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MARKSCHEME

May 2009

BUSINESS AND MANAGEMENT

Higher Level

Paper 2

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

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0–6</th></tr>
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• No use of appropriate terminology.</td></tr>
<tr><td colspan="5">1–2</td><td>• 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.</td></tr>
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• Some reference is made to the information in the stimulus material, not just to the name of the organization.</td></tr>
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• An analysis/examination that uses appropriate terminology throughout the response.
• Explicit references are made to the information in the stimulus material.</td></tr>
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Section B			**Level descriptors**
(d) questions			
Q3 (d)	**Q4 (d)**	**Q5 (d)**	
Marks 0–9			
0			• No knowledge or understanding of relevant issues, concepts and theories. • No use of appropriate terminology.
1–2			• 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			• 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			• 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			• 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) Define the following terms:

(i) ***patent*** ***[2 marks]***

Patent: the right to be the sole producer or user of the invention of a process or product. *Altair Incorporated* will have the sole rights to produce Zyra for five years.

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

Award ***[2 marks]*** for a full, clear definition that is similar to the model answer above. An application is not required.

(ii) ***price discrimination.*** ***[2 marks]***

Price discrimination: the ability to charge different prices to different customers in different markets for what is essentially the same product. To be successful each market should have a separate elasticity of demand. *Altair Incorporated* could charge lower prices to countries with lower *per capita* GDPs.

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

Award ***[2 marks]*** for a full, clear definition that is similar to the model answer above. An application is not required.

(b) (i) Calculate the payback, average rate of return and net present value, using a discount factor of 10 %, for *Altair Incorporated* for both production facilities in Alpha and Bravo. *(Show all your working)* ***[8 marks]***

Workings: payback calculations

Payback of Zyra if produced in Alpha

Cost = \$240m

Income streams to pay back: $80+80+70+\left(\frac{10}{60}\times 12 \text{ months}\right)$

<u>Payback = 3 Years and 2 months</u>

Payback of Zyra if produced in Bravo

Cost = \$180m

Income streams to pay back: $80+80+\left(\frac{20}{70}\times 12 \text{ months}\right)$

<u>Payback = 2 Years + 3.4 months</u>

Maximum of ***[2 marks]*** for correct answers with working shown. Maximum ***[1 mark]*** if correct answer is given with no working or one error is present with working easy to follow.

Workings: average rate of return – Alpha

Total profit from Alpha over 5 years = 340 – 240 = 100

Average annual profit = $\frac{100}{5}$ = \$20m per year

<u>Average rate of return =</u> $\frac{20}{240}\times 100$ <u>= 8.3 % to 1 d.p.</u>

Workings: average rate of return – Bravo

Total profit from Bravo over 5 years = 340 – 180 = 160

Average annual profit = $\frac{160}{5}$ = \$32m per year

<u>Average rate of return =</u> $\frac{32}{180}\times 100$ <u>= 17.8 % to 1 d.p.</u>

[1 mark]
There is some logical attempt to calculate ARR but there are two errors.

[2 marks]
Answers are correct but no working is shown or allow one error with full working.

[3 marks]
Both ARRs are correct with full working shown.

Workings: Net Present Value calculation for Alpha and Bravo

Present value of income stream

2010	$80 \times 0.91 = 72.8$
2011	$80 \times 0.83 = 66.4$
2012	$70 \times 0.75 = 52.5$
2013	$60 \times 0.68 = 40.8$
2014	$50 \times 0.62 = 31$

Total Present Value 263.5m

NPV (Alpha) = TPV – Initial Capital Cost

= 263.5m – 240m

= <u>$23.5m</u>

NPV (Bravo) = 263.5m – 180m

= <u>$83.5m</u>

Country	Payback	ARR	NPV
Alpha	3 yrs 2 months	8.3 %	23.5m
Bravo	2 yrs 3.4 months	17.8 %	83.5m

Apply Own Figure Rule (OFR).

[1 mark]
There is some logical attempt to calculate NPV but there are two errors.

