Te Tohu Whakahaere Pūtea
Certificate in Money Management

Wāhanga Tuawhā:
Ngā Hua me ētahi atu Whakatupuranga
Module 4: Equity and Other Investments

Whakamātautau Tuarua:
Te Taumahi Hoko Pakihi
Assessment 2: Business Purchase Case Study

Ngā Whakautu Hei Tauira
Model Answers

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Part One

1. What is a 'silent partner' and what is <u>one advantage</u> and <u>one disadvantage</u> of having Rikau and Phoebe as a silent partner in the business?

   What is a 'silent partner'? ***A silent partner is somebody who invests in a small business but does not work in it and takes no part in the day-to-day running of the business.***

   The main advantage of a silent partner is that they are a source of finance – e.g. Whare and Keri can use Rikau and Phoebe's money to help buy the business. The main disadvantage is that the arrangement may cause discontent between the two couples as Rikau and Phoebe may, for example, disagree with what Whare and Keri plan to do with the profits. That is, Whare and Keri may use profits to expand the business instead of making payments out to Rikau and Phoebe.

   Note: tauira may identify other relevant advantages and disadvantages.

2. Whare and Keri want to analyse their own strengths and weaknesses to help decide whether they are ready to run their own business. What are two strengths and one weakness that the couple have in regards to operating this business?

   There are a number of correct answers to this question. Some examples are provided.

   Examples of Strengths:

   - ***Whare is confident with working with numbers.***
   - ***Whare has done accountancy in the past and has recently upskilled in this area.***
   - ***Keri has had some (although minimal) experience that would be of benefit to the business (through her roles as treasurer and secretary).***
   - ***The couple's two children are willing to help with the business.***
   - ***One of their children is a radio presenter – s/he may be able to occasionally mention the business on the radio, thus providing free promotion.***
   - ***The other of their children is a carpenter – s/he may be able to assist with repairs and maintenance required for the shop.***
   - ***The couple have some savings that they can contribute towards the business.***

- ***The couple have the option of financing from a silent partner.***
- ***The couple have assets that could be used as collateral to secure a business loan.***
- ***The couple have a lot of enthusiasm for the business.***

Examples of Weaknesses:

- ***Neither Keri nor Whare have ever run a business – Whare has only worked in a small business as a child.***
- ***The business is based in Auckland, it is therefore likely that the couple would need to move there (or incur large travelling costs).***

3. What are two factors that Whare and Keri will need to consider in regards to their own financial position *before* they arrange preliminary finance and make an offer on Soccer Delights?

There are a number of correct answers to this question. Some examples are as follows:

- ***They would need to know how much they need to be able to draw from the business each year in order to support themselves.***
- ***They would need to know whether they could support themselves within the first year if they needed to make substantial changes to the business (e.g. repairs and maintenance, etc.).***
- ***They would need to consider which assets they would be prepared to use as security if they were to get a loan (and the value of these assets).***
- ***If they were to instead sell assets, such as their rental property, to buy the business, they would need to know how much they would be likely to get from the assets and how easy it would be for them to sell.***
- ***They would need to know how much they could afford to borrow and how much they would actually be willing to borrow.***

4. Even if Rikau and Phoebe become silent partners in the business, Whare and Keri are aware that the contribution they make, plus their own savings, will not be enough to cover the purchase price.

   - Identify two ways in which Whare and Keri could finance the purchase of the business, and

   - Identify an advantage of each of these finance options.

   Although there are a number of possible answers to this question, the most common options are likely to be:

   - ***Secure a business loan. An advantage of this is that they can retain their other assets, including their rental property, which is likely to be a less risky investment than the business. They may even be able to use income from their rental property to help support the business.***
   - ***Sell an asset, such as their rental property and use the cash to buy the business. An advantage of this is they would be debt free and would not need to worry about whether their cashflows will enable them to meet their debt repayment obligations when they fall due.***

5. Identify one type of professional adviser which you would suggest that Whare and Keri meet with before (or throughout) the business purchase process. Also identify two matters that they could consult this adviser about.

   Examples of Professional Advisers include accountants, lawyers, business consultants and bank advisers. Tauira may give a range of correct responses in regards to the matters that they could consult the adviser about. Refer to the content in Section 2 of the Module for examples of relevant matters.

6. Whare and Keri think that Ronald has given very valid reasons for wanting to sell Soccer Delights. However, the couple are concerned that there may be other reasons which Ronald has not told them.

