Q5 Interpretation of Accounts **50**

(a)

(i) Cash sales if the period of credit given to debtors is 3 months.

$\frac{\text{Debtors X 12}}{\text{Credit sales}} = 3$ $\frac{174{,}000 \text{ X } 12}{\text{Credit sales}} = 3$

$\frac{174{,}000 \text{ X } 12}{3} = 696{,}000$

Total sales less credit sales = cash sales
908,000 - 696,000 = 212,000 **[12]**

(ii) Return on capital employed.

$\frac{\text{Operating profit X100}}{\text{Capital Employed}}$ $\frac{39{,}000 + 20{,}000 \text{ X } 100}{621{,}000} = 9.5\%$ **[10]**

(iii) The Current Market Price if the Price Earnings Ratio is 12 times

EPS = $\frac{\text{Net profit – preference dividend}}{\text{No of ordinary shares}}$ $\frac{39{,}000 - 9{,}000}{200{,}000} = 15\text{ c}$

Price Earnings Ratio x Earnings Per Share 12 x 15c = 180c **[10]**

(iv) Dividend Cover

$\frac{\text{Net Profit – Preference Dividend}}{\text{Ordinary Dividend}} = \frac{30{,}000}{4{,}000} = 7.5 \text{ times}$ **[10]**

(v) Interest Cover

$\frac{\text{Operating Profit}}{\text{Debenture Interest}} = \frac{39{,}000 + 20{,}000}{20{,}000} = 2.95 \text{ times}$ **[8]**

(b) **40**

The Shareholders would be broadly satisfied with the performance, state of affairs and prospects of the company, for the following reasons: **[2]**

Performance

Profitability [7]

The return on capital employed for 2020 is 9.5%. It has improved by 0.43% from 2019 when the return was 9.07%.
The Return on Equity Finance is also very good at 11.07%.
The company is in a relatively profitable position as the return of 9.5% is much better than the return from risk free investments of 0-2% and is above the Debenture rate of 8% and the Preference Capital rate of 9%.
The company is making efficient use of its resources this year.
The earnings per share have disimproved slightly by 1 cent per share from 16 cent in 2019 to 15 cent in 2020.

Dividend Policy [7]

The dividend cover is 7.5 times, the firm is paying out 13.33% of its available profits in dividends.
Last year's dividend cover was 2.5 times meaning the firm was paying out 40% of available profits to shareholders.
This is an improvement, as much more profit is being retained for expansion purposes and the repayment of loans.
The dividend per share has fallen from 6.4 cent in 2019 to 2 cent in 2020 which will make shareholders unhappy.
The dividend yield has disimproved from 4% last year to 1.1% this year and is only marginally above the return on risk free investments of 0-2%.

State of Affairs

Liquidity [8]

The Acid Test (Quick Ratio) has improved from 1.8:1 in 2019 to 2.49:1 in 2020, and is above the ideal of 1:1.
The Working Capital Ratio is also an extremely safe 3.37 to 1.
Fauci plc does not have liquidity problems and is able to pay its bills as they arise.
They have 249 cent available in Liquid Assets for every Euro they owe in the short run which means they will have no trouble paying interest and future dividends.
However Fauci's liquidity figures are too conservative. Too much capital is tied up in Debtors and is unavailable for other purposes.

Gearing [7]

Gearing has improved from 62% in 2019 to 56.36% in 2020, but it is still highly geared.
This is a positive trend, Fauci plc are now less dependent on outside borrowing than before but there would appear to be significant risk to the firm from outside investors. They are less financed by debt this year than last year but are still financed more by debt than equity.
If using the debt to equity ratio the gearing position has disimproved from 62% to 129.15% which is a negative trend. The company is now more dependent on outside borrowing than before and there is significant risk to the firm from outside investors. The business is highly geared and is financed more by debt than by equity.
Interest cover has worsened from 3.2 times in 2019 to 2.95 times in 2020. The firm could have trouble making their interest payments in the future.
These figures mean that the firm may not have extra funds available for paying dividends, or reinvesting for expansion purposes, or paying off debt.
However, the Debentures are not listed for repayment until 2030. Fauci plc has enough time to put aside resources to be able to repay these when the time comes.
The bank account is overdrawn yet Debtors owe €174,000. Fauci should follow up on this.

<u>Prospects</u>
Sector [4]

Fauci plc is in the computer security industry. In the short term this industry is growing as more people work from home increasing the need for computer security systems. In the long term, the economic recovery is uncertain and the firm is likely to face competition and takeover from large multinational competitors.

Share Performance [5]

The earnings per share has disimproved slightly from 16c per share in 2018 to 15 c per share in 2020.The Price Earnings Ratio has increased slightly in the same period from 10 years to 12 years, meaning it will take a longer time to earn back the Market Price of the share at current performance levels. The market share price has improved from €1.60 to €1.80 since last year.

This indicates that the investors in the stock market have confidence in the company.

(c) **10**

(i) 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 means 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.

(ii) Explain two ways to reduce gearing of a company.

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