

Markscheme

November 2015

Business and management

Higher level

Paper 2

This markscheme is **confidential** and for the exclusive use of examiners in this examination session.

It is the property of the International Baccalaureate and must **not** be reproduced or distributed to any other person without the authorization of the IB Assessment Centre.

The markbands on pages 3–4 should be used where indicated in the markscheme.

Section A		Section B			Level descriptors
Q1 (f)	Q2 (e)	Q3 (d)	Q4 (d)	Q5 (d)	
Marks 0–6					
0					<ul style="list-style-type: none"> • No knowledge or understanding of relevant issues, concepts and theories. • No use of appropriate terminology.
1–2					<ul style="list-style-type: none"> • Little knowledge and understanding of relevant issues, concepts and theories. • Little use of appropriate terminology. • No reference is made to the information in the stimulus material. The response is mainly theoretical.
3–4					<ul style="list-style-type: none"> • A description or partial analysis/examination with relevant knowledge and/or understanding of relevant issues, concepts and theories. • Some use of appropriate terminology. • Some reference is made to the information in the stimulus material, not just to the name of the organization.
5–6					<ul style="list-style-type: none"> • A balanced analysis/examination with accurate, specific, well-detailed knowledge and understanding of relevant issues, concepts and theories. • An analysis/examination that uses appropriate terminology throughout the response. • Explicit references are made to the information in the stimulus material.

Section B			Level descriptors
Q3 (e)	Q4 (e)	Q5 (e)	
Marks 0–9			
0			<ul style="list-style-type: none"> • No knowledge or understanding of relevant issues, concepts and theories. • No use of appropriate terminology.
1–2			<ul style="list-style-type: none"> • Little knowledge and understanding of relevant issues, concepts and theories. • Little use of appropriate terminology. • No evidence of judgments and/or conclusions. • No reference is made to the information in the stimulus material.
3–4			<ul style="list-style-type: none"> • A description with some knowledge and/or understanding of relevant issues, concepts and theories. • Some use of appropriate terminology. • No evidence of judgments and/or conclusions. • Some reference is made to the information in the stimulus material, not just to the name of the organization. • The response is mainly theoretical.
5–7			<ul style="list-style-type: none"> • A response with relevant knowledge and understanding of relevant issues, concepts and theories. • A response that uses relevant and appropriate terminology. • Evidence of judgments and/or conclusions that are little more than unsubstantiated statements that has balanced analysis and demonstrates understanding. • Explicit references to the information in the stimulus material are made at places in the response.
8–9			<ul style="list-style-type: none"> • A response with accurate, specific, well-detailed knowledge and understanding of relevant issues, concepts and theories. • A response that uses appropriate terminology competently throughout the response. • A response that includes judgments and/or conclusions that is well supported and underpinned by a balanced analysis. • Explicit references to the information in the stimulus material are made throughout the response.

Section A

1. (a) Describe **one** advantage **and one** disadvantage, for Dan, of using primary market research.

[4]

Possible advantages for Dan of using primary market research include:

- Dan can collect first-hand responses based on tailor-made questions by distributing questionnaires or interviewing some of his customers, in order to discover their opinion on the various marketing mix especially the possible pricing strategies. Dan found valuable information that the customers were not willing to pay as high a price as before.
- Moreover, given the small size of the organization, the customers chosen are likely to be a representative sample.
- The information collected is only available for Dan / *EcoCycle*. Competitors have no access.

Accept any other relevant advantage.

Possible disadvantages for Dan of using primary market research include:

- Using / targeting his current customers as a sample, he might overlook potential different, viable segments that might be interested in the different bicycles he might be selling.
- Primary market research is likely to be more expensive and time consuming for Dan as a sole trader than the use of secondary market research.
- Dan might not have the knowledge and the experience to design a good, unbiased questionnaire or interview.

Accept any other relevant disadvantage.

Mark as 2+2.

Award [1] for identifying each appropriate advantage / disadvantage and [1] for an appropriate and applicable description up to a maximum of [2].

- (b) Using **Table 1**, calculate for Dan, for **2015**:

- (i) the break-even number of bicycles (*show all your working*);

[2]

$$\text{Break-even point} = \frac{\text{Fixed cost}}{\text{Contribution}}$$

$$= \frac{\$42000}{\$1000 - \$650} = \$350$$

$$= 120 \text{ bicycles}$$

N.B. *Candidates may use a different method.*

Award [1] for a correct answer and [1] for correct working. Award up to a maximum of [2].

- (ii) the total profit (*show all your working*). [2]

$$\begin{aligned} \text{Profit} &= \text{Total revenue} - \text{Total cost} \\ &= 130 \times \$1000 - (\$42000 + \$650 \times 130) \\ &= \$130000 - \$126500 \\ &= \$3500 \end{aligned}$$

N.B. Candidates may use a different method, eg contribution per unit x margin of safety.

Award [1] for a correct answer and [1] for correct working. Award up to a maximum of [2]. Award full marks even if the \$ sign is not presented.

- (c) Explain **one** benefit for Dan of the income elasticity of demand for his bicycles being greater than one. [2]

If the income elasticity of demand for his bicycles is greater than one, it means for Dan's business that for every 1 % change in customers' income, their response in terms of spending on purchasing the bicycles is going to be larger than 1 %. Practically, given that the economy is forecasted to grow and therefore people will experience an increase in their income, for every 1 % increase in income, there is going to be a more significant higher spending on Dan's bicycles. Dan is likely to benefit significantly through increased revenue and if costs remain the same then also through increased profits.

Award [1] for a relevant and correct benefit for Dan of the consumer demand for bicycles being income elastic identified and [1] for an explanation of this benefit up to a maximum of [2]. Accept application of names – the correct explanation should show understanding of the concept.

N.B. If the explanation is generic and not applied to Dan / the product bicycles / EcoCycles award [1].

