Unit 3.7 Cash flow

Question 3.7.1 McDonald's

(a) Possible reasons why McDonald's experienced an increase in sales revenues but a decline in its net profits could include:

- Due to its revamped menu, McDonald's was able to entice more customers thereby helping to boost its sales by 6%.
- However, sales revenue is not the same as profit. The costs of product research and development for its new menu, for example, would contribute to higher expenses and hence lower net profits.
- It is likely that there is a significant time lag between investment expenditure (R&D and marketing costs for its revamped menu) and receiving sufficient sales revenue to recoup these costs.

- McDonald's expansion plans, such as opening its first store in Vietnam, would help to boost sales revenues but increase operations costs. Again, this contributes to declining net profits at least in the short term.
- Hence, it is probable that overall net profits declined despite sales revenue being higher.

Award *1 mark* if the answer lacks depth and substance. There is little, if any, reference to the stimulus material in the case study.

Award *2–3 marks* if there is some understanding of how it is possible for McDonald's to report an increase in sales revenue but a fall in net profits, although the explanation lacks some detail.

Award *4–5 marks* if there is a clear understanding of how it is possible for McDonald's to report an increase in sales revenue but a fall in net profits, written in the context of McDonald's. There is appropriate use of relevant business management terminology.

(b) Credit cards allow customers to 'buy now and pay later' through a third party, i.e. a financial lender such as a bank or credit company. The finance company pays the retailer (and charges the retailer a small fee for the service) and charges the customer at a later date.

Since credit improves flexibility and convenience (customers do not need to carry so much cash with them) and allows customers to buy now but to postpone payment, it can attract a large number of customers to businesses, including McDonald's. Hence, sales revenues may increase as customers have a greater choice of payment systems.

However, retailers and restaurants such as McDonald's will not receive their payment instantaneously, i.e. there is a (relatively short) delay in payment from the credit card company. This therefore extends the working capital cycle of the business that offers credit to its customers. In addition, the amount received from the finance company will be slightly lower because a fee is charged by the creditor.

Award *1 mark* if the answer lacks depth and substance. There is little, if any, reference to the working capital cycle of McDonald's.

Award *2–3 marks* if there is some understanding of the working capital cycle being affected by the use of credit. At the top end, there is some reference to McDonald's.

Award *4–5 marks* if there is a clear understanding of how the introduction of credit card payments offers greater flexibility and convenience for McDonald's customers. There is a good explanation of how the working capital cycle is affected by consumer credit.

Question 3.7.2 Le Royal Méridien Hotels

(a) Working capital (or net current assets) refers to the liquidity available to a business, i.e. the existing short-term assets of a firm to cover its short-term debts. Working capital is calculated as the sum of current assets (cash, stocks and debtors) minus the sum of current liabilities (overdrafts, tax, dividends and creditors).

Award *1 mark* for a vague understanding of working capital.

Award *2 marks* if working capital is clearly understood with the appropriate use of business management terminology and/or examples.

(b) Improved cash flow management is needed during a long working capital cycle, such as when Le Royal Meridien is building new hotels because:

- There is a prolonged delay between payments for production costs (to construct the new hotels) and the proceeds from customers paying to stay at the new hotels. Poor cash flow management could therefore cause the construction work to halt due to a lack of working capital.
- Current liabilities (such as overdrafts, creditors and tax demands) will further drain cash flow during the construction period. Again, it is vital to manage cash flow in order to keep the Le Royal Meridien afloat.
- Poor cash flow management can make the organization go further into debt as it seeks to borrow more finance to fund the construction of the new hotels. This may cause gearing problems for Le Royal Meridien.

Award *1–2 marks* if the answer lacks some detail and/or substance. There may be little, if any, application to Le Royal Meridien.

Award *3–4 marks* if there are good explanations of why Le Royal Meridien needs better cash flow management, with reference to a long working capital cycle during the construction of its new hotels. There is appropriate use of business management terminology with relevant application.

Question 3.7.3 Menelao Stationers

(a) Cash flow forecast for Menelao Stationers

	Aug ($)	Sep ($)	Oct ($)	Nov ($)
Cash inflow				
Cash sales	2 000	5 500	3 200	3 000
Cash outflow				
Stock purchases	1 000	2 750	1 600	1 500
Rent	0	2 000	0	2 000
Utilities	500	500	500	500
Other costs	1 800	1 100	1 100	1 100
Total outflow	3 300	6 350	3 200	5 100
Net cash flow	-1 300	-850	0	-2 100
Opening cash balance	6 500	5 200	4 350	4 350
Closing cash balance	5 200	4 350	4 350	2 250

Award *1 mark* for an acceptable format used to present the cash flow forecast. Award up to *5 marks* for the construction of the CFF, deducting *1 mark* for each error (apply the own figure rule (error carried forward) where necessary).

(b) The answer should show an understanding (or definition) of 'liquidity position', i.e. the extent to which Menelao Stationers can meet its short-term debts. The firm seems to be suffering from worsening liquidity as seen by the closing balance figures. The net cash flow for the first four months of trading is either zero or negative, suggesting its liquidity position is somewhat of a concern for Menelao Stationers. Without the initial cash inflow of $6500 from Denise Menelao to start the business, there would be insufficient working capital.

