# STATE EXAM

# THEORY QUESTION AND ANSWERS

# INTERPERTATION OF ACCOUNTS

# STATE EXAM

# THEORY QUESTION

# INTERPERTATION OF ACCOUNTS

## Questions

2022 – Question 5 - Part C

1. The gross profit percentage of Watson plc in 2020 was 36%.
   (i) Calculate the gross profit percentage for Watson plc in 2021.
   (ii) Give possible reasons for the change in gross profit percentage in 2021.
   (iii) Outline how a company could improve their gross profit percentage. (10)

2021 – Question 5 - Part C

1. What are the disadvantages to a business of having a high gearing?
2. Explain two ways to reduce gearing of a company. (10)

2020 – Question 5 - Part C

1. Explain how a faster stock turnover can increase the profitability of a business (10)

2019 – Question 5 - Part C

1. Shannon plc is considering acquiring a solar panel company, Gener8 Ltd in 2019.
   Gener8 Ltd has supplied the following balance sheet information for 31/12/2018.

| | |
|---|---|
| Closing stock | €47,000 |
| Creditors | €45,000 |
| Debtors | €39,000 |
| Expenses accrued | €15,000 |
| Expenses prepaid | €13,000 |
| Bank overdraft | €16,500 |

Based on the information given in the above table:

(i) Calculate the current ratio for Gener8 Ltd. Calculate the acid test ratio for Gener8 Ltd.

(ii) Using the calculated figures explain why it is important for Shannon plc to analyse the liquidity position for Gener8 Ltd. (10)

2018 – Question 5 - Part C

1. Born2Run plc is considering expansion by purchasing a small sportswear company. It has obtained the following information relating to this company:

| | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|
| Period of credit allowed to debtors | 60 days | 54 days | 46 days | 40 days |
| Period of credit received from creditors | 20 days | 26 days | 30 days | 34 days |
| Stock turnover | 12 times | 11 times | 9 times | 6 times |

Having analysed the information in the above table, what advice would you give Born2Run plc regarding this purchase? (10)

2017 – Question 5 - Part C

1. As an employee I would be interested in the financial information for the following reasons
2. Identify two other users of financial information (10)

2016 – Question 5 - Part C

1. Explain the term 'Gearing'.
2. What are the benefits to a business of having a low gearing?
3. State two ways to reduce the gearing of a company. (15)

2015 – Question 5 - Part C

1. State the limitations of ratio analysis as a financial analysis technique

(10)

2014 – Question 5 - Part C

1. Explain the difference between the terms 'Liquidity' and 'Solvency' when used in Ratio Analysis. Refer to relevant ratios in your explanation (10)

2013 - Question 5 - Part C

1. Question on ROCE

2012 – Question 5 - Part C

1. Calculate the gross profit percentage for 2011 (5)

2012 – Question 5 – Part C

Give 5 different explanations for the decrease/increase in 2011. (10)

2011 – Question 5 - Part C

1. Explain the limitations of ratio analysis (10)

2010 – Question 5 - Part C

1. Question on advice to a friend

# STATE EXAM

# THEORY SUGGESTED SOLUTIONS

# INTERPERTATION OF ACCOUNTS

## SUGGEST SOLUTIONS

## 2022 – PART C

The gross profit percentage of Watson plc in 2020 was 36%.

**Calculate the gross profit percentage for Watson plc in 2021.**

$$\frac{\text{Gross Profit}}{\text{Sales}} \times \frac{100}{1}$$

Gross Profit = 950,000 – 682,000

= 268,000

$$\frac{268{,}000}{950{,}000} \times \frac{100}{1}$$

Gross profit Margin = 28.21 %

**Give possible reasons for the change in gross profit percentage in 2021.**

This could be caused by

1. Reduction in the selling price without corresponding fall in cost of sales
2. Cost of sale increased without the increase being passed on to the consumer.
3. Cash losses - Cash sales not recorded or theft of cash.
4. Stock losses – Theft of stock or stock obsolete
5. Change in the sales mix – more low margin items being sold and less high margin items been sold
6. Incorrect valuation of stock overvaluing opening stock and or undervaluing closing stock
7. Increase competition in the market reducing profit margins.
8. Reduction in selling price to get rid of old stock.

