INTRODUCTION

With effect from 27 January 2020, the AAT have ‘refreshed’ both of its live and sample assessments for Cash and Treasury Management (CTRM).

The specification of the standards is unchanged, so there is no change to the content of the assessment. However there is a change in emphasis in one small area as follows:

With the changes to accounting for leases brought about by the introduction of IFRS 16, the AAT has taken the opportunity to only assess in CTRM the outline of the implications of leasing, and instead cover more of the other financing options. The distinction between operating and finance leases outlined on page 176 of the Tutorial will, therefore, no longer be relevant in a CTRM assessment. There is no additional content that is required for the CTRM Tutorial.

The revised AAT sample assessments contain the same number of tasks as previously. These tasks are presented in the same order, cover the same content and carry the same number of marks, as previously. There are, however, changes in the style of some tasks.

In the CTRM Workbook, there is one task in Practice Assessment 2 that is no longer valid based on the above policy. This is task 8 on pages 79 and 80 of the workbook, with the accompanying answer on page 124.

The following replacement task (and answer) is provided to supplement the CTRM workbook.

No changes are required to the practice assessments in the Osborne Books Tutor Zone.
Task 8
An established company currently has equity of £2 million, based on 100,000 issued ordinary shares. The company currently has long term debt of £500,000. It has no short-term debt and has never issued any preference shares.

The company requires long-term financing to complete a planned expansion. It needs a further £500,000, and is considering the following three alternatives:

- issue £500,000 of unsecured debentures to be redeemed in 10 years, paying a fixed rate of 8% interest p.a.
- issue 100,000 7% irredeemable preference shares at £5 per share
- issue 20,000 ordinary shares at £25 each including a premium

Required
(a) Calculate (to the nearest %) the current gearing ratio, and then what the gearing would be under each of the three financing options.

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(b) Identify the main implications of each financing option.

**Issue of debentures:**

**Issue of preference shares:**

**Issue of ordinary shares:**
Solution to replacement task 8 for practice assessment 2
(page 124)

Task 8

(a)  

**Current gearing:**

\[
\frac{\text{Debt}}{(\text{Debt} + \text{Equity})} = \frac{\£500,000}{(\£500,000 + \£2,000,000)} = 20\%
\]

**Gearing with issue of debentures:**

\[
\frac{\text{Debt}}{(\text{Debt} + \text{Equity})} = \frac{\£1,000,000}{(\£1,000,000 + \£2,000,000)} = 33\% \text{ (until redemption of debentures)}
\]

**Gearing with issue of preference shares:**

\[
\frac{\text{Debt}}{(\text{Debt} + \text{Equity})} = \frac{\£1,000,000}{(\£1,000,000 + \£2,000,000)} = 33\%
\]

(note that preference shares are treated as debt for gearing calculation)

**Gearing with issue of ordinary shares:**

\[
\frac{\text{Debt}}{(\text{Debt} + \text{Equity})} = \frac{\£500,000}{(\£500,000 + \£2,000,000 + \£500,000)} = 17\%
\]

(note that new ordinary shares, including share premium is treated as equity)

(b)  

**Issue of debentures:**

- Annual interest cost of £40,000 is tax deductible
- Interest is a contractual liability
- As debentures are unsecured, they may not be particularly attractive to lenders
- Gearing would increase to 33%, making future further borrowing more difficult
- The full £500,000 must be available in ten years to redeem the debentures

**Issue of preference shares:**

- Annual dividends of £35,000 are not tax deductible
- Preference share dividends must be paid before ordinary share dividends
- Preference shareholders rank before ordinary shareholders if the business were to wind up
- This would be permanent financing of the business
- Gearing would increase to 33%, making future further borrowing more difficult
Issue of ordinary shares:

- New shareholders would become part-owners of the company
- Existing shareholders would have their ownership and control of the business diluted (e.g., after the shares are issued existing 50% owners would only own approximately 42% of company)
- There is no obligation to pay dividends on ordinary shares in the future
- This would be permanent financing of the business
- Gearing would fall to 17%, making future borrowing easier