5 Interpretation of Accounts 50

(a)

(i) Opening Stock $\frac{\text{Cost of Sales}}{\text{Average Stock}}$ = 14 **[10]**

$\frac{€560{,}000}{14}$ = €40,000

(€40,000 x 2) = €80,000

€80,000 – €42,000 = €38,000

(ii) Return on capital employed $\frac{\text{Net Profit + Interest}}{\text{Capital Employed}}$ x 100 **[10]**

$\frac{€104{,}000 + €32{,}000}{€1{,}028{,}000}$ x 100 = 13.23%

(iii) Price Earnings Ratio

$\frac{\text{Market Price}}{\text{Earnings Per Share}}$ = $\frac{130c}{22.22c}$ = 5.85 years **[10]**

EPS = $\frac{\text{Net profit – Preference dividend}}{\text{Number of ordinary shares}}$

$\frac{€104{,}000 - €4{,}000}{450{,}000}$ = 22.22 cent

(iv) Dividend Cover

$\frac{\text{Net profit – Preference dividend}}{\text{Ordinary dividend}}$ **[10]**

$\frac{€104{,}000 - €4{,}000}{€36{,}000}$ = 2.78 times

OR

$\frac{\text{EPS}}{\text{DPS}}$ $\frac{22.22 \text{ cent}}{8 \text{ cent}}$ = 2.78 times

Dividend per share = $\frac{€36{,}000}{450{,}000}$ = 8 cent per share

(v) Dividend Yield **[10]**

$$\frac{\text{Dividend per share}}{\text{Market price}} \times 100 \qquad \frac{8 \text{ cent}}{130 \text{ cent}} \times 100 = 6.15\%$$

$$\text{DPS} = \frac{\text{Ordinary Dividend}}{\text{No of Ordinary Shares}}$$

$$\frac{€36{,}000}{450{,}000} = 8 \text{ cent}$$

(b)

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Performance

Profitability **[7]**
O'Malley PLC is a profitable company. Its ROCE in 2022 is 13.23%. This has disimproved from 14.28% in 2021. The return is much better than the return from risk free investments of 0-2%. It is also higher than the 8% being paid to debenture holders and the 4% to preference shareholders. The company is making less efficient use of resources this year than last year. The EPS has disimproved slightly from 23c to 22.22c.

Dividend Policy **[4]**
The Dividend Cover has improved from 2.57 times to 2.78 times in 2022. In 2021 38.9% of the company's profits was paid out in dividends. In 2022 35.97% is being paid out. This shows that more money is being retained in the company for repayment of the loan, loan interest and expansion purposes. The Dividend per share has disimproved from 8.95 cent to 8 cent.

State of Affairs

Liquidity **[7]**
O'Malley PLC is a liquid company. The acid test ratio is 1.2:1. This has disimproved since 2021 when it was 1.5:1. It is still greater than the ideal ratio of 1:1. The company has €1.20 in liquid assets to repay every €1 owed in short-term debt. The company should have no problem making interest payments but would be concerned about the disimproving trend. If this trend continues, the ability to pay interest would come under pressure and funds would not be available to invest for the purpose of repaying the loan

Gearing **[7]**
O'Malley plc is a lowly geared company. The gearing has disimproved from 35% in 2021 to 48.64% in 2022(students can use the debt to equity ratio here which is 94.7%. The company is financed more by equity than debt but is becoming more reliant on debt. The Debenture is due for repayment in 2026. There is nothing in the accounts to show that provision is being made for this repayment. The Interest cover has disimproved from 7.12 times in 2021 to 4.25 times in 2022. This is a cause for concern as the company is becoming less capable of repaying its loan interest.

Security **[7]**
Debentures are secured on Fixed Assets. Debenture holders would like to question the depreciation policy to ascertain the real value of assets. The value of Fixed Assets is €670,000/€970,000. There is adequate security for the loan of €400,000 due for repayment in 2026. Debenture holders would be satisfied that the investments which were bought for €300,000 are now worth €310,000 . This shows good management of investments by the management of the company.

Prospects

Sector **[5]**
O'Malley is a retailer in the fast food industry. Short term prospects in this industry are not good as people become more health conscious and move away to healthier foods. Long term prospects are not good as it is a highly competitive industry with many well known brands to compete against.

[3] Overall the debentures holders would be satisfied with the company. However they would be concerned with the disimproving trends in certain parts of the company such as in profitability, liquidity and gearing.

(c)

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Distinguish between the terms liquidity and solvency when used in ratio analysis.

Liquidity measures the ability of the company to pay its short-term debts as they fall due. The acid test ratio is a good indicator of liquidity as it includes only liquid assets i.e. cash and debtors

Solvency is the ability of a company to pay all of its debts as they fall due for payment . Solvency is the most important indicator of a business's ability to survive in the long term. A business is solvent if its total assets exceeds its outside liabilities. Debt to equity or total debt to total assets are good guides.

A rising liquidity ratio is a sign of prudent management. Discuss briefly.

A rising liquidity ratio can be a sign of prudent management because it indicates that is easier for the firm to pay its short-term debts on time and so avoid paying interest or help it achieve cash discounts for prompt payment. However, if the ratio is much higher than 1:1 it could mean that the company has too much of its resources tied up in liquid assets when they could be invested in fixed assets enhancing the productive capacity of the business.