

## Case study 7: Mark scheme

Chapter 18: Sources of finance

Chapter 19: Investment appraisal (included in Worksheet 19, so not covered here)

Chapter 20: Working capital

Chapter 21: Budgeting (HL only)

### Canine Couture

In January 2009 two friends, Mayako Takahashi and Basil Smith, set up a partnership in the UK to produce shoes for dogs. Mayako had a degree in Business and Basil had just finished a degree in clothes design. Mayako's aunt had left her £20,000 and, unable to find jobs during the recession, they decided to work for themselves. They had not done any market research but had recognised that dog shoes were not currently available. With the reduction in birth rates in Europe, more people were buying pets. The dog clothes market had been established and with colder, snowier winters in the UK there was potential for demand for foot protection. The business could perhaps be expanded later to encompass the more competitive dog coat market.

Mayako found a small factory for rent that had been left vacant by a bankrupt clothing manufacturer. Twenty old industrial sewing machines were bought from the liquidator for only £5000: around 20% of what new machines would have cost. In addition, they needed two new computers and a printer for the office; these cost £1200. They planned to buy a photocopier in March for £3500. The rent of £2000 a month seemed reasonable because there was a huge amount of space. Electricity and heating costs were estimated at £500 a month, payable at the end of each quarter. Office supplies, coffee and cleaning costs were estimated at £200 a month. Mayako and Basil decided to pay themselves a salary of £1500 a month each, which is what they estimated they would have earned if they had found jobs. In addition, they were able to persuade one of the unemployed machine operators from the bankrupt business to work for them for fixed wages of £1000 a month. Basil set to work making shoe designs and orders were put in for £200 worth of materials each month. Unfortunately, suppliers would only give credit of one month on 50% of the order value because Canine Couture was a new business.

A few wholesale customers placed some orders worth about £10,000 a month, deliverable from February onwards with credit terms of two months. After the first month of operation, however, Mayako began to worry that they would soon need extra working capital. She and Basil went to see the bank manager. He suggested that they should prepare cash-flow forecasts.

### SL questions: 20 marks, 35 minutes

- 1 Define the term 'working capital'. (2)
- This is money borrowed to pay for raw materials, day-to-day running costs and credit offered to customers.

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

2 Prepare a cash-flow forecast for the first six months of operation of Canine Couture.

(10)

**Canine Couture cash-flow forecast for January to June 2009 (£)**

Item	Jan	Feb	March	April	May	June
Cash flow IN:						
Debtors	0	0	0	10,000	10,000	10,000
Total inflows (a)	0	0	0	10,000	10,000	10,000
Cash flow OUT:						
Asset purchase	6200		3500			
Rent	2000	2000	2000	2000	2000	2000
Salaries	3000	3000	3000	3000	3000	3000
Wages	1000	1000	1000	1000	1000	1000
Utilities			1500			1500
Cleaning, etc.	200	200	200	200	200	200
Materials	100	200	200	200	200	200
Total outflows (b)	12,500	6400	11,400	6400	6400	7900
Net cash flow (a – b)	(12,500)	(6400)	(11,400)	3600	3600	2100
Opening balance (b)	20,000	7500	1100	(10,300)	(6700)	(3100)
Closing balance b + (a – b)	7500	1100	(10,300)	(6700)	(3100)	(1000)

**9– 10 marks:**

Correct and perfectly laid out cash-flow forecast. For 10 marks, all calculations must be fully evident and annotated.

**7– 8 marks:**

One or two minor errors.

**4–6 marks:**

Three or four errors.

**1– 3 marks:**

Cash flow attempted but more than four errors or layout difficult to follow.

- 3** Explain **two** reasons why the bank manager may have wanted to see cash-flow forecasts before agreeing to lend finance for working capital. **(4)**
- To see if and when the loan could be repaid, so that the bank can structure the finance to be in line with Canine Couture’s ability to repay.
  - To assess the maximum amount of the loan, so that security can be taken if it is needed.

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

- 4** Explain **two** other ways in which Mayako and Basil could have avoided their cash-flow problems. **(4)**
- Take lower salaries until the business has consistently positive cash flow.
  - Negotiate lower pay with their employee, who would otherwise be unemployed.
  - Find a smaller, cheaper factory.
  - Only buy the sewing machines they need immediately.
  - Lease sewing machines, computer and printer instead of buying them.
  - Find other suppliers willing to offer longer credit terms.
  - Do the cleaning themselves until they are better established.
  - Delay buying the photocopier or lease it (see above).

Award 1 mark per valid method of avoiding cash-flow problems.

**HL questions: 25 marks, 45 minutes**

- 1** Define the term ‘working capital’. **(2)**
- This is money borrowed to pay for raw materials, day-to-day running costs and credit offered to customers.

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

- 2** Prepare a cash-flow forecast for the first six months of operation of Canine Couture. **(10)**

See answer to SL question 2.

- 3 Explain **two** reasons why the bank manager may have wanted to see cash-flow forecasts before agreeing to lend finance for working capital. (4)
- To see if and when the loan could be repaid, so that the bank can structure the finance to be in line with Canine Couture's ability to repay.
  - To assess the maximum amount of the loan, so that security can be taken if it is needed.

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

- 4 Explain **two** other ways in which Mayako and Basil could have avoided their cash-flow problems. (4)
- Take lower salaries until the business has consistently positive cash flow.
  - Negotiate lower pay with their employee, who would otherwise be unemployed.
  - Find a smaller, cheaper factory.
  - Only buy the sewing machines they need immediately.
  - Lease sewing machines, computer and printer instead of buying them.
  - Find other suppliers willing to offer longer credit terms.
  - Do the cleaning themselves until they are better established.
  - Delay buying the photocopier or lease it (see above).

Award 1 mark per valid method of avoiding cash flow problems.

- 5 Explain how Canine Couture could use a variance report. (5)
- Explanations should include:
- A regular check of how real performance compares to the plan may highlight problem areas so that they can be addressed.
  - It will alert Canine Couture to redo cash-flow forecasts and address any financing problems in advance.

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