= \frac{\text{Net Profit after Tax} - \text{Preference Dividend}}{\text{Number of Ordinary Shares Issued}} = \frac{215{,}000\ \textbf{(2)} - {}^{\bullet}25{,}000\ \textbf{(2)}}{850{,}000\ \textbf{(2)}} \times \frac{100}{1}$$

$$= \frac{190{,}000}{850{,}000} \times \frac{100}{1}$$

= 22·352941...

= ●●22·35 cent per share **(2)**

● Allow 1 mark for student's own figure.
●● 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, *etc.*) 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

$$= \frac{\text{Total Ordinary Dividends}}{\text{Number of Ordinary Shares Issued}} = \frac{110{,}000\ \textbf{(2)} - 25{,}000\ \textbf{(2)}}{850{,}000\ \textbf{(2)}} \times \frac{100}{1}$$

$$= \frac{85{,}000}{850{,}000} \times \frac{100}{1}$$

$$= \text{●●}10 \text{ cent } \textbf{(1)}$$

⇒ Dividend Yield

$$= \frac{\text{Dividend per Share}}{\text{Market Price per Share}} \times \frac{100}{1} = \frac{\text{●●●}10\ \textbf{(1)}}{115\ \textbf{(2)}} \times \frac{100}{1}$$

$$= 8{\cdot}695652...$$

$$= \text{●●●}8{\cdot}70\%\ \textbf{(2)}$$

(v) Projected market value of one share in **2019**. (8)

= Price Earnings Ratio × Earnings per Ordinary Share

= 5 **(3)** × 25 **(3)**

= ●●125 cent / €1·25 **(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, *etc*.) omitted from final answers.
** No deduction if '€' symbol <u>or</u> 'cent' omitted.
** Allow 3 marks for correct formula if no other work shown.

**5. Interpretation of Accounts (cont'd.)**

**(b)** Plummer plc intends to raise further finance by issuing the remaining Ordinary Shares.

Would you as a shareholder be prepared to purchase more shares in the company?
Use relevant ratios, percentages and other information to support your answer. (40)

– before deciding whether to purchase more shares, I would consider the following:

❶ Performance

(i) Profitability (7)

– in 2018, Return on Capital Employed / ROCE was •13·01% $\left[\frac{215{,}000 + 16{,}000}{1{,}775{,}000} \times \frac{100}{1}\right]$ (1)
– ratio shows that Plummer plc is a very profitable company (1)
– in 2019, it is expected to rise to 14%, which is better (1)
– company profitability is expected to improve on the previous year, which will represent a more efficient use of resources in 2019 (1) - this indicates a healthy trend that will satisfy ordinary shareholders (1)
– the return of ••13·01% in 2018 is significantly above the return from risk-free investments of 1-2% (1)
– the return of ••13·01% in 2018 is also well above the 8% being paid on debentures / the rate being paid on debentures, which are secure (1)

(ii) Dividend Policy (7)

– in 2018, Dividend per Ordinary Share was is ••10c (1)
– in 2019, the dividend is projected to rise to 11·5c, which is better (1) - ordinary shareholders will be satisfied with this trend
– Dividend Yield is expected to rise from ••8·70% in 2018 to •9·20% $\left[\frac{11{\cdot}5}{125} \times \frac{100}{1}\right]$ in 2019 (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 are significantly above the return from risk-free investments of 1-2% (1)
– Dividend Cover is not expected to change significantly from •2·24 times $\left[\frac{215{,}000 - 25{,}000}{110{,}000 - 25{,}000} \;/\; \frac{23{\cdot}75}{10{\cdot}625}\right]$ in 2018 to •2·17 times $\left[\frac{25}{11{\cdot}5}\right]$ in 2019 (1)
– percentage of profits to be paid out in 2019 is expected to be ••46·08% $\left[\frac{1}{2{\cdot}17} \times \frac{100}{1}\right]$, which is slightly more than the ••44·74% $\left[\frac{110{,}000 - 25{,}000}{215{,}000 - 25{,}000} \times \frac{100}{1}\right]$ or ••44·64% $\left[\frac{1}{2{\cdot}24} \times \frac{100}{1}\right]$ that was paid out in 2018 (1)
– ordinary shareholders will be satisfied that adequate profits / earnings are being retained by the company for the growth and development of the company and the repayment of loans and debentures while at the same time adequate profits / earnings are being paid out 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 (6)

