2.3 Sources of Finance: Share Capital, Loan Capital and Venture Capital

Total Marks

AQA 7132 · Calculators not allowed · about 55 minutes · Write-in edition

Name: _____ Date: ____ / ____ / _____

Answer ALL questions in the spaces provided. Show your working for any calculation. Use the data and figures given in each question's prompt; no prior knowledge beyond what is specified is required. Where a question asks you to apply to the case, use the figures and balance sheet extracts provided in that question's prompt.

1 Which one of the following best describes 'ordinary share capital' for a private limited company seeking growth finance?

- ☐ A) A short-term loan from a bank repaid within one year
- ☐ B) Capital raised by issuing shares that give owners voting rights and a residual claim on profits
- ☐ C) A form of grant that must be repaid only if the business makes a profit
- ☐ D) A fixed interest bond secured against company assets

(Total for Question 1 is 1 mark)

2 State two features that typically distinguish venture capital funding from a bank loan for an early stage growth business.

(Total for Question 2 is 2 marks)

3 Identify one reason an early stage biotech company might prefer business angel funding over venture capital.

(Total for Question 3 is 1 mark)

4 GreenGrow plc, a medium sized agri-tech firm, is considering issuing a 5 year debenture to raise £500,000 at a fixed interest rate of 6% per year. Calculate the total interest the company will pay over the 5 years. Show your working.

(Total for Question 4 is 2 marks)

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5 State one control-related advantage or one control-related disadvantage of BrightBrew Ltd accepting venture capital rather than issuing new ordinary shares to existing owners.

(Total for Question 5 is 1 mark)

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6 Explain one advantage to a high growth technology start up of accepting venture capital rather than taking a long-term bank loan. Use application to a start up planning rapid expansion that requires cash for marketing and product development.

(Total for Question 6 is 3 marks)

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7 Identify one cost-related factor a management team should consider when choosing between issuing debentures and selling ordinary shares to raise 2 million pounds.

(Total for Question 7 is 1 mark)

8 Case extract for Q13 and Q14: BrightBrew Ltd is a UK private limited company making speciality coffee machines. Balance sheet extracts (simplified) at 31 Dec: Shareholders equity: Ordinary share capital £600,000; Retained earnings £200,000. Non-current liabilities: Long-term bank loan £400,000. Current liabilities: Trade creditors £50,000. BrightBrew plans to raise £300,000 to fund a new European sales team and asks whether to issue new ordinary shares, seek venture capital, or issue a 5 year debenture. The directors are concerned about gearing and control: current gearing ratio measured as long-term debt / (long-term debt + equity) is useful. Using the extracts, calculate BrightBrew's current gearing ratio (long-term debt / (long-term debt + equity)) as a percentage to 1 decimal place, then calculate the new gearing ratio if a £300,000 debenture is issued (assume the debenture is classed as long-term debt). Show your working and state which option (share issue, venture capital or debenture) would keep gearing lowest, based on your calculations.

(Total for Question 8 is 8 marks)

9 Explain two non-financial factors BrightBrew Ltd should consider when choosing between issuing shares, accepting VC or issuing a debenture to fund the sales expansion. Refer to relevance to the sales expansion decision in your answer.

(Total for Question 9 is 8 marks)

10 BrightBrew Ltd is deciding between three options to raise £300,000: (A) issue new ordinary shares to existing investors, diluting founders slightly; (B) accept a venture capital investor who will take 30% of the new enlarged equity and take a board seat; (C) issue a 5 year debenture at 6% interest. Recommend which source BrightBrew should use. Justify your recommendation using the figures and the gearing/control information supplied in Q13 and the balance sheet extracts. Consider cost, gearing, control and suitability for funding a sales expansion. You should weigh the options and reach a clear justified decision.

(Total for Question 10 is 12 marks)

Mark scheme · 2.3 Sources of Finance: Share Capital, Loan Capital and Venture Capital

Question 1

B cao **B1**

Answer: B

Question 2

VC provides equity in exchange for ownership and often active management involvement **B1**

VC accepts higher risk and expects higher returns and an exit via sale or IPO, unlike bank loans which require fixed interest repayments **B1**

Answer: Any two, e.g. VCs take equity and often join the board; VCs accept higher risk and expect an exit and high returns, while bank loans require interest and repayment.

Question 3

one valid reason, e.g. individual may offer mentoring and industry contacts suited to early stage needs, or smaller, more flexible investments than VCs **B1**

Answer: An angel can provide mentoring and useful industry contacts suited to early stage biotech needs.

Question 4

500,000 x 0.06 seen (= £30,000 per year) **M1**

£150,000 cao (total interest over 5 years) **A1**

Answer: £150,000.

Question 5

either an advantage, e.g. VC may bring professional governance that improves strategic decision-making, or a disadvantage, e.g. VC will take equity and expect influence, reducing founder control **B1**

Answer: Either advantage: a VC can bring professional governance and strategic support; or disadvantage: the VC will take equity and likely demand board influence, reducing founder control.