**Outline how a company could improve their gross profit percentage.**

1. Changing the sale mix to sell higher margin items.
2. Increasing selling price without an increase in purchase prices
3. Reducing cost of sales by shopping around to find cheaper more competitive suppliers.
4. Avail of discount from suppliers for bulk buying or paying more promptly.
5. Avail of cash discounts rather than relying on credit.

## 2021 – PART C

**What are the disadvantages to a business of having a high gearing?**

When fixed interest debt is a high proportion of overall capital it has the following disadvantages:

1. High interest repayments mean less profits are available for investment elsewhere in The business
2. Shareholders are less likely to get a good dividend when gearing is high.
3. The business would find it more difficult to raise additional loan finance.
4. There is a higher risk of liquidation due to not being able to make interest payments.

**Explain two ways to reduce gearing of a company.**

1. Sell more ordinary shares to increase shareholders equity as a proportion of capital empl oyed.
2. Reduce or repay loans to reduce fixed interest debt as a proportion of
3. capital
   employed.
4. Increase reserves/retained profits to increase shareholders equity as a proportion of
5. Increase reserves/retained profits to increase shareholders equity as a proportion of capital employed.
6. Convert long - term debt to ordinary shares reducing fixed interest debt and increasing Shareholders equity.

## 2020 – Part C

**Explain how a faster stock turnover can increase the profitability of a business.**

1. Each time stock is sold, because it contains a mark-up, profitability increases.
2. If the cost of buying the extra stock increases at a slower rate than the mark-up then profitability increases.
3. The more times the stock is turned over the greater the mark-up and profit will be increased.
4. Where stock turnover is high less stock may be held resulting in reduced stock holding costs (insurance, waste etc.) which could lead to an increase in profitability.
5. A faster stock turnover means that the firm may enjoy economies of scale, such as bulk-buying discounts, which will reduce costs and increase profitability.

## 2019 – Question 5 - Part C

**Calculate the current ratio for Gener8 Ltd.**

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$= \frac{47{,}000 + 39{,}000 + 13{,}000}{45{,}000 + 15{,}000 + 16{,}500}$$

$$= \frac{99{,}000}{76{,}500}$$

= 1.29 : 1

**Calculate the acid test ratio for Gener8 Ltd.**

$$\text{Acid Test} = \frac{\text{Current Assets – Closing stock}}{\text{Current Liabilities}}$$

$$= \frac{99{,}000 - 47{,}000}{76{,}500}$$

$$= \frac{52{,}000}{76{,}500}$$

= .68 : 1

**Using the calculated figures explain why it is important for Shannon plc to analyse the liquidity position for Gener8 Ltd.**

**<u>Current Ratio</u>**

1. The current ratio is 1.29 : 1.
2. This means that for every €1 they owe they have €1 to pay in the short term. This is well below the recommended ration of 2:1.
3. If this trend continues Gener8 will find it difficult to pay their debt as they fall due

**<u>Acid Test Ratio</u>**

1. The acid test ratio is .68c : 1.
2. This means that for every €1 they owe they only have .68c to pay its debts as they fall due

3. This means that Gener8 is not liquid and will not be able to pay their debts and forced into bankruptcy.

This would be a major factor in the decision of Shannon plc to purchase Gener8 or not.

## 2018 – Question 5 - Part C

Having analysed the information in the above table, what advice would you give Born2Run plc regarding this purchase?

**Period of credit given to debtors**

1. The number of days given for a debtor to settle their bill with the business has improved by 20 days form 60 days to 40 days. This is a positive trend.
2. This means that liquidity position of the business is improving as the debts of the business are being collected quickly.
3. It must be noted that the period of creditors days is longer than the debtor's day. Remember that money received form debtors will be used to pay creditors.

