

Note: Higher level questions are marked with an asterisk*

3. Monk Ltd

a)

Option 1 Debenture interest : £300,000 x 6% = £18,000.

Option 2 Debenture interest : £600,000 x 8% = £48,000.

b)

	Option 1	Option 2
First year	£	£
Profit	55,000	55,000
Debenture interest	18,000	48,000
Profits available to ordinary shareholders	<u>37,000</u>	<u>7,000</u>

	Option 1	Option 2
Second year	£	£
Profit	130,000	130,000
Debenture interest	18,000	48,000
Profits available to ordinary shareholders	<u>112,000</u>	<u>82,000</u>

Carey & Knowles: Accounting - A Smart Approach
Chapter 5 - Company Finance
Solutions to practice questions

shareholders		
---------------------	--	--

c)

	Option 1	Option 2
First year	£	£
Profits available to ordinary shareholders	37,000	7,000
Number of ordinary shares	70,000	40,000
Profit per share	<u>52.9 pence</u>	<u>17.5 pence</u>

	Option 1	Option 2
Second year	£	£
Profits available to ordinary shareholders	112,000	82,000
Number of ordinary shares	70,000	40,000
Profit per share	<u>160 pence</u>	<u>205 pence</u>

d) Factors Chris should consider:

- Chris should be made aware that the interest payments would have to be made each year.
- Option 2 would be riskier than option 1, as it involves taking on a much higher level of debt and, as a result, a much higher interest obligation. In the first year when expected profits are £55,000, option 2 would leave the company with only £7,000 left after interest obligations have been met. If profits were to fall below the expected level, the business would still have to meet those interest obligations. There would be the risk that it might struggle to do so.
- Option 1 would be a less risky option as the interest obligations are significantly lower.

The disadvantage of option 1 is that it leads to a greater number of shareholders invested in the business and, as a result, future profits will be spread across a greater number of shares. This can be seen in year 2 when the profit per share is higher under that option as a result of the smaller number of shares in issue.

- If Chris is going to hold a certain number of the ordinary shares, then he will end up with a higher proportion of the share capital in option 2, where fewer ordinary shares will be issued. Depending on how many ordinary shares he intends to buy, this might mean that he has control of the voting shares.

4. Shiver Ltd

a) **Advantages of raising venture capital:**

- Often the venture capitalists will invest a significant sum and will usually do so in exchange for equity in the company.

- The venture capitalists will usually expect to have a representative on the board of directors. This new board member should bring wider expertise to the board.

Disadvantages of raising venture capital:

- Because the venture capital investment is often made in the form of equity, Bill's 60% shareholding in the company will fall and he will lose overall control of Shiver Ltd if his holding falls below 50%.
- The venture capitalist's board representative may prove to be a possible source for conflict as it is possible that the VC board member may have different ambitions for the business from the rest of the board.
- The venture capitalists would expect to receive regular briefings from Bill and other members of the management team on how the company is performing. This could prove onerous and time-consuming.

b) Advantages of raising a long-term loan

- Raising a loan will bring funds into the company.
- Raising funds by way of a loan means that Bill's stake in the company will not be reduced. He will continue to hold a majority of the ordinary shares.

Disadvantages of raising a long-term loan:

- Once a long-term loan has been received, the company will have

to meet its interest obligations on the loan. Unlike shares, whereby a company can opt not to pay dividends, interest is an obligation the company will need to meet.

- Loans are often repayable, and the company would need to ensure that it was able to fund the repayment when due.
- c) Security on a loan is where an asset or assets are given as collateral or backing for the loan. If the interest and capital repayments become overdue, then it will usually be possible for the secured assets to be used to repay the lender.
- d) Another possible source of funding would be any retained profits the company makes. Less likely would be an issue of ordinary or preference shares to new or existing shareholders.

***5. Asif**

- a) Limited liability means that the liability of the shareholders is limited to the amount they have invested in the company. If the company fails, then the shareholders' own assets will be safe should the company be unable to meet its obligations.
- b) Two possible advantages of forming a limited company are:
- the possibility of raising extra funding
 - the limited liability provided to shareholders.

c) A €500,000 loan would need to be raised and, as interest is payable at 6%, the annual interest obligation = €500,000 x 6% = €30,000.

d)

	Year 1 €	Year 2 €	Year 3 €	Year 4 €
Profit before interest	30,000	42,000	65,000	88,000
Interest	30,000	30,000	30,000	30,000
Profit available to ordinary shareholders	Nil	12,000	35,000	58,000
Number of ordinary shares	400,000	400,000	400,000	400,000
Profit per share	Nil	3 pence	8.8 pence	14.5 pence

e) If Asif forms the business into a limited company and raises the funds by way of €400k of share capital and €500k of debt, the workings in part (d) show how variable the returns available to the ordinary shareholders would be.

The company needs to be confident that it can always meet its interest obligations and, in the first year, the forecast profits will just cover the interest due. This will be an uncomfortable position for the company to be in and, even in the second year, the vast majority of the profits made will be needed to cover interest payable. In years 3 and 4 when profits rise, then the company will be able to easily cover its interest obligations and have profits available for ordinary shareholders.

Based on the above analysis, it would be advisable for Asif to raise more of the funding required from the share issue and less by way of a loan.

***6. Toybin plc**

a) Points that could be made include:

- Ordinary shares do not carry a fixed rate of dividend whereas preference shares do.
- Dividends on preference shares are usually cumulative whereas ordinary dividends are not.
- Preference shareholders would be repaid before ordinary shareholders in the event that the company is wound up.
- Preference shareholders are not entitled to vote at company meetings whereas ordinary shareholders can vote.

b) Points which could be made include:

- Debenture holders make a loan to the company whereas preference shareholders are part of the ownership of the business.
- Debenture interest has to be paid whereas preference dividends do not have to be paid.
- Debentures are usually secured on assets of the company whereas preference shareholders have no such security.

- c)** The ordinary dividend per share paid for the year ended 31 December 2022

$$= 232,000 / 4,000,000 = 5.8 \text{ pence.}$$

- d)** The preference dividend per share paid for the year ended 31 December 2022

$$= 63,000 / 1,400,000 = 4.5 \text{ pence.}$$

- e)** The ordinary dividend per share paid increased by 0.5 pence.

The ordinary dividend per share paid in 2023 = $5.8 + 0.5 = 6.3$ pence.

If the total dividend paid during that year = £378,000, then the number of ordinary shares in issue = $378,000 / 0.063 = 6,000,000$ shares.

In January 2023 when the share issue was made, 2 million ordinary shares must have been issued.

- f)** The debentures attract interest at the rate of $300,000 / 6,000,000 \times 100 = 5\%$