

Question 1

5.	<p>(a) Debt: Equity Ratio Debt Capital: Share Capital + Reserves $700,000:220,000 + 130,000$ $700,000:350,000 = 2:1$</p> <p>(b) Lalco Ltd. is highly geared – this means the firm has to make high interest payments resulting in low/no dividend payments to shareholders. Assets may be used as security/Capital repayment required/May impact on ability to borrow in the near future/Impact on the firm's profits/cash flow.</p>	10
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Question 2

3	<p>(a) Using the figures below calculate the Net Profit Percentage of Auburn Publishing Ltd for 2014:</p> <p style="text-align: center;">Net profit/Sales X 100</p> <p style="text-align: center;">Gross Profit 22,000 – Expenses 12,000 = Net Profit of €10,000 Net Profit 10,000 / Sales 50,000 = 20%</p> <p>(b) The Net Margin has fallen by 5% showing that the firm's profitability has decreased and that it may be time for management to control its costs by deciding for example to cut wages, source cheaper raw materials or it should try to increase sales revenue.</p>	10
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Question 3

5	B	<p>The following figures are taken from the final accounts of Flame Ltd for 2013.</p> <table border="1" style="margin-left: auto; margin-right: auto;"> <thead> <tr> <th style="text-align: left;">Flame Ltd</th> <th style="text-align: center;">2013</th> </tr> <tr> <th></th> <th style="text-align: center;">€</th> </tr> </thead> <tbody> <tr> <td>Authorised Share Capital</td> <td style="text-align: right;">900,000</td> </tr> <tr> <td>Issued Share Capital</td> <td style="text-align: right;">450,000</td> </tr> <tr> <td>Long Term Loan</td> <td style="text-align: right;">200,000</td> </tr> <tr> <td>Retained Earnings</td> <td style="text-align: right;">150,000</td> </tr> </tbody> </table> <p>i Explain the term 'Debt/Equity Ratio'. The debt/equity ratio is an analysis of the capital structure of the business. It indicates what proportion of capital is made up of long term loans and what proportion of capital is made up of reserves and issued ordinary share capital.</p> <p>ii Calculate the Debt/Equity Ratio for 2013. Show your workings.</p> <div style="border: 1px solid black; padding: 5px; margin: 10px auto; width: fit-content;"> <p style="text-align: center;">Debt: Equity 200,000 : 450,000 + 150,000 200,000 : 600,000 .33 : 1</p> </div> <p>iii Discuss the importance of the Debt/Equity Ratio in deciding on new sources of finance for Flame Ltd.</p> <p>Flame Ltd is a lowly geared company which means the majority of the capital has been provided by the owners in the form of share capital and retained earnings. Flame Ltd can raise further capital by selling shares up to a limit of €450,000 (Authorised – Issued).</p> <p>Raising finance through additional loans is an option for Flame Ltd because it does not have too many existing loans already, as it is lowly geared.</p>	Flame Ltd	2013		€	Authorised Share Capital	900,000	Issued Share Capital	450,000	Long Term Loan	200,000	Retained Earnings	150,000	20
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Question 4

(Show your workings)

Debtors	€12,000
Bank Overdraft	€20,000
Cash	€15,000
Creditors	€50,000
Closing Stock	€ 8,000

Workings

Current Ratio is CA: CL

$$CA \quad 12000 + 15000 + 8000 = \text{€}35000$$

$$CL \quad 20000 + 50000 = \text{€}70000$$

$$\text{Current Ratio} = \text{€}35,000 : \text{€}70,000$$

Answer: 0.5:1

(b) Comment on the liquidity position of Sentry Ltd:

- Sentry Ltd has not managed to attain the recommended current ratio of 2:1.
- Sentry Ltd is not liquid and is overtrading i.e. it cannot pay its debts as they arise.
- Sentry Ltd will have difficulty in raising cash quickly and paying its bills as they fall due.
- Maintaining a healthy working capital is essential to a businesses' cash flow. However, this was not the case for Sentry Ltd with only €0.50 available to pay for every €1 of liabilities.