[2 marks]
There is one error or answers are correct without any working.

[3 marks]
NPV for both countries is correct with full working shown.

(ii) Comment on your results from part (b)(i) and other information from the stimulus material. *[3 marks]*

The NPV and payback calculations confirm that Bravo should be selected. The ARR for Bravo is double that of Alpha and the NPV is \$60m higher. This seems like a very good return although we do not know what the directors are looking for other than quick results for their investment. However, it must be noted that the external factors especially non-financial could be considerable and may still influence the final location decision.

[1 mark]
The candidate provides a brief comment about the suitability of Bravo based on the available financial information but makes little use of supported calculations or mention of the importance of non-financial factors.

[2 to 3 marks]
Comments are made which are relevant to *Altair Incorporated*. There is good use of the candidate's calculations and an awareness of the need to incorporate at least one relevant non-financial factor (decisions) which may influence the directors for ***[3 marks]***.

If comments include **either** the investment appraisal calculations **or** an awareness of the non-financial factors but are relevant to *Altair Incorporated* then award ***[2 marks]***.

A final decision is not required.

(iii) Explain *two* non-financial factors *Altair Incorporated* should also consider before selecting the location of the Zyra production plant. ***[4 marks]***

Financially, Bravo is the more attractive option for the production of Zyra. However, a number of non-financial factors may give the directors cause to rethink.

Given the reconstruction work needed in Bravo after the civil war, the cost figures may not reflect the additional time required to build-up the infrastructure required by a large incorporated organization. The stimulus reveals that the shareholders of *Altair Incorporated* are impatient and may consider switching to Alpha, which already has the required technological and logistical infrastructure in place. There is no information on how long the reconstruction will take. Transport delays in delivery and distribution may also occur. *Altair Incorporated* is looking to sell this product in a global market. There is no need to locate near a local albeit needy market.

Secondly, the possibilities of external economies of scale in Alpha could be very attractive to *Altair Incorporated*. This could provide a pool of locally sourced skilled labour and provide additional research and development opportunities (this factor could be enhanced, if a joint venture between *Altair Incorporated* and its rival manufacturer is conducted). Given the large sums in development already invested by *Altair Incorporated* and the desire to recoup these costs, long run advantages might be gleamed from locating in Alpha.

Any other reasonable factor in context could be considered.

[1 to 2 marks]
For ***[2 marks]***, two non-financial factors are briefly explained but are relevant to *Altair Incorporated*. Or one relevant non-financial factor is explained in detail. For ***[1 mark]*** the factors are listed generalized and may include additional financial factors.

[3 to 4 marks]
Two non-financial factors are explained in detail and relevant to *Altair Incorporated* for ***[4 marks]***. For ***[3 marks]***, two non-financial factors are considered but one may lack depth.

(c) Analyse *two* possible conflicts that could arise between stakeholders if *Altair Incorporated* sets a fixed price globally. ***[6 marks]***

A number of potential conflicts could exist if *Altair Incorporated* adopts a fixed global price.

The key stakeholder conflict would seem to revolve around the demands of *Altair Incorporated's* shareholders for immediate returns – a cause which would be furthered by adopting a global probably skimmed high price – to be reconciled with the needs of consumers living in high density malaria countries in sub-Saharan Africa who may not be able to afford to pay. *Altair Incorporated* could use a policy of price discrimination but in order to police this and ensure limited leakage between different markets, *Altair Incorporated* will have to spend additional sums. A global fixed price minimizes these costs and will through the profit motive guarantee supply.

Altair Incorporated's shareholders could probably argue that a fixed global price reduces uncertainty of revenues and will encourage other MNCs to invest large sums of capital into other worthwhile vaccines, which may or may not be successful.

However, the decision to fix the price of Zyra will anger the pressure groups that have lobbied hard for price discrimination in favour of those most in need. This may create unwelcome publicity and erode goodwill towards *Altair Incorporated* and its competitor. The Internet and the presence of the anti-globalization movement have made this threat very real and significant.

