Exercise walk-through

Business finance ▪ 5.1

eXercise

You must be able to

- distinguish capital from revenue expenditure
- calculate **working capital** and explain why it matters
- explain why a profitable business can still run out of cash

Method — Working capital, and cash versus profit

$$\text{working capital} = \text{current assets} - \text{current liabilities}$$

- **Worked:** current assets \$80,000, current liabilities \$50,000 → working capital $= \$30{,}000$.
- **Capital expenditure** = fixed assets (machines, buildings); **revenue expenditure** = day-to-day (wages, rent).
- A profitable firm can run out of cash if customers have not yet paid — **profit** ≠ **cash**.

Answer shapes: AO1 + AO2 + AO3 (reasoning chain) + AO4 (a supported judgement *in context*).

Method — Working capital, and cash versus profit

a firm can be profitable but still run out of cash

profit (on paper)
revenue − costs
= positive

cash (in the bank)
low — customers
haven't paid yet

A firm can look profitable yet have no cash to pay its bills

Practice 2.1 ▪ 2 marks

Define the term *working capital*.

Solution 2.1

Method: Working capital, and cash versus profit

Worked steps

the money a business has available for its day-to-day needs, found as current assets minus current liabilities (2 for a clear definition; 1 for a partial idea).

Practice 2.2 ▪ 2 marks

A firm has current assets of \$60,000 and current liabilities of \$45,000. Calculate its working capital.

Solution 2.2

Method: Working capital, and cash versus profit

Worked steps

$\$60{,}000 - \$45{,}000 = \$15{,}000$ (2; award 1 for a correct method with the wrong figure).

Practice 2.3 ▪ 2 marks

State the difference between *capital* and *revenue* expenditure.

Solution 2.3

Method: Working capital, and cash versus profit

Worked steps

capital expenditure is money spent on fixed assets that last a long time (machines, buildings); revenue expenditure is money spent on day-to-day running (wages, rent, materials) (2 for a clear difference; 1 for a partial idea).

Exam-style 3.1 ▪ 3 marks

Explain one reason why a profitable business might still run short of cash.

Solution 3.1

Method: Working capital, and cash versus profit

Worked steps

[3] **AO1** 1 — give a reason (sells on credit and customers have not paid; bought too much stock or assets; overtrading). **AO2** up to 2 — develop it, e.g. goods are sold but customers pay 60 days later → the firm has profit on paper but no cash now → it cannot pay wages (2 developed / 1 limited).

Exam-style 3.2 ▪ 8 marks

Analyse two reasons why working capital is important to a business.

Solution 3.2

Method: Working capital, and cash versus profit

Worked steps

[8] For **each** of two reasons: **AO1** 1 + **AO2** 1 + **AO3** up to 2. Example chains — *pay bills*: enough working capital → the firm pays suppliers and wages on time → it keeps trading and its reputation. *Avoid failure*: too little working capital → it cannot meet short-term debts → it may be forced to close even if profitable. Maximum 4 per reason, 8 total.

Exam-style 3.3 ▪ 12 marks

'A business should always hold as much cash as possible.' Evaluate this view.

Solution 3.3

Method: Working capital, and cash versus profit

Worked steps

[12] **AO1** 2 / **AO2** 2 / **AO3** 2 / **AO4** up to 6. **For** holding cash: it pays bills, covers emergencies and avoids failure. **Against:** idle cash earns nothing and could be invested in stock, assets or marketing that raise profit. Judgement: a firm needs *enough* cash to stay safe, but too much is wasted — good working-capital management means a sensible balance, not "as much as possible"; the right level depends on how steady its cash flow is.