(B) (i) Calculate the following for 2011 for Bianua Ltd:

- Return On Investment (ROI);
- Current Ratio;
- Acid Test Ratio;
- Debt/Equity Ratio.

Return on Investment = Net Profit x100 / Cap. Employed
(Ordinary share capital + Retained Earnings + Long Term Loan)
50,000/(500,000 + 100,000 + 300,000)
50,000/900,000
5.56%

Current Ratio = Current Assets: Current Liabilities
155,000: 85,000
1.82:1

Acid Test Ratio = Current Assets – Closing Stock: Current Liabilities
(155,000 – 80,000): 85,000
75,000:85,000
0.88:1

Debt Equity Ratio = Debt: Equity/ (Ordinary share capital + Retained Earnings)
300,000: (500,000 + 100,000)
300,000:600,000
0.5:1

(20 marks)

(ii) Analyse the *profitability* and *liquidity* of Bianua Ltd, with reference to the industry average results, shown in the box above, **and make recommendations for Bianua Ltd.**

Profitability

The ROI for Bianua Ltd is 5.6%, which measures the return on capital for investors in a business. This is half the average performance of companies in the same industry. However, it is a new company and its ROI still compares favourably with the prevailing interest rates currently available on deposit accounts e.g. Rabo Direct personal savings account offering a return of 3.10%.

Recommendation for Bianua Ltd

Bianua Ltd will want the ROI to be as high as possible and to remain above the bank interest rate. To improve its position it needs to reduce its capital employed figure or improve its net profit by for e.g. controlling its expenses/overheads or trying to increase its sales.

Liquidity

The Current ratio

The average industry result in 2011 had a very healthy level of working capital. It had €2 available to pay for every €1 of liabilities. Maintaining this healthy working capital is essential for a businesses' cash flow.

Bianua Ltd has €1.82 available to pay for every €1 owed, a little below the ideal of 2:1. It should make every effort to maintain its current ratio so that it can pay its short term debts as they fall due. If the liquidity position of a new business is poor and it cannot pay its current liabilities it may have to go into liquidation.

The Acid test ratio

In 2011 the average industry result was 1.2:1 indicating that on average €1.20 was available immediately to pay for every €1 owed. The situation for Bianua Ltd in 2011 was 0.88:1 with the business only having 88c available to pay for every €1 it owes. Neither the industry average, nor Bianua Ltd manages to attain the ideal acid test ratio of 1: 1. The industry has some idle resources; however it is able to pay its short term debts as they fall due. On the other hand Bianua Ltd may have difficulty raising cash quickly to pay its bills as they fall due. Failure to improve on this could result in Bianua Ltd having difficulty in buying goods on credit in the future.

Recommendation for Bianua Ltd:

- Sell slow moving stock at a discount.
- Effective cash flow forecasting in order to avoid liquidity problems.
- Effective credit control will reduce the risk of bad debts.
- Effective stock control will reduce the amount of money tied up in stock.
- Increase cash sales.

(20 marks)

Question 6

- (a) Explain the term 'Return on Investment' (ROI).

ROI is the **net profit a business generates** from the **total finance used by the business (capital employed)**.

It measures the profitability of a business, compared with the money invested in it.

- (b) **Calculation of ROI:**

$$\begin{aligned} \text{ROI} &= \frac{\text{Net Profit}}{\text{Capital Employed}} \times 100 \\ &= \frac{€57,000}{€140,000 + €56,000 + €24,000} \\ &= 25.91\% \text{ or } 26\% \end{aligned}$$

Question 7

(A) (i) Explain what is meant by the term performance appraisal.

Performance appraisal is reviewing the performance of the employees in business.

It is usually carried out by the Human Resource Manager to judge/assess/evaluate the employee.

The Human Resource Manager forms a judgement on a person's work by reviewing the quality of the work, the progress the person has made or the capability of the person.

An interview/discussion may take place between the employee and HRM to discuss goal setting targets, expectations, problems employees may be encountering or resources needed in order to achieve targets.