The World Bank and other similar lending institutions may also face additional scrutiny if it is viewed by the pressure groups that MNCs are having their profits subsidised even if *Altair Incorporated's* intentions are honourable to set up in countries such as Bravo.

There are clearly a number of ethical and moral dilemmas here emerging from this stakeholder conflict, which may be difficult to separate when life-prolonging vaccines are produced by MNCs where the profit motive is the key reward for risk taking.

The response may look at the shareholders as a central anchor but there has to be two potential conflicts from two different sources.

If the response is a one-sided relevant approach with no analysis award a maximum of ***[4 marks]***. If only one possible conflict is analysed award a maximum of ***[4 marks]***.

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

2. (a) Define the following terms:

(i) *below-the-line promotion* ***[2 marks]***

A marketing term to indicate promotional activities other than main media advertising – direct selling techniques such as point of sale material, promotions or other incentives where the consumer reaction can be either observed or easily monitored. (TV advertising or other forms of media advertising are considered to be above-the-line). When below the line promotion is used the control remains with the business. (For *Passionate Pizza*, newsletters and other point of sale material have been used).

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

Award ***[2 marks]*** for a full, clear definition that is similar to the model answer above. An application is not required.

(ii) *price elasticity of demand*. ***[2 marks]***

Price elasticity of demand measures the responsiveness in the quantity demanded for a good/service as a result of change in price of the same good/service. In other words, it is percentage change in quantity demanded as per the percentage change in price of the same good/service.

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

Award ***[2 marks]*** for a full, clear definition that is similar to the model answer above.

(b) (i) Prepare a forecast profit and loss account, using the same format as *Table 1*, for *Passionate Pizza* for the year ended 31 December 2009, assuming that they implement the two-stage strategy at the start of the year. ***(Show all your working)*** ***[8 marks]***

Working

Current price of Pizzas is \$10. Revenue is \$10m $\Rightarrow$ 1 million pizzas sold.

If price elasticity of demand is 0.5, a 10 % cut in price will lead to a 5 % increase in the quantity demanded.

5 % of 1 million = 50 000 additional pizzas sold after price cut. ***[1 mark]***

Price is reduced to \$9.

However, with the increase in advertising expenditure by 25 % and the advertising elasticity of demand = 1.0, quantity demanded will increase by a further 25 %.

1 050 000 $\times$ 1.25 = 1 312 500 pizzas sold ***[1 mark]***.

Forecast sales revenue = 1 312 500 $\times$ \$9 = \$11 812 500 ***[2 marks]***.

We assume that the cost of goods sold initially rises by 5 % and then by 25 %.

Cost of goods sold increases from \$4m to \$4.2m (5 %) ***[1 mark]*** and then from \$4.2m to \$5.25m (\$4.2m $\times$ 1.25) ***[1 mark]***. Maximum = ***[2 marks]***.

For correct final figures and no working award up to ***[4 marks]***.

Total for workings *[6 marks]*.

To prepare forecast profit and loss, we have to account for advertising expenditure increases from \$2m to \$2.5m.

Indirect costs remain unchanged.

If the final figures are correct but no working is shown, award 4 out of 6 possible marks. The remaining ***[2 marks]*** are awarded for the profit and loss account.

Forecast profit and loss account for *Passionate Pizza* for the year ended 31 December 2009

Item	**$**
Forecast sales	11 812 500
Forecast cost of goods sold	5 250 000
Gross profit	6 562 500
Advertising expenditure	2 500 000
Other indirect costs	2 000 000
Forecast net profit	2 062 500

[1 mark]
The forecast profit and loss layout is poor. The title may not include "forecast" or a date. There is some logic in preparing a forecast profit and loss account.

[2 marks]
The forecast profit and loss is presented in good style with the adjustment for promotion expenditure included and no change in indirect costs. Own Figure Rule (OFR) is applied in order not to double penalise candidates. There is an appropriate title.

