

QUESTION:

Alpha Limited and Beta Limited are two companies that operate in the same business sector. An examination of the companies most recent financial results have revealed the following:

BALANCE SHEET

	Alpha	Beta
Net Assets	1,200,000 =====	1,600,000 =====
Financed by:		
Share Capital	100,000	100,000
Reserves	700,000	300,000
Long Term Borrowings	<u>400,000</u>	<u>1,200,000</u>
	<u>1,200,000</u>	<u>1,600,000</u>

PROFIT AND LOSS ACCOUNT:

Profit before financial charges	210,000	280,000
Financial charges - Loan Interest	<u>28,000</u>	<u>84,000</u>
Profit before taxation	182,000	196,000
Taxation	<u>27,000</u>	<u>29,000</u>
Profit after taxation	<u>155,000</u>	<u>167,000</u>

a. Compute for each company:

- The Gearing Ratio (5 marks)
- Times Interest Covered (5 marks)
- Earnings per share. (5 marks)

b. Comment on the risk-return factor in high gearing making reference to your calculations at a. (10 marks)

Total 25 marks.

A. Ratio computations

RATIO	FORMULA	ALPHA	BETA
GEARING RATIO	$(\text{DEBT}/\text{DEBT}+\text{EQUITY})\%$	400K/1200K=.33 OR 33%	1200K/1600K=.75 OR 75%
INTEREST COVER	PBIT/INTEREST	210K/28K=7.5 TIMES	280K/84K=3.33 TIMES
EPS	PROFIT AFTER TAX/NO.SHARES	155K/100K=1.55 OR 155 CENT	167K/100K=1.67 OR 167 CENT

B. RISK RETURN FACTOR:

Should a company make use of debt finance rather than share capital, then the return to the fewer shareholders arises where the funds borrowed are used to earn a rate of return significantly in excess of interest cost. Beta is highly geared. Its profit is similar to Alpha but with fewer shareholders, the EPS computes higher than Alpha.

The risk from high gearing arises where the rate of return on borrowed funds are not sufficient to cover interest costs. This is reflected by reduced interest cover and/or negligible EPS. Beta is more highly geared than Alpha and this is reflected in the significantly lower interest cover of 3.33. Though the rate of return is in excess of interest cost, Beta would be exposed should interest rates rise and profitability falls.