(ii) Outline the benefits of performance appraisal for a business.

Benefits for a business.

Opportunity to review rewards (benefits structures): It may be used in determining pay increases or promotion. It can help a business to review & reduce the costs of reward and benefits packages such as pension schemes.

Increased productivity: Performance appraisals are important for staff motivation, attitude and behaviour development, communicating and fostering a positive relationship between management and staff. This leads to greater productivity from employees.

Overtime Costs may be reduced through increased productivity during normal time. Overlaps between departments can be highlighted which will cut down on the duplication of work.

Retain the right staff/ identify poorly performing staff: helps a business identify top talent and ensures that these employees are retained and guided towards reaching the businesses plans and objectives.

A business can identify employees who are not reaching their potential. Restructuring of the business may occur to remove surplus layers of management i.e. **delaying**.

Industrial relations: conflicts in the workplace may be highlighted through performance appraisals. This enables the business to help solve problems between management & employees and helps improve industrial relations in the workplace. It may improve loyalty to the organisation if positive rewards are given.

Hidden strengths/delegation: performance appraisals identify unused hidden strengths which can be used, for the good of the business. This can be achieved by developing individual skills and thus improving the overall performance of the business. It can be used to assess employees' potential for promotion.

Delegation: managers can decide to delegate tasks to certain employees who are performing well in the business. This will relieve pressure on managers.

Selection and Training: it helps a business decide if too much or too little training is being delivered in various departments of the business. e.g. they may need to reduce training in some departments that have a high staff turnover and thereby reduce business costs.

Planning: it makes it easier for managers to plan financially and brings stability to planning, as business costs such as wages can be accurately forecasted/predicted.

(B) From the figures given below calculate for 2009 the following for CES Ltd.

- (i) Net profit margin;**
- (ii) Current ratio;**
- (iii) Acid Test ratio;**
- (iv) Debt Equity ratio.**

(i) Net Profit Margin = $\frac{\text{Net Profit} \times 100}{\text{Sales}}$

$$\frac{33,750}{135,000} \times \frac{100}{1}$$

$$= 25\%$$

(ii) Current Ratio = Current Assets: Current Liabilities

$$\frac{84,500}{65,000}$$

1.3:1

(iii) Acid Test Ratio = Current Assets – Closing Stock: Current Liabilities

$$\frac{84,500 - 39,000}{65,000}$$
$$\frac{45,500}{65,000}$$

0.7:1

(iv) Debt Equity ratio = Debt: Equity/ (Ordinary share capital + Retained Earnings)

$$\frac{192,000}{300,000 + 20,000}$$
$$\frac{192,000}{320,000}$$

$$= 0.6 : 1$$

(C) Analyse the significance of the trends over the two years for the following stakeholders:

(i) Investors/ Shareholders;

(ii) Suppliers;

(iii) Employees.

(i) Investors/Shareholders

Potential investors will be interested to see whether it is worthwhile investing money into the business. They will have particular interest the **debt: equity ratio**. This will give investors an indication of how highly / lowly geared the business is.

In this case the business had a lower debt to equity capital in 2008 (**0.4:1**) compared to 2009 (**0.6:1**).

Potential investors may be concerned that the business has increased long term debt with high interest payments.

Existing shareholders/Investors will be interested in the **Net Profit Margin**. The higher the percentage the better. Dividends payable depend on the net profit figure of the business. In this situation Investors/Shareholders may not be satisfied as there was a drop of 7% from 2008(32%) to 2009(25%).

(ii) Suppliers

Suppliers who have supplied goods on credit to the CES.Ltd will be interested in the businesses ability to pay for the goods. They will have particular interest in the liquidity ratios (Current ratio and Acid test ratio). **The Current ratio** will give them an idea of the businesses ability to pay its current liabilities out of its current assets. This business in 2008 had a very healthy level of working capital. It had €2 available to pay for every €1 liabilities. Maintaining this healthy working capital is essential to a businesses' cash flow. However, this was not the case in 2009 with only €1.30 available to pay for every €1 liabilities.