(d) Using **Table 2**, for the new *EcoCycle* bicycles, for **2016**:

- (i) Calculate the price that Dan must charge to earn a target profit of \$20 000 (with sales of 200 *EcoCycle* bicycles) (*show all your working*); [2]

$$\begin{aligned} \text{Price needed to reach a target rate of profit} &= \frac{\text{target profit} + \text{total cost}}{200 \text{ units}} \\ &= \frac{\$20\,000 + (\$65\,000 + 200 \text{ units} \times \$300)}{200 \text{ units}} \\ &= \$725 \text{ per } EcoCycle \text{ bicycle} \end{aligned}$$

Award [1] for a correct answer and [1] for correct working. Award up to a maximum of [2].

- (ii) using your answer to part (i), and assuming that Dan reduces this price by 5%, calculate the number of bicycles *EcoCycle* must sell to still have a target profit of \$20 000. [3]

A 5% reduction of the price of \$725 is \$36.25

The new price is therefore: \$725 – \$36.25 = \$688.75

The number of bicycles that must be sold to achieve the same level of profit:

$$\begin{aligned} \text{Total revenue} - \text{Total cost} &= \$20\,000 \\ \$688.75X - (\$65\,000 + \$300X) &= \$20\,000 \\ \$688.75X - \$65\,000 - \$300X &= \$20\,000 \\ \$388.75X &= \$85\,000 \\ X &= 218.65 \text{ to } 2\text{d.p} \end{aligned}$$

219 *EcoCycle* bicycles need to be sold to reach a target profit of \$20 000.

N.B. Do **not** accept 218 bicycles as EC will not reach the target profit.

Award credit for a logical / clear method that results in a correct answer even if there are no headings.

If the candidate rounded up the new price but the working is correct, award a maximum of [2].

Accept any other method.

Allow candidate own figure rule (OFR).

Award [1] for the correct calculation of the reduced price.

Award [1] for the correct number of bicycles and [1] for correct working.

If no workings are shown, but the final answers are correct, award a maximum of [2].

- (e) Explain **two** reasons why branding of the new *EcoCycle* bicycles will be important.

[4]

Moving away from *GreenRide*, and not really having much of a new USP, Dan needs to brand *EcoCycle*. The market research clearly indicates that currently the customers' perception of the brand is somewhat different to what Dan expected. Branding has a vital role in creating awareness of the *EcoCycle* bicycles as well as the right positioning and perceptions supported by a USP / some sort of differentiation. Successful branding could lead to more customer loyalty. Hence, the availability of substitutes, like *GreenRide*, is reduced in their minds. *EcoCycle* bicycle's demand will increase, market share should also increase and more revenue / profit is likely to be generated.

Strong branding will create barriers to entry for other bicycle producers. Some potential competitors may be reluctant to enter the market. *EcoCycle*'s market power may increase / increase in demand.

If Dan and David are able to create a strong brand image with the desired positioning, the more price inelastic they will be to *EcoCycle*, hence less responsive to possible increases in the price of the bicycles and be able to tolerate a high (premium) price. The market research clearly indicates that currently the customers' perception of the brand is somewhat different to what Dan perhaps expected and customers expect a reduction in the price of the *EcoCycle* bicycles due to its untested nature. Correct and successful branding should address this issue, hence more flexibility in setting a high price possibly in the future to cover the costs and increase profit.

It is not expected that candidates will refer to **price elasticity** in their answers, but they do have to show understanding of the current reluctance of the customers to pay a high price.

N.B. Reward candidates that cover other relevant but different issues not just an extension of the above points / issues.

Award [1–2] for a response that lacks some depth. For [1] the response may only refer to **one** reason why branding is important to the new *EcoCycle* bicycles. For [2], one reason is given in depth only and may refer to either only loyalty or market power and or pricing implications.

Award [3–4] for a response that clearly explains the importance of branding for the new *EcoCycle* bicycles. For [4], two reasons are explained and may refer to building loyalty and the ability of Dan to charge in the future, higher than currently expected prices / or increased market power. For [3], the explanation includes two aspects, but it is unequal.

- (f) Examine Dan's decision to create a partnership with David to manufacture and sell *EcoCycle* bicycles.

[6]

Currently, as a sole trader Dan makes a very small amount of profit: \$3500. This amount is probably not sustainable hence; a solution has to be found.

Through a partnership with David, perhaps Dan can specialize in marketing while David's specialization clearly lies in the operation function of the business. Both have complementary skills. One of the advantages of forming a partnership is specialization of the partners and sharing the burden and responsibilities of running the organization. Decision-making in this new business will be improved due to shared skills / experience.

The increased capacity of the new business will enable Dan / *EcoCycle* to create a strategic fit between internal strengths like good manufacturing of the bicycles and the growth opportunities in the external environment.

It implies, that David will bring a considerable amount of assets and funds to increase the capacity from 130 to 200 bicycles.

The increased capacity and different costs due to the partnership will indeed enable Dan to charge a lower price of \$725 or less which is around 25% reduction in price, which Dan discovered that he must do given the results of the market research. A price reduction will make the business more customer focused.

Profit will have to be shared but given quantitative results, the profit for Dan will increase considerably in 2016, after the partnership has been established. Even after dividing the \$20 000 between the two partners, Dan will have \$10 000 profit, much more than \$3500.

The procedures of forming a partnership are minimal, short and not very expensive. The partnership does not have to be approved by any legal body. Financial documents of the business will not have to be published.

However, if the price is reduced due to the lower product positioning and current customers' brand perception, the business will not have the capacity to manufacture and sell the 219 bicycles required to achieve the target profit of \$20 000.

Forming a partnership with David will not enable Dan to have limited liability. The risk of losing his personal assets which will be larger than before, still exists.

Some disagreement between David and Dan might occur and the partnership may have to be dissolved if they cannot reach an agreement. It will take some time to see how well Dan and David can operate together before we can make a judgment over whether the partnership will be a success.

Accept any other relevant and applicable argument for or against.

Allow candidate own figure rule (OFR).

It is expected that the candidate goes beyond just a theoretical coverage of the advantages and disadvantages of forming a partnership and incorporate / apply perhaps some relevant financial information and other information / issues from the stimulus material such as the issue of increased capacity and so on.