Award *1–2 marks* if the commentary is vague and/or incoherent. The answer might appear in a list-like form, without little, if any, explanation.

Award *3–4 marks* if the commentary is sound, with a clear understanding of the liquidity position of Menelao Stationers. There is good use of examples and reference to the case material.

Question 3.7.4 Bereti's Boutique

(a) Cash flow forecast for Bereti's Boutique (Aug–Nov):

	Aug ($)	Sep ($)	Oct ($)	Nov ($)
Opening balance	10 000	5 850	3 040	890
Cash inflows	4 000	4 800	6 000	8 100
Total cash inflows	14 000	4 800	6 000	8 100
Cash outflows				
Variable Costs	2 000	2 160	2 700	3 645
Advertising	1 600	900	900	900
Staffing (5 × $800)	4 000	4 000	4 000	4 000
Others	550	550	550	550
Total cash outflows	8 150	7 610	8 150	9 095
Closing bank balance	5 850	3 040	890	-105

Deduct *1 mark* for each error, but apply the own figure rule (error carried forward) as appropriate.

(b) The cash flow forecast suggests several issues for Nicole Bereti:

- The business is expected to have a negative closing balance in November. This is an unfavourable position to be in, so short-term external finance is likely to be needed.

- The net cash flows between Sept and Oct are negative, i.e. the liquidity position is rather unfavourable. The closing balance in August is only positive because of the initial $10 000 from Nicole's personal bank account. However, it can be seen that net cash flow does improve during this time.

	Aug ($)	Sep ($)	Oct ($)	Nov ($)
Net cash flow	5850	(2810)	(2150)	(995)

- Cash inflows from sales have continually increased by 102.5% (from $4000 to $8100) whilst payments have only increased by 11.6% (from $8150 to $9095), i.e. the liquidity position is improving over time.
- Given that Bereti's Boutique is a new establishment, the cash flow forecast suggests that the firm might still succeed since negative cash flow only occurs temporarily.
- However, it is difficult to conclude whether Bereti's Boutique will have a positive net cash flow and a positive closing balance after December (the most profitable time of year for perfume retailers).
- Overall, the cash flow position faced by Bereti's Boutique may not be too much of a concern, especially with its rising sales revenue, so long as it can secure finance to overcome the short-term liquidity problem in November (a $105 deficit rather insignificant).

Award *1 mark* for a vague answer that lacks substance or is simply descriptive.

Award *2–3 marks* if there is an attempt at examining the cash flow position of Bereti's Boutique, but the answer may lack detail or application of the stimulus material.

Award *4–5 marks* if there is a detailed examination of Bereti's Boutique's cash flow position. Appropriate business management terminology has been used with reference to the case study.

Question 3.7.5 Ducie's Dance Studios Ltd.

(a) Profitable firms such as Ducie's Dance Studios Ltd. can experience cash flow problems for a number of reasons, such as:

- Overtrading
- Long working capital cycle
- Poor credit control
- Long credit periods

Award *1 mark* for a vague outline of why profitable firms might experience cash flow problems, with some understanding shown.

Award *2 marks* for a clear outline of why profitable firms might experience cash flow problems. The answer makes appropriate use of business management terminology.

(b) Cash flow forecast for Ducie's Dance Studios Ltd. for the period April to June:

	April ($)	May ($)	June ($)
Cash sales	5 000	4 500	5 500
Credit sales	6 000	5 000	4 500
Cash inflows	11 000	9 500	10 000
Direct costs	5 500	4 950	6 050
Indirect costs	5 100	5 100	5 100
Cash Outflows	10 600	10 050	11 150
Net cash flow	400	-550	-1 150
Opening balance	1 200	1 600	1 050
Closing balance	1 600	1 050	-100

Deduct *1 mark* for each error, but apply the own figure rule (error carried forward) as appropriate.

(c) The options available to Marj Ducie in dealing with her liquidity problems include:

- Applying for a preapproved overdraft for June (and perhaps May when net cash flow is negative) in case actual cash outflows are higher than those forecast, in which case the closing balance would be negative; but this option would incur high interest charges.
- Offering incentives to customers to pay earlier (or by cash) because currently half of the sales are paid for on credit. Whilst this might improve liquidity, offering such incentives might reduce the profits of the business.
- Better credit control by offering less credit (as 50% of customers pay by credit) or a shorter credit period (currently one month's credit); but this might lead to fewer customers thereby reducing the attractiveness the business.
- Negotiate the option to pay indirect costs in instalments in order to ease the firm's cash flow.
- Reviewing marketing planning to help Ducie's Dance Studios Ltd. to better meet the needs and wants of its customers, thereby helping to improve the firm's cash inflows.
- Reviewing the firm's pricing strategy in order to raise sales revenues.

Award *1–2 marks* if the answer is generalized and lacks detail. The answer might appear in a list-like format.

Award *3–4 marks* if there is an explanation of the options available to Ducie's Dance Studios Ltd. although the answer might lack application or substance.

Award *5–6 marks* if there is an examination of the options available to Ducie's Dance Studios Ltd. Application is clearly shown.

Award *7–8 marks* if there is a thorough examination of the ways in which Ducie's Dance Studios Ltd. could deal with its liquidity problems, with an evaluation of the effectiveness of these options to the firm. Appropriate business management terminology is used in the context of Ducie's Dance Studios Ltd.