

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

(a) You are required to calculate the following for 2019 (where appropriate, calculations should be made to **two** decimal places):

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

$$\begin{aligned}
 & \text{Rate of Stock Turnover} \\
 &= \frac{\text{Cost of Sales}}{\text{Average Stock}} = 10 \text{ times} \\
 \Rightarrow & \text{Average Stock} \\
 &= \frac{\text{Cost of Sales}}{10} = \frac{670,000 \text{ (2)}}{10 \text{ (1)}} \\
 &= \text{€}67,000 \text{ (1)} \\
 & \text{Average Stock} \\
 &= \frac{\text{Opening Stock} + \text{Closing Stock}}{2} \\
 \Rightarrow & \text{Closing Stock} \\
 &= (\text{Average Stock} \times 2) - \text{Opening Stock} = (\text{€}67,000 \text{ (1)} \times 2) \text{ (1)} - 63,000 \text{ (2)} \\
 &= 134,000 - 63,000 \\
 &= \text{€}71,000 \text{ (2)}
 \end{aligned}$$

(ii) Return on Equity Funds. (8)

$$\begin{aligned}
 & \text{Equity Funds} \\
 &= \text{Issued Ordinary Share Capital} + \text{Reserves} \\
 \Rightarrow & \text{Return on Equity Funds} \\
 &= \frac{\text{Net Profit after Tax} - \text{Preference Dividend}}{\text{Equity Funds}} = \frac{144,500 \text{ (1)} - 12,500 \text{ (2)}}{600,000 \text{ (1)} + 132,000 \text{ (2)}} \times \frac{100}{1} \\
 &= \frac{132,000}{732,000} \times \frac{100}{1} \\
 &= 18.032786... \\
 &\cong \text{€}18.03\% \text{ (2)}
 \end{aligned}$$

(iii) Interest Cover. (8)

$$\begin{aligned}
 &= \frac{\text{Net Profit} + \text{Interest} - \text{Investment Income}}{\text{Interest}} = \frac{144,500 \text{ (2)} + \text{€}22,000 \text{ (1)} - 3,000 \text{ (2)}}{\text{€}22,000 \text{ (1)}} \\
 &\text{or} \frac{\text{Operating Profit}}{\text{Interest}} = \frac{163,500}{22,000} \\
 &= 7.431818... \\
 &\cong \text{€}7.43 \text{ times (2)}
 \end{aligned}$$

- Must use figure for 'Interest Paid' (€22,000) and not calculate interest (8% of €300,000).
- Award full marks for correct answer even 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)

$$\begin{aligned}
 & \frac{\text{Dividend per Share}}{\text{Total Ordinary Dividends}} = \frac{66,500 \text{ (2)} - 12,500 \text{ (2)}}{600,000 \text{ (2)}} \times \frac{100}{1} \\
 & = \frac{54,000}{600,000} \times \frac{100}{1} \\
 & = \text{9 cent (1)} \\
 \Rightarrow & \text{Dividend Yield} \\
 & = \frac{\text{Dividend per Share}}{\text{Market Price per Share}} \times \frac{100}{1} = \frac{\text{9 (1)}}{133 \text{ (2)}} \times \frac{100}{1} \\
 & = 6.766917... \\
 & \cong \text{6.77\% (2)}
 \end{aligned}$$

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

$$\begin{aligned}
 & \frac{\text{Earnings per Ordinary Share}}{\text{Net Profit} - \text{Preference Dividend}} \times \frac{100}{1} = \frac{144,500 \text{ (2)} - 12,500 \text{ (2)}}{600,000 \text{ (2)}} \times \frac{100}{1} \\
 & = \frac{132,000}{600,000} \times \frac{100}{1} \\
 & = \text{22 cent (1)} \\
 \Rightarrow & \text{Length of time to recover its value at present earnings} \\
 & = \frac{\text{Market Price}}{\text{Earnings per Ordinary Share}} = \frac{133 \text{ (2)}}{\text{22 (1)}} \\
 & = 6.045454... \\
 & = \text{6.05 years (2)}
 \end{aligned}$$

- Award full marks for correct answer even 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.)

- (b) Advise the bank manager if a loan of €100,000, on which an interest rate of 7% would be charged, should be granted to Connacht plc. The loan is to finance the modernisation of its manufacturing plant.

Use relevant ratios, percentages and other information to support your answer.

(40)

- before deciding whether to recommend the loan, I would consider the following:

① Performance

(i) Profitability (7)

- in 2018, the Return on Capital Employed/ROCE was 10.2% (1)
- in 2019, the figure was •12.75%  $\left[ \frac{144,500 + 22,000 - 3,000}{1,282,000} \times \frac{100}{1} \right]$  (1)
- the figure for 2019 shows that Connacht plc is a very profitable company (1)
- company profitability has improved on the previous year, which represents a more efficient use of resources in 2019 than 2018 - this is a positive trend (1)
- the return of ••12.75% in 2019 is significantly above the returns from risk-free investments of 1-2% (1)
- the return of ••12.75% in 2019 is well above the cost of debentures of 8% (1) and also well above the interest rate of 7% being charged on the loan (1)

(ii) Dividend Policy (5)

- in 2019, the Dividend Cover was •2.44 times  $\left[ \frac{144,500 - 12,500}{66,500 - 12,500} / \frac{22}{9} \right]$  (1)
- no significant change from 2018, when the figure was 2.375 times (1)
- percentage of profits paid out in 2019 was ••40.91%  $\left[ \frac{66,500 - 12,500}{144,500 - 12,500} \times \frac{100}{1} \right]$
- or ••40.98%  $\left[ \frac{1}{2.44} \times \frac{100}{1} \right]$ , which is slightly less than the figure of ••42.11%  $\left[ \frac{1}{2.375} \times \frac{100}{1} \right]$  in 2018 (1)
- the figure indicates that sufficient profits in both 2019 and 2018 are being retained in the company for growth and development and the eventual repayment of the debentures, while shareholders are receiving a reasonable dividend (1)
- the high retention of profits will ensure that the new loan is more easily repaid (1)

• Penalise once for incorrect 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.)

