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ACCA F9

Financial Management (FM)

财务管理

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1. Gearing
2. Effect on shareholder wealth
3. Finance for small and medium-sized entities

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Gearing

Gearing is the amount of debt finance a company uses relative to its equity finance.

Gearing reflects the financial risk of the company——the higher the debt finance, the higher the financial risk of the company.

Debt finance tends to be relatively low risk for the debtholder as it is interest-bearing and can be secured. The cost of debt to the company is therefore relatively low.

Financial gearing measures the relationship between shareholders' funds (equity) and prior charge capital.

Operational gearing measures the relationship between contribution and profit before interest and tax. It indicates the degree to which an organization's profits are made up of variable (as opposed to fixed) costs.

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Gearing

Financial risk can be seen from different points of view.

(a) Ordinary shareholders

Higher levels of financial gearing increase the variability of after-tax profits and earnings per share. Greater variability in returns to equity shareholders means greater financial risk.

(b) The company as a whole

If a company builds up debts that it cannot pay when they fall due, it will be forced into liquidation.

(c) Suppliers / lenders

If a company cannot pay its debts, the company will go into liquidation owing suppliers money that they are unlikely to recover in full.

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Gearing

Financial Gearing ratios

The financial risk of a company's capital structure can be measured by a gearing ratio.

- **Debt ratio=Total debts : Total assets**
- **Debt/Equity ratio**
- **Interest cover=PBIT : interest**

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Gearing

Operating gearing ratio

Operational gearing = Contribution : Profit before interest and tax

Contribution is sales minus variable cost of sales.

- **If contribution is high but PBIT is low** , the company has a high proportion of fixed costs, which are only just covered by contribution. Business risk, as measured by operational gearing, will be high.
- **If contribution is not much bigger than PBIT** , the company has a low proportion of fixed costs, which are fairly easily covered by contribution. Business risk, as measured by operational gearing, will be low.

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Gearing

One determinant of the suitability of the gearing mix is the stability of the company. It may seem obvious, but it is worth stressing that debt financing will be more appropriate when:

- The company is in a healthy competitive position
- Cash flows and earnings are stable
- Profit margins are reasonable
- Operational gearing is low (ie the fixed costs that have to be covered by profits from trading activities are low)
- The bulk of the company's assets are tangible
- The liquidity and cash flow position is strong
- The debt-equity ratio is low
- Share prices are low

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Effect on Shareholder Wealth

A company will only be able to raise finance if investors think the returns they can expect are satisfactory in view of the risks they are taking.

If a company can generate returns on capital in excess of the interest payable on debt, financial gearing will raise the EPS. Gearing will, however, also increase the variability of returns for shareholders and increase the chance of corporate failure.

- EPS
- PE ratio
- Dividend cover ratio
- Dividend yield

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Finance for SME

SMEs have the following characteristics:

- Firms are likely to be unquoted private companies.
- The business is owned by a few individuals, typically a family group.
- They are not micro businesses – very small businesses that act as the owners' medium for self-employment.

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Effect on Shareholder Wealth

The problems of financing SMEs:

- SMEs are restricted in their sources of new equity finance.
- SMEs therefore rely heavily on retained profits for new equity finance, but there is a limit to the amount of equity that can be obtained from this source.
- It is not easy for SMEs to attract venture capital.

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Effect on Shareholder Wealth

Potential sources of financing for SME include the following.

- Owner financing
- Overdraft financing
- Bank loans
- Trade credit
- Equity finance
- Business angel financing
- Venture capital
- Leasing
- Factoring

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Example

CTF Co has the following information relating to its ordinary shares.

Dividend cover	5
Earnings per share	150
Published dividend yield	3.75%

What is the price of CTF Co's ordinary shares?

A 30c

B 113c

C 563c

D 800c

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Example

Step 1: Calculate the dividend amount using dividend cover.

Dividend cover = EPS / Dividend per share

Dividend per share = EPS / Dividend cover = 150 / 5
= 30c per share

Step 2: Calculate the market price per share using dividend yield.

Dividend yield = Dividend per share / Ex div market price per share

Market price per share = Dividend per share / Dividend yield
= 30c / 0.0375 = 800c per share

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Thank You!