1. Analyse the accounts and investments statistics of OSU PLC and comment on the financial structure and current position of the company?

Answer

Ratio analysis is an important tool of financial analysis. The absolute accounting figures do not provide any meaningful information for the purposes of analysis of financial performance and financial position of the firm. But when two relevant accounting figures are co-related, this gives some meaningful understanding with regard to financial performance.

Profitability ratio:

These ratios are designed to highlight the end results of the business activity. They measure the operating efficiency or profit earning capacity of the company.

$$\text{Net operating profit ratio} = \frac{\text{net operating profit}}{\text{sales}} * 100$$

2000	**2001**	**2002**
185/1600*100 = 11.56%	190/1800*100= 10.55%	150/1775*100= 8.45%

Operating ratio = cost of goods sold + operating expenses/sale *100

2000	**2001**	**2002**
1415/1600*100= 88.43	1 610/1800*100= 89.44	1625/1775*100= 91.55

Comments:

As per calculations net profit ratio is falling every year and this declining trend is showing companies less capacity too bear any fall in sales it may happen also due to expenses related to

sales have been increasing also the operating ratio is increasing. As per the investment statistics of the osu plc share price is falling i.e. From rs.230/- in year 2001 to rs.85/- in year 2002.low share price means less credit worthiness of the company in the market and again it will lead to less investment in shares, less availability of funds, more of borrowed funds, more risk involved in business. So current status of the company is more risk involved, as debts are more than the shareholders funds. And also liquidity position is also not so good, net profit is decreasing, working capital is nil, and costs are increasing. So company is facing financial distress.

2. Liquidity ratios:

These ratios measure the ability of the firm to meets it short term obligations and reflect the short-term financial strength. It indicates the capacity of the business to pay its current liabilities as when they fall due for payment.

$$\text{Current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

2000	**2001**	**2002**
417/505=0.83	430/611=0.70	500/623=0.80

$$\text{Quick ratio} = \frac{\text{quick assets}}{\text{current liabilities}}$$

2000	**2001**	**2002**
152/505= 0.30	153/611= 0.25	215/623= 0.34

Comments:

Low current ratio shows poor liquidity position and short term solvency of the company because it is below the ideal current ratio i.e. 2:1 as the quick ratio is less than 1:1 it indicates that inventory level is high or bank credit is low.

Capital structure ratio:

These are calculated to know the long-term financial position of the company. They measure the contribution of financing by owners compared with the financing provided by outsiders.

Debt-equity ratio = long term borrowings/equity

2000	2001	2002
300/200=1.50	232/200=1.16	197/200=0.98

Fixed assets ratio = fixed assets/long term funds

2000	2001	2002
743/1093=0.68	811/1052=0.77	850/1042=0.81

Comments:

Normally debt equity ratio of 2:1 is considered satisfactory. Higher the owner's contribution, lower will be the financial risk and vice versa. But in this case shareholders fund are less than the long-term liabilities so there is more risk involved. The ratio should always be less than 1 and 0.67 is considered satisfactory.

Turnover ratio:

These ratios are intended to measure the effectiveness of the employment of resources i.e. they evaluate the efficiency with which the firm manages and utilises its assets. The greater the turnover, the more efficient the utilisation or management of the assets.

Capital turnover ratio = $\frac{\textbf{sales}}{\textbf{capital employed}}$

2000	**2001**	**2002**
1600/1093= 1.46	1800/1052= 1.71	1775/1042= 1.70

Sales to fixed assets = sales/net fixed assets

2000	**2001**	**2002**
1600/743= 2.15	1800/811= 2.21	1775/850= 2.08

working capital ratio = $\frac{\textbf{sales}}{\textbf{working capital}}$

2000	**2001**	**2002**
1600/-88 =-18.18	1800/-181 =-9.90	1775/-123 =-14.43

Debtors turnover ratio = $\frac{\textbf{net receivables}}{\textbf{net sales}}$ *** 100**

2000	**2001**	**2002**
68/1600*100= 4.25%	75/1800*100= 4.16%	95/1775*100= 5.35%

Collection period = 360/4.25 360/4.16 360/5.35 85 days 86 d ays 67 days.

Comments:

As, the **capital turnover ratio** of OSU Plc is showing an increasing trend, it indicates that the company capital is generating higher sales but in the year 2002 sale is slightly reduced according to **sales to fixed assets ratio**. In year 2001 its increasing trend shows that fixed assets are being used effectively and then in 2002 it shows the decline in ratio. In the case of working capital its negative part shows its inefficient use because quantum of working capital should decline or increase in proportion to sales. But the negative relation ship is showing no working capital (current liabilities are more than current assets). In case of debtors the higher ratio will show better credit policy of the company and debt collection period will also decrease. The year 2002 indicates that the company debts are collected after an average of 67 days that shows the debts are collected within reasonable period.

