

Q5

Suggested Approach:

1. Read the question carefully.
2. Prepare the following workings/identify key figures in advance of the solution
 - Identify the industry: Growth area/In decline/Open to competition.
 - Calculate Gross profit.
 - Highlight/Calculate the Operating profit.
 - Calculate the Ordinary dividend and the Preference dividend.
 - Calculate the reserves at start/end of year. Shows trend.
 - Note the cost/market value of Investments.
 - Calculate the total current liabilities.
 - Earnings = Profit after Tax minus Pref. Div.
 - Check the nominal value of one ordinary share. €1?
3. Do part (a) of the question.....all the calculations. Remember
 - Write out the formula.
 - Substitute the figures.
 - Do calculations
 - Show answer to two decimal places
 - Identify the answer i.e. cents, years, euro, times, % etc.
4. Look at the set of figures given on RHS.
 - Past or projected figures?
 - Calculate similar figures from these years' accounts.
- 5 Do part (b) of the question: Comment from viewpoint of:
 - Shareholder: Existing or potential? (Page 3&4)
 - Debenture holder Page (5&6)
 - Loan Application to Bank Manager.(Page 7&8)
6. **Do not forget part (C) : Theory question/ Text Book**

When answering part(b):

- Be sure to state the obvious and then elaborate on what that means in the second/third sentence.
- Try to avoid using words like “Good” or “Bad”. It is better to use words like “it appears satisfactory/healthy” or “ it appears unsatisfactory/unhealthy”
- If you have calculated certain ratios in part (a) try and bring them into part (b) in order to save valuable time.
- A student should aim to take two ratios from each of financial categories i.e. Profitability, Liquidity, Gearing and Investment, when answering part (b).

Comment from the point of view of the shareholders:
Existing /Potential

Profitability:

- Calculate Return on capital employed / Return on shareholders funds
- Compare to previous figures.
- Identify the trend Healthy or unhealthy
- Rewards shareholders sufficiently (OR not) for taking the risk
- Shows efficient use of resources by management (OR not)
- Gross profit %: In an efficient business this figure should remain the same.
- Effect on share price Increase or Decrease?
- Compare to return on risk free investments. (2% - 3% Approx)
- Also higher/lower than the rate of interest charged on loan.

Liquidity:

- Calculate Working capital ratio (2: 1) and acid test ratio or Quick ratio (1:1)
- Compare to previous figures. Identify trend
- Compare to recommended ratios.
- Ability to meet debts as they fall due
- Quick ratio is the more severe test of the firm’s liquidity.

Share price:

- Compare figures. Identify trend Healthy/Unhealthy
- Indicates growing shareholder confidence in the company OR not
- **Existing Shareholder:** Proportion of share owned. Control of Company?
- Current price Vs offer price?? Good investment??

Dividend Policy:

- Calculate the EPS and DPS. % Dividend Payout
- Calculate the Dividend Yield. Trend. Shareholders concerned/not concerned with return
- Compare to risk free investments.
- Calculate the Dividend cover. Generated adequate profits to meet dividends OR not

Gearing:

- Calculate Gearing ratio. Compare figures.
- High or Low geared firm? (>50% H, <50% Low)
- This would please shareholders as it increases their chance of getting dividends and has little risk from outside. (Or Not)
- Ability to borrow funds in the future as most of it long term finance comes from ordinary shareholders.

Interest Cover:

- Calculate the figures
- Compare to previous
- Identify trend
- Adequate profits available to meet interest payments or Not??
- Shareholders happy?

Sector:

- Identify the industry
- Growth area or in decline? Prospects? Open to Competition?
- Potential for future profits or not?

Investments:

- Compare Cost and current market value
- Indicates good/poor management of resources. Shareholders happy?

Reserves:

- Identify any reserves
- Trend of reserves. Increasing or decreasing
- Company building towards the future with the retention of profits.

Conclusion:

- Overall shareholders would/would not be happy with this company?
- There is a concern over.....
- It is looking towards the future.....
- Therefore I would advise my friend to buy/not buy these shares???