Candidates might not use specific figures, but relevant application to the issue of forming a partnership for manufacturing the EcoCycle bicycles is expected. Application should go beyond just mentioning the names.

It is not expected that the candidates covers all of the above issues.

For one relevant issue that is one-sided, award up to [3]. For more than one relevant issue that is one-sided, award up to a maximum of [4].

For one relevant argument for and one relevant argument against award up to [4].

For [5] it is expected that the examination is relevant and detailed, but it may lack some balance. For example, it includes only two detailed arguments for and one detailed argument against.

For [6] it is expected that the examination will contain at least two detailed arguments for and at least two detailed arguments against Dan's decision to create a partnership with David to manufacture and sell EcoCycle bicycles.

Marks should be allocated according to the markbands on page 3.

2. (a) Describe **one** reason why customers might be reluctant to use an online booking service (e-commerce). [2]

Possible reasons why customers might be reluctant to use an online booking service (e-commerce) include:

- Security reasons: sometimes e-commerce is “hacked” and thieves steal credit card numbers or money.
- Impersonal service: many customers find online booking services impersonal or intimidating because they are not interacting with a human being.
- Lack of access: though this is less of a problem today, not everyone has easy access to computers, or the internet, or has a computer and internet access that can handle the most up-to-date software or applications, thus making e-commerce difficult.

Accept any other relevant reason.

Award [1] for a correct identification of a reason and [1] for a relevant description. Award up to a maximum of [2]. Application is not expected.

- (b) Identify **two** features of a partnership. [2]

Possible features include:

- it's an association between 2 to 20 partners
- partners do not have limited liability
- it is an unincorporated business.

Accept any other relevant feature.

Award [1] for each appropriate feature identified up to a maximum of [2].

- (c) (i) Prepare a monthly cash-flow forecast, for *BB*, for the first six months of operation.

[6]

All figures are in \$.

	December 2015	January 2016	February 2016	March 2016	April 2016	May 2016
Sales revenue	11 000	11 000	11 000	1000	1000	1000
Total receipts	11 000	11 000	11 000	1000	1000	1000
Overheads	2000	2000	2000	2000	2000	2000
Leasing fee	5000		5000		5000	
Variable costs	1500	1500	1500	300	300	300
Total payments	8500	3500	8500	2300	7300	2300
Net cash flow	2500	7500	2500	–1300	–6300	–1300
Opening balance	1000	3500	11 000	13 500	12 200	5900
Closing cash balance	3500	11000	13500	12200	5900	4600

Accept slightly different headings / format.

N.B. Allow candidate own figure rule (OFR): if a candidate makes an error in one row and carries it through the remainder of the forecast, that is only one error. This provision includes both mathematical errors and conceptual errors (for example, if a candidate has the leasing fee monthly rather than every other month, it is one error) and candidates should only lose [1] for that error.

Award [1] if the candidate conveys some understanding of what a cash-flow forecast is, but otherwise the forecast is largely inaccurate, incomplete, or illegible.

Award [2–3] if a cash-flow forecast is drawn, but either it is not in a generally accepted format or it is untidy, and the forecast contains two or more errors, which could include, in addition to number placement problems and mathematical errors, conceptual errors (using the word “profit” rather than “net cash flow”) or omissions, such as not having a line like “closing balance”.

Award [4–5] if the cash-flow forecast is drawn essentially correctly and neatly in a generally accepted format, but there is one error for [5] or two errors for [4].

Award [6] if the cash-flow forecast is drawn accurately and neatly in a generally accepted format, and is error free. Substituting the term “net profit” in the cash-flow forecast for “net cash flow” is inaccurate.

If the candidate has only one row for all cash outflows, subtract [1] from the total mark awarded.

- (ii) Explain *BB*'s forecasted cash-flow position.

[3]

Although the cash balance is positive at the end of six months, the monthly net cash flows are only positive in the first 3 months. If the figures for remaining low-season months (June through November) continue, *BB*'s cash balance would be negative by the end of month 7 (June) and, by the opening of high season next summer, the cash balance would be $-\$18\,200$, far greater than the cumulative positive balances for the 3 peak months. The cash-flow forecast shows that the current business model is not sustainable.

Allow candidate own figure rule (OFR).

Award [1] for an accurate basic description.

Award an additional [1] for an explanation that incorporates some reference to specific figures, which could be actual numbers or references to a specific row in specific time periods (“net cash flows in December, January, and February”) is a specific reference to actual numbers, even if numbers are not present in the text, whereas “In the seasons that they do not rent as much, the cash inflows do not sustain their cash outflows” is not a specific reference to specific numbers).

Award [1] if the candidate recognizes that the business will have a deficit or cash-flow problems in the months to come.

N.B. *A candidate could produce a response that earns [1] for a basic description and [1] for recognizing a deficit in months to come for a total of [2], even though the candidate did not have specific reference to numbers.*

- (iii) Calculate the forecasted net profit, **without any depreciation**, for the first six months of operation (*show all your working*). [2]

Method 1

Profit = sales revenue – total costs

Sales revenue = $11000 \times 3 + 1000 \times 3 = \$36\,000$

Total costs = overheads + variable costs + leasing fee

Total costs = $2000 \times 6 + 1500 \times 3 + 300 \times 3 + 5000 \times 3$

= $12\,000 + 4\,500 + 900 + 15\,000 = \$32\,400$

Forecasted net profit = $36\,000 - 32\,400 = \$3\,600$

Method 2 (allow OFR)

Closing balance in May – opening balance in December

= $4600 - 1000 = \$3600$

Award [1] for correct working and [1] for the correct answer. Award up to a maximum of [2].

A candidate may calculate monthly profit for all six months such as:

All figures in \$

	December	January	February	March	April	May
Revenue	11 000	11 000	11 000	1000	1000	1000
Expenses	8500	3500	8500	2300	7300	2300
Net profit	2500	7500	2500	–1300	–6300	–1300

This approach is acceptable, even if a total for all six months is not produced. Award [1] for working and [1] for the correct answer (all six months correct, though OFR does apply). Award up to a maximum of [2].

