Q.5

(a) Interpretation of Accounts **50**

(i) **The Opening Stock if the Rate of Stock Turnover is 8 based on Average Stock**

$$\frac{\text{Cost of Sales}}{\text{Average Stock}} = 8 \text{ times}$$

$$\text{Average Stock} \times 8 = 790{,}000$$

$$\text{Average Stock} = \frac{790{,}000}{8} = 98{,}750$$

$$\text{Average Stock} = \frac{? + 50{,}000}{2} = 98{,}750$$

Opening stock = €197,500 -€50,000 = €147,500

Opening Stock = €147,500 **[12]**

(ii) **Interest Cover** =

$$\frac{\text{Net profit + interest}}{\text{Interest}} \qquad \frac{50{,}000 + 30{,}000}{30{,}000} = 2.67 \text{ times}$$ **[8]**

(iii) **Dividend Cover**

$$\frac{\text{Net profit – Preference dividend X100}}{\text{Ordinary dividend}} = \frac{50{,}000 - 10{,}500}{34{,}500} = 1.15 \text{ times}$$ **[10]**

(iv) **Return on shareholders funds**

$$\frac{\text{Net profit – Preference dividend X 100}}{\text{Ordinary shares +Reserves}} \qquad \frac{50{,}000 - 10{,}500 \quad \text{X } 100}{350{,}000 + 80{,}000} = 9.19\%$$ **[10]**

(v) **Price Earnings Ratio** =

$$\frac{\text{Market price}}{\text{EPS}} = \frac{160c}{11.29c} \qquad 14.17 \text{ years}$$

EPS

$$\frac{\text{Net profit – preference dividend X100}}{\text{Ordinary Share capital}} = \frac{50{,}000 - 10{,}500}{350{,}000} = 11.29 \text{ C}$$ **[10]**

(b) The Shareholders would not satisfied with the performance, state of affairs and prospects of the company for the following reasons: **[2]**

Profitability [7]

The return on capital employed for 2021 is 9.09%. It has dis-improved by 0.91%, from 2020 when the return was 10%. The Return on shareholders funds is also very good at 9.19%.
The company is profitable .The return of 9.09/9.19% is much better than the return from risk free investments of 0-1% & the Preference Capital rate of 7%. However it is below the Debenture rate of 10% .Why borrow money if the return is less than the cost of borrowing.
The company is not making efficient use of its resources this year.

Dividend Policy [7]

The dividend per share is 9.86c in 2021, disimproved from last year's 12c. The dividend yield 6.16% is slightly down on last year's 6.32% but still higher than risk-free investment of 0-1%.
The dividend cover is 1.15 times, the firm is paying out 86.96% 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 would worry shareholders that not enough is being retained for expansion and repayment of loans.

<u>State of Affairs</u>

Liquidity [7]

The Acid Test (Quick Ratio) is improved slightly from 0.95:1 in 2020 to 1:1 in 2021, and equals the ideal of 1:1.
Ash ltd does not have liquidity problems and is able to pay its bills as they arise.
They have 1 euro available in Liquid Assets for every Euro they owe in the short run which means they will have no trouble paying interest and if the trend continues allows for future improved dividends.

Gearing [7]

Gearing has dis-improved. It has gone from being low geared in 2019 at 45% up to 51.14% in 2020, which is highly geared.
This is a negative trend, Ash plc are now more dependent on outside borrowing than before but there would appear to be a significant risk to the firm from outside investors. They are more financed by debt than equity this year.
Interest cover has worsened from 8 times in 2019 to 2.67 times in 2020. The firm could have trouble making their interest payments in the future if this trend continues.
These figures mean that the firm may not have more money available for paying dividends, or reinvesting for expansion purposes, or paying off debt.
The Debentures are not listed for repayment until 2026. Ash Ltd 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 €100,000. Ash should follow up on this.

<u>Prospects</u>
<u>Sector</u> **[5]**

Ash Ltd is in the food processing industry. Although the long-term prospects are good because world population is exploding, the short term is unfavourable due to the effect of the current difficulties with Brexit etc.

Share Performance **[5]**

The earnings per share have dis-improved by 18.71 cent per share from 30 cent in 2020 to 11.29 cent in 2021

The Price Earnings Ratio has increased slightly in the same period from 6.33 years to 14.17 years, meaning it will take a longer time to earn back the Market Price of the share at current performance levels.

The share price has disimproved from €1.90 in 2020 to €1.60 since 2019.

This indicates that the stock market has reduced confidence in the company.

Investment Policy

The market value of investments at €60,000 is lower than the cost of €80,000 and this 25% fall in value indicates poor management of resources. Shareholders will not be pleased with this.

(c)

Limitations of Ratio Analysis **10**

1. Ratio Analysis is based on historical data only. These figures can become out of date very quickly, even by the time they are being used. They are of limited use in predicting future values.
2. Ratios do not show seasonal fluctuations within the accounting period.
3. Ratios do not take account of external factors such as the strength of the economy or the relative impact of global pandemics.
4. Figures requiring the Share Price for calculation, (PER, period to recoup and Dividend Yield) can be impacted by the mood of the markets and the irrationality of public investors. Share prices change based on levels of optimism, or panic in the market.
5. Different firms use different accounting bases making comparisons questionable. The comparison of one company to another may not be either accurate nor meaningful.
6. Financial Statements give a limited picture of a business. Many important aspects of a company are not revealed in the Financial Statements. These include
    a. The firms market position, e.g. Monopoly, dominant, niche.
    b. External changes within the market, e.g. technology, legislation or public attitudes.
    c. Staff morale and management/staff relationships. Staff turnover.