2) Indicate and comment on four items not contained in the accounts which are infl uential in financial decision-making.

Answer

Accounting is a language of business. It communicates the financial performance and position of enterprise. Its main objective is to

Determine the results of operations during the period,
Determine the financial position,
Maintaining control over assets,
Planning in respect of cash and providing information.
There is a need to disclose all information affecting the business to know the true and fare view of the business. American accounting association that treated accounting as gives a widely accepted definition

"*The process of identifying, measuring and communicating information to permit judgement and decisions by the users of accounts*"

(Source: management accounting by B.M.aggarwal; edition 2000)

It is expected that the accounting system should generate information to meet the requirements of both the internal management and the external users. Various users groups may have diversified interest either contradictory or complementary, but it is not possible to provide information separately to all such users group. Thus a general-purpose financial statement is provided to all the users. So to make the message contained in the financial statement clear and meaningful these are drawn up according to some conventions.

But in the case of this company accounts some more items should have
Been presented which are influential in final decision-making, which are as
Follows:

1. **Disclosure of policies**: the view presented in the financial statement of an enterprise of its state of affairs and of the profit or loss can be significantly effected by the accounting policies followed in the preparation and presentation of the financial statements. The accounting policies followed vary from company to company but disclosure is necessary if the view presented is to be properly appreciated. Law in some cases requires the disclosure of sum accounting policies followed.

The accounting policies referred to the specific accounting principles and the methods of applying those principles adopted by the company in the preparation and presentation of the financial statements. There is no single list of the accounting policies, which are applicable to all circumstances. The differing circumstances in which enterprise operates in a situation of diverse and complex economic activity make alternative accounting principal and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods calls for considerable judgement by the management of the enterprise.

The following are some of the examples of the areas in which different
Accounting policies may be adopted by different enterprises.

- Methods of deprecation
- Valuation of inventories
- Treatment of goodwill
- Valuation of investments
- Conversion of foreign currency items
- Valuation of fixed assets
- Treatment of contingent liabilities

The primary consideration in the selection of accounting policies is that the financial statement should represent a true and fare view of the state of affairs of the company as at balance sheet date.

2. **Non-cash transactions:** many investing and financing activities do not have a direct impact on current cash flows although they do effect the capital and assets structure of the enterprise. The exclusion of non-cash transaction from the cash flow statements is consistent with the objective of a cash flow statement, as these items do not involve cash flows in the current period. For examples non-cash transactions are:

A) The acquisition of assets by assuming directly related liabilities
B) Acquisition of a company by means of issue of shares
C) The conversion of debt to equity

Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement such transactions should be disclosed elsewhere in the financial statements in a way that provides all relevant information about these investing and financing activities.

3. **Contingencies and events occurring after the balance sheet date:** A contingency is a condition or a situation, the ultimate out come of Which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events. Events occurring after the balance sheet dates are those significant events, both favourable and unfavourable that occur between the balance sheet date and the date on which the board of directors approves financial statements. The amount of contingent loss should be provided for by a charge in the statement of profit and loss if:

A) If it is probable that further events will confirm that an assets have been impaired or a liability has been incurred as on the balance sheet date.
B) A reasonable estimate of the amount of the resulting loss can be made. Disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments effecting the financial position of the company.

If the disclosure is required than the information should be provided regarding the nature of contingencies, uncertainties that may affect future out come and the estimate of the financial effect.

4. **Accounting for fixed assets:** fixed assets is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.

A) The gross book value of a fixed asset should be historical cost or a revaluation.

The cost of fixed assets should comprise its purchase price and attributable cost of bringing the asset to its working conditions.

C) Subsequent expenditure related to an item of fixed asset should be added

To its book value only if they increase the future benefits.

D) Fixed assets should be eliminated from the financial statements on disposal or when no other benefits are expected from its use and disposal.

E) When a fixed asset is revaluating, an entire class of asset should be revaluated or the selection of assets for its revaluation should be made on a systematic basis. This basis should be disclosed.

F) An increase in the net book value arising on revaluation of fixed assets should be credited directly to owner's interest under the head of revaluation reserved. These items are important and not contained in the accounts and which are influential in financial decision-making.

3) Drawing from the theories underpinning dividend to support your arguments, examine the effects of the pattern of dividend payments by Osu Plc over the past three years?

Answer

The basic Dividend Theories are:

Traditional View:

Dividend policy is important for shareholders. Shareholder might prefer to receive its benefit today rather than to have it reinvested in the business even though it might yield in the future benefits or dividend.

The reason behind this is the certainty of future dividend is less.