- (d) In June 2016, *BB* discovered that some of their forecasts had been inaccurate.

For December 2015, and January and February 2016, variable costs had been 10 % lower than forecasted.

- (i) Calculate the impact of lower variable costs on *BB*'s closing cash balance, at the end of February 2016 (*show all your working*). [2]

Variable cost (VC) = 1500

10% lower VC = $1500 \times 0.9 = 1350$ per month

VC should be \$150 **lower** per month

$150 \times 3 = 450$ saving from December 2015 to February 2016

\$13 500 closing balance at end of February + 450 = \$13 950

Allow candidate own figure rule (OFR).

Award [1] for correct working and [1] for a correct answer. Award up to a maximum of [2].

- (ii) For March, April and May 2016, revenue was 10 % higher.

Calculate the impact of lower variable costs **and** higher revenue on *BB's* closing cash balance, at the end of May 2016 (*show all your working*). [2]

Method 1

10% = \$100 increase in total revenue per month x 3 = \$300 in total

The closing balance in May 2016 has an improvement of \$5350:
4600 + 450 (lower VC Dec to Feb) + 300 (higher revenue Mar to May)
= \$5350 closing balance for May

Method 2

Calculating the new variable costs based on 10% reduction = 100: the first calculation.

Multiply by 3 to arrive to the total reduction of 300: second calculation.

Add to the closing balance at the end of May: third calculation.

Transfer the 450 reduction to the closing balance at the end of May, or use closing balance of 13 950 at the end of February.

Add the figures together / the saving together of 750 to arrive at the final closing figure of \$5350 at the end of May: (4600 + 750 = 5350).

Accept any other correct working.

Allow candidate own figure rule (OFR).

Award [1] for correct working and [1] for a correct answer. Award up to a maximum of [2].

- (e) Analyse the role of budgets and variances, in strategic planning, for businesses such as *BB*.

[6]

Budgets are an important planning tool for businesses, as they are based upon forecasted revenues and costs, thus providing a business such as *BB* a framework as part of its strategic planning. It translates objectives and strategies / financial discipline.

A budget is essentially a tool for resource allocation as part of a strategic planning.

Budgets provides financial direction / discipline for a business / *BB*. Managers such as Nicolás and Loura know to limit expenditures to remain within their allocated resources and to ensure that the forecasted revenue are also met.

However, the process of budgeting is time consuming especially for Nicolás and Loura as both are inexperienced. Still, given the small size of the business, one may argue that the process can be quick and relatively efficient.

Budgets, especially if negotiated rather than imposed, can create a sense of clarity / direction, unity, and if adhered to / achieved, sense of achievement to *BB*'s employees.

However, budgets are a form of forecast. Actual revenue or expenditure can differ due to internal and external circumstances.

For this reason, analysing variances, or instances when revenue or expenditures differed from the budget can be helpful. If a business can understand why particular expenses or revenues were higher or lower than budgets, in subsequent periods, budgets can be adjusted depending on the reasons why a variance occurred, allowing for better decision-making about allocation of resources.

Budgets can create resentment and demotivation among *BB* employees, especially if unrealistic high targets for revenue and low targets for expenditure are set. There may also be some disagreement between Nicolás and Loura especially as they lack experience. Unhealthy competition may occur.

Moreover, analysing variances can also take up time and resources. The partners of *BB*, who are essentially the decision makers, can be biased in their interpretation of the variances. They may have to employ an accountant or outside person to give them a more objective view of the performance of the business.

Accept any other relevant analysis.

It is not expected that the candidates covers all of the above issues.

Do not credit an answer that refers to different sources of finance to deal with the forecasted / budgeted cash flow problems.

It is expected that candidates refer to: the issue of strategic planning; budgets and not just cash flow.

Since there are two issues / concepts to analyse, one argument for and one argument against each (budgets and variances) should be judged as a balance response.

*Accept generic application as there is not much specified in the stimulus. A balance response of one concept / issue, award up to **[4]**.*

*For **[5]** it is expected that the analysis is relevant and detailed, but it may lack some balance. For example, it includes only two detailed arguments for and one detailed argument against.*

*For **[6]** it is expected that the analysis will contain at least two detailed arguments for and at least two detailed arguments against budgets and variances, in strategic planning, for businesses such as BB.*

Marks should be allocated according to the markbands on page 3.

Section B

3. (a) Identify **two** characteristics of a company with a high degree of centralization. [2]

Characteristics include:

- decision-making being made by a small number of directors/managers/owners
- limited, if any, two-way communication between levels of hierarchy.

Accept any other relevant characteristic.

Award [1] for each characteristic correctly identified. Up to a maximum of [2].

- (b) Describe **one** benefit of an employee share-ownership scheme. [2]

Possible benefits to employees of an employee share-ownership scheme include:

- financial gain in the form of dividends or capital gain
- as shareholders, they will have the right to vote at the AGM and approve, or otherwise, the strategic decision of the board of directors.

Possible benefits to *Transfer* of an employee share-ownership scheme include:

- increased motivation of staff and hence productivity improvements
- a reduction in waste and an acceptance of the mission statement
- staff turnover will be lower, if motivated, leading to reduced induction, training and recruitment costs.

N.B. *The benefit of an employee share-ownership scheme could be in the context of the employee and/or the employer.*

Award [1] for a relevant benefit identified and [1] for a description of this benefit. Up to a maximum of [2].

- (c) Explain **one benefit and one cost** of *Transfer*'s mission statement.

[6]

A mission statement is designed to guide the current objectives and operations of *Transfer*. Managers, customers, will be attracted to *Transfer* for its excellent customer service and commitment to satisfying needs whatever the cost. This could be a possible USP within the shipping industry, in an era of increased global competition.