Comment from the point of view of the Debentures Holders:

Profitability:

- Calculate Return on capital employed
- Compare to previous figures.
- Identify the trend Healthy or unhealthy
- Compare to risk free investments.
- Compare to rate of interest on the debentures
- Gross Profit %
- EPS: improved or disimproved from last year?
- Figures show efficient use of resources by management (or NOT)

Liquidity:

- Calculate Working capital ratio and acid test ratio
- Compare to previous figures.
- Identify trend
- Compare to recommended ratios.
- Ability to meet debts as they fall due and more interest payments
- **Debenture holders would (would not) be worried about the implications of this liquidity position for interest payments.**

Interest Cover:

- Calculate the figures. Compare to previous. Identify trend. Adequate or NOT?
- Trend will (will not) jeopardize interest payments.

Security:

- State Value of Fixed assets.
- Depreciation policies need to be investigated to estimate true value of fixed assets.
- State value of Intangible assets. These cannot be given as security. Need to know what this figure actually represents.
- Investments: state market value.
- **Repayment date: Existence of Debenture Redemption Reserve?**
- **Debenture holders feel secure (or Not) because of the excess in the value of the fixed assets over the amount of the loan.**

Gearing:

- Calculate Gearing ratio. High or Low?
- Compare with previous figures. Trend
- Low gearing suits debentures holders.
- **The higher the gearing the more at risk are the interest payments**

. Dividend Policy:

- Calculate the EPS: DPS Dividend Payout Policy. Excessive or Not
- Retained Earnings available to repay Debentures (or not)
- Div. Cover: profits distributed to shareholders with (No) provision for repayment of loan.
- **Debenture holders prefer to see profits retained**

Share price:

- Identify trend
- Indicates growing shareholder confidence in the company or Not

Sector:

- Identify the industry
- Growth sector with good prospects? Why
- Potential for future profits or not. Open to competition?

Reserves` :

- Identify any reserves
- Trend of reserves. Increasing or decreasing
- Firm is looking to future and building its reserves.

Conclusion:

- There may be concern over.....
- Overall the Debenture holders should be satisfied with the performance of Co. XY Ltd. (OR vica versa)

Would the Bank Manager grant a Loan ? :

Profitability:

- Calculate Return on capital employed / Return on shareholders funds
- Compare to previous figures.
- **Compare to rate of interest on the loan.**
- Identify the trend Healthy or unhealthy
- Effect on share price Increase or decrease.
- Compare to return on risk free investments. (2% - 3% Approx)
- **If loan is granted re-calculate the ROCE. Acceptable or not? Be careful with calculations here, as Operating Profit remains the same, whereas Total Capital Employed changes. Net effect is that Loans increase and Reserves decrease. If the loan is granted, it is imperative that the granting of the loan will lead to an increase in profits.**

Liquidity:

- Calculate Working capital ratio and acid test ratio
- Compare to previous figures.
- Identify trend
- Compare to recommended ratios.
- Ability to meet debts as they fall due
- **However extra interest payments will cause this to be less favourable.**

Gearing:

- Calculate Gearing ratio. High or Low?
- Compare with previous figures
- **If the loan is granted, recalculate the gearing figure. What happens? Gearing will get higher, certainly in the shorter term.**

Interest Cover:

- Calculate the figures
- Compare to previous
- Identify trend
- Adequate or Not??
- **If the loan is granted this will disimprove with extra interest payments.**

Security:

- Value of Fixed assets to cover bank loan and other loans??
- Debentures Repayment date? Any provision for repayment?
- Intangibles cannot be used for security
- Real value of assets. Investigate depreciation policies
- Is the purpose of the loan given?
- Is it for a potentially profitable purpose?
- Favourable response.

Share price:

- Identify trend
- Indicates confidence in the company by the market. Or NOT

Dividend Policy:

- Calculate the EPS: DPS Dividend Payout Policy
- Retained Earnings.
- Calculate the Dividend Yield. Compare to return on risk free investments.
- Trend.
- Calculate the Dividend cover.
- Amount of Retained earnings to help repay the loan.

Sector:

- Identify the industry
- Vibrant or in decline?
- Potential for future profits or not?

Investments:

- Compare Cost and current market value
- Good investment decision or Not?
- Could be used as security for the loan.

Reserves:

- Identify any reserves
- Trend of reserves. Increasing or decreasing
- Long-term implications for the firm.

Conclusion:

- The Bank Manager may have concern with.....
- Overall, I would advise the bank manager to grant (or Not grant) the loan.