(ii) Comment on your results from part (b)(i) using your forecasts and other information from the stimulus material. ***[3 marks]***

Clearly the increase in forecasted net profit from $2m to $2 062 500 represents some reward for introducing the new two-stage strategy. This represents a 3.125 % increase. A key point though is whether the directors will accept this as sufficient (no real information from the stimulus) for the risks taken with above-the-line promotion, (this is their first line) the affects of which are not easily measured by the firm. Finally, the new strategy must be viewed and be subject to the external factors (social and economic) outlined in the stimulus.

[1 mark]
Candidate provides a brief and generalized comment about the results of two-part strategy. No mention is made of external factors or *Passionate Pizza* explicitly.

[2 to 3 marks]
Comments are made about the results of two-part strategy which are relevant to *Passionate Pizza* based on the forecasted profit and loss figures **and** an awareness of the importance of external factors should be given ***[3 marks]***. If comments include **either** forecasted figures **or** external factors that are relevant to *Passionate Pizza* then award ***[2 marks]***.

(iii) Explain *one* advantage and *one* disadvantage for *Passionate Pizza* of commissioning market research from an independent market research company. ***[4 marks]***

Advantages could include:

- A heightened degree of objectivity and a lack of bias in obtaining the figures.
- *Passionate Pizza* can use the agency's experience and ability to access the most up-to-date information on the takeaway food market.
- *Any other reasonable advantage*.

Disadvantages could include:

- The cost of hiring an external agency may be prohibitive even for a successful company such as *Passionate Pizza*.
- Given that *Passionate Pizza* has not undertaken above-the-line promotion before researching customers on awareness and effectiveness of such promotion is unlikely to be effective. They need to be careful of whom to ask. *Passionate Pizza* could save themselves time and money by asking customers in store themselves.
- *Any other reasonable disadvantage*.

Mark as 2+2.

Award ***[1 mark]*** for identifying one appropriate advantage/disadvantage of commissioning market research from an independent market research company and ***[1 mark]*** for an appropriate explanation that directly refers to *Passionate Pizza*.

(c) **Examine *two* factors from the external environment that may influence the decision of the directors to implement the two-stage strategy.** ***[6 marks]***

The key external factors emerging from the stimulus would seem to be:

- concerns over the use of controversial point of sale material and the impact of the advertising agency's decision (legal)
- the degree of obesity among its target market (social)
- concerns about possible recession and actions of the market leader (economic).

Given the elasticity estimates, the threat of the market leader may be negligible given that the cross price elasticity of demand is almost zero. However, with the threat of recession, cutting prices by 10 % may be prudent for the new two-part strategy to attract interest.

In order to appeal to the new segment, the attentions of the *Advertising Standards Agency* and use of controversial promotion would seem to be important. The new segment may be younger or older than the current one targeted and may take offence to the current newsletter. A delicate balance needs to be struck, however, *Passionate Pizza* will not wish to cannibalise its own market share by alienating existing male customers.

The last external factor may be beyond *Passionate Pizza's* control. Although publicity surrounding the dangers of a high fat diet based on takeaway food is well documented, *Passionate Pizza* could operate in the pizza segment a plan not too dissimilar to *McDonald's* Healthy Options Choices. To appeal to a new segment, *Passionate Pizza* may have to offer "more health conscious alternatives". This may lead to a further increase in cost of sales and thus an erosion in profits in the short run.

A PEST analysis is not required to achieve the top markband.

If the response is a one-sided relevant approach with no examination award a maximum of ***[4 marks]***. If only one factor is examined award a maximum of ***[4 marks]***.

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

SECTION B

3. (a) Define the following terms:

(i) ***corporate social responsibility*** ***[2 marks]***

A socially responsible business is one that incorporates the interest of various stakeholders and the environment in a manner which is deemed to be beneficial and correct according to societal values, *e.g.* a socially responsible enterprise may manufacture products in such a way as to limit carbon emissions.

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

Award ***[2 marks]*** for a full, clear definition that is similar to the model answer above.

If the response only repeats the question in the answer *e.g.* corporate social responsibility is when a firm acts in a manner which is responsible for society, award ***[0 marks]***.

