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Practice exam questions

Maintaining competitiveness

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Check your answer to the question on pp. 2–4 of the magazine.

Sample answer

The inn is a family-run, 10-bedroom inn that has very high ratings on Tripadvisor. It already invests 50% of its profits back into the business and the owners manage their cash flow carefully.

One reason why the inn should look to improve its cash flow is so that it is able to pay suppliers on time, every time. An improvement to cash flow means that the inn may not need to go overdrawn when paying suppliers and may even gain a discount for prompt payment. Therefore, cash outflows for stock such as food, beer and wine may reduce together with improved relationships with suppliers. This may, in the longer term, lead to suppliers offering increased loyalty discounts on stock such as bacon, beef or beer that could result in a greater reduction in outflows leading to improved working capital, which in turn can be used to make larger purchases such as upgrading the bedrooms. Ultimately this may lead to not only reduced average costs per guest but also an enhanced reputation and allow the inn to increase its number of room and food rates, ultimately improving its finances and profit margins.

However, the inn is already carefully managing its cash flow by seeking out more cost-effective produce from suppliers and this may mean that there is little else it can do in terms of cost cutting through discounts. Overly aggressive cost cutting risks alienating suppliers, who may no longer provide the inn with produce that meets the expectations of customers. As a result, even though unit costs are lower, customers may complain about poor quality food and this may reduce their reputation through poor ratings on the internet. Ultimately, this strategy may lead to less working capital as the inn may have to give refunds to disappointed guests, which reduces their positive cash flow and may lead to the inn not having sufficient working capital to pay suppliers on time.

One reason why the inn should focus on increasing profit to manage its finances more effectively is because an increase in profits can lead to an increase in other financial benefits. For example, if the inn generates large profits, it is likely it may also have positive cash flows and good liquidity. The business can use this opportunity to pay off any debts it might have that may decrease its operating costs, such as paying down the capital of a mortgage on the inn to reduce interest payments. With this reduction in costs comes the ability to increase retained profits, which can then be used to reinvest in the inn, such as building an extension to the already successful restaurant.

However, the inn may struggle to increase its profits as the only way to do this is either by increasing its sales revenue or decreasing its costs. As the market for accommodation and food in Cumbria is very competitive the option of increasing its room rates and food prices risks customers deciding to look at other establishments, such as L'Enclume, that previously were seen by some as not as good value for money. Reducing variable costs also risks the food not being up to the expected standard, with the

loss of customers to local competitors. In the longer term, this may mean the inn losing its ability to charge premium prices for its offering, ultimately worsening its finances. If fixed costs have already been rationalised, further cost savings may currently be impossible without risking customer satisfaction.

In conclusion, increasing cash flow may be the best approach to managing the inn finances more effectively. As it operates in the niche food and accommodation sector — where quality of ingredients and surroundings are critical to maintaining its standing with customers — building up closer relationships with its suppliers may carry the least risk in reducing its cash outgoings. Closer supplier relationships may mean the inn gains access to premium produce, such as duck and Cartmel puddings, that other restaurants are not given. These may be given at a discount to the inn meaning that not only can it manage its outgoing more effectively, increasing its working capital, but as it may gain early access to unique produce that may tempt customers away from competitors, increasing revenues and profits. In the longer term, such supplier relationships may give the inn the ability to work in partnership on further unique produce that allow its team of chefs to produce menus that gain a Michelin star and allow the business to increase profit margins while also increasing demand.

Sample examiner comment

Mark: 20/20 (Level 4 — an excellent response fully focused on the question).

The answer gives a benefit of the inn managing its cash flow more effectively with evidence.

The answer then develops the benefits of each option in detail using relevant analysis and evaluation of qualitative and quantitative data, relating this back to which may be the most effective option to manage finances effectively. A drawback of each option is then developed using detailed evidence and again relates back to managing finances. The answer then uses MOPS* and a wider range of evidence to evaluate and recommend the most appropriate approach to achieving the effective management of finances for the inn.

*MOPS stands for market, objectives, product and situation and is a way to help focus on the wider areas that should be considered in the evaluation of the question

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