

Management Accounting

7th Edition

- Link 10.A –
Alternative Capital Structure

We change the capital structure of VANHUIZEN BV to demonstrate the leverage effect on the performance measured as return on equity.

We assume, the financing of the company is 900,000.00 EUR equity, 1,200,000.00 EUR bank loan at a rate of interest of 5.5 %/a and 900,000.00 EUR bonds at a coupon rate of 4.5 %/a.

The interest of: $1,200,000 \times 5.5\% + 900,000 \times 4.5\% = 106,500.00$ EUR is included in the headquarters costs.

We now change the capital structure for VANHUIZEN BV: equity is 500,000.00 EUR and the bank loan is 1,600,000.00 EUR (same total). This increases the interest (before taxation) to the extent of: $1,600,000 \times 5.5\% + 900,000 \times 4.5\% - 106,500 = 22,000.00$ EUR. We apply these changes for the division comparison as disclosed in Figure 1 (headquarters contribution increased by 11,000.00 EUR in both divisions):

VanhuiZEN BV
PERFORMANCE REPORT
for 20X1

	Geldern	Pieterburen
Total sales	832,000	1,456,000
less variable costs	(468,000)	(819,000)
Variable short-run Contribution Margin	364,000	637,000
less controllable fixed costs	(45,000)	(48,000)
Controllable Contribution Margin	319,000	589,000
less non-avoidable costs	(140,000)	(260,000)
Divisional Contribution Margin	179,000	329,000
less HQ contribution (<u>adjusted</u>)	(211,000)	(211,000)
Divisional NP before taxes	(32,000)	118,000
Entire NP before taxes	86,000	
less income taxes	(25,800)	
Net operating profit after taxes NOPAT	60,200	

Figure 1: VANHUIZEN BV's performance report
(alternative capital structure)

In Figure 1, the headquarters costs are in total 22,000.00 EUR higher than before. Check the table where the headquarters costs are indicated as “adjusted”. The return on equity now is: $60,200 / 500,000 = 12.04 \text{ \%/a}$. We acknowledge an increase of 3.64 % in return on equity

only due to a change of the company’s capital structure.

However, the company does not perform better. There are now even more costs of capital to the extent of 22,000.00 EUR.