   What are two questions that Whare and Keri could ask Ronald to help them to work out if there are other reasons for selling that they should be concerned about?

   Example: Are your main suppliers experiencing any problems that are impacting on Soccer Delights?

   There are many possible correct responses to this question. A couple of examples include:

- ***Are you aware of any new competitors starting in the area or online?***
- ***Is the business likely to face notable increases in costs in the near future?***

7. During their recent visits to Soccer Delights, Whare and Keri have noticed that the premises seem a bit 'run down'. For example, it is in need of a new paint job and could do with some better shelving. They wonder if the need for repairs and maintenance is actually a reason why Ronald wants to sell.

   If this is the case, does this mean that Whare and Keri should ***not*** consider buying the business? Explain your response.

   No, it does not mean that they should not consider buying the business. It just means that they will need to determine exactly what repairs and maintenance are required and factor this into the price that they are willing to pay for the business.

8. Should the fluctuations in net profit concern Whare and Keri – why / why not?

   Yes, the fluctuations should be of concern to Whare and Keri.

   Tauira may give a variety of correct responses as to why the profit should be a concern. For example:

   "The couple need to have a good idea of what they can expect to earn from the business. Given that the fluctuations are very large, it may be difficult for them to budget or to even prepare an offer of how much they are willing to pay for the business. The couple need to find out what is causing the fluctuations to help them determine the value of the business."

9. Whare and Keri take the financial accounts of Soccer Delights to an independent accountant (Jim Baker) to examine. After looking through them, Jim informs the couple that he believes the profit of the business in the past financial year would be higher than the $35,000 reported.

   What is one possible reason for this difference?

   Tauira may give a variety of correct responses. Some examples include:

   - ***Ronald and Vera may pay themselves higher wages than usual for the duties they do. For example, Vera may only work 10 hours per week in the business, but the business may pay her for a full 40-hour week.***

- ***Other expenses may be inflated – i.e. Ronald and Vera may have included expenses that are more likely to be personal expenses.***
- ***Ronald and Vera may have a very expensive car that they have bought through the business. This would result in a higher than necessary amount of depreciation (which reduces profit) and, if the car uses a lot of petrol, higher fuel expenses.***

10. Whare and Keri decide to visit the business premises (again!) to look at exactly what it is that they are considering buying. What is one thing that the couple should do / examine / make note of during their visit? Why?

    Example: They should try to match the assets in the store with those shown in the financial accounts. This is so they can see which assets in the store actually belong to the business and what condition the assets are in.

    Tauira may give a variety of correct responses. Some examples include:

    - ***Talk with the employees. They could see what their intentions are in terms of staying with the business. Does Jack, who does not seem to be a good worker, intend on staying with the business long term? What about Jennifer? Does she intend on staying with the business long term? She is a good worker and losing her would be a loss to the business. Employees may also provide other valuable information about the business – e.g. they may be able to identify problems that the owner has not identified.***
    - ***They should make note of the number of customers to the store.***
    - ***They should examine the inventory to see what condition it is in and to determine whether it is likely to be worth the amount shown in the books.***

Part Two

11. Whare and Keri decide to do a basic valuation of Soccer Delights using the capitalisation rate method. Whare has learnt a little about this method and suggests that a very low capitalisation rate of 20% be applied. His rationale for this is that the business has been in operation for 15 years, and is thus very stable. After looking at the books, Jim Baker (the independent accountant) disagrees with Whare and suggests a rate of 35% be applied.

    Given the information in the case study, which of these two rates (20% or 35%) would be most appropriate? Explain your answer.

    The rate of 35% would be more appropriate. The Module recommends that 20% is the lowest rate that should be applied, and that this should only be applied to a very low risk business. Given that the profits of Soccer Delights have varied between $25,000 and $45,000 over a 5 year period (a difference of $20,000, which represents up to 80% of profits) and that this variance has included both increases and decreases, it could not be said that profits are stable or steadily increasing. Therefore a higher rate than 20% should be applied.