(ii) ***e-commerce.*** ***[2 marks]***

E-commerce is generally regarded as the trading/exchange of goods and services over online electronic systems such as the Internet and other computer networks.

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

Award ***[2 marks]*** for a full, clear definition that is similar to the model answer above.

(b) Explain *one* advantage and *one* disadvantage for an organization such as *Kiva* of becoming more socially responsible. ***[6 marks]***

It is expected that the candidates refer to *Kiva* as venture capitalists and/or provider of funds rather than as a manufacturer/retailer.

Advantages may include but are not limited to:
- Attract ethical investors to put their money in *Kiva's* funds. This can create a USP.
- Enable *Kiva* to become more of a niche player.
- Attract additional philanthropic financing in the future.
- Might get some tax concession from the government to encourage the provision of ethical funds.
- *Any other relevant advantage*.

Disadvantages may include but are not limited to:
- Resistance from some shareholders/investors as the decision to become socially responsible may reduce their return/profit or prohibit the firm from competing in some markets. It is said in the stimulus that the market is very volatile.
- Possible increased costs of compliance to maintain credibility in the eyes of stakeholders with an accompanying sacrifice in profitability. It is said in the stimulus that the investors can be impatient for quick returns.
- *Any other relevant disadvantage*.

Mark as 3 + 3.

Award ***[1 mark]*** for identifying **one** appropriate advantage/disadvantage of an organization becoming socially responsible (which may be generic), ***[1 mark]*** for an appropriate explanation that directly refers to *Kiva* and ***[1 mark]*** for a further development of this explanation up to a maximum of ***[3 marks]***.

(c) Examine *two* difficulties faced by new business start-ups in the developing world. ***[6 marks]***

A number of issues present themselves:
- A lack of initial capital and access to future capital if the business grows.
- Competition from MNCs in the developed world for market share.
- Local markets may be too small to support a large number of start-ups despite entrepreneurial best intentions.
- Under-developed infrastructure/technology leading to delivery delays fragmented supply and distribution chains, limited e-commerce opportunities if the firm attempts to compete in global markets.

However,
- Lending to small business in the world's poorest countries is growing rapidly. It might become easier for small businesses to raise funds through organizations like *Acumen Funds* and *Kiva*; $20 million investment by one organization can be considered as a significant one.
- Small scale investors with as little as $25 can now contribute to organizations like *Kiva* which distributes the funds globally. More ethical funds are likely to be raised.
- The use of e-commerce reduces the search cost and time. Organizations in need in LDCs can have global access to ethical funds.
- Some successful transfers of funds will as mentioned in the stimulus enable a better standard of living and hence demand.
- *Any other relevant points*.

If the response is a one-sided relevant approach with no analysis award a maximum of ***[4 marks]***. If only one difficulty is examined award a maximum of ***[4 marks]***.

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

(d) To what extent is "venture capital" from the developed world an appropriate source of finance for new business start-ups in the developing world? ***[9 marks]***

Given the success of *Kiva*, the *Acumen Funds* and the shrinking global financial market place with increased capital mobility, it would be reasonable to suggest that venture capital sourced from the United States and other developed countries is an appropriate source of finance. The stimulus makes reference to a number of socially responsible projects, which have been funded by this form of capital successfully. This has only encouraged local entrepreneurs and allowed them to finance projects which otherwise may have been unrealised. The positive impact on stakeholders in these communities will have been considerable. Moreover, *Kiva* is genuinely interested as shown in the stimulus in being socially responsible and helping people in need.

Unfortunately, business start-ups will need time to incubate and build consumer loyalty and thus market share to ensure survival. Venture capital by definition and nature may be "impatient"; the technology, which so easily can provide funding could easily repatriate monies, if other, perceived profitable opportunities make themselves known via the Internet.

This point may give venture capitalists considerable leverage and force start-ups to place a greater emphasis on short-term profitability rather than longer-term sustainability.