Maintaining their quality benchmark of a first class business, in a first class way, through the mission statement can provide a sense of direction and can be motivating for the workers. There is evidence in the stimulus that the workers are motivated and the staff turnover is very low.

However, the mission statement can be a problem for *Transfer* given that the firm has experienced a significant financial loss. "First class service" may have an expensive cost aspect as the stimulus reveals. "Whatever it takes", implies further that *Transfer* will carry out its service regardless of the impact on profitability and this may be unwise. The mission statement may be seen as unrealistic and too ambitious for different stakeholders to believe in it.

The mission statement represents a noble if costly exercise, which it would appear that *Transfer* does not have the financial resources to honour.

Accept any other relevant issue.

N.B. *Candidates may refer to some benefits to different stakeholders.*

N.B. *Application could relate not just to repeating the statement, but to the consequences.*

Mark as 3+3.

Award [1] for identification of the relevant benefit / cost, [1] for a clear explanation and [1] for full application to Transfer and not just the name of the business. Award a maximum of [3].

- (d) Examine the decision to remove all profit centres.

[6]

Possible arguments against:

Transfer's success has been built on regional profit centres with empowerment for local managers. By removing profit centres the accountability of each centre in different regions will be removed. Staff will be less motivated as decision-making power that goes with profit centres will disappear. Constructive competition between the regions may also be eroded. Overall, *Transfer's* quality may be reduced as the link to profit sharing has gone and the mission statement and the consequent objectives may not be fulfilled. It might be harder for Heather to monitor performance of individual parts of *Transfer*. Removing profit centres is risky given that employees own 40% of the organization. The link to profit sharing has gone which could be demotivating.

However, there is evidence from the stimulus that profit centres are not providing the competitive edge that *Transfer's* mission statement would suggest. Costs are rising and increasing global competition will drive down revenues.

Moreover, the managers did not follow the mission statement and set their own objectives. Hence centralization will align all regions with *Transfer's* objectives. Consistency will be created. *Transfer* could avoid duplication of resources by removing the profit centres and perhaps reach purchasing / promotion / managerial economies of scale which is very essential now that a loss is being made. Cost cutting is a must.

The move to centralization will increase efficiency and improve communication. Moreover, monitoring and compiling profit centre data can be time consuming and expensive for *Transfer*. The move to remove all profit centres and increase centralization would fit more closely with Heather's leadership style and may have pleased the other shareholders.

Accept any other relevant examination.

N.B. *It is not expected that candidates incorporate all of the above points/issues.*

Do not highly credit candidates that show no evidence of understanding of the meaning / the nature of profit centres, but refer to a decision to remove regional production. The assumption, based on the stimulus, is that the regional centres remain.

For one relevant issue that is one-sided, award up to [3]. For more than one relevant issue that is one-sided, award up to a maximum of [4].

For one relevant argument for and one relevant argument against award up to [4].

For [5] it is expected that the examination is relevant and detailed, but it may lack some balance. For example, it includes only two detailed arguments for and one detailed argument against.

For [6] candidates must give a balanced examination of two possible arguments for and two possible arguments against the decision to remove all profit centres.

Marks should be allocated according to the markbands on page 3.

- (e) Discuss the effectiveness of Heather's leadership style at *Transfer*. [9]

From a financial point of view, given the increase in profits and share price, Heather's leadership style could be considered to be a success. Non-employee shareholders who voted for the changes at the AGM will clearly be very pleased. The stimulus indicates that the previous organizational structure was too bureaucratic with empowerment and a resistance to change despite the poor industry performance leading to the dramatic financial loss. The empowerment factor may have led to some managers underestimating the extent of *Transfer's* financial difficulties and to set new objectives without considering the financial implications. Too much emphasis was put on customer service, but with a decrease in productivity.

The turnaround in *Transfer's* performance occurred within six months. This is a very rapid and significant improvement given the performance of previous years.

However, one may argue that the short-term success is indeed impressive but may not last in the medium and long term when employees and managers will fear her and resent the new culture of *Transfer*. Low level of motivation, potential high staff turnover may create a real problem for *Transfer*. An autocratic leader who will do "whatever it takes" to return *Transfer* to profitability may severely affect motivation.

Recruitment of new employees may be difficult when *Transfer* expand and need more staff. Customers may also choose competitors due to rumours of the threats to the employees and Heather's leadership style. Negative publicity from a newspaper article is already evident.

Heather's leadership style may conflict with the mission statement of the company (although this may be what she intends to happen) and may lead to industrial action and further unrest, but more importantly to the loss of its USP. However, the stimulus refers to Heather's past in turning other companies around. This might suggest that her tenure is only likely to be short term anyway, perhaps to be followed by a more paternalistic leadership style.

Possible judgment:

The stimulus indicates that *Transfer* needed to change after a number of years of less than satisfactory performance. Centralization and a reduction in communication may speed up decision making at *Transfer* and there seems to be a need for increased productivity. Heather's changes has quickened the recovery and was financially successful.

However, effectiveness cannot be judged on quantitative issues only. Given the change, it could lead to long term qualitative problems, perhaps the change has been too dramatic and perhaps a paternalistic leadership style should have been adopted, or perhaps not all of her suggestions should have been implemented at once, but introduced more incrementally.

Heather's changes may have been successful financially in the short run, but we must question whether they will continue to be so over the longer term.

Accept any substantiated discussion.

N.B. It is **not** expected that the candidates incorporate all of the above points/issues.

*A balanced response is one that covers at least **two** issues for and at least **two** issues against.*

*For one relevant issue that is one-sided, award up to **[3]**. If the response is a one-sided relevant approach with no discussion award a maximum of **[4]**.*

*Award a maximum of **[5]** if the answer is of a standard that shows balanced analysis and understanding throughout the response with reference to the stimulus material but there is no judgment / conclusion.*

*Candidates cannot reach the **[5–7]** markband if they give judgment/conclusions that are not based on analysis/explanation already given in their answer.*

Marks should be allocated according to the markbands on page 4.

