Question 5

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Cash Sales

$$\frac{\text{Debtors x 12}}{\text{Credit sales}} = 2 \qquad \text{Credit Sales} = \frac{100{,}000 \text{ x } 12}{2}$$

Credit sales = 600,000

Cash sales = 980,000 – 600,000 = €380,000 **[10]**

Return on Capital Employed

$$\frac{\text{Net profit + Debenture interest}}{\text{Capital employed}} \text{ x } 100 = \frac{45{,}000 + 25{,}000 \text{ x } 100}{848{,}000} = 8.25\% \text{ [8]}$$

Earnings per share

$$\frac{\text{Net profit after preference dividend}}{\text{Number of ordinary shares}} = \frac{39{,}000}{450{,}000} = 8.66\text{c [8]}$$

Dividend Yield

$$\frac{\text{Dividend per share x 100}}{\text{Market price}} = \frac{6.89 \text{ x } 100}{120} = 5.74\% \text{ [10]}$$

Period to recoup share

$$\frac{\text{Market price}}{\text{Dividend per share}} = \frac{120}{6.89\text{c}} = 17.42 \text{ years [9]}$$

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Performance **[15]**

Profitability. Watson plc is a profitable business as its ROCE in 2008 is 8.25% and 10.6% in 2007. This indicates that the firm is earning nearly 4 times the return from risk free investments of about 2%. However, the profitability has disimproved by 2.35% since 2007 which shows a less efficient use of resources.

Dividend Policy

The Dividend per Share is 2008 is 6.89c and was 12.7c in 2007. This has disimproved by 5.81c since 2007. The company's dividend cover is 1.2 times but was 1.5 times in 2007. Less profits are retained in 2008. The dividend yield is 5.74% in 2008 and was 9.77% in 2007. This has declined by 4.03% since last year. This is a worrying trend and the shareholders would prefer a higher dividend yield. The yield is above the return on a risk free investment of about 2%. The real return to ordinary shareholders would be 6.89% based on available profits as percentage of market value. In 2007 it was 14.65%

State of Affairs **[15]**

Liquidity. Watson plc has a liquidity problem and would have great difficulty paying its debts as they fall due. The company only has 74c available in liquid assets to pay each €1 of short term debts. This has disimproved from 2007 when the company had 98c available to cover each €1 owed. In both years the ratio has been below the ideal of 1:1 and is a cause of worry to shareholders.

Gearing. This is a low geared company. The Gearing of the company is 41.27%. This would please the shareholders as it increases their chances of getting a dividend and there is little risk from outside investors. However the gearing was 34% in 2007. This trend would worry the shareholders.
The interest cover is 2.8 times and shows that the ability of the company to meet their interest charges is satisfactory though not exceptionally good. It has fallen from 4 times in 2008.

Investment Policy. The investments made by the company cost €190,000. These investments now have a market value of €140,000, a drop in value of 26.3%. This shows poor management of resources although one must take into account the economic downturn globally in 2008. This would not please the shareholders.

Prospects **[10]**

Value of shares. The market value is €1.20 in 2008. In 2007, it was €1.30. The price has dropped by 7.7%. This would not please the shareholders as it shows a lack of public confidence in the company by the market.

Sector. Watson plc is a manufacturer in the construction industry. This is not a good sector to be in at the moment as the construction industry has declined significantly in the past year due to the slow down in economic growth. Property developers are finding it hard to sell properties and this in turn has a knock on effect for companies in the building industry as building has almost come to a standstill.

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Acid Test Ratio is only 0.74 to 1. Ratio dropped from 0.98 to 1 in 2007. Company has a liquidity problem

Raise cash and improve liquidity by:

1. Paying out lower or no dividends
2. Selling investments rather than issuing debentures.
3. Issuing the remaining 50,000 shares.
4. Improving gross profit percentage of 19.9% by reducing cost of sales or by passing on the increased costs.
5. Diversifying into other areas
6. Collection of debts more quickly
7. Sale and lease back