Dividend Irrelevancy:

Nothing that the company does in the way of paying or not paying a dividend has any effect upon the shareholders' wealth. There is no optimal dividend policy and that the reason that manager need not worry to find it.

This means shareholders wealth is the regardless of the decision the company makes about dividend.

Dividend signalling theory:

An unexpected change in dividend is regarded as a sign of how the director views the future earning prospects of firm.

Generally, arise in dividend payment is viewed as positive signal, conveying positive in formations about the firms future prospects resulting in the rise in share price.

Conversely reduction in dividend payment is viewed as negative signal, resulting in decrease in share price.

The bird-in the-hand theory — (Lintner, 1962; Gordon, 1963)

Shareholders are risk averse. They prefer to receive dividend at present then in future because present dividends are actual cash. The latter is based on future dividend, which is yet to be received. Gordon contended that the payment of current dividends resolves investor.

(Source: Module Handbook)

Dividend Policy of OSU Plc

Dividend policy play an important in the financial dividends and share holders are the one who are liable to get benefits from it, so it's important that dividend should favour to them. To structure and distribute dividends among the shareholders efficiently, company has some related policies known as dividend policy.

The most important point is that what ever is the market situation and in that situation whether company is going in lose or profit but it would never put shareholders in lose. Shareholders are take part in profit only and ratio of amount given to them would always proportionate according to number of shares.

In OSU Plc price of share is slashed and as per proportionality between share and dividend, dividend price is also decreased.

(Millions of pound sterling)

Year	Profit	Dividend	Percentage
2000	141	47	33.33
2001	145	50	34.50
2002	90	30	33.33

(source: case study)

Capital value of OSU Plc is fell down during end 2001 to end 2002 accounting year from £1500 m to £573 m. In the year 2000 and 2001 the price of the share was £175 and £230 but in 2003 it was fall down. Because of the decrease in price of share, shareholders had affected much and as I mentioned above it is proportionate to dividend so dividend also went down. The rate of dividend is not calculated for last three years.

In OSU plc in past three years they not revalue the dividend. Even there is profit or loss in the company they should revalue the dividend. Shareholders should get more benefits from the company even there is loss it will compensate. Shareholders are most important to the company. They are also the part of the company. The ratio of dividend should increase in every year.

The company should attract the shareholders by the dividend and the bonus of shares. When there is more profit on the particular year the company will declare the bonus of shares it will be benefit to the shareholders. If the dividend is less and the shareholders are risk is high they will be getting the future capital gains in the form of bonus.

4. The possible difficulties that might be experienced when trying to calculate the WACC from the information given in OSU PLC:

Answer:

A calculation of a firm's cost of capital that weights each category of capital proportionately. Included in the WACC calculation is all capital sources including common stock, preferred stock, bonds, and any other long-term debt.

WACC is calculated by multiplying the cost of each capital component by its proportional weighting and then summing:

WACC= E/V x Re + D/V x Rd x (1-Tc)

Where:
Re = cost of equity
Rd = cost of debt
E = the market value of the firm's equity
D = the market value of the firm's debt
V = E + D
E/V = percentage of financing that is equity
D/V = percentage of financing that is debt
Tc = the corporate tax rate

Source: http://www.investopedia.com/terms/w/wacc.asp

In the case study the financial statements have the insufficient items for calculating WACC. As per data given in the case, I can not calculate WACC because of insufficient data. It have Equity market value, tax and Total Market value but there is no information given for about Equity required rate. We can also notice that there is no specific information is given for Debt for example Debt market value, Debt required rate.

So it is not possible to calculate the WACC for OSU PLC, with the insufficient items which are required for calculations.

5) What is the NPV of the project and what is your decision on whether to proceed with investment.

Answer

An approach used in capital budgeting where the present value of cash inflow is subtracted from the present value of cash outflows.
Source: http://www.investopedia.com/terms/n/npv.asp

The NPV is calculated as the present value of the project's cash inflows minus the present value of the project's cash outflows. This relationship is expressed by the following formula:

$$NPV = \sum_{t=0}^{T} \frac{CF_t}{(1+r)^t} = CF_0 + \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \dots + \frac{CF_T}{(1+r)^T}$$

where

- CF_t = the cash flow at time t and
- r = the cost of capital.

Source: http://www.prenhall.com/divisions/bp/app/cfldemo/CB/NetPresentValue.html

NPV OF THE OSU Plc:

Payments	-	475,000	489,250	503,928	519,046	534,617
Net Cash Flow	(2 000,000)	475,000	517,750	536,492	612,419	664,736
Disc. Rate(14%)	1	0.8772	0.7695	0.675	0.5921	0.5194
Present Value	(2 000,000)	416,670	398,409	380,357	362,613	345,264
NPV	-96,687					

In the decision making tools like calculating of NPV we only include the cost which can affect future decision as our cost turned out to be negative so I recommend that OSU PLC should not carry on with the project which they are planning. Otherwise it will be impossible to recover money within five years as per calculations of NPV.