12. If Soccer Delights is valued using the capitalisation rate method, based on the reported profit for the previous year ($35,000) and a capitalisation rate of 20%, how much is it worth? *Show your calculations.*

    Value of Business = Profits / Capitalisation Rate
    = $35,000 / 0.2
    = $175,000

13. If Soccer Delights is valued using the capitalisation rate method, based on the reported profit for the previous year ($35,000) and a capitalisation rate of 35%, how much is it worth? *Show your calculations.*

    Value of Business = Profits / Capitalisation Rate
    = $35,000 / 0.35
    = $100,000

14. Recall that Jim Baker (the independent accountant) told Whare that he actually believed profit for the previous year to be higher than $35,000. If he estimates profits at $42,000, how much is the business worth if a capitalisation rate of 35% is applied? *Show your calculations.*

Value of Business = Profits / Capitalisation Rate
= $42,000 / 0.35
= $120,000

15. Whare and Keri prepare a business plan for their first year of business. As part of the plan, they decide to add a 'Masters one on one soccer coaching clinic' to Soccer Delight's product / service range. As a result of this, along with some other changes they plan on making to the business, they estimate that profits will increase to $48,000 in the first year.

    Given a capitalisation rate of 35%, what is the business worth to Whare and Keri? *Show your calculations.*

    Value of Business = Profits / Capitalisation Rate
    = $48,000 / 0.35
    = $137,142.86

16. What price do you suggest that Whare and Keri offer Ronald to buy the business for? Base your answer on the information given in, and your answers to, Questions 11 to 15. Give at least **two reasons** why you have suggested this price.

    Tauira may give a variety of responses, however they should NOT suggest a price which is higher than the value of the business that they calculated for Question 15, UNLESS they provide a good argument that a lower capitalisation rate than 35% should be applied, which would increase the value. For example, if they argue that a rate of 35% is too high, yet 20% is too low, and that a rate of 30% should instead be applied, the value of the business to Whare and Keri would be $160,000 (calculated as $48,000 / 0.3). In this case, the tauira should not suggest a price any higher than $160,000 so that they do not pay more for the business than it is worth to them.

    The two most likely responses are that the offer price be $100,000 or below, or that it be $120,000 (or below).

    If the tauira suggests an offer price of $100,000 or below, reasons could include:

    - ***This is the lowest valuation calculated. It is best to start with a lower price and then negotiate upwards. If you start high, you may end up paying more than you need to.***
    - ***Even though this is the lowest price, it is easy to justify it to Ronald and say it is 'fair'. This is because it uses the profit figure shown in Ronald's books ($35,000) and uses a capitalisation rate recommended by an independent accountant.***

- ***It is lower than the value of the business to Whare and Keri (i.e. lower than the $137,142.86) – they should not pay more for a business than what it is worth to them. Furthermore, since it is lower than this amount, it leaves room for negotiation.***

If the tauira suggests an offer price of $120,000, reasons could include:

- ***This uses a more realistic profit figure of a capitalisation rate recommended by an independent accountant, so is likely to be a truer reflection of the value of the company than a valuation that uses $100,000.***
- ***As it is more than the value that results from using the reported profit figure of $35,000, Whare and Keri may be able to present this offer in a way that makes them look very generous. I.e. they could say that the value based on actual reported profit is $100,000, yet they are prepared to pay $120,000, so Ronald would be more likely to happily accept the offer than negotiate a higher price.***
- ***It is lower than the value of the business to Whare and Keri (i.e. lower than the $137,142.86) – they should not pay more for a business than what it is worth to them. Furthermore, since it is lower than this amount, it leaves room for negotiation.***

17. Jim (the independent accountant) tells Whare and Keri that Soccer Delights can also be valued based on its net assets. Soccer Delights is a leased shop, but Ronald owns all of the stock (soccer memorabilia), shop fittings, two computers and the business vehicle (a bright yellow sign-written car which is quite an icon on Auckland streets).

    What are two further pieces of information that Whare and Keri would need to know in order to value the business based on net assets?

    Given that valuation based on net assets involves determining how much the business would be worth if it sold its assets and paid off debts (i.e. value of assets – debts) the expected responses are:

    1. ***The market value of assets, and***
    2. ***The amount of debt in the business.***

    However, if tauira identify other relevant factors, they may still achieve this question. That is, they may identify factors which affect these two factors, but not specifically identify them as outlined above – e.g. they may identify that Whare and Keri need to know what condition the assets are in (which is true, because this will affect the market value of the assets) and if the business has any debt (which is also correct, because if it does the amount of debt will affect the valuation).

18. Whare learnt in his accounting night classes about valuing a business based on average sales per year. If the average sales per year of Soccer Delights are $300,000 and if the 'rule of thumb' in retail was 35% of the average sales, then what would be the value of Soccer Delights using this method?

    Value of business = 35% of $300,000
    = $105,000

19. Assume Whare and Keri end up paying $118,000 for Soccer Delights, and that the net assets of the business are only valued at $95,000. What is the term given to the difference between these two amounts?

    Goodwill