4. (a) Describe **one** difference between a merger and a takeover. [2]

The difference between a merger and a takeover is that a merger is largely done in a friendly or voluntary manner. The managements and the shareholders of both companies agree to bring both firms together under a common board of directors and create one new legal entity.

In contrast a takeover is commonly hostile or involuntary.

For one company to takeover / take control of another company, the majority of shares has to be bought by the bidder, usually 51 %. (It can be less.)

N.B. The difference does not have to be based on being hostile or not as a takeover can also be friendly. The candidates need to show understanding of the need to buy shares to gain control for a takeover for full marks.

Candidates are **not** expected to word their description **exactly** as above.

Award [1] for a basic description that conveys partial knowledge and understanding of either a merger or a takeover.

Award [2] for a full, clear description that conveys knowledge and understanding similar to the answer above.

- (b) Define the term *economies of scale*. [2]

Economies of scale are the factors that cause a reduction in average costs / cost per unit as the organization increases the scale of production.

Award [1] if the candidate refers just to the growth of an organization rather than to the scale of production.

Candidates are **not** expected to word their definition **exactly** as above.

Award [1] for a basic definition that conveys partial knowledge and understanding.

Award [2] for a full, clear definition that conveys knowledge and understanding similar to the answer above.

*For **only** a relevant: example **or** application to the stimulus award [1].*

- (c) With reference to the airline industry, explain **two** differences between external growth and internal growth.

[6]

Internal growth within the airline industry occurs when the airline itself grows organically by using its own resources to increase its scale of operation / increasing revenue and market share. Typically through investment in more aircrafts, new routes/destinations (or as stated in the stimulus more travel options), by targeting new passenger segments / different classes, heavy promotion, changes and its pricing strategies – to name some examples.

Internal growth will allow each individual airline to maintain full ownership / control of the process in terms of expenditure and speed. Internal growth is often a cheaper strategic option than external.

External growth within the airline industry occurs with interaction / involvement of other airline(s) typically through mergers, acquisition, joint ventures or a strategic alliance. The stimulus provides examples of friendly mergers between American airlines as well as between two European airlines on top of the current proposed takeover (hostile) of *Aer Lingus* by *Ryanair*.

External growth will give an airline a faster growth option while reducing competition in the market. *American* is now the biggest carrier in the US.

External growth is an expensive option. The proposed takeover of *Aer Lingus* will cost *Ryanair* £560 million.

Accept any other relevant and applicable difference.

Mark as 3+3.

Award [1] for identifying each appropriate difference between the two methods of growth, [1] for an appropriate explanation and [1] for a further development of this explanation with reference to the airline industry. Award a maximum of [3].

Award a maximum of [2] for each difference explained if no relevant reference is made to the stimulus material / airline industry.

- (d) Examine the Irish government's decision to own 25 % of the shares of *Aer Lingus*.

[6]

One **possible** reason for the Irish government's decision to own 25 % of shares in *Aer Lingus* is to raise revenue in the form of dividends from the profit of a commercial airline. Owning 25 % of a commercial airline that can generate profit can give the Irish government a substantial sum of money. The Irish government needs revenue to pursue its economic objectives. Dividends shared among all shareholders is one source of revenue. In short, a profit / commercial motive.

However, it is implied in the stimulus that such an expected profit motive / commercial interest was perhaps not a good decision as profit / dividends has not been materialized as yet for the Irish government. Only by selling its shares will the Irish government get its first commercial return.

Another **possible** reason / positive benefit is to make a capital gain by selling its shares when the government sees fit. It is stated in the stimulus that the Irish government will make a positive return by selling its shares in *Aer Lingus*. Hence, a commercial success.

However, some citizens and competitors may argue that the decision to buy shares in an airline and waiting for some positive return for such a long time is a waste of tax payers' money. The money could have been spent on perhaps more worthwhile provisions by the government.

Furthermore, some critics may argue that this decision reduced the incentive for *Aer Lingus* to be a commercial success.

Still, national pride of being part owner of a national airline can be seen as another possible reason. The Irish government might have a strong national interest of enabling an Irish airline to compete with other airlines by providing the funds for investment. There may be significant longer term benefits and future dividends and returns from having an interest in an airline which is able to generate longer term growth through being more competitive.

Candidates may mention security / political reasons and any other relevant reason.

Accept any relevant arguments for and against.

N.B. It is **not** expected that the candidates incorporate all of the above points/issues.

For one relevant issue that is one-sided, award up to [3]. For more than one relevant issue that is one-sided, award up to a maximum of [4].

For one relevant argument for and one relevant argument against award up to [4].

For [5] it is expected that the analysis is relevant and detailed, but it may lack some balance. For example, it includes only two detailed arguments for and one detailed argument against.

For [6] candidates must give a balanced examination of two possible arguments for and two possible arguments against the Irish government's decision to own 25% of the shares of Aer Lingus.

Marks should be allocated according to the markbands on page 3.

- (e) With reference to **one** internal stakeholder **and one** external stakeholder, discuss the statement that “larger is not always better” from the perspective of the airline industry.

[9]

Candidates should look at the issue from two perspectives: Internal, such as from the employees / managers, or any relevant internal stakeholders’ point of view. They should also look at the issues from an external stakeholders’ point of view such as passengers / customers (see below).

From the customers / passengers point of view:

On the positive side, as indicated in the stimulus, a larger company like *American* can experience different economies of scale that can benefit the passengers:

- financial economies of scale – a larger airline could raise more finance cheaply to buy new and more comfortable aircraft(s)
- technical economies of scale will enable a larger airline to become more efficient by reducing operating costs per flight, hence the price of a ticket can be reduced.

Analysts suggest that a merger in order to grow will enable the new airline to rationalize and create a possible small monopoly/domination on some routes as well as create some economies of scales, such as operation and purchasing. The new airline is likely to be more cost efficient which is a significant argument especially in the short run given the amount of current losses.

Consequently, customers may experience some price reduction as well as a more comfortable and possibly safer aircraft.