However, with the expansion of e-commerce lending. The choice is wider and any organization from LDC can shop around from more ethical funds and better lending conditions to a very large extent. Given the increase in online competition in lending, the funds providers might have to become less impatient in terms of return and conditions attached to their lending.

Candidates may judge that venture capitals from the developed world can be seen as an appropriate source of funds to a large extent in the short run. In the long run, perhaps with the growth of their own economies, more domestic funds can be generated.

Accept any substantiated evaluation.

For a response with judgment supported by substantiated analysis award ***[9 marks]***.

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

4. (a) Define the terms:

(i) ***capacity utilization*** ***[2 marks]***

Capacity utilization is the extent to which the maximum productive capacity of a firm is being used, that is actual output as a percentage of maximum potential output. It can be calculated by using the following formula.

$$\text{Capacity utilization} = \frac{\text{Actual output per period}}{\text{Full capacity output per period}} \times 100$$

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

Award ***[2 marks]*** for a full, clear definition that is similar to the model answer above.

(ii) ***penetration pricing.*** ***[2 marks]***

Penetration pricing is achieved by setting a price low enough to gain market share away from incumbent firms and to create brand loyalty when launching a new product/service. It is essentially short-term to medium-term strategy as it may result in short-term losses.

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

Award ***[2 marks]*** for a full, clear definition that is similar to the model answer above.

If the response only repeats the question in the answer *e.g.* a price penetration strategy is when a firm sets a price to penetrate the market, award ***[0 marks]***.

(b) Explain *two* capacity utilization issues that *Pacific Blue* may face. ***[6 marks]***

The stimulus highlights two main capacity issues namely the negative consequences of reaching full capacity/operating at above capacity and the need for an increase in capacity.

Pacific Blue will have only two planes to service the most popular route in New Zealand. With the response to its low prices being considerable, it may run into difficulties especially if one or both planes break down. *Pacific Blue* may not be able to satisfy its current level of demand and could lose customer goodwill if it fails to deliver on its initial promises.

The online booking system clearly may struggle to cope if *Pacific Blue's* popularity grows again with a loss of goodwill if customers get frustrated trying to book despite the lower prices. This will not help the New Zealand public's feelings towards *Pacific Blue*; a key factor in allowing *Pacific Blue* to grow in the medium-term.

(The stimulus does not mention human resource issues but if *Pacific Blue* is hoping to run additional services to other centres, it will require more operational staff such as pilots, flight attendants and support staff to maintain its online booking system.)

Any other reasonable answer concerning relevant capacity issues for *Pacific Blue* trying to enter a new international market will be allowed.

Mark as 3 + 3.

Award ***[1 mark]*** for identifying one capacity utilization issue (which may be generic), ***[1 mark]*** for an appropriate explanation that directly refers to *Pacific Blue* and ***[1 mark]*** for a further development of this explanation up to a maximum of ***[3 marks]***.

(c) Examine *two* problems that *Pacific Blue* could face when using penetration pricing. ***[6 marks]***

A number of issues/problems may present themselves to *Pacific Blue*:

- *Pacific Blue* will have to accept lower gross margins. How will *Pacific Blue* react if costs rise especially fuel costs? The service could be run at significant losses.
- *Pacific Blue* may set a low-price image in the minds of consumers and may find it hard to shift the notion of low quality unless they reposition themselves as a no-frills service.
- Linked to this point is that customers may be resistant to increasing prices once *Pacific Blue* has gained a percentage of the market share.
- *Air New Zealand* and *QANTAS* have vowed to remain competitive. There could be a "race to the bottom" in terms of low pricing. Can *Pacific Blue* survive even with the assurances of their chief executive?

However,

- Given the information in the stimulus, penetration pricing is the better pricing strategy to use in the short run. It had a very good and promising response to the low price of $29. *Pacific Blue* had a very good response to the initial reduction in price.
- *Pacific Blue* perused this strategy before in different markets successfully.

If the response is a one-sided relevant approach with no examination award a maximum of ***[4 marks]***. If only one problem is examined award a maximum of ***[4 marks]***.