Question 6

identifies an advantage, e.g. VCs provide large amounts of equity finance suited to rapid growth **B1**

develops the point, e.g. equity finance does not require fixed repayments, so cash flow is not burdened during scaling **B1**

links to the scenario, e.g. this allows the start up to invest heavily in marketing and product development without the immediate pressure of loan repayments **B1**

Answer: VCs can provide large equity investments, which do not require fixed repayments, so the start up can spend on marketing and development without immediate cash flow pressure.

Question 7

compare fixed interest cost of debentures with potentially higher long-term cost of equity via dividends and diluted profits **B1**

Answer: They should compare the fixed interest cost of debentures with the potential long-term cost of equity in terms of dividends and diluted profit per share.

Question 8

calculates current gearing numerator and denominator: long-term debt 400,000 and long-term debt + equity = 400,000 + (600,000 + 200,000) = 1,200,000 **M1**

computes current gearing as 400,000 / 1,200,000 **M1**

33.3% cao (current gearing to 1 dp) **A1**

shows new long-term debt = 400,000 + 300,000 = 700,000 and new long-term debt + equity = 700,000 + 800,000 = 1,500,000 **M1**

computes new gearing as 700,000 / 1,500,000 **M1**

46.7% cao (new gearing to 1 dp) **A1**

concludes which option keeps gearing lowest with reasoning, e.g. issuing shares or taking VC would increase equity and so lower gearing, whereas a debenture increases debt and raises gearing **B1**

applies recommendation to BrightBrew, e.g. share issue or VC keeps gearing lower, and choice between share issue and VC depends on control implications **B1**

Answer: Current gearing = 400,000 / (400,000 + 800,000) = 400,000 / 1,200,000 = 0.3333 = 33.3%. With a 300,000 debenture: gearing = 700,000 / (700,000 + 800,000) = 700,000 / 1,500,000 = 0.4667 = 46.7%. Issuing shares or taking venture capital would keep gearing lowest because they increase equity rather than debt; issuing a debenture increases gearing.

Question 9

identifies factor 1, e.g. availability of investor expertise and contacts	**B1**
develops factor 1, e.g. VC or an angel could provide market knowledge and distribution contacts vital for European sales expansion	**B1**
applies factor 1 to BrightBrew, e.g. VC involvement might speed market entry and improve sales team effectiveness	**B1**
identifies factor 2, e.g. impact on corporate governance and decision-making speed	**B1**
develops factor 2, e.g. more external shareholders or VC board seats may slow decisions due to more stakeholders to consult	**B1**
applies factor 2 to BrightBrew, e.g. slower decision-making could hinder quick local market responses in Europe	**B1**
identifies an additional non-financial factor or further develops either factor, e.g. reputational signals to partners and customers of having a reputable VC	**B1**
applies this extra point to the sales expansion context, e.g. a reputable VC could reassure distributors and speed negotiations	**B1**

Answer: Possible non-financial factors include access to investor expertise and contacts, which could directly help BrightBrew establish a European sales network and train a sales team; and the impact on corporate governance and decision speed, since more external shareholders or VC board seats may slow strategic responses needed during expansion. A third relevant factor is reputation: partnering with a reputable VC could reassure distributors and customers, aiding market entry.

Question 10

Level 1 Makes simple statements about one or two options with little use of the provided figures and provides no clear, justified recommendation.	**1-4**
Level 2 Gives a developed comparison of at least two options using some of the figures (gearing, cost) and begins to weigh pros and cons, but the recommendation is not fully justified or lacks clarity.	**5-8**
Level 3 Weighs all three options using the provided figures and contextual issues (gearing impact, cost, control, suitability for expansion), shows clear analysis of trade-offs and reaches a justified recommendation supported by evidence.	**9-12**

Indicative content:

- Use the gearing calculations from Q13: current gearing 33.3% and debenture option raises gearing to 46.7%, increasing financial risk.
- Cost: debenture interest at 6% creates fixed payments and total interest cost over 5 years, increasing pressure on cash flow during expansion; issuing shares or VC avoids fixed interest costs.
- Control: issuing new shares to existing investors may be least disruptive to control if founders retain voting majority; VC taking 30% and a board seat would reduce founder control significantly.
- Suitability: sales expansion benefits from partners offering industry knowledge and contacts; VC might add expertise and networks but demands high returns and control; share issue keeps decision-making with current owners but may not add expertise.
- Gearing and investor appetite: if directors prioritise low gearing and keeping control, issuing shares to increase equity is preferable; if rapid scaling and external expertise are critical, VC could be justified despite higher control cost, provided founders accept dilution.
- Judgement examples: recommend issuing new ordinary shares if keeping gearing low and control is top priority; recommend VC if rapid pan-European scaling needs active investor support and founders accept dilution; argue against debenture if directors worry about higher gearing and fixed interest burdens during expansion.