However, given the large size and the larger market share (combined) and the suggested small monopoly/domination, it is unlikely that the prices will be reduced, especially if the bargaining power of the airline is likely to increase. Customers may end up with less choice, a poorer service and higher prices imposed by a large airline that monopolizes the market. The stimulus makes a reference to such a possibility.

Other possible internal stakeholders:

Larger airlines such as the newly created *American*, is likely to be more cost efficient which is a significant benefit for the operation manager / employees as well as the finance manager. Efficiency due to size with subsequent lower costs and increased profit can significantly increase the motivation of managers and employees. Moreover, a rewards system might be based on such performance.

Managers’ objectives for increased power / self-satisfaction of managing a large number of employees may also increase.

On the other hand, one may argue that working for a large airline like the creation of *American*, the US biggest airline, will reduce employees' motivation given some possible lack of contact with managers and from feeling like a small and insignificant part of a very large group of employees. Customer service, which is an extremely significant issue in a service industry (people, process) might be negatively affected.

Communication barriers may be erected in a large organization which may affect each and every employee negatively.

Internal diseconomies of scale may be created due to the large size which can negatively affect all employees and managers' morale and competencies.

External stakeholders such as competitors and or regulatory bodies.

Competitors:

Being a large airline might be seen by the organization strategists as a necessary action to an increase in global competitiveness of other airline groups like *A/G*, *KLM / Air France etc* and many others yet to be faced in the growing global market place.

However, being large might not be sufficient / appropriate to create customer values and global competitiveness which is currently the main problem of the large airlines. Cost efficiency will not solve these deficiencies, hence, a larger airline is unlikely to be successful especially if competitors follow suit. It will become increasingly difficult to create a USP apart from perhaps location or destinations. There is evidence from the stimulus that there are a number of mergers / takeovers.

Regulatory bodies:

Also larger airlines are more likely to catch the attention of the *American MMC* or any national regulatory body. A reference to such a possibility is also mentioned in the stimulus. These bodies are likely to put some restrictions on the operation of the newly created large airline or any other established large airline. Restrictions may be put on the top management team and decision making in terms of routes, landing slots, pricing *etc*. Management freedom may be reduced. Moreover, finance managers may spend a large sum of money on legal battles / procedures.

Accept any other relevant and applicable argument for or against the notion of being large is not always better from the perspective of any relevant internal or external stakeholder.

In conclusion, one should not undermine the benefits of being a large airline and the possibilities of reducing costs, increasing prices and hence increasing profit and cash flow. The profit can potentially be invested in improving customer service in the medium to longer term, done from a stronger financial position. However, management at large airlines should be aware of possible inefficiencies in the extra 3Ps as well as other diseconomies of scale and the inevitable interest which being large will develop from competitors. Nevertheless, it appears that merger and acquisitions are the prevailing trend in the airline industry and many airlines use these strategy even as a defensive measure. The evidence in the stimulus clearly demonstrate this point whereas the notion that larger may not always be better perhaps more theoretical / suggested by analysts and hence of lesser weight.

However, one cannot accept the notion that larger is not **always** better.

Candidates are expected to use the airline industry as an example and to comment on the merit or otherwise of their arguments. Other stakeholders could be considered.

Accept any substantiated discussion.

N.B. It is **not** expected that the candidate incorporates all of the above points/issues.

*A balanced response is one that covers at least **two** issues for and at least **two** issues against.*

In this case, as discussion in relation to two stakeholders is expected, one argument for and one argument against for each stakeholder is sufficient. Candidates can provide a balance response comparing and contrasting the effects on different stakeholders, eg, positive effects on customers but negative effects on employees, but at least two arguments for and two arguments against for balance.

*If there is no classification of the stakeholders in term of internal / external award up to a maximum of **[7]**.*

*For one relevant issue that is one-sided, award up to **[3]**. If the response is a one-sided relevant approach with no discussion award a maximum of **[4]**.*

*Award a maximum of **[5]** if the answer is of a standard that shows balanced analysis and understanding throughout the response with reference to the stimulus material but there is no judgment / conclusion, or the there is only reference to either one internal stakeholder (balanced analysis) or one external stakeholders (balanced analysis with a judgment).*

*Candidates cannot reach the **[5–7]** markband if they give judgment/conclusions that are not based on analysis/explanation already given in their answer.*

Marks should be allocated according to the markbands on page 4.

5. (a) Describe **one** reason for the importance of innovation for *SP*. [2]

The stimulus indicates that the combination of shorter product life cycles for online games due to a rapidly changing technological and competitive environment implies that in order to remain viable and retain its market leader status, *SP* will need to keep innovating. It also takes at least three years for a computer game to be introduced to the market so this innovation should be ongoing.

N.B. Direct application to *SP* is not required, but some understanding of the nature of the industry is.

Award [1] for identification of the importance of innovation with an additional [1] for a description. Award a maximum of [2].

- (b) Identify the first **two** stages of the product life cycle. [2]

The first two stages of the product life cycle (PLC) are traditionally:

- introduction
- growth.

N.B. Accept “development then introduction” as some textbooks refer to the former as the starting point of the PLC.
Accept “launch”.

Award [1] per stage identified up to a maximum of [2].

- (c) Explain **one** benefit and **one** cost of family branding for *SP*.

[6]

Family or umbrella branding occurs when a business uses the same brand name for a range of products. *SP* as it is the market leader, will brand new games with the same established family name and perhaps with a *SP* logo to reassure customers that they belong and are associated to *SP*.

Family branding allows for *SP* to save funds with brand development of new products and allow for some marketing economies of scale – unit costs of advertising, as *SP*'s advertising expenditure such as above the line could be spread over a number of products/games.

The use of family branding for the new products in the same industry will create immediate recognition. Brand loyalty can be transferred from *Sigma Starfighter 1* to the new products of *Sigma Starfighter 2* as well as to the new app.