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

(d) Evaluate *two* potential opportunities and *two* potential threats which *Pacific Blue* could face when entering into a new international market. ***[9 marks]***

Pacific Blue's attempt to enter this market based on an aggressive pricing strategy has, according to the stimulus made a media impact and found favour with customers who booked almost 35 000 cheap flights within hours. It appears that the customers are receptive in their social/economic attitudes to value for money/low price airlines. *Air New Zealand's* and *QANTAS'* quick reaction shows that they both take this new rival seriously. The reaction of the competitors is a threat but given that *Pacific Blue* has "money in the bank" to survive short-term losses, and the fact they have had experience of this type of strategy before in Australia, would suggest that they are well placed to guarantee success. The economic opportunities in terms of market share and growth are considerable, especially if they can extend their network.

However in the longer run, there are already two major competitors who have "vowed to remain competitive". They will certainly be watching very closely to see how *Pacific Blue* copes with the capacity issues. It can be judged as a major threat especially if *Pacific Blue's* repair and wage costs will rise as a promise to maintain a consistent service especially if they need to lease new planes. Future success will also depend heavily on *Pacific Blue* receiving government approval to serve more cities in New Zealand. Government approval can be seen as a major opportunity. This external factor will be outside the control of the company and if unsuccessful, *Pacific Blue* may be restricted in how big it could grow. There is also the threat that the support of the local population may be difficult to guarantee. The locals might favour its national carrier – *Air New Zealand*. However, given the initial favourable response – almost half of the tickets were sold within hours the threat is likely to be minimal.

Unresolved issues from the stimulus:

- Is this a hit and run strategy or a serious attempt to be a major player in what could be a small market?
- Is there room for three airlines? What about safety issues? Can local infrastructure/airports cope with an additional airline?
- Under what criteria will approval for more routes be given and when?

Responses should be credited where potential new **or** existing opportunities and threats are evaluated in context directly relating to *Pacific Blue*.

Accept any substantiated evaluation.

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

5. (a) (i) Define the term *working capital*. ***[2 marks]***

Working capital, sometimes called circulating capital, is the amount of money needed to pay for the day-to-day running of a business. Without working capital, businesses cannot trade. It is important as it enables firms to pay for expenses such as wages, electricity and raw materials. The working capital of a business is the amount of current assets left over after all the short-term debts have been paid. It is normally shown in a balance sheet as the difference between current assets and current liabilities.

It is not expected that all of the above are covered for ***[2 marks]***.

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

Award ***[2 marks]*** for a full, clear definition that is similar to the model answer above.

(ii) Identify *two* characteristics of a private limited company. ***[2 marks]***

Answers may include:

- Owners have limited liability.
- Restrictions can be placed on sale of shares.
- Not allowed to sell shares to the public via the stock exchange. Shares can only be privately sold.
- Has to disclose less public information in accounts than a plc.
- Threat of takeover is reduced given limited number of shareholders compared to say a publicly traded company.
- *Any other valid characteristic*.

Award ***[1 mark]*** for each appropriate response up to a maximum of ***[2 marks]***.

(b) Explain *one* advantage and *one* disadvantage for a firm such as *Scholastic* of holding high levels of working capital. ***[6 marks]***

The advantages/disadvantages to *Scholastic* from holding too much working capital depend on the nature of the excess of current assets over current liabilities.

- If *Scholastic* is holding large reserves of cash, then the firm has prioritized liquidity over potential profitability or whatever the investors deem to be the opportunity of holding cash. With potential profitable opportunities given up, the investors may feel that growth in the company could be restricted. However, if surplus cash is available then *Scholastic* could fund "risky" new future projects or spend time searching for the "next big author", without the need to borrow. Surplus cash can also be used as a safety net for unexpected costs or for bad debts (see third bullet point).
- If too much stock is held by *Scholastic* then money again is tied up in assets which may not yield future profits, although this may not be such an issue for *Scholastic* given the enormous success of the Harry Potter books. When a new film is released or book published a new army of fans is created so it may be prudent of *Scholastic* to keep additional stocks of all stories.
- If the source of the excess is high debtor figures then *Scholastic* may find its working capital figure overstated especially if the incidence of bad debts rise. This will have an impact on liquidity.
- *Any other reasonable response accepted*.