The Acid test ratio indicates a businesses ability to raise cash immediately to pay for its current liabilities. Suppliers will be interested in whether this business can pay back its debts immediately, if needed. In 2008 the business had €1.10 available immediately to pay for every €1 it owed. The situation deteriorated in 2009 with the business only having 70c available to pay for every €1 it owes. Failure to improve on this will result in the business having difficulty in buying goods on credit in the future.

(iii) Employees

The employees wish to know how secure their jobs are and the likelihood of them being able to negotiate a pay increase. They would be very interested in the **profitability** of the business. The drop in the NPM% diminishes their chances of obtaining a pay increase. Management could be looking at ways to reduce the wages bill.

Profitability would be of great concern to an employee if they own shares in the business, as they would be interested in the amount of dividend being paid out. Dividends payable depend on the net profit of the company. In this situation the business is not as profitable in 2009 as it was in 2008 with a drop of 7% in the Net profit percentage.

Question 8

	2006	2007
Long Term Loans	300,000	364,000
Ordinary Share Capital	450,000	450,000
Retained Earnings	50,000	70,000

The Debt Equity Ratio provides an indication of the financial structure/gearing of the business. The debt equity ratio is calculated as follows:

Formula Debt Capital: Equity Capital

	2006	2007
Debt/Equity Ratio	300,000: 500,000 0.6:1	364,000 :520,000 0.7:1

- (ii) **Comment on the significance of the trend in the Debt/Equity ratio over the two years for the existing shareholders.**

The Debt Equity ratio in 2006 was 0.6:1 while the Debt Equity Ratio for 2007 has increased to 0.7:1. This may be a worrying trend for the existing shareholders.

Significance of the trend for existing shareholders:

- Higher interest repayments may reduce profits.
- Where profit levels are falling, the payment of dividends to ordinary shareholders will be adversely affected
- Reduction in dividends may lead ordinary shareholders to sell shares – the increased supply of shares on the market will reduce the market price of shares
- In a period of high profitability a deterioration in the debt equity ratio may result in a higher return to shareholders , if interest charges are lower than the Return on Investment

Question 9

7. Debt/Equity ratio (calculate)

2004	2005
<u>270,000</u>	<u>140,000</u>
320,000 + 40,000	420,000 + 30,000
<u>270,000</u>	<u>140,000</u>
360,000	450,000
0.75 : 1	0.31 : 1

Improving ✓.

One possible relevant reason required.

Question 10

(B) (i) Gross Profit Margin, Net Profit Margin and Return on Investment (calculate)

Profitability	2004	2005
Gross Profit Margin GP / Sales	$100,000/400,000 \times 100 = 25\%$	$120,000/500,000 \times 100 = 24\%$
Net Profit Margin NP/ Sales	$60,000/400,000 \times 100 = 15\%$	$70,000/500,000 \times 100 = 14\%$
Return on Investment NP / Cap. Employed	$60,000/600,000 \times 100 = 10\%$	$70,000/650,000 \times 100 = 10.76\%$

(ii) Profitability trends and use by shareholders in making decisions (analyse and discuss)
Development of issues required

Question 11

8	3 + 3 + 1 + 3 marks
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8. Asset Test Ratio

Current Assets – Stock/Current Liabilities

2004	2003
$(90,000 - 20,000)/60,000$	$(85,000 - 25,000)/40,000$
7 : 6	6 : 4
1.17 : 1	1.5 : 1

Improving/disimproving
Debtors increased
Bank overdraft Increased
Creditors increased.

Question 12

6.	4 + 6 (3 + 3) marks
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6. Debt Equity Ratio: To examine the relationship between the equity capital of an enterprise and its loan capital (fixed interest securities) (relative amounts). The gearing.
High loans equal high interest to be paid out of profit therefore less for distribution.

Calculations / 2003:

100,000 : 75,000

1.33 : 1

The level of Debt to Equity is relatively high. Access to raising more funds may not be readily available in the future.

Question 13

Question 6 (A) (i) and (ii) The benefit for the good financial management of a business of the Profit and Loss account and The Balance Sheet.