- in 2018, the Quick Ratio / Acid Test Ratio is •1·5:1 $\left[\frac{329{,}500 - 97{,}500}{154{,}500}\right]$ (1)
- the company has €1·50 / 150c available to pay every €1 owed in the short term (1)
- the company has good liquidity and should have no difficulties in paying its short-term debts as they fall due for payment (1)
- in 2019, the Quick Ratio / Acid Test Ratio is expected to improve to 1·6:1 (1)
- in both years, the ratio is well above the ideal of 1:1 (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 (6)

- in 2018, the Gearing Ratio is •39·44% $\left[\frac{200{,}000 + 500{,}000}{1{,}775{,}000} \times \frac{100}{1}\right]$ (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 expected to be less favourable, rising from ••39·44% in 2018 to ••45% in 2019 - the company will be slightly more dependent on outside borrowings (1)
- Interest Cover is expected to improve from ••14·44 times in 2018 to 15 times in 2019 (1)
- ordinary shareholders will be satisfied as the company has no problem in paying interest charges and dividends in 2018 and this is expected to remain the same in 2019 (1)

(v) Investment Policy (4)

- investments made by the company costing €200,000 now have a market value of €125,000, which represents a decrease in value of €75,000 / 37·5% (1)
- this will not satisfy shareholders as it shows poor management of resources (1)
- debentures are due to be repaid in 2020 and the company will require further borrowing or sale of fixed assets as these investments will only partially repay these debentures (1)
- shareholders may not be fully satisfied that sufficient resources are in place to repay debentures in 2020 and this may affect the payment of future 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.
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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 2018, the market price of one share was €1·15 (1)
- at the end of 2019, the projected value of one share is ••€1·25, which represents an increase of 10c / 8·7% (1)
- this will please shareholders as it indicates market confidence in the company (1)
- based on current earnings, it should only take •5·15 years $\left[\frac{115}{22 \cdot 35}\right]$ based on the figures in 2018 and •5 years $\left[\frac{125}{25}\right]$ based on the figures in 2019 to recover its value - both are extremely short (1)

(vii) Sector **(4)**

- the company operates in the construction sector (1)
- there is at present an upsurge in construction activity in the Irish market as the economy recovers / continued economic growth (1)
- however, prospects are more uncertain in the medium and long term as:
  Any 2: (2 × 1)
  - property developers and house buyers find it more difficult to access finance and this has a knock-on effect for companies in the construction industry //
  - the closure of some larger construction firms, *e.g.* Carillion, can have an adverse effect on smaller contractors in the sector //
  - however, increasing population will push up demand for more housing and this will have a positive effect for companies in the construction sector //
  - increased development of office space in Dublin and other towns and cities due to economic growth / increased uncertainty about 'Brexit' // *etc*.

❹ Conclusion **(2)**

- overall, ordinary shareholders should be happy with the performance of the company (1) and I would buy more shares in the company (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.)**

**(c)** (i) Explain the term 'Gearing'. **(5)** (5)

- a measure of how a business is financed on a long-term basis / refers to the capital structure of a business (1)
- measures the relationship between fixed interest debt (loans / debentures + preference shares) and total capital employed / total equity (2) //
- when the ratio is less than 50% / 100%, the business is lowly geared - the company is not dependent on outside borrowing and is not at risk from outside investors (1) - which is preferable //
- when the ratio is above 50% / 100%, the business is highly geared - the company is dependent on outside borrowing and is at risk from outside investors (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.

(ii) What are the implications for a business of being highly geared? (3)

Any 3: **(3 × 1)**
- high interest repayments mean less profits are available for investment elsewhere in the business //
- shareholders are less likely to receive a dividend when the gearing is high //
- the business should find it more difficult to raise additional loan finance //
- the business has less financial stability as it is more affected by rises in interest rates //
- greater risk of liquidation due to not being able to make interest payments // *etc*.

** Accept student's own wording if equivalent meaning conveyed.
** Accept other appropriate answers.

(iii) State **two** ways in which a company can reduce its gearing. (2)

Any 2: **(2 × 1)**
- sell more ordinary shares //
- reduce or repay loans //
- increase reserves / retained profits //
- convert long-term debt to ordinary shares // *etc*.

** Accept student's own wording if equivalent meaning conveyed.
** Accept other appropriate answers.