Q5 Interpretation of Accounts

50

(a)

(i) Cash Purchases if the period of credit received from trade creditors is 3.6 months and 20% of total purchase are cash purchases.

Credit Purchases

$$\frac{\text{Creditors} \times 12}{\text{Credit purchases}} = 3.6 \text{ months}$$

$$\frac{21{,}000 \times 12}{3.6} = €70{,}000$$

Cash Purchases

70,000 = 80% of total purchases **[10]**

$$\frac{70{,}000}{80} \times 20 = €17{,}500$$

(ii) Price earnings Ratio

$$\frac{\text{Market Price}}{\text{Earnings Per Share}} = \frac{140c}{8.77c} = 15.96 \text{ years}$$ **[10]**

$$\text{EPS} = \frac{\text{Np – preference dividend}}{\text{Number of ordinary shares}} = \frac{41{,}000 - 9{,}000}{365{,}000} = 8.77 \text{ cent}$$

(iii) Return on Shareholder Funds

$$\frac{\text{Net profit – preference dividend}}{\text{Shareholders Funds}}$$ **[10]**

$$\frac{41{,}000 – 9{,}000}{365{,}000 + 101{,}000} \times 100 = 6.87\%$$

(iv) Dividend Cover

$$\frac{\text{Net profit – preference dividend}}{\text{Ordinary Share Dividend}} \quad \text{OR} \quad \frac{\text{EPS}}{\text{DPS}}$$ **[10]**

$$\frac{41{,}000 – 9{,}000}{9{,}000} = 3.56 \text{ times}$$ **OR** $$\frac{8.77 \text{ cent}}{2.47 \text{ cent}} = 3.55 \text{ times}$$

(v) **Gearing -** **Debt to Capital Employed -**

$$\frac{500{,}000 + 150{,}000 \times 100}{1{,}116{,}000} = 58.24\%$$ **[10]**

Debt to Equity - $$\frac{500{,}000 + 150{,}000 \times 100}{466{,}000} = 139.48\%$$

(b)

40

Bank Loan Application

Profitability [7]

The return on capital employed for 2021 is 6.81**%.** In 2020 the return was 4.56%.
Profitability has improved very slightly by 2.25%.
The company is profitable/not very profitable as while the return of 6.81% is better than the return from risk free investments of 0-1% it is below the Debenture rate of **7%** and only just above the Preference Capital rate of 6%.
The company is currently borrowing at an interest rate of 7% and using that money to make a return of less than this. Why borrow at a rate that is higher than the return on capital.
The company is not making efficient use of its resources this year**.**
The retained profit for 2021 would be insufficient to cover the annual interest charge of €40,000 on the new loan if it were to be granted.

Dividend Policy [5]

The dividend cover is 3.56 times**,** the firm is paying out 28.16% of its available profits in dividends.
Last year's dividend cover was 4.2 times meaning the firm was paying out 23.81% of available profits to shareholders. The firm is paying out a higher proportion of profits this year than was paid out last year**.**
An adequate proportion of the earnings are being retained for repayment of loan and future expansion**.** However given that the profit is low the company should consider increasing the dividend cover.

Liquidity [7]

Watson Plc does not have liquidity problems**.** The Acid Test (Quick Ratio) has improved from 2.3:1 in 2020 to 2.97:1 in 2021, well above the ideal of 1:1. They should have no problems in paying their interest and other bills as they fall due.
They have 297 cent available in Liquid Assets for every Euro they owe in the short run**.**
Watson PLC's liquidity figures are very conservative**.** Too much capital may be tied up in Debtors and is unavailable for other purposes.
The Current Ratio is also an extremely safe 3.43 to 1.

Gearing [6]

The firm is already highly geared at 58.24%/139.48**%.** Watson Plc is dependent on outside borrowing and there would appear to be a significant risk to the firm from outside investors. They are already financed more by debt than equity**.** The loan would adversely impact the gearing to 71.16%/246.78**%.** Interest cover is slightly improved from 1.9 times in 2020 to 2.17 times in 2021**.** This is concerning as it is significantly below the ideal of 3 to 1 or greater. The firm could have trouble making their interest payments on existing and any new loans. These figures should mean that the firm is unlikely to have more money available for paying dividends, reinvesting, or paying off debt.

The interest cover will get much worse if the loan of €500,000 is granted. The interest on the new loan would be €40,000.

Security [6]

Tangible Fixed assets, including Investments are valued at €737,000/€787,000/487,000/1,037,000**.** The lender should question the depreciation policy to ascertain the real value of the tangible assets**.**

The investments cost €250,000 but now have a market value of €270,000 which shows efficient use of resources on the part of Management**.**

As the existing debenture debt is €500,000**,** it would appear the firm is already barely solvent. The security for a new loan is not adequate**.**

The lender should question the nature of the Intangible Assets, they seem excessively large relative to the other assets, yet do not seem to be generating any income.

This situation will get much worse if the loan is granted.

Sector [5]

Watson plc is a manufacturer in the Confectionary sector**.**

In the short term this industry is growing as the global economy recovers post pandemic**.**

However, particular consumers are looking for healthier options**,** such as low calorie, high cocoa, and functional ingredient-based confectionery. Healthier snacking, along with convenience and taste, is the rising trend among consumers, and there is a growing demand for healthy snacks.

In the long term, Watson Plc may face competition from large, established multinational competitors and will have to conduct research to assess and meet the demands of changing consumer tastes in existing and new markets. Inflation will also present challenges with regard to the prices of raw materials and the reduction in the real income of consumers.

Purpose of the loan [2]

The loan is to finance the firm's expansion into the European market**.** This expansion plan needs to be more specific as to exactly what the money will be spent on and how this will generate more profit. It is unclear if Watson's expansion could generate the level of extra income needed to service the loan**.**

Recommendation **[2]** The bank manager should **not grant** the loan based on the above figures.

- The company is not very profitable, yet it has a generous dividend policy and not enough profits are being retained in the business.
- The company is highly geared making it vulnerable to outside investors as a small change in profitability could mean it cannot make interest payments.
- The firm is barely solvent, it would be insolvent if the loan is granted.

(c)(i) The gross profit percentage is 28.21**%** a disimprovement of 7.79% from last year.

10

(ii) This could be caused by

-Reduction in selling price without a corresponding fall in cost of sales
-Cost of sales increased without the increase being passed on to the consumer
-Cash losses**.** Cash sales not recorded or theft of cash
-Stock losses –theft of stock or obsolete stock
-Change in sales mix –more low margin items being sold and less high margin items being sold
-Incorrect valuation of stock overvaluing opening stock and/or undervaluing closing stock
-Increased competition in the market reducing profit margins
- Reduction in selling price to get rid of old stock.

(iii) This could be improved by

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