**Period of credit received from creditors**

1. The number of days given for the business to settle their bill and pay their creditors has improved by 14 days form 20 days to 34 days. This is a positive trend.
2. This means that liquidity position of the business is improving as it takes longer for the business to pay their debts.
3. It must be noted that the business may lose out on discounts for paying on time which can have a negative effect on their liquidity

## 2017 – PART C

**As an employee I would be interested in the financial information for the following reasons**

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

**Identify two other users of financial information**

1. Lending institutions
2. shareholders,
3. competitors
4. Trade creditors
5. The revenue,
6. Directors.

## 2016 – Part C

**Explain Gearing**

1. This is a measure of how a business is financed on a long-term basis.
2. It measures the relationship between fixed interest debt (loans/debentures + preference shares) and total capital employed/equity.
3. When this is less than 50%/100%, the business is lowly geared. Above 50%/100% is highly geared. Low gearing is preferable.

**What are the Benefits of a low gearing Company?**

When fixed interest debt is a small proportion of overall capital it has the following benefits:

1. Low interest repayments mean more profits are available for investment elsewhere in the business.
2. Shareholders are more likely to get a dividend when gearing is low.
3. The business should find it easier to raise additional loan finance.
4. Less risk of liquidation due to not being able to make interest payments.

**State two ways to reduce gearing in a company**

Possible ways to reduce gearing includes the following

1. Sell more ordinary shares.
2. Reduce or repay loans.
3. Increase reserves/retained profits.
4. Convert long-term debt to ordinary shares.

## 2015 – Part C

State the limitations of ratio analysis as a financial analysis technique

1. It analyses past figures only and these figures are quickly out of date (historical). It merely gives us clues to the future.
2. Ratios do not show seasonal fluctuations

3. Firms use different accounting bases and therefore company comparisons are not accurate
4. Financial Statements do not reveal other important aspects of a company
5. Accounts alone cannot measure aspects which may be extremely significant such as monopoly position, economic climate, staff morale and management/staff relationships.

## 2014 – Part C

**Explain the difference between the terms 'Liquidity' and 'Solvency' when used in Ratio Analysis. Refer to relevant ratios in your explanation.**

**Liquidity**

This measures the ability of the company to pay its short term debts as they fall due.

For example - The acid test ratio is a good indicator of liquidity as it includes only liquid assets i.e. cash and debtors.

**Solvency**

1. This is the ability of a company to pay all of its debts as they fall due for payment (long term).
2. Solvency is the most important indicator of a business's ability to survive in the long term.
3. A business is solvent if its total assets exceed its outside liabilities.

For Example - Debt to equity or total debt to total assets are good guides

## 2012 – Part C

**Calculate the gross profit percentage for 2011.**

$$\frac{\text{Gross Profit}}{\text{Sales}} \times \frac{100}{1}$$

Gross Profit = 790,000 – 595,000 = 195,000

$$\frac{195{,}000}{790{,}000} \times \frac{100}{1}$$

Gross profit Margin = 24.68 %

**Give 5 different explanations for the decrease/increase in 2011**

| | |
|---|---|
| Cash losses | cash sales not recorded. |
| Stock losses | pilferage of stock or obsolescent stock |
| Change in sales mix | more sales of low markup goods. |
| Mark downs | during sales to get rid of out-of-date stock. |
| Incorrect valuation of stock | over-value of opening stock, undervalue of closing stock |
| Increased cost of sales | without an increase in sales price |
| Falling sales price | without corresponding drop in cost of sales |

## 2011 – Part C

**Explain the limitations of ratio analysis.**

State the limitations of ratio analysis as a financial analysis technique.

1. It analyses past figures only and these figures are quickly out of date (historical). It merely gives us clues to the future.
2. Ratios do not show seasonal fluctuations.
3. Firms use different accounting bases and therefore company comparisons are not accurate.
4. Financial Statements do not reveal other important aspects of a company.
5. Accounts alone cannot measure aspects which may be extremely significant such as monopoly position, economic climate, staff morale and management/staff relationships.