Mark as 3 + 3.

Award ***[1 mark]*** for identifying **one** appropriate advantage/disadvantage for a firm such as *Scholastic* of holding high levels of working capital (which may be generic), ***[1 mark]*** for an appropriate explanation that directly refers to *Scholastic* and ***[1 mark]*** for a further development of this explanation up to a maximum of ***[3 marks]***.

(c) With reference to the product life cycle, analyse why firms such as *Scholastic* undertake extension strategies. ***[6 marks]***

The product life cycle traces the sales profile of a good or service over a specified time period. There are principally five stages; Introduction, Growth, Saturation, Maturity and Decline.

As the product enters the maturity stage of the life cycle, firms may wish to "inject new life" into a good or service to encourage additional sales thereby "extending the life" of the product. This may be especially important if the market has become more competitive since the original product launch. These "injections" are commonly referred to as extension strategies.

They include but are not limited to:
- redesigning or repackaging the product (paperback version of hardback copy or box sets of all the books)
- product tie-ins to movies, games or other media (there will be seven Harry Potter movies)
- adding value through new editions or extra features (special edition–extended, collector DVDs), seasonal variations to products for holidays or festivals.

The above should maintain and/or recreate interest in the books and related products and generate cash flow.

Sales promotions or additional advertising spending would not be regarded as extension strategies. These are ways of injecting life into a product that could work equally well at **any** stage of the cycle.

However, *Scholastic* should be careful not to over flood the market with related product and bear in mind that the life cycle of these products might be very short. Attention should also be paid to the costs vs revenue of extending the product life cycle. Given the fact that this is the final book of Harry Potter, perhaps the extension strategies suggested will be of some but rather limited value, if other strategies like product development to create a new product life cycle is used by *Scholastic*.

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

(d) Evaluate whether the leadership of *Scholastic* should be taken away from the Robinson family. ***[9 marks]***

The stimulus provides a strong case for retaining the Robinson influence. *Scholastic* has been very successful especially since 1997 and by being private and family run could claim that continuity of leadership has ensured success. The figures from the stimulus speak for themselves.

Remaining private and being run by the same family allows *Scholastic* to take risks without interference from outside shareholders and the need to drive the business towards short-termism; a characteristic which is so common to many publicly traded companies. Moreover by being family run, *Scholastic* has allowed continuity of leadership/ownership, which may have allowed consistent objectives. One is drawn to the inevitable conclusion that the Robinson family are satisficing and this is more than appropriate for the current set of investors although it may deter future possible ones.

However, apart from charges of nepotism, with *Scholastic* having been run by the same family since 1920, one could argue that new ideas or fresh thinking is needed once the Harry Potter series draws to its conclusion. The decision to retain the current leadership may be questioned when the final books, movies, DVDs and other extension strategies have been exhausted. Revenues are predicted to fall to $10-15 million for the years 2009–11. We must assume that other *Scholastic* and *Bloomsbury* projects are in development but the stimulus gives us no indication as to what these might be. The Harry Potter series may represent a profit windfall, which these companies may find difficult to replicate without additional outside capital, experts or thinking. A danger of inertia, inflexibility may exist if the current leaders remain.

The question that needs to be asked is whether the Robinson family are best equipped to lead *Scholastic* in a time when traditional media companies are under threat from the Internet, piracy and simply the proliferation of choice. There is an argument such as in the case of the *Body Shop* and the *Disney Corporation* for the original founders to give way, act as a steadying influence on the board but let younger, potentially more “dynamic” entrepreneurs have greater involvement in strategic decision-making.

This issue may be relevant in the longer-term. On the information given to us in the stimulus, there is a strong argument for maintaining the current leadership.

Candidates should be awarded for evaluating a change in ownership **as well as**/or leadership.

Accept any substantiated evaluation.

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