② State of Affairs

## (iii) Liquidity (6)

- in 2019, the Quick Ratio / Acid Test Ratio was  $\bullet 1.19:1 \left[ \frac{205,000 - 71,000}{113,000} \right]$  (1)
- the ratio has improved from 0.92:1 in 2018 to  $\bullet\bullet 1.19:1$  in 2019 (1)
- the company has €1.19 / 119c available in liquid assets to pay every €1 owed in the short term (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)
- if the loan is granted, the company should have no difficulty paying the additional annual interest payments of €7,000 (1)

## (iv) Gearing (7)

- in 2019, the Gearing Ratio was  $\bullet 42.9\% \left[ \frac{300,000 + 250,000}{1,282,000} \times \frac{100}{1} \right]$  (1)
- the ratio indicates that Connacht plc is currently lowly geared - the company is not dependent on outside borrowings / not at risk from outside investors (1)
- the ratio has become more favourable after dropping slightly from 44.8% in 2018 to  $\bullet\bullet 42.9\%$  in 2019 - the company is slightly less at risk in 2019 than 2018 (1)
- however, if the new loan is granted, the Gearing Ratio will be less favourable, rising to  $\bullet 47.03\% \left[ \frac{300,000 + 250,000 + 100,000}{1,282,000 + 100,000} \times \frac{100}{1} \right]$  (1)
- the company will remain lowly geared but will be marginally more at risk from outside investors - the company will still be financed more by equity than debt / the company will be slightly more dependent on outside borrowings (1)
- Interest Cover has improved from 5 times in 2018 to  $\bullet\bullet 7.43$  times  $\left[ \frac{144,500 + 22,000 - 3,000}{22,000} \right]$  in 2019 (1)
- the company should have no difficulty paying additional annual interest payments of €7,000 if this trend continues (1)

$\bullet$  Penalise once for incorrect figure but accept thereafter if used consistently.

$\bullet\bullet$  Allow full marks for student's own figure if consistent with previous work.

$\bullet\bullet$  Figures in brackets show the breakdown of marks if answer incomplete.

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

(b) (cont'd.)

③ Prospects

## (v) Security (6)

- the total value of tangible fixed assets at cost is €940,000 / the total value of fixed assets at cost is €1,190,000 / €1,040,000 (1)
- however, the real value of fixed assets should be ascertained as there appear to be no write-offs for depreciation in the accounts / the lender should question the depreciation policy of the company, to ascertain the real value of the fixed assets (1)
- investments that cost €100,000 now have a market value of €130,000, which indicates an excellent investment policy (1)
- there is already €300,000 of the fixed assets committed to securing the existing debentures (1)
- the value of tangible fixed assets is €940,000, leaving ••€640,000 as security against the new loan (1)
- security for the new loan is adequate (1)

## (vi) Sector (4)

- the company operates in the food processing sector (1)
- the long-term prospects are very good as the world's population continues to grow and people are more conscious about what they eat (1)
- however, prospects are more uncertain in the short and medium term as:
  - Any 2: (2 × 1)
  - this sector is extremely competitive and in the short term may be under pressure from cheap imports //
  - very large retailers are increasingly dictating the price of products to suppliers as consumers have become more price sensitive //
  - full implications of how 'Brexit' may work are causing increased uncertainty for many Irish food exporters to the UK // etc.

## (viii) Purpose of the loan (3)

- the loan is required for the modernisation of the manufacturing plant (1)
- 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 (1)
- the extra production will generate more income to repay and service the loan (1)

④ Conclusion (2)

- yes, the bank manager should grant the loan (2)

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\*\* Accept other appropriate material.

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

- (c) Connacht plc is considering acquiring a small artisan food company ArtMax Ltd, which operate in the same market. ArtMax Ltd has supplied the following information:

	2016	2017	2018	2019
Net Profit Percentage	6%	8%	9.2%	12.3%
Acid Test / Quick Ratio	1.2:1	1.05:1	0.92:1	0.8:1

Having analysed the information in the above table, what advice would you give Connacht plc in relation to this purchase?

(10)

① Net Profit Percentage (4)

- Net Profit Percentage measures the amount of profit that ArtMax Ltd has made from its total sales (1)  
- this shows an improving trend from 6% in 2016 to 12.3% in 2019 (1)
- shows the company is generating increasing profits from its sales through improving gross margin while keeping operating and overhead costs under control (1)
- artisan food companies have been able to command a premium price for their niche products - however, Connacht plc will want to know if scaling up production, post acquisition, will have an impact on gross margin with a knock-on effect on Net Profit % (1)

② Acid Test Ratio (4)

- Acid Test Ratio has deteriorated continuously from 1.2 to 0.8 between 2016 and 2019 - this is a negative trend (1)
- ratio is now less than the ideal of 1:1 and ArtMax Ltd has liquidity problems (1)
- Connacht plc will want to know if the company can take any positive action to improve its liquidity position (1)
- the poor liquidity of ArtMaxLtd could be a significant factor in whether Connacht plc decides to buy the company or not (1)

③ Conclusion (2)

- I would not recommend that Connacht plc should invest in this business (2)