However, the major cost of family branding is that with a brand stretched over a number of products in this case the new app as well as *Sigma Starfighter 2*, the possibility arises that if one product/game that *SP* produces for some reasons fails to live up to expectations, or has an even shorter product life cycle than rival product/game(s), the whole *SP* family brand could be tarnished affecting current and future brand development in the minds of customers. The new mobile phone app is something that *SP* has not tried before, hence the increased level of risk of brand erosion / extended negative brand image.

It is expected that a specific reference is made either to the app and/or *Sigma Starfighter 1* and/or *2*, not just to “the games”.

Mark as 3+3.

Award [1] for identifying / describing each appropriate benefit/cost of family branding, [1] for an appropriate / further explanation and [1] for application to SP. Award a maximum of [3].

If the answer makes reference only to branding and not family branding, but is in context to SP then award a maximum of [4], [2+2].

- (d) Analyse the appropriateness of penetration pricing for *SP* when they launch *Sigma Starfighter 2*.

[6]

Penetration pricing may be appropriate for *SP* because:

Given the competitive nature of the online market, penetration pricing may allow *SP* to capture and increase its market share. *SP* may not have a choice but to use a competition-based pricing strategy regardless of the nature of the innovative product. Given the short-term cash flow difficulties, *SP*'s current cash flow is weak therefore, it may be possible that *SP* decided to use price penetration to attract customers and generate immediate cash, even if it does not cover the R&D.

But

Innovative products normally command price skimming, in order to cover the high costs of R&D of *Sigma Starfighter 2*, especially when the product life cycle tends to be short due to improved technology as well as a strong chance that the competition will come up with a new and possibly more exciting / innovating game(s). It does say in the stimulus that the technological and competitive environment is changing rapidly, hence *SP* should ensure that profit is generated at the early stage of its innovative product.

SP's decision will anger some of their investors from putting its future innovation and longer-term projects in jeopardy as there are no guarantees that penetration pricing will lead to an increase in profits. This is an important source of finance for *SP*.

Penetration pricing may lead to a "race to the bottom" if competitors follow suit and this may again impact on the future cash flows / profits for *SP*, further threatening their opportunities for innovation.

There may be quality concerns if the market perceives that the price of the new game is "too low".

Accept any other relevant analysis.

N.B. It is **not** expected that candidates incorporate all of the above points/issues.

For one relevant issue that is one-sided, award up to [3]. For more than one relevant issue that is one-sided, award up to a maximum of [4].

For one relevant argument for and one relevant argument against award up to [4].

For [5] it is expected that the analysis is relevant and detailed, but it may lack some balance. For example, it includes only two detailed arguments for and one detailed argument against.

*For [6] candidates must give a balanced analysis of two possible arguments for and two possible arguments against the use of penetration pricing for *SP* when they launch *Sigma Starfighter 2*.*

Marks should be allocated according to the markbands on page 3.

- (e) Discuss **two** problems of financing research and development (R&D) for a business such as *SP*.

[9]

One has to assume that R&D in such an innovative industry is **frequent / continual** and **expansive**. Hence a significant and frequent amount of finance is needed for *SP* to develop its products.

One also has to bear in mind that due to some cash-flow problems *SP* might not have enough cash to inject, which also indicates the need to raise large funds.

The stimulus clearly demonstrates that *SP* is operating within a competitive marketplace. There will be other businesses in the same industry who will also be looking for investment finance, hence competition.

However, due to its market leader position / brand image *etc*, some external sources of finance like business angels / venture capitalist *etc* might be willing to invest.

The other problem is that the time taken – three years – to bring creative innovative ideas to the market may mean that investors become impatient. There is a considerable amount of risk which will need to be experienced by investors. There is also the issue that within a rapidly changing technological market, the three-year time lag may be too long. A game may be out of date before it is released. Investors may have to accept lower returns.

Also, *SP* is looking to give away an app for free. Some potential investors may be concerned with this idea. Payback periods (if at all) will be much longer. *SP* will need to spend time and resources convincing potential investors that short-term losses will be offset by longer-term profits when the app begins to add value. Risk averse investors who are not aware of “freemium” type services may be further reluctant to invest.

However, there might be risk-taking investors, again, like venture capitalists, who might be attracted by the new app and the general direction taken by *SP* despite some short-term difficulties. These investors might be willing to accept long-term returns on innovative products of the current market leader.

Moreover, as *SP* operates online, the search for a global investor is possible.

On a more general issue, *SP* appears to be unincorporated and this severely limits access to most forms of finance for R&D and many game firms can operate with a very small asset base and hence they will have very little security for loans for R&D.

Despite a weak cash flow, some potential investors may see this new app as a way for *SP* to confirm themselves as the market leader. *Sigma Starfighter 2* has the potential to be very popular financially and this could have significant benefits for *Sigma Starfighter 1* and other products under the family brand which is very strong. Profits could grow reducing the reliance on external sources of finance allowing greater creativity and innovation in the future.

Possible judgment:

Perhaps one may judge the current problem of raising finance as a short-term problem only, hence not a very significant one. Given the successful past and the possible future success of the new app and *Sigma Starfighter 2*, in the medium-term, if the two products are successful, more cash and profit will be generated to finance future R&D. Moreover, many other potential sources of finance can be available as well, possibly through the use of price skimming rather than penetration in the short run.

Accept any other relevant discussion.

N.B. *Accept any relevant argument for and against the problems of financing R&D for SP and other similar businesses in this industry.*

N.B. *It is not expected that the candidate evaluates different sources of finance available for SP.*

*A balance response covers at least **two** arguments for and at least **two** arguments against.*

*For one relevant issue that is one-sided, award up to **[3]**. If the response is a one-sided relevant approach with no discussion award a maximum of **[4]**.*

*Award a maximum of **[5]** if the answer is of a standard that shows balanced analysis and understanding throughout the response with reference to the stimulus material but there is no judgment / conclusion.*

Or if the candidate only discusses one problem in financing R&D for businesses such as SP. The one problem for example may only refer to attitudes to risk.

*Candidates cannot reach the **[5–7]** markband if they give judgment/conclusions that are not based on analysis/explanation already given in their answer.*

Marks should be allocated according to the markbands on page 4.