6) What are the main disadvantages of debt financing compared to equity financing?

Answer

Capital structure of a business consists of long-term funds, which are not repayable in the short run, and short-term funds, which are repayable in the short run.

Long-term funds are: -

Funds from equity shares

Funds from debts

Funds from equity shares or equity financing - equity means shareholders funds that consist of equity and preference share capital and reserves minus losses and fictitious assets.

Funds from debts or debt financing: - debt financing as per guidelines is debt that means all term loans, debentures and bonds with an initial maturity period of 5 years or more including interest accused thereon. It also includes all deferred payments but it does not include short-term bank borrowings and advances, unsecured deposits or loans from public, shareholders and employees and unsecured loans or deposits from others. It should also include the proposed debenture issue.

Main disadvantages of debt financing compared to equity financing:

Higher the debt fund used in the capital structure, greater is the risk. This risk is technically called financial risk. Since business income fluctuates over the time for many reasons, both internal and external, such income volatility can cause risk, since in the year of low income, the business may not be able to make payment of interest to suppliers of loan funds.

As long as rate of interest is lower than the return on capital employed, the return to equity fund will be more than the return on capital employed. But when average interest rate will be above the return on capital employed it will cause disadvantages. So use of debt in the capital structure will act either in favour or against the equity.

The interest payment is compulsory for the finance raised in the form of debt. But in case of equity financing the balance of profit after appropriating dividend to preference share may be distributed as dividend to equity shareholders. Equity serves as the protector for out side liabilities. If the company goes into liquidation firstly the losses have to be met by equity, the outside liabilities have to bear the loss only if the amount of loss is more than equity. Hence stronger the equity safer the outside liabilities. Higher the debt greater is the risk.

Source: Financial Management by Peter Atrill

7) Who bears the financial risk and what would be the effects on OSU Plc in the event of bankruptcy or financial distress? Give reasons

In a company higher the debt fund used in the capital structure, Greater is the risk. This risk is technically called financial risk. Since Business Income fluctuates over the time for many reasons, both internal and External, such income volatility can cause risk, since in the year of low income the business may not be able to make payment of interest to Suppliers of loan funds. So shareholders also called the owners of the company bears the financial risk all the time. The court may wind OSU Plc if it is bankrupt. The test is whether the company has reached the state where it is commercially insolvent- i.e. to say that its existing and probable assets would be insufficient to meet the existing liabilities. Commercial insolvent means unable to pay debts or liabilities as they arise in the ordinary course of business. After all the winding of a company is a drastic remedy which may have far reaching consequences such as financial and commercial, and also consequences effecting not only the company but person who have been concerned with the conduct of its affairs. In that case the court should act with caution in exercising its discretionary jurisdiction. Once the court makes an order for the winding up of the company, its consequences date back to the commencement of winding up. The other consequences of winding up by the court are as follows:

Intimation to official liquidator and registrar:

Where the court makes an order for the winding up of the company it shall forthwith cause intimation to be sent to the official liquidator and registrar of the order of winding up.

Copy of winding up order to be filed with registrar:

On the making of winding of order, it shall be the duty of the petitioner of the company to file with the registrar within 30 days of certified copy of the order.

Order of winding up deemed to be notice of discharge:

The order for winding up shall be deemed to be notice of discharge to the officers and employees of the company. Whereas the servant of the company is on contract basis on a fixed term and the term has not expired. The order operates as a wrongful discharge and the damages are allowed for breach of contract of service.

Suits stayed:

When the winding up order has been made, no suit or other legal proceedings shall be commenced against the company except by the leave of the court. Similarly pending suits shall not be preceded apart from leave of court.

Powers of court:

The court, which is winding up the company, shall have Jurisdiction to entertain or dispose of

Any sue or proceedings by or against the company.

Any claim made by or against the company.

Any application made for compromise with creditors and /or members.

Any question of priorities or any other question what so ever, whether Of Law oe fact, which may relate to arise in course of the winding up of The Company

Effect of winding up order:

An order of winding up the company shall operate in favour of all the creditors and of all the contributories of the company as if it had been made on the joint petition of a creditor and a contributory.

Official liquidator to be liquidator:

On the winding up order being made in respect of the company, the official liquidator shall, by virtue of his office become the liquidator of the company.

Bibliography

1. Management accounting by b.m.aggarwal; edition 2000
2. Management accounting by Peter Atrill; 2nd edition
3. Refer tutor handouts
4. Business Finance by EJ McLancy; 4th edition