(i) *The Trading Section:* All businesses have a trading section which is made up of:

- All the sales, both cash and credit.
- The costs of sales, including all the costs incurred directly in producing the goods, e.g. direct labour and materials is deducted from the total sales figure.
- Sales minus the cost of sales is the gross profit of the business.

The Profit and Loss Section: All the expenses or overheads of the business are deducted from the gross profit figure to arrive at the net profit figure before taxation:

- The expenses include selling, administration and financial outlays, e.g. the labour costs for selling or clerical functions will appear here. Bad debts are an expense.
- The net profit figure before taxation is then distributed. The Revenue Commissioners receive the taxation charge. The shareholders receive their dividend. The enterprise retains some of the profit to allow for development in the future.
- The part of the profit that is retained is added to the balance of unappropriated profits retained from previous years and accumulated. This accumulated figure is the balance of retained earnings. It is sometimes referred to as a 'revenue reserve' or 'profit and loss account balance' or the 'ploughed back profits balance'.

(ii) *Balance Sheet Section:* A balance sheet is a financial statement of an enterprise on a particular date. It includes the value of assets and liabilities of the business at that point in time:

- The assets and liabilities are set out in a particular agreed format. It shows where the money invested in the business has come from and where and on what it has been spent.
- All balance sheets show the following details: Fixed Assets are items of value to the business, which are purchased to be retained and used by the business over extensive periods of time.
- Current Assets are items of value to the business but generally speaking they would be held for less than one year eg. stock, debts and cash or bank balances..
- Current Liabilities are amounts the business owes and are due to be paid in the immediate future, generally within one year. Examples include: trade creditors, bank overdrafts, amounts owed to the revenue, accrued expenses.
- Capital Employed is the money invested in the business by the owners of the business and/or bankers. It is the long term capital of the business and is made up of issued shares, profit and loss account balances (revenue reserves) and long term loans.
- The revenue reserves are the undistributed profits accumulated over the years out of the profits made and put aside by the business for future plans, e.g. expansion, takeovers.

(B) (i) The profitability and liquidity trends in Calty Construction and Co. Ltd.

Profitability	2002	2003
GPMGP / Sales	$45,150/169,500 \times 100 = 26.64\%$	$40,950/157,500 \times 100 = 26\%$
NPMNP/ Sales	$15,100/169,500 \times 100 = 8.9 \%$	$12,285/157,500 \times 100 = 7.8\%$
ROINP / Cap. Emp	$15,100/120,000 \times 100 = 12.58\%$	$12,285/126,000 \times 100 = 9.75\%$

Liquidity

Working Capital CA : CL $15,900 : 8,100 = 1.96 : 1$ $16,800 : 7,400 = 2.27 : 1$

Acid Test Ratio CA - Stock : CL

$(15,900 - 9100) 6,800 : 8,100 = 1 : 1.19$ $(16,800 - 12,400) 4,400 : 7,400 = 1 : 1.68$

(ii) How trends might be improved

GPM went from 26.64% to 26%. Margins steady. Sales and Gross Profit both reducing.

Direct Expenses under control.

The NPM went down from 8.9 % to 7.8%. This reflects the reducing Sales and Gross Profit figures.

Expenses increasing: need control. Examine closely for possible savings or unusual unnecessary increases.

The ROI went down from 12.58% to 9.75%. Changed by 2.83% downwards. Compare to industry average and prevailing interest rates. Reduced profit levels but increased Capital Employed. Why?

The WCR went from: 1.96 : 1 to 2.27 : 1 Creditors increasing. Slow payment - Why? Not collecting debts? Stock levels/Control

ATR went from 1 : 1.19 to 1 : 1.68. Creditors and Bank overdraft going up ? Control. Stock levels/Control

ATR A dis-improvement over the year. There is less chance of the business being able to pay debts as they fall due for payment. While current assets have increased and current liability levels have reduced, the level and cost of stocks being held has increased. There is a danger of obsolescence and increased costs for storage and insurance etc.