Case study – Figures in the boardroom

This is the solution to the case study found at the end of:

- Chapter 11 *Financial reporting by limited companies*

Workings:

1. Cost of sales:

Opening stock	263 404
Add: purchases	1 715 027
	1 978 431
Less: closing stock	(279 800)
	£1 698 631

2. Administrative expenses

Directors' remuneration	69 550
Other administrative expenses	386 024
	£455 574

3. Dividends proposed

150 000 shares @ 50p per share = £75 000

Note: because this amount has not yet been paid it must be included in current liabilities in the company balance sheet.

4. Tangible fixed assets

Office building at net book value	423 751
Retail units at net book value	1 744 850
Vehicles, fixtures etc. at net book value	404 470
	2 573 071

5. Other creditors

Creditor for corporation tax	158 888
Dividends payable (final proposed dividend)	75 000
	233 888

6. Reserves

Accumulated reserves at 1 January 20X5	1 788 208
Profit for the year	237 237
Accumulated reserves at 31 December 20X5	2 025 445

The draft financial statements are as follows:

Daley Limited: draft profit and loss account for the year ending 31 December 20X5

	£
Turnover	2 793 800
Cost of sales (working 1)	(1 698 631)
Gross profit	1 095 169

Selling and distribution costs	(100 470)
Administrative expenses (working 2)	(455 574)
Other operating income	29 350
Operating profit	568 475
Interest payable and similar charges	(38 850)
Profit on ordinary activities before taxation	529 625
Taxation	(158 888)
Profit on ordinary activities after taxation	370 737
Dividends:	
Paid	(58 500)
Proposed (working 3)	(75 000)
Profit for the financial year	237 237

<u>Daley Limited: draft balance sheet at 31 December 20X5</u>

	£	£
Fixed assets		
Tangible assets (working 4)		2 573 071
Current assets		
Stock	279 800	
Debtors	86 411	
Cash at bank	76 360	
	442 571	

Creditors: amounts falling due within one year		
Trade creditors	106 309	
Other creditors (working 5)	233 888	
	340 197	
Net current assets		102 374
Total assets less current liabilities		2 675 445
Creditors: amounts falling due after more than one year		(500 000)
		2 175 445
Capital and reserves		
Share capital		150 000
Reserves (working 6)		2 025 445
		2 175 445

Advice to Joe Daley

The draft accounts show that operating profit margin has dropped further this year, to 20.3% (£568 475/2 793 800 x 100), which may help to convince the other directors that radical action needs to be taken. The proposed scheme involves borrowing £200 000. At a 7% rate of interest this would increase interest charges by £14 000 per annum. The other directors need to be convinced that the proposal will increase profits by at least that much.

It seems likely from their initial response that Carol and Nasser will vote in favour of the proposal, but the other three directors appear to be very much opposed to it. It will almost certainly be very difficult to win them round. If the proposal is taken to a vote, it seems likely that it will result in an even split of 3:3. Joe can use his casting vote, but this is likely to create a great deal of ill-feeling. The three directors most involved in the company's day-to-day running will be split (Joe and Nasser voting for the motion and Gervase against), and this may create further problems.

The continuing decline in profit margins probably means that something will have to be done soon, and it may be that a radical change, such as the one proposed by Joe, is called for. However, if effective change is to be brought about, any proposal really needs the active support of most, if not all, of the directors.

What is the relevance of the individuals' shareholdings? The directors each have an equal vote on the board, but their shareholdings are not the same (this is a quite common arrangement). The individuals' shareholdings could be significant in the Annual General Meeting where shareholders vote on re-appointment of directors, because the proportion of shares held makes a difference to the voting. Suppose Gervase, Eric and Edward feel so strongly that Joe is taking the company in the wrong direction that they try to vote him off the board? (A simple majority – i.e. 50% – of votes is required to vote a director off the board). Between them they hold 49% of the shares. Provided that Carol and Nasser will vote with Joe, his position is safe (just).

It may be relevant to query Edward's and Eric's retirement arrangements. How soon will they give up taking any active part in the business? Will they pass on their shares to their children? If they were to do this, presumably Eric would transfer all of his holding to Gervase, giving him a total of 34% of the shares, and Edward would split his holding equally between his children Joe and Carol (this would leave Joe with 41.5%, Carol with 17.5% and Nasser with his existing 7%). No one individual would control the company, although Joe and his sister would control a majority of the shares).

Joe is in a very difficult position. Unless he can persuade at least one of the dissenting directors to his way of thinking, the issue is likely to split the board and may leave a residue of ill-feeling, whether or not he exercises his casting vote. He may need to think of a less radical plan to take the business forward, or accept suggestions by other directors on how to address the problem of declining profitability. In the worst case scenario, he may need to wait until he inherits sufficient shares to place him in a more secure position.

The case study illustrates a very typical family company scenario. The original founders are often very reluctant to let go of a business which they have spent their working lives building up. Their children may become impatient and may try to reduce the parents' involvement. This type of business arrangement can lead to lasting conflict and very serious consequences at both a personal and business level.

The business illustrated is a limited company, with uneven shareholdings amongst six members of the same family. Democratic arrangements for voting at board level may not reflect percentage shareholdings. Some of the directors participate more fully in business activities than others. However, it is worth reiterating that all directors are equally responsible in law.