

Chapter 20: Exam practice question**‘Coffee Call’ seeks funds for expansion**

1 Define the following terms:

a loan finance

(2)

This can comprise either short-term (under a year) or long-term (over a year) borrowing. It can be sourced from banks, other businesses or business angels (investors who give finance for start-ups when banks will not), and may be secured or unsecured. Secured means that the lender would be legally entitled to take and sell the secured assets if there is a default on payment of loan interest or capital repayments.

b liquidity.

(2)

This is the ability of a firm to pay its short-term debts. It is analysed by examining working capital (current assets – current liabilities) and the current ratio (current assets ÷ current liabilities). If working capital is positive and the current ratio is more than 1, then the business is said to be liquid because it can pay all its short-term liabilities by liquidating its short-term assets. In reality, liquidation of assets may not achieve full book price and so estimates of liquidity are approximate.

Apply **Resources table 3a** mark band descriptors.

2 Explain why material costs have been forecast to be 50% of sales.

(4)

There is no direct evidence in the case study of how a figure of 50% was arrived at.

Suggested reasoning:

Many retail businesses make a 100% mark-up on the cost of materials. This means that the cost of materials would be doubled in order to arrive at the selling price of the product.

If sales have been estimated, for the purposes of the cash flow statement it would therefore be necessary to halve the sales price in order to arrive at the cost of materials. The calculation is thus done in reverse.

Students may not know that many retailers use 100% mark-up for pricing purposes and there is nothing in the case study to indicate that this would be the case. If the student has made any sort of realistic suggestion, backed up by a reasonable explanation, the 4 marks should be awarded.

Strictly speaking, in order to earn 4 marks the student should state two specific points, explain each and relate each to the case study. In this case, however, students should be given the benefit of the doubt.

3 Draw up a cash-flow forecast for Coffee Call for the first six months of the year. **(8)**

\$000	Jan	Feb	March	April	May	June
Inflows						
Sales	20	20	20	40	40	40
Loan		20				
TOTAL IN (a)	20	40	20	40	40	40
Outflows						
Materials	10	10	10	20	20	20
Elec./gas		20				
Wages	2	2	2	3	3	3
Erin & Carl			20			
Marketing	0.5	0.5	0.5	0.5	0.5	0.5
Refit cost			20			
TOTAL OUT (b)	12.5	32.5	32.5	23.5	23.5	23.5
Net cash flow (a – b)	7.5	7.5	(12.5)	16.5	16.5	16.5
Opening balance	7	14.5	22	9.5	26	42.5
Closing balance	14.5	22	9.5	26	42.5	59

8 marks:

A completely correct cash flow which shows the working for net cash flow (a – b).

6– 7 marks:

Up to two minor errors.

4– 5 marks:

Up to four errors but with an essentially correct table with all elements (headings and totals) included.

2– 3 marks:

An attempted table that shows some evidence of a logical attempt to calculate inflows and outflows.

1 mark:

An attempted answer.

- 4 Discuss the advantages and disadvantages of Coffee Call using the venture capitalist as a source of finance. (9)

Define venture capitalist: this is a company that offers money to new companies or for high-risk expansion in return for a percentage share ownership.

Advantages:

- Extra advice and experience of venture capitalists could be useful.
- £20,000 is a sizeable sum which is only really needed for March and April and so could offer the possibility of further future expansion.
- Share capital need not be repaid.
- Share capital is paid for in dividends, which can be optional if other expenses make them difficult to pay.
- Leverage would be lower, leaving the possibility of future bank finance for other projects.
- Cash-flow forecasts are rarely certain. The extra cash could be useful if reality does not live up to expectations.
- Any other relevant point.

Disadvantages:

- Erin and Carl would be giving away 20% of the ownership when they only really need the cash for two months. This seems a heavy price to pay.
- If they simply delayed taking their own drawings for two months they would not need to give up 20% of the business.
- Dividends are paid after tax whereas loan interest is paid before tax.
- ROCE would be lower.
- Any other relevant point.

9-mark questions usually require a conclusion, although the wording of this question does not immediately demand a conclusion. Students should probably be encouraged to write a conclusion for 9-mark questions as a matter of habit.

Suggested justified conclusion: while there are both positive and negative arguments, the short time this money is needed for would probably not warrant giving up 20% ownership of the business. It would probably be better to delay paying the £20,000 to Erin and Carl until May.

SL: apply **Resources table 1** mark band descriptors.

(SL questions do not usually go up to 9 marks, so the HL table is best used for SL students.)

HL: Apply **Resources table 2** mark band descriptors.

A justified conclusion should be